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Lowering trade costs in services markets: The final frontier?

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Trade in the services sector is a central theme of the Doha trade negotiations. This column argues that restrictive policies can make trade costs in the services sector up to three times higher than in the goods sector. Such high costs, it claims, are holding back the growth of trade in services.

Nearly two-thirds of all economic activity in the G20 – and over three-quarters in France, the US, and the UK – is made up of services. So it is striking that while goods exports account for nearly 20% of the G20's combined GDP, the corresponding figure for services is less than 5%. Although services trade was growing rapidly prior to the full onset of the global financial crisis – by 19% in 2007, according to the WTO – it still represents a surprisingly modest share of the international economy.

We argue that a large part of the explanation for why services trade is so much smaller in value than goods trade lies in trade costs, i.e. the full range of costs a firm confronts when it decides to sell its services overseas. In goods markets, these costs include tariffs, non-tariff measures, transport charges, "behind-the-border" regulatory measures, and frictions related to geographical, cultural, and institutional differences. In services sectors, trade costs are largely related to regulatory measures that either create entry barriers or increase the cost burdens facing firms, in addition to geographical, cultural, and institutional differences. Indeed, as recently argued on this site (Hoekman and Mattoo 2010), there are many who call for regulatory reform to correct this.

The character of services sector trade costs makes them difficult to quantify. In our working paper (Miroudot et al. 2010), we apply a new theory-based methodology (Novy 2010) to estimate the overall level of trade costs for up to 61 countries, 12 services sectors, and 17 goods sectors. Due to data limitations, we only cover pure cross-border services trade (GATS Mode I). Intuitively, our approach relies on the observed pattern of intra-national versus international trade to infer the level of international relative to domestic trade costs. The more a country trades with itself relative to its partners, the higher the level of international relative to domestic trade costs. Trade costs calculated in this way are a "top down" measure, in the sense that they capture all sources of trade costs, even unobservables.

Trade costs in goods and services markets

Table 1 shows that the absolute levels of trade costs in services are very high in the major economies; over 100% ad valorem in all cases, and over 200% for India. Moreover, trade costs in services markets are much higher than for goods. Data for the full sample of countries suggest that a multiple of two or even three times is not uncommon. Although the numbers should be interpreted cautiously, because they depend on an assumed parameter value, only under extreme assumptions would the basic pattern of a higher level of trade costs in services than in goods be reversed.

Table 1. Comparison of trade costs in goods and services, major trading economies vis-à-vis the rest of the world, latest year (percent ad valorem equivalent).

Country	Goods	Services
US	91%	144%
Canada	77%	165%
EU	72%	143%
Japan	100%	173%
China	91%	183%
India	139%	205%
Simple Average	95%	169%

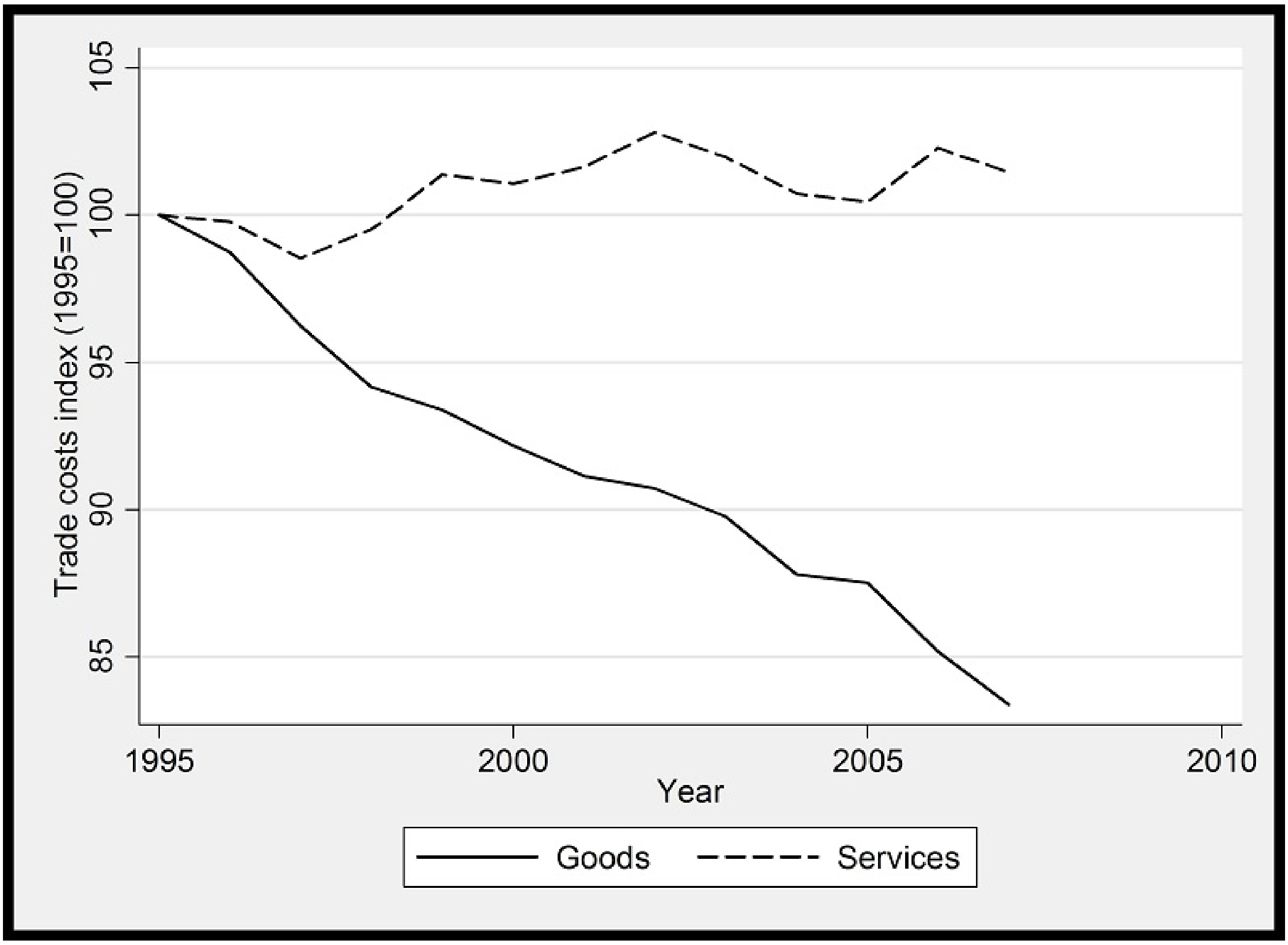
Source: Miroudot, Sauvage, and Shepherd (2010).

At first glance, some might find it surprising that the costs of pure cross-border services trade are so much higher than for goods, given that international transport costs and tariffs are largely absent in the case of services. Our measure of trade costs, however, covers the full range of regulatory and other measures that impact the cost of doing business abroad. Although the breakdown of trade costs in services remains uncertain, it is likely that factors such as regulatory heterogeneity, and differences in cultural and legal traditions, make it substantially more costly for foreign firms to enter the market.

Changes in trade costs over time

We can also use our data to track trade costs in goods and services markets through time (Figure 1). The contrast between goods markets and services markets is striking. Trade costs fell substantially over the 1995-2007 period in goods, by over 15%. In services, however, they have remained essentially static: there is no evidence of a significant fall in services trade costs during the same time frame. As we show in our working paper, the same basic pattern emerges – with one exception, see below – when we consider the major trading economies individually.

Figure 1. World aggregate trade costs indices for goods and services, 1995-2007 (1995=100).



Source: Miroudot et al. (2010).

On a sectoral level, however, some heterogeneity is evident. Trade costs in construction services have increased markedly over the last decade, by nearly 20%. Construction is also the most insulated sector, with ad valorem equivalent trade costs of around 200%. Trade costs in transport services have remained approximately constant over the last decade. By contrast, trade costs in financial and computer services have fallen by more than 10%. This finding is perfectly consistent with the rise of outsourcing in those sectors over roughly the same time period: as trade costs fall, probably due to improved information and communications technologies, it becomes feasible for firms to have more of these kinds of tasks performed overseas. Sectors such as transport and construction, on the other hand, are largely immune to such developments because of the need for physical proximity between producer and consumer.

External commitment mechanisms can help

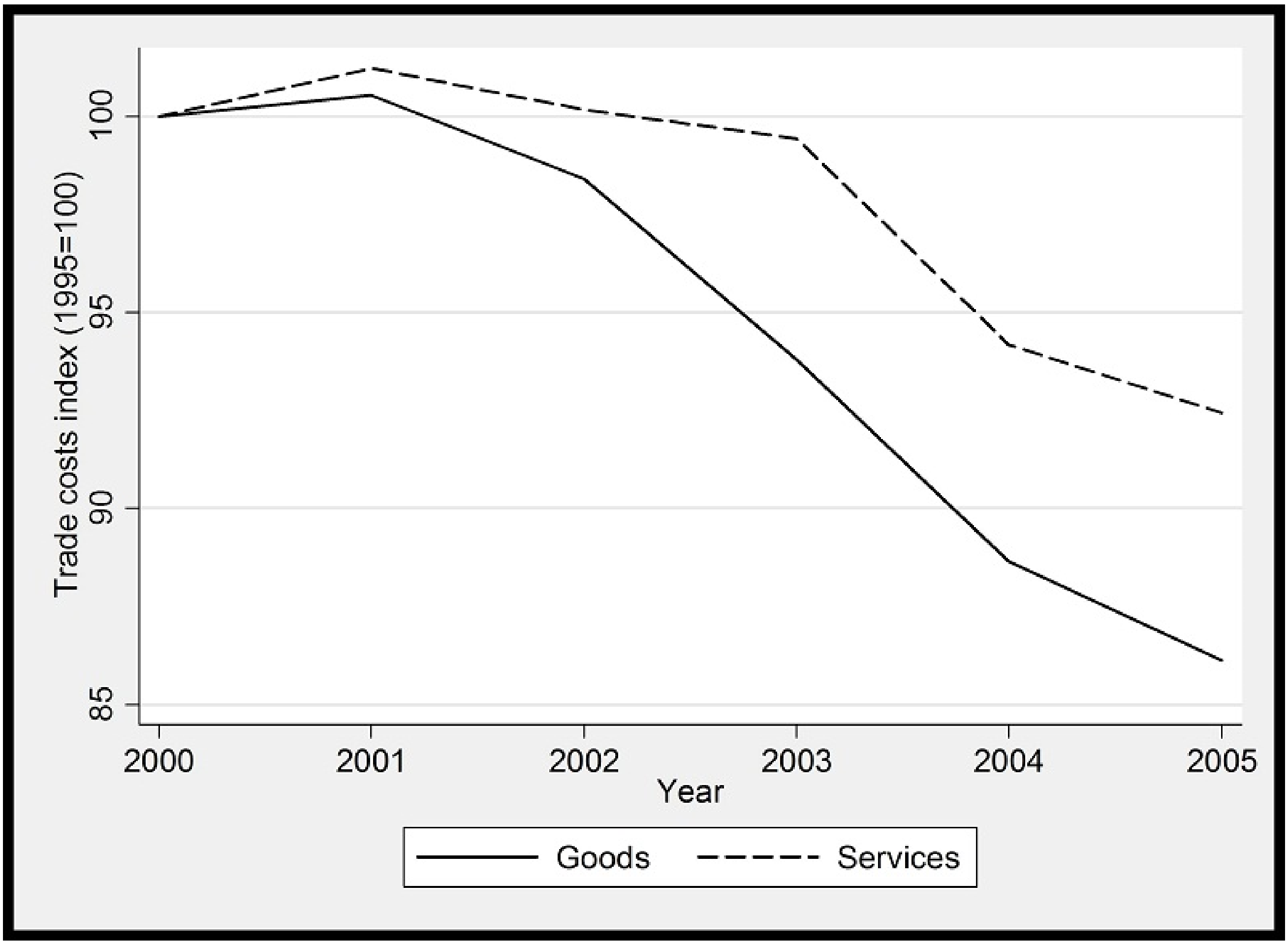
The obvious exception to the pattern described above is China (Figure 2), where trade costs have declined substantially in services markets as well as in goods following WTO Accession in 2001. It is important to highlight two caveats to this finding.

- First, Table 1 shows that China still features high levels of trade costs relative to other major economies, so whatever change has taken place is due in part to having started from a high baseline. There is still considerable room for further movement. Nonetheless, the proportional reductions since 2000 remain impressive.

- The second caveat is that the trade costs that we are measuring represent an average of trade costs facing foreign producers exporting to China, and trade costs facing Chinese firms exporting to other countries. Thus, we cannot conclude that the large trade cost reductions observed for China are solely due to policy reforms undertaken at home. They are also linked to trade cost reductions by China's trading partners following accession to the WTO, which provided China with permanent MFN status.

Nonetheless, our findings align well with recent work suggesting that the terms of China's WTO Accession Agreement had real "bite" in services, in the sense that they required significant liberalisation of applied policies (Mattoo 2004). This is in stark contrast to most countries' GATS schedules submitted at the end of the Uruguay Round – they established binding policy ceilings, but contained little in the way of genuine liberalisation. Whatever liberalisation has occurred since the Uruguay Round has been undertaken unilaterally or preferentially, it is therefore not surprising that for other countries, changes in trade costs on a multilateral basis have been limited.

Figure 2. China trade cost indices for goods and services, 1995-2007 (1995=100).



Source: Miroudot, Sauvage, and Shepherd (2010).

Conclusion

We find strong evidence that trade costs in services are much higher than in goods, perhaps a multiple of two or even three times. The data also suggest that trade costs in goods have fallen substantially over the last decade, but that they have remained essentially stable in services markets. China's experience is different, however, and is suggestive of an important role for external commitment mechanisms such as the WTO in reducing trade costs in services.

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