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QUANTIFYING BARRIERS TO TRADE IN SERVICES THROUGH COMMERCIAL PRESENCE: SELECTED SERVICES IN MALAYSIA

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─Abstract ─
The services sector in Malaysia is slowly liberalising in terms of equity ownership. However, trade and investment barriers in the services sector are difficult to measure since it is not easily quantifiable. Previous studies were mainly macro-level, multi-country cross-sectional assessments while there are no country level studies over time. This paper has two objectives. The first is to measure barriers to trade in services carried out through commercial presence (Mode 3) in Malaysia in several industries over time. The second objective is to assess the policy implications of the measurement obtained. Based on available data, the industries covered in this study include communications, construction, distribution, higher education, financial, healthcare, tourism and transportation and logistics services from 2001-2010. This assessment is important as Malaysia hopes to attract more foreign direct investment (FDI) into its services sector. Information is gathered through surveys, focus group discussions and content analysis of secondary sources. Restrictive policies on FDI are transformed into an index to measure the extent of liberalisation for each subsector. Based on the index, it can be seen that the liberalisation process is still slow. To facilitate further progress in liberalising the services sector, it is important to liberalise barriers beyond mere equity ownership.

Key Words: *Trade in Services, Services Liberalisation, Foreign Direct Investment, Malaysia*

JEL Classification: F14, F21

1. INTRODUCTION

Generally, Malaysia welcomes foreign direct investment (FDI) and it is considered as an open and liberal economy. Whilst the manufacturing sector is very liberal and has attracted many leading global manufacturers, the services sector is still regarded as restrictive and less attractive to foreign investors despite it being the biggest contributor to the economy with a share to Gross Domestic Product (GDP) consistently above 50 per cent since 2005. The current target of the Tenth Malaysia Plan (2011-2015) is for the services sector to grow by 7.2 per cent annually and its contribution to GDP is expected to increase from 58 per cent in 2010 to 61 per cent in 2015. This sector is also targeted to generate 40 per cent of its investment from foreign investment, up from 15 per cent of total service sector investment in 2009 (EPU, 2010).

The investment target is not something that is impossible to achieve if the investment regime in Malaysia is perceived to be sufficiently liberal. However, how is liberalisation measured? So far, attempts to measure liberalisation are available in a few studies such as Hardin and Holmes (1997), Golub (2003) and UNCTAD (2006) that focus on the measurement of restrictions or barriers to inward FDI in especially the OECD countries. Malaysia is included only UNCTAD (2006:17) and they find that there is a strong negative correlation between how restrictive a country is, and how attractive it is to FDI. Measures of services liberalisation in Malaysia were also calculated by Dee and Dinh (2009), where Malaysia is classified as restrictive in healthcare services and relatively less restrictive in financial services.

Since previous studies are cross country studies, this study aims to focus on a single country time series study on the services sector in Malaysia, where barriers to FDI inflows are still substantial. Specifically, this study has two objectives. The first is to measure barriers to trade in services carried out through commercial presence (Mode 3) in Malaysia in several industries over time. The second objective is to assess the policy implications of the measurement obtained. Taking into cognizance that barriers in services sector involve regulations governing this sector, quantifying these barriers remain a challenge in most countries.

2. LITERATURE REVIEW

2.1. Theoretical Context

Inflows of foreign direct investment (FDI) in the services sector in Malaysia will be analyzed based on the locational advantages of the eclectic paradigm or the OLI (ownership, locational and internalisation) Model developed by Dunning (2003 and 2008). Dunning argues that firms choose to operate from a foreign location to serve some other markets only if they find that the associated transaction costs to move their production facilities to a foreign location is lower compared to servicing such markets from their home countries. Therefore, it is important for Malaysia to ensure that the Government's policy towards inward FDI provides a more conducive environment, especially by improving its regulations and systems through liberalisation measures.

2.2. Measuring Liberalisation of the Services Sector

The growing importance of the services sector to the economy has called for more accurate and relevant indicators or measurements for the sector. The Department of Statistics Malaysia (DOSM) collects data for the services sector, in both macro and micro data. Macro data is more commonly produced as they are generated for the National Accounts and the Balance-of-Payments Account. In addition, the DOSM also collects specific-industry data through census and surveys for various services. Nevertheless, these micro level surveys do not have a sufficiently long time series and have not covered all service industries in order to conduct a more comprehensive sector-wide analysis.

Furthermore, the heterogeneity and highly regulated nature of services sector also imposes more difficulty in the assessment if a researcher is interested to study the level of openness or restrictiveness of the sector. Unlike the goods sector, liberalisation of services trade does not exist in the form of tariff reduction, but in terms of deregulation of domestic regulations such as qualification requirements and procedures, technical standards and licensing in order to foster competition, reduce cost and increase transparency. This information is not readily available in Malaysia as systematic quantification and analysis of services liberalisation are mainly undertaken in cross-country studies by international organisations such as UNCTAD, OECD, APEC and ASEAN as part of a multi-country analysis such as studies by Dee and Dinh (2009), UNCTAD (2006) and Golub (2003).

The absence of country level assessment of services liberalisation is the primary motivation for this study. There is no central agency that compiles liberalisation indicators since they predominantly exist in a qualitative form, especially when they are related to licensing, employment and business operations. The relevant regulations are normally provided in various acts and regulations, which may not be regularly revised.

2.3. Foreign Direct Investment in the Services Sector

Malaysia's FDI policy has imposed various restrictions to ensure local industries are not marginalised and to safeguard certain national objectives. Studies on the commercial presence or FDI in the services sector such as the one by Productivity Commission of Australia (Dee, 2005), OECD (Golub, 2003), UNCTAD (2006) and APEC (Hardin and Holmes, 1997) have used questionnaires and secondary data from official sources as the main research instruments. The above studies generally translated qualitative information into an index of restrictiveness or liberalisation of the regulatory environment. The index constructed harmonizes the translation of qualitative information across sectors and enables cross sectoral comparisons on the relative restrictiveness of each sector. The lack of systematic collection of such data in Malaysia has called for a new set of data to be generated.

3. METHODOLOGY

Quantitative and qualitative information is used to quantify the extent of liberalisation and this is then used to construct an index of investment restrictiveness of each sector. A combination of survey questionnaires, focus group meetings and secondary qualitative and quantitative data sources are employed, based on Golub and Koyama (2006) which measured the explicit regulatory restrictions on FDI in 29 OECD and 13 non-OECD member countries. The questions are divided into three main categories of variables, namely, foreign equity participation (maximum percentage of foreign equity allowed), screening and approval (economic benefits test versus automatic approval through notification) and other restrictions (proportion of nationals in the board of directors/managers, maximum duration allowed for working permit and domestic content requirement for financing and employment). Each category has been detailed out into a few items and they are assigned individual scores based on Golub (2003). The respondents are expected to provide 10 responses to each question that correspond to the period between 2001 and 2010.

The scoring system looks into explicit regulatory barriers, excluding non-policy institutional restriction i.e. governance. The biggest weight is accorded to restrictions on equity since the extent of foreign ownership is an important condition for attracting FDI. The system also allocates a full restrictive score of 1 if a specific sector in banned totally i.e. foreign equity participation is not allowed. Therefore, even though the scores for each question are expected to add up to an index of between 0 and 1, in which 0 represents full liberalisation and 1 represents full prohibition, a score of more than 1 is possible if a certain sector has a total ban on equity. From the study, Golub and Koyama (2006) found that the most liberal economies are mainly European countries with the restrictiveness index of below 0.20. The result relates back to the late 1980s when intra-European Union (EU) FDI flows are almost completely unrestricted. In addition, the European Economic Community (EEC) has also liberalised policies towards inward FDI, with substantial harmonisation of regulations have occurred.

Based on available data, this study covers eight subsectors of services, namely, communications, construction, distribution, higher education, financial, healthcare, tourism and transportation and logistics services from 2001-2010. The respondents are purposefully selected among 35 potential respondents, which consists of 11 governmental authorities, two central government agencies that are responsible for the establishment of companies and the movement of human capital and 22 industry associations, were contacted. In the case where an industry association is not available, a representative firm is included in the survey. The main reason for selecting these two groups of respondent is that they are expected to have the knowledge about market access policies as well as regulations governing pre- and post-establishment of a foreign investor in Malaysia.

3.1. Survey

Malaysia's liberalisation commitments do have differences depending whether they are made at the multilateral and regional levels. Therefore, two versions of the questionnaires were prepared and distributed by mail. The first set is for responses applicable to non-ASEAN countries, while the other is for ASEAN member countries. Since there are two versions of the responses, the average score will then be calculated to represent the index for each subsector. Less than five percent of the respondents provided complete answers, and they are from the public sector. With such a low response rate, the information is insufficient to help construct the liberalisation index.

3.2. Qualitative Inquiry

As the effort to gather the required information through the survey received few responses, a focus group discussion with trade negotiators from the Ministry of International Trade and Industry (MITI) who coordinates multilateral and regional trade negotiations on services was conducted, based on Bryman (2008:474). As the main approach in this study is to identify actual restrictions, content analysis was also conducted on various official documents, texts and reports, especially Malaysia's GATS schedules of specific commitments, the AFAS services packages, WTO trade policy review reports, APEC individual action plans, Companies Act 1965 and some other related guidelines. Nevertheless, GATS commitments by themselves are not comprehensive since they are prepared as positive lists, which may not include certain restrictions that are intentionally not included by the authority concerned. Therefore, some other sources have been referred to as well in order to improve the credibility of the data.

4. RESULTS

The process of quantifying services liberalisation is carried out as best endeavour, using as many data sources as possible. Even though the results may not be perfect, it is expected to provide some indication of how Malaysia performs compared to other countries, based on the same methodology used as in the cross country studies. The credibility and accuracy of the estimated liberalisation index could be improved by selecting the right restrictive regulations, as many as possible.

4.1. Overall Score Results

The summary results of the restrictiveness of FDI in Malaysia are presented in **Table 1**. In general, the degree of liberalisation of each subsector has not reached the OECD standard as none of them has a score below 0.20. However, the decreasing values of the indices over time indicate that each subsector had shown some degree of liberalisation from 2001-2010. Tourism and banking and insurance subsectors have made the most significant improvements and emerged as the most liberal subsectors, especially due to the policy changes that permitted 100 per cent equity ownership in 2009.

Table 1: Calculated Regulatory Restrictiveness Index

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Communications	0.52	0.52	0.52	0.52	0.51	0.51	0.51	0.51	0.44	0.42
Construction	0.60	0.60	0.60	0.60	0.60	0.50	0.50	0.50	0.50	0.50
Distribution	0.65	0.65	0.65	0.35	0.35	0.35	0.35	0.35	0.35	0.35
Education	0.65	0.65	0.65	0.65	0.50	0.48	0.48	0.48	0.43	0.43
Banking and Insurance	0.49	0.49	0.49	0.49	0.49	0.44	0.44	0.44	0.28	0.28
Healthcare	0.63	0.63	0.63	0.63	0.53	0.53	0.53	0.53	0.43	0.43

Tourism	0.65	0.65	0.65	0.65	0.60	0.60	0.60	0.60	0.25	0.25
Transport	0.84	0.84	0.84	0.84	0.84	0.81	0.81	0.81	0.66	0.60

Source: Calculation by authors

4.2. Foreign Equity Participation

Limitations on foreign equity ownership depend on the respective subsector's development path as each subsector approaches liberalisation based on its own sensitivities. For instance, a subsector such as land transport is very restrictive due to its strategic nature for socioeconomic development. In the early years under study, commercial presence is generally confined to joint ventures, in which a cumulative foreign ownership cannot exceed 30 per cent. Insofar as barriers to commercial presence restrict competition in the provision of services, they tend to impair efficiency in the sector, so that the prices paid for these services, by businesses and households, are higher than would be the case in a more competitive market. The resulting higher costs of doing business can hamper the competitiveness of all firms in Malaysia that require essential services (such as finance, communications and transportation) as inputs in their production and delivery of goods and services (WTO, 2001: 68). However, it can be seen from Table 1 that Malaysia seeks to encourage foreign investment in services by progressively liberalising the services sector. Most of the subsectors offer majority shareholding to foreign investors, with some subsectors permitting a 100 per cent foreign ownership.

Some of the significant policy changes made during 2001-2010 are enumerated as follows:

- Foreign equity participation for foreign Islamic banks and international insurance companies were increased up to 100 per cent (WTO, 2010).
- For distribution services, the introduction of the new Guidelines on Foreign Participation in the Distributive Trade Services 2004 allows for foreign equity participation of up to 70 per cent.
- For tourism, Malaysia has been promoting the tourism industry, among others, by removing or reducing foreign equity restrictions. From April 2009, 100 per cent foreign equity is allowed in theme parks, convention and exhibition centres (seating capacity above 5,000), travel agencies and tour operators (for inbound travel only); and hotel (for 4 and 5 star hotels) and restaurant services (WTO, 2010: 67).

- The Private Higher Educational Institutions Act 2009, which regulates the establishment of new higher learning institutions, including foreign-owned universities, allows for up to 100 per cent of foreign equity participation.
- Communications, construction and healthcare have little improvements as liberalisation measures are mainly directed for ASEAN investors.
- Transportation services have been restrictive for land and rail services as they constitute public transport services. Only maritime services are being offered equity ownership up to 70 per cent in ASEAN.

4.3. Screening and Approval

Every subsector requires the foreign investor to make a formal application to establish their operation in Malaysia, as in other countries. Malaysia receives a high score (maximum of 0.2) on this category as the authorities require the investors to carry out the economic needs test (ENT), which is considered as a barrier to market access since there is no clear rule of on implementation. A decision to allow an investor to enter could be delayed if the authority intentionally uses ENT as a protection tool. However, ENT is not imposed on ASEAN investors, except in matters related to labour mobility.

4.4. Other restrictions

While there is no performance requirement imposed on services, the rules on establishment of branches, the membership of the board of directors and the composition of managerial posts are normally standardized across the sector as provided by the Companies Act 1965 but they are deemed to be restrictive as they require the majority of nationals i.e. at least 50 per cent of them must be Malaysian citizens or residents. In terms of the approval and allowable number of licenses, branches and work permits for expatriates, Malaysia is generally quite generous as there is essentially no specific limit to the number of new licenses, except for banking and insurance and healthcare services. Expatriates are generally granted a 5-year work permit, and normally renewable for another 5 years.

5. CONCLUSION

There has been significant liberalisation in FDI restrictions in Malaysia’s services sector in the last decade, although there remain substantial variations in the degree of liberalisation across industries. The accuracy of the assessment can undoubtedly be improved with better information, especially by surveying and getting answers from areas of regulations that are more specific and could affect the sector directly.

Based on the information collected in this study, services liberalisation requires reduction or removal of restrictions in various aspects of domestic regulations. Even though there are many aspects of liberalisation, restrictions on foreign ownership, ENT and expatriate-related issues are found to have a huge impact on the index. Hence, these are the areas which require special consideration for future liberalisation. The index provides a tool to assess restrictions and trade cost, where they exist, and allows for some comparison with other studies and comparisons across sectors. The results in this study can be used to assist economists and trade negotiators in their analysis and policy formulations by ascertaining the gains and costs of trade barriers through economic modeling in future studies. Simulation exercises from such modeling can be used in policy formulation, especially for Malaysia's international commitments and domestic reforms aimed at improving the competitiveness of the services sector.

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