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*Impediments in Services Trade*

Brussels  
05-09-2006

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# **Regulatory Heterogeneity as Obstacle to International Services Trade**

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# Contribution of trade to GDP, by sector, OECD average, 2001



## Why so little trade in services?

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- Technical reasons:
  - ▶ most service products cannot be shipped in boxes
  - ▶ physical proximity of service producer and consumer often required
  
- Alternative international supply form: setting up a local subsidiary (FDI)
  
- Regulation-based trade barriers
  - ▶ Directly trade barriers (non tariff)
  - ▶ Non-tariff barriers caused by regulation of service markets

# Regulation-based barriers for services

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- Many different types
  - ▶ additional diplomas, certificates, licenses, requirements on input use, marketing, local professional insurance, membership of professional association, juridical form, etc. (EC, 2002)
  - ▶ common element: qualification costs
  
- Different motives for regulations:
  - ▶ ensure quality of the service or
  - ▶ reliability of the service provider
  - ▶ protect incumbent firms
  - ▶ satisfy special domestic interest groups

## Nature of regulatory barrier

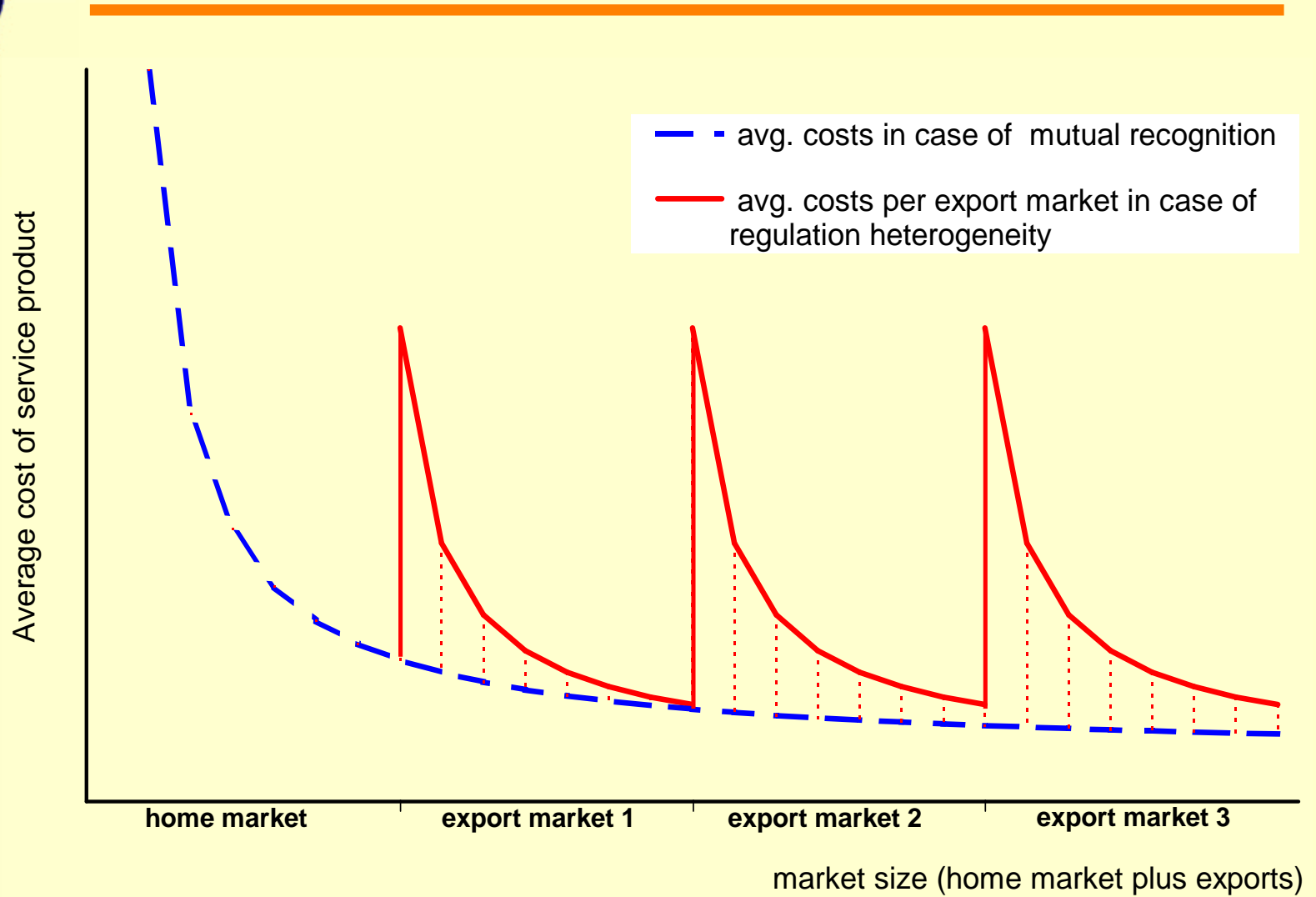
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- Qualification costs for service providers: mainly fixed costs
- Regulation-caused costs could be a source of scale economies..... if borders were open!
- Foreign service regulation comes on top of regulation in home market
  - ▶ Every country regulates it its own way
- Compliance costs are independent of firm size
  - ▶ → press hardest on SME

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## Bilateral policy heterogeneity

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- For explaining bilateral trade we need a quantitative measure for bilateral policy heterogeneity
  
- Use OECD International Regulation database
  - ▶ Database: 1 100 regulation items
  - ▶ Selection of 200 items in product market regulation
  
- For each regulation item pair-wise comparison of countries
  - ▶ yields a matrix of bilateral indicators for policy heterogeneity

# Refinements

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- Heterogeneity indicator:
  - ▶ an indicator for regulation-caused NTBs
  - ▶ increases in the level of policy heterogeneity between countries
  - ▶ specific for each country pair
  
- Decomposable for separate regulation domains:
  - ▶ Barriers to competition
  - ▶ Administrative burdens on startups
  - ▶ State control
  - ▶ Regulatory and administrative opacity
  - ▶ Explicit barriers to trade / investment



## Empirical model

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- To be explained:
  - ▶ bilateral trade in commercial services (excl. transport) of 14 EU countries, 1999-2001
- Model:
  - ▶ gravity model augmented with policy variables
- Explanatory variables:
  - ▶ GDP origin, GDP destination
  - ▶ distance factors (physical distance, language distance)
  - ▶ regulation heterogeneity indicators (5 sub-domains)
  - ▶ indicator for level of product market regulation in origin and destination country
  - ▶ fixed effects for origin and destination countries (country dummies), year dummies

# Bilateral commercial services exports (ln), 1999-2001, 480 obs

TLS/SUR	Country of origin	Of Destination
GDP origin	0.83***	
GDP destination		0.88***
Distance	-0.85***	-0.85***
Language	-0.70***	-0.70***
PM Regulation origin	-0.34***	
Barrier entrepre. dest		-0.03
Hetero. Start ups	0.35	0.35
Hetero. Competition	-3.10***	-3.10***
Hetero. EBT	-0.86***	-0.86***
Hetero. reg & adm.	-0.23	-0.23
Hetero, state control	0.74	0.74

# Results trade regressions

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- Heterogeneity in market regulation has a strongly negative impact on bilateral trade in commercial services
  - ▶ especially indicator for competition regulation (BC)
  - ▶ less so, indicator for discriminatory treatment (EBT)
- Regulation level in origin country significant
- Regulation level / strictness) in destination county not significant
- Tests:
  - ▶ other estimation methods (OLS, FE, DIM/FIML)
  - ▶ other service trade aggregates
  - ▶ results appear robust!

## Policy context:

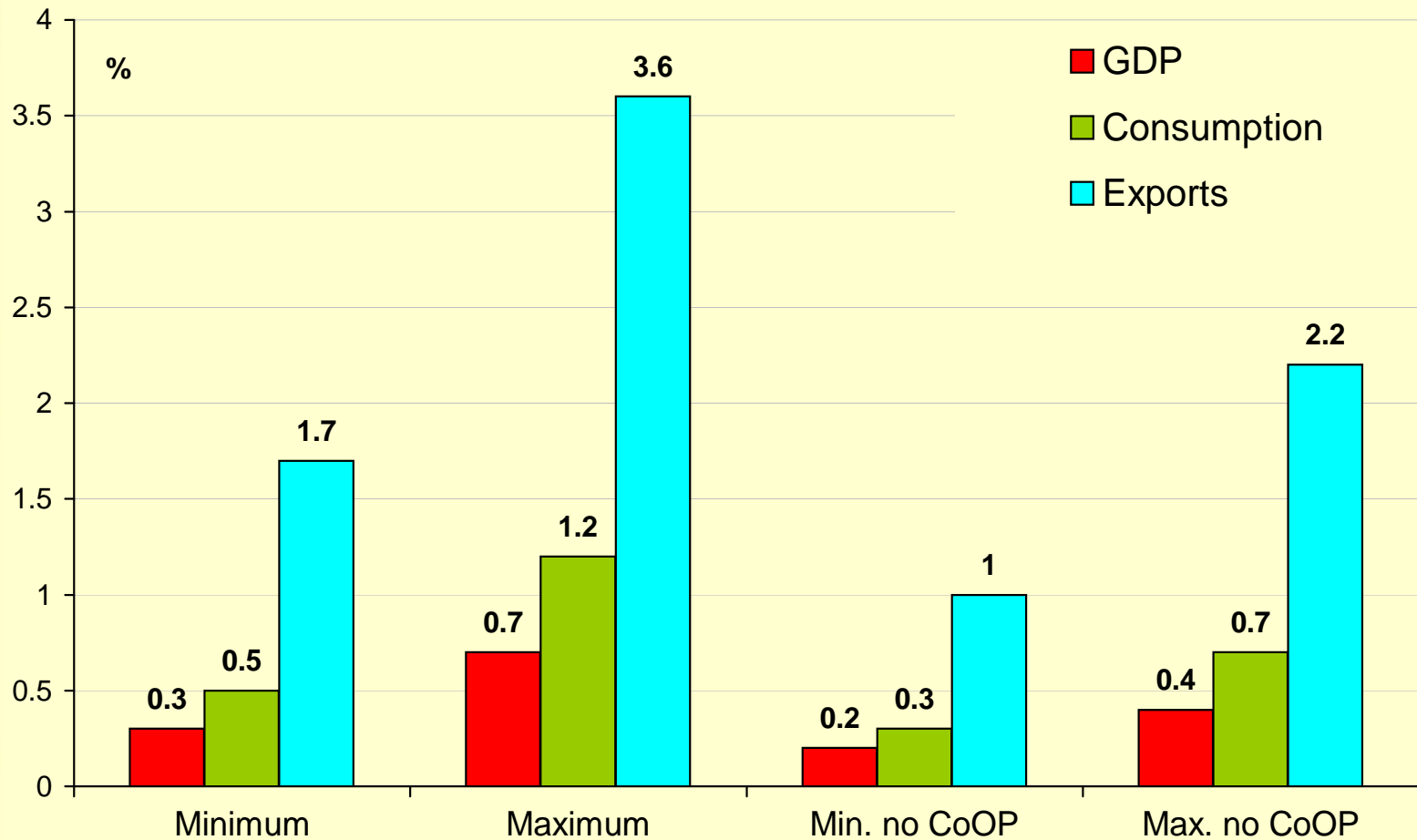
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- EC (2004): new proposals that should boost internal service market by 2010. Principal instruments:
  - ▶ reduce regulation heterogeneity
  - ▶ Country of origin principle
  - ▶ abandon discriminating regulations
- Use our regression results for quantifying possible effects of EU proposals
- Bilateral trade in services could increase by 65%
- Elimination of regulatory heterogeneity could triple trade.
- FDI could increase by 35%

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## Conclusions

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- Heterogeneity in regulation hampers services trade
  - ▶ In particular barriers to competition and explicit barriers to trade and investment
- It acts as fixed costs for market entry
- Elimination of heterogeneity could triple trade
- avg. GDP increase of SD 0.3 - 0.7% (= 32 - 74 bln. Euros)

# CPB research on Services Directive

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- **Effects Directive on intra-EU services trade and FDI (September/October 2004)**
  - The Free Movement of Service within the EU (CPB Document 69)
  - Policy heterogeneity as obstacle for international services trade (Discussion Paper 49)
  
- **Macro-economic effects (Febr. 2006)**
  - Trade-induced effects of the Services Directive and the country-of-origin principle (CPB Document 108)
  - Opening services markets: the role of foreign establishments (CPB Discussion Paper forthcoming)

Regulation comparison item	Implementation mode	Regulation Country 1	Regulation Country 2	Heterogeneity count for item	Cumulative heterogeneity count	Average bilateral heterogeneity count
License or permit required for operating in service sector ..X..	a) No requirement b) Always c) Only firms in activity ..Y.. d) Only firms larger than ..Z..	No requirement	Only firms in activity ..Y.	1	1	1
Nationality requirements for management of companies operating in service sector ..Q..	a) Yes b) No	No	No	0	1	0.5
Existence of restrictions (other than capital and technical) for participation in public tendering for service contracts	a) No restrictions b) Always c) Often d) Sometimes	Sometimes	Always	1	2	0.67



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<b>Policy domain</b>	<b>Initial policy heterogeneity, avg. for EU14, (1998)</b>	<b>Reduction due to Services Directive</b>
<b>Regulatory &amp; admin. opacity</b>	<b>0.38</b>	<b>66-77%</b>
<b>Explicit barriers trade / FDI</b>	<b>0.21</b>	<b>73-78%</b>
<b>Admin. burden start-up firms</b>	<b>0.55</b>	<b>34-46%</b>
<b>Barriers to competition</b>	<b>0.32</b>	<b>29-37%</b>
<b>State control</b>	<b>0.42</b>	<b>3-6 %</b>
<b>Overall PMR</b>	<b>0.39</b>	<b>31-38%</b>