Service Sector Protection: Considerations for Developing Countries

Brian Hindley

The inclusion of services in the Uruguay Round of multilateral trade negotiations has focused attention on the protection of domestic service suppliers against competition from foreign suppliers. Issues arising from these negotiations, however, may obscure another and more important issue: the case for unilateral *liberalization. This article first surveys methods of protection in the service sector, and then examines the likely cost of protection. Particular attention is given to developing countries. What evidence there is suggests that the costs of protection may be high. The article also discusses economic principles that could guide a review of policy toward international transactions in the service sector. Quantitative restrictions or bans on foreign service suppliers—whether they wish to supply through trade or establishment—cannot easily be defended in economic terms, and provide an obvious first target.*

Few governments of developing countries have welcomed the proposal that services should be the subject of a negotiation within the framework of the General Agreement on Tariffs and Trade (GATT). The compromise at Punta del Este, by which services were included as a topic for the Uruguay Round of multilateral trade negotiations, should not conceal the underlying negative response—ranging from indifference to hostility—of many developing countries. (Bhagwati 1987 provides an excellent discussion of this aspect of the Punta del Este meetings.)

Several arguments are advanced in defense of that negative response. Liberalization is seen as leading to an increase in imports of services without any compensatory improvement elsewhere in the balance of payments. Hence, balance of payments difficulties are cited as a reason for rejecting liberalization. In addition, doubts are often expressed that domestic service industries can survive foreign competition, and the infant industry argument for protection is frequently invoked. These arguments, of course, are a familiar defense of protection by developing (and other) countries—if they have novelty, it lies in their application to services.

Brian Hindley is senior lecturer at the London School of Economics and Political Science and counselor for studies at the Trade Policy Research Centre, London. An earlier version of this article was prepared for the World Bank Conference on Developing Countries' Interests and International Transactions in Services, Washington, D.C., July 15–16, 1987.

Other arguments are more overtly political. Thus, for example, liberalization of service transactions is often treated as a threat to local culture and even to national sovereignty. National security is cited as a reason for not liberalizing some services.

The complex of motivations and attitudes implied by the range of these arguments against liberalization suggests that the Uruguay Round negotiations on services will be difficult, at least to the extent that an attempt is made to involve a large number of developing countries. There is a clear possibility that even arduous negotiations will produce few substantive rules which will be generally acceptable to GATT members. Of course, nothing in the GATT compels a contracting party to accept any new agreement on services. A plausible prognosis is that many developing countries will not accept the code on trade in services that is expected to emerge from the Uruguay Round, or that even if they accept an "umbrella" code, few will accept its application to particular service industries.

Issues arising from the Uruguay Round, and attitudes toward the negotiations, however, should be very clearly distinguished from the issue of what policies governments pursue with respect to the service sector. The GATT negotiations are directed toward the production of an enforceable multilateral agreement on controlling government interventions in international service transactions. There are substantial difficulties in the way of arriving at such an agreement (Hindley 1987a), and there may be good reasons for developing countries to avoid entanglement in those difficulties.

A too single-minded focus on the negotiation issues, however, raises the risk that another question, one that is more important for most developing countries, will slip out of view. That is the question of the economic case for *unilateral* liberalization. The recent prominence of services in discussions of international economic policy raises several questions for the governments of developing countries, in particular whether a reduction in protection for domestic service suppliers against foreign competition will further the economic interests of the country. Whatever policy steps are contemplated, this question needs to be faced.

Protection against foreign sources of supply is likely to increase the price or reduce the quality of the services available in the protected market. When the purchaser of a service is its final user, this gives rise to losses of a type that are familiar from analysis of the protection of goods. Many services, however, are not for final use but are inputs into production of other goods and services.[1]

The taxation of inputs into import-competing or exportable outputs raises complex problems for an assessment of final effects. A naive analysis of the balance of payments consequences of a relaxation of restrictions on imported inputs, for example, is likely to be highly misleading. Increases in the price of

1. Evidence from input-output tables for Malaysia and the Philippines suggests that somewhat more than half of all services are for final demand and somewhat less than half for use as intermediate inputs (Sieh Lee 1984, p. 5; Arroyo 1984, p. 14).

inputs brought about by protection will in many cases translate into a tax on the production of exportable and import-competing goods and services. The effect on the balance of payments is uncertain and, in any case, does not provide the basis for an assessment of the benefit—or otherwise—to the economy as a whole.

Governments are often aware of the dangers of protection of *tangible* inputs into production processes. Protection of service inputs raises similar problems and may be even more costly. Material output at the end of a production line or in a field does not in itself have much value. All the activities involved in techniques of production, design, financial arrangements and risk sharing, communications, transport, and marketing are services. Unreliable transportation, poor communications, poor product or production design, or inadequate financial or legal advice can diminish or destroy otherwise favorable prospects for meeting domestic or export demand.

Section I discusses the means by which service industries are protected. Section II takes up the question of the costs that might arise from service sector protection. Section III deals with questions of public policy.

I. Means of Protection

Defining Protection

The first problem that arises in discussing protection in the service sector is how to define what actions constitute protection. Services and goods are not equivalent in this respect. There are three interrelated differences between them which are relevant to policy: (1) Because of the "invisible" properties of services, imports of many services typically cannot be controlled by tariffs or by some forms of import quotas; instead, imports of services are impeded by means analogous to nontariff barriers (other than quotas) or "gray area measures" in trade in goods. (2) The efficient delivery of many services requires the producer of the service to have a presence in the buyer's market, so that international service transactions often entail foreign investment. (3) Service industries are frequently subject to regulation of a type and intensity that are unusual in industries producing goods.

That protection in the service sector is almost entirely by means of nontariff measures raises serious problems for international negotiations on liberalizing services. In part, the problem lies in obtaining agreement between governments (some of which do not wish to abandon practices that others regard as nontariff measures) on what constitutes a nontariff barrier to trade and on what action is appropriate to deal with such barriers. There are also problems of identification and policing. Tariffs and many forms of import quotas cannot be concealed from trading partners, but some nontariff barriers are difficult to identify and quantify. The GATT process has been markedly less successful in dealing with these forms of barriers to trade in goods than it has been in reducing tariffs and quotas.

For a discussion of unilateral liberalization, however, the difference in the means of protecting goods industries and services industries is less important. A government contemplating unilateral liberalization does not have to agree with any other government on what constitutes a nontariff barrier or on what action to take about it. And the identification and policing of nontariff barriers are likely to be very much easier for the government of the country with imports which are affected than for foreign traders or foreign governments (though of course conflicts of analysis and prescription can arise between departments and ministries within a government). In the context of this article, therefore, this difference between the protection of goods and the protection of services is not central.

Imports of services, open to impediment by nontariff barriers, arise from international *trade* in services. International trade in services can be defined, analogously with trade in goods, as the sale of a service by a producer located in one country to a user located in another country without either buyer or seller changing location. For many services, however, such trade is not technically feasible (for example, surgery or viewing pyramids) or is not currently feasible on a large scale (for example retailing).[2] Hence, the sale of such services requires some proximity of the provider and receiver, and in an international context, this implies that at least one of them must change location for a transaction to go forward. This does not necessarily require the presence of the producer of the service in the market of the buyer (Sampson and Snape 1985), but that is what it very often means in practice. Even where trade in services is technically feasible, it is often more efficient to supply the service through local establishment than through trade. Hence, the efficient delivery of many services requires establishment of some form in the vicinity of potential buyers. Many of the most effective barriers to international transactions in the service sector are restrictions on establishment.

Inward investment, of course, is a sensitive subject in many developing countries. The fact that genuine liberalization of international service transactions would call for such investment goes some way to explain the widespread hostility among developing countries to liberalization.

The frequency and type of regulation also differentiate protection in the services sector from protection of industries producing goods. Regulation of service industries is widely regarded as a justified measure of public policy and as essential to the efficient supply of the service. Whatever the merits of these positions, however, the powers of regulators clearly can be used to create

2. The qualification "currently" is necessary since the proposition depends in some degree upon the cost and efficiency of communication systems. Retailing, for example, can be a matter of mail, telephone, or computer links rather than personal visits, and in principle could be performed across national borders. Moreover, although it is necessary to visit Egypt to actually see (Egyptian) pyramids, images of them can be viewed in a variety of ways other than by visiting Egypt, and the number of such ways has expanded markedly in the past century. Might it one day be possible to perform intercontinental surgery?

barriers to international transactions in a service. In practice, nevertheless, it is sometimes difficult to identify where legitimate regulation ends and protection against foreign competition begins.

This problem is not unique to trade in services. Health and safety regulations play an analogous role in impeding trade in goods. In goods trade, however, the object of regulation is very often the product itself, rather than the producer. In service industries, where products are less standarized, producers rather than products are usually the object of regulation. Hence, regulatory authorities in service industries typically are able to control the entry of producers into the industry and also to control the way in which they conduct their business once in it.

An important new element is added to the problem of regulation when regulators have substantial *discretionary* power to control entry into an industry and the conduct of producers. Such power opens the possibility of a regime that is not restrictive de jure but that is highly restrictive de facto. Regulations themselves may be worded so as to place domestic and foreign suppliers on an equal footing. Their administration, however, may be less unbiased.

The "capture" theory of regulation assumes that members of the regulated industry often succeed in ensuring that regulators' powers are used in ways that will be of benefit to themselves (Stigler 1971). In this event, regulatory powers that are ostensibly granted for the protection of domestic buyers of a service will instead be used to protect domestic suppliers of the service—in part, at least, against competition from foreign suppliers.

National regulatory systems, by their mere existence, create a major dilemma for efforts to negotiate liberalization of international trade in services. The problem is that differences in regulatory standards are likely to translate into a competitive advantage for suppliers subject to one regulatory regime rather than another. Thus, for example, banks or insurance companies subject to high reserve requirements are likely to object to competition with bankers or insurers from a regulatory regime that requires lower reserves. (Hindley 1987b develops this notion more fully in the context of the European Community's difficulties in liberalizing trade in services.)

As with nontariff barriers, however, a government contemplating unilateral liberalization has a much more tractable problem. The question facing it is whether the structure of its own regulations, and the way in which they are administered, serves any genuine national interest that could not be better served by other means.

Although there is now a variety of sources from which examples of these forms of protection in the service sector can be drawn,[3] there is little or no

3. A principal source of material on restrictions in developing countries is the inventory compiled by the U.S. Trade Representative of complaints by U.S. service suppliers against restrictions applied to them in foreign markets. In addition, five of the national studies submitted to the GATT provide information on obstacles encountered by their suppliers in overseas markets (those of Canada, Denmark, Germany, the Netherlands, and the United States). Finally, the Organisation for Economic Co-

systematic information deriving from developing countries. Various U.N. Conference on Trade and Development (UNCTAD) studies refer in passing to restrictions applied in developing countries, but they neither aim for nor claim complete coverage. One consequence is that an uncritical acceptance of the contents of the available sources runs the risk of bias against developing countries—and indeed, some of the complaints about the policies of developing countries that are listed in the developed country sources border on the trivial.

Examples of Protection Measures

The aim of the following paragraphs is to convey some flavor of the range and scope of protectionist activity in the service sector. For that purpose, it is not necessary to restrict the discussion to developing countries, and where it seems appropriate, examples are also drawn from developed countries.

With respect to barriers to imports, some means of protection are general, applying to a broad spectrum of industries. An obvious example is foreign exchange control. Exchange controls can be administered to serve as a blanket prohibition on the import of services from abroad. Other methods, however, are specific to particular industries.

A good example of a tradable service is cargo insurance. However, there is frequently official insistence that imports be insured domestically—and sometimes that exports be insured domestically. Sometimes both imports and exports must be insured in the domestic market (for example, in Bangladesh, Burundi, Cameroon, Cuba, Dominican Republic, Italy, Malta, Mexico, Rwanda, Senegal, and Tanzania). What happens in (or to) trade between countries both of which insist upon domestic insurance for exports and imports is something that I have not yet discovered. Presumably the hapless traders must insure in both markets.

Trade in other forms of insurance is in principle possible but is impeded. The purchaser of a policy from a nonadmitted insurer is subject to fines in some countries. Insurers and agents who sell insurance policies without being admitted to the market are sometimes subject to fines and sometimes to imprisonment (for example, in France, for a second offense; Philippines; Singapore; Switzerland; Thailand; and Turkey). In a number of countries, the purchase of insurance from foreign-based companies does not qualify for tax concessions that are available on policies issued by domestic insurers: such a policy is similar to an import tariff, the rate of which varies with the economic circumstances of the taxpayer.

Insurance trade, however, can take place at two levels. Direct insurance transactions entail sales from the insurer to an agent or directly to the final purchaser of the insurance. Reinsurance, however, involves transactions be-

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operation and Development (OECD) has conducted studies of barriers in particular sectors (banking, insurance, construction services, air transport, shipping, and telecommunications services) in OECD countries.

tween insurers, with the reinsurer accepting all or part of the risk insured by the direct insurer. The international reinsurance business is subject to some restrictions, mainly in the form of rules governing the amount of reinsurance that local insurers must cede to local reinsurers—typically a single state-owned firm. Kenya and Turkey, for example, call for the cession of 25 percent; the Philippines permits no more than 20 percent reinsurance with foreign companies; and Brazil requires all reinsurance to be with the state corporation. Apart from the case of domestic reinsurers themselves reinsuring abroad, these policies are analogous to the domestic content plans common in the motor vehicle industries in many countries.

Nevertheless, international reinsurance is still relatively unrestricted. This opens the possibility that protection imposes lower costs than would otherwise be the case, because it implies the possibility that local insurers in some degree act as agents of the international reinsurers, who in turn are operating in an extremely competitive and open global market. By the same token, however, it also opens to question the rationale of the very heavy protection given to local insurers. (Hindley 1982 discusses protection of the insurance industry in developing countries in more detail.)

The supply of other tradable services is not structured in the same way as is insurance, and protection against imports accordingly calls for different means. A striking example is that of air passenger transport. International carriers are typically excluded from domestic carriage. In international air transport, bilateral agreements between governments regulate routes, capacity, and prices and in many cases have the effect not just of protecting against imports but also of eliminating net trade. An English person might be transported to Frankfurt by Lufthansa, and British Airways might carry a German to London. Nevertheless, the effect of the bilateral agreements between the British and German governments is that other airlines cannot enter major routes and that roughly the same number of Germans will fly by British Airways as Britons will fly with Lufthansa. Furthermore, many bilateral agreements call for revenue sharing, so that if one of the two airlines on a route carries more passengers than the other, it makes little difference to the financial outcome for either airline.

That such a tight system of protection needs supplements is perhaps surprising. Nevertheless, a number of other devices are recorded. These include limitations on access to reservation systems, discriminatory user charges at airports, preferential ground handling facilities for domestic airlines, and the allocation to national airlines of superior landing and take-off slots and to foreign carriers of inferior airport space—or even inferior airports.

International maritime transport has traditionally been largely free of official restrictions. A bilateral system similar to that in international aviation has made inroads through the UNCTAD Liner Code, and the code is administered by developing countries so that it is more restrictive in fact than on paper. The code division of freight between country A and country B is 40:40:20—40 percent in A ships, 40 percent in B ships, and 20 percent reserved for cross-

trade. In many trades, however, the de facto division is reported to be 50:50:0. (As with air transport, cabotage—shipping between domestic ports—has commonly been reserved for domestic carriers.)

Also noted as a large impediment is the cargo reservation system, whereby government regulation reserves a certain amount of cargo for national carriers. The U.S. Trade Representative inventory reports that eighteen countries operate such schemes. Fifteen of these are developing countries.

A service that is tradable in the sense that it does not require local establishment is construction engineering. (Indeed, requirements of establishment in the country in which a contract is to be carried out are reported as barriers to international transactions in this industry.) A very frequent complaint of suppliers in this industry relates to public procurement practices, which also appear as complaints in other industries. The importance of governments and public authorities in large construction works, however, means that a biased public procurement policy is more important in this industry than in most service industries. Another widespread complaint relates to subsidization of competing bidders. Very often, however, the subsidization referred to is not by the government of the country offering the contract but by other foreign governments which are backing the bid for a contract of one of their national firms.

Like restrictions affecting trade, some of the restrictions affecting establishment are general. Limits on the repatriation of profits, for example, are likely to deter investment in any sector, and limits or barriers on the deployment of personnel or on transborder data flows will affect the operations of firms in many sectors. Other restrictions, however, apply to specific industries.

Two broad types of restrictions affect establishment. Restrictions of the first type either place restrictive conditions upon initial establishment or simply ban it (de jure or de facto). The second type of impediment limits the activities of establishments of foreign producers of services: locally established foreign producers may not be able to enter certain lines of business, for example, or service particular classes of customers, or open new branches.

The financial services sector is heavily affected by restrictions on establishment. Banking services can be traded across borders in some small degree—many persons and companies resident in one country maintain a bank account in another country, for example, although foreign exchange restrictions seek to prevent this for the residents of many countries. To offer a full range of banking services, however, and hence to be able to compete in a domestic market, a bank must, at present, have a presence in the other country. Many countries impede establishment by foreign-based banks. Some completely prohibit establishment. Others will allow only a representative office, which cannot engage in any form of banking business. Restrictions on the opening of branches and on the acquisition of domestic banks through takeover are also common.

Even where establishment is allowed, foreign-owned banks are often treated differently from domestically owned banks. Foreign-owned banks are often subject to discriminatory reserve requirements, to higher requirements on cap-

ital-asset ratios, or to higher taxation than domestic banks. A frequent complaint of foreign-based banks is that they do not have access to the rediscount facilities of the host central bank or to subsidized lines of credit, such as export guarantees. They are restricted in the range of services they can offer and in the assets they can acquire. (Walter 1987 supplies a detailed analysis of the restrictions placed on foreign banks.)

A similar picture emerges for insurance. Some governments prohibit access by foreign insurers. Others require local incorporation. Foreign-owned insurers are often subject to discriminatory capital and deposit requirements and are also restricted in the assets they can acquire (Carter and Dickinson 1987).

Other service industries in which establishment problems are reported as a major barrier to entry are advertising and accountancy. Indeed, establishment is a general problem for international transactions in professional services.

The validity of administrative decisions by regulatory authorities, or of complaints about them, are difficult to assess except on the basis of detailed case-by-case study. It is a fact, however, that a variety of service suppliers complain of unfair treatment by regulatory authorities. This is true, for example, of banks, insurers, and advertising agencies.

II. The Cost of Protection

Available data do not permit a reliable numerical estimate of the cost of protecting domestic service industries against foreign competition for any economy. In this section, I discuss some of the facts that are relevant to a judgment of whether the cost is likely to be "large" or "small."

Issues Affecting the Cost of Protection

The first and most often cited fact is that services bulk very large in national incomes. The proportion of national income assigned to services obviously depends on what is included as a service. By World Bank definitions, production of services accounted in 1983 for a third of the gross domestic product (GDP) of low-income developing countries and half of the GDP of middle-income countries. By itself, this observation suggests that policies that deny domestic users of a wide range of services access to the price-quality combinations that are available internationally may cause substantial economic damage.

The services that are of concern in the present context of protective policies, however, are those which entail some form of international transaction. In many services, the possibility of international trade is very limited, if it exists at all, so that the distinction between trade and investment is again relevant. The quality of a retailing or local transportation system might be improved as a result of the involvement of foreigners in the supply of the services through foreign investment or franchising or as a result of the use of foreign consultants. There is little possibility of achieving this through direct trade in the services themselves.

From the standpoint of assessing the potential costs of protection in the service sector, however, the distinction between delivery through trade and delivery through local establishment may not be important. Although the distinction is significant from a political point of view, it is less significant from a strictly economic point of view. From that standpoint, the central question is whether price can be reduced or quality improved through the involvement of foreign producers. The exact mode of their involvement seems less important.

The argument regarding establishment can also be applied to the temporary relocation of labor. For unskilled labor, this applies much more to exports from developing countries than to imports. Thus developed countries suffer economic losses from refusing to allow developing countries to supply construction works, which, because they cannot be built in one location and shipped to another (for example, roads), would require a temporary relocation of labor from developing countries. (On this, see Bhagwati 1987.)

There is, however, an economic reason for distinguishing trade and the movement of factors of production in the context of a discussion of the costs of protection. Where a service can be either imported or produced by locally established foreign firms, the output of the latter may be closer to local price and quality than services imported from abroad. Local establishments are subject to local regulatory authorities, for example, who may themselves be a cause of inefficiency in domestic production. Moreover, locally established service producers are likely to use at least some local factors of production, and this may limit the extent of potential improvement. (It may also allow even lower costs, of course; from the standpoint of economic efficiency, there is a case for allowing producers—foreign or domestic—to choose their own methods and locations of production.) Nevertheless, where for either technical or legal reasons foreign producers can be involved only through establishment or some other nontrade means, they may not be able to transfer fully to a foreign market any greater efficiency they may have in their home market.[4]

Any attempt to estimate the cost of protection in the service sector requires a comparison of some estimate of the price and quality of a service within the protected economy with an estimate of the price and quality that would be available to its residents in the absence of protection. One reason for the lack of relevant figures lies in the nature of the nontariff barriers that protect service industries. Tariffs provide a basis for making a direct estimate of the difference

4. A basis for a second possible argument is supplied by Brecher and Diaz-Alejandro (1977). In the context of a 2x2 model, they provide circumstances which must lead to an overall loss for a host country importing capital-intensive goods which it protects by tariff. A limited inflow of capital expands domestic production of the capital-intensive good, so substituting expensive domestic output for imports on which tariffs would have been paid. The host country loses tariff revenue, and the foreign investors gain the higher profits brought about by protection of the capital-intensive good. The argument might have a parallel in the service sector when limited foreign investment is permitted in an oligopolistic industry earning high profits. In both cases, however, the possibility of loss depends on the restriction on foreign investment. Foreign investment in sufficient quantities to press returns in the sector to a competitive level would not create an economic loss.

between world and domestic prices attributable to the tariff. Most nontariff barriers do not, and consequently their use in either goods industries or service industries presents difficulties for estimating the cost of protection.

Examples of the Cost of Protection

A starting point for an estimate of the cost of protecting services would be data on the price of a service in a country where it is protected and in one where it is not. True prices, however, are often difficult to obtain, and even when they are available, prices by themselves do not provide very useful information. The quality of a service must also be considered, and this is often difficult to measure objectively. Were a service from two countries simultaneously and freely traded in a common market, the price differential (or the lack of one) would shed some light on the issue; but that is not a common state of affairs.

For some services, prices are available and quality can reasonably be assumed to be constant or corrections can be made for the difference in quality. Transport services are one area in which price comparisons have been made. The results suggest that the effects of protection are substantial.

U.S. shipments of Public Law 480 agricultural aid provide a striking example of the cost problem. Until early 1986, U.S. law required at least 50 percent of such shipments to be carried in U.S. flag ships (in 1986, the requirement was raised to 75 percent). The remaining shipments were open to competition by ships flying other flags. Hence, there are two prices for such shipments: one for U.S. ships and another for other ships, which presumably provides some approximation of a world price.

One recent study (White 1986), after correcting for type and size of cargo and distance shipped, concluded that "as a conservative estimate, we can say that the U.S. flag rates for the protected shipments were about double those of foreign flag carriers." This conclusion is consistent with those of previous studies of the differential (U.S. General Accounting Office 1982, 1984; Binkley and Harrer 1981).

Studies of another protected U.S. maritime market show even greater differentials. Data on the shipment of petroleum suggest that the price per ton-mile of U.S. tankers operating in the protected environment of shipments for the Strategic Petroleum Reserve is about four times the international rate (Morgan 1980; U.S. Congressional Research Service 1983; Roush 1984).[5]

Civil aviation provides other examples of the effect of protection and regulation. Twenty years ago, observers of air fares in the United States found fares on intrastate routes, which were not subject to federal regulation, to be very

5. U.S. policy toward maritime transport provides an interesting example of a service affecting exports of a good. The fact that lumber shipped from Seattle must use U.S. bottoms—because of U.S. cabotage law—whereas lumber shipped from Vancouver can be shipped at international rates apparently gives Canadian lumber a competitive advantage in the southeastern part of the United States.

much lower than fares over similar distances on federally regulated interstate routes. Following deregulation in the United States, simple comparisons of fares on routes within the United States, or on international routes to the United States, with fares within heavily regulated areas such as Europe yield numerous cases in which the European fares over similar distances are two or three times higher than U.S. fares. More detailed research suggests that these fare differentials may in some degree be explicable in terms of higher costs of operation in Europe. It seems that they cannot be made to vanish by this means, however (Civil Aviation Authority 1983).

Airline costs and revenues appear to be related to regions. The International Civil Aviation Organization (1983) has commented on this as follows:

> The differing revenue/cost ratios achieved by European airlines appear to be determined by the competitive situation on each route group in 1982. On routes between Europe and Asia-Pacific the competition was such that neither the European nor the Asia-Pacific airlines achieved profitability. On Europe-Middle East routes the European airlines could earn a profit because they were able to maintain a higher average revenue yield than the Middle East airlines. On the Europe-Africa route group, the European airlines were also profitable because they had much lower cost levels than the African airlines.

An interesting aspect of the deregulation of airlines in the United States is the apparent failure of advocates of regulation to anticipate the extent to which deregulation would exert downward pressure on wages in the industry. That is to say, they had not appreciated the extent to which labor in the industry had captured the rents created by regulation.

Regulation may have produced similar effects elsewhere. European airlines frequently object to comparisons of their fares with those in the United States, saying that their costs of operation are higher. But as Pryke (1987) comments, "The main reason for this disparity in costs was that the maintenance costs of West European airlines were 27 percent greater, their expenditure on ticketing and sales was 52 percent higher and their general administration costs were 112 percent more than for American airlines" (p. 28). Pryke's discussion of payments to staff of European airlines also suggests the possibility that wages in the industry are inflated.

The possible effects of protection on costs and wages in the protected industry raises another issue: the problem of assessing the consequences of protection or liberalization in the service sector. For example, from currently available data, it seems clear that airlines based in the United States have a comparative advantage over airlines based in Western Europe, and it is easy to arrive at the conclusion that open and unsubsidized competition between the two groups would result in U.S. airlines dominating the field. But to reach this conclusion is to assume that such open and unsubsidized competition would not affect wages and effective labor inputs in Europe. This is a dubious proposition, as

the analysis and figures cited above suggest. The extent of U.S. comparative advantage is therefore almost certainly overestimated by any exercise based on current statistics for the industry—and perhaps there is no U.S. comparative advantage that would survive competition.

Protection of other service industries may raise the wages or lower the effective input of workers in the industry. If so, estimates of the chances of survival and success of industries in the face of international competition that do not take account of this fact may be much too pessimistic.

To generalize from these examples for the transport industry to service industries in general would be foolhardy. Nevertheless, it is clear that the effects of protection on the price of services can be substantial. It seems plausible that the effect of protection on the quality of service offered on the domestic market may also be substantial, especially when that market is isolated from international conditions by bans or quotas. On this basis, the cost to an economy of heavily protecting its service sector may be high.

III. Appropriate Public Policy toward the Service Sector

Arguments for Protection

The policies of many developing (and other) countries toward the services sector invite economic losses. These losses cannot yet be quantified, but the possibility that they are substantial seems clear. Is there any economic argument—as distinct from cultural integrity or national security arguments, which are discussed later in this section—to suggest the existence of offsets to the economic losses caused by protection of service industries against foreign competition?

The infant industry argument and the need to balance external payments are often advanced in this context. As a defense of protection in the service sector, these two arguments have one major strength and one major weakness.

The strength is institutional. Article XVIII of the GATT accepts these arguments as valid grounds for protection in developing countries. The weakness is intellectual. Properly analyzed, neither position offers anything other than third or fourth best arguments for protection.

An extensive literature deals with the difficulties of constructing a case for trade protection from the infant industry argument (see Bhagwati and Ramaswami 1963; Johnson 1965), and also with the ineffectiveness in many circumstances of protection as a response to balance of payments deficits (Johnson 1961; McKinnon 1981). These general arguments have been applied to services (Hindley 1982; Hindley and Smith 1984), and they seem even less applicable to service industries than to goods industries. It is unnecessary to cover the ground anew here: the economic arguments for protection of the domestic service suppliers against foreign suppliers are not compelling.

Arguments based on national sovereignty and security, however, cannot be disposed of so easily, at least by means of economic analysis. Economic analysis

may have something to say about appropriate means of achieving policy objectives, but it has little that is useful to say about the ultimate objectives themselves.

Moreover, the residents of developed countries are not in a strong position to rebut arguments from developing countries based on concern with local sovereignty or culture. The United States, for example, insists for a variety of services that the companies supplying them in the United States be owned by U.S. nationals (for example, television stations and airlines). Developing countries which maintain that their communications, banks or insurance companies, or entertainment industry should be controlled by their nationals are therefore not without precedents to cite.

Even after all of that is conceded, however, there is still scope for economic examination of policies. One ground for this is cost. A national insurance industry may be thought important to national welfare. Translation of that judgment into support of such an industry, however, is unlikely to be independent of the true cost of that policy. A second ground, related to the first, is provided by the means employed to achieve the stated ends. To accept that it is a valid national goal to have locally owned suppliers of insurance is very far from accepting that any policy that impedes foreign suppliers is therefore justified.

Economic Ranking of the Instruments of Protection

From the standpoint of international trade theory, the issue is the ranking of instruments of protection. It is a standard proposition of international trade theory that if the object of policy is to sustain the output of an import-competing industry at a higher level than would otherwise exist, then from the point of view of the importing country, a subsidy to the output of the industry is superior to tariffs as a means of achieving that end (Corden 1957)[6] (except in the unlikely circumstance that the least-cost way of raising government revenue is an import tariff on the good in question).

The assessment of quantitative restrictions from this point of view is more complex because there are so many ways of administering them. Two key variables determining their social cost, however, are the destination of the rents associated with the quota rights, and the state of competition in the affected industry. At one extreme, in which domestic residents receive quota rents and there is perfect competition in all affected markets, it can be shown that tariffs

6. The same theorem states that the most efficient means is not independent of its objective—in particular, if the objective is to restrict imports, then a tariff is superior to a subsidy. In some service industries, the goal might indeed be to restrict imports—for example, where foreign films or television programs are seen as a threat to local culture—and the ranking would then be reversed. Moreover, to rank a subsidy to output as superior to a tariff assumes that a country is unable to affect the terms of trade—or at least that the level of tariff protection is less than the optimal tariff. For most developing countries, if not all, this appears to be a plausible assumption with respect to services.

and quotas are equivalent in a static, efficiency sense. But if the quota rents go to foreigners (as may be the case with voluntary export restraints), a quota is a very much more expensive means of expanding output in the import-competing industry than a tariff, from a national point of view.

Moreover, the effects of quotas and tariffs can be quite different from one another in the presence of imperfect competition (Bhagwati 1969). Measures affecting the price of imports, such as tariffs on goods, create problems of monopoly only when the tariff eliminates imports. Even when there is only one or a few domestic producers, imports can be substituted for home output at the world price plus the tariff. Quantitative restrictions on imports of goods, however, prevent such substitution. When there is a single domestic producer, for example, it is easily shown that a policy imposing the free trade level of imports as a quota will induce the domestic producer to *reduce* his output.

Quotas on imports therefore can be an extremely expensive means of expanding the output of an import-competing industry and may actually cause it to contract. Quotas are most costly, and their effects on the output of the protected industry most dubious, when they shelter an industry consisting of one or a few firms or when the quota rents go to foreigners.

This kind of analysis yields a ranking, in terms of economic cost, of policies to expand the output of an import-competing industry that produces a good. Where $X > Y$ denotes that X is less costly than Y, the ranking is

$$\text{subsidy to output} > \text{tariff} \geq \text{quota},$$

where, as explained, equality between tariffs and quotas demands quite restrictive conditions, and the costs of a quota may be very much greater than those of a tariff.

The relevant question is whether this kind of analysis can be applied to international transactions in services. It has been shown that the measures by which domestic producers of services are protected are often different from those adopted in goods industries and that the details of the measures may vary according to the particular service. Nevertheless, those means can be separated into two broad types. The first type of protective measure imposes a cost disadvantage on foreign producers (or provides a cost advantage to domestic producers). The second type imposes quantitative limits on the sales of foreign producers—a category which includes total bans on sales of any kind by foreign producers.

From an analytical point of view, the provision of a price or cost advantage to local producers without increasing the price or cost of the service provided by foreigners can be viewed as equivalent to a subsidy to local output in trade in goods. The imposition of a price or cost increase upon foreign producers can be viewed as equivalent to a tariff. The policies differ in that the latter will cause a deterioration in the price–quality-of-services combination that foreigners are able to offer in the local market, whereas the provision of a price

advantage to domestic producers retains for local buyers the option of purchasing the best price-quality combination available to them on the international market.

The result from the theory of trade in goods, that a subsidy to output is superior to a tariff as a means of expanding the output of the import-competing industry, is based precisely on the fact that the tax on buyers that is implicit in a tariff does nothing to further the objective of the policy and is therefore deadweight loss. That is also true in the present case of services. From the standpoint of economic efficiency, therefore, a policy of providing a cost advantage to domestic producers is superior to one of placing a cost disadvantage on foreign producers or suppliers.

The costs associated with import quotas when the quota rents go to foreigners or when the protected industry consists of one or a few firms also survive the transition to services. The enhanced profits of foreign firms that have access to the quantity-protected market now play the role of quota rents for foreigners. A plausible conjecture about the hesitation of European service industries to support the U.S. initiative on services in the GATT is that some important members of those industries have grandfathered subsidiaries in the heavily protected markets of their nations' former colonies, and so any thoroughgoing liberalization would threaten the profits of these subsidiaries.

Analysis of quota protection of monopolistic industries also finds application to service industries. Some service industries in developing countries contain few firms. Moreover, the potential for oligopolistic behavior is reinforced by the presence of regulators with strong powers, which the local producers may have "captured." Where such an industry is protected by a quantitative restriction placed on foreign producers, there is an incentive for monopolistic exploitation of domestic buyers by domestic sellers of the service. The incentives for foreigners permitted in such a market will, of course, be affected as well. Because the quantitative restriction will not permit them to increase sales, the price or quality of their service is also likely to deteriorate. Where this is reflected in enhanced profits, the outcome is similar to the worst yielded by a quota in the theoretical analysis of goods trade.

When due modification is made for the nature of the policy instruments that can be applied to the service sector, it appears that the ordering of policies for the support of import-competing industries applies to services as well as to goods. As a matter of practical policy, the prevalence of quantitative restrictions in the service sector, and the possibility and probability that the harm they cause may be high, suggests a clear first step for reviews of policy toward international transactions in the service sector. That step is to ensure that measures limiting the quantity of sales of services by foreigners are necessary for the achievement of policy goals. Where such measures can be replaced by others that affect the relative costs of foreign and domestic producers, there is a very strong presumption that the replacement will lead to economic gains. The argument presented above can be summarized by discussing the

implications of this analysis for the various protection measures described in section II.

Restrictions on Imports. There does not appear to be an economic case for restricting imports of services. If the desire is to maintain the import-competing industry at a greater scale than it would have in the absence of any policy, the least-cost way to achieve that end is likely to be by subsidizing domestic producers of the services.

It follows that many of the practices complained of by U.S. service suppliers which amount to subsidies to domestic producers of a service are defensible in the sense that they may impose a lesser cost on the country adopting them than alternative policies aimed at the same objective. Of course, the ends to which a policy is directed are very much open to debate—even though economic theory does not have any very useful contribution to make to that particular debate.

Any proposal for subsidies runs into the objection that it calls for disbursement of governmental revenue rather than its collection, which a policy of taxing foreign suppliers would achieve. The objection is regarded as very much more compelling by finance ministries than it is by many economists,[7] and it therefore must be supposed that some finance ministries will look more favorably upon a policy of supporting import-competing industries by taxing foreign suppliers and domestic consumers than on one of directly subsidizing domestic producers.

If the judgment of finance ministries is accepted, along with the judgment that it is socially worthwhile to support a domestic industry, then another set of policies complained of by service suppliers from developed countries—discriminatory taxes on their products—may be justified. The argument from raising revenue, however, now cuts in another direction. There can be very little economic sense in policies that reduce the competitive ability of foreign suppliers but that do not raise revenue. Such policies will indeed help local suppliers, but apart from such nebulous factors as pride in local ownership, they are the only ones who will gain from them. There is a strong economic case for substituting a tax on foreign suppliers for such policies.

Bans or quantitative restrictions on foreign suppliers are impossible to defend in terms of economic efficiency, and they raise no revenue. Given the availability of alternative and superior policies to assist the domestic industry, a ban on foreign suppliers requires strong justification. The terms in which such a justification could be formulated are not evident for most service industries.

Impediments to Establishment. Establishment may touch politically sensitive nerves, but from an economic standpoint it is simply an alternative to imports as a means of delivering a service. The comments made above on imports of

7. It does not seem relevant to economists for two reasons. First, subsidies to one industry can always be increased by increasing taxes on other industries, although that clearly may not make good political sense. Second, taxes on foreign suppliers will allow domestic producers to raise their prices and thus collect a "tax" directly from purchasers of their product. The fact that the "tax" does not go through the finance ministry does not seem very relevant to a judgment on overall social welfare.

services also apply to services delivered through establishment. If the aim of supporting the import-competing industry is accepted, then the best means of supplying that support is by the payment of subsidies to that industry; the second best means of supporting it is by taxing foreign suppliers, whether they are locally established or provide their services through trade. Measures that impede the competitive efficiency of foreign suppliers without raising revenue are unlikely to constitute good policy. Bans and quantitative restrictions cannot be defended, either on grounds of economic efficiency or of raising revenue.

Regulation. Regulatory powers are often justified as necessary to protect domestic buyers of a service from lazy or rapacious sellers of the service. Both theory and observation suggest that such powers sometimes are used instead to protect domestic sellers of a service from the impact of competition from abroad—and therefore foster inefficiency. Where this has occurred, governments must decide on whose behalf they want to use their regulatory powers—in the interests of users of the service or those of producers.

There does not appear to be any good economic case for using regulatory powers on behalf of suppliers. Support of the domestic industry would be better achieved by the measures suggested above. The protection of buyers is a legitimate function of regulation, but if the powers granted for the exercise of that function are instead used on behalf of local producers—and so against the buyers of the service—it might be better to do away with the regulatory authority and permit buyers to fend for themselves.

IV. Concluding Comments

As a practical matter, it must be said that the resistance of the governments of developing and other countries to liberalization in the service sector is in some degree a natural consequence of the prior lack of international rules governing protection in that sector. Service industries in some economies are very heavily protected. Some members of such industries very understandably prefer the status quo, and they are likely to possess very substantial blocking power. It would be foolish to suppose that they will easily be shifted.

The arguments for and against protecting the service sector in developing countries have been discussed. The arguments for protection are much less solid than the structures of protection that have been built upon them. The restrictive policies pursued by some governments are likely to impose substantial costs upon members of their economies.

To have that conclusion backed by more research on service sector protection in developing countries and by practical experience with liberalizing services in developing countries would be valuable. Enough is already known, however, to strongly support the proposition that for most developing countries, reviews of policy toward international transactions in the service sector will yield a number of possibilities for economic gain, and that for some developing countries, these gains will be large.

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