The European Community

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Liberalization of services in the European Community (EC) sends three clear messages to the current and future multilateral negotiations on services.

1. As predicted by economic theory, unilateral liberalization pays. Three or four EC states undertook unilateral liberalization of services during the 1970s and 1980s, more than ten years before the EC initiated its 1992 program. Because these liberalizations were trade oriented (they opened national markets to foreign competition), they have yielded large gains to the consumers of these "liberal" EC states.

2. Unilateral liberalizations are fragile. A host of domestic and international factors have joined forces to close markets that had been liberalized. Monopolies that provided many services before liberalization have retained considerable influence in the small national markets. Nonliberal EC states have inhibited competition by keeping their own markets closed. As a result it has proved difficult to maintain a substantial level of competition in liberalized service markets in the long run.

3. Reinforcing and expanding unilateral liberalizations inside the EC has required a multilateral liberalization—the 1992 program, which was nurtured by the unilateral liberalizations and is consolidating them by diluting former dominant firms in larger markets. The program also makes liberalization attractive to EC states unable to undertake unilateral liberalizations in that it decreases the political costs of implementing liberal policies.

These three messages suggest that the Community's experience can be a driving force in the Uruguay Round negotiations on services. The 1992 program, however, is merely domestic liberalization. It does not contain an explicit foreign trade policy in services, and this missing aspect has nurtured fears of a "Fortress Europe." If the 1992 program is implemented behind high barriers, it will generate huge distortions that will be detrimental to the welfare of the Community and the world. The huge size of the EC service sectors has fueled these fears. Services account for roughly 60 percent of the gross national product (GNP) of the EC—the equivalent of the GNPs of all the developing economies together. In the mid-1980s EC banking and insurance represented one-third and one-fourth, respectively, of world business in those sectors. The EC fleet accounted for one-fourth of world shipping capacity, EC transport for one-fourth of the air traffic of the countries of the Organisation for Economic Co-operation and Development (OECD), and EC investment in telecommunications equipment for more than 40 percent of OECD investment.

Unilateral Liberalizations as a Driving Force

Only the United Kingdom and, more marginally, the Federal Republic of Germany, Ireland, and the Netherlands have been able to undertake unilateral liberalization in airlines, banking, securities, and telecommunications.[1] All of these moves share three features. They have followed common time sequences, and the resulting convergences have considerably eased the 1992 program. They offer alternative solutions to the delicate balance between competition and privatization that may be of some interest for developing countries. Last, and of the utmost importance, they all include a crucial trade component that qualifies them as genuine trade liberalizations.

Common Liberalization Sequences

Financial services provide the most complete illustration of common time sequences in unilateral liberalizations. During the 1970s and 1980s public policies and regulations have been a crucial engine of innovation in financial services. In banking, macroeconomic policies have been accompanied by an endless flow of new financial products—Eurobonds, fixed rate Euronotes, floating rate notes, note issuance facilities (NIFs), revolving underwriting facilities (RUFs), and swaps of all kinds.[2] In insurance, innovations have been fueled by domestic policies, in health care, for example, and by international policies such as freer trade in goods, which gives rise to larger risks. These innovations have required easier access to increasingly large capital markets. In such an environment some financial operators—such as the "universal" banks or insurers that provide most of the financial products—have exhibited comparative advantages.

All unilateral liberalizations in financial services have sought to favor the emergence of these new types of operators and their access to large and flexible stock markets by following a three-step pattern: removal of the barriers between the various parts of the banking industry to facilitate the move toward universal banks; abolition of foreign exchange controls to provide the large amounts of funds needed by financial operators; and the introduction of stiff competition in the stock market—the key market for an industry increasingly dominated by securitization.

Germany has long had universal banks and no exchange controls. By contrast, British financial services were heavily regulated at the end of the 1960s. Starting in 1971, however, the interest rate cartel operated by the principal British clearing banks was dismantled and the markets serviced by the banks and the building societies (the main savings and mortgage institutions in Britain) were integrated. In 1979 Britain abolished foreign exchange controls, finally catching up with Germany. In the mid-1980s the balance between the two countries changed. German financial services, although liberalized, remained protected from foreign competition, whereas Britain, starting in 1986, was the first to open the stock market to stiff foreign competition. The new regulations aimed at creating one market (by merging the Euromarket and the London Stock Exchange) and one type of operator (by merging brokers and jobbers into market makers); giving the Bank of England a decisive role in the crucial market of gilts (British government securities); and introducing a drastic trade component. The admission of corporate members to the stock exchange regardless of nationality and with no preset limit on the number of seats available has been at the core of the increasing importance of the London Stock Market since then.

Financial services elsewhere in the EC have followed the same pattern of evolution. Most EC states have taken the first step by now, and nearly half have reached the second step (the exceptions are Greece, Ireland, Portugal, and Spain). Only Britain has fully achieved the third step.

Competition and Privatization

A powerful force behind liberalization in services was the brake on the potential growth of many service sectors exerted by the existing public monopolies. Public firms were well adapted to provide standardized services with the use of traditional technology—transport of small numbers of air travelers between a few important towns, basic phone calls, and so on. But protected flag carriers and post and telecommunications operators (PTOs) have not been able to provide efficiently the "new" services made possible by modern technology. Examples of such services are "charter" air transport of large crowds of tourists to a host of exotic places and "electronic highways" that provide a wide range of services—from data transmissions to "chatlines" and telephone games—to individuals or firms who hook their computers to their telephones (Feketekuty 1989). Monopolies could not cope with such a rate of innovation. Market competition was necessary.

The capacity of public firms to discriminate and cross-subsidize between the markets of traditional services reinforced the complexity of the problems raised by diversity. The best illustration is provided by PTOs. More profitable than flag carriers (their average net income represented 10–20 percent of their revenue, as against 5–7 percent for flag carriers), PTOs were able to subsidize equipment manufacturers massively. For instance, direct subsidies from French Telecoms to French equipment producers have amounted to more than ECU 1 billion a year since 1983, and roughly 65 percent of the costs of the videotext Minitel are subsidized by French Telecoms (OECD 1988, p. 30; *Le Monde*, June 30, 1989 and July 17, 1989). Despite this strong grip on their sector, PTOs have been unable to forecast the demands with the highest growth (for instance, mobile phones in the French case) and to raise the financial and human resources necessary to match competition-driven markets in providing the "new" services.

Privatization of public monopolies was seen as the natural way to create the competitive markets required by the "new" services. Unilateral liberalizations, however, show that there can be a conflict between competition and privatization, especially as the latter is rarely a constraint-free choice. The privatization of British Telecoms was an unexpected consequence of British rules on the public budget,[3] and the German constitution has prevented privatization of the Bundespost. Governments that are obliged to privatize may want to make the step more attractive by selling firms with a flow of future potential rents—that is, by selling monopolies. Private buyers of such public monopolies are likely to oppose any future move toward competition that might erode the rents expected or paid.

A sound liberalization sequence can overcome the potential conflicts between competition and privatization. If new services—those that public monopolies are unable to provide—are opened up long enough before traditional ones, competitive markets can evolve that are large enough to reduce the potential anticompetitive impact of privatization. This is be illustrated by three examples.

In Britain, the liberalization of charter air transport (a "new" service) in the 1960s and 1970s gave birth to markets that by 1984 represented one-third of all British air transport. In that year Britain began to liberalize the traditional scheduled services by privatizing the flag carrier, British Airways, and by tacitly setting up a duopoly with a private carrier, British Caledonian (Vickers and Yarrow 1988).[4] In 1988 the duopoly collapsed with the takeover of British Caledonian by British Airways, but the negative effects of the collapse on competition were limited because the large charter carriers were powerful enough to buy half of the route licenses and of the 5,000 airport slots owned by British Caledonian and submitted to bids by the Civil Aviation Authority.

British telecommunications offers a different story. Britain began to liberalize traditional and new services almost simultaneously, in 1982, when Mercury was licensed to offer the traditional voice services and to operate a network of the new value added services. At that time value added services represented only 1 percent of telecommunications revenues in Britain. As a result, the prospects for competition did not look very encouraging, especially since the government explicitly established a duopoly consisting of British Telecom and Mercury (both privatized firms) for the first phase of liberalization, 1984–89. It was feared that the two firms would share a reason to oppose further liberalization—the need to undertake huge investments to modernize an old network, in the case of British Telecom, or to create a new one, in Mercury's case (Vickers and Yarrow, 1988; Beesley and Laidlaw 1989).[5] The new regulatory environment, however, was liberal enough to allow British consumers to take full advantage of a wave of technological progress and to generate an explosive growth of demand for private telecommunications networks, basic services (mobile phones), and value added services. In less than five years the size of the markets under competition has become so large that the British government can contemplate a huge injection of new competition: at least one firm, British Railways, with its huge and modern telecommunications network, can compete on equal terms with British Telecoms and with Mercury; three more licensees (in addition to the two initial ones) in mobile phones; and, possibly, authorization for firms to resell part of their private telecommunications networks to third parties.

The German experience in telecommunications suggests that when privatization is ruled out, a quicker and more massive introduction of competition is necessary to make liberalization credible.[6] In a single year (1989), several drastic measures were taken: the Bundespost was split into three corporations (post, bank, and telecommunications); its monopoly in customer equipment was ended; competition from private firms in data and mobile telecommunications was introduced; the Bundespost's ability to cross-subsidize was reduced by requiring that German Telecoms use flat-rate charges (easier than the former usage-sensitive tariff for competitors to match) in some data services; and the first network of mobile phones was licensed to a private group led by Mannesmann.[7] Large competitors have been convinced and have begun large-scale operations. Meganet (a subsidiary of German insurance firms) has started leasing lines in bulk from German Telecoms and selling capacity on them for data traffic. Volkswagen, IBM, and EDS (General Motors), among others, have begun to provide a wide spectrum of value added services. But in the absence of privatization, the competitive fringe of smaller operators that may be crucial for reaping all the potential gains from liberalization remains cautious.

Domestic Liberalizations as Trade Liberalizations

All the unilateral liberalizations undertaken by the EC states, although domestic in nature, rapidly incorporated a trade component and became authentic trade liberalizations.

First, liberal EC states felt it necessary to set up bilateral agreements among themselves and with the United States to strengthen their liberalizations. Air transport provides an illustration: multiple designation (licensing more than one domestic carrier for a given route), removal of restrictions on capacity and frequency, and the automatic approval of airline fares (except in case of disapproval by both countries) were introduced in bilateral air agreements between liberal EC states (Britain–Netherlands, Britain–Ireland, and so on) after 1984.

Second, unilateral liberalizations offered consumers new opportunities for substituting services produced in different EC states, including nonliberal states. Because of this larger set of potential "arbitrages," the prices charged in all EC states were driven by the prices emerging in the more competitive markets of the liberal states. Telecommunications is a good illustration of the power of arbitrage. In 1985–86 the tariff reductions that AT&T introduced on transatlantic calls made phone calls from France to the United States 30 percent more expensive in relative terms and obliged French Telecoms to lower its own tariff by 20 percent. Heavy additional pressure was imposed by the new tariffs of British Telecom, which made calls to the United States from eight of the EC states 15 percent cheaper (on average) if they were routed through Britain. Modern technology increased the role of arbitrage. Since British Telecoms and AT&T were able to offer large multinational clients a better service and to persuade them to locate their telecommunications hubs outside nonliberal countries, the PTOs concerned have been forced to take a more liberal attitude with their largest clients in order not to lose them.

Arbitrage seems to have played a more important role than bilateralism. For example, in banking EC states were concerned that their markets might lose business to more open financial markets in other EC members. Indeed, the failure of some EC states to liberalize their stock exchanges has benefited the stock markets of the most liberal EC states. The London Stock Market reform triggered a general movement away from the Continental stock exchanges, which obliged other EC states to begin to liberalize their own regulations, and the liberalization of some Continental stock exchanges in turn induced the London market to relax some of its stringent regulations.

The opening of domestic markets to foreign producers of services has been the most important feature of the unilateral liberalizations. Vested interests understood this point well and tried to stop arbitrage and bilateralism. In telecommunications the PTOs of the nonliberal EC states (France and Germany) have refused to conclude operating agreements with Mercury, which was obliged to enter into market-sharing agreements with British Telecom.[8] In airlines the International Air Transport Association (IATA) deliberately designed complex rules for air fares to ensure that travelers from nonliberal EC states could not take advantage of the proximity (by road or rail) of European airports to one another to benefit from the few existing liberal policies (Kasper 1988, p. 77).

The Gains from Unilateral Liberalizations

Britain's unilateral liberalizations of the early 1980s were profitable enough to induce a few other EC states (Germany, Ireland, and the Netherlands) to undertake similar policies. Gains from liberalizations come from three sources: lower prices for consumers, larger markets, and new comparative advantages revealed by more competitive firms.

Lower Prices

Liberalized airlines, banking, and telecommunications have all experienced price decreases. A few months after the introduction of the 1986 regulations, commission rates on the London Stock Market had decreased by 20 percent on average. In 1986 average British air charter fares were lower by 10 to 30 percent than the comparable scheduled fares and were similar to those in the deregulated U.S. markets (McGowan and Trengrove 1986, p. 78). In 1987 scheduled fares on European routes with a significant charter presence were estimated to be 40 percent lower than fares on routes with little or no charter competition (*Financial Times*, December 24, 1987). In 1985 Mercury's phone tariffs were, on average, 15 percent lower than those of British Telecom; in 1989 they were 30 percent lower (Beesley and Laidlaw 1989, p. 29).

The impact on tariff structures has been even greater. Average price changes underestimate the impact from competition because liberalizations tend to increase the prices of costly services and to compensate by huge decreases in less costly services. For instance, commission rates on the London Stock Market increased by 5–25 percent for transactions of less than 50,000, decreased by 20–35 percent for bargains of 50,000–500,000 (the largest part of the market), and remained stable for larger purchases (Price Waterhouse 1988, p. 133). Tariffs on the London-Amsterdam route increased by 5–15 percent for the most expensive seats, whereas inexpensive fares (late bookings in economy class) were offered at a 60 percent discount.

These new tariff structures reflect the reduction or elimination of the cross-subsidization policies of domestic monopolies. Following liberalization in Britain, price structures in telecommunications have diverged from those in Continental Europe. In 1987 local calls were twice as expensive in Britain as in France or Germany, whereas long-distance trunk calls were 50 to 70 percent more expensive in France and Germany than in Britain. In the few niches that have seen stiffer competition, price changes have been larger. In 1987 international leased lines were 30 to 100 percent more expensive in France and Germany than in Britain (Muller 1988, p. 139). The most recent prices for private lines are considered roughly in line with costs in Britain (although long-distance traffic is still subsidizing short-distance circuits) whereas in Continental Europe they are, on average, four times costs (*Financial Times*, May 10, 1989).[9]

Larger Markets

Lower prices brought about by domestic liberalization are a sure way of increasing the size of domestic markets and thus the probability that domestic exports will become internationally competitive—a goal that industrial policies often fail to achieve at a reasonable cost.

The number of stocks traded in the London Stock Market grew by 20 percent in the first six months after the introduction of the new 1986 regulations. This growth was mainly attributable to the competitive "betatype" stock markets, defined as those with six or more market makers (or four quoting firm prices).

Air charter markets—now more or less liberalized in most EC states—represented more than 60 percent of total European air markets in 1987. The British liberalization was the first and has been the most far-reaching up to now, as can be seen in the fact that in 1987 British charter services represented 60 percent of independent intra-European charter air traffic and more than twice the share of Germany (the second largest in the EC).

In telecommunications the ratio of calls as a share of British gross domestic product (GDP) or to exports increased in relation to the corresponding ratios for Germany and France by 15 percent and 25 percent, respectively, between 1980 and 1986. During the same period calls from Britain to the United States as a share of total calls between the two countries increased by 8 percent, reflecting decreased relative prices. Meanwhile, the corresponding proportion decreased by 7 percent for Germany and by 13 percent for France. In some niches changes were more dramatic. The British market for value added network services is estimated to represent 80 percent of the total European value in the late 1980s. The British mobile phone market—operated by two (soon, five) firms under competition—had five times more subscribers than the German or French markets, which are run or dominated by PTOs.

Revealing New Comparative Advantages

New comparative advantages are revealed by firms working under the strict discipline of high competition and minimal rents. It is currently estimated that at least one-fourth of the existing market makers in the London Stock Market will leave in the near future. In the gilts market alone ten market makers of the initial twenty-eight have retreated since 1986, and the current leading four account for roughly 50 percent of the market. (Prior to liberalization, however, the two leaders in a field of only eight firms accounted for 75 percent of the market.) Over the past ten years the number of tour operators licensed in Britain increased from 473 to 703, and the profit margins of the top thirty slumped from 4 percent in 1983 to roughly zero in 1987–88, leading to difficulties for the charter airlines (such as British Island Airways) that depend on them.

Benefits from such disciplines are most visible in the sectors that have been liberalized for the longest time, such as charter air transport. Massive entry in air charter markets has selected the most successful tour operators to build large low-cost charter carriers able to compete with and become credible alternatives to foreign-flag carriers. Since the mid-1980s the largest British (and EC) charter company, Britannia, has been responsible for roughly as many passenger–kilometers as Air France on the intra-European routes, the second largest EC flag carrier after British Airways. In the second half of the 1980s two charter airlines, Britannia and Dan-Air, accounted for more passenger–kilometers than Swissair. In telecommunications the experience acquired in the liberalized cellular phone market in Britain has allowed British Telecom to buy 20 percent of McCaw Cellular, one of the largest U.S. firms in this booming niche and the first truly national cellular network in the United States.

The Limits of Unilateral Liberalizations: Toward a Multilateral Effort

Despite these large gains, unilateral trade liberalizations have proved fragile, and their political costs can be high. Voters may find it easy to accept that cheaper air tickets for holidays improve their welfare, but—as users of subsidized short-distance phone calls—they are harder to convince that loss of these subsidies might be offset by the increased efficiency in the economy brought about by cheaper long-distance calls. Firms—the direct beneficiaries of telecommunications liberalizations—have little incentive to lobby for liberalization if they are able to pass through their telephone bills to consumers, as most European firms did during the 1970s and early 1980s, when telecommunications still accounted for less than 10 percent of their costs. As a result, the late 1980s saw some erosion of the unilateral liberalizations in two ways.

First, unilateral liberalizations have been under strong pressures in the liberal EC states. The competitive forces introduced in domestic markets have been eroded by former, but still powerful, monopolies. Flag carriers have reacted to lower profits brought about by increased competition by buying substantial shares in the emerging competitors, as KLM did on the London–Amsterdam route. This vulnerability to old vested interests has also been observed in the United States; in the early 1980s the U.S. government renounced a more comprehensive competition policy in air transport under the double pressure of foreign governments and of European and U.S. carriers (Kasper 1988, p. 80). In telecommunications duopolies complain bitterly about being excluded from new licenses—an example is British Telecom in mobile phones—and lobby heavily for them.

Second, gains from unilateral liberalizations have led the nonliberal EC states, initially hostile to liberalization, to introduce quasi-liberalizations—"quasi" because the sectors concerned are still sheltered from foreign competition. Air transport offers good examples of quasi-liberalizations. Flag carriers have created their own charter carriers behind high barriers, as Lufthansa did with Condor and Air France with Air Charter. "Flag charters" were conceived by their owners largely as a deterrent to the entry of domestic independent air carriers, which as a result have had a difficult time growing. In 1987 the average size of the French and German independent carriers was 7 percent and 40 percent that of the British ones. The 35 percent stake that Air France was able to buy in TAT (the fourth largest French air carrier) in 1989 led to increased dominance by the flag carrier. In such closed markets, domestic competition is easily inhibited. For instance, a recent attempt by Aero-Lloyd, the fourth biggest German charter airline, to compete on domestic scheduled routes with Lufthansa failed because a large proportion of Lufthansa's passengers use internal flights only to connect with international flights and enjoy almost free internal flights. Finally, quasi-liberalized markets remained under political control. In 1988 a proposal to merge two small (by British standards) French and Belgian charter carriers, Point Air and Trans European, was blocked by the French government (this was in sharp contrast with the government's blessing of the takeover of UTA—the only large independent French carrier—by Air France). Similar experiences can be observed in telecommunications and posts (express freight); most European PTOs have created private subsidiaries—for instance, French Telecom created Chronopost (express mail) and Transpac (data traffic).

Having kept foreign competition at bay can be a source of future difficulties, as French banking illustrates. In the 1980s the French government actively pursued a policy of "universal" banks, and France has some of the largest world conglomerates of banks-insurers-brokerage houses. But because these giant "universal" banks were consolidated through state ownership and regulations in noncompetitive markets, it is difficult for them to attain the Cooke Committee standard for capital adequacy (a minimum ratio of capital to assets of 8 percent), which will become the standard in the post–1992 Community. To improve their competitive situation in post–1992 Europe, French banks might have to acquire foreign firms. But that would require capital and would increase assets, causing further deterioration of the Cooke ratios. In air transport the increasing dominance of Air France has inhibited a necessary decrease in wage costs; pilots' wages have absorbed 70 percent of the decrease in labor costs allowed by the new 747-400 aircraft bought by the flag carrier (*Le Monde*, September 3, 1989). Under these circumstances, European liberalization is an attractive solution.

The 1992 Program

This section reviews the part of the 1992 program devoted to internal trade liberalization in services and the corresponding economic gains that can be expected. It then examines the competition rules embodied in the Treaty of Rome, which have been the engine of the intra-EC liberalization and have made the Court of Justice the cornerstone of that liberalization, and the elements of an EC foreign trade policy on services that might emerge in the wake of the 1992 program.

The 1992 "Single Market" in Services

The part of the 1992 program that deals with services consists of fifty-one directives to be drafted and adopted between 1986 and 1992.[10] As of January 1990 more than half have been adopted and the rest tabled. The program has adopted the broadest definition of services: it deals with trade in services related to factor movements—including labor movement—and to cross-border movements of consumers as well as of services. Its sectoral scope is wide, covering previously untouched services such as insurance, shipping, road transport, and professional services. Finally, the 1992 program interprets progressive liberalization essentially as meaning that the less developed EC states will be granted longer time periods for adopting common rules. Appendix 14–A focuses on the most important directives in each service sector.

The Gains to Be Expected

The 1992 program aims at dismantling intra-EC barriers. Despite previous unilateral liberalizations, these barriers remain substantial, as indicated by the low ratio of intra-EC to extra-EC trade in services, which is 25 to 30 percent, or half of the corresponding ratio for goods. As a result, price reductions and welfare gains can be expected to be large. Studies done under the auspices of the Commission (the Cecchini report) estimate that price reductions will be 21 percent (in Spain) to 4 percent (in the Netherlands) in financial services, about 10 percent in air transport, 5 percent in road transport, and 3 percent in professional services, for total estimated savings to consumers of roughly 2 percent of the GDP of the EC (Emerson and others 1988).

These studies give to scale economies a large role that some have found excessive. In a substantial range of services, such as retail banking and insurance, economies of scale are likely to be small (Neven 1989), and the "single" European market could offer more opportunities for differentiating products in diversified markets than for homogenizing them to make possible massive economies of scale (Centre for Business Strategy 1989). Others, however, have argued that adding dynamic effects to the static effects measured by Emerson greatly increase the gains to be expected (Baldwin 1989). Despite these controversies on the extent of the gains, there is a consensus that the 1992 program will bring substantial benefits to the Community.

The Engine of the 1992 Program: Competition Rules

EC competition rules are embodied in three articles of the Treaty of Rome: article 85, on collusive practices; article 86, on abuses of dominant power; and article 90, which states that public firms are not exempt from competition rules embodied in articles 85 and 86 except as necessary for their "general interest" tasks. Until the mid-1980s these rules were barely used in services because existing service providers, benefiting from noncompetitive markets, had no motive for invoking them. Competition-oriented markets shaped by unilateral liberalizations since then have generated firms and people that are eager to see their rights to competition enforced and to take cases to the European Court of Justice.

AIR TRANSPORT. In a 1986 ruling on a case examining Air France's allegations of price undercutting by the French tour operator Nouvelles Frontières, the Court stated that EC competition rules apply to scheduled air transport. That ruling has definitively brought the sector—which since 1962 was exempted from the enforcement of articles 85 and 86—back under competition rules (van Bael and Bellis 1987).

In April 1989 a second ruling extended, de facto, the scope of competition rules to routes between the EC and the rest of the world. The case concerned the Frankfurt–Tokyo route. Two German travel agents discovered that, because of the difference between the market exchange rates and the exchange rates used by the IATA when setting the global network of European fares, the Lisbon–Frankfurt–Tokyo fare was much less expensive than the simple Frankfurt–Tokyo fare. An association "for the campaign against unfair competition," backed by flag airlines, lodged a complaint of unfair competition and price undercutting against the two travel agents. The Court stated that price-fixing agreements for flights between EC and non-EC airports were under the scrutiny of article 86 if they induced competitors to charge excessively high or low prices fares on a single route—that is, if they abused a dominant position. Moreover, airlines carrying out a task of "general interest" (flag carriers) were also subject to competition rules insofar as the application of such rules did not obstruct the performance of these particular tasks—a reminder of the article 90 philosophy.

FINANCIAL SERVICES. Through a growing number of cases looking at national banking associations and commission rates in commodity markets, the Court is exerting increasing pressures for a strict enforcement of competition rules in banking (Commission of the European Community, *Reports on Competition Policy*, various years). The main contribution of the Court, however, has concerned the definition of the *mutual recognition* principle governing cross-border trade in insurance according to which each EC state will recognize the licensing rules of the others and will apply its own operating rules on a nondiscriminatory basis to EC firm affiliates (see appendix 14–A, "Banking"). In four recent rulings the Court extended to this trade two basic concepts elaborated for trade in goods in the Cassis de Dijon case: the obligation that EC states not erect trade barriers between themselves and the relevance of the public interest test as a restriction on freedom to provide services. According to the Court, existing Community law does not provide sufficient harmonization to justify a claim that the public interest is already protected by the home state of the exporters of insurance services. Small policyholders ("mass" risks, in Community jargon) could thus be confused about the real coverage offered by insurance products imported from other EC states. In other words, "imperative reasons relating to the public interest" may justify restrictions on the freedom to provide cross-border insurance services for small policyholders.

This ruling on insurance has been criticized as a setback to intra-EC liberalization (Hindley 1988). If greater harmonization in "mass" risks is difficult to achieve in the near future, the Court's ruling would de facto limit the 1992 program to large policyholders ("large risks")—the only ones supposed to be capable of mastering the problems arising from "imported" insurance contracts.

The "general interest" principle, however, is sufficiently complex to have a positive impact on liberalization. First, it has obliged the Commission to definitively abandon the harmonization route in insurance and to adopt the much less heavily regulatory approach of mutual recognition through branching. This is the meaning of the proposal by the vice-president of the EC Commission, Leon Brittan, to allow insurers to sell the full range of their products on the basis of a single license (see appendix 14–A, "Insurance"). Second, the principle will be useful for solving the disputes likely to emerge when enforcement of mutual recognition requires a precise border between licensing and operating rules. Finally, the principle can be a powerful argument against monopoly power. For instance, if the basic telecommunications network is of "general interest" and could, under the Rome Treaty, be entrusted by EC states to a single operator (*Financial Times,* June 29,1989), the result may be a stronger enforcement of article 90 than under the present circumstances.

TELECOMMUNICATIONS. In telecommunications the Court launched the 1992 program by reaffirming that article 90 of the Treaty of Rome subordinates public firms to competition. A first ruling (on telex forwarding, in 1985) stated that government-sanctioned monopoly practices could conflict with article 86 of the treaty. In 1987 the Commission used the procedure for the first time under article 90 in the 1992 program as the legal basis for the directive liberalizing telecommunications terminal equipment. Such a procedure (which can be applied only if public firms that enjoy exclusive rights use them in a way that restrains competition) authorizes the Commission to act without a vote by the EC states. Because of this procedure, the directive on terminals has been enforced and continues to be valid, although four EC states (Belgium, France, Germany, and Italy) have asked the Court to examine the legitimacy of the Commission's use of article 90. Since then, the Commission has used the article 90 procedure twice: as a basis for liberalizing the Community's ECU 65 billion market of value added services and to request regulatory changes in the Dutch express mail regulations (*Financial Times,* January 9, 1990).

The Emerging EC Foreign Trade Policy in Services

The 1992 program deals exclusively with intra-EC matters. The number and force of the trade barriers to be dismantled if the EC opens its borders to foreign services indicate how deeply entrenched is protection of some sectors (table 14–1). Whatever the borderline between the Commission's and the EC states' powers in trade policy in services turns out to be, the EC states will retain many ways of influencing trade in services in the near future. (For instance, airports and air control are still under the jurisdiction of the EC states, and restrictive practices in this domain may create substantial barriers to freer air transport.) The figures confirm the leading role of Britain and the foot-dragging of France, Italy, Spain (and, at this time, Germany). It also suggests that the smaller EC states may be more open than the larger ones.

The 1992 program has indirectly led to the emergence of the first elements of the EC foreign trade policy in services, as illustrated by the debate on reciprocity in banking and the Commission's desire that it (instead of the EC states) negotiate bilateral air agreements after 1992.

The most elaborate elements concern the shipping sector. Two directives of the four on shipping in the 1992 program specify rules involving non-EC states. The first directive deals with "noncommercial" advantages enjoyed by foreign fleets in markets in which EC fleets are operating. The directive introduces regulations and procedures that, except for a few points related to the respective roles of the Council and the Commission in trade policy in services, are similar to those of the EC antidumping law, which is an instrument with a well-established protectionist and anticompetitive impact. This first directive has already been enforced, in 1988. A Korean shipping firm, Hyundai, was accused of noncommercial advantages by European liners operating in the European–Australian Conference and was subjected to a "redressive" duty of approximately 25 percent. As a result, Hyundai has stopped its operations on the route.

The second directive provides for coordinated Community action with diplomatic initiatives or countermeasures in cases in which third countries restrict access of EC shipping companies to ocean trade. The threat of Community action—which makes this directive similar to a U.S. Section 301 case, but limited to shipping—covers bulk and liner cargoes, tramp services, passenger transport, and movement of people or goods to or between offshore installations. The first case under this directive, which concerned the routes between Europe and the United States, was lodged in 1987 and was renewed in September 1989.

The concept of "fair" trade is not ignored in other services, even if it has not been embodied in directives so far. As shown below, it has surfaced in the banking dispute between the EC and United States. In air transport the unfair advantages allegedly enjoyed by "low-wage" air carriers have been cited. In telecommunications the first liberalizations in services are not, at this stage, giving rise to actions such as those against Hyundai in shipping, but they have triggered increased imports of telecommunications equipment, which have already been under antidumping actions. In July 1987 and March 1988 the ad hoc office of the EC Commission initiated an antidumping case against exports of mobile cellular phones from Canada, Hong Kong, and Japan. This action was echoed in the warning by Oftel, the British watchdog in telecommunications, against service providers that lure users with cheap, low-quality mobile phones but impose high call charges.

Table 14–1. ***Main EC Barriers, as Reported by U.S. Firms, 1985***

Service	*Belgium*	*Denmark*	*France*	*Germany*	*Greece*	*Ireland*	*Italy*	*Netherland*	*Portugal*
Air transport	2	1	3	2	1	1	2		1
Banking									
Construction							1		
Insurance	1	1	1	4	2	2	3	1	1
Films and broadcasting	2	2	2	2	2	2	2	2	2
Professional services	2		4	1			2	1	
Telecommunications	2	2	2	5	2	2	2	2	2
Tourism	1		2		2		3		4
Total, excluding shipping	10	6	14	14	9	7	15	6	10
Percentage	8.3	5.0	11.6	11.6	7.4	5.8	12.4	5.0	8.3
Shipping	2	5	4	4	4	5	3	5	1
Total, including shipping	12	11	18	18	13	12	18	11	11
Percentage	7.3	6.7	10.9	10.9	7.9	7.3	10.9	6.7	6.7

Note: The U.S. Trade Representative study is based on reports by U.S. exporters of services about "selected problems" they encounter. As a result, it tends to mirror the capacities of the United States to export—that is, it overestimates barriers in relatively open states or sectors and underestimates the others. This is why another source has been considered for shipping (White 1988).

Sources: For all services except shipping; USTR (1985). For shipping; White (1988).

The EC 1992 Program and the Uruguay Round on Services

What implications and lessons does a successful 1992 program have for the Uruguay Round negotiations? The implications concern the impact on the EC's negotiating position of the crucial choice made by the 1992 program—to adopt the widest scope of trade in services. Lessons follow from the fact that the 1992 program has already begun to test many of the main concepts to be embodied in the Uruguay Round, as best illustrated by the rules on market access and competition.[11]

Scope

The 1992 program embraces the widest scope the Uruguay Round agreement on services could consider: it covers movement of consumers and of the factors of production required for producing and selling services as well as cross-border trade in services, and it includes future as well as existing services. The scope of the program has influenced the Community's response to the invitation in the Montreal ministerial declaration to submit an indicative list of service sectors of interest; the EC was one of only three Contracting Parties to table such a list, and its list covers all internationally tradable service sectors. There is, however, a significant difference between the 1992 program and the EC approach in the Uruguay Round: the EC opposes coverage by the Round agreement of trade in services that requires labor movement other than that of "skilled and key personnel and for a limited duration." This limit will not harm all workers from developing countries; some will be recruited by EC firms, as in the case of the flagging-out shipping policies examined above. But it will undoubtedly hamper many firms from developing countries in exploiting their comparative advantages.[12]

The Impact on the EC Negotiating Attitude

That no service sector is a priori excluded from the agreement has allowed the EC to balance as much as possible the interests of its potential exporters and importers in the Uruguay Round negotiations. To this extent, the 1992 program has decreased the likelihood of a "Fortress Europe"—a combination of intra-EC liberalization with high external protection.

Trade balances are an indicator of the likely reactions of EC service industries to a world liberalization under Uruguay Round auspices. Negative or deteriorating balances are likely to be used as an argument for protection; increasingly positive balances could support protrade arguments. Table 14–2 shows the trade balances between the EC and the rest of the world for fourteen service sectors. There may be active lobbies for protection against the rest of the world in four industries: telecommunications, advertising, films and broadcasting, and sea freight. Three industries—banking, insurance, and travel—might favor a freer EC trade policy. The attitude of the other sectors is more difficult to predict, either because trade balances are positive but deteriorating or because no clear trend has emerged. Table 14–2 is confirmed by table 14–1, which also suggests that telecommunications, films and broadcasting, shipping, and air

Spain	United Kingdom	EC Total	EC (percentage)
2	3	18	10.9
3		3	1.8
	1	2	1.2
1	1	18	10.9
2	2	22	13.3
3	2	15	9.1
2	2	25	15.2
4	2	18	10.9
17	13	121	
14.0	10.7	100.0	
8	3	44	26.7
25	16	165	
15.2	9.7	100.0	

transport are good candidates for supporting protectionist policies, whereas banking should be more supportive of freer trade because it is more open.

The sectors in which protectionist pressures are likely to be the highest (telecommunications and air and sea transport) are also likely to be the most difficult to liberalize within a multilateral framework. That raises a question: will the 1992 program, which aims at creating a customs union in services (or, to use the current wording of the Uruguay Round, a regional integration arrangement) increase trade distortions by facilitating trade between the constituent territories and raising barriers to the trade of other contracting parties with such territories—as most of the custom unions in goods did? Or might regional agreements in services differ from custom unions in goods in that they generate more forces able to inhibit trade distortions than do customs unions?

The second alternative seems the more plausible because prior to regional agreement services are regulated by a host of international agreements that make it difficult to increase the barriers between the members of the regional integration agreement and the rest of the world. These agreements were necessary because service producers put much more emphasis on establishment for market access than did producers of goods. The following list gives a flavor of this extensive pre-1992 network of agreements and their impact on the EC.

In banking the rules adopted under the aegis of the Bank for International Settlements have been incorporated in the EC directives, and bilateral agreements on cooperation between agencies in charge of monitoring securities markets have been signed between non-EC and EC countries. In insurance the directive on motor insurance must

Table 14–2. *EC Trade Balances in Services, 1980–86*
(billions of ECUs)

Service	1980	1981	1982	1983	1984	1985	1986
Banking	0.89	0.95	0.80	1.77	2.32	2.88	3.12
Insurance	0.31	1.26	1.05	1.22	1.08	2.65	4.08
Telecommunications	-0.11	-0.31	-0.47	-0.58	-0.47	-0.36	-0.33
Air freight	0.51	0.50	0.48	0.53	0.69	0.92	1.08
Air passenger	2.14	2.12	2.38	2.82	3.33	3.20	1.60
Sea freight	1.15	0.15	0.07	-1.14	-2.08	-2.32	-1.61
Sea passenger	0.25	0.28	0.42	0.41	0.41	0.54	0.53
Other transport	0.04	-0.28	-0.72	-1.37	-0.73	0.46	-0.47
Advertising	-0.36	-0.37	-0.57	-0.83	-0.87	-1.02	-1.16
Films and broadcasting	-0.12	-0.21	-0.21	-0.24	-0.30	-0.28	-0.46
Trade	0.05	-0.39	-0.20	0.39	0.08	-1.27	0.19
Other business services	1.92	2.53	2.56	2.82	2.76	2.79	2.70
Construction	2.61	3.50	3.57	3.00	3.58	3.15	2.62
Travel	-0.58	0.23	2.38	6.49	10.47	11.86	5.76
Property incomes	-1.53	-1.56	-1.89	-1.81	-2.31	-2.42	-2.60
Other services	2.14	3.48	3.56	3.88	2.61	5.28	6.33
Unallocated	3.07	3.31	3.38	3.52	4.25	4.39	4.30
Total	12.35	15.18	16.61	20.87	24.82	30.46	25.67

Note: There are no doubt many problems with these data. The main one is that they capture cross-border trade flows and not sales of services related to foreign presence—a crucial point for such sectors as banking.

Source: Mathisse (1989).

remain compatible with the green card system that covers non-EC countries. A U.S. life insurer can do business in Britain under the 1986 Financial Services Act if its home state is considered a "designated territory" under the act—like, for example, Pennsylvania is. In airlines the 66 air agreements between EC states are intertwined with the 218 agreements involving the 22 European members of the European Civil Aviation Conference (ECAC). That Norway and Sweden are part of the SAS airline network with Denmark has necessitated special adjustments to EC rules to grant the Community's passport to SAS. In telecommunications the technical rules adopted by the International Telecommunication Union (ITU) are enforced by the European PTOs. EC rules are compatible with regional agreements involving non-EC countries, such as the future MDNS (Managed Data Network Services) elaborated by Europe's twenty-two PTOs.

Market Access Rules

Market access clauses, which are harder to define in the context of services than of goods, have already been tested in actual situations in the EC. The 1992 program has had to find operational ways of using such concepts as national treatment, reciprocity, and progressive liberalization.

NATIONAL TREATMENT, AND MORE. The Montreal declaration defines national treatment by the "no less favorable" provision. For cross-border services, the concept of treatment "no less favorable" in respect of all regulations than that accorded domestic services in the same market has a clear meaning, similar to the accepted one for trade in goods. But this definition is plagued by many problems when services are "traded" through the establishment of suppliers in "importing" countries. For instance, it may exclude situations in which the domestic provider in the importing country is a monopoly, as in air transport or telecommunications in many developing countries.

This first source of problems is modest compared with the second: what does the Montreal definition mean when one trade partner imposes stricter regulations on its domestic firms than another partner—a situation that is likely to be very frequent, if not the rule? The EC faced this problem in the specific context of the banking sector in a (sometimes acrimonious) debate with the United States and Japan.[13] Similar cases are likely to emerge in other service sectors if the 1992 program succeeds. For instance, in air transport the fifth freedom between two EC states will become close to a cabotage right after 1993.

Such situations have led the EC to expand the definition of national treatment (the "no less favorable" clause) by a provision that takes into account the mode of delivery of services in foreign markets. The EC forged the concept of "effective market access," defined as the situation in which service providers of the two countries enjoy "comparable competitive opportunities" (to use the wording of the Second Banking Directive) in the two markets. This concept sheds some light on reciprocity and progressive liberalization.

RECIPROCITY. Reciprocity is the threshold of mutual concessions that trade partners consider satisfactory enough to sign a trade agreement. It is a concept used in negotiations, not in economics. In cross-border services, national treatment links reciprocity to host country rules, as it does in trade in goods. That financial services exported by EC banks are subject to U.S. regulations in the United States and the other way around seems to be an acceptable bargain for the two partners and is generally the equilibrium point of the negotiation. By contrast, that suppliers of services are subject to host country rules does not lead to such an acceptable bargain: producers in the most liberal country are seen as disadvantaged in comparison with producers in the less liberal country. Although there is no economic rationale for this proposition consumers may prefer the more stringent rules.

The "comparable competitive opportunities" concept makes assessing reciprocity more complex because it compares host and home country rules. The rule of the most regulated home country could be chosen as the internationally agreed standard for reciprocity. In this restrictive option U.S. banks would operate in the EC under U.S. rules—that is, they would not be able to engage in securities activities in the EC or to enter simultaneously into all the EC states. (Such an option is close to the 1988 position of former EC Commissioner de Clercq.) Conversely, the rule of the most liberal home country could be chosen as the international standard. Then EC banks would operate in the United States under rules similar to those of the EC; that is, they would be able to conduct securities business in the United States, to branch freely, and to provide cross-border services throughout the country (which U.S. banks are not allowed to do). This option is close to mutual recognition and to the principle adopted in July 1989 by the EC and Switzerland in an agreement on nonlife insurance that opens EC markets to Swiss firms on condition that Switzerland adapt its insurance laws to those of the EC.

In the mercantilist approach to trade negotiations, this wide range of options leaves no equilibrium point that is easily acceptable by both partners. As a result, the EC has chosen to leave the task of finding such an equilibrium point to procedures (internal consultations and negotiations with the trade partner) that are applied case by case. Such an approach seems to be plagued by an opportunistic attitude and could endanger the multilateral trading system, as illustrated by the acrimonious banking debate between the EC, Japan, and the United States, which has been summarized as follows: "Reciprocity is a missile aimed at Tokyo which will land in New York and explode on Capitol Hill" (*Financial Times* October 28, 1988). Although there may be some basis for this fear, two points are worth noting.

First, countries that take the mercantilist approach to multilateral negotiations tend "involuntarily" to favor solutions that are the most economically sound for the trading partners. Country A tries to get country B's markets as open as possible—a policy beneficial to the consumers of country B—and the other way around. Second, reciprocity is not only a conflict between trading partners but it is also a conflict of interests within each domestic industry of the two trading partners. For instance, the restrictive option described above would favor U.S. banks that already have a subsidiary in one EC state (and are thus able to branch through the Community and reap all the benefits from the 1992 program) over U.S. banks that are not already established in the EC. By contrast, the large influx of foreign securities firms into the EC brought about by the liberal option could be beneficial to Continental stock exchanges—in which there are a lot of niches to be exploited—in relation to London.

PROGRESSIVE LIBERALIZATION. The concept of progressive liberalization is essential in the context of the participation of the developing countries in the Uruguay Round. The concept of "comparable competitive opportunities" can take progressive liberalization into account in two ways. First, it suggests that developing countries need to create competitive structures in their own services sectors in order to open them. It thus recognizes that developing countries may face the heavy task of building new, competition-oriented, domestic regulations—a point often emphasized by developing country negotiators. Such a perspective is present in the 1992 program: the Community's less developed countries have often been granted a longer time period for opening their sectors so as not to put them at risk.

Second, industrial countries may agree to give firms from developing countries advantages greater than those granted by these countries to firms from industrial countries. They can do so by defining what they judge as "comparable" to the competitive opportunities they offer. Industrial countries may be eager to graduate their reciprocity threshold to the level of development of their trade partners, especially if they do not feel trapped by a rigid rule of "special and differentiated" treatment.

Competition Rules

Competition rules have been crucial to the EC internal liberalization. Lessons to be drawn for the Uruguay Round can be grouped around the three types of competition rules: "antimerger" (antitrust) rules, rules against the "abuse of a dominant position," and rules against "collusive practices."

There is one crucial motive—in addition to the usual one of promoting competition—for including competition rules in the Uruguay Round: such rules are an extremely economical way of regulating an economy. There are three reasons for this. First, competition rules do not require lengthy provisions: the Treaty of Rome devotes 3 articles (out of 246) and fewer than 60 lines to these rules. Second, since they concern only real problems revealed by the functioning of the markets, they minimize the need for reregulation and thus the risk of premature or excessive reregulation—a danger in multilateral negotiations, which are always quick to consider all possible problems. Third, they maximize the efficiency of the minimal set of reregulations really necessary by offering a sure way of enforcing these regulations if they are consistent with the interests of consumers.

ANTIMERGER RULES. Antimerger rules are unlikely to be part of the Uruguay Round agreement because in many countries many services are provided by public or private monopolies or duopolies, as in telecommunications. The experience of the Community suggests, however, that the absence of antimerger rules will not impede the world liberalization; such rules at the EC level have played no role in the intra-EC liberalization, since they were adopted only in December 1989.

More interestingly, the EC experience even suggests that mergers—apart from their economic pros and cons—can be a positive force for adopting a trade liberalization program. Mergers offer to each member firm a share in the comparative advantages of the other suppliers and in other national markets that may have larger or more dynamic demands. National monopolies or dominant firms can thus reduce the risks associated with trade liberalization through mergers, which become a crucial instrument for dissolving the "national champions" inherited from the 1970s. For instance, the emerging European "megacarrier" consisting of British Airways, KLM, and Sabena offers an unique opportunity for improving the efficiency of Sabena by linking it to two efficient and wealthy firms and for achieving a partial privatization of Sabena at the same time. (British Airways and KLM will each own 20 percent of the shares of the new Sabena World Airlines.) Both effects can only make Belgium's air transport policy more liberal.

There are similar recent examples involving firms from developing countries. For instance, Singapore Airlines and Swissair have signed a cooperation agreement with exchanges of equity. This agreement indirectly reinforces the links between Singapore Airlines and Delta Airlines (a U.S. company), and opens the way for similar deals with SAS, Finnair, and a few other airlines. It generates a "global aviation system" that reduces the risks of changes associated with world liberalization for each member firm and thus lessens the fears of the governments concerned.

This role of mergers can also be observed in the equipment industries linked to service sectors. This is best illustrated by the telecommunications equipment producers, which have constituted consortia for definite tasks.[14] For instance, the recent German bid for a mobile phone license was granted to a Mannesmann-led consortium that included British, French, and U.S. firms. Four of the other offers also involved British firms, including British Telecom itself. In the short run, such mergers, which are now frequent in telecommunications and construction, are a partial substitute for liberalization of the public procurement procedures. They lay the ground for the still rare successes of individual firms (Ericsson in the United States, AT&T in Italy, Sony in Britain, and Fujitsu in Britain and Germany). In the long run, they ease the introduction of more competition-oriented rules in public tenders.

There is a point, however, at which the costs of such mergers or consortia become higher than the gains. Mergers may reach sizes that will hinder the emergence and survival of otherwise efficient mavericks and will thus make competitive markets impossible. In airlines, for instance, the coalition between British Airways, KLM, and Sabena and the one between Air France, Lufthansa, and Iberia would in 1985 have represented 50 to 55 percent of the air services operated by all the EC airlines. In sum, the absence of antimerger rules is an easily acceptable risk only if there are competition rules against abuse of a dominant position.

RULES AGAINST ABUSE OF A DOMINANT POSITION. Dominant positions are likely to be frequent in many service sectors because a successful Uruguay Round will merely open the legal possibility for obtaining better access to networks run by dominant firms (monopolies). These networks include telephone lines run by PTOs, computerized reservation systems, or CRSs—the electronic networks that allow travel agents to book flights and facilities—run by airlines; slots run by airport authorities; roads controlled by governments; and so on. In sum, services will be liberalized, but networks will not, leading to the risk that the network owners will abuse their dominant position if they provide services and compete with mere suppliers of services.

Rules against abuses of a dominant position allow the solution to potential competition to be shifted from *ex ante* general regulations to *ex post* specific cases, as shown by telecommunications value added services. Under the 1992 program PTOs will keep their monopoly on networks but will make them accessible to competitors in value added services. Preventing network-owner PTOs from abusing their privileged position to eliminate competitors has led to special rules of conduct (see appendix 14–A, "Telecommunications"). In other words, liberalizing cross-border services—such as value added services—has led to the reregulation of the providers (the PTOs) of equipment (networks) and services (basic services) that are not yet liberalized. Such a situation generates complex questions. Should reregulation be applied to the PTOs alone, or should the regulatory activities cover newcomers as well? A satisfactory solution is unlikely to reside in static and detailed regulations; it is more likely to emerge from the analysis of a concrete situation in which a given service provider perceives that it faces abuse of a dominant position, in the light of the economically sound criterion of competition rules: the interests of the consumers.

Rules against abuses of a dominant position are necessary for effective enforcement of codes of conduct and similar regulations, as illustrated by the computerized reservation systems. The two emerging EC megacarriers are organized around two CRSs, with, so far, no future competitors in the EC, and with international connections.[15] As CRSs are extremely expensive (both in physical and human capital), they are operated by joint ventures of airlines that have been exempted from competition rules (another example of limited use of antimerger rules). The Commission is well aware of the risks of such an exemption, and the exemption has been subject to conditions that ensure free access to the systems, elimination of biases between air carriers, and more flexibility for the contracts offered to travel agents. It has also been complemented by the adoption of a mandatory code of conduct insisting on nondiscriminatory and transparent use of the CRS. But the credibility of the exemption and of the code relies on the threat imposed by the existence of rules against abuses of a dominant position and on the ability of firms to complain on a case-by-case basis.

All these considerations are of special interest for the Uruguay Round. Many believe that "sectoral annotations"—that is, additional provisions interpreting and clarifying framework provisions for each individual sector—will be necessary. That could represent a great danger for the Round: interminable negotiations and increasingly ambiguous, inconsistent or useless clauses, offering a back door for protection. One can argue that many "sectoral annotations" could be avoided by competition rules.

Two final remarks are necessary. First, competition is often stiffer than initially expected. In telecommunications, private networks are only starting up. Public firms in similar services can generate competition pressures; for example, SNCF, the French railways company, has decided to create its own worldwide reservation system based on the technology of Sabre, the CRS developed by American Airlines (*Le Monde*, November 30, 1989). Second, a balance between the regulations to be applied to dominant private or public firms should be maintained. These two types of firms have different ways of abusing a dominant position, and the Uruguay Round framework should take this difference into account, as the Treaty of Rome did by supplementing article 86 (focusing on private firms) with article 90 dealing with public firms.

RULES AGAINST COLLUSIVE PRACTICES. The EC experience shows that competition rules against collusive practices are a crucial ingredient in the initiation of liberalization in services. Including such rules in the Uruguay Round framework would be useful for three main reasons.

First, Uruguay Round provisions are unlikely to lead to an immediate application of essential provisions to some service sectors. For instance, the most favored nation clause is unlikely to be applied in air transport because this sector relies on a host of bilateral arrangements. As a result, it is likely that there will be a "freeze" in this sector. The danger is that the freeze in liberalization of some sectors will continue forever and become a de facto permanent exception, as in the case of textiles in goods. Accepting a freeze is a risk that can be taken only if there are provisions that permit market forces to reveal a desire to move toward more competition. In the EC experience the enforcement of rules against collusive practices has started the liberalizations in air transport and telecommunications equipment, in particular.

Second, many industrial and developing countries already have active competition rules. When applied to service sectors, these national rules can easily lead to problems of extraterritoriality, which are political and legal nightmares. In such circumstances, actions can take decades or be abandoned, to the detriment of an economically sound procompetitive solution. For instance, the EC code on CRSs applies not just to Amadeus and Galileo but to all CRSs operating in the Community, whether based inside or outside the EC states. The implied risk in terms of extraterritoriality may inhibit enforcement of the code. The adoption of rules against collusive actions in the Uruguay Round would offer a way of solving this type of problem.

Third, the Uruguay Round will adopt safeguards and provisions that have a similar economic impact, such as antidumping and antisubsidy regulations (Hoekman and Leidy 1990). The GATT experience in such matters is crystal clear: either provisions are designed with economically sound constraints (nondiscriminatory measure, compensation, and so on) and are rarely used, as illustrated by the GATT article XIX, or they rely on ambiguous concepts ("unfair" competition, domestic industry, and injury that are rapidly captured by domestic firms looking for protection and are used as devices for enforcing collusive practices with public sponsorship (Messerlin 1990a). The concepts embodied in competition rules against collusive practices offer a way of limiting this phenomenon of capture.

A Brave New World: Competition in Regulations

Services are regulation-intensive. As a result, comparative advantages in services are determined by the ability of states to generate the best rules: states that open their service sectors will compete in regulations. The more market access is granted, the stiffer is the competition. This is best illustrated by the mutual recognition principle, which can mean better treatment of foreign firms than does national treatment. For example, if British licensing or operating rules are better designed than French rules, French branches of the British banks will enjoy better treatment than French banks.

Developing countries may be afraid to compete on these terms because they may feel "disadvantaged" and "unprepared." But there are good reasons for them to accept the challenge and to participate in the "uneasy" free market revival (Henderson 1988).

First, competition in regulations will induce developing countries to elaborate their own regulations. Far from inhibiting their capacity to regulate—a fear often expressed by developing countries—an economically sound Uruguay Round will be a stimulus for them to adopt better regulations. The EC experience in the past decade can be best described as a continuous effort to move from a set of inefficient regulations to a new set of rules that are more efficient because they support a higher level of competition. There is no better illustration than the ongoing competition between the London and Continental stock exchanges. The 1987 crash revealed the weaknesses of some of the new regulations in the liberalized London International Stock Exchange, from too stringent rules on shareholders' preemption rights to medieval methods of transfer. Continental stock exchanges took these weaknesses as an opportunity to step up the removal of old regulations and the introduction of new ones, and the past two years have seen a constant emulation among the regulatory bodies of the national stock exchanges.

Second, competition in regulations will be as dynamic as in goods. Comparative advantages will shift, as they do in goods. By liberalizing long-regulated national markets, the 1992 program has imposed adjustment efforts on the "free" markets that prospered during the nonliberal period, such as the Eurobond market, the reinsurance market, and the insurance markets of the Isle of Man and the Channel Islands. And the EC financial integration is accelerating the pace of U.S. and Japanese reforms of regulations that have imposed tight constraints on U.S. and Japanese banks and insurance firms in their domestic markets. Similarly, the expected liberalization in EC telecommunications has attracted the "Baby Bells"—the regional U.S. phone monopolies born of the breakup of the Bell System. The restrictions on their U.S. operations have induced them to invest in mobile phones, cable television, computer services, and fiber optic cables all over the EC: six "Baby Bells" (out of seven) have invested in such liberal EC states as Britain and Germany, and, even more remarkably, three have invested in France and two in Spain and Italy.

Finally, the gains to be expected by developing countries from liberalizing services are enormous. Liberalization of services opens competition in equipment, as shown by the EC experience in telecommunications. Competition in services has induced European PTOs to abandon their traditional domestic suppliers for cheaper sources, and new services have induced European consumers to buy new equipment. Developing countries have largely benefited from these evolutions: the market shares of their exports of telecommunications equipment to EC countries increased, on average, by 20 percent in the first two years after the beginning of liberalization, and in only a few years some developing countries have upgraded their products from phone sets to small terminals (Messerlin 1990b). These increased exports will give developing countries the means to pay for increased imports in services, which in turn will allow them to improve the efficiency of their economies by decreasing the costs of services used as inputs. The estimated gains from the 1992 program to the EC countries—2 percent of their total GNP—look impressive. It is likely, however, that they greatly understate the gains to be expected in developing countries, where the lack of adequate telecommunications or finance often has an infinite cost, since it inhibits potential exports.

Appendix 14–A. The 1992 Program, by Service Sector

BANKING. The main new directive, the Second Banking Directive, deals with the creation and implementation of a single EC banking license. After 1992 (and as in the past), bank subsidiaries, which are classified as factor-related trade in services in the EC framework, will be governed by the *national treatment* clause—that is, they will be treated by the host EC state as domestic banks in terms of licensing and operating requirements. For instance, a French subsidiary of a British bank will be treated as a French bank. The crucial innovation of the directive concerns the provision of cross-border banking services (for instance, money transfers) and bank branches, which are classified by the EC as cross-border services. After 1992 these services will be ruled by the principle of *mutual recognition;* each EC state will recognize the licensing rules of the others and will apply its own operating rules on a nondiscriminatory basis to branches of banks licensed in other EC states. For instance, a French branch of a British bank will be under British, not French, licensing rules and will operate under French operating rules concerning monetary regulations, liquidity, and the like.

In fact, banks operating throughout the Community would be largely regulated by their home countries. The exact coverage of mutual recognition is still uncertain because the borderline between licensing rules and operating rules is difficult to draw with precision at this stage. For instance, will a firm operating under a British building society license be able to offer variable mortgages or money market funds in the whole EC, including in EC states that prohibit such mortgages and funds? If so, the French ban on such mortgages will "disadvantage" French banks in relation to British banks or to banks from EC states that allow this service. Similarly, the German ban on money market funds will work to the "disadvantage" of German banks.

The main benefit of the mutual recognition approach is to require the minimal effort in regulatory harmonization—a huge gain in efficiency when twelve countries are involved. Because of its enormous potential impact, the mutual recognition principle is likely to trigger creeping resistance to liberalization, as indeed has been seen in the efforts of some EC states (led by France) to impose withholding taxes on capital to prevent capital movements and limit competition. The ambiguity of the principle is also likely to generate cases for the Court of Justice.

The Second Banking Directive is flanked by two directives—on mutual funds (the "undertakings for collective investment in transferable securities," or UCITS, in EC jargon) and on "investment services" (brokers, dealers, and so on). The directives apply to these two types of securities firms the same mix of national treatment and mutual recognition principles. The three directives constitute the backbone of the 1992 program as it applies to banking and securities. The minimal harmonization in prudential matters is covered by eight directives on banking, five on securities, and three on capital movements.[16]

INSURANCE. The 1992 program inherited the free establishment principle that was adopted in 1973 for nonlife insurance and in 1979 for life insurance. The huge effort to harmonize the regulations of the EC states necessary to transform this principle into actions failed. Insurance markets remained closed, except for reinsurance. As a result, the 1992 program initially focused on the right of firms to provide services across the borders of the EC states. Its main success concerns the nonlife "large risks"—property and damage risks that involve firms of a minimum size, as measured by number of employees, turnover, and assets, and that are estimated to represent 50–65 percent of the nonlife market. After 1991 such risks will be offered by insurance firms operating under home country rules, which implies mutual recognition of insurance regulations among EC states.

In the remaining areas of nonlife insurance ("small" policyholders) and in life insurance, progress has been limited. As a result of rulings by the Court of Justice (discussed above), the current 1992 program allows EC insurers to compete in all EC states only under host country rules. The expected impact of such measures is not high: insurers will not be keen to undertake the huge costs of penetrating markets in a alien legal environment, except through mergers—an ambiguous move from the point of view of competition. As a result, the vice-president of the Commission, Leon Brittan, recently proposed that the same approach as in banking and securities be followed: insurers would be free to set up branches in other EC states and to sell their products on the basis of a single license and supervision from the home country (*Financial Times*, November 28, 1989).

AIR TRANSPORT. The December 1989 package expands the decisions made in the December 1987 package. Quota (capacity-sharing) arrangements are dismantled, the initiative of basing prices on costs is given back to airlines by generalizing the "double disapproval" procedure, and discounts are authorized.[17] These provisions, however, are not likely to introduce significant changes in competition and fares unless new rights regarding market access are adopted: "multiple designation" (that is, the capacity to designate more than one carrier to operate the same route) and the fifth freedom (the capacity to set down and pick up passengers at an intermediary airport en route to the final destination). Without these two conditions—particularly the first one, which represents a shift from bilateral to multilateral liberalization—airlines have no strong incentives to enter new routes.

The ambiguity of the December 1989 package is that it includes these provisions, but only as nonbinding agreements. The 1987 package has not allowed a major breakthrough in these matters. The coverage of multiple designation increased from 5 percent of the scheduled air routes in June 1987 to 7 percent in June 1989, mainly because of Britain's policy. The coverage of the fifth freedom is even lower: one fifth-freedom service was operated by a Community airline before 1988 and only 14 in 1989 (Commission 1989).

TELECOMMUNICATIONS. The content of the 1992 program concerning telecommunications has been confirmed and refined by the December 1989 agreement. The program relies on two main directives that strike a delicate balance between forces in favor of and against liberalization.

The directive on telecommunications services states that value added network services will be liberalized but that the PTOs will keep their monopoly in basic services. The crucial point—the borderline between the two types of services—is defined by the December 1989 agreement: by mid-1991 value added services will cover advanced services, such as electronic mail and access to computer data bases, and in early 1993 they will be extended to cover basic data communications—at 25 to 30 percent a year, the fastest growing part of the market—leaving only telex and voice telephony to basic services.[18]

The directive on open network provisions (ONP) aims at harmonizing the conditions under which the liberalized telecommunication services industry would gain access to the networks. It states three basic rules: technical harmonization that allows full connectivity among the EC networks; minimal standards required for private firms under competition; and harmonization of the principles for setting tariffs, preferably on the basis of cost. More detailed regulations are to follow the directive. The fact that they will be drafted by a body emanating from the twelve PTOs has raised fears of collusion or abuse of dominant positions by PTOs.

SHIPPING. During the 1980s shipping suffered from a decline of activity coupled with the emergence of new competitors—an unusual feature among services, and one unfriendly to liberalization. During these years EC state shipping policies were limited to waivers to cabotage rules and to more liberal grants of cargo reservations. The progressive implementation of "flagging-out" policies (opening ship registers, with fewer constraints on hiring, meaning lower taxes and wages) is introducing a subsidy policy through a "fiscal" delocalization of the industry. The flagging-out policies have only a modest liberalization component in that the protectionist bias against crews from developing countries is reduced, facilitating movement of semiskilled labor. Finally, the drift of liner conferences into cartels backed by international agreement (the UNCTAD Liner Code) has made virtually impossible the adoption of more competitive rules within the EC.

The 1992 program in shipping mirrors these problems. Liberalization is slow: freedom to provide services between EC states has been adopted, but freedom to provide services within EC states has not. (So far, this is the only 1992 directive to be rejected). Competition has difficulty in emerging: liner conferences have been granted a "block exemption" from the competition rules of the Rome Treaty.

ROAD TRANSPORT. In road transport the 1992 program is starting from scratch with the issuance of 15,000 special permits, to be distributed by EC states, that will be valid for limited periods and will enable haulers to do business across the Community.

BUSINESS SERVICES AND LABOR MOVEMENT. The main business services dealt with in the 1991 program are accounting, television programming, and the legal and medical professions. Nine directives deal with the progressive introduction of the mutual recognition principle in professional services to ensure free movement of skilled labor. Enforcement of this principle is likely to be a long, contentious process. Semiskilled or unskilled labor (for instance, in the construction sector) is partly covered by EC provisions dealing with public procurement, as illustrated by the recent contract for the construction of the Great Belt Bridge in Denmark; the initial clause calling for use of Danish labor was dropped after the Commission intervened.

Notes

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1. In a very few instances the absence of national firms has allowed EC states to be liberal for a long time—Denmark in telecommunications and Luxembourg in airlines are examples.

2. NIFs are note issuance facilities (revolving facilities that enable borrowers to issue a stream of short-term notes). RUFs are revolving underwriting facilities, a kind of guaranteed NIF.

3. The "Ryrie rules" stated that private financing of public firms should be allowed only if this would result in improved efficiency—a condition close to a veto with the British Treasury as umpire (Ryrie 1989). The privatization of British Telecoms required the raising of 2.5 times more funds than the five privatizations undertaken between 1981 and 1984.

4. Liberalization of scheduled services took off in 1984 with relaxations of the licensing rules (licenses were given to fly any route, except some specified ones) and the domestic fare approval system (Barnes 1988).

5. To license new competitors (such as British Railways) or to authorize the resale of leased lines from British Telecom might have been alternatives to the duopoly, if one ignores potential entry by large foreign firms. Interestingly, Mercury relies on Hong Kong Telecoms for most of its profits (*Financial Times*, June 10, 1989).

6. Until 1987 Germany was considered the most protectionist EC state in telecommunications by any standard: a 100 percent state-owned monopoly dominated public procurements in telecommunications, and there was no separate regulatory agency, no other network operator, no separate subsidiaries in competitive markets, and no unrestricted use of leased lines for value added services (Muller 1988, p. 172).

7. This decision has applied to low-speed data services since April 1989 and to the much more important high-speed data services (64K bit per second and 2 megabit per second lines) since June 1989.

8. Mercury's ability to survive as an independent firm was attributable to the fact that it was owned by Cable & Wireless, a firm that had a long tradition of world-wide telecommunication systems (Ergas and Paterson 1989) and was well established in other key areas, such as Hong Kong; to the most recent technology, which makes possible considerable flexibility for locating telecommunications hubs in other countries; and to the competitive pressures from the other side of the Atlantic (although U.S. Judge Harold Greene did bar a joint project of Nynex and Cable & Wireless for a transatlantic fiber optic telephone cable *Financial Times*, February 15, 1989).

9. This is confirmed by recent estimates from a National Utility Services study according to which a standard 3-minute long-distance call is three times more expensive in Germany than in Britain and a local call is 25 percent less expensive in Germany than in Britain (*Financial Times*, June 30, 1989).

10. Directives are Community laws that have to be introduced as national laws. The complete 1992 program deals with many other topics in addition to trade in services and rests on 279 directives. The Commission is increasingly worried about delays in transforming directives into national laws.

11. For a view about the EC 1992 program and the Uruguay Round embracing manufacturing and services, see Sapir (1989). For a view focusing on 1992 and developing countries in services, see Nicolaides (1989).

12. Policies such as flagging out cast some doubt on the value of the immigration argument raised by all industrial countries for limiting labor movement. Would foreign crews recruited by EC firms be "less foreign" than foreign crews employed by foreign firms?

13. For a detailed and comprehensive analysis, see Key (1989). Under article 58 of the Treaty of Rome, subsidiaries of non-EC banks benefit from all the rights accorded by Community law. There were roughly 530 foreign bank branches in the EC as of February 1989 (Fitchew 1989).

14. Some mergers or consortia cover equipment and services, as, for example, the recent "pact" between British Telecom, STET of Italy, and Telefonica of Spain on network modernization, mobile communications, value added services and international communications (*Financial Times*, December 19, 1988).

15. Galileo is built by British Airways, KLM, and Sabena (with Alitalia and Swissair) and Amadeus by Air France, Lufthansa, and Iberia (with SAS). Galileo is connected with United Airlines (a U.S. airline) and Amadeus with Texas Air (a U.S. airline) and with several Asian–Pacific airlines through Abacus, the common CRS of Cathay Pacific, China Airlines, Malaysian Airlines, Philippine Airlines, and Singapore Airlines, which was developed with the technical support of Cable & Wireless.

16. In banking the main harmonizations concern solvency standards, own funds, accounts of banks and of foreign branches of banks,

cross-border provision of house mortgages, and principles to be adopted by supervisory authorities in dealing with institutions in difficulties. In securities harmonization provisions deal with information to be provided in case of sales to the public or of acquisitions of major holdings and with insider trading, with derogations for Greece and Portugal. Capital adequacy directives covering credit risk and risks related to interest rate, exchange rate, position, and settlement are being drafted. Capital movements provisions spell out harmonizations with a longer period of transition for Greece, Ireland, Portugal, and Spain and a safeguard clause in case of major macroeconomic problems.

17. The 1987 directive on capacities replaced the traditional capacity sharing rule (50–50 percent) with a lower quota (45–55 percent and, in October 1989, 40–60 percent). The 1989 agreement targets a 25–75 percent quota by the end of 1992. Fares that "reasonably reflect the costs of an individual airline" should be approved by the EC states. Discount and deep discount fares are available for off-peak periods and specific passenger categories. Fare measures are accompanied by safeguards if fares drop by more than 20 percent.

18. But EC states that wish to issue license conditions for data communications will be able to do so if the conditions are nondiscriminatory and are vetted by the Commission. Greece and Portugal have received a potential derogation up to 1996 if their public services are at risk.

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