Chapter 4

The welfare effects of preferential services liberalisation

Having discussed the significance of services for the EU and India, the barriers to trade that exist between them and possible areas of coverage in an EU–India FTA, we now ask whether such liberalisations would be preferential or MFN. The principle of an FTA is discrimination – the preferential liberalisation of trade – but *de facto* it may be difficult, if not impossible, to implement the opening up of some sectors on a preferential basis. While market access and national treatment restrictions may be relaxed on a preferential basis, the removal/reduction of most regulatory barriers has more or less to be on an MFN basis. As an example, the number of partners in Indian accountancy firms is restricted to 20. If this were to be relaxed, it would be extremely difficult to limit this to preferential suppliers. Similarly, improved regulation of banks will apply to all, not just EU and Indian, banks. In such cases, *de jure* preferential access becomes *de facto* MFN access.

One caveat to the *de facto* multilateralisation of concessions is to note that even if all regulations eventually apply to all suppliers, there may be first-mover advantages for the preferred partner in the form of incumbency advantages which operate to the detriment of those from excluded countries. Preferential access to a services supplier could initially be in terms of market access, national treatment and regulatory requirements. These then translate into significant privileges in the domestic market once the foreign supplier has established presence. Think of a retail chain opening an outlet as part of a preferential agreement in a hitherto closed market. Such preferential market access could allow the incumbent significant advantage in terms of domestic clients and resources – access to land, labour, capital, entrepreneurship – and knowledge and use of the supply chain. These may be sufficient to give it a competitive advantage even if it is inferior to more competitive suppliers from the excluded countries. Then such incumbency advantages would have durable adverse welfare consequences relative to a more even-handed liberalisation, and the country could be stuck permanently with weaker providers even when it subsequently liberalises on an MFN basis. Such incumbency-advantages are likely to be particularly important in services with network externalities[63].

On the demand side, once a supplier has been granted preferential access, it may also be able to develop a clientele through advertising and promotional campaigns that pre-empt demand. The more imperfect the consumers' information and the more important the costs of switching suppliers, the greater would be this 'clientele effect.' For example, consumers are often reluctant to switch banks and telecommunications suppliers even when new entrants offer better terms. Such incumbency effects may be stronger in services with network externalities, like telecommunications, where new entrants' technical standards

must be the same as those of the incumbent. On the supply side, the incumbent may succeed in assuring itself of the services of the most capable franchisees and other stages in the supply chain by selecting them initially and imposing exclusivity on them.

Each of these forms of 'capital accumulation' thus enhances the first-mover advantages for a preferential supplier and, once established, allows such an incumbent to restrict or prevent competition. The importance of sunk costs and the consequent incumbency advantages imply that sequential entry can produce very different results from simultaneous entry. If entry is costly, then the incumbent may be able to completely deter entry so that the outcome is a much more concentrated market structure. Moreover, the first-mover advantage conferred on an inferior supplier may be used by it to establish a position of market dominance. Once again, though, the durability of such a position would depend on the importance of sunk costs relative to differences in costs and quality[64].

Notes

63 As Fink and Mattoo (2002) discuss, in a way these incumbency advantages are in the nature of sunk costs of investment and, as shown by Tirole (1988), these matter because of their commitment value and their use as a strategic signalling mechanism by those who are allowed to enter the market first. A firm that establishes a telecommunications or transport network today, for instance, signals that it will be around tomorrow if it cannot easily resell the equipment. Of course, the commitment value would depend on the rate of capital depreciation and would also be specific to the firm/industry. Thus, if some suppliers are allowed preferential access, such incumbents may accumulate enough capital to limit entry of other firms.

64 'Two qualifications to this argument based on sunk costs are important. First, entry by the more efficient firm could take place through acquisition circumventing some of the problems of first-mover advantage. But this would require no asymmetry of information about the value of assets and no direct costs of transferring assets. Secondly, in certain services sectors, firms could learn by doing: the experience acquired by the established banks during the previous period reduces their current costs, enhancing their competitiveness and discourages others from entering. This form of entry deterrence may well promote welfare.' (Fink and Mattoo, 2002)