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Services Trade and Domestic Regulation: Issues for Developing Countries

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1. INTRODUCTION

The service sector has become increasingly important in national output and employment of developing and least developed countries (LDCs). For many of these economies, services constitute a fast growing and often-dominant sector in gross domestic product (GDP), with important forward and backward linkages to the economy. With growing global trade and investment flows in services along with technological advances, the sector presents many developing countries with opportunities to diversify their economies as well as their export baskets and markets, to tap emerging segments that leverage their inherent and acquired sources of comparative advantage, and to address domestic concerns of service quality, accessibility, and economic efficiency.

However, growing trade and investment flows in services, and the liberalization and deregulation of trade and investment regimes also pose regulatory challenges and raise many concerns. These relate to issues of consumer protection, universal service provision, equity-efficiency trade-offs, and the need for institutional and regulatory reforms and measures to support liberalization and to ensure that the potential benefits are realized and risks mitigated. There is also the challenge of deciding the right balance between public and private delivery of services, the right degree of regulation so as to ensure competition and efficiency without compromising on various public policy objectives, the need to put in place the right kind of institutional structures so as to balance commercial, social and other concerns, and issues of institutional capacity. These challenges are further compounded by the lack of quality data on services in most developing countries.

This Trade Hot Topic summarizes the cross-country experience with domestic regulation of services and liberalization of services trade and investment, based on a multi-country study of six developing countries, namely, Bangladesh, The Gambia, India, Jamaica, Kenya, and Zambia. The sample countries provide an illustrative mix of developing and least developed countries with considerable variation in terms of income, size, degree of openness, and institutional and regulatory capacity so that interesting commonalities and differences can be drawn and the role of country specific features identified. This paper outlines how the service sector has evolved and been impacted by trade and investment liberalization and sectoral reforms in these countries, the contribution of services to these economies,

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some of the negative outcomes associated with liberalization, the regulatory challenges that have shaped the liberalization process, and how the national experiences have in turn shaped the multilateral commitment strategy of these countries under the WTO negotiations on services (under the General Agreement on Trade in Services or GATS).

2. CROSS-COUNTRY OVERVIEW OF THE SERVICE SECTOR: TRENDS AND CONTRIBUTIONS

The significance of the service sector can be assessed in terms of its contribution to growth and GDP, to employment, trade and investment flows, and competitiveness. An important feature that emerges for all the six countries covered under the multi-country study is that services constitute the dominant sector, accounting for over 50 per cent of GDP. Services have exhibited the most dynamism while the primary sector's share in GDP has declined. The extent of this shift has, however, varied across the countries, depending on initial conditions, resource endowments, and the degree of liberalization undertaken in each economy, all of which have affected their ability to take advantage of new market opportunities and developments in the service sector. Table 1 demonstrates the trends in the significance of services in the economies of the six selected countries.¹

Table 1: Services share in GDP, selected years (%)

	2000			2005		
	Agriculture	Industry	Services	Agriculture	Industry	Services
Bangladesh	25.5	25.3	49.2	20.1	27.2	52.6
The Gambia	35.8	13.1	51.1	32.6	13.1	54.2
India	23.4	26.2	50.5	18.3	27.3	54.4
Jamaica	6.7	31.3	62	5.7	33.1	61.2
Kenya	32.4	16.9	50.7	27	18.5	54.4
Zambia	22.3	25.3	52.4	18.5	25.1	56.3

The common factors that might have contributed to growth in the service sector include policy reforms, deregulation of commodity and factor markets, and privatization of state owned enterprises. In addition, exogenous developments due to technological advancement, increased tradability of many services, and the pattern of global demand have also shaped trends in the service sector of all these economies.

The country experiences seem to demonstrate a positive correlation between employment growth and opening up of services, with the most dynamic subsectors exhibiting the highest rates of employment growth. However, in some countries, it has been observed, that the employment elasticity in services is lower than that in manufacturing and agriculture, thus the service sector's contribution to employment is not commensurate to its overall contribution to value added.

The country studies further reveal that the expansion of the service sector has created opportunities for developing countries and LDCs to improve overall efficiency and capacity to export both goods and services, as well as to diversify their means for foreign exchange earnings. However, not all countries have been able to capitalize on these opportunities, with some countries exhibiting no significant improvement in export competitiveness in their service sectors. Tables 2-3 show trends in the services trade for the six countries, based on the WTO's international trade statistics.²

On the trade front, countries have often benefited to different degrees following service sector liberalization and reforms. However, for most countries, the gains have not been commensurate to those observed for output and employment, while in countries that have been able to take advantage of

¹ World Development Indicators, miscellaneous years.

² WTO, International Trade Statistics Yearbook (2007).

Table 2: Trends in services share in total exports (%)

	1996	2000	2005
Bangladesh	4.98	4.24	4.85
Gambia	80.73	80.51	90.9
India	17.82	27.44	35.36
Jamaica	53.22	60.38	60.01
Kenya	27.62	29.54	31.62
Zambia	10.91	14.61	13.71

Memo Items*Total Exports of Commercial Services (US\$ million)*

Bangladesh	223	283	474
The Gambia	88	62	80
India	7,179	16,030	54,382
Jamaica	1,574	1,988	2,296
Kenya	789	727	1523
Zambia	112	114	232

Table 3. Trends in services share in total imports (%)

	1996	2000	2005
Bangladesh	13.08	14.63	12.64
The Gambia	18.86	24.59	15.95
India	22.47	26.83	26.16
Jamaica	27.38	29.48	26.17
Kenya	19.44	17.63	13.38
Zambia	25.61	24.82	17.6

Total imports of commercial services (US\$ million)

Bangladesh	1059	1523	2011
The Gambia	60	61	45
India	11000	18896	49195
Jamaica	1118	1391	1683
Kenya	712	665	950
Zambia	282	328	431

emerging segments and market opportunities, the impact has been highly favorable. The telecommunications sector commonly emerges as the service sub-sector that experiences the most gains and also contributes significantly to the rest of the economy, indicative of its importance in output and its key role as a producer service input to a wide range of tradable services. Almost all the country studies highlight the fact that services have become an increasingly attractive destination for foreign investment.

3. LIBERALIZATION AND REGULATORY REFORMS IN SERVICES: ISSUES AND CONCERNS

The multi-country study highlights the process of liberalization and regulatory reform in the selected countries, with particular focus on the interplay between the two, i.e., how domestic regulation has shaped liberalization, how liberalization has in turn given rise to certain regulatory issues and challenges, and how the countries have responded to these challenges through changes in their domestic regulations. A common feature that emerges is that although there are benefits from liberalizing trade and investment flows in such services, there have also been unforeseen outcomes mainly due to lack of adequate preparedness and institutional capacity on the regulatory front. Moreover, the challenges associated with liberalization vary across infrastructural and social services. Different groups or classes of services have different regulatory issues and concerns, which may require different approaches. Hence, it may not be advisable to adopt a standard approach to liberalization across different service sub-sectors. Accordingly, the approach to multilateral liberalization may also need to vary to accommodate the different concerns associated with liberalization in different services. The country-based sectoral studies on financial, telecommunication, education, health, information and communication technology, and wholesale trade and distribution services will illustrate these varied issues and challenges.

Financial services

The financial services sector perhaps best highlights how changes in domestic regulation have facilitated liberalization and have also been necessitated by opening-up. The cases of Jamaica and Zambia show that in the absence of sound regulatory and legal frameworks, as well as the absence of institutional capacity to regulate, financial sector liberalization may not improve the overall performance of the sector and can also have adverse consequences. Domestic structural factors are moreover important in

shaping the effects of liberalization. However, the country studies demonstrate that well-implemented regulatory measures in the form of improved quality of supervision, stronger bankruptcy laws, improved consumer protection mechanisms, and other prudential measures can help address such problems as reduced access to credit in rural areas, rise in non-performing loans, and higher cost of credit that have been faced by some countries following the opening up of this sector. Such regulatory measures, when properly timed to support liberalization, can not only help to avert the aforementioned problems but can also enable a healthier and more competitive financial services sector in the long run. Countries where financial liberalization has been successful have witnessed gains in terms of financial product diversification, greater competition, improvement in regulatory oversight capacity, adoption of modern technologies, and improved efficiency in the financial sector.

The country experiences also reveal that the expansion of the banking sector and entry of foreign players need not yield the expected efficiency gains or improved access to credit if domestic players are not well equipped to access this growth. Liberalization may also aggravate inequities, especially in terms of the public-private and the rural-urban mix of financial services delivery and performance, thus affecting the realization of social and developmental objectives that are the mandate of the public sector. For instance, liberalization of the banking sector may shift low-risk businesses away from public sector banks to foreign and domestic private sector banks and worsen inequities in credit allocation. The public sector may not be able to benefit from liberalization to the same extent as the private sector unless additional regulatory reforms and measures relating to debt recovery, restructuring, consolidation, and greater autonomy and transparency in the functioning of the public sector banks, are introduced. In the poorest countries, liberalization of financial services may not necessarily promote the cause of universal access and improved consumer welfare as entitlement to such services may be limited. Here, the government may need to promote various forms of financial services, such as micro finance, investment funds, and the like to ensure wider access and competition. A guarded or phased approach to liberalization and perhaps conditions on private suppliers regarding the provision of services to other segments and geographic areas may also be warranted.

Telecommunication services

The liberalization experience in the case of telecommunication services, incorporates several interesting challenges that have been faced by some developing and least developed countries. For instance, case studies find that there are huge and broadly similar gains to be realized from telecommunications liberalization. These gains include increased teledensity and traffic volumes, improved profitability and returns on assets, greater efficiency, increased investment, adoption of new technologies, service convergence, and consumer gains due to improved quality, increased access, and reduction in calling rates. Innovation and technological change have also played an important role in shaping these gains.

However, there are also challenges that have been common across countries undertaking liberalization of this sector. These challenges pertain to rapid technological developments and the emergence of new segments and opportunities, the presence of multiple operators within the sector, continued government intervention in regulatory decision making, resistance of incumbents to entry of new players, conflicts of interest between regulators and incumbents, and difficulties faced by regulators in balancing commercial objectives and social obligations such as universal service provision.

The country studies seem to indicate that the content and process of liberalisation and regulatory reform are equally important. Where institutional and regulatory frameworks have been introduced to support the liberalization process, with well-defined functions and objectives, the experience has been more favorable. Where the process has been marked by lack of transparency, absence of independent regulatory oversight, absence of incentives to promote operational efficiency, failure to promote competition in key segments and to define responsibilities across multiple agents who may be involved in regulation, lack of prior planning and clear objectives, and failure to garner domestic stakeholder support, gains have been limited and liberalization has been subject to much debate and criticism. For instance, it has been seen that privatization may not necessarily result in greater competition and could actually formalize the creation of private monopolies if an important prerequisite to effective competition,

i.e., non discriminatory access to the telecommunications network is absent. Several of the country experiences highlight the need to strengthen technical and institutional capacity. For instance, through the establishment of a regulatory information system via networking with consumer societies, and through the development of capacity to deal with a multi-operator environment, a level playing field is ensured for all. The country experiences underscore the importance of the regulatory set up and its explicit independence from the government, the regulator's ability to balance commercial and social interests as well as the interests of incumbents and new players, and the need to instill confidence among consumers and investors. Another important point that emerges in the telecommunication services sector is the impetus that can be provided to the domestic liberalization and regulatory reform process by pre-commitments and adoption of regulatory principles under the WTO.

Wholesale trade services

The wholesale trade sector is recognized for its potential contribution to economy-wide competitiveness and efficiency. Liberalization of wholesale trade can yield considerable potential benefits in terms of improved logistics, transport and storage facilities, and an improved back end supply chain for the manufacturing and agricultural sectors. But as the multi-country study reveals, where there are backward and forward linkages, liberalization in the particular sector alone is not sufficient. The supporting policy and regulatory framework in related areas may be just as important, in the absence of which the desired benefits may not materialize. For instance, the development of a large scale, organized wholesale service sector is an important determinant of the gains that are expected to materialize from the opening up of retail services as it provides back-end support to retailers. An efficient wholesale sector can provide producers with effective and profitable outlets, promote competition, improve inventory management, and facilitate quality control, while also diminishing the possible concentration of market power in the hands of a few retailers. However, as the study indicates, even if the sector has been completely liberalized, with foreign equity permitted up to 100 per cent, other domestic regulations in the form of approval requirements for establishing commercial presence, regulations on prices and movement of commodities within the country that limit wholesale trade of agricultural commodities, legislation in other areas (such as on prices and subsidies), and existence of public distribution schemes, can pose trade and investment barriers and curtail the efficiency of the wholesale sector and its ability to integrate different markets and develop a modern supply chain. Hence, FDI liberalization and multilateral commitments may not be sufficient to attract investment or realize gains in reality. An integrated view of an entire subsector across its various segments may be warranted in such services when initiating liberalization and introducing regulations.

Education services

Liberalization of a social service sector such as education raises many important issues. The most significant of these is the need to ensure equity and to put in place the right extent of regulation so that the latter is adequate to achieve its intended objectives but does not itself become an impediment to trade and investment flows. The debate in the context of liberalizing education services typically pertains to the higher education segment. It mostly stems from concerns about the lack of adequate regulatory frameworks and uniform guidelines to regulate the establishment and operations of private institutions, domestic and foreign.

The multi-country study once again indicates that the process by which liberalization and regulatory reform is undertaken is crucial in shaping the impact of opening up education services. It is important to have unambiguous, well-defined, and well-conceived regulations so that they do not become cumbersome and rigid to act as *de facto* barriers to trade or altogether fail to meet their original objectives. Clarity in objective and what is being sought from privatization is very important. Another important point that emerges is that in social services, such as education, where there are broader social concerns, the regulatory framework that is required to support liberalization need not be specific to foreign suppliers. There is an equal need to provide guidelines to domestic private providers as the issues and concerns regarding quality, standards, consumer protection, and equity apply to both

domestic and foreign suppliers. Thus, foreign versus domestic ownership may be less of an issue than the public-private dimension of the debate as well as ensuring that the public segment is not at a disadvantage. Moreover, the government may need to introduce measures that provide greater regulatory autonomy to public sector providers so that they are able to better face competitive challenges posed by foreign providers rather than stifling entry through numerous conditions and procedural requirements. External liberalization in the form of relaxed FDI and trade regulations may not have a major impact if various domestic structural and regulatory constraints continue to bind.

Health services

Similar to education services, this is another social sector where trade and investment liberalization and more generally privatization have been fraught with concerns about possible adverse consequences for equity, domestic consumers, and capacity. As the country experiences indicate, benefits arising from the liberalization of health services in the form of increased access, quality, and availability are not automatic. They are to a large extent shaped by existing capacity, the structure of the sector, and the existing regulatory and policy environment affecting all players, domestic and foreign. In some countries, the opening up of health services and greater private involvement and foreign ownership in the health sector has been fraught with debates on social and equity grounds concerning increased public-private divide, reduced affordability of healthcare to the poor, and worsening of existing inequities and shortages in the sector. As in the case of education services, the multi-country study underscores the importance of a strong regulatory framework to ensure quality and consumer protection and the fact that the domestic versus foreign ownership dimension is not as important as is the public-private dimension in the delivery of such social services. An important point that emerges is that the public segment needs to play a complementary role to private health care delivery, if social objectives have to be balanced with commercial interests.

Overall, the multi-country study clearly highlights the fact that service sector liberalization is not without its challenges. It may result in some initial instability as in the case of financial services, or may give rise to problems of introducing independent regulators and creating effective competition as in the case of telecommunications, or may give rise to public-private segmentation and equity issues as in the case of health and education services. Moreover, countries may need to adapt their regulations to the outcomes of liberalization, especially in the initial phases, and also take a holistic approach to liberalization by adopting and amending regulations in other areas.

4. MULTILATERAL LIBERALIZATION OF SERVICES

The varied concerns and challenges that accompany the process of liberalization and regulatory reforms suggest that developing countries may need to take a cautious and phased approach to liberalization and may also need to conduct an impact analysis regarding the outcomes of liberalization. As is also evident from the multi-country study, a developing country's ability to commit multilaterally is also likely to be contingent on its institutional capacity to regulate. An examination of the commitments and offers that have been made by the selected countries across different clusters of services highlights the many regulatory concerns discussed earlier, particularly in the context of commercial presence or GATS Mode 3.³

In the case of infrastructure services, Mode 3 tends to be partially bound. The commitments in telecommunication services are more liberal; Mode 3 commitments in this sector are mainly subject to limits on foreign equity participation, in some cases restrictions on the form of foreign participation, and usually subject to the approval of concerned regulatory authorities. In contrast, financial services tend to be more restricted with several countries not scheduling this sector for commitments despite undertaking unilateral liberalization. Those countries that have scheduled financial services have

³ See, WTO (1994-2006), Council for Trade in Services, miscellaneous documents (commitment schedules, initial and revised offers, communications, proposals). <http://www.wto.org>. There are four modes of supply under the GATS. These are mode 1 or cross border supply of services (where the service itself crosses borders); mode 2 or consumption abroad of services (where the consumer moves to another country to consume the service); mode 3 or commercial presence (setting up of a juridical entity in a service sector in another country); and mode 4 or movement of natural persons (temporary cross border movement of service providers).

generally maintained restrictions on Mode 1, reflecting the concerns about the vulnerability of their financial systems to volatile capital flows. Mode 3 also tends to be more restricted than for telecommunication services with several countries limiting the scope of their commitments to a few specified activities. If one places these commitments and offers against the unilateral liberalization undertaken by countries, it is apparent that these developing countries have preferred adopting a guarded approach in their multilateral commitments and to putting in place the required regulatory structures and capacity before they make more liberal commitments. Such a cautious stance on Mode 3 is most likely explained by the fact that given unforeseen outcomes of liberalization in some sectors such as financial services, countries may be wary of making binding commitments multilaterally as reversal of these commitments would be difficult and costly. In some cases, countries have not even scheduled the sector, as they lack the capacity and technical skills to assess the impact of such commitments.

The extent of liberalization committed under distribution services tends to be very limited. It reflects concerns about employment displacement, monopoly power, price effects that are associated with the opening up of distribution services and possibly also the implications for government regulations on prices, subsidies, distribution networks and other controls that could be affected by liberalization of this sector.

The summary of commitments and offers in social services such as health and education reveals that the central concern in these areas is that of ensuring quality, through licensing and certification requirements, and of ensuring consumer protection through various conditions on entry and operation. Fewer countries are prepared to schedule these services. There are fundamental concerns about the role of private players and corporatization of such services as well as ambiguities about the carve-out of social services under the GATS. In contrast the greater willingness to negotiate infrastructure services such as finance and telecommunications reflects the recognition of these services as critical inputs to overall efficiency and growth and the importance of signaling openness to FDI through multilateral liberalization.

The summary commitments and offers in the travel and tourism services sector are indicative of the more liberal approach adopted by countries in sectors where there are few restrictions. The scope of commitments and offers tends to be larger in such services. Even Mode 3 is by and large unrestricted. The relatively liberal approach to travel and tourism services can be explained by its commercial nature, the clear need for increased capacity in this sector in most developing countries, and beneficial linkages in terms of employment creation, foreign exchange earnings, and other multiplier effects through the economy. There are no obvious concerns in terms of equity-efficiency tradeoffs, no clearly defined role for the public sector except in terms of supporting infrastructure provision, no prudential or macro stability type of considerations, and no direct independent regulation type concerns associated with this sector, which enable a more liberal stance multilaterally.

Interestingly, only few developing countries have made initial and revised offers, under the Doha Round of negotiations. These countries that have made subsequent offers have generally expanded the scope and depth of their commitments by scheduling more services, including some sensitive ones, and by making more liberal offers, especially on commercial presence. However, the multilateral offers tend to remain less liberal than what has been liberalized unilaterally, notwithstanding the reduced wedge between autonomous and multilateral liberalization. In general, it appears that commitments and offers under the GATS are more likely to follow unilateral liberalization and regulatory strengthening which gives countries the confidence to undertake multilateral liberalization. A country may also use its multilateral commitments and offers as part of a quid pro quo negotiating strategy, where improvements in its own commitments and offers are traded off against improved offers in its areas of offensive interest. Of course, such as political economy approach to multilateral liberalization is not pertinent to small developing countries and LDCs.

5. CONCLUSION

One of the most important messages that can be drawn from the multi-country study is that timely and well-enforced domestic regulation backed by a sound, transparent, and unambiguous regulatory

framework is a prerequisite for service sector liberalization. Without these prerequisites, countries are unlikely to gain to the extent possible from services liberalization and may in fact be faced with unforeseen and adverse consequences. This is particularly important in sectors where volatility could give rise to wider economic instability. While the issues and challenges may vary depending on the nature of the service sector, this precondition is applicable to all services in different forms and to different degrees.

It is also evident from the country experiences that often the real issues do not concern whether ownership is domestic or foreign but whether ownership is private or public. Government may need to redefine and reorganize its role in some services once it liberalizes these sectors and may need to play a complementary role if liberalization is expected to yield efficiency and competitiveness gains and other benefits. And in sectors where supporting infrastructure requirements exist or where prudential regulations are required, the government has a vital role to play in shaping the liberalization process and the ensuing outcomes.

The relationship between unilateral and multilateral liberalization and regulatory reforms also follows a general pattern. Countries generally prefer undertaking autonomous liberalization, adapting and strengthening their domestic regulations, and preserving their flexibility before they are prepared to bind their liberalization multilaterally. However, pre-commitment may serve as a stimulus to liberalization. The study also shows that foreign investment is the most sensitive area for commitment, where most developing countries are likely to maintain conditions to address their quality, equity, and regulatory capacity related concerns. Even if developing countries or LDCs are recipients of requests, they may often not be in a position to go ahead and bind in their autonomous liberalization due to their limited institutional capacity and confidence in being able to tackle unintended consequences of multilateral liberalization.

A final issue of importance is the need to improve data on services in developing countries and in LDCs, particularly as regards trade and investment flows. Analysis of the likely impact of liberalization cannot be undertaken unless there is reliable and sufficiently disaggregated data available on services trade and investment that is comparable to international classification norms. Some of the country studies under this project were affected by the paucity of reliable and detailed service sector data. There were also difficulties in drawing cross-country comparisons due to differences in the classification of service sector data. Hence, there is need for technical assistance to improve data collection and data quality on services, which would also enable countries to undertake impact analysis to better understand the consequences of liberalization. Technical assistance would also be required by LDCs for designing regulations and regulatory framework. Such assistance may enable more developing countries and LDCs to participate pro-actively in the multilateral negotiations.

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