

The Role of Institutions in the Services Sector

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Introduction

This paper describes the development of institutions following North (1989). The role of institutions in the services sector is highlighted due to the unique character of services as opposed to goods. In particular, information asymmetry, the difficulty of measurement, and the problems of enforcement in the services sector require a regulatory and institutional system that minimizes the transactions cost of both supplier and buyer and, hence, prevents market failure. In the international trading environment, these concerns become doubly complicated by the myriad forms of governance that are as much a product of history and culture as they are of national tastes and preferences.

The primary approach to services trade liberalization is to look into a balance of national and international regulatory systems, that is, allowing national governments to maintain some autonomy without being subject to a "competition" of regulatory systems. In this sense, harmonization and mutual recognition agreements may be the best approach to a smoother series of negotiations in trade in services. Given the difficulties attached to this undertaking, however, a second best approach for national governments is to require commercial presence for foreign service providers. Such a requirement forces foreign providers to be subject to domestic laws, rules and regulations.

1. Institutions and the Division of Labor

North (1989) ascribes the increasing role of institutions in economic transactions to the change in the nature of economies from one characterized by personal exchange to one of impersonal exchange. In a world of personal exchange, economic

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agents are well informed of each other's "attributes, characteristics and features" through social networks and repeated dealings allowing them to make a confident assessment of their ability to meet obligations exchanged in the market. The corollary is a greater ability to judge the quality of goods and services being exchanged where quality is a function of the combination of productive inputs of the seller, that is, how a producer fuses his set of knowledge with physical inputs to produce the good or service being sold. In small communities, especially those built on kinship relations, information is easily exchanged and, therefore, free or has minimal cost.

Over time, markets have gained greater complexity represented by specialized interdependence. What used to be commodities produced within the confines and boundaries of the household, for example, staple food and clothing, are now bought in modern markets. What used to be activities done by family members, for example, laundry and housekeeping, modern markets now offer as services. With specialization, the range of occupations and industries has expanded to accommodate the greater demand for goods and services that have ceased to be produced internally by households.

Market exchange becomes impersonal as transactions cover longer time periods and traverse greater distances. There are more densely populated communities. With globalization, economic boundaries are less distinct enabling exchange across greater distances. Futures markets, where goods are exchanged even before they are produced, now complement spot markets. Technological advancement, especially in areas of computing and telecommunications, have reduced the cost of transacting over distances resulting in greater accessibility of markets and the creation of new ones. Agents are now less able to determine the attributes of the buyers and sellers and the features of the good or service that is being exchanged. The difficulty raises the need to enforce agreements and contracts but time and space limit this ability as well.

The costs of transacting in the market can be high if buyers still have to get the necessary information to assess the nature of the market exchange being proposed, that is, to ascertain whether the nature of the good or service is commensurate to its price. In case of failure to meet obligations the buyer will have to incur additional costs in order to enforce

the contract. The inability to measure attributes and the high cost of enforcement serve as incentives to engage in opportunistic behavior. Some sellers can cheat by providing inferior goods and services or shirking from their responsibilities. Society must face losses when opportunistic behavior is not curtailed. Thus, some mechanism must be found to minimize these losses. The inability to do so may lead to widespread market failure—buyers will not buy because goods and services are suspect while sellers will not sell because there are no buyers.

Institutional structures, both formal and informal, have developed along with the increase in the division of labor in order to reduce uncertainties that come with impersonal market exchange. Only those structures that prove to be reliable remain over the entire course of development.

There are two complementary institutional structures. One is government, which serves as enforcer and arbitrator of contracts. The state or the government is a regulatory agency or has regulatory agencies acting on its behalf. Judges and legislators are the enforcers of contracts using a set of laws, rules and regulations that govern transactions. Property rights are assigned to agents and violations of those rights by either party requires the involvement of government—more often the judicial branch—to resolve conflicts. Goldberg (1976) divides contractual relations into two levels. There is a collective contract between the regulatory agency and regulated firms and individuals. The collective contract describes the environment for the second level of contractual relations, which is the contract as a formal representation of the actions of and between the economic agents. The collective contract, which can come in the form of the regulatory codes governing an industry or an occupation, defines the extent and limits of the formal contract.

North believes that enforcement is never perfect because of measurement problems and the often-conflicting interests of the agents involved in the transactions. Measurement is required to establish grounds for allegations regarding the behavior of agents. Efficacy of enforcement depends on reliability of measures used to demonstrate violations of property rights.

Incentive structures may not always support impartiality on the part of the regulators since they are agents themselves. The enforcers are agents of the state and of the people that

constitute the state. Unfortunately, the regulators' interests do not always coincide with the interests of the people. Corruption typifies this behavior. A payoff scheme can always be devised that will convince the regulator to act in behalf of the regulated rather than serve as impartial arbitrator serving the greater good.

The second set of institutions that North describes are those that dictate norms, which control the behavior—particularly social behavior—of economic agents. Norms are informal rules that are formed to explain and evaluate each individual's environment based on his perceptions and experiences, which are sometimes influenced by organized ideologies such as a religion, philosophy, and socio-political values. A person's set of behaviors is limited by what he or she believes in at a specific moment in time. To the extent that a person believes in the current set of laws, rules and regulations (that is, that these laws, rules and regulations represent his or her personal beliefs), that person will take on the responsibility of meeting his contractual obligations and forego any gains to be had from opportunistic behavior.

2. Information Asymmetry and Contracting in the Services Sector

Opportunistic behavior is likely to be prevalent in service provision than goods sale. Goods are physical products that have dimensions that are easily measured. Technological advancement has made measurement easier, not only increasing precision but also the range of dimensions that can be measured. Services, however, are intangible and non-storable thus lending themselves to information asymmetry problems. Only the service providers have the information necessary to ascertain the quality of input (skills and level of effort) and the resulting contingency of the quality of the service being rendered. Its intangible nature makes it difficult to be measured and monitored and this inability implies that standards will be difficult to set and maintain.

Markets characterized by information asymmetry problems have consumers and producers holding different information sets regarding the service being bought or sold.

The following three cases of information asymmetry all have service industries as examples.

When producers (or suppliers) know more than the consumers do, it is possible for them to influence the demand curve. This phenomenon is called supplier-induced demand, when the provider is able to increase the level of demand for a service. The case of medical practitioners is often cited as an example. Their superior information set on medicine and its practice allows them to influence the purchase of (and, hence demand for) drugs, the types of laboratory examinations, the length of hospital stay, and even their own consultancy services without the consumer having the information to determine whether those drugs or laboratory examinations or extra days in the hospital are indeed necessary.

Adverse selection is another form of information asymmetry problem that occurs in markets where consumers can be grouped according to a specific characteristic. From the groupings, it is possible for at least one group to impose a cost that is higher than the market average giving the producer an incentive to exclude them from the rest to save on production costs. This phenomenon is observed in the credit or financial market. Debtors can be good or bad depending on their loan repayment rate. Bad debtors increase bankers' costs by defaulting on loans. Bankers are unable to differentiate a good debtor from a bad debtor. As such, they may choose to impose a requirement for collateral as a sign of ability to pay. Unfortunately, this requirement immediately excludes borrowers who do not have the collateral but may be better at paying back the loan.

Another form of information asymmetry problem is moral hazard usually observed in the insurance market. Consumers have different risk profiles and these profiles may be altered by the presence of an insurance policy. Persons with insurance policies may have an incentive to be careless about their activities raising the probability of an accident or illness, thus, leading to more insurance payments. At worst are cases of insurance fraud when policyholders actually induce accidents to enable them to make a claim against their policy.

The losses associated with service provision are not only in terms of negative social behavior but also in the irreversibility of the service. Once a service is performed, the cost of reversing the result of the service may be prohibitive.

One cannot undo a haircut, for example, or return the advice of a lawyer, or even undo a major surgery if service provision fell below the expected level of quality.

The service provider must also be protected from consumers who can understate the level of satisfaction in order to get a free service.

Producers try to find ways to signal the level of service quality. Consumers, in turn, must seek different means of gauging the quality of service provision. The credential instruments are qualification controls, examples of which are educational degrees, certifications, licenses, and, on an informal level, reputation and membership in a club or professional association. These are usually imposed on professionals by government or private associations to ensure that some minimum standard is met and maintained. The regulations usually attempt to establish the service provider's competence, regulate practice, and ensure compliance with a code of conduct. These regulations are normally set by the government (such as the Philippine Regulatory Commission) and, in some instances, private associations in the educational and professional fields.

Buyers of services incur transactions costs if they have to ascertain the truthfulness of signals contained in credential instruments each time they need to purchase a service. Government, as an impartial third party, incurs, in behalf of the consumer, the cost of establishing standards and determining the providers' ability to meet the standards. In this way, transactions costs are minimized for the consumer.

Other service occupations and industries, however, have greater difficulty in establishing standards, especially those that have lower skills requirements or those that employ general skills. In these instances, informal means of signaling competence may be more applicable, such as the use of references and recommendations from a network of persons that carry credibility in the eyes of the service buyer.

While these signals are important, the specification of the contract remains the most important instrument for ensuring that the consumer's expectations will be met. The formal written contract contains a description of the obligations of each contractor and the terms of exchange between them. The more specific the contract in terms of identifying contingencies, the smaller the margin for violation but the greater the complexity

resulting in much higher transactions costs for both parties.

The greater the ability to enforce a contract the better the chances that obligations specified in the contract are fulfilled. Thus, governance over contracts becomes an important consideration in ensuring the validity of service contracts.

Governance structures over contracts, not only in the sense of government but that of mechanisms (including government) that regulate contracts, differ according to the features of the good or service being transacted. More importantly, governance in this paper deals with opportunism and contract violations. Williamson (1979) differentiates governance by the market from other forms of governance, including vertical integration. The market itself is a form of governance structure using the price mechanism to provide information on the commodities being transacted. The market itself is an institution that lends itself to governing activities *that meet its requirements*. Vertical integration removes transactions from the market and uses employment relations (and employment contracts) to govern labor service provision. When using this distinction in the services sector, the market for services is differentiated from the market for labor, which is labor service meant to be vertically-integrated into a firm.

Williamson describes transactions according to frequency of occurrence, which refers to the level of activity of the buyer in the market. They are also described according to the specificity of investment made by the supplier. A high frequency of occurrence, or repeated dealings, gives buyers enough information about the quality of the service that transactions cost is minimized because of little information required. Every time the buyer enters the market, more information is generated. Low frequency results in the opposite.

If a supplier does not need to invest further to produce a service, that is, that the service requires non-specific investments, then it is likely to involve general skills. The service providers would be unskilled, low-skilled and semi-skilled labor. Earlier, however, the labor services market was differentiated, therefore these types of labor services would not be sold in the market for services by definition especially when they are needed by the buyer very frequently.¹

¹ Needless to say, exemptions may be found but many of these are in the informal setting on short-term basis.

On the other extreme are transactions that require very specific investments in physical and human capital, e.g. additional training, to produce a service that is useful only for the transaction currently being negotiated. In this case, the transaction will not have any value outside of the current contract and are, thus, relationship-specific. If investments are highly specific and required frequently, the buyer may opt to internalize the service by employing the provider. As with general skills then, the transaction is taken out of the market and is vertically integrated into the firm. In both cases, the services could not command enough value-added in order to be transacted in the market for services.

Somewhere in between are mixed transactions, not requiring highly specific investments by the supplier but needing more than the general skills.

When mixed transactions occur occasionally, a third party mediating between buyer and seller (arbitrators) are adequate for settling claims against contracts. Arbitration allows both parties to sustain their relationship over a longer period given that the service is needed occasionally. Vertical integration would be too expensive for the infrequent nature of the service provision while market exchange is not feasible because mixed transactions need non-standard, relationship-specific investments. (This is also a good explanation for why services tend to be differentiated products.)

Most services would be characterized as mixed transactions that occur more frequently. Transaction-specific contracts will be made between buyer and supplier if the service provided is not too general that the buyer will opt to hire a service provider on a regular basis (employee relations) or too specific that the buyer is the only one that will find the service useful and, therefore, too costly to supply. In either case, a service cannot be said to have been sold in the market rather the buyer internalized the service.

A service, before it can be sold, must necessarily offer its supplier an advantage or a value-added and that advantage will come from the additional investment needed by the buyer. Instead of the buyer making the additional investment, it is more reasonable to hire someone who has or is willing to do so. Sick people do not have to study medicine to cure themselves because that would be more costly than buying medical service

The additional investment, usually additional knowledge, is the source of the information asymmetry—the supplier should know more than the buyer before a transaction will take place—and, at the same time, this additional knowledge is the source of the incentive to engage in opportunistic behavior precisely because the supplier knows more than the buyer.

A typical approach to the information asymmetry problem (a.k.a. the principal-agent problem) will take the form of designing a fee structure that will induce the service provider to internalize the optimization problem of the service buyer. This is the market solution and is acceptable only up to a certain degree. Governance, regulation and contract specification remain necessary to balance out the conflicting interests between the buyer and the supplier since the problem of information asymmetry leads to market failure.²

3. Trade in Services: International Conflicts

Governance and regulatory issues become just a little more complicated when service provision crosses national borders since service contracts will now have to face the problem of jurisdiction.

A service provider is both an economic agent and a political citizen. She brings to the negotiating table not only her skills but also her rights, duties and obligations as a citizen of a specific polity. She is subject to the laws, rules and regulations of her home country, and agrees to be subject to the laws, rules and regulations of her prospective host country. The problem is that these two sets of laws, rules and regulations are often not the same in their most important respects, and may even be incompatible at times.

Principal and agent are not bound by the same set of rules. Their negotiations toward a mutually satisfying fee structure may be hampered by divergences in the applicable rules. The solution—usually contained in the service contract—may contain provisions only grudgingly accepted by one or both parties. The laws are not only different in terms of those that govern contract-making itself but also in terms of the regulations

² Microeconomics textbooks discuss this as the market for lemons.

governing a particular service industry. The regulations differ in form and in strictness.

Since services are difficult to measure, trade protection will also be difficult to implement. Tariffs are obviously not applicable. Hence, the tendency will be to use non-tariff barriers that are likely to affect the applicability of foreign credential instruments. Bans against entry, establishment and practice are also heavily used. The unfortunate result of these barriers is to lower the frequency of transactions occurring in the market and thereby limiting the amount of information made available to buyers.

The presence of regulation is not without cost to the supplier of the service, with stringent regulation assumed to be more costly to the producer. The entry of foreign service providers into countries with stricter regulation can have two effects according to Hindley (1991). One possibility is that the domestic service industry will be unable to compete because the foreign service provider will have lower cost of production. The other possibility is that the domestic regulatory system itself adjusts its level of stringency (i.e., lowers) in order for domestic producers to become competitive. Hindley (1991) refers to this as competition between regulatory systems. Differences among regulatory systems also reflect differences in consumer preferences since regulators are their representatives. Trade in services asks consumers which of the regulatory systems reflect their preference for quality control. Consumers must then ask themselves if stricter regulation is worth the higher price.

Opening up to trade in services thus goes beyond trade policy and into a country's institutional setting. Laws, rules and regulations become subject to debate every time a contract involves parties from different—and probably opposing—sets of institutions. Cultural differences, especially those that rule private professional clubs and associations, can serve as barriers in themselves, and removing these differences can be very costly not just economically but politically and socially as well. This difficulty is in addition to the tendency of regulators to rationalize their existence in the face of potential job loss that comes with trade liberalization (or deregulation).

Unfortunately, many trade negotiators and policymakers do not recognize these observations. Given such a situation, it

will be almost impossible to talk about liberalization of trade in services without discussing its implications on regulatory institutions.³

Mattoo (1997) saw the difficulties of implementing the World Trade Organization principles of market access and national treatment given the way that the General Agreement on Trade in Services (GATS) has been formulated. Under the General Agreement on Tariffs and Trade (GATT) that covered trade in goods, a clear distinction was made between tariff concessions (or border measures) and internal measures, the latter referring to internal taxes and charges, as well as laws and regulation, that may be imposed on an imported good or to a similar domestic product. GATT Article III does not allow for internal measures and considers them as a violation of the national treatment principle.

Under trade in services, most measures will be in the form of internal measures rather than border measures. Is it still possible to distinguish between the principles of market access and national treatment? Mattoo asks. The current make-up of the GATS contains definitional problems that not only refer to the scope of market access and national treatment but also how these are applied to the various modes of supply for services as enumerated in the Agreement. The four modes of supply identified under the GATS seem to have the effect of diluting commitments. Mattoo points out that a service sector may continue to receive protection as long as a country can differentiate commitments by mode of supply. It can opt to open the sector through one mode of supply but not in another.⁴

Harmonization of regulations and institutions is a solution to the difficulties described above but this will require long-standing negotiations and very few countries will succeed in doing so. Self-regulating organizations have the reputation of being protective of their own territories. The more countries engaged in harmonization, the harder it will be to reach agreement on a level of regulation that is acceptable to all, especially when rights and obligations are a function of a people's historical and cultural context.

³ Indeed, the financial crisis triggered by the series of currency devaluations in Asian economies in 1997 has come to be recognized as a crisis of financial regulation at the international level.

⁴ The four modes of supply are: cross-border supply, consumption abroad, commercial presence, and presence of natural persons.

Mutual recognition may be a less contentious approach because it allows the countries to maintain its institutions. However, mutual recognition removes only those barriers related to quality signals. It does not deal with the rights and obligations of persons in a contract. The ASEAN is preparing a draft Mutual Recognition Agreement following guidelines produced by the World Trade Organization for the accountancy sector.

The experience of the European Economic Community (EEC) in establishing a common market for services reflects the difficulties associated with harmonization and mutual recognition. Roth (1988) pointed to the change in the EEC's view on the appropriate approach to removing the restrictions against trade in services. The Community began in the 1960s with a rather ambitious aim of "far-reaching approximation of substantive law." This meant that harmonization of laws, for example, the law on insurance contracts, training regulations and professional standing, would be achieved. During the 1970s, this view had changed to search for a minimum level of harmonization. In the mid-1980s, mutual recognition especially in education and training became the humbler objective. It became the responsibility of the home country to determine the appropriate "standards," to wit:

Services shall—at least in principle—be treated according to the home country principle throughout the Common Market as regards "product" requirements. (Roth, 1988: 44)

Eventually, it is not only laws, rules and regulations that are affected by harmonization and mutual recognition but also the institutions that deal with the production of credential instruments, specifically education, training and apprenticeship institutions. Once the quality of output is standardized, the "production methods" become standardized, too. According to the Philippine Regulatory Commission, the medical and related professions are already discussing guidelines to harmonize academic and experience requirements in preparation for liberalization of the sector although discussions are limited to domestic concerns. The maritime sector, in particular, knows that its training institutions do not meet world standards.

The imposition of commercial presence requirement is

services trade, or the requirement for service providers to establish legal presence in the host country is a partial solution to the problem discussed above. This is equivalent to a preference for foreign direct investment in services over trade in services. It is resorted to by countries as a means to preempt the potential damage from the opportunistic behavior that is inherent in services trade. The commercial presence requirement places all parties under one institutional regime by converting a trade in service between two countries into domestic production in one country.

4. Trade in Services: Internal Conflicts

Foreign direct investment distributes assets beyond domestic borders to take advantage of tariff walls or location-specific attributes that lower overall cost of production. Development policy is geared towards attracting foreign investment to boost national income and generate employment.

One hundred percent equity for foreign investors is allowed in the Philippines except for the sectors listed in the negative list of the Foreign Investments Act of 1991 (R.A. 7042). The Act and several other statutes and regulations set the extent and limits, and rights and obligations of an investor. Most of the sectors in the negative list are service industries. The World Trade Organization considers foreign investment as a mode of supply for services and refers to it as commercial presence. The Foreign Investments Act of 1991 is also a basis for Philippine commitments to the GATS.

Another mode of supply for services according to the GATS is the movement of natural persons. Both modes recognize that many services need physical proximity of buyer and supplier before they can be provided.

Discussions under the movement of natural persons mode of supply revolve around barriers to entry and practice and the effects of trade in services liberalization on domestic employment. Many countries reserve employment for their citizens, which is consistent with objectives of employment generation. The Philippine Constitution in Article XII Sections 2 and 14 and enabled by Article 40 of the Labor Code indicates a preference for Filipino labor. However, since physical proximity is important in service provision, is it possible to

distinguish between commercial presence and the movement of persons in terms of their employment effects?

One of the requirements for an employment permit is the labor market test.⁵ The labor market test determines whether a Filipino "who is competent, able and willing, at the time of application, to perform the services for which the alien desired" is available to take on the job. If so, the alien cannot be employed. The Philippines has committed to reviewing its labor market test in the General Agreement on Trade in Services within two years of date of effectivity. Malaysia and Thailand have requested the Philippines to relax the requirement in relation to negotiations within the ASEAN Framework of Agreement on Services. The Department of Labor and Employment is the lead agency for undertaking the review and has held consultations with seven sectors to determine whether the test should be removed or not: construction, tourism, maritime, air transport, telecommunications, finance, and business and professional sectors. The GATS commitments of the Philippines were limited to four service sectors only: transport services, communications, finance, and tourism.

Exemptions to the labor market test are possible if employment is undertaken under a joint-venture or technology transfer arrangement or when expertise is needed such as when knowledge is specific to the installation of specialized machinery manufactured outside the Philippines. There is a memorandum of agreement between the Department of Labor and Employment (DOLE) and the Board of Investments intended to "relax procedural guidelines relative to the issuance of Alien Employer Permits."⁶ Relaxation of guidelines, however, refers mostly to shortening the application period. The technology transfer arrangement usually means engaging two Filipino understudies who will later on assume the foreigner's position. This requirement has had limited success, however, because less than 10 percent of the understudies assumed the trainer's

⁵ The labor market test is only one of several requirements for employment but is perhaps the most important. Entry into Philippine borders is regulated by the Department of Foreign Affairs through the issuance of a visa. For purposes of employment, the 9G visa is needed for entry. Employment cannot begin, however, without the Alien Employment Permit given by the DOLE. Some DOLE regional offices have complained that the permit has been circumvented by letters from the Department of Justice allowing the foreigner to work even without the permit.

⁶ Director Manzala of BLE-DOLE during the Integrative Consultative Workshop regarding the Review of the Labor Market Test held last 20-22 November 1997 in Olongapo City.

Table 1
Number of Alien Employment Permits Issued by Occupation

| Occupation | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|--------------|--------------|--------------|--------------|--------------|--------------|
| Professional, Technical and Related Workers | 352 | 404 | 400 | 509 | 611 | 825 |
| Administrative, Executive and Managerial Workers | 1,001 | 1,427 | 1,069 | 1,722 | 2,092 | 2,463 |
| Clerical and Related Workers | 1 | 1 | 0 | 1 | 5 | 11 |
| Sales Workers | 12 | 8 | 1 | 4 | 8 | 37 |
| Service Workers | 105 | 63 | 63 | 39 | 110 | 180 |
| Agricultural, Animal Husbandry and Forestry Workers | 31 | 23 | 71 | 64 | 73 | |
| Production and Related Workers | 112 | 107 | 140 | 112 | 195 | 185 |
| Total | 1,614 | 2,033 | 2,144 | 2,457 | 3,094 | 3,701 |

Source: DOLE

position. The Office of the President, through the Department of Justice, can also give a letter of exemption. These exemptions exist because of the policy to promote entry of foreign investors. Many investors prefer to bring in their own personnel, mostly managers, to direct their operations. These managers ostensibly carry specific knowledge and skills for running the company. Data on Alien Employment Permits show that most foreigners in the Philippines are employed in administrative, executive, and managerial occupations. (see Table 1.) The foreigners are mostly employed by service industries.⁷ (see Table 2.)

If it is not possible to distinguish employment effects between commercial presence and movement of persons, then how can one reconcile the investment promotion and employment protection in the services industry?

The presence of a negative list in the Foreign Investments Act implies a preference for the employment of foreign service providers rather than foreign direct investment. This is so in

⁷ This includes all industries except agriculture, fishery and forestry, mining and quarrying, and manufacturing.

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Table 2
Number of Alien Employment
Permits Issued by Industry

| Industry | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|--------------|--------------|--------------|--------------|--------------|--------------|
| Agriculture, Fishery & Forestry | 59 | 41 | 107 | 102 | 90 | 31 |
| Mining & Quarrying | 14 | 15 | 26 | 59 | 48 | 21 |
| Manufacturing | 715 | 913 | 863 | 939 | 1,140 | 1,260 |
| Electricity, Gas and Water | 7 | | | 83 | 61 | 67 |
| Construction | 29 | 13 | 101 | 282 | 462 | 438 |
| Wholesale & Retail | 256 | 400 | 372 | 347 | 451 | 573 |
| Trade | | | | | | |
| Transportation, Storage & Communication | 190 | 229 | 652 | 206 | 300 | 431 |
| Financing, Insurance, Real Estate & Business Services | 89 | 93 | 119 | 134 | 210 | 432 |
| Community, Social and Personal Services | 255 | 329 | 204 | 299 | 332 | 448 |
| Total | 1,614 | 2,033 | 2,144 | 2,457 | 3,094 | 3,701 |

Source: DOLE

the sense that employment is possible as long as the appropriate requirements, including providing the credential instruments, are met. Very few foreigners are able to come in perhaps because the stipulations are difficult to meet. These observations are true especially for the professional services sector.

To practice a profession necessarily means investment in that sector, and investment, in order to be meaningful, must be accompanied by practice.⁸ Therefore, to ban investment in certain services sectors necessarily implies a ban on the

⁸ Gray areas abound, of course. One can always think of an owner-investor as a manager and not a practitioner. The practice of professions falls under the jurisdiction of the Philippine Regulation Commission (PRC) while employment falls under the Department of Labor and Employment (DOLE).

THE ROLE OF INSTITUTIONS IN THE SERVICES SECTOR

Table 3
Comparison of Actions on Service Sectors
on Foreign Equity Limit and the Labor Market Test

| Service Sector | Foreign Equity Limit (R.A. 7042) | GATS Commitment | | Labor Market Test Consultations |
|--|----------------------------------|---|--|---|
| | | Commercial Presence | Movement of Persons | |
| Mass media except recording | 0% | Not in schedule | | No consultations |
| Service involving the practice of licensed professions | 0% | Not in schedule | | Relaxation for selected occupations ⁹ |
| Retail Trade | 0% | Not in schedule | | No consultations |
| Private Security Agencies | 0% | Not in schedule | | No consultations |
| Ownership, operation and management of cockpits | 0% | Not in schedule | | No consultations |
| Private recruitment for employment | 0% | Not in schedule | | No consultations |
| Contracts for the construction and repair of locally-funded public works (with exceptions) | 0% | Not in schedule | | Status Quo for Construction Industry |
| Advertising | 30% | Not in schedule | | No consultations |
| Public utilities | 40% | 40% (scheduled for voice telephone, telegraph, telex, packet-switched data transmission, facsimile, and cellular mobile telephone services) | | Telecommunications: relaxation for selected occupations |
| Educational Institutions | 40% | Not in schedule | | No consultations |
| Financing companies | 40% | 49% (bank) 20 - 40 % (non-banks) | Insurance Industry: Foreigners may be employed for 5 years only, with 2 understudies | Relaxation for computerization of banking operations |
| Contracts for the construction of defense-related structures | 40% | Not in schedule | | Status Quo for Construction Industry |

⁹ These are nursing, medical technology, teaching, veterinary, medicine, nutrition/dietetics, optometry, agricultural engineering, midwifery, pharmacy, and information technology. Only information technology is not in the negative list of the Foreign Investments Act.

Table 3 (cont.) - Comparison of Actions on Service Sectors
on Foreign Equity Limit and the Labor Market Test

| Service Sector | Foreign Equity Limit (R.A. 7042) | GATS Commitment | | Labor Market Test Consultations |
|---|--|--|---|--|
| | | Commercial Presence | Movement of Persons | |
| Project proponent and facilitator of a BOT project requiring a public utilities | 40% | | | No consultations |
| franchise Private domestic construction contracts | 40% | | Not in schedule Not in schedule | Status Quo for Construction Industry |
| Air Transport General Sales and Cargo Sales Agency | Not in negative list | Commercial | Foreigners may be employed for 5 years only, with 2 understudies in Transport Industry | Relaxation for skilled, highly skilled and managerial in Air Transport Industry |
| Courier Services | Not in negative list | presence required Commercial presence required | | No consultations |
| Tourism accommodation | Not in negative list | 40% (pension house, tourist inn and apartel) | | Status Quo for Tourism Industry |
| Professional congress organizers | Not in negative list | 40% | | Status Quo for Tourism Industry |
| Travel Agencies | Not in negative list | 40% | | Status Quo for Tourism Industry |
| Maritime Transport | Not in negative list | | For specialized vessels, aliens may be employed as supernumeraries only for 6 months | Relaxation for certain areas and occupations |

Sources: Foreign Investments Act; GATS Schedule of Commitments GATS/SC/70; DOLE

employment of the persons wishing to be employed in the same sectors. While there are no explicit bans in place, the instrument for effecting a ban is the citizenship requirement for getting credential instruments. Very often, licenses and certificates cannot be issued to non-citizens. Hence, the result is similar to the negative list of the Foreign Investment Act.

Another issue on the choice of governance structure for service provision relates to whether commercial presence qualifies as a trade in service. The previous section has alluded

to this issue in terms of reconciling the differing regulatory systems of buyer and seller.

Foreign service providers must be employed by a domestic firm before they can practice. The local firm is liable for their actions and is committed to ensure that the foreigners meet minimum "quality" standards set by regulatory agencies. If this is the preferred arrangement, contractual obligations are governed by the firm but foreign service is not bought by the domestic consumer because the consumer deals with a local firm. It was only a matter of coincidence that the employee was a foreigner. Therefore, no trade occurred.

If the foreign service provider enters the domestic market by establishing a commercial presence, trade also does not occur. The foreign provider takes on a domestic identity by incorporating under local laws and agreeing to be subject to them. Although ownership of the firm is foreign,⁹ production or service provision is domestic. This is the same as a foreign manufacturing firm like Nissan establishing a factory locally and producing cars. All cars sold by this firm are domestic sales and not imports from Japan.

The insurance services sector allows 100 percent foreign equity but the authority to transact business in the Philippines comes from the Insurance Commission. Market access in the insurance industry is in fact limited by the Philippine GATS Schedule of Commitments requirement that "risks located in the Philippines shall be insured with companies authorized to transact business in the Philippines." This prerequisite translates to commercial presence requirement because a company must register with the Insurance Commission before it can engage in the insurance business.

Setting equity limits implies that entry and establishment of foreigners is allowed up to a point, although at 0 percent limit, a ban is in effect. Commercial presence requirement not only allows entry and establishment, it insists on it. Ownership limits must be specified separately. The commercial presence requirement only makes sense when seen relative to cross-border supply of services which, following this paper's

¹⁰ Following the OECD Benchmark Definition of FDI and the IMF Balance of Payments Manual, at least 10 percent of the ordinary shares of a corporation qualifies as effective control.

arguments, is pure trade in services. The only movement that takes place is the service itself.

The case of the insurance industry discussed above can be used as an illustration. A risk in the Philippines can be insured in another country as long as the insurer is able to collect the premiums and the insured can collect against the insurance should the conditions arise. The buyer and seller need not meet for both transactions. This would constitute cross-border supply of services or trade in services. The Philippines does not allow this type of activity, as it effectively requires commercial presence through the rule that insurance be undertaken through authorized agents. Full foreign ownership is allowed as soon as commercial presence is established.

5. Conclusion

The services sector cannot be studied without looking at the institutions that govern its activities. Governance over service contracts are not only limited to regulatory systems but may be undertaken by the market itself. Market-based mechanisms of governance are not likely to arise because of information asymmetry problems which rationalize and require government intervention. Trade in services asks policymakers to reconsider negotiation strategies due to the unique nature of service transactions across borders.

Herein lies the greatest weakness of the WTO's approach to services trade liberalization. The WTO seemed to have operated under the assumption that goods and services are basically the same. This appears from the parallel articles found in the GATT and the GATS. The difficulties raised by Mattoo regarding the implementation of the principles of market access and national treatment also attest to this claim. The problems he discusses have their roots in the inability of the GATS to confront the role of institutions in the services sector. Had this role been recognized, the GATS would have been negotiated very differently and the problems Mattoo identified would have been dealt with.

Based on Table 3 below, very few service sectors are truly prepared for liberalization in trade in services and understandably so. There are those that have questioned the impingement on sovereignty over trade policy by the World

Trade Organization, how much more when liberalizing trade in services necessarily involves redesigning governance systems. This paper has asked more questions than established clear directions. What is clear is that discussions on services cannot be undertaken without looking at regulation and governance systems.

It is best to learn from the experience of the European Community. The ASEAN may already be right in starting mutual recognition agreements, however, the ASEAN should take care in addressing the loopholes in the WTO framework for services if it wishes to create a strong regional market for services. Even though the informational requirements for such an undertaking is large, that is, that each country in the negotiations will have to compare and contrast their laws, rules and regulations, as well as their institutional arrangements, it will be well worth the effort. Information—or the lack thereof—is the most important reason why the role of institutions in the services sector cannot be ignored.

Differentiating product from provider is a crucial distinction. Laws, rules and regulations should then be classified accordingly, that is, those that apply to the service product and those that apply to the providers. It will not be surprising to find that laws, rules and regulations cannot be classified as such because service products do not have physical units. Thus, it is the providers that are regulated.

Market access regulations will likely refer to entry and establishment requirements. National treatment, meanwhile, would refer to supervisory regulation including consumer protection, at least in terms of some minimum standard. Consumer protection, however, may be best left to national governments as this will be determined by consumer preference.

In the absence of these adjustments, a commercial presence requirement for all services (without necessarily imposing any limits on proportion of foreign equity) is a second best solution. This allows governments to retain their regulatory autonomy without being subject to the rules of the foreign service provider's home country as would be the case if the example of the European Economic Community is followed. In addition, this is a less costly arrangement than multiple bilateral arrangements for every nation represented by a foreign provider. Such an arrangement need not violate any market access

commitments since the important condition to be met is that the foreign service provider is made accountable to the host country.

This conclusion does not take into account any developmental impacts of foreign direct investment, which varies highly. Any negative impact on economic development must then be weighed against potential benefits from maintaining regulatory autonomy in the face of information asymmetry in a highly integrated world economy.

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