Economic Research Institute for ASEAN and East Asia

Policy Brief

Deepening East Asian Economic Integration in Services

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In services markets, there may be legitimate reasons to regulate. Integration efforts should target regulatory restrictions that explicitly limit competition, and those that are intended to meet legitimate objectives, but are clearly more burdensome than need to be. In health and maritime, ASEAN is already relatively liberal by international standards, although there is still scope to promote cross-border trade and ease costly cabotage restrictions. In telecommunications, the residual foreign equity limits are hard to understand, given that past reforms and current technologies have ensured that most markets are already relatively competitive. In finance, there is substantially more to do, despite progress made during the Asian financial crisis. And in air transport, despite commitments to open skies, there is a need to further align the content of bilateral air services agreements with regional integration objectives.

1. Defining integration in services

The key objective of ASEAN economic integration is to improve the competitiveness of the ASEAN economies so they can maintain their position as desirable destinations for foreign direct investment, as vital players in regional production networks, and as major trading entities in their own right. The key to ASEAN improving its competitiveness is to improve its productivity.

Competition can be a powerful force for generating productivity improvements. It exerts pressure on producers to find the least cost way of serving customer needs, and to innovate in order to better serve those needs. Competition sets in train a dynamic process that leads to prices reflecting production costs, and costs being as low as possible.

In services, foreign competition can play an important part, but it is not enough. Competition from domestic new entrants is arguably even more important. A recent study examined the empirical evidence on the relative importance of discriminatory barriers to foreign competition in services, and non-discriminatory barriers to *any* new competition, among a group of East Asian economies. The exercise combined econometric evidence on the first round impacts of regulatory restrictions in seven selected services sectors (McGuire and Schuele 2000; Kalirajan *et al.* 2000; Kalirajan 2000; Clark, Dollar and Micco 2004; Nguyen-Hong 2000; Warren 2000; Doove *et al.* 2001) with computable general equilibrium modelling of the flow-on effects (Dee 2007). The results were striking. The gains to the region from unilaterally reforming the non-discriminatory restrictions on competition were almost six times those from forming an East Asian preferential trade area, and three times those from a successful Doha Round.

2. Integration is not the same as deregulation

In many services sectors, there are legitimate reasons for domestic regulation. For example, prudential regulation is required in banking and insurance markets to guard against systemic instability of the financial system. Transport industries are regulated to ensure passenger safety. Access regimes in telecommunications are intended to avoid the inefficient duplication of infrastructure components that have 'natural monopoly' characteristics. And health markets are regulated to ensure quality and equitable access.

Attempts to promote market integration in services need to recognise the right of individual governments to regulate to meet these legitimate objectives. Integration efforts should first target restrictions that explicitly limit competition in various ways. They should also target regulations that are intended to meet legitimate objectives, but are more burdensome than they need to be to meet those objectives.

Sometimes it can be very difficult to define what is 'more burdensome than necessary', especially since governments at different levels of development often make different judgements about which legitimate objectives to pursue, and how hard to pursue them. So typically, market integration efforts in services focus first on regulations that are primarily designed to restrict competition.

3. Identifying pro and anti- competitive regulation

In some services, it is reasonable easy to separate those regulations that restrict competition from those designed to achieve legitimate objectives.

In banking and insurance, the instruments commonly used for prudential purposes include minimum capital requirements, capital adequacy ratios, liquidity reserve ratios, possible coverage by an insolvency guarantee or deposit insurance scheme, and transparency measures. The instruments commonly used to restrict competition include licensing restrictions on the entry of new domestic or foreign banks, equity limits that prescribe minimum domestic or government involvement, and operating restrictions limiting the nature and scope of bank operations.

In most cases, banking and insurance services can be liberalized without jeopardizing prudential objectives, which are achieved using other means. Of course, there is still a sequencing issue — it would be unwise to open financial markets without adequate prudential regulation and without adequate regulatory capacity to design and enforce it.

Similarly in telecommunications, there is a relatively clear-cut distinction between regulatory instruments designed to prevent the abuse of 'natural monopoly' power, and restrictions on competition. The WTO Reference Paper on Telecommunications outlines the key elements of a pro-competitive regime. These include arrangements to ensure that competitors can get access to those components of the incumbent's network that have natural monopoly characteristics, and regulations to ensure interconnectivity and number portability. Restrictions that unduly impede competition include limited or heavily prescriptive licenses, equity limits, and failure to adopt a pro-competitive regulatory regime of the type just described.

In international air transport, bilateral air services agreements cover legitimate matters such as aviation security, incident investigation, immigration and control of travel documents. But they often contain other, anti-competitive elements, such as limits on the number of airlines flying between countries, the ownership structure of those airlines, their capacity and pricing, and whether they can provide domestic as well as international services in the two countries. Open skies agreements are designed to liberalise at least some of these anti-competitive elements.

Maritime services are similar to aviation services in that there is scope for legitimate regulation to ensure safety. But anti-competitive regulation is also common. In particular, cabotage restrictions may require that shipping services between domestic ports in a country be carried out by ships that are domestically owned, operated, built, and/or crewed. These regulations have been shown to be costly, particularly to developing countries (Kang 2000).

In health services, the distinction between instruments used to achieve quality and access objectives and those deemed to be anti-competitive is less clear-cut. Entry may be restricted to ensure that low-quality providers do not enter the market. Or entry may be restricted to protect incumbent service providers. Similarly, access to subsidies may be limited because governments cannot afford to subsidize everybody. Or access to subsidies may be limited in order to disadvantage new entrants.

Achieving quality objectives in health will inevitably mean that there are barriers to the entry and operation of at least some providers. However, a well-designed quality control framework will ensure that the providers who are locked out are the genuinely low-quality ones. The framework can afford to be relatively neutral in its treatment of domestic and foreign providers, or incumbents and new entrants. Similarly, governments should be neutral in providing subsidies to incumbents and new entrants, even if they are not neutral in their treatment of domestic and foreign customers.

In other professional services markets, such as for accounting services, the problem of quality assurance is largely dealt with after the event, via mechanisms such as professional indemnity insurance. These ex post controls on quality are reasonably easy to distinguish from barriers to entry. Thus the targets/instruments problem does not extend to all professional services.

4. ASEAN progress towards integration of services markets

The extent of integration in ASEAN services markets has been assessed for medical, health and financial services (Dee 2009), maritime, air transport and telecommunications (Dee 2010).

In **health and medical services**, the ASEAN region is already relatively liberal (see also Arunanondchai and Fink 2007). In part, this is because ASEAN has centres of excellence in medical and healthcare. Some ASEAN countries have also bound relatively liberal regimes as part of their WTO accession. And many ASEAN countries cannot yet afford the expensive universal healthcare subsidies available in the developed world, and so have not instituted the restrictions on access to subsidies that can also restrain trade.

To facilitate further progress in liberalizing health and medical services, the ASEAN countries need to work together to establish satisfactory regimes for regulating and enforcing *minimum acceptable* quality standards, both for individual professionals and for healthcare institutions. This will be a key prerequisite to dismantling the regulatory and other restrictions that, while having a possible rationale in quality assurance, are either more discriminatory or more burdensome that required.

Finance, along with telecommunications, is an area where services trade liberalization has progressed most rapidly. For example, these were the two services areas where substantial agreement was reached in the WTO at the conclusion of the Uruguay Round. In other parts of the world, liberalization of financial services has continued since.

In ASEAN, the situation has been at least partly one of stasis, if not backsliding. Ironically, this can be attributed in part to the Asian financial crisis. In the wake of the crisis, many ASEAN countries undertook significant reform of their prudential regulation, and some loosened restrictions on foreign ownership on a most-favoured nation basis, albeit sometimes only temporarily. Even in trade circles, this created an impression that 'everything that needs to be done, has been done'. Yet in banking in particular, a majority of ASEAN countries have yet to reach the ASEAN Economic Community Blueprint targets for foreign equity limits. And barriers to trade extend far beyond these limits, as the Blueprint itself recognizes.

In **air services**, only one ASEAN country meets the Blueprint target of allowing at least 70 per cent foreign ownership in domestically established air services companies by 2010. However, effective liberalization of trade in air services not only requires the reform of investment laws, it also requires the reform of withholding clauses in air services agreements so that at minimum, they allow substantial ownership by an *ASEAN community of interests*, rather than substantial *domestic* ownership. ASEAN members should be working towards further reform of their air services agreements, and should be demanding much greater transparency of their provisions.

Most ASEAN countries have taken a relatively liberal approach to many aspects of **maritime** regulation. But few have stated that they grant exemptions from cabotage restrictions. ASEAN members should be looking to expand the scope of these exemptions, given how costly cabotage restrictions have been shown to be for developing countries. No ASEAN country meets the Blueprint target of allowing at least 51 per cent foreign ownership by 2010 in all maritime services. However, some countries meet it for some services.

Only two ASEAN countries currently meet the Blueprint's foreign equity targets in all

telecommunications services. The remaining restrictions on foreign equity limits are hard to understand, given the extent of existing competition in most countries, even in fixed line services. The persistence of very high market shares of incumbent service suppliers in a few ASEAN countries is perhaps indicative of remaining problems with general regulation in those countries.

5. Postscript — should integration efforts be preferential?

The Blueprint itself only suggests preferential liberalization in the case of foreign equity limits. A broader focus on preferential liberalization would have several significant drawbacks.

If concessions were made to ASEAN trading partners, prior to removing non-discriminatory distortions and ensuring the general contestability of markets, then liberalisation would simply risk handing monopoly rents to those trading partners. Furthermore, if the new trading partner had to incur sunk costs to enter the market, then a country would risk landing itself permanently with a second class supplier who is difficult to budge (see also Dee and Findlay 2008, Marchetti and Roy 2008).

Second, a focus on granting preferential concessions to particular foreign suppliers would be poor politics as well as poor economics. It risks taking the attention away from measures that also affect domestic new entrants. If these measures are not attended to, then ASEAN economies lose the opportunity to expand their own domestic business base. They also miss the opportunity to harness an important new set of domestic pro-reform champions.

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