



TRADE NOTES

TOWARDS EAST AFRICAN SERVICES

Liberalization of services is normally discussed as a WTO phenomenon. This bulletin is concerned not with multilateral but preferential liberalization of services within the East African Community context. Liberalisation itself is a term that carries various connotations. We use this term to refer to removal of market access and national treatment limitations facing East African services, and not privatisation of government provision of services.

The East African integration process is envisaged to be a progressive one, beginning with a customs union, moving to a free trade area encompassing the free movement of capital, goods, services and labour, and ultimately resulting in a political union.

INTRODUCTION

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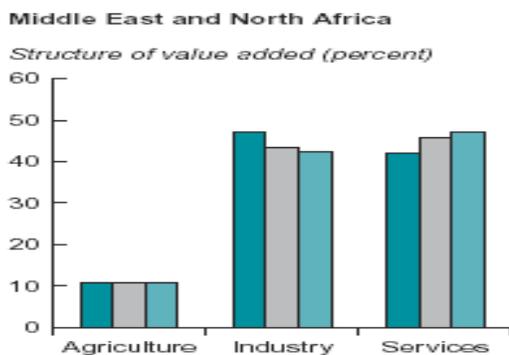
With the enactment of the Customs Union protocol, there is progress towards preferential liberalisation of trade in goods. However, the issue of preferential services liberalization has not merited comprehensive and separate treatment, and while it is mentioned sporadically as desirable, the treaty establishes a mandate for further liberalization but goes no further. Members have committed to free merchandise trade within the

Community in the next five years. As barriers to merchandise trade look set to come down, the next logical step is dialogue as to whether there may be any advantages to services liberalization in the regional context and what form such liberalization ought to take. In this bulletin, we outline some economic and legal aspects of services liberalization, with the intention of spurring further debate on this issue.

ECONOMIC ASPECTS OF PREFERENTIAL LIBERALISATION

Services have become increasingly important in the world's economies in general and Africa in particular as may be seen below. The three columns per sector represent the years 1982, 1992 and 2002 respectively.

Precedents have already been set in preferential services



liberalization within the context of free trade areas. The EU and NAFTA have led the way in this regard, establishing the two basic models of services liberalization that have subsequently been followed by MERCOSUR, ASEAN, the Andean Pact and bilateral US free trade agreements (FTAs) with a number of countries ranging from Chile to Singapore. Preferential liberalization carries with it some potential advantages and disadvantages as we now discuss.

➤ What does Preferential Liberalisation entail?

Preferential liberalisation entails the lowering or

removal of market access and national treatment limitation facing East African services. A national treatment limitation is one where a country treats its domestic services and service providers more favourably than those of its counterparts in the East African Community. The bulk of measures that restrict market entry and national treatment in services are typically not border measures, such as tariffs and quotas, although the latter may be found in restrictions on the number of foreign workers or the number of foreign service providers. Most of the time, however, potential foreign service providers are restricted by domestic regulations such as limitations on entry of foreign firms, domestic capital ownership requirements, licensing and technical regulations, and limited or no recognition of foreign academic or vocational qualifications. Preferential services liberalisation would entail the lowering of such barriers preferentially to East African services, and their retention for services from the rest of the world.

➤ No Revenue Loss

Unlike tariffs, these regulations as described above while imposing barriers do not generate revenue for government. As such, costs of liberalization in services, in terms of revenue losses, are potentially less than those for liberalization of goods trade. A country would therefore need to assess what it gains from restricting foreign entry in service

provision. Where a country's regulations in this regard impose only costs to foreign providers without any benefits to the host country, then preferential liberalization of services would improve welfare.

➤ Regulatory Co-operation.

Barriers to services trade may be seen as regulatory measures by government. They may not be as explicit as tariffs, but nonetheless may be said to constitute fixed costs to potential investors. Regional integration may make the East African market more attractive to East African investors by reducing the number of fixed costs that must be incurred. A licensing qualification or fee, for instance, may be seen as a fixed cost to business; barring integration, a service provider will have to qualify separately in the three East African countries and incur the same kind of cost thrice. With integration, the number of separate requirements in the three countries reduces and may make the region a more attractive place to invest.

Moreover, regulatory co-operation might help mitigate regulatory capture, which occurs when domestic service providers successfully advocate for regulations which have nothing more than a protectionist effect, and do not promote overall welfare. It is important to ascertain whether domestic protection is justified on a case to case basis, and whether protection is the best solution.

More on this subject is discussed below under the heading 'necessity test'.

In addition, regulatory co-operation regionally may serve as a kind of experiment to find out what regulatory approaches may be best suited to East Africa, and subsequently inform current multilateral negotiations in the WTO.

Such co-operation has two aspects: the mutual recognition of the standards and qualifications of services providers, or the establishment of common rules (harmonization), or both. It has been observed that the two measures are not mutually exclusive and can complement one another, resulting in a situation where a service provider in any one country is qualified to provide the same service in the three countries.

➤ Competition

There are two aspects to this discussion, which shall be dealt with in turn. The first is competition and scale and the second is the necessity for pro-competitive regulation of services prior to liberalization, an important aspect of the sequencing of liberalisation.

The removal of trade barriers can be likened to a market enlargement, as separate national markets

move towards integration into a bigger, regional, market. Such expansion may allow firms to take advantage of greater scale and attract investment projects for which market size is a central determinant. Removing barriers may also induce heightened intra-firm competition, possibly resulting in greater efficiency. In other words whereas there might ordinarily be a trade off between competition and economies of scale, where increasing one reduces the other, if the market is enlarged it increases the possibility of experiencing both conditions.

As an illustration of the practical effect of such considerations, arguments have been raised in the provision of mobile telephony services in Kenya, that a third mobile service provider will not necessarily cause prices to fall because the size of the market makes two providers ideal. Regional integration enlarges the market, and reduces this trade off, so that it may be possible to have both larger firms and greater competition. This is of particular importance to the three East African economies, where comparatively small markets in individual countries may have limited the full realization of economies of scale by East African service providers. Greater competition and scale may also encourage East African investment, lead to the formation of firms in the region that are better placed to compete globally, and make the

region better placed to eventually reap benefits from multilateral liberalization.

In competition and regulations, competition is good and a lack of competition, being too much market power in the hands of market actors, is bad. However, the scenario is not always this simple. Countries may choose, through laws and regulations, to limit competition and incur short term losses for the purposes of reaping future gains. In the patent system for instance, a patent holder is granted a monopoly right to an invention. This enables him to reap monopoly profits, which is a short term loss to society, but on the other hand may encourage innovation, which is a long term gain. In the context of services, a limitation on competition could enable service providers to charge higher prices, which is a short term loss. It could also enable service providers to expand their capacity, modernise their services, and invest in future capacity building, which is a long term gain.

However, such considerations have not always been persuasive to policy makers in the region. In particular, political patronage has been a key factor behind the granting of market access. Some of the beneficiaries of such patronage have even been companies controlled by foreigners. Countries have thus done themselves a double disservice; first by limiting competition and enabling producers to

charge high prices without the hope of long term gain, consumers have been denied access to quality services at a reasonable price indefinitely. Secondly, where companies providing such services are controlled by foreigners, monopoly profits have been repatriated abroad. It remains a common theme of popular economic discourse in Kenya, for instance, that too much of the economy is in foreign hands.

Limitations on competition have costs but can be justifiable. However, they must always be based on economic rather than political considerations. Also, barriers to competition should not be indefinite but should only obtain for as long as is necessary to achieve economic objectives. In general, a pro competitive regulatory environment is a necessary precursor to liberalisation of any kind.

➤ Joint Provision of Services

Member countries to the East African Community may wish to revisit the joint provision of services in such common aspects as shipping, air, road and rail transport, and even tourism. Potential benefits in this direction might include pooling of scarce governmental resources, taking advantage of economies of scale and reduced transaction costs.

➤ Trade Diversion

Trade diversion has long been a concern of

economists in the area of preferential trade in goods, and its lessons bear consideration in a discussion about services. Trade diversion refers to a situation where preferential rules have the effect of supporting high cost producers who would otherwise be out of the market. Trade is diverted from efficient to inefficient producers. A potential disadvantage of services trade liberalization on a regional basis is trade diversion caused by location specific sunk costs inherent in many services. Sunk costs are those costs that cannot be recovered from the sale of an asset. Services are generally less capable of exportation than goods, and sunk costs in services are normally to a geographical market in close proximity. Intuitively, this may be seen to be the case in such service sectors as transportation, telecommunications, and financial services, and even some professional services such as dentistry, where start up costs are high and they are intended for the geographical market where they were incurred. Take the case of mobile phone services. A preference granted to an inferior regional service provider in such services will have lasting effects even if the market is subsequently liberalized and access granted to everyone from everywhere. The market will be stuck with a second-best provider because the high location specific sunk costs will act as a disincentive to investment for subsequent providers even if they are more efficient and would result in higher overall welfare gains for consumers and for the economy as a whole. In principle, this

problem might be eventually overcome if the beneficiary of preferential access subsequently becomes more efficient through learning by doing, or through economies of scale.

Another aspect that should inform such considerations is that the more preferential the trade regime is, the higher the risk of trade diversion. That is, the harder it is for foreigners to set up shop in East Africa, the higher the risk of entertaining inefficient service providers. Again, this risk will be worth bearing if preferential measures today lead to competitive services provision in the future.

LEGAL ASPECTS OF PREFERENTIAL LIBERALISATION

➤ Similar Legal Environments

It might be worthwhile at this juncture to explore some possibilities as to how a protocol on services for the East African community might result in the regulatory co-operation described above. East Africa has a shared legal history much influenced by British law. In the past, Kenya, Tanzania and Uganda have enjoyed a long history of co-operation under successive regional integration arrangements. These have included the Customs Union between Kenya and Uganda in 1917, which the then Tanganyika later joined in 1927; the East African High Commission (1948-1961); the East African Common Services Organization (1961-

1967); the East African Community (1967-1977) and the East African Co-operation (1993-2000). Moreover, until 1977 the East African Court of Appeal, an institution of the East African Community, was a final court of appeal from decisions of national courts on both civil and criminal matters except constitutional matters and the offence of treason for Tanzania. This shared legal history, combined with a similarity in the levels of development of East African countries, could increase the feasibility of regulatory co-operation.

The three countries have similar legal systems and operations and their economies are similar in terms of GDP and GDP per capita. The latter fact is important when one recalls that the purpose of regulation in services is to remedy market failure resulting from asymmetric information, externalities and natural monopolies. Similarity in the underlying conditions for regulation coupled with similar legal regimes may increase the possibility of successful regulatory co-operation.

➤ Compatibility with GATS

Preferential liberalization is contrary to the Most Favoured Nation (MFN) principle of WTO rules, which states that concessions granted to one member must be extended to all WTO members. A preferential liberalization regime would mean

that East African Countries' services would be treated better than foreign services. An exception to MFN is therefore needed, and is provided for in the General Agreement on Trade in Services (GATS) at Article 5, which allows for such exceptions if two main conditions are met. First, the preferential liberalization regime must have substantial sectoral coverage, and second that there must be substantial elimination of discrimination as between the parties to the agreement.

In practice, members have largely chosen to ignore this provision. This is mainly because its terms are vague and capable of wide interpretation. 'Substantial sectoral coverage' could mean that a preferential services agreement should not exclude any sector or mode. Or it could mean it should not exclude many sectors or modes. In several instances, WTO members have excluded even important sectors and modes from their services agreements, especially Mode 4-movement of natural persons.

As may be expected of any rule, in Article 5, one has exceptions. Importantly, the full liberalisation it suggests doesn't have to come to effect immediately but within a 'reasonable period of time'. What constitutes a reasonable period of time is not clear. In GATT it is 10 years and this example has been followed by EU agreements. MERCOSUR and the Andean Community have

set the period at 8 and 10 years respectively, and 10 years seems to be the general understanding of WTO members on what a reasonable period of time is. On the other hand there are flexibilities in the case of preferential trading agreements among developing countries, whose scope is not defined. This leaves room for various interpretations and possibilities, such as an increased implementation period or favouring companies owned or controlled by nationals of the member states.

As regards mutual recognition of qualifications, GATS Article 7 provides that a country granting such recognition must also give the opportunity to other countries to show that they are similarly worthy of such recognition. This being an MFN type provision, it is possible that article 5 discussed above is also an exemption to this provision. Some members hold this view, others disagree. At the moment, therefore, member countries seem to have *carte blanche* as to what they choose to do. It has already been recognized that more work needs to be done to clarify the terms and flexibilities of GATS article 5, without which it is not possible to conclusively comment on the GATS compatibility of a preferential trading arrangement.

➤ The Necessity Test

A necessity test would be useful in weeding out regulations whose purpose, rather than to address



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the market failures is purely protectionist. The necessity of a rule could thus be assessed on the basis of the market failure it purports to redress- economics as a discipline can provide useful guidance for the establishment of legal rules in this regard. So for instance, if an accountant is required to re-qualify from scratch to practice in all three countries, such a rule might be judged un-necessary since the market failure it purports to redress, being asymmetries of information as to the skills of professionals, could be remedied by a better tool, namely a test of competence.

➤ Negative Vs. Positive Listing

Services can be supplied internationally in 4 ways (referred to as modes of supply): first through cross border movement of services, where the service provider and the consumer are located in different countries; second through consumption abroad, where the consumer

travels; third through commercial presence, where a corporation moves abroad; and fourth through movement of natural persons (as opposed to corporations) abroad. Countries commit themselves to liberalization in services by way of schedules of concessions, in which the service sectors and modes of supply to be liberalized are listed. There are two ways of doing this, positively or negatively. A positive list approach is where no sector or mode of supply is liberalized unless it is explicitly listed by a country. The GATS type model of services liberalisation is a hybrid one, with a positive list of sectors which are subject to specific commitments combined with a negative listing of GATS incompatible measures in the listed sectors. Typical of this model is that countries retain the full right to make no commitments whatsoever and are under no obligation to supply their trading partners with information on restrictive or discriminatory measures. Another frequent complaint heard of GATS is that the movement of capital occupies a higher position than the movement of labour, so that you have free flow on capital on the one hand, and ubiquitous visa restrictions on the other.