

# 6

## **Service sector reform options**

### The experience of China

**Christopher Findlay, Mari Pangestu and Roy Chun Lee**

The gains from reform and liberalisation of services have attracted a growing literature. Messerlin and Zedillo (2004), for example, note the effect of service sector reform on competition, market scale, diversity, lower prices and higher quality, as well as the capacity to remove bottlenecks to growth in the infrastructure sector. They remark on the contribution of services to export performance, and they stress the interests of developing economies in market access for services exports.

Policy reform in services that delivers these benefits has a wider scope than reform programs in the goods sectors. There are services policy measures that apply only to foreigners: for example, rules on the form in which they can enter local markets. Services markets are also regulated by measures such as licensing, which affect all suppliers, wherever they come from. As Whalley (2004) observes in his review of empirical work on the effects of services liberalisation in developing economies, 'one is talking of domestic regulation, entry barriers, portability of providers, competition policy regimes more so than barriers at national borders, as with tariffs' (Whalley 2004:1,250). The connections between regulatory reform and services trade liberalisation are examined in detail in Mattoo and Sauve (2003).

The scope of the services agenda also differs from that of goods because of the substitutability between the modes of supply: that is, delivery of the service through establishment in the customer country, through the movement of people (either consumers or providers) or through the cross-border modes

of supply—options for which are expanding through technological change. Cross-border supply is the mode most similar to trade in goods.

The architects of the GATS recognised the value of considering all the modes of supply and all the impediments that applied to those modes. They sought commitments in the GATS to open up sectors and modes of supply and to eliminate measures that limit entry by all suppliers and those which discriminate against foreign suppliers.

Studies of services reform have examined these various dimensions. Some concentrate on the removal of discriminatory policy in a limited range of modes of supply, such as that across borders (Francois and Spinanger 2001). Others stress the value of coverage of other modes of supply (Whalley 2004; Walmsley and Winters 2003). Some examine the different impacts of the removal of discriminatory policy (that is, implementation of the principle of national treatment) compared with reform of policy affecting entry to markets by all services suppliers (in GATS language, matters of market access) (Dee and Hanslow 2000a, 2000b).

Services sector policymakers are confronted by questions of which sectors are the priorities for reform, which modes of supply should be included and to what extent should commitments refer to national treatment and market access questions? More specifically, they must decide whether domestic markets should be deregulated before foreign suppliers are allowed to enter, whether these reforms should be carried out simultaneously or whether foreign firms should be able to enter while impediments remain to domestic entry.

The first step in this chapter is to characterise options for services sector policy change in broad terms, and to discuss what factors determine the direction of change. Some of the points derived from the framework are illustrated by reference to China's experience in services, which offers many lessons. China made substantial commitments to reform its services sector, as part of its WTO accession. Mattoo (2004) reviews the significance of these reforms and notes how extensive they are compared with the experience of even industrialised economy commitments in the WTO (see also WTO 2006:Table AIV.2, for a summary of China's accession commitments). The commitments made are now being implemented. The construction of the original commitments and the pattern of their implementation are a source of insight for other policymakers contending with a similar task.

Options for services sector reform are presented in the next section. One is to free up entry to domestic suppliers. Another is to open markets to all suppliers. These are referred to below as 'domestic deregulation' and 'liberalisation' respectively. There are other outcomes, called 'foreign rent seeking' and

'back-sliding'. Some comment is offered on the welfare implications of each of these.

China's experience of services sector reform is then reconsidered. Some comments are offered on the relative importance of various aspects of the policy and political economy frameworks. That discussion includes reference to reform in the financial services, transport, distribution and telecommunications sectors. The chapter concludes with some key points and a suggestion for further empirical work that is relevant to these questions.

## **Options for reform**

Many impediments to entry into services markets apply to domestic and foreign producers, and in some cases foreign producers face extra requirements. An index of policy restrictiveness has been developed to assess the importance of both types of restrictions, following the work of Warren (2000), Findlay et al. (2002) and McGuire and Findlay (2005). The index is a frequency measure that estimates the restrictiveness of an economy's trading regime based on the trade barrier framework developed for the GATS.

Under the GATS framework, trade impediments are classified into two primary categories.

- 1 Market access. The GATS identified four modes of supply for trade in services: that is, cross-border, consumption abroad, commercial presence and presence of natural person. Market access represents the restrictions on market entry by either of the four supply modes on national and foreign new entrants (Warren 2000).
- 2 National treatment. National treatment obligations require GATS members to identify all measures that discriminate against foreign services suppliers in terms of advantages given to domestic suppliers or extra regulatory requirements imposed on foreign suppliers.

Following the GATS framework, the first step is to classify trade restrictions into two primary categories.

- Establishment. The ability of services suppliers to establish a physical outlet in a territory and supply services through those outlets, which includes market entry via foreign investment. This runs parallel with the mode of commercial presence in the GATS.
- Continuing. The operations of a services supplier after it has entered the market, including an interconnection regime, or its equivalent, and cross-border supplies. Regulatory measures that foster and enhance competition would also be captured under this category.

The second step is to reclassify trade restrictions into discriminatory and non-discriminatory categories to capture the degree of compliance with national treatment obligations.

- **Non-discriminatory.** Restriction applied to domestic and foreign services suppliers equally.
- **Discriminatory.** Restricting only foreign or only domestic services suppliers.

Table 6.1 provides an example of how restrictions in telecommunications are classified under the index.

The index value is then calculated for each economy using a methodology of scores and weights. Scores are assigned for each liberalisation index on the basis of a judgment about its stringency. The more stringent the restriction, the higher is the score. For example, a country that restricts the number of fixed-line licences is assigned a higher score than an economy that issues several new licences.

The restriction categories are then weighted together according to a judgment about their relative economic cost. For example, in telecommunications, restrictions on the issuance of licences are weighted more heavily than restrictions on leased-line operations. The weights are chosen so that the total restrictiveness index score ranges from zero to one.

An index score is calculated separately for domestic and foreign services suppliers (Figure 6.1). A foreign index (F) is calculated to measure all the restrictions that hinder foreign firms from entering and operating in an economy. It covers discriminatory and non-discriminatory restrictions. A domestic index (D) represents restrictions that are applied to domestic firms and it generally

---

**Table 6.1 Examples of restriction categories of trade in telecommunications services**

---

Non-discriminatory	Establishment The number of fixed-line local service licences is restricted	Continuing operations Voice resale is prohibited
Discriminatory	Foreign investment in fixed-line local service is restricted	Voice resale is permitted only to domestic operators

---

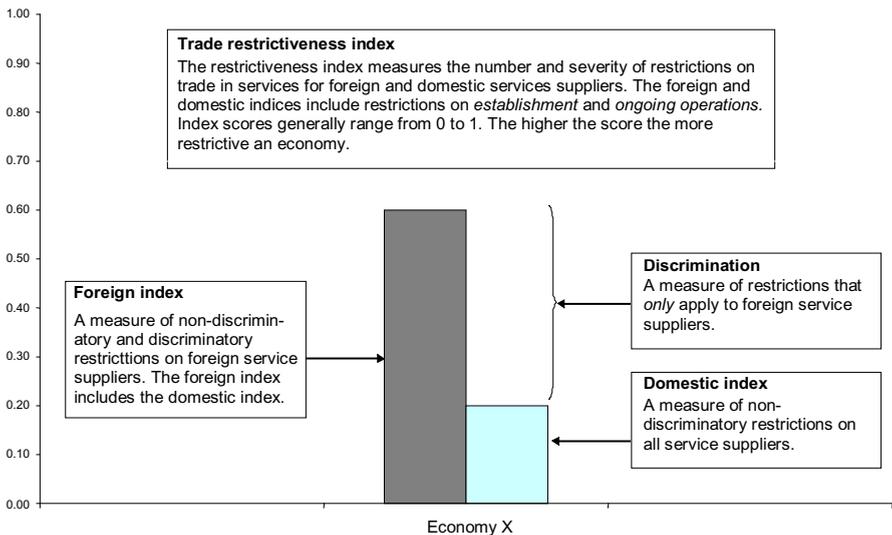
**Source:** McGuire, G. and Findlay, C., 2005. 'Restrictions on trade in services: trade liberalisation strategies for APEC member economies', *Asian-Pacific Economic Literature*, 19(1):18–41.

---

covers only non-discriminatory restrictions. The difference between the foreign and domestic index scores is a measure of discrimination against foreigners. This classification of the restrictions suggests a number of paths for reform, which can be specified. For example, F and D could be reduced at the same rate, or by the same amounts in absolute terms, or one could be reduced faster than the other.

These options are illustrated in Figure 6.2. The horizontal axis represents the size of the domestic index (D). The vertical axis shows the size of the gap between F and D—that is, the extent of discrimination. The maximum value of the D axis is shown as one.<sup>1</sup> At point O, the value of D is zero, and the maximum value of (F-D) is one. There is an additional constraint since the value of F is also, at most, equal to one. Given any value of D, the value of (F-D) must therefore lie on or below the line XY: for any value of D, a point along XY implies an index value for F of one.

Figure 6.1 **An illustration of the results from the trade restrictiveness index**



**Source:** McGuire, G., 2003. 'Methodologies for measuring restrictions on trade in services', in Organisation for Economic Co-operation and Development (ed.), *Quantifying the Benefits of Liberalising Trade in Services*, Organisation for Economic Co-operation and Development, Paris.

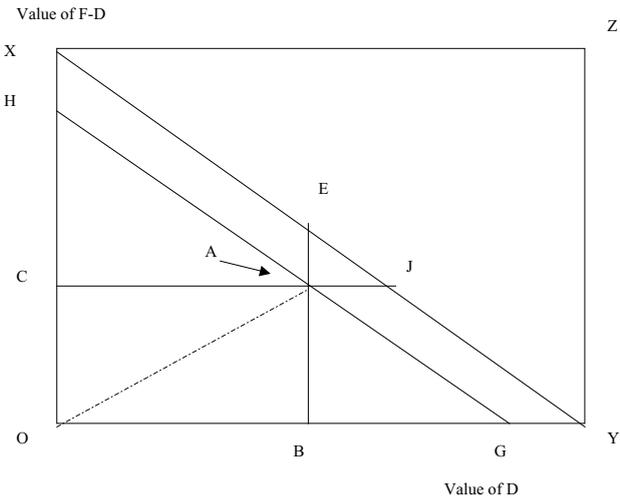
Suppose the current policy leads to a situation in which the index values of F-D and D lie at point A. In that case, there are four main options for policy change (noting that movement into the area XYZ is not possible).

One option (or liberalisation) is reform in which D and the margin of discrimination are reduced and point A moves into the space OCAB. If the ratio of (F-D) to D is maintained, the reduction would take place along the line OA, while above that line the proportionate reduction in D exceeds that in (F-D).

Another option is domestic deregulation, in which D is reduced but F-D increases. In this case, A moves into the area ACXE. The value of F does not necessarily increase but will do so if point A moves into the space AHXE.

Another option is that point A moves into the space BAJY, in which the extent of discrimination falls but the restrictions on domestic entry rise (when D moves to the right of BA). This case could be called foreign rent seeking, since foreign suppliers emerge with a relatively less restricted position compared with domestic suppliers. The effect of the policy change could, however, also be to increase the value of F (the total value of the index confronting foreigners), when the point A moves into the space AJYG.

Figure 6.2 Options for policy reform



One other less likely option is back-sliding, in which A shifts into the region AEJ, in which domestic restrictions and the margin of discrimination increase—along the extremes of which D is constant (along AE) or the extent of discrimination is constant (along AJ).

There are some other important special cases.

- Along the line AC, the extent of discrimination remains constant while restrictions on domestic entry fall. This could be called market access reform, in terms of the language of the GATS, since restrictions to foreign and domestic entry are being decreased by the same amount (although F-D—that is, the margin of discrimination—is constant).
- Along the line AB, the extent of restrictions on domestic entry remains constant but there is a reduction in the extent of discrimination. In terms of the language of the GATS, this could be referred to as reform in the direction of national treatment, since (F-D) is being reduced, while other universally applied impediments to entry stay the same.

The empirical work on the benefits of services reform tends to focus on the impact of removal of discrimination against foreigners. Francois and Spinanger (2001), for example, examined the effects of China's WTO accession. Their model included a number of services sectors. China's services policy was characterised by implicit tariff rates derived from gravity equations in which Hong Kong's relationships were used as the benchmarks. The gap between real and expected imports, according to this benchmark, was used with an estimate of an import demand elasticity, to estimate a price effect of the policy (akin to a tariff that would have the same effect of reducing imports relative to their free trade level). The data were therefore based on services that were traded across borders (not including those delivered through commercial presence). Further, the measures they assessed included policy that affected foreign relative to domestic supply, that is, the (F-D) margin. The modelling results, therefore, in terms of Figure 6.2, refer to a movement along the AB line, but with respect only to operations, not to establishment. The results, therefore, capture only part of the reforms made by China in the context of its GATS commitments.<sup>2</sup>

Empirical work on the effects of services reform can isolate the contribution of reform in these different directions, though so far at the expense of a narrower sectoral coverage. For example, Dee and Hanslow (2000b) provide some modelling results that classify policy measures in the manner illustrated in Table 6.1. They find that removing restrictions on market access causes much larger gains than reductions in discrimination—partly, this is because of the size of the reductions in restrictions on market access.

## The experience in China

China had already made substantial changes to policy in many services sectors before 2001 and its accession to the WTO led to further development of that policy. Our interest here is whether these two steps were in the same or different directions, and how the negotiating process has affected the direction of change. China's services reform commitments are reviewed also by Mattoo (2004) and Whalley (2003).

As observed in the cases to follow, China had in many cases already embarked on a reform program before the WTO accession negotiations had been resolved—but were those changes in the form of liberalisation, as defined in Figure 6.2, or were they a form of domestic deregulation? To see this, we examine the situation in banking, insurance, transport, distribution and telecommunications.

### Telecommunications

Dramatic changes have occurred in the telecommunications market, but the main drivers appear to have been the consequences of technological change.

Pangestu and Mrongowius (2004) review China's experience in the telecommunications sector. They report significant price reductions and increases in tele-density since 1998. These changes obviously occurred in advance of WTO accession. Pangestu and Mrongowius attribute these changes to competition in telecommunications markets, but they stress that the government orchestrated this competition and price reduction. In addition, there were instances of the influence of technological advancement that overcame government control, such as the use of the Internet for telephone calls.

While China's rate of reform in telecommunications has been rapid, it remains an outlier. Findlay et al. (2002), in a sub-sample of Asia-Pacific Economic Cooperation (APEC) countries, find that the extent of liberalisation in China exceeds that in all other countries reviewed. But they also note that despite the rapid change, China's degree of openness remains less than the sample average.

According to the WTO accession commitments (reviewed by Pangestu and Mrongowius 2004), foreign investment was allowed to enter but initially at a lower ownership level and with geographical restrictions. In a certain period—two years for value-added services, five years for mobile telephony and six years for domestic and international services—the geographical restrictions

were to be removed. Foreign ownership caps were to be removed gradually according to a schedule running through the next few years: the removal of this restriction has been accelerated, although the 50 per cent ceiling still applies. The Chinese authorities reaffirmed in 2006 their decision to increase the foreign participation cap in joint ventures for basic services (fixed-lined and mobile) to 49 per cent by 2007, in line with China's WTO commitments (WTO 2006).

Even after accession, foreign investment is not intended to hold a majority in the sector, although the treatment of foreign entry is more liberal in value-added services than for the other two sub-sectors. Geographical restrictions also continue to apply, including to some extent to domestic firms. In May 2002, China Telecom—the former monopoly in fixed-line operations—was split into two entities along provincial lines, with China Telecom serving 21 provinces in the south and the newly created China Netcom serving 10 northern provinces. Both operators enjoy the right to compete in each other's territories. These two share about 95 per cent of the market (WTO 2006). Two minor domestic suppliers—China Unicom and China TieTong—have also entered the fixed-line market with a limited presence.<sup>3</sup>

The major operators in basic telecommunications in China are state owned, and this situation is unlikely to change even in the short term. The main issue, however, is not the presence of government ownership but whether the few and predominantly state-owned players will be operating in a competitive environment. This increases the importance of China meeting its commitments to establish an independent regulatory body. Instead of having a separate regulatory agency, the Ministry of Electronic Industries (MII) remains as the policymaking body as well as the sectoral regulator. While according to China's own statement, the MII will act as an impartial and independent regulator (WTO 2006:232), the United States Trade Representative (USTR 2004) makes clear its concerns about the agency's regulatory practices, including the licensing process. Other issues have been the reclassification (in April 2003) of some services from the value-added category to basic services, in which the latter are on a slower schedule of liberalisation and with higher capitalisation requirements. China still has no central piece of telecommunications legislation, although a draft Telecommunications Law was circulated among ministries in 2004.

The progress of reform can be summarised in Figure 6.3. China moves into the area OCAB after WTO accession in late 2001, and has been progressively reducing its restrictions on foreigners. This is captured by the change in score between 2004 and 2007. This refinement is consistent with China's WTO commitments. On the other hand, not much improvement was observed after

1998 for the elimination of non-discriminatory restrictions on market access. This is demonstrated in the movement of scores along a straight line between 2004 and 2007, which reflects the fact that while discriminatory treatment against foreigners is reducing, domestic reforms that would benefit domestic and foreign suppliers have been relatively slack. Details of the scoring methods are in Table A6.1.

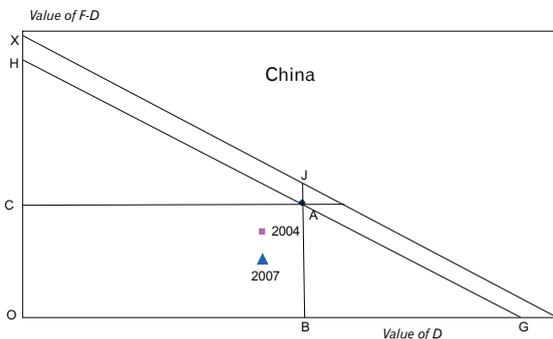
China’s experience can be compared with that of Taiwan. Taiwan’s experience is a movement into OCAB, that is, liberalisation—and this is the more common case, which is observed also in Hong Kong, Japan and Korea, for example (Figure 6.4). While discriminatory measures persist, Taiwan’s liberalisation pattern is highlighted by the non-discriminatory and simultaneous liberalisation approach. Specifically, Figure 6.4 shows that the index value for Taiwan migrates from point A—which is the original value in the base year—into the space OCAB. It also demonstrates that the level of discrimination between domestic and foreign suppliers remains when restrictions for domestic firms are removed completely by 2007.

### Banking

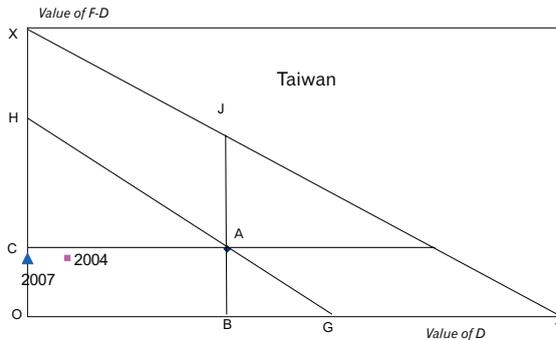
In banking, foreign banks continued until recently to be restricted in their forms of entry and operations compared with their locally owned competitors. Interestingly, one of the most important remaining issues is of equal significance to local and foreign banks.

In early 2006, business interests in the United States (Overmyer 2006) remained concerned about geographical restrictions on operations, restrictions

Figure 6.3 **China's telecommunications reform**



Source: Table A6.2.

Figure 6.4 **Taiwan's telecommunications reform**

**Source:** Table A6.2.

on doing business in local currency for local citizens and limits on foreign investment in Chinese banks (25 per cent in total and 20 per cent for any one investor). These restrictions were consistent with the staging process laid out in the GATS commitments, but it was pointed out that domestic banks did not face the geographical and customer restrictions that were faced by wholly foreign-owned banks. Many of these restrictions were, however, to be removed in 2006. Other issues are 'exorbitant capital requirements and slow licence-approval processes' that limit the growth of branch networks (delays of up to one year are reported and biases are evident in the allocation of licences for interior cities).

On 11 December 2006, China did indeed announce that foreign banks could offer renminbi services to local consumers (China 2006). Regional restrictions were also removed. Foreign-owned banks would be treated the same as domestic banks. Foreign banks could also incorporate a local legal entity from this time, however, the caps on ownership in domestic banks remain: the issue then becomes the rate at which foreign entrants can establish a branch network.

More important in the near future is likely to be the debate about foreign bank access to electronic payment systems, although this is an issue for local and foreign banks. The US Coalition of Services Industries (USCSI 2007) reports that foreign electronic payment cards cannot be issued by any bank, local or foreign, unless they are branded with China UnionPay, the monopoly domestic electronic payments processor. There is debate about whether or not this requirement is consistent with the December 2006 GATS commitments.

## Insurance

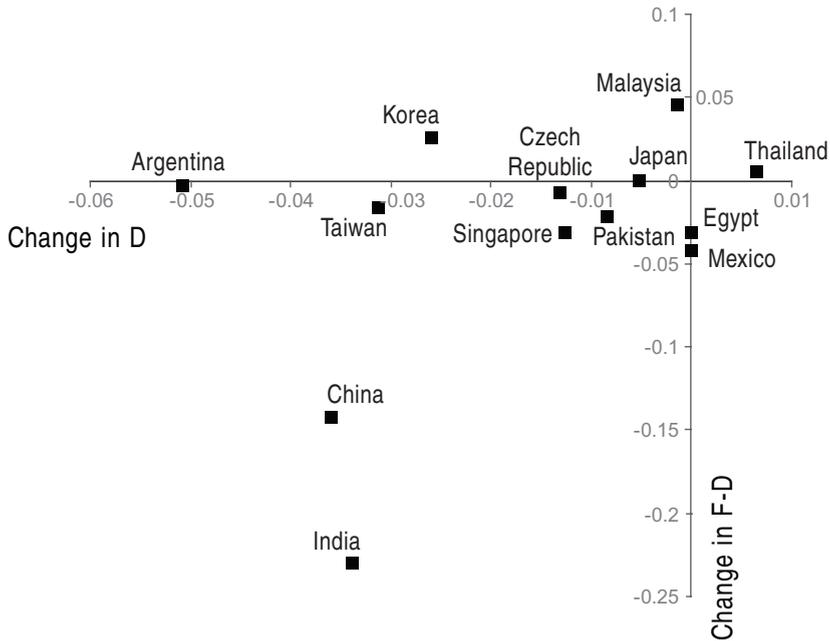
Changes in insurance policies in China are compared with those in other countries for the period 1997–2004 in Figure 6.5, which shows the changes in (rather than the levels of) (F-D) and D. This figure was reported by Dee and Dinh (2007), who pointed out that, for many countries, the policy change in this period was relatively small. China, however, is one of the outliers, along with India. China's reform was driven by its WTO accession, but India's was driven by unilateral action. In China's case, significant contributors to reform were the removal of economic needs tests and quantitative restrictions on the issuance of licences for foreign firms, a widening of the scope of business that foreign insurers could undertake and a gradual reduction in the proportion of business that had to be reinsured with a nominated domestic reinsurer.

The USCSI (2007) points out that a number of impediments remain in the insurance sector, including a differential approach to approving branches for foreign and domestic companies, delays in approval of applications to convert foreign-owned branches to subsidiaries, excessive capitalisation requirements for new branches or subsidiaries, a high qualifying threshold for companies to invest their foreign exchange capital in overseas funds or equities (applies also to domestic firms), a rule that says providers that have held licences for more than eight years (which rules out foreign companies entering the market since WTO accession) can set up insurance asset management companies, protection for domestic reinsurers and differential treatment of companies that invested in China before or after its WTO accession.

## Transport

In many cases, the domestic markets for road transport, inland water transport, forwarding, storage and warehousing and courier services had already been deregulated. WTO commitments then extended that policy to foreign entry, though the policy change was not usually applied immediately (for details see Luo and Findlay 2004). It was instead according to a schedule and with restrictions on the form of foreign entry. With the exceptions of air transport (which is discussed in more detail below) and internal water transport, the impact of the commitments at the time of accession and in the medium term—as commitments to higher levels of foreign ownership are phased in—will be significant. Even the relatively closed rail sector will be open to foreign entry under China's WTO commitments. The strategy in logistics, in other words, has been first a movement to domestic deregulation followed by a reduction in the discrimination against foreigners.

Figure 6.5 Reform of barriers to trade in insurance services, 1997–2004



**Source:** Dee, P. and Dinh, H., 2007. Regulatory barriers to trade in insurance services, The Australian National University, Canberra (unpublished).

Luo and Findlay (2004) stress the effect of liberalisation on process innovation. They note that the demand for integrated logistics services—that is, those provided by so-called third-party logistics firms—is increasing. These firms try to provide and control the whole chain of services. They need to have access to all the relevant licences, which could include international freight forwarding, different modes of transportation (air, international shipping, domestic shipping, road, rail), storage and warehousing, container station and depot services, as well as courier services. The opening up of the different sectors in logistics, Luo and Findlay argue, would have a significant impact on the ability of third-party logistics firms to provide the whole chain of services. Some foreign and domestic firms that originally had restricted access to some links of the services (for example, international freight forwarding) will develop integrated services after the restrictions are lifted.

The commitment to allow fully foreign-owned international freight forwarding operations was implemented in rules issued in December 2005. According to the USCSI, a problem remains in the application of the regulations: it says that its experience has been that wholly foreign-owned firms have been unable to obtain a licence that allows them to book cargo space on airlines within China or operating internationally.

The airline sector provides an example of domestic deregulation: the policy on foreign entry has remained restrictive while restrictions on entry to domestic routes have been relaxed (Zhang and Chen 2003).

The first steps in reform of the air transport sector in China involved the separation of commercial operations from government. This process began in 1987, when six key state-owned airlines were separated from regional administration bureaux, while the entry of new operators was encouraged. The main carriers tended, however, to have a regional specialisation.

The only source of capital for these airlines initially was government funding, but this constraint was relaxed in 1993 and the sector was opened to foreign investment with some remaining restrictions on foreign control (still at a maximum of 49 per cent) (WTO 2006:236). Prices on major routes charged by these businesses remained under government control, until that regulation was relaxed in 1997.

A process of reorganisation of the sector under government leadership began in 2001. The airlines then under the regulatory control of the Civil Aviation Administration of China (CAAC)—a total of 10—were consolidated into three groups. Policy had shifted, in other words, from a position encouraging entry to one of a process of managed consolidation. An important driver was the financial losses earned in the industry. Non-CAAC airlines were not affected by the plans for consolidation and a number continued to operate.

While domestic policy moved through a cycle from state monopoly to free entry to managed consolidation, international policy remained conservative. Chinese policymakers—in the bilateral negotiations on market access that operate in international aviation—aimed to balance market shares, sought commercial arrangements between carriers from both ends of a route, limited the number of Chinese and foreign airlines designated to operate on a route and attempted to limit entry by third-country carriers.

In July 2004, the United States and China signed a new bilateral agreement, however, it was not the form of 'open-skies' agreement promoted by the United States. The agreement added substantial capacity to the routes, opened up more cities for services and increased the number of operators. In a speech on 2 December 2004, US Under-Secretary of Transportation, Jeffrey Shane, said

that the agreement ‘was a huge step forward but did not remove all constraints and left “a lot to be desired”’—mainly because of the processes used to regulate access to the routes by carriers from each country.<sup>4</sup>

Zhang and Chen (2003) attribute this conservative stance on international policy to a perception of a lack of competitiveness of Chinese airlines, including lack of management experience in competing in international markets, an expected imbalance between foreign arrivals (likely to prefer their own home-country carriers) and Chinese tourist departures, and inadequate airport capacity (although this constraint is being relaxed).

## Distribution

Distribution of trade services is composed of four main sub-sectors: commission agents’ services, wholesaling, retailing and franchising. Principal activities include reselling merchandise, accompanied by a variety of related subordinated services, such as: inventory management; assembly, sorting and grading of bulk lots; breaking bulk lots and redistributing into smaller lots; delivery services; refrigeration, storage, warehousing and garage services; sales promotion, marketing and advertising, installation and after-sales services, including maintenance and repair and training services. Chul et al. (2003) review China’s experience in reform in this sector.

Before the reform that began in 1978, state-owned firms or government bureaucracies dominated the retail and wholesale distribution system and nearly all prices were government controlled. By 2000, in the consumer goods sector, state-owned firms accounted for 18.2 per cent of sales, collectively owned firms for 15.6 per cent and the balance was in the hands of private firms or foreign-owned firms from Hong Kong, Macau or Taiwan (the last group accounting for 1.7 per cent).

Until 1992, foreign investors were prohibited from operating joint ventures or wholly owned enterprises in retailing or wholesaling. In that year, however, new regulations permitted joint ventures (in which the Chinese partners were dominant and with some limitations on operations) in retailing in selected cities. After that time, local governments also took the initiative to approve a number of joint ventures, but most were not mandated by the central government and were set up without permanent establishments—for example, through management contracts or leasing arrangements. A new regulation in 1998 prohibited local governments from offering approvals in this sector. Further regulatory change in 1999 removed the geographical restrictions on the location of joint ventures that the central government had previously imposed.

Wholesaling was opened to foreign firms (operating as minority foreign ownership joint ventures) within a year of China's WTO accession. Longer time limits applied to books, pharmaceutical products, pesticides and films (all three years after accession) and fertilisers and oil products (five years), although salt and tobacco remained exceptions. Majority foreign-owned joint ventures were permitted after two years. All geographical restrictions on wholesaling and all restrictions on ownership were to be removed within three years—that is, by 11 December 2004. In retailing, caps were retained on the number of joint ventures in some larger cities and special economic zones. Geographical restrictions were removed in the case of provincial capitals. The same time limits applied in retailing to the groups of products to which schedules applied in wholesaling. Otherwise there was no constraint on the types of products that could be sold. All market access limitations were to be removed within three years (various restrictions remained for longer on operations and ownership of some types of chain stores and very large department stores).

China fell behind schedule in the implementation of these commitments (USTR 2004). For example, in wholesaling, participation was limited to minority-owned joint ventures beyond the December 2003 deadline for a further relaxation of that rule. Also a number of qualification requirements were imposed (for example, rules on sales volumes and asset values). The schedule was reinstated by mid 2004, when a commitment was made to also meet the next milestone of 11 December 2004. This commitment was embodied in new regulations, which continued to require approval from the Ministry of Commerce before services could be provided. The USTR (2004) remained concerned, however, that there was no guidance on how the process of approving applications would operate (the USTR report is dated 11 December 2004). The same experience occurred in retail services. By 2006, US businesses were referring to distribution as a 'success story' (United States-China Business Council 2006). The Ministry of Commerce devolved the right to grant licences to provincial authorities and 'the problem largely disappeared' (p.2). In some parts of distribution, however, devolution does not necessarily solve the problem. As the United States-China Business Council also points out (p.10), municipal authorities can reject applications for new retail outlets on the grounds that otherwise local commerce would be 'disrupted'. Strictly, this concern applies to domestic and foreign entrants.

WTO accession shifted the direction of reform to removing discrimination against foreigners. The assessment by Chul et al. (2003) is that the deregulation of the 1990s had larger impacts on distribution than those expected from WTO accession, at least within the first couple of years. Many large foreign retailers had already entered China and their geographical spread was widening. Foreign

participation in this period had the advantage of providing new methods (including those related to information technology) and different retail formats, which were examples of process innovation similar to those observed in logistics. Reform had also contributed to competition, which was associated with a fall in sales margins.

## Conclusions

China's experience to date in financial services, transport, distribution and telecommunications services shows the importance of distinguishing between key elements of the reform process.

The first step in China has usually been to deregulate the domestic market. In some cases, restrictions on foreign participation have not changed and, if they did, the extent of discrimination against foreigners increased. In other cases, foreign participation has been permitted, but usually with restrictions on the form of establishment and the nature of operations.

The second stage—implemented in most cases after WTO accession—has been to reduce the extent of discrimination against foreigners. This stage also involves a schedule of steps, not an immediate movement to full liberalisation.

Services reform tends to be partial, for good public policy reasons. It involves a series of steps, and in that respect China's experience is not unique. But the problem is that different sequences can be followed. In one of these—more likely when a process of international negotiations drives reform—foreign entry receives priority while entry by domestic firms remains regulated. This approach risks welfare losses from rent seeking by foreign providers, who form a new set of political interests affecting the next steps in the reform process.

In another sequence, evident in China's approach, the priority in the first stages is given to domestic deregulation instead of foreign entry. This avoids the risk of foreign rent seeking, but there are trade-offs. A focus on domestic deregulation delays the receipt of the benefits of foreign participation (and, in the short term, discrimination against foreign suppliers could even increase). There is also a risk that reform could stall, as this sequence creates a new set of domestic interests who oppose further reform.

The choice among these options hinges on the ease of management of the various interests created as a consequence of the sequencing problem—domestic and foreign. China's choice clearly has been to prioritise domestic deregulation before a wider opening. This process has been effective in the sectors studied here, though with substantial progress remaining to be achieved in some sectors, particularly telecommunications and aviation.

WTO commitments play a key role in either approach. Even as in China's case, with a schedule of implementation, they help deal with the risk that partial reform could be captured and stalled. They set up a credible set of policy commitments, which trading partners can monitor and influence, as illustrated by the annual reporting of the USTR. Further application of WTO principles avoids a situation in which putative foreign entrants seek a share of the market and then argue to hold out further entry, as might happen as a consequence. This argument is explained in more detail by Dee and Findlay (2007).

Our interests in this chapter are China's commitments under the GATS and their implementation. China has, however, become an active participant in bilateral negotiations and in some of these agreements services are included. Antkiewicz and Whalley (2005) review China's negotiations in preferential trading arrangements. They point out that, at least for the negotiations with Hong Kong and Macao in 2003, eligible suppliers 'gain improved access to Chinese markets and sooner than those from other countries' (p.1544). In this case, the continuing implementation of China's WTO commitments could limit the impact of the preferential elements of these agreements, although firms from Hong Kong and Macao have important 'first-mover' advantages. Antkiewicz and Whalley (2005:1,544) also note the possibility that the effect of local regulations could prove to be the 'binding restriction' and, in that case, commitments under the preferential agreements would be of little importance.

The China material here is illustrative, but further empirical work on the nature of services sector policy reform is valuable, including work on the modelling of options for reform. The calculation of a set of indices of services policy restrictiveness in China for a time period beginning as early after the start of reforms as possible and continuing through to the present could be used to 1) confirm the impressions of the path of reform, in particular, its two-step structure; 2) test hypotheses about the differences between sectors in the degrees of restriction and the trajectories of their removal, including the rate at which the WTO commitments are implemented; 3) extend the options for the design of experiments in policy modelling; and 4) identify the factors that add to or ameliorate the risks of stalling reform. A further application of this material is to relate the changes in the index values to outcomes in services markets and to various performance indicators, such as productivity improvements, price falls, quality increments, innovation and so on, and thereby to assess the contribution of policy reform to these changes.

## Notes

- 1 Generally, the value of D will be less than one, since some restrictions that apply to foreign entry do not apply to domestic firms. For more discussion of the calculation of the indices, see the papers in Findlay and Warren (2000).
- 2 Kox and Lejour (2004) review a number of other studies that examine the effect of reform of cross-border trade. Whalley (2004), in his review of the empirical work, highlights the complementarity of openness in factor markets with liberalisation of cross-border transactions but pays less attention to the sequencing questions examined here. Walmsley and Winters (2003) estimate the benefits of more open markets for labour.
- 3 For example, China Unicom has fixed-line operations only in the city of Tianjin and part of the province of Sichung.
- 4 From US Department of State (2004). Available online at <http://usinfo.state.gov/eap/Archive/2004/Dec/06-984604.html>

## References

- Anderson, K., 1995. 'Lobbying incentives and the pattern of protection in rich and poor countries', *Economic Development and Cultural Change*, 43(2):401–23.
- Antkiewicz, A. and Whalley, J., 2005. 'China's new regional trade agreements', *The World Economy*, 28(10):1,539–57.
- Bhattasali, D., Li, S. and Martin, W.J., 2004. *China and the WTO: accession, policy reform, and poverty reduction strategies*, World Bank, Washington, DC.
- China, 2006. 'China fully opens up its banking industry from Monday', Embassy of the People's Republic of China in the United States of America, Washington, DC, 12 November. Available online at <http://www.china-embassy.org/eng/gyzg/t283169.htm>
- Chul, K.H., Itoh, M., Luo, W., McGuire, G., Moon, W. and Shimoi, N., 2003. The costs and benefits of distribution services trade liberalization, University of Tokyo, Tokyo (unpublished).
- Dee, P. and Findlay, C., 2007. Services in PTAs—donuts or holes?, The Australian National University, Canberra (unpublished).
- Dee, P. and Hanslow, K., 2000a. *Multilateral liberalisation of services trade*, Staff Research Paper, March, Productivity Commission, Canberra.
- , 2000b. 'Modelling the liberalisation of services', in *Achieving Better Regulation of Services*, Conference Proceedings, AusInfo, November, Productivity Commission and The Australian National University, Canberra.
- Dee, P. and Dinh, H., 2007. Regulatory barriers to trade in insurance services, The Australian National University, Canberra (unpublished).
- Dee, P. and Sidorenko, A., 2003. The rise of services trade: regional initiatives and challenges for the WTO, Paper prepared for the twenty-ninth PAFTAD Conference, 'Reshaping the Asia Pacific Economic Order', Jakarta, December.

- Domah, P., Pollitt, M.G. and Stern, J., 2002. *Modelling the costs of electricity regulation: evidence of human resource constraints in developing countries*, DAE Working Paper, No. 0229, Department of Economics, University of Cambridge, Cambridge.
- Findlay, C. and Warren, T. (eds), 2000. *Impediments to Trade in Services: measurement and policy implications*, Routledge, London.
- Findlay, C., Chun Lee, R., Sidorenko, A. and Pangestu, M., 2002. Telecommunications, Paper presented to the twenty-eighth Pacific Trade and Development Conference, 'Competition Policy in the New Millennium', Philippine Institute for Development Studies, Manila, 16–18 September.
- Francois, J. and Spinanger, D., 2001. Greater China's accession to the WTO: implications for international trade/product and for Hong Kong, Paper prepared for the Hong Kong Development Council, December.
- Hoekman, B., 1999. The next round of services negotiations: identifying priorities and options, Paper presented at the Federal Reserve Bank of St Louis conference, 'Multilateral Trade Negotiations: issues for the millennium round', 21–22 October (revised 4 November 1999).
- Kox, H. and Lejour, A., 2004. *A different approach to WTO negotiations in services*, CPB Discussion Paper, No. 36, July.
- Luo, W. and Findlay, C., 2004. 'Logistics in China: accession to the WTO and its implications', in D. Bhattasali, S. Li and W.J. Martin, *China and the WTO: accession, policy reform, and poverty reduction strategies*, World Bank, Washington, DC.
- Mattoo, A., 2004. 'China's accession to the WTO: the services dimension', in D. Bhattasali, S. Li and W.J. Martin, *China and the WTO: accession, policy reform, and poverty reduction strategies*, World Bank, Washington, DC.
- Mattoo, A. and Sauve, P., 2003. *Domestic Regulation and Service Trade*, World Bank, Washington, DC.
- McGuire, G., 2003. 'Methodologies for measuring restrictions on trade in services', in Organisation for Economic Co-operation and Development (ed.), *Quantifying the Benefits of Liberalising Trade in Services*, Organisation for Economic Co-operation and Development, Paris.
- McGuire, G. and Findlay, C., 2005. 'Restrictions on trade in services: trade liberalisation strategies for APEC member economies', *Asian-Pacific Economic Literature*, 19(1):18–41.
- Messerlin, P. and Zedillo, E., 2004. *Trade, Development and the WTO: an action agenda beyond the Cancun Ministerial*, Interim report, 20 April. Available from <http://www.unmillenniumproject.org/html/tf9docs.shtml>
- Overmyer, M., 2006. 'WTO: year five—with China's WTO entry requirements winding down, will 2006 become China's "Year of the bank"?', *China Business*

- Review Online*. Available from <http://www.adelaide.edu.au/news/news19001.html> (accessed 21 May 2007).
- Pangestu, M. and Mrongowius, D., 2004. 'Telecommunications services in China: facing the challenges of WTO accession', in D. Bhattasali, S. Li and W.J. Martin, *China and the WTO: accession, policy reform, and poverty reduction strategies*, World Bank, Washington, DC.
- United States-China Business Council (US-CBC), 2006. China's implementation of World Trade Organization commitments, Written testimony, 28 September.
- United States Coalition of Services Industries (USCSI), 2007. Statement by the Coalition of Service Industries for Senate Finance Committee Hearing on Challenges in US-China Economic Relations, 27 March.
- United States Trade Representative (USTR), 2004. *2004 Report to Congress on China's WTO Compliance*, Washington, DC, 11 December. Available from [http://www.ustr.gov/assets/Document\\_Library/Reports\\_Publications/2004/asset\\_upload\\_file281\\_6986.pdf](http://www.ustr.gov/assets/Document_Library/Reports_Publications/2004/asset_upload_file281_6986.pdf)
- Walmsley, T.L. and Winters, L.A., 2003. *Relaxing the restrictions on the temporary movement of natural persons: a simulation analysis*, CEPR Discussion Paper, No. 3719, CEPR, London.
- Warren, T., 2000. 'The impact on output of impediments to trade and investment in telecommunications services', in C. Findlay and T. Warren (eds), *Impediments to Trade in Services: measurement and policy implications*, Routledge, London and New York:85–100.
- Whalley, J., 2003. *Liberalization in China's key service sectors following WTO accession: some scenarios and issues of management*, NBER Working Paper 10143, National Bureau of Economic Research, Cambridge, MA.
- , 2004. 'Assessing the benefits to developing countries of liberalisation in services trade', *The World Economy*, 27(8):1,223–53.
- World Trade Organization (WTO), 2006. *Trade Policy Review, Report by the Secretariat—People's Republic of China—Revision*, WT/TPR/S/161/Rev.1, 26 June, World Trade Organization, Washington, DC.
- Zhang, A. and Chen, H., 2003. 'Evolution of China's air transport development and policy towards international liberalization', *Transportation Journal*, 42:31–49.

## Acknowledgments

Thanks to Will Martin and Aaditya Mattoo for comments on earlier versions of this chapter. Thanks to Philippa Dee for providing the insurance sector diagram and commentary on that figure. Errors are the authors'. Work on this chapter was supported by a grant from the Australian Research Council.

Table A6.1 **Telecommunications index components**

Category weight	Score	Policy categories
0.3		Licensing of new fixed-network operation licences
	1.00	Issues no new licences
	0.75	Issues 1 new licence
	0.50	Issues up to 3 new licences
	0.25	Issues more than 3 new licences
0.3	0.00	No limitation on the number of new licences
		Licensing of new mobile network operation licences
	1.00	Issues no new licences
	0.75	Issues 1 new licence
	0.50	Issues up to 3 new licences
0.3	0.25	Issues more than 3 new licences
	0.00	No limitation on the number of new licences except for technical reasons
		Investment restrictions—general
		The score is inversely proportional to the maximum direct equity participation permitted in an existing telecom operator. For example, equity participation to a maximum of 75 per cent would be given a score of 0.25 <sup>a</sup>
0.1		Investment restrictions—incumbent
		The score is inversely proportional to the maximum direct equity participation permitted in a specific domestic telecom operator. If there is no operator-specific restriction, the score will be the same as the score for general restriction. <sup>a</sup>

<sup>a</sup> In circumstances where no new operator is allowed, a score of one is recorded for domestic and foreign indices, whereas in circumstances where new licences are issued only to domestic new entrants, a score of one is recorded for the foreign index only.

Table A6.2 Telecom index, 1998, 2004 and 2007

	Weight	China		Taiwan	
		Domestic	Foreign	Domestic	Foreign
1998					
Restrictions on establishment					
Licensing of new fixed-line operator	0.3	1	1	1	1
Licensing of new mobile operator	0.3	0.75	1	0.25	0.25
Direct investments					
— General	0.3	-	1	-	0.51
— Incumbents	0.1	-	1	-	0.80
Total		0.525	1	0.375	0.608
2004					
Restrictions on establishment					
Licensing of new fixed-line operator	0.3	0.5	0.5	0.25	0.25
Licensing of new mobile operator	0.3	0.75	0.75	-	-
Direct investments					
— General	0.3	-	0.75	-	0.4
— Incumbents	0.1	-	0.75	-	0.8
Total		0.375	0.675	0.075	0.275
2007					
Restrictions on establishment					
Licensing of new fixed-line operator	0.3	0.5	0.5	-	-
Licensing of new mobile operator	0.3	0.75	0.75	-	-
Direct investments					
— General	0.3	-	0.51	-	0.4
— Incumbents	0.1	-	0.51	-	0.8
Total		0.375	0.579	-	0.2