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Challenging Conventional Wisdom:

Development Implications of Trade in Services Liberalization

Trade, Poverty and Cross-cutting Development Issues



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**Challenging Conventional Wisdom:
Development Implications of Trade
in Services Liberalization**

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NOTE

Luis Abugattas Majluf and Simonetta Zarrilli are staff members of the Division on International Trade in Goods and Services, and Commodities of the UNCTAD secretariat. Part of this study draws on policy-relevant research undertaken at UNCTAD on the assessment of trade in services liberalization and its development implications.

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ABSTRACT

The implications of trade in services liberalization on poverty alleviation, on welfare and on the overall development prospects of developing countries remain at the hearth of the debate on the interlinkages between trade and development.

Assessing the actual and potential implications of services liberalization in developing countries is a complex exercise. Empirical studies remain anecdotic, with examples concerning a rather limited number of countries and services sectors. Quantitative assessment has produced inconclusive results. Moreover, a number of theoretical and methodological issues need to be addressed. Among those, there is the fundamental issue of whether the theoretical assumptions for justifying reform in the goods sector can be directly and fully transferred to the services sector and what could be the possible implications of such a transfer for welfare, equitable public policies and democratic sustainability. Answering this question is a precondition for formulating policy recommendations to developing countries, and for these countries to put in place sound domestic policies and accept international obligations that bind certain policy options. This paper holds the view that trade in services has some specificities, above all the movement of factors of production – that makes it rather different from trade in goods.

This paper reaches the overall conclusion that liberalizing trade in services, under appropriate regulatory and policy frameworks, may contribute to enhancing global welfare through increased efficiency, lower prices and greater choice of services, as well as increased competition at a country level. Liberalization is expected to be instrumental to expand access to basic services and contribute, therefore, to reducing poverty and achieving the MDGs. Developing countries, however, face a number of structural weaknesses that jeopardize the achievement of the above-mentioned results, namely poor or inexistent regulatory frameworks, difficulty in putting in place the right sequencing of policy reforms and liberalization initiatives, inability to compete with TNCs, numerous and fragile SMEs, poor access to capital and technology, pressure from investors and trade partners, huge fiscal deficits. Moreover, the ever-changing nature of markets and technologies, which is a key feature of several services sectors, can easily render the regulatory regime outdated, this characteristic demanding continuous and systematic fine-tuning of the regulatory and de-regulatory framework.

Evidence shows that market liberalization may bring about different results, according to the specific services sector and the specific country/region at stake. In some cases evidence also demonstrates that the results are more the consequence of flanking domestic policies than of services liberalization. Given the increasing concentration of many services industries worldwide, there is a risk that the liberalization of services sectors in developing countries can fall short of producing the expected beneficial outcomes, due to industries structures and behaviors. Because of the technological changes, some services sectors are becoming increasingly difficult to define - as it is the case for audiovisual and telecom services - with the related complexity of establishing appropriate policies.

Lacking a coherent and broad picture of the overall impact of services liberalization on the sustainable development prospects of developing countries, a cautious approach to liberalization seems in order, keeping in mind that the final goal of the GATS is not the expansion of international trade in services *per se*, but rather the economic growth of all trading partners and the development of developing countries.

The “knowledge gap” regarding the effects of liberalizing trade in services on developing countries was among the factors that hampered progress in the negotiations on services carried out in the framework of the Doha Work Programme. Lacking such a crucial element, developing countries felt reluctant to embark in broad liberalization commitments. The overall negotiations were suspended on 24 July 2006 because of the difficulties in building consensus among major trade partners on the core issues of the Work Programme. Diplomatic efforts are, however, ongoing to try to revive the negotiations.

Work in the area of assessment of services liberalization in developing countries must continue, including in UNCTAD, with increasing emphasis on the possible policy options available to developing countries to strengthen their domestic services sector, their export capacity and to link the liberalization of trade in services with sustainable development and poverty alleviation goals, including the achievement of the MDGs. Hopefully, such a work will contribute to move the analysis from an anecdotic picture to a full-fledged picture.

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“...the hallmark of the conventional wisdom is acceptability. It has the approval of those to whom it is addressed. ...Numerous factors contribute to acceptability of ideas...But perhaps most important of all, people most approve of what they best understand...Because familiarity is such an important test of acceptability, the acceptable ideas have great stability. ...The fatal blow to the conventional wisdom comes when the conventional ideas fail signally to deal with some contingency to which obsolescence has made them palpably inapplicable. This, sooner or later, must be the fate of ideas which have lost their relation to the world.”

*J.K. Galbraith, “The Concept of Conventional Wisdom”, in *The Affluent Society*, 40th anniversary ed. (Boston Mariner/Houghton Mifflin, 1998) pp. 6-17.*

INTRODUCTION

The main challenge that developing countries are facing in the services area is how to strengthen domestic supply capacity, maximizing the contribution of services to economic growth, while reconciling this objective with social and equity considerations. The liberalization of trade in services – i.e. the elimination of market access restrictions and regulations discriminating against foreign providers – is actively promoted as the preferred approach that developing countries should adopt for assuring developmental gains. There is a state of conviction in the mainstream thinking that the liberalization of trade in services can advance the economic growth of all countries and the development of developing countries. However, there are a number of issues and concerns to be addressed about the potential effects of trade reform on: (i) areas previously considered to be the exclusive domain of the public sector; (ii) domestic stakeholders; and (iii) legitimate national developmental objectives. While these issues fall directly or indirectly within the scope of multilateral or regional services negotiations, being at the core of the development processes, they go beyond such negotiations. As related considerations, it is worth to consider: (i) the frequent links made in many developing countries between the role of the state as provider of essential services and the efficiency of the democratic system, the provision of essential services being perceived as the main achievement of democratic governments from the point of view of social policy; (ii) the fact that in many developing countries trade in services liberalization is driven by the need to attract private capitals for infrastructure maintenance and development and, above all, to alleviate fiscal deficits.

Trade negotiations on services – be they multilateral, regional or even bilateral – are posing a major challenge to developing countries: undertaking specific commitments on trade in services implies accepting international obligations that bind certain policy options. In making such commitments, developing countries need clarity and assurance that these are the best options available to them in terms of reaching development objectives.

There seems to be a convergence of views on the fact that the existing “knowledge gap” concerning services and trade in services in developing countries, as well as the potential effects of trade liberalization, constitute an obstacle to developing country effective participation in trade negotiations, affecting also their ability to define and implement pro-development domestic policies.

The assessment of trade in services is a continuing effort of research and policy-formulation carried out by several institutions. Some of the main issues and findings from UNCTAD’s work, and also from the contributions of other institutions and analysts, are presented in this paper.

Part I of the study is devoted to analyse the different dimensions and interpretations of the assessment of services and trade in services liberalization. It presents and analyses the main views expressed during the debate on assessment carried out at the WTO prior to the launching and during the Doha Round negotiations on services and reviews the submissions on assessment tabled by developing countries. Part II has a fourfold purpose. First, it stresses the crucial role that services play in the process of economic growth and social development, but also singles out some concerns and questions regarding the effect of services trade liberalization, especially on access to essential services, the achievement of non-economic policy objectives, the magnitude of short term adjustment costs, the effect on domestic supply capacity, and distributional impacts. Secondly, it reviews economic trade theory and tackles a specific issue, namely whether the assumptions for justifying reform in the goods sector can be directly and fully transferred to the services sector. In this context, it analyses the question of the mobility of factors of production in trade in services. Thirdly, it deals with the question of the extent to which the shift towards services in developing countries is proceeding along the same path followed by developed countries. Fourthly, it deals with developing country trade performance in dynamic services sectors. Part III focuses on trade liberalization in eight specific services sectors – financial, telecommunication, energy, environment, construction, professional, distribution, and tourism. This section of the study – which mainly relies on “first-hand” information – provides illustrative examples of country experiences of trade liberalization in the selected services sectors. The theoretical assumptions and theories presented in parts I and II of the study are checked against those specific examples. The analysis includes a reference to the “collective requests” put forward within the GATS negotiations after the sixth WTO Ministerial Conference. Some concluding remarks are presented at the end of the paper.

PART I - ASSESSMENT OF TRADE IN SERVICES UNDER THE GATS

As provided by GATS Article XIX, for each round of negotiations the WTO Council for Trade in Services (CTS) shall carry out an assessment of trade in services in overall terms and on a sectoral basis with reference to the objectives of the Agreement, including those set out in paragraph 1 of GATS Article IV. According to Article IV, the increasing participation of developing countries in services world trade shall be facilitated through negotiated specific commitments relating to: (a) the strengthening of their domestic services capacity and its efficiency and competitiveness, *inter alia* through access of technology on a commercial basis; (b) the improvement to their access to distribution channels and information networks; and (c) the liberalization of markets access in sectors and modes of supply of export interest to them.

There are different dimensions to the needed assessment of services and trade in services in developing countries: (i) to analyse the contribution of services to the growth and development of developing countries; (ii) to elucidate the policy options available to enhance the contribution of services to national developmental objectives; (iii) to examine ways and means to assure overall economic gains from services trade liberalization; and, (iv) to evaluate the extent to which the specific commitments adopted by WTO Members in the GATS have contributed to achieving the objectives set for in GATS Article IV.

The CTS carried out the “analysis and exchange of information” process between December 1998 and October 1999. It was however unable to reach any agreed conclusions with respect to the assessment prior to launching the current round of services negotiations in February 2000. After negotiations were launched, the Council moved the assessment issue to the Special Session agenda, thereby linking it directly to the negotiations: assessment has become a standing item in the agenda of the Special Session of the Council (CSS).

Different interpretations of the assessment mandate have made it difficult to agree on the best approach to fulfil this requirement. Some WTO Members, as well as some analysts, have emphasized the benefits of services trade liberalization as the core issue to be addressed in the context of the assessment exercise. For others, the assessment should focus mainly in evaluating the extent to which the specific commitments adopted by WTO Members have contributed to achieving the objectives set for in Article IV. Also, there are contending views with respect to the nature of the assessment exercise. For some Members the assessment should be an ongoing and collective exercise in the CSS aimed at arriving to agreed conclusions that would allow adjusting negotiations to assure that the objectives of the GATS are adequately fulfilled. Conversely, for others each Member should undertake its own assessment of trade in services, as a process parallel to negotiations, as the basis for identifying negotiating objectives and strategies. The former approach seems to have been incorporated in the Guidelines and Procedures for the Negotiations on Trade in Services adopted by the Council for Trade in Services in Special Session.¹ Paragraph 14 of the Guidelines establishes that “negotiations shall be adjusted in the light of the results of the assessment”.

¹ WTO (2001), S/L/93, 29 March.

Two issues needing attention have surfaced in this context, namely what are the concrete implications of the fact that “negotiations shall be adjusted in the light of the results of the assessment”? There are vastly disparate interpretations: specific commitments could be conditioned to the assessment’s results; negotiating guidelines could be modified in light of the results; and different timeframes could be implemented. Secondly, should the assessment mandated by Article XIX.3 concretely address the effects of trade in services and investment flows in relation to Members’ specific commitments? Should it determine to what extent those commitments have improved developing country participation in trade in services, domestic services capacity, and access to distribution channels and information networks?²

Despite diverging interpretations of the assessment mandate, several WTO Members have actively contributed to the debate by sharing their national experiences and their evaluation of trade in services liberalization.

By and large, developing countries have taken the position that services liberalization remains the way forward, but progressive liberalization is the preferred path.³ Liberalization is an end that can be achieved through various means. The unique situation of a specific country should dictate the pace and the path of liberalization most suitable to its circumstances.⁴

Market opening has contributed to attracting foreign capital into the services sector – which had suffered from limited investments from domestic operators, thus accelerating its development. As a consequence, consumers are enjoying more diversified and better services and new job opportunities are available. Moreover, market opening has been conducive to the introduction of new technologies and management experience, as well to establishing competition mechanisms; it has promoted the development and growth of the domestic service market and contributed to the training of local services providers.⁵

The benefits related to market opening in the services sector do not come, however, automatically. Positive and development-oriented results from privatisation and liberalization of the services markets may be achieved only if the appropriate preconditions are in place, including those to help improving access to essential services for the poor, and if policies to encourage and enhance technological capacity and diffusion are set up. The vast range of services sectors precludes any generalization of market-opening policies, as each sector affects the economy differently when liberalized. Moreover, services liberalization entails adjustment costs, therefore, without adequate flanking policies liberalization might not achieve the goal of promoting economic growth for all trading partners and the development of developing countries.⁶

² Abugattas Majluf L. and S.M. Stephenson (2003), “Liberalization of Trade in Services: Options and Implications”, in *Trade Negotiations in Latin America*, Diana Tussie (Ed), Palgrave Macmillan, Houndmills, Basingstoke and New York, at 85-86.

³ A less cautious approach, however, has been taken by several developing countries in the framework of bilateral trade and investment agreements.

⁴ WTO (2002), *Communication from Thailand - Assessment of Trade in Services*, TN/S/W/4, 22 July.

⁵ WTO (2002), *Communication from the People’s Republic of China - Assessment of Trade in Services*, TN/S/W/9, 19 December.

⁶ WTO (2002), *Communication from Cuba, Dominican Republic, Kenya, Nigeria, Pakistan, Senegal and Zambia - Assessment of Trade in Services*, TN/S/W/3, 10 June, at 3; WTO (2005), *Communication from Cuba - Assessment of Services Trade and Liberalization in Underdeveloped Economies*, TN/S/W/44, 17 June.

In addition to domestic considerations and endowments, factors such as technological, economical and political changes tend to destabilize even the best planned liberalization processes. Yet, they cannot be avoided; this means that liberalization should occur slowly, progressively but continuously. In the same vein, governments should enjoy flexibility to redress the problems that they had not anticipated when undertaking liberalization commitments. Developing countries face the challenging task to devise and implement a regulatory framework that works properly in a rapidly changing international environment and allows liberalization to take place smoothly while ensuring that the benefits reach all parties concerned.⁷

An insufficient and/or inadequate regulatory framework hampers market liberalization from functioning smoothly. While for developing countries the enactment of new laws and regulations has never been an easy undertaking, the continuous changes experienced in the international services market make the task even more demanding.⁸

These considerations confirm that the content and the sequencing of liberalization are equally important. Many unsuccessful examples of services liberalization in developing countries are the result of a rushed process of liberalization often due to the need to find quick solutions to fiscal deficits.

Sharing the conclusions of an UNCTAD study,⁹ developing countries¹⁰ have stressed that many of them have made substantial commitments under the GATS with respect to many services industries, often binding recently adopted legislation or pre-committing future policies without having had much experience in their implementation. They have also undertaken a higher share of full bindings under the cross-border and commercial presence modes of supply. In contrast, they have not received concessions of any meaningful economic value under the movement of natural persons. As a result, most developing countries have a deficit in trade in services, except in the areas of tourism and travel and transportation services. Dependence on these two sectors may pose a structural problem for producing countries since supplies in these two sectors are closely related to the physical movement of persons and goods – and thus to merchandise trade – rather than to movement of knowledge and information.¹¹

This imbalance is further accentuated by the major commitments that some developing countries have undertaken autonomously, including under structural adjustment programmes, and as a result of the negotiations on financial and telecommunication services.¹²

⁷ WTO (2002), *Communication from Thailand - Assessment of Trade in Services*, TN/S/W/4, 22 July.

⁸ WTO (2002), *Communication from the People's Republic of China - Assessment of Trade in Services*, TN/S/W/9.

⁹ UNCTAD (1999), *Assessment of services of developing countries: Summary of findings*, 26 August.

¹⁰ WTO (2001), *Communication from Cuba, Dominican Republic, Haiti, India, Kenya, Pakistan, Peru, Uganda, Venezuela and Zimbabwe - Assessment of Trade in Services*, S/CSS/W/114, 9 October; WTO (2002), *Communication from Cuba, Dominican Republic, Kenya, Nigeria, Pakistan, Senegal and Zambia - Assessment of Trade in Services*, TN/S/W/3, 10 June.

¹¹ WTO (2001), *Communication from Argentina - Assessment of Trade in Services: The Participation of Developing Countries*, S/CSS/W/44, 29 January, at 2.

¹² WTO (2001), *Communication from Cuba, Dominican Republic, Haiti, India, Kenya, Pakistan, Peru, Uganda, Venezuela and Zimbabwe - Assessment of Trade in Services*, S/CSS/W/114, 9 October.

Developing countries face a number of critical barriers to their services exports, ranging from prohibition of access to services markets (e.g. nationality, residency or visa requirements); to price-based measures (e.g. entry and exit taxes, visa fees, tariffs on goods in which services are embodied); subsidies granted in developed countries; technical standards and licensing requirements; and lack of transparency in government measures. Developing countries providers – mostly SMEs – face competition from large services multinationals with massive financial strength, access to the latest technology, worldwide networks and sophisticated IT infrastructure. It has often proved difficult for developing countries to gain access to information and communication technologies (ICTs). However, without the possibility to acquire technology, capital and markets, there is little point in opening domestic services markets.¹³ While some of the above-mentioned difficulties fall within the scope of the WTO framework, others – such as the gap in market power, technological skills and managerial capacity between foreign transnational companies and local SMEs, go beyond it.

Developing countries have also stressed that the presence of foreign services suppliers and investors is invariably concentrated in the most dynamic regions of a country, while poorer and rural areas are completely neglected, thus widening the gap between regions.¹⁴

In conclusion, in the medium- to long-term the services sector may act as an important driver of economic and social growth if the proper sequencing of liberalization and deregulation takes place. Services liberalization requires the institutional and regulatory environment to be strengthened both prior to and during the process of liberalization. It then involves much more than just the simple opening of the market: it implies striking a balance between deregulation and re-regulation.¹⁵ Conversely, a rushed process of liberalization, often linked to the need to find quick solutions to budget deficits, lack of flexibility to redress problems which may emerge after liberalization takes place, and limited access to technology and financing may jeopardize the achievement of positive results for developing countries embarking into services liberalization. Liberalization, while desirable, should take place at a pace commensurate to the economic and social readiness of each country, in conformity with the GATS principles of progressive liberalization, right to regulate, and recognition of developing country trade, development and financial needs, which should be fully preserved.

¹³ WTO (2002), *Communication from Cuba, Dominican Republic, Kenya, Nigeria, Pakistan, Senegal and Zambia - Assessment of Trade in Services*, TN/S/W/3, 10 June.; WTO (2005), *Communication from Cuba - Assessment of Services Trade and Liberalization in Underdeveloped Economies*, TN/S/W/44, 17 June.

¹⁴ WTO (2002), *Communication from the People's Republic of China - Assessment of Trade in Services*, TN/S/W/9, 19 December.

¹⁵ WTO (2004), *Communication from the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu - Assessment of Trade in Services*, TN/S/W/18, 26 February.

PART II - SERVICES AND DEVELOPMENT

1. Services and development: Policy options for developing countries

Economic literature has highlighted the importance of services identifying major areas in which these activities perform a crucial role in the process of economic growth and social development. Education and health services are fundamental for the development and reproduction of human capital, which is widely acknowledged to yield great economic and social returns. Financial, distribution, telecommunications, energy, environmental and transport services constitute the underlying basic networks of the economy allowing for the functioning of the overall economic system. These services glue the economy together and being intermediate inputs into production in all sectors, their availability, price and quality determine to a large extent the systemic competitiveness of an economy.

Professional services are responsible for the generation, dissemination and application of “knowledge” increasingly constituting, in the context of the emerging knowledge economy, a crucial interface between knowledge generation and productive and other social endeavours. Professional services enhance the performance of other firms through organizational improvement, with technology becoming the basis of increased productivity and competitiveness. Accounting and legal services constitute critical components of the overall required infrastructure of a market economy. Without an adequate provision of these services no sound economic activity would be possible. Beyond the multi-purpose information that accounting services provide, they are the foundation of the countries fiscal systems and play a key role in corporate governance.¹⁶ Legal services, on their part, provide for the adequate implementation of laws and regulations, the protection of rights and fulfillment of contractual obligations, and facilitate conflict resolution allowing for the adequate functioning of the markets.

Services such as the cultural industries and a number of social, communal and governmental services are fundamental in developing what has been defined in economic literature as “social capital”, contributing to the internal social and cultural coherence of society which guarantees economic growth or human well-being.¹⁷ Finally, other services, such as entertainment services, restaurants and hotels and personal services, significantly contribute to improving the overall quality of life in society.

Services increasingly contribute to the integration of national economies into the international trading system. Trade in services is a very dynamic element in the world economy: an efficient integration into the evolving world services economy is becoming crucial for the development prospects of many developing countries.

¹⁶ Trolliet C. and J. Hegarty (2003), “Regulatory Reform and Trade liberalization in Accountancy Services”; in Mattoo A. and P. Sauvé (2003), *Domestic Regulation and Service Trade Liberalization*, World Bank and Oxford University Press.

¹⁷ World Bank (1998), “The initiative on defining, monitoring and measuring social capital: Texts of proposals approved for funding”; World Bank, Social Capital Initiative, *Working Paper*, No 2.

The importance of services for economic growth and social development is already well entrenched in economic analysis and this issue is no longer a matter of debate. Our attention today is centered in elucidating what would be the best policies for developing countries to strengthen domestic capacities in services activities and enhancing their contribution to economic development and welfare. The potential benefit of services trade liberalization is also underlined by the GATS which aim at expanding trade in services and at achieving a progressive higher level of liberalization as a means of promoting the economic growth of all trading partners (Preamble and Article XIX).

Even though there is widespread recognition of the potential benefits of trade liberalization, the analysis of the historical experience of developed countries, the observed mixed outcomes of domestic policy reform processes in the area of services in developing countries, and the ambiguous results of studies assessing the developmental impact of services trade liberalization have raised a number of questions and of legitimate concerns regarding the absolute suitability for all countries of conducting multilateral and/or plurilateral negotiations aimed at adopting legally binding liberalization commitments, including the bound liberalization of commercial presence through Mode 3.

Concerns and questions regarding the effect of services trade liberalization have been raised, *inter alia*, on the following issues: (i) the possible impact of liberalization on access to essential services, especially for the least favored segments of the population; (ii) the extent to which liberalization can affect national non-economic policy objectives in sensitive areas such as education, health, and culture, and about its effect on other activities in which domestic control may be viewed as a desirable expression of societal preferences; (iii) the magnitude of short-term adjustment costs and the availability of ways and means to address them. These costs arise from import penetration that can generate unemployment and underutilization of factors of production in declining sectors, while new competitive activities may expand only gradually; (iv) the effect on the development of domestic supply capacity, especially considering that some services activities may require a certain degree of protection before achieving, along a learning curve, international competitiveness; and, (v) the distributional impact of services trade liberalization, as theory is inconclusive about the distribution of the costs and benefits of trade liberalization within a country and between countries.

There are also a number of questions concerning how to best undertake trade reform in services. The issues of the speed and sequence of the reforms and the effects of the prevailing regulatory framework on the final outcome of trade liberalization have received increased attention as they seem crucial for assuring developmental gains from the liberalization of trade in services. In this context, there is for example widespread recognition that the gains from reform will not materialize, or will be seriously undermined, if a competitive environment cannot be assured and if firms can collude and restrict competition. A strengthened regulatory framework and the institutional development of competition and other regulatory authorities are most often needed to precede trade liberalization. In this connection, the difficulties and complexities surrounding institution - building in developing countries are widely recognized in development literature. There is also the need to identify other flanking policies that are required to assure the strengthening of domestic capacities in services activities. As it is the case in the realm of goods, trade liberalization alone does not guarantee either that those services needed for growth and development will automatically emerge in developing countries, or that their contribution to national development objectives would be assured. Finally, there is the need of assessing

the effects of the global structure of services industries on the outcome of services trade liberalization. For example, studies on maritime transport have shown that the benefits expected from the liberalization of trade in both goods and services can be seriously undermined by worldwide business practices in the sector.¹⁸ Given the increasing concentration of many services industries worldwide, there is a real risk that reform in developing countries can fall short of producing the expected beneficial outcomes, due to industries structures and behaviours.

The understanding of trade in services and of the implications that trade reform may bring about, especially in developing countries, has increased significantly since these issues were brought to the centre of attention during the Uruguay Round negotiations. However, there is still much to be learned in order to adequately assess the best policy options that developing countries may resort to in order to strengthen their domestic supply capacity in services and enhance their contribution to economic growth and welfare. The implications that trade and investment liberalization in the services sector may have for sustainable development is an area that requires increased worldwide attention from both analysts and policymakers. The UNCTAD secretariat, in accordance to its mandate, has undertaken a number of country and sectoral studies assessing how services have evolved in developing countries and their impact on economic growth and welfare. Expert meetings on specific services sectors and on horizontal issues, such as the temporary movement of natural persons supplying services, have contributed to enhancing the collective understanding of these activities in developing countries and of the challenges these countries are confronting to ensure gains from trade in services. Some of the main issues and findings from this work, and also from the contributions of other institutions and analysts, are presented in the following parts of this note.

2. Applying the market-based competition model to trade in services: Possible impact on welfare, public policies and democratic sustainability

Economic theory and conventional wisdom suggest, at least regarding non-basic social services, that liberalization of trade in services – i.e. the elimination of market access restrictions and of discrimination against foreign providers according to GATS Articles XVI and XVII, and the highest possible market-reliance in the domestic economy – i.e. no state intervention at all, or, if necessary, the least resource-allocation distorting type of intervention, constitute the policy framework that would allow services to best fulfill their role in the process of economic growth and sustainable development, optimizing welfare at the global and national levels. According to this view, state intervention in services markets can only be justified to correct special and isolated cases of market failure which can be rectified to restore the competitive optimum. Economic theory suggests that developing countries can expect, under certain conditions, to reap significant gains from comprehensive liberalization of trade in services, both from the static welfare and income effects resulting from a more appropriate specialization and factor utilization, as well as from the dynamic effects on capital formation and technology dissemination. Services trade liberalization, through important spillovers to “downstream” user activities, increases the expected static and dynamic effects of trade liberalization on income and welfare.

¹⁸ Fink C., A. Mattoo and I. Neagu (2002), “Trade in Maritime Services: How Much Does Policy Matter”, *World Bank Economic Review*, 16. Also, Francois J. and I. Wooton (2001), “Trade in International Transport Services: The role of competition”, *Review of International Economics*, 9(2), May.

It is worth noting that the proposition of the market-based competition model for the liberalization of trade in services is based on the same theoretical assumptions that are applied in the realm of trade in goods. This theory raises a number of serious questions.¹⁹ Benefits are expected to result from more competition, lower prices and wider choice, faster innovation, and greater FDI and enhanced technology transfer. In the case of goods, much of economic analysis of trade liberalization uses a combination of classical trade and welfare theory to deduce, under idealized market conditions, that trade liberalization will lead to increased economic welfare. However, there is growing recognition that in imperfect market conditions, and when some of the underlying assumptions are modified, welfare gains cannot be directly assumed, and both negative and positive effects could be expected from trade liberalization.²⁰ The debate on the overall effects of liberalization of trade in goods is therefore still ongoing and no unambiguous consensus conclusions have been achieved. Also, empirical studies reach differing conclusions on the relationship between trade liberalization, economic growth and social indicators.

The assessment of the welfare impact of services trade liberalization is a more recent area of concern and, as in the case of trade in goods, there are still a number of theoretical and methodological issues to be addressed. Among those, there is the fundamental issue of whether the theoretical assumptions for justifying reform in the goods sector can be directly and fully transferred to the services sector; including the question if theory could help to explain the potential outcome of services trade reform equally for all services; or whether the particularities of different services merit a differentiated approach to capture their structural and behavioral specificities. Early work carried out on trade in services, which gave rise to the conventional wisdom, suggests that the basic concepts of international trade theory are well suited to explain trade in services and its developmental implications.²¹ As Feketekuty put it some time ago, "the normative conclusions that can be drawn from international trade theory are as valid for shoes and oranges as for insurance and engineering".²² Nevertheless, the direct applicability of conventional trade theory to the case of services is an issue that has received attention in the past. In this regard, for example Deardorff's early work pointed out that trade in management services takes place from expensive locations to areas in which management commands low wages, arguing that this represents a paradox in the context of conventional trade theory.²³

¹⁹ For a discussion on the weakness of conventional trade theory refer, among others, to: Shaik A. (2003), "Globalization and the Myth of Free Trade", paper prepared for the conference on "Globalization and the Myths of Free Trade", New School University, New York, April 5.

²⁰ Kirkpatrick C., C. George and S. S. Scricciu (2004), "The Implications of Trade and Investment Liberalization for Sustainable Development: Review of Literature", Impact Assessment Research Centre, University of Manchester, Working Paper Series, Paper No 4, May.

²¹ Among other authors refer to: Bhagwati J. (1984), "Splintering and Disembodiment of Services and Developing Countries" *The World Economy* 7; Hindley B. and A. Smith (1984), "Comparative Advantage and Trade in Services", *The World Economy* 7; Richardson J. (1987), "A Sub-Sectoral Approach to Services' Trade Theory", in Orio Giardi (ed) *The Emerging Services Economy*, Oxford, Pergamon Press for the Services World Forum, Geneva; and, Sampson G. and R. Snape (1985), "Identifying the Issues in Trade in Services", *The World Economy* 8.

²² Feketekuty G. (1988), *International Trade in Services: An Overview and Blueprint for Negotiations*; American Enterprise Institute/Ballinger Publication, Cambridge, MA, at 124.

²³ Deardorff A. (1985), "Comparative Advantage and International Trade and Investment in Services", in Robert Stern (ed) *Trade and Investment in Services: Canada/US Perspectives*, University of Toronto Press, Toronto, Canada.

Recent work on trade in services has increasingly addressed the issue of the extent to which conventional trade theory, derived for trade in goods, and its underlying assumptions can adequately help explain trade in services and its developmental implications. Work has been undertaken to assess the efficacy of trade theory and identify those features of trade in services that would make it necessary to adjust theoretical models to capture the realities and complexities of trade in services.²⁴ In this regard the fact that many services may be customized to the needs of individual purchasers has been identified as a potentially critical property of services for the effects of their international trade causing a potential divergence between the effects of trade liberalization in goods and that in services.²⁵ The particularities of offshoring of services and its theoretical and modeling implications have been subjected to scrutiny.²⁶ The issue that the determinants of comparative advantage in services might differ from those in goods has to be brought into consideration. The literature on services highlights services' knowledge-intensity and the role of knowledge in competitiveness, as well as the role played by intangible assets, as brand awareness and perceived leverage, all these factors providing incumbency advantages which determine comparative advantages. From a point of view of theory a problem arises if different modes of supply are close substitutes as there is no easy way to predict whether comparative advantage will manifest itself as trade flow, investment or labour flow.²⁷ Also, the close interlink between different modes of delivery being necessary to efficiently provide some services across-borders has been highlighted, and that interface needs to be adequately incorporated in the theoretical constructs. The fact that trade in services intrinsically involves the mobility of factors of production introduces significant differences with trade in goods, and their theoretical implications need to be clearly sorted out. Also, the nature of economies of scale in services needs further analysis as is now commonplace to assume, as in the case of goods, increasing returns to scale; this assumption that might not hold true in the case of many services activities.

Other characteristics that might be of high relevance for our theoretical understanding of trade in services and the basis of comparative and competitive advantage are, *inter alia*: (i) the fact that in the case of services, due to their high credence values, in many cases price is not a determining variable in user's choice; (ii) some services, as producers services, are knowledge-based and intra-firm differentiated with important implications for market behaviour;²⁸ (iii) value in transaction seems to be perceived, both by providers and users, quite differently than use-value of goods;²⁹ (iv) considering that the outcome of a service is a transformation in the condition of the recipient, the concept of productivity might

²⁴ For a review of different issues refer to: Dee Phillipa (2001), "Trade in Services", Paper prepared for the conference on Impacts of Trade Liberalization Agreements on Latin America and the Caribbean, Inter-American Development Bank, Washington DC, 5-6 November 2001.

²⁵ Brown D., A. Deardorff and R. Stern (1995), "Modelling Multilateral Trade Liberalization of Services", Research Seminar in International Economics, School of Public Policy, University of Michigan, Discussion Paper No 378.

²⁶ Markusen J. (2005), "Modelling the Offshoring of White-Collar Services: From Comparative Advantage to the New Theories of Trade and FDI"; Prepared for the Brookings Forum Offshoring White-Collar Work: The Issues and Implications, May 12-13.

²⁷ Matto A. (2000), *Trade in Services: Economics and Law*, mimeo.

²⁸ Raff Horst and M. von der Ruhr (2001), "Foreign Direct Investment in Producers Services: Theory and Empirical Evidence", *CESifo Working Paper* No 598. Center for Economic Studies and Ifo Institute for Economic Research, Munich.

²⁹ Lapierre J. (1997), "What does value mean in business-to-business professional services?" *International Journal of Service Industry Management*, Vol 8, Issue 5, at 377.

significantly differ from that applying in goods;³⁰ and, finally, (v) the environment in which project-selling firms operate has been described as something in between markets and networks.³¹ These characteristics should be taken into account when modeling trade in services, assessing the potential effects of services trade liberalization, and evaluating the basis for comparative advantages in trade in services. The unique characteristics of trade in services remain to be fully explored and a considerable amount of theoretical and empirical work needs to be undertaken to enhance our understanding of trade in services and its developmental implications.

Liberalizing trade in services entails the movement of factors of production and trade theory does not directly address investment in facilities abroad or the temporary movement of natural persons as services providers. In this connection, the effects of services FDI liberalization on the development prospects of developing countries constitute an integral aspect of the needed assessment of trade in services. Even more, one might even assert that the main objective both for developed and developing countries in promoting the liberalization of trade in services is to open world markets for FDI; for the former to favour their services firms and for the latter with the expectation of receiving greater FDI inflows. In a sense the GATS was brought into the multilateral trading system mainly as an investment agreement. There is widespread recognition that inflows of FDI could bring benefits to the recipient economies in the form of capital inflow, technology spillovers, human capital development, international trade integration and overall enhancement of enterprise development. However, determining exactly how FDI affects development has proven to be remarkably elusive.³² There is growing recognition that benefits might not be automatic, and that FDI under certain conditions could even produce negative effects on market structure, could lead to crowding out of domestic enterprises, as well as generating other adverse economic and social impacts.³³ Therefore, government policies might be needed to enhance benefits and minimize the negative effects of FDI. With regard to services, most attention has been given to assess the effects of FDI in the telecommunication and financial services sectors, however, efforts are needed to assess the potential effects on economic growth and development of FDI in other services activities.

Attempts have been made through quantitative analysis and econometric modeling to assess the effect of the elimination/reduction of trade barriers in services on market prices, on the availability of services and on their quality, and on the overall economy of a country. These attempts rest mainly in estimating the "tariff equivalent" of barriers to trade in services, in order to single out suitable market responses to those changes.

³⁰ Nachum L. (1999), "Measurement of productivity of professional services: An illustration on Swedish management consulting firms", *International Journal of Operations and Production Management*, Vol 19, Issue 9, at 922. See also: Johnson R. and P. Jones (2004), "Service Productivity: Towards understanding the relationship between operational and consumer productivity", *International Journal of Productivity and Performance Management*, Vol 53, Issue 3, at 201.

³¹ Cova B. and A. Ghauri (1997), "Project Marketing. Between Mass Marketing and Networks" Working Paper, European Seminar on Project Marketing and System Selling.

³² Moran T; E. Graham and M. Blomstrom (2005), *Does Foreign Direct Investment Promote Development?*, Institute for International Economics, Center for Global Development, Washington D.C, April.

³³ Negative effects of trade and investment liberalization are found in the results of some modelling exercises. For example refer to Blecker R. (1996), "The New Economic Integration: Structuralist Models of North-South Trade and Investment Liberalization", in *Structural Change and Economic Dynamics*, 7.

The results of different studies estimating worldwide welfare gains from multilateral trade liberalization in services differ significantly, albeit all of them show an overall positive impact. Estimation of the welfare effect range from gains of \$90 to \$688 billion, depending, among other things, on the depth of reduction of trade barriers; gains being distributed between developed and developing countries in proportion of their GDP. There is a general recognition that, because of uncertainty in the modeling data and assumptions, the results of these studies should be heavily qualified. After reviewing a number of them, the OECD concluded, for example, that quantitative modeling is valuable in providing an order of magnitude to estimate the effects of multilateral liberalization, but that quantification of services barriers is unlikely to be ever sufficiently accurate to be used directly in the conduct of negotiations and that the results should be only taken as indicative.³⁴

There are also a number of studies aimed at quantifying, at the sectoral level, the restrictiveness of measures affecting trade in services and at assessing their effects on welfare and on the growth path of specific countries. They also aim at assessing the economy-wide impact of liberalization of particular services sectors.³⁵ National studies on the effect of services liberalization predict on average modest static welfare gains of less than one per cent of GDP, even though some country studies show larger gains, and the dynamic effects provide potential considerable greater long term benefits. A study on Tunisia estimates, for example, that full services liberalization raises welfare and GDP by 7.8 and 7.6 per cent, respectively.³⁶ Studies that assess the growth effect of the liberalization of financial and telecommunications services show that those countries which have opted for an open regime are growing at a higher rate – 1.3 to 1.6 percentage points higher – than countries that limit competition in these sectors. The growth effect of liberalizing financial services is found to be more significant than that of liberalizing telecommunication services.³⁷ A positive relation has also been found between the openness of a sector to FDI, external trade and private ownership, and respective sectoral growth rates.³⁸ A review of different quantitative studies assessing the effects of services trade liberalization in developing countries concludes that in many countries the potential GDP gains from liberalizing services imports are considerable, especially if compared with the liberalization of merchandize imports. However, the potential benefits are highly country specific and sectoral priorities for liberalization need to be established on a country-by-country basis, thus confirming the need to preserve the existing flexibility of the GATS.³⁹ Some recent analytical work also suggests that liberalization in some services might not always yield gains for developing countries.⁴⁰

³⁴ Dihel N. (2002), *Quantification of Costs to National Welfare from Barriers to Services Trade: A literature review*, OECD-Trade Committee, TD/TC/WP(2000)24 Final.

³⁵ For a review of different studies, see: Deardoff A. and R. Stern (2004), *Empirical Analysis of Barriers to International Services Transactions and the Consequences of Liberalization*, World Bank, mimeo.

³⁶ Konan D. E. and K. E. Maskus (2004), *Quantifying the Impact of Services Liberalization in a Developing Country*, September, World Bank Policy Research Working Paper 3193, January.

³⁷ Francois J. and L. Schuknecht (2000), *International Trade in Financial Services, Competition and Growth Performance*, Policy Discussion Paper 006. Center for International Economic Studies, University of Adelaide. See also Mattoo A., R. Rathindran and A. Subramanian (2001), *Measuring Services Trade Liberalization and its Impact on Economic Growth: An illustration*, World Bank Research Working Paper 2655.

³⁸ Gordon J. and P. Gupta (2004), *Understanding India Services Revolution*, IMF Working paper WP/04/171, September.

³⁹ Lucke M. and D. Spinanger (2004), *Liberalizing International Trade in Services: Challenges and Opportunities for Developing Countries*, Kiel Discussion Papers 412, Institut Fur Weltwirtschaft Kiel, July.

⁴⁰ Whalley J. (2003), *Assessing the Benefits to Developing Countries of Liberalization in Services Trade*, NBER Working Paper Series Working Paper 10181, National Bureau of Economic research, December.

The main difficulty facing quantitative approaches assessing the effects of services trade liberalization is the lack of data, which makes necessary further assumptions and approximations. Moreover, results depend on the way trade barriers are quantified and on the particular model's specifications.⁴¹ Concerning the quantification of trade barriers, it has been observed that even the best available methods are hopelessly inadequate.⁴² An additional hurdle confronting quantitative estimates of the impact of services trade liberalization is the difficulty in isolating the effects of trade liberalization from the effects of other intervening variables, as in many cases reforms in different policy areas take place simultaneously. There is also the issue that, in assessing the effects of services trade liberalization, it is necessary to take into account the specific features of individual services, and the different impact of trade according to the different modes of delivery. Those issues that are not usually addressed in the studies which have been reviewed. Considering that quantitative analysis provides important insights into the effects of services trade liberalization, there is a need to refine estimating techniques and economic modeling to capture the specificities of trade in services. There is an equally urgent need to improving data on services as the basis for formulating policy recommendations to developing countries.

3. The shift towards services: Back to basics

The structural change experimented by developed economies from agriculture to a services economy has been widely analysed in economic literature focusing on the factors accounting for the continuous shift to service industry employment. Differing supply and demand factors have been examined to explain the observed evolution in the structure of developed economies. Among them there are: the shift in the structure of final demand from goods to services as income rises; the effect of inter-industry productivity differentials; and the impact of changes in the inter-industry division of labour, favouring the emergence of specialized services activities through a process of externalization of functions by firms in all sectors of the economy.⁴³ The process of economic growth and development of industrialized countries has been the result of a positive cross-fertilization, a close and symbiotic relationship between manufacturing and services, where growth has mutually reinforced the dynamism of manufacturing and services activities and has increasingly blurred the boundaries between them.⁴⁴ The growing *externalization* of functions by other economic activities, and also by services companies themselves, is reputed to explain growth of modern business services in developed countries, and their contribution to enhancing overall economic efficiency through specialization and economies of scale effects. In a parallel process, manufacturing industries are increasingly generating a higher proportion of their income through the sales of services.⁴⁵ At the same time services have emerged as the main source of demand for ICT products, and other technology-embodying capital

⁴¹ Whalley J. (2003), *op.cit.*

⁴² Mattoo A. (2005), "Services in a Development Round: Three Goals and Three Proposals", *Journal of World Trade*, Vol. 39, no 6.

⁴³ Schettkat R. and L. Yocarini (2003), *The Shift to Services: A Review of the Literature*, Institute for the Study of Labor, IZA DP, No 964.

⁴⁴ OECD (2000), *The Services Economy*, Business and Industry Policy Forum Series.

⁴⁵ OECD (2000), *The Service Economy*, Business and Industry Policy Forum Series; Howells J. (2000). *Innovation and Services: New conceptual framework*, CRIC Discussion Paper no 38, Center of Research on Innovation and Competition, University of Manchester.

goods, sustaining increasing levels of production of many manufacturing activities. In developed countries, the intermediate demand for producer services originating from the manufacturing sector has emerged as a strategic variable for international specialization and as a determinant of the competitiveness of countries in producer services.⁴⁶

Developing countries have also experienced a rapid shift towards services which currently account for a significant proportion of their GDP and employment, and in some cases approximate the situation observed in developed economies. In the case of South Africa, for example, services activities already account for 68 per cent of total employment. However, the very nature of the structural transformation developing economies went through has in most cases not received adequate attention. A relevant question, with important implications for policy formulation, is the extent to which the process taking place in developing countries is proceeding along the same path followed by developed countries, or whether developing countries are facing a different phenomenon with dissimilar development implications. The impact of policies depends on the structure of the markets being targeted. Therefore, a clear understanding of the evolution of the services economy and of its relation to other economic activities in developing countries is a prerequisite for assessing the potential effects of alternative policies governing services activities.

Preliminary findings of national studies on services tend to suggest that in most developing countries the increasing importance of services might be the expression of a process quite different from the one historically experienced by developed countries today. The following issues can be highlighted in this respect: (i) the shift toward services in developing countries is taking place at significant lower levels of per capita income than in the case of developed countries; (ii) in many developing countries the more traditional, non-tradable, low-productivity services with reduced capital accumulation potential are the ones accounting for the increasing share of services in GDP and in total employment.⁴⁷ This process appears closely related to the expansion of the “informal economy” that accounts for a significant and growing proportion of economic activity, in particular in the services area.⁴⁸ Some studies have shown that marginal labour productivity in services activities in developing countries approaches to zero. A suggestive comparative analysis of the Latin American experience finds however that in the expansion of tertiary employment two different trends can be observed, one demonstrating spurious tercerization of the economy, and one reflecting what the author calls genuine tercerization;⁴⁹ (iii) in many developing countries there is no observable positive symbiotic relationship between services

⁴⁶ Guerrieri P. and V. Meliciani (2004), *International Competitiveness in Producer Services*, March, found at: <http://ssrn.com/abstract=521445>.

⁴⁷ Small retail trade, restaurants, urban public transport, repair shops, and personal and community services are the activities experiencing significant growth rates and explaining the increasing participation of services in GDP and in total employment.

⁴⁸ The Latin American case can provide some light on the extent of this phenomenon. For the region as a whole, in 2001 46.3 per cent of total non-agricultural employment was accounted by the informal sector, as opposed to 42.8 per cent in 1990. In some countries this proportion is significantly higher: Honduras 60.7 per cent; Peru 59.5 per cent; Ecuador 57.4 per cent; Colombia 55.6 per cent and Venezuela 49.2 per cent. Out of 12 Latin American countries, only in three cases employment in the informal sector, as a proportion of total non-agricultural employment, is below 40 per cent. These are the cases of Panama (37.3 per cent), Chile (38.0 per cent) and Mexico (39.6 per cent). Informal employment is highly concentrated in the services sector.

⁴⁹ Weller J. (2004) “El Empleo Terciario en América Latina: entre la modernidad y la supervivencia”, in *Revista de la CEPAL* 84, December.

and manufacturing, and there is a limited externalization process taking place; (iv) the expected tendency for an increasing share of services in total GDP, as income growths, is challenged by the recent experience of many developing countries. For example, out of 51 African countries for which information is available, in 28 cases (56 per cent of the total) the services share of GDP declined during the 1990-2001 period, and in three cases it practically remained the same. This has been also the case of other developing countries in other regions of the world.⁵⁰

Another issue that deserves careful attention is the assessment of the extent to which all developing countries are experiencing the same kind of structural transformation or whether there are significant differences in the pattern of change that they are pursuing. A study finds, for example, significant differences between Latin America and Asian countries on the process of structural change, with important implications for development.⁵¹ In some industrializing developing countries, a positive relationship has been found between the growth of services and industrial productivity and growth. A two-way effect of growth of the services sector and growth in manufacturing has also been noticed.⁵² However, this seems not to be the case in most developing countries and LDCs. National studies on services also show significant differences among developing countries in the structure of services output. Further work is needed to assess the structure and behaviour of services industries in developing countries and the development implications of the pattern of structural transformation that these countries are pursuing.

In examining structural change in developing economies, special attention should be paid to the contribution of public administration and defense, as well as of "ownership of dwellings" to services GDP. The first reflects a set of societal preferences that account for the size of the public sector, while the second is an imputed value accounting for the production of housing services aimed at final consumption by owner-occupiers.⁵³ Estimation of the contribution of these items to GDP varies among countries and in general tends to account for a significant share of total services output in developing countries. In the case of Venezuela, for example, these items account for over 36 per cent of total valued added by services. In the case of Rwanda, these non-market services account for almost 50 per cent of the total value added by services activities. Analysis therefore should focus primarily on the structure and evolution of market services and their relationship with other productive activities.

⁵⁰ UNCTAD (2003), *Handbook of Statistics*.

⁵¹ Ananya Ghosh Dastidar (2004), *Structural Change and Income Distribution in Developing Countries: Evidence from a Group of Asian and Latin American Countries*; Centre for Development Economics, Department of economics, Delhi School of Economics, February.

⁵² Banga R. and B. Goldar (2004), *Contribution of Services to Output Growth and Productivity in Indian Manufacturing: Pre and Post Reforms*; Indian Council for Research on International Economic Relations (CRIER), Working paper No 139, July; Clemes W.L. *et al* (2003), "An Empirical Estimation of the Spillover Effects of Services and Manufacturing Sectors in ASEAN Countries", *Asia Pacific Development Journal*, Vol 10, No 2.

⁵³ The ratio of owner-occupied to rented dwellings can vary significantly between countries and even over short periods of time within a single country, so that both international and intertemporal comparisons of the production and consumption of housing services could be distorted, if no imputation were made for the value of own-account housing services.

A better understanding of the services economy in developing countries, both in overall terms and in relation to the structure of specific services sectors, as well as its relationship with other productive activities, is necessary to address questions regarding the different policy options available to developing countries to strengthen their domestic services capacities, and for assessing the possible impact on growth and sustainable development of alternative policies. One of the main problems that need to be addressed in this connection is the lack of precision and reliability, as well as the high degree of aggregation, of the services sector statistics in most developing countries.

4. Trade in dynamic services sectors and the developing countries

Trade performance in services is an important dimension of the assessment, since one of the GATS objectives is increasing participation of developing countries in trade in services. Trade, in turn, is expected to be an engine for growth. World exports of commercial services amounted to \$2,125 billion in 2004. Trade in services is still concentrated in developed countries that account for 78 per cent of total world exports and a similar percentage of total imports. Developing countries' share of total world services exports is nevertheless gradually increasing. The most dynamic segment of trade in services is that of "other commercial services".⁵⁴ Those services represent 47 per cent of total world exports and have experienced two digit growth rates – up to 16 per cent – in recent years.

Twelve developed countries account for 67.1 per cent of total exports of "other commercial services", and three developing countries – i.e. India, China and Hong Kong, China – for an additional 8.2 per cent. "Other business services", which are a subcategory of "other commercial services" and encompass a wide range of services activities, represent almost 50 per cent of world exports of "other commercial services", while financial and insurance services and royalties and licenses fees account for an additional 17 and 13 per cent respectively of "other commercial services". Contrary to developed countries, most developing countries still concentrate their supply on traditional travel and transport services whose demand has grown at a significant lower rate than that of other commercial services. Nevertheless, national studies indicate that a process of gradual diversification of services exports is ongoing in many developing countries and that other commercial services are representing an increasing share of total exports. Developing countries currently account for approximately 25 per cent of total world exports of business services.

The assessment of trade in services should address the conditions for enhancing developing country competitiveness in "other commercial services", in particular in business services and computer and information services, which offer the promise of significant developmental gains. Intra-firm trade represents a relevant proportion of trade in these services. In the case of the United States, for example, around 70 per cent of total imports of these services constitute intra-firm trade. Therefore, trade in these services is closely interlinked with FDI flows. Developing countries that have been successful in attracting FDI are the ones increasingly participating in trade in the more dynamic services activities.

⁵⁴ Includes the following items: construction, insurance, financial, computer and information services, personal cultural and recreational services, other business services, and royalties and licences fees.

They are also the ones that have been able to reap benefits from merchandize trade: there is a high and growing concentration of trade both in goods and services originating in those developing countries. The 12 leading developing countries exporters of services account for over 70 per cent of the total services exports of the group. This concentration ratio increases when considering only exports of “other commercial services”. Available evidence strongly suggests that public policies have played a significant role in those countries that have been successful in exporting services, in particular ITC-based services, and that public policies are equally necessary to ensure that services exports contribute to the achievement of national policy objectives.

Another issue that deserves attention is the importance for developing countries of South-South trade in “other commercial services”. In most cases, as shown by national studies, regional markets are the main importers of “other commercial services” from developing countries, in particular business services. Moreover, when analysing commercial presence in foreign markets by developing countries firms, available evidence suggest that flows take place primarily at the regional level in services such as distribution, construction, professional services, and other activities prone to be exported through Mode 3. Measures should be put in place at the regional level in the framework of Regional Trade Agreements to enhance developing country export opportunities in business services. The possible effects of increasing regional trade on developing country ability to venturing into the international markets should also be explored.

PART III - SECTORAL ANALYSIS

This section – which mainly relies on empirical studies – provides illustrative examples of country experiences of trade liberalization in selected services sectors. The theoretical assumptions and theories discussed in parts I and II of the study are checked against those specific examples. The results of trade liberalization are analysed against the background of the Doha Round negotiations on services and, more specifically, of the “plurilateral/collective requests” tabled at the WTO after the Sixth Ministerial Conference: Hong Kong as a means to intensify and expedite services negotiations. This section of the study also singles out areas where further work is deemed necessary to move from an anecdotic to a full-fledged analysis where the full implications of trade in services liberalization can be fully understood.

1. Financial services

Recognizing the crucial role performed by financial services in the process of economic growth and development, many developing countries have in recent years undertaken drastic reforms of their financial systems. These reforms include the withdrawal of government interventions by privatizing state-owned financial entities; freeing interest rates and credit allocation to be determined by the market; the removal of quantitative or qualitative regulations that discriminate against foreign financial entities; and the removal of restrictions on intra-sectoral activities by financial entities. Financial liberalization is expected to produce benefits, both to consumers and business, through enhanced competition, which will translate in lower fees; improved quality and choice of services; access to new products and technologies; and access to new sources of capita. In addition, systemic benefits such as the strengthening of financial entities sheltering the system from shocks, improving overall risk assessment and allocation of resources, and the fostering of regulatory reform and greater transparency are among the expected outcomes of the reform process.

Literature, however, also highlights the fact that financial liberalization is not without risks, and that countries should carefully assess the potential implications of reform on the basis of national realities.⁵⁵ Designing appropriate financial services liberalization policies largely depends on country-specific conditions; therefore, it is not possible to pursue a “one-fits-all” approach, while the best approach seems to be to determine the potential costs and benefits of reforms and also the appropriate pace and sequence of the process. A major issue is that, in absence of adequate prudential policy, liberalization may contribute to increased financial instability.

Experiences of financial reform in developing countries are highly diversified. Some countries have deregulated domestic markets but maintained restrictions to new entrants, in some cases on the basis of general restrictions (i.e. Chile during a significant period of time), in others only to foreign providers. Moreover, in some cases the reform was

⁵⁵ IMF (2000), *International Capital Markets*, Washington, DC, September.

accompanied by the liberalization of the capital account, while in other cases regulation restricting movement of capitals was maintained. In some countries all state ownership of financial entities was terminated, including that of development banks, while in others some state participation in the financial system was maintained, pursuing some development objectives. In some countries commercial presence was fully liberalized, while restrictions were maintained on cross-border trade. Differences can also be observed in the speed of the reform and in the sequence between financial sector liberalization and regulatory upgrading. Considerable efforts have been deployed in assessing the effects of financial sector liberalization on the growth and development of developing countries. Findings are not conclusive as the different paths to reform show varying results with respect to the expected beneficial outcomes. Moreover, in some cases other intervening effects might have undermined the expected benefits of the reform process.

Regarding financial liberalization, for example, the Thai experience shows that “fast and furious” liberalization has not worked well. Liberalization should have been planned as a process and implemented in steps rather than being set out as an objective to be achieved through incoherent policy measures. The experience also demonstrates how challenging it is to adapt the external fast developments to suit a country’s need and readiness. The rapidly growing banking system and the influx of short-term foreign capitals proved, for instance, to be too much and too fast for the Thai authorities to catch-up on the regulatory front. While financial reform and the strengthening of the financial system are of paramount importance, they should be devised and implemented on a continuous basis and not only when an acute need or extraordinary circumstances force a country to undertake drastic reforms.⁵⁶ In the case of Mexico, which underwent total liberalization, there are serious concerns with the availability of credit to the domestic economy. Credit to the private sector as proportion of the GDP has decline considerably after the reform was implemented and foreign banks became dominant in the domestic market.

Assessments of reform in the financial sector show at least to two clear main resulting trends: increasing foreign penetration of the domestic financial system; and increasing concentration in the domestic market. Countries undertaking liberalization of the financial sector have experienced a fast increase of the participation of foreign financial entities in the market at the expense of domestic firms. Domestic financial entities have been bought by foreign firms or have been forced to leave the market, not being any longer able to compete. In some cases, such as Mexico, Botswana, Benin and Lesotho, foreign firms have almost fully displaced domestic financial entities. At the same time a process of increasing concentration has been unleashed, through which progressively a smaller number of financial entities control a larger share of the total financial market. The development implications of these two trends are under close scrutiny. Findings are not conclusive. Two main question arise: Does nationality matter in control of the financial entities? and is concentration beneficial for developing countries or prone to anti-competitive behaviour with perverse developmental implications? A major issue of concern is how to assure that adequate levels of financing in the domestic economy can be assured. In some cases, as the above mentioned case of Mexico, financial liberalization has not contributed to increasing lending to the private sector as percentage of the GDP, but, on the contrary, a sharp decline has been observed after the reform. SMEs and operators in the agricultural sector have been particularly affected by limited access to credit.

⁵⁶ WTO (2002), *Communication from Thailand - Assessment of Trade in Services*, TN/S/W/4, 22 July.

2. Telecommunication services

Telecommunication services constitute the vital infrastructure which allows interconnectivity among countries. Besides providing basic and enhanced telecom services, they are the platform for delivering information communication technology services (ICT). These services are the main drivers of the global tradability of goods and services, as well as the means for offshoring a wide range of IT-enabled services (ITES) and business process outsourcing (BPO). The geometric growth of telecom services in most developing countries reflects the shifting of demand trends and the flows of investment from developed countries to developing regions, in particular to the Asia Pacific region. According to ITU estimates, the industry's revenues are already above \$1 trillion, representing more than 3.2 per cent of global GDP. The Asia Pacific region has emerged as the world's largest telecommunication market with a 36 per cent share, as compared to 22 per cent ten years ago. Two of the three largest mobile economies worldwide, measured by mobile phones per capita, are also from the region. China is the world's largest telecom market overall. It ranks the first in the size of the mobile phone market and second in the fixed line market, after the United States.

In recognition of the role that telecommunications services play as key enablers of trade and development, Australia, Canada, the EU, Hong Kong China, Japan, the Republic of Korea, Norway, Singapore, Taiwan Province of China and the United States introduced in February 2006 a "plurilateral request"⁵⁷ in telecommunications services addressed to a group of 24 WTO Members.⁵⁸ The request recommends countries to undertake broad liberalization commitments which cover particular voice and data transmission services and leased circuit services, as well as the so-called value-added services.⁵⁹ More specifically, under Mode 1, the request urges trade partners to refrain from requiring using networks of specific suppliers, commercial presence or commercial arrangements. Under Mode 2, to refrain from introducing any market access or national treatment limitations. Under Mode 3, the request calls for removing economic needs tests, restrictions on the types of legal entity permitted, limitations on nationality or residency and for allowing majority foreign capital participation and effective control. Under Mode 4, the request urges for new or improved commitments on the categories of intra-corporate transferees and business visitors and encourages WTO members to include telecommunications services within horizontal Mode 4 commitments. The request reconfirms the concept of "technological neutrality"⁶⁰ and the key relevance of measures, as included in the reference paper, aimed at ensuring fair conditions of competition.

⁵⁷ "In addition to bilateral negotiations, we agree that the request-offer negotiations should also be pursued on a plurilateral basis in accordance with the principles of the GATS and the Guidelines and Procedures for the Negotiations on Trade in Services. The results of such negotiations shall be extended on an MFN basis." Doha Work Programme, Ministerial Declaration, Adopted on 18 December 2005, Annex C, para 7, WT/MIN(05)/DEC, 22 December 2005, p.C-3.

⁵⁸ The list of "Collective/Plurilateral Requests" is available in the web site of the Coalition of Services Industries: <http://www.uscsi.org/wto/crequests.htm>, visited on 2 April 2006.

⁵⁹ Electronic mail, voice mail, on-line information and data base retrieval, electronic data interchange, enhanced facsimile services, code and protocol conversion, online information and/or data processing.

⁶⁰ The thrust of this notion is that where no specific references are made to the type of technology used in providing basic telecommunications services, specific commitments would automatically cover all means of technology (i.e. services transmitted via all types of cable, wireless or satellites). Nevertheless, where WTO members applied different measures in regulating market access or national treatment, depending on the type of technology, they scheduled them in their commitments.

In recognition of the significant gaps that exist in current commitments related to the cross-border supply of services (Modes 1 and 2) and of the desirability to plug the gap between such commitments and commercially meaningful market-access opportunities that have arisen, a collective request on cross-border supply was introduced in March 2006 by Chile, Hong Kong China, India, Mexico, New Zealand, Pakistan, Switzerland, Singapore and Taiwan Province of China. Trade partners are urged to consider taking full national treatment commitments and removing requirements of commercial presence, citizenship/residency requirements that they maintain in the market access column. The so-called value-added telecommunication services are included in this plurilateral request.⁶¹

Japan liberalized the telecommunication business, one of the sectors which continued negotiations after the end of the Uruguay Round, by eliminating all restrictions on foreign capital participation and board members. As a result, employment in the telecommunication sector doubled during the five years starting in 1993, the sales increased by more than 70 per cent, investment for plant and equipment by 50 per cent, and employment of new common carriers increased by 70 per cent during the same period.⁶²

The trade policy regime and legal framework of telecommunications has changed radically in most developing countries in the past decade. Natural monopolies of public telecommunications services have been dismantled as a result of autonomous liberalization in the context of domestic reform processes. The adoption of the Protocol IV of GATS on basic telecommunications by most WTO Members brought about comprehensive commitments to open domestic markets to foreign participation, and to implement a pro-competitive framework in line with the reference paper. Domestic reform generated massive investment flows from companies aiming to participate in the privatization of telecommunications all over the world.

The impact of such trends and the distribution of the benefits between developing countries and between different segments of the population within countries, however, have not been balanced. Although substantive progress on IT access and massive investments in telecommunications infrastructure have taken place, the level of coverage and telephone density in LDCs and in many African countries lag behind world averages. Telephone density is 5.4 per cent in Africa, and 14.01 per cent in Asia. In India it is only 3.9 per cent. Many studies by international organizations, including multilateral agencies, advocate the need of undertaking the necessary steps to revert such a situation to assure the achievement of the MDGs.

Studies assessing the impact of liberalization of telecommunication services in developing countries show some contrasting results; however, there now seems to be a growing consensus on the benefits of liberalizing trade in these services. Most developing countries do not have the financial and technological means required for developing world-class telecommunication services that are crucial for economic development and for an effective participation in international trade in goods and services. Therefore, there is the need to liberalize the sector to lure FDI into the countries to undertake the necessary tasks and link national systems with the emerging global telecommunications networks. In those

⁶¹ *Collective request - Cross border supply*, found at: <http://www.esf.be/pdfs/Collective%20Requests/Cross%20Border%20Supply%20C%20R.pdf>, visited on 4 April 2006.

⁶² WTO (1999), *Communication from Japan - Assessment of Trade in Services*, S/C/W/105, 26 April.

countries where the sequencing of policy reforms has been well framed, telecommunication services are playing a crucial role in development, including in achieving the MDGs, and significant progress has been made in achieving universal coverage. Nevertheless, JITAP country studies⁶³ in Africa show that liberalization has resulted in some cases in improved access to telecom services mainly for the more favoured segments of the population and for urban areas, while there is still striking marginalization of rural areas and of SMEs, due to onerous prices of services. Foreign companies tend to “cherry pick” their clients and many developing countries lack the financial and technological resources necessary to ensure universal coverage.

In the experience of Taiwan Province of China, liberalization has been bringing benefits in terms of more choice, greater innovation and higher quality of services at reduced prices. Furthermore, it has generated positive spillover effects on other parts of the economy. Two immediate consequences of liberalization have been the opening up of market access and the subsequent proliferation of private operators. As a result, the penetration rates of mobile phone services and broadband Internet access have grown extremely fast. The incumbent’s market share in the mobile phone services sector has dropped to a level of around 30 per cent. Viable market competition has led to phased decreases in mobile phone service tariffs of 50 per cent at the outset of liberalization and 40 per cent in 2000.

The entry of private operators has resulted in a huge amount of realized or anticipated investment in the telecommunications services industry. Additionally, telecommunication liberalization has produced a vast array of spillover effects such as the unleashing of both price and non-price competition. The telecommunications sector has become an important customer, for example, for the advertising industry. While at the beginning, due to lack of indigenous supply, foreign firms benefited the most from market liberalization, in a subsequent phase local firms have been able to become important players in contract manufacturing work for the globally branded marketers of handsets. There are strong grounds for arguing that foreign participation in the local market arising from telecommunications liberalization has helped to promote the overall efficiency of the sector. One of the key steps towards liberalization undertaken by Taiwan Province of China was the separation of the commercial operations from the regulatory functions of the Directorate-General of Telecommunications. In addition, efforts are currently under way for establishing a new independent regulator outside the jurisdiction of the competent ministry, in order to eliminate potential conflicts of interests between industrial promotion and open competition and to tackle the trend of convergence between the telecommunications and broadcasting sectors.⁶⁴

Most studies undertaken by UNCTAD and other institutions underline that liberalization *per se* it is not a sufficient condition to assure increasing trade benefits and development gains. The JITAP country studies argue that the results of liberalization may

⁶³ JITAP – the Joint Integrated Technical Assistance Programme – mobilizes the expertise and support of the WTO, UNCTAD and ITC to help African countries benefit from the multilateral trading system. The countries involved in the initiative are: Benin, Botswana, Burkina Faso, Cameroon, Côte d’Ivoire, Ghana, Kenya, Malawi, Mali, Mauritania, Mozambique, Senegal, Tanzania, Tunisia, Uganda, the United Republic of Tanzania and Zambia.

⁶⁴ WTO (2004), *Communication from the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu - Assessment of Trade in Services*, TN/S/W/18, 26 February.

be hampered if additional domestic policy reforms are not implemented to effectively prevent and repress anticompetitive behaviour, to ensure universal coverage, affordable pricing and widening the access to Internet and distribution networks. Other assessment studies in Latin American and in some Asian countries underline the substantial improvement in density of telephony and coverage of rural areas. Some assessment studies⁶⁵ underline the growing potentialities of developing countries as providers of ICT offshored services⁶⁶ (ITES/BPO) as a result of falling of telecom rates.

The ever-changing state of technology in the telecommunication sector can easily render the regulatory regime outdated, this characteristic demands continuous and systematic fine-tuning of the deregulatory and regulatory framework. Sequencing of policy reforms and flexibility of regulators to constantly update and innovate the legal framework are preconditions for using telecom in a sustainable perspective.

Developing countries would certainly benefit from a well-managed process aimed at liberalizing telecommunication services. However, they confront two major post-reform challenges, namely how to assure a competitive environment in the domestic markets in the light of the growing concentration of the industry worldwide (in Latin America, for example, there is a trend towards two dominant suppliers in each country); and how to assure regulatory adaptation to fast and profound technology changes which are constantly modifying the industry and bringing new services to the market. For example, how should countries address the blurring of the boundaries between audiovisual and telecommunication services?

3. Energy services

Energy services constitute the value added in the chain from the location of the potential energy source to its distribution to the final consumer. The dynamism of trade in the energy services sector is accelerating due to the increasing demand for energy, the liberalization of energy markets, increased investment in the energy sector, and the introduction of new technologies. On the other hand, in many developing countries the lack of access to commercial energy by large segments of the population constitutes a major impediment to socioeconomic development.⁶⁷

While developed countries have by and large reformed their energy sector, developing countries are in the process of doing so, though most of them are concentrating on reforms in the electricity industry. Structural reform is meant to cut costs and improve the economic performance and efficiency of the energy sector by imposing free-market disciplines and commercial criteria. As it is the case for other infrastructure services, reform can take different

⁶⁵ Telecom India and Costa Rica have quoted UNCTAD's background paper on BPO.

⁶⁶ Typically, off-shored services include customer contact centres, data entry operations, telemarketing and basic technical support at the lower end of the spectrum; the processing of financial transactions such as credit card billing, insurance claims and debt collection in the middle of the spectrum, and professional services like R&D, engineering and architectural services, investment analysis, medical diagnostics, etc. at the higher end.

⁶⁷ 1.6 billion people did not have access to electricity in 2005. According to the International Energy Agency's estimates, 1.4 billion people will still lack access to electricity in 2030.

forms, including privatization, increasing competition, demonopolization and deregulation, covering both the removal of regulations and the reassessment of regulatory methods in areas where regulation remains appropriate. Regulatory reform is itself part of a wider phenomenon – the drawing back by governments from direct intervention in markets.⁶⁸

Considering that the energy sector embraces several energy sources and a long and complex production-transport-distribution chain, the process of liberalization varies considerably among countries. Some developing energy-producing countries have adopted successful policies aimed at developing a strong domestic upstream energy service sector (exploration, extraction, drilling and other construction services) as a stimulus to development. For example, in 1980 PDVSA – the Venezuelan state oil company – established a policy aimed at the development of the Venezuelan engineering, procurement and construction (EPC) companies. Foreign EPC companies had to establish partnerships or joint ventures with local companies to be invited as bidders for contracts. The partnerships had to produce transfer of technology and training. The management of the projects had to be shared between foreign and Venezuelan executives. On the other hand, attractive contracting conditions were applied and stable workloads were offered. As a result, in 2001 90 per cent of EPC contracts were executed by the local EPC companies, up from 20 per cent in 1980. In the same year, there were more than 140 firms of various sizes and degrees of specialization.

On the other hand, the opportunity to take advantage of the presence of foreign energy services companies to enhance domestic capacity through the establishment of partnerships or joint ventures may be substantially reduced if countries take the commitment to eliminate joint ventures and joint operations requirements for foreign service suppliers, as is recommended in the plurilateral request on energy services put forward in February 2006 within the negotiations on services by Australia, Canada, the EC, Japan, Norway, Saudi Arabia, the Republic of Korea, Taiwan Province of China, Singapore, and the United States.⁶⁹

At the downstream level of the industry (energy transformation, transportation and distribution), many countries are taking steps to liberalize their energy markets by removing state monopolies and allowing private suppliers to provide energy to consumers, which has resulted in lucrative markets for trading in energy. Indonesia, for instance, has liberalized the downstream segment of the oil and gas sector with the aim of attracting foreign investors who would bring the capitals and technology needed to improve domestic refinery capacity. Indonesia is also liberalizing the upstream segment of its oil and gas sector and has recently changed the legal status of the national oil company – Pertamina – which has been converted into a limited liability company. Liberalization of the upstream segment concerns, for the time being, only Indonesian investors, under the assumption that domestic companies would need some time to be able to compete with foreign operators.

⁶⁸ UNCTAD (2003), *Managing “Request-Offer” Negotiations under the GATS: The Case of Energy Services*, UNCTAD/DITC/TNCD/2003/5, 23 May, at 2.

⁶⁹ *Collective Request in Energy Services*, found at: <http://www.uscsi.org/publications/papers/collective/energy.pdf>, visited on 3 April 2006.

Despite of the assumption that energy markets liberalization may yield development gains and contribute to the achievement of the MDGs, some recent setbacks in the electricity segment of the industry may prompt a more cautious approach. A series of power emergencies occurred in California in 2000-2001 leaving hundreds of thousands of consumers without electricity and major power corporations facing bankruptcy. Wholesale prices went up because of supply shortages and a surge in demand. Limited transmission capacity made it difficult to import electricity from neighbouring states. The impact of the supply squeeze was amplified by structural rules which forced the utilities to buy all their power through a single market – the state’s power exchange – no more than a day in advance. The intention was to prevent long-term contracts between the major players from limiting the scope of competition. The result was to introduce an element of price volatility that proved beyond the scope of financial planning. Chile went through a similar crisis in 1998-1999. Although the origin of the crisis was essentially due to drought, the elements that prompted the crisis were very similar to those which influenced the California crisis.

Some lessons can be drawn from these experiences: partial deregulation may create problems; electricity liberalization should be accompanied by carefully planned regulatory structures and by a dynamic regulatory process where institutions must be flexible enough to introduce changes as circumstances require; reform of the energy sector should encompass many elements: competition – keeping in mind that markets can be truly competitive only if there is surplus capacity; adequate investment in generation and transmission; consumer education; and demand reduction. The failure of California’s vanguard effort to engineer a smooth deregulation of its electricity sector has cast doubt on the viability of similar efforts underway in other countries, especially in developing countries.

Electricity and natural gas markets have traditionally been run under monopolistic or oligopolistic conditions by state-owned companies with virtually no competition taking place in most markets. On the other hand, market access for electricity and natural gas depends on access to networks. This means that establishing fair conditions of competition are preconditions for both effective market liberalization and international trade in electricity and natural gas to take place.

Ensuring such conditions, however, has proved to be a rather complex task. In the case of the EU, for example, two recent reports – one on the functioning of the internal market in electricity and natural gas, and the other on energy sector competition – confirm that cross-border competition is not yet sufficiently developed to provide customers with a real alternative from the nationally-established suppliers. Key indicators in this respect are the absence of price convergence across the EU and the low level of cross-border trade.

Several causes are at the origin of market integration below expectations, namely the failure of EU Member States to implement timely and fully the relevant EU legislation; inadequate use of existing infrastructure and – in the case of electricity – insufficient interconnection between many EU Member States, lack of liquidity of both natural gas and transport capacity in the case of the natural gas market.

Five areas of market malfunctioning have been identified as the cause of inadequate competition in the energy market, namely natural gas and electricity markets in many EU Member States continue to be concentrated, creating scope for incumbent operators to influence prices; many wholesale markets are not liquid either because of long-term

contracts (gas), or because companies are active both in production and in the retail market limiting the development of wholesale markets (electricity). There is also an inadequate level of unbundling of network and supply activities; barriers to the cross-border supply of natural gas and electricity prevent the development of integrated EU energy markets; a lack of transparency on the markets that benefits incumbents and undermines the position of new entrants. Lack of transparency also aggravates the mistrust; finally, there is little trust by industry and consumers in the specific price formation mechanisms on energy wholesale markets and prices have increased significantly.⁷⁰

Country case studies carried out in Latin America in 2001 show that energy market liberalization has, on balance, been beneficial to countries that have implemented it. Both energy availability and the quality of the service have been enhanced, mostly through a rapid transfer of technology and systems and more efficient modern management. Energy accessibility and affordability, although better overall, have not improved for marginal populations. In general market liberalization has tended to reduce employment in the sector as public monopoly enterprises tended to be over-staff. Reductions in personnel in privatized companies have been accompanied, however, by increases in the number of jobs in contracting companies and as a result of the increasing outsourcing of many activities.⁷¹ Within the context of heavy reliance on services companies, there is still a great variety in the degree to which energy companies vertically integrate backwards or outsource services to external providers.

4. Environmental services

Environmental services are one segment of the environmental industry. The industry is going through important changes from a structural point of view – e.g. privatization, consolidation; and as regards the kind of outputs it provides – e.g. from end-of-pipe to cleaner technology; and the goals it is aiming for – i.e. from compliance with environmental regulations to resource productivity.⁷²

The size of the global environmental market was estimated at \$563 billion in 2002, with the EU, the United States and Japan combined accounting for about 85 per cent of the total market and 90 per cent of total exports. The environmental industry is estimated to have grown by 15 per cent between 1996 and 2002. Most analysts expect that the industry will continue to expand, reaching over \$600 billion by 2010. This is roughly the same size as the pharmaceuticals or information technology markets. Developing countries are net importers of environmental services, although their exports are increasing and are oriented mainly towards regional markets.⁷³

⁷⁰ EC Commission (2005), *Energy: Member States must do more to open markets; competition inquiry identifies serious malfunctions*, Press Release, IP/05/1421, 15 November, found at: <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/1421&format=HTML&aged=0&language=EN&guiLanguage=en>, visited on 3 April 2006.

⁷¹ World Energy Council (2001), *Energy Markets in Transition: The Latin American and Caribbean Experience*, London.

⁷² Zarrilli S. (2003), "International trade in environmental services and the developing countries" in *Energy and Environmental Services: Negotiating Objectives and Development Priorities*, UNCTAD/DITC/2003/3, New York and Geneva.

⁷³ Geloso Grosso M. (2005), *Managing Request-Offer Negotiations under the GATS: The Case of Environmental Services*, OECD Trade Policy Working Paper No.11, OECD, Paris, 15 February.

In 2002, the environmental services sector accounted for over 65 per cent of the environmental industry. The infrastructure segments of water, sewage and solid waste management represented over 80 per cent of the global environmental services market, although environmental non-infrastructure and support services are becoming increasingly important. The industry has a dual structure, with a small number of large firms accounting for about 50 per cent of output in individual market segments and a large number of smaller firms accounting for the remainder.

In developing countries, the market has seen infrastructure-related projects, primarily in sewage treatment and water delivery as the main drivers. In particular, the market for water and waste-water treatment has expanded rapidly. British and French water companies, thanks to a comparative advantage gained mostly as a result of accelerated privatization, have been able to take advantage of the demand.⁷⁴

The main reasons for privatization have been problems of investments in a sector where demand has been constantly on the rise, especially for countries that, due to loans from international financial institutions, urgently need to reduce fiscal deficits. Additional reasons are linked to problems of access and efficiency under public management. As it is the case for other infrastructure services, the privatization of environmental services has taken place in the context of a tense debate about the appropriate roles for the private sector in this area. The debate has been polarized around diverging ideological positions and has led to major conflicts, especially around large-scale projects involving multinational companies.

In some developing countries, governments have been reducing their investments in water supply and sanitation with the hope that private-sector investments would fill the gap. Recent evidence suggests that this expectation is often overly optimistic. While there has been a steep increase of cumulative investments in water and sanitation projects, from less than \$2 billion in 1992 to close to \$53 billion in 2000, this has been followed by a market slow down in recent years. From a peak of 38 worldwide water and sewerage private projects in 1999, the number went down to 18 in 2002. The frequency with which water and sanitation concessions in both developing and developed countries have been postponed or cancelled over the past several years (often due to currency shocks) is evidence of how difficult it is to design and implement successful private-sector involvement in water and sanitation services.

⁷⁴ In the Philippines the water supply, treatment and distribution utility serving metropolitan Manila, Rizal and part of Cavite was privatized in August 1997. Two consortia (including Philippine, British, American and French industrial groups) were awarded 25-year concessions to assume full operational and investment responsibility for the cities' water and sewage system, covering 11 million people. In 1992 a consortium led by a French firm won a 30-year contract to run water and sewerage services in Buenos Aires; the same company was subsequently awarded a 25-year contract to construct and operate a drinking water treatment plant in the city of Medan, Sumatra (Indonesia). China's first water supply build-operate-transfer (BOT) project was approved in July 1998 to help meet the demand for water in Chengdu (3.2 million inhabitants). This is the first urban water infrastructure project approved by the Government using foreign funds (consortium led by a French firm) under a BOT plan. In South Africa a subsidiary of a French company won a EUR 76 million build-own-operate-transfer (BOOT) contract for the construction of a treatment plant for the recycling of process effluent water in Durban. A services contract valued at \$25 million was awarded in September 1999 to a consortium for managing the water supply and distribution system for Maputo and the four other major cities (2.5 million people) in Mozambique. The programme relies upon financing from the World Bank. Source: OECD (2001), *Environmental Goods and Services – The benefits of further global trade liberalization*, Paris.

Private investment projects have mainly been realized in high- and middle-income countries, while LDCs have hardly been touched by the phenomenon: for instance, less than 0.2 per cent of all private sector investments in the water and sanitation sector of developing countries went to sub-Saharan Africa. Moreover, multinational water companies operating in developing countries have shown a tendency to 'cherry pick' – concentrating on supplying large cities and those consumers who can pay market prices for the services. Rural areas, small and medium cities and poor neighborhoods have usually been disregarded by private operators.⁷⁵ Such developments prove the inadequacy of the regulatory framework put in place prior to liberalization or the lack of it.

In the "collective request"⁷⁶ presented in February 2006 within the GATS negotiations by Australia, Canada, the EC, Japan, the Republic of Korea, Norway, Switzerland, Taiwan Province of China and the United States, it is recognized that, thanks to information technology, some environmental services (non-infrastructure services) may increasingly be provided through Mode 1; the request therefore urges WTO members to schedule no restrictions to market access and national treatment for this mode of supply. On Mode 3, the request recognizes the predominance of this mode for supplying environmental service and calls for ambitious commitments and for the removal of barriers to commercial presence, such as foreign equity limitations, joint operation requirements, restrictions or requirements on types of legal entity for foreigners, such as joint venture. The request, according to requesting members, assumes that commercial presence by itself necessarily leads to employment of local personnel and transfer of technology and know-how. It is interesting to note that those measures which are commonly used by developing countries to anchor the presence of foreign services suppliers to domestic development strategies are regarded as trade barriers. No commitments are being sought for water collection, purification or distribution services. Environment-related consultancy services are also covered by the plurilateral request on cross-border supply.

Questions remain about the assumption that market liberalization automatically produces improvements in the efficiency of water utilities and in the connection of new customers. In the case of Buenos Aires, for example, although there have been some impressive gains in the extension of water infrastructure, the majority of the concession's negative impacts have been most deeply felt in the poorest sections of Buenos Aires. Many poor households have fallen into serious arrears and have been disconnected from the network, especially prior to 1998. Environmentally, those living in the poorest areas of the city have also been faced with the negative effects of rising groundwater and the health risks associated with nitrate-contaminated aquifers. These municipalities have some of the lowest average incomes in the Greater Buenos Aires area and yet a large part of the financial burden for extending the network has fallen on these households.⁷⁷ Other cases of privatization of infrastructure services have been dramatic; e.g. privatization in Cochabamba, Bolivia, led to serious social unrests. Successful experiences have as well

⁷⁵ OECD (2003), *Public-Private Partnerships in the Urban Water Sector*, Policy Brief, April, Paris.

⁷⁶ *Plurilateral request - environmental services*, found at: <http://www.uscsi.org/publications/papers/collective/environmental.pdf>, visited on 4 April 2006.

⁷⁷ Loftus A. L. and D. A. McDonald (2001), *Of liquid dreams: A political ecology of water privatization in Buenos Aires*, *Environment & Urbanization*, Vol 13 No 2, October, found at: http://www.queensu.ca/msp/pages/Project_Publications/Journals/Loftus.pdf

been recorded. In Cartagena, Colombia, a new company – Acuacar – took over in 1995 Cartagena's water and sanitation services from the public sector. The company is a joint venture between the municipality of Cartagena, a European company and local investors. Acuacar's record has been largely positive, with connection to the network extended to poorer districts of the city and improved continuity of the service.⁷⁸

An alternative to full-fledged privatization is the one followed by several countries when they opted for Public-Private Partnerships (PPPs), where private partners are to different extents involved in the design and construction of infrastructure and/or in the management, operation and/or the financing of assets.

A crucial question in partnerships between the public and private sectors relates to the ownership of natural resources. In less advanced regions of the developing world, local communities – rather than governments – often have the ownership of these resources and have traditionally managed and used them according to their needs. Traditionally, this has not posed any problems but property becomes an issue when market liberalization jeopardizes traditional ownership and usage by local communities. Experience shows that where traditional ownership by local communities prevails, the participation of central or local governments in partnerships does not guarantee non-conflicting access to natural resources or an adequate resolution of the ownership problem. Moreover, this aspect highlights the wider question of the relationship between communities and the management of natural resources on the one hand, and national and international legislation on the other.⁷⁹

Despite privatization, it is estimated that only 3 per cent of the population of developing countries is provided with drinking water through private operators. Globally, there are about 200 million people that are served through private operators. These data reflect the market reality where there are only a limited number of international water operators: the three largest water operators account for more than 50 per cent of the global market.⁸⁰

Trade liberalization in the waste management subsector of the environmental services market can contribute to job creation, especially if competing firms supply the market with a variety of discrete services. It presents, however, high risks of employment displacement, since excessive mechanization and modernization target the livelihoods of some of the poorest and least skilled people who may find it hard to be employed in other sectors.⁸¹ A related issue is the possible displacement of the informal sector. The latter is well illustrated by the Egyptian experience where the informal sector, which had for long been in charge of waste collection and recycling in a cost- and environment-effective way, was replaced by foreign

⁷⁸ Hilary J. (2003), *GATS and Water: The threat of services negotiations at the WTO*, Save the Children UK, London, at 16.

⁷⁹ UNCTAD (1998), *Report of the Expert Meeting on Strengthening Capacities in Developing Countries to Develop their Environmental Services Sector*, TD/B/CMO.1/18 and TD/B/COM.1/EM.7/3, 5 August, at 10.

⁸⁰ Hilary J. (2003), *GATS and Water: The threat of services negotiations at the WTO*, op. cit.

⁸¹ UNDP (2005), *International Trade in Environmental and Energy Services and Human Development*, Discussion Paper, Asia-Pacific Trade and Investment Initiative, UNDP Regional Centre in Colombo, September, at 22.

waste management companies.⁸² This case provides a good illustration of certain major conceptual issues confronting decision-makers in developing countries when facing deeper international integration through the medium of services provided by foreign multinationals. In this case trade in services liberalization is part of the problem, but could also be part of the solution. Indeed, the deepening of international economic integration may be conducive to the unleashing of synergies between the traditional local sector and foreign contractors, thus empowering, rather than marginalizing, dynamic local economic enclaves. Developing linkages between the formal and the informal, the global and the local, will maximize the inclusionary potential of globalization, as well as the overall economic welfare.

5. Construction and related engineering services

All countries recognize the importance of the construction industry in its own right and as a crucial component of public and private investment. Construction of physical infrastructure – such as roads, sanitation infrastructure, and water, energy and telecommunication systems – and their maintenance are needed as a priority to support economic growth and ensuring universal access to basic services. Construction also accounts for a significant share of private investment in other sectors of economic activity. Moreover, there is a need to develop basic low-cost housing, address shelter issue, and implement slum relocation schemes, all of which imply huge social and economic costs and bear development implications.

In general, the construction sector remains a low-margin, highly-regulated and high-risk activity. It is among the most cyclical sectors of the economy in many countries, nearly 50 per cent more volatile than the manufacturing sector. Construction-related engineering services are a component of the sector and may account for 5 to 30 per cent of total

⁸² In the early 2000, Egypt launched a new national strategy for solid waste management (SWM) based on soliciting interest and bids from foreign SWM-service providers and contracting the servicing of vast metropolitan areas to the successful bidder. Four zones in Cairo were identified and the servicing of each zone was subsequently offered for tender in a competitive bid process. Awards were granted to Italian and Spanish firms. In the new SWM scheme, the service charge for garbage collection is to be collected with the electricity bill and the Cairo Cleaning and Beautification Authority has the exclusive responsibility for collecting fees. Instead, the awarded company is entitled to the contractual amount corresponding to the accepted value of its bid. The new integrated system makes the contractor responsible for all services pertaining to the solid waste chain, including the collection, transport and transfer of refuse, as well as disposing, through composting or land filling, of unrecyclable material. Before this scheme, garbage collection was carried out by the informal sector. The main garbage collectors' community in Cairo had over the years emerged as a centre of waste recovery and recycling activity and had developed a distinctive economic vitality. The traditional garbage collection system had also undergone a process of increased formalization and the largest garbage collectors' settlement had managed to become a vibrant industrial hub with considerable forward linkages into processing and manufacturing activities. The new system, when compared with the previous one, exhibits some sub-optimal features. Egypt faces a net hard-currency outflow, amounting to the contractual amount corresponding to the accepted value of its bid, to the extent that this amount will not be fully recovered through collection fees. Conversely, the traditional collection system did not entail official costs. The general public, for the first time, is burdened with collection fees, much beyond the nominal fees previously owed to the informal sector. Finally, the refuse is not recycled anymore, but dumped. This raises serious environmental concerns; mostly, it implies disruptive implications for the dynamic downstream recycling industry that relied on the refuse sorted by the garbage collectors as its primary inputs. The move towards global solutions has led to a sub-optimal output, displacing cost-effective and sustainable local arrangements. Musselli I. (2003), *At the junction of the global and the local: Solid waste management in Cairo*, mimeo on file with the author.

construction investment. Construction brings together professional and services, goods (material and equipment) and technological processes. It has further evolved to include new areas, for example environmental impact assessment. The industry is characterized by the importance of technical and related standards, which are applied to both products and service providers in areas such as technological processes, quality, safety and health, and environmental preservation, resulting in a complex system of regulations. Land use and ownership regulations often have direct bearing on the provision of the services.

The assessment of the sectors contribution to development and the potential impact of services trade liberalization have to recognize the existence of three clearly differentiated market segments within the construction sector. Each of these segments presents differentiated structural and behavioural characteristics. One segment corresponds to investments in public infrastructure which accounts for almost 50 per cent of total construction expenditures in most developing countries. Demand in this segment is a function of budgetary allocations for public investment and, particularly in the case of developing countries, the availability of external financing. This segment is usually dominated by large construction firms among which foreign firms tend to be dominant. Some studies have shown that more than 70 per cent of all projects in developing countries are undertaken by foreign firms. Some developing countries have been able to develop construction firms that are competitive worldwide in this market segment, that undertake projects in other developing countries. For developing countries a challenge is to increase the participation of local construction firms in large public infrastructure projects. With respect to competition conditions, issues of "tied aid" and subsidies to foreign providers have been raised in relation to this market segment. This segment falls outside the current coverage of the GATS as being government procurement. A new trend is the increasing private participation in infrastructure development under a variety of public-private forms of partnership, raising new challenges for developing countries.

Experience with market liberalization suggests that, in the long run, infrastructure investment tends to contribute to economic growth if combined with human resource development and other policies that are conducive to technological innovation and overall development. Developing countries which have been successful in ensuring that local firms fully participate in infrastructure development projects have achieved positive results in terms of enhanced technical skill and economic efficiency. Such results have had positive repercussions on the overall economic development and efficiency of the private sector. On the other hand, often local firms face difficulties in the domestic market to secure effective and substantive participation in projects funded by multilateral funding agencies, because of their inability to meet prequalification requirements, and are left with small contracts based on low-level technology, while foreign firms execute the most profitable part of construction projects. If local firms are not given the chance to participate in domestic construction projects, they are missing opportunities to develop and upgrade their technical expertise and, as a result, are unable to participate in construction projects abroad.⁸³

Another construction market segment involves private investments projects. Construction accounts for an important component of total investment in most economic

⁸³ UNCTAD (2000), *Report of the Expert Meeting on National Experiences with Regulation and Liberalization: Examples in the Construction Services Sector and its Contribution to the Development of Developing Countries*, TD/B/COM.1/32 and TB/B/COM.1/EM.12/3, 18 December, at 11 and 14.

activities, and as such the evolution of this segment of the market depends on the behaviour of total private investment in the economy. This activity being highly sensitive to the overall business cycle. In most cases this type of construction activity is undertaken by specialized firms and usually under turnkey type of projects covering since the design stage to physical construction and the installation of required capital goods. Developing country firms more often participate in this type of construction activity at the low technology end, for example in commercial real state development, while complex productive projects are developed by foreign specialized firms. Most developing countries do not have the technological and financial capacities to engage in this segment of the market. Also, the participation of foreign firms in networks with design firms and capital goods producers confers a competitive edge in these activities.

A third segment of the construction market is that of building homes. The dynamism of this segment depends on household income and the availability and conditions of mortgage credit. In most cases domestic construction firms are dominant in developing countries as the size of the projects is not particularly attractive to large international construction firms. However, in large housing project developments foreign firms then participate in developing countries markets. In developing countries there is significant construction activity undertaken by households themselves, and most countries show an informal sector operating in the construction sector, but its share in developing countries is particularly significant. In some developing countries, it is estimated to account for 50 per cent of the total number of people employed in this particular segment. The informal sector is unregulated and involves economic actors who are unprotected and supply their services both to the formal construction sector and to clients directly.

Developing countries need to assess in which segments of the construction sector they can benefit from foreign participation, while implementing measures aiming to strengthen their domestic supply capacities and setting the required regulation and enforcement capabilities. LDCs in particular face great challenges in promoting the development of their construction services firms, which typically have inadequate technical and managerial skills, poor delivery capacity, low capital base, rely on the use of outdated technologies and practices and provide low quality services. LDCs manifest their particular economic weakness in a significant trade imbalance and on heavy reliance on aid for development and concessional external borrowing. Construction markets in LDCs are dominated by foreign providers who often account for 70 per cent of market share. These factors suggest that there is a limit to which growth and development could be achieved exclusively through an internal reform process.

6. Distribution services

Distribution services encompass a number of different activities related to bringing together producers and consumers, dealing both with business-to-business transactions and transactions between business and the final consumer. They are closely linked with other services, such as transport, packaging, warehousing, financial services and commercial real estate development. They operate at the margin between ex-factory and wholesale and retail prices. The value added in the global chain of supply of goods and services has made distribution services a key infrastructural service and a vehicle in international trade and competitiveness, trade in goods being highly sensitive to the market structure and

competitive behaviour of the distribution sector.⁸⁴ Employment in the distribution sector accounts for a sizeable share of non-agricultural employment in developing countries – for example 6-7 per cent in India – and is significantly higher than in developed countries.⁸⁵

Distribution services in both the retail and wholesale sectors have become a highly concentrated activity in developed countries, and also play a commanding role in the overall organization of production, with large retailing conglomerates dominating markets. The top 200 retailers account for 30 per cent of worldwide retailing sales. The distribution chain has become shorter, and a direct relationship between producers and retailers has emerged, driven by enabling technologies and the desire to lower transaction costs. Rapid diffusion and incorporation of new business methods and technologies have brought about fundamental institutional and organizational changes related to procurement, inventory control, management methods and payment formula. A shift is occurring towards personalized services and user-friendly store facilities.

The phenomenon of increased concentration in distribution services is also taking place in many developing countries, in part as the result of the growing participation of foreign retailing conglomerates in the domestic markets. The situation is rapidly shifting from highly competitive markets, with tens of thousands of small firms competing in the different market segments, to a situation in which a small number of firms concentrate most of the industry turnover, generating a situation of oligopolistic competition. This is an expected outcome of the modernization of the sector.⁸⁶ Concentration in retail trade, as studies have shown, displace small retailers and can also have profound impact on the wholesale segment of the market and on local suppliers of goods, in particular in the farm sector. When assessing the developmental implications of transformation in distributive trade, it is necessary to assess the particular effects that might be generated by the participation of foreign firms in the domestic market. The transformation of distribution services necessarily entails adjustment costs, but these effects can not only be attributed to the participation of foreign firms. Foreign firms may contribute to accelerate the modernization process, but adjustment costs would be equally generated by the expansion and consolidation of large domestic retailers. In both cases, support to SMEs and a solid competition framework seem necessary to minimize negative impacts on small retailers and suppliers.

Liberalizing distribution services and allowing/encouraging FDI may contribute to enhancing global welfare through increased productivity, lower prices, greater product choice and distribution formats, technological innovation and increased competition at a country level. Possibly the most clear positive sign of this phenomenon is its impact on prices: Wal-Mart alone accounted for a drop of nearly 10 per cent in food prices in the United States. Large international retailers operating in the domestic market can become an avenue for increasing exports, as domestic suppliers are incorporated into the global procurement network. The presence of large chains in the retail market is usually conducive to the improvement of local worker skills, especially in logistic, marketing and management.

⁸⁴ Francois Joseph and I. Wooton (2005), "Market structure in Services and Market Access in Goods", Centre for Economic Policy Research (CEPR) Discussion paper Series No 5135, July.

⁸⁵ See: UNCTAD (2005), *Distribution Services*, TD/B/COM.1/EM.29/2, 7 September.

⁸⁶ Ellickson, P. (2004), *Supermarkets as Natural Oligopoly*, Duke University Press.

Distribution services in developing countries are experiencing a rapid and profound transformation, in some countries displaying features similar to those of developed market economies. In the food retail business, there has been an impressive expansion of domestic and foreign supermarket chains, with Latin America leading the way among developing countries. Supermarkets' share rose from 20 per cent of total national food retailing in 1990 to 50-60 per cent of total turnover in 2002. The development of supermarket chains in Asia and Africa has followed a pattern similar to that of Latin America, but with a later take-off. The share of supermarket chains in grocery retail is currently around 33 per cent in Indonesia, Malaysia and Thailand and around 63 per cent in the Republic of Korea, Taiwan Province of China and the Philippines. On the other hand, supermarket penetration in India stands at only 5 per cent. The most recent venue for supermarket take-off is Africa, especially eastern and southern Africa; in South Africa, supermarket chains represents 55 per cent of total national groceries sales, while in Nigeria they still account for only 5 per cent.

Thailand's experience with liberalization in the retail sector shows that consumers have been able to benefit from access to a larger variety of products exhibiting better prices and enhanced quality. However, the emergence of hypermarkets and cash-and-carry has had a negative impact on traditional retailers and small shopkeepers. Moreover, due to the trend toward increasing concentration in the sector, the Thai government is concerned about possible price collusion and is devising measures to prevent price-fixing practices on some consumer products. Another concern relates to the control on distribution networks and the possible inclination of large retailers to exploit their advantages on distribution channels. The evolution of the retail sector after liberalization has given rise to serious thoughts in the country on the need to have an appropriate and sound regulatory framework set before liberalization is unleashed in a fast and uncontrolled manner. An additional lesson learned is that domestic entrepreneurs and services suppliers need to be prepared to meet greater competition that comes with liberalization. Sound competition policies have to be in place to take care of both consumer interests and to allow domestic entrepreneurs to flourish.⁸⁷

The full implications of liberalizing distribution services and expanding trade and investment in the sector are yet to be fully understood, especially at the country-level. Positive correlations have been noted in such countries as China - where 95 per cent of the products distributed by foreign retailers are locally sourced and foreign retailers export Chinese products abroad; and Vietnam - where the presence of foreign distributors has contributed to upgrading the quality of goods provided by local suppliers, including agricultural products, but different concerns have emerged in smaller developing and least developed countries. Impacts may differ in urban and rural areas, and according to the type of distribution services in question. Not all developing countries and LDCs that seek to attract foreign investment in the sector have been successful, as the experience of Nepal demonstrates, as developing countries are normally low-value markets and for FDI to come sufficient volume of sales should be available.⁸⁸

⁸⁷ WTO (2002), *Communication from Thailand - Assessment of Trade in Services*, TN/S/W/4, 22 July.

⁸⁸ UNCTAD (20005), *Report of the Expert Meeting on Distribution Services*, TD/B/COM.1/EM.29/3, 15 December, at 5 and 12.

At the same time, experiences in those developing countries that have open their retail market to foreign supermarket chains prove that local suppliers, especially small ones, are often unable to adjust to competition and are forced out of the market. Considering the high incidence of unemployment in developing countries and the role of the distribution sector as one of the leading employers of low-skilled labour, developing countries may find it difficult to advocate any reform measures in the absence of complementary policies, including providing for alternative employment and trade opportunities. In Colombia, for example, the modernization and liberalization of distribution services has had a negative impact on medium- and small-sized companies, which have been displaced from the market. The government has, then, implemented a special programme – PYMECO – to support small retailers through training in management and distribution processes.⁸⁹

Small shops play an important role as employers of people who migrate from rural to urban areas and of foreigners: they therefore perform a crucial social role which big chains would be unable to perform since they require a certain skill level for employment. Moreover, shifting the social status of people from that of shop owners to that of shop employees has the effect of shrinking the middle class, with possible negative social implications, especially for fragile democracies in developing countries. Therefore, the overall developmental and social implications of liberalizing distribution services have raised justifiable concerns and have brought questions about the potential benefits of liberalization in this sector.

Market access restrictions – such as foreign ownership limitations or import restrictions, discriminatory operating and planning regulations aimed at limiting the market power of the incumbents, and price control practices to protect competitors – have often been used to ensure retail competition. They imply a direct action by public authorities in the functioning of the distribution market and have not necessarily led to the expected results. Other policies have proved more successful, such as the setting up of vigorous and clear anti-trust legislation aimed at regulating cartels, predatory behaviours, abuses of market power and deceptive practices, and at promoting consumer welfare; policies aimed at supporting retail diversity and entrepreneurship; the extension of unfair contract law to business-to-business contracts; measures aimed at the proper implementation of trade marks and copyright law; the setting up of franchise law, including mandatory disclosure of information; the development of soft law instruments, such as codes of good practices, which have proved very effective in regulating buyers' anticompetitive behaviours. Conversely, opening up the retail market to FDI without ensuring the necessary conditions for fair competition has often not yielded the expected welfare gains.⁹⁰ The same holds true for other services sectors.

A collective request on distribution services was in tabled in March 2006 by Chile, the EC, Japan, the Republic of Korea, Mexico, Singapore, Taiwan Province of China and the United States. The request calls for new and improved liberalization commitments in all sub-sectors on market access and national treatment with no limitations, but with some flexibility regarding economic needs tests, transitional periods and a limited number of other exceptions.⁹¹ Some sub-sectors of distribution services, namely commission agents' services, wholesale trade services and franchising, were also included in the collective request on cross-border supply.

⁸⁹ *Ibid.*, at 10-11.

⁹⁰ *Ibid.*, at 9.

⁹¹ *Collective request on distribution services*, found at: <http://www.tradeobservatory.org/library.cfm?refid=79991>, visited on 4 April 2006.

A growing number of domestically-owned firms from developing countries have ventured abroad, mostly expanding operations to neighbouring countries, with some entering developed markets as well. For example, South African companies have been active in other African countries, India, Australia and the United Kingdom. In Latin America, Chilean companies have expanded to Argentina, Colombia, Peru, Mexico and Brazil, and a Mexican company operates in the United States. In total, stock of Asian investment in the retail trade in the United States in 2002 stood at \$3 billion.

There is no one-size-fits-all approach to reconciling efficiency considerations with social concerns, which are particularly pronounced in this sector. Developing countries should base their policy decisions on an assessment of the peculiarities of distribution services and their interlinkages with other economic activities.

7. Professional services

Professional services are one of the fastest growth sectors worldwide. Export of professional services reached \$270 billion in 2002, with developing countries accounting for 15 per cent of total exports. Employment in professional services has been growing at a faster pace than in the other sectors of the economy. In Kenya, for example, employment in professional services reached 40 per cent at the end of the 1990s, as compared to 27 per cent in the 1970s. On the other hand, the relative share of trade in professional services in total services trade of developing countries as a group has been on the decline. This implies that developing countries are not benefiting as much as they could from the sector's dynamism.⁹²

Assessing the effect of services trade liberalization in professional services raises a number of complex issues. In particular whether, due to the intrinsic characteristics of these services, traditional trade theory may or may not provide an adequate analytical framework. The main features of those services are the following: professional services contribute to the "knowledge economy" and are often at the cutting edge of innovation; they are mostly customized; in most cases price is not a determining variable in users choice; professional services imply a high level of expertise and credence values, consumers finding it difficult to assess competing offerings, and often feeling unqualified to fully assess the information they obtain; value in transaction seems to be perceived, both by providers and users, quite differently than use-value of goods.⁹³ Considering that the outcome of a service is a transformation in the condition of the recipient, the concept of productivity might significantly differ from that applying in goods.⁹⁴ In the case of professional services, the basis of competitiveness are rooted in intangible assets, with intangibles as brand awareness and perceived leverage providing "incumbency advantages". Size and geographical scope seem to play a crucial role in the performance and competitiveness of firms: the larger and

⁹² UNCTAD (2004), *Trade and Development Aspects of Professional Services and Regulatory Frameworks*, TD/B/COM.1/EM.25/2, 25 November, at 3-5.

⁹³ Lapierre J. (1997), "What does value mean in business-to-business professional services?" *International Journal of Service Industry Management*, Vol 8, Issue 5, p. 377.

⁹⁴ Nachum L. (1999), "Measurement of productivity of professional services: An illustration on Swedish management consulting firms", *International Journal of Operations and Production Management*, Vol 19, Issue 9, at 922. See also: Johnson Robert and P. Jones (2004), "Service Productivity: Towards understanding the relationship between operational and consumer productivity", *International Journal of Productivity and Performance Management*, Vol 53, Issue 3, at 201.

the more global they are, the better.⁹⁵ Finally, the environment in which project-selling firms operate has been described as something in between markets and networks.⁹⁶ These characteristics should be taken into account when assessing the potential effects of services trade liberalization and the potential competitiveness of developing countries firms.

It has been noted that in the case of some professional services imports – i.e. legal, accounting and auditing services – services provided by foreign suppliers receive a premium fee over prevailing market rates. National studies on professional services suggest that, further to liberalization, a segmented market might emerge where foreign firms, or domestic firms associated with large foreign players, cater foreign companies in the domestic market and large domestic firms, while domestic providers supply their services to SMEs. An interesting feature emerging from a study done in Colombia at the firm level is that those professional services firms that were able to export their services had first gained the needed reputation by providing services to the foreign firms established in the domestic market.⁹⁷ Trade liberalization of professional services could have negative implications on the export potential of domestic firms if liberalization hampers the chances of those firms to gain experience and reputation in the home market. At the same time opening to FDI could generate the adequate conditions allowing domestic professional services firms achieving reputation and international competitiveness.

Regulators in all countries, but especially in developing countries, face the challenge to design regulations which are flexible enough to adapt to market and technological developments, which are particularly rapid in this services sector. Experience shows that a process that started with the deregulation and liberalization of professional services often ends with their re-regulation.⁹⁸

Professional services are included in the collective request on cross-border supply.

8. Tourism services

Global international tourism revenues amounted in 2004 to \$750 billion, 20 per cent of which came from developing countries destinations, and less than 2 per cent by LDCs. Tourism is among the top five export revenues generators for 75 countries regardless of their level of development. For 45 of them it is the top generator, including for 17 LDCs. In the past two decades, tourism flows have shown higher annual average growth rates than world trade. Studies assessing tourism in Africa, and in LDCs and small economies, show the growing importance of tourism as the main and sometimes the only driver of economic

⁹⁵ Firm size has been found to positive correlate with firms performance. See: Phu Nguyen Van, F. Paisley and U. Kaiser, "The Performance of German Firms in the Business-Related Service Sector: A dynamic analysis", *Journal of Business and Economic Statistics*, July 2004, Vol 22, Issue 3, p. 274. See also: Weiren Wang, (2000) "Evaluating the Technical Efficiency of Large US Law Firms", *Applied Economics*, Volume 22, Number 6, May. The article finds that the number of lawyers, paralegals and the number of associated partners have a positive and statistical significant effect on production of legal services, measured in terms of revenue.

⁹⁶ Cova B. and A. Ghauri (1997), "Project Marketing. Between Mass Marketing and Networks", Working Paper, European Seminar on Project Marketing and System Selling.

⁹⁷ Nino J. (2005), *Exportar Servicios Profesionales desde Colombia: Problemas y Oportunidades*, UNCTAD, mimeo.

⁹⁸ UNCTAD (2005), *Report of the Expert Meeting on Trade and Development Aspects of Professional Services and Regulatory Frameworks*, TD/B/COM.1/EM.25/3, 2 March, at 6.

and social development on a sustainable basis. Meaningful linkages to other productive sectors, such as agriculture, industry, transport and handicrafts have been proved in many developing countries. Backward and forward linkages with these sectors influence the performance and profitability of tourism, the extent of multiplier and spill over effects, and the retention of value added, i.e. the magnitude of the leakage effect.

Countries' experience shows that domestic regulation meant to prevent unfavourable clauses – such as franchising contracts with import requirements, exclusive dealing between tour operators and hotels, reservations without deposit, inadequate repayment periods – being included in contracts plays a key role in limiting leakages.⁹⁹

Tourism is probably the most liberalized sector of international trade in services, and as such constitutes a good case to assess the gains from liberalization. It has been noted that benefits from domestic liberalization of tourism rely on the liberalization of other services sectors in trading partners. The striking reliance of tourism on networking, transport, business and financial services makes it necessary for liberalization to go beyond domestic boundaries and involve a range of services.

Recent studies, including national assessments, show that business practices and existing competitive conditions in markets where large integrated suppliers dominate produce a disproportionate distribution of benefits in favour of those operators and a constant erosion of trade gains for tourist destinations, including local small operators and communities in developing countries. The lack of integration of tourism with the domestic economy generates leakage effects. Most of the small Central American economies, for example, have shown increasing leakages. Some estimates refer to leakages of between 60 and 90 per cent of the price paid by tourists in the originating country. The bulk of revenue accrues mainly to large tour operators which own airlines, administer hotels and control almost the totality of the value-added chain. Effective mechanisms to deal with anti-competitive practices in the tourism sector and related sectors are necessary and represent a prerequisite for the further liberalization of some sub-segments of the tourism industry, such as air transport.

Access to Global Distribution Systems (GDS) and other electronic media, for example, is a critical variable in the business operations of developing country tourism service suppliers. According to them, GDS operators pursue some unfair practices, including the neutrality of screen displays, which are sometimes biased in favour of integrated suppliers; restrictions in access to encryption algorithms for reasons of national security; and the incompatibility of systems and technologies.¹⁰⁰

Performance and growth perspectives for the tourism sector depend on consumers' access to tourism destinations and on the movement of natural persons as services providers, both hardly limited by visa restrictions and by safety and security measures, such as travel warning. Also, tourism is highly volatile to sharp movements in tastes or real exchange

⁹⁹ UNCTAD (1998), *Report of the Expert Meeting on Strengthening the Capacity for Expanding the Tourism Sector in Developing Countries, with Particular Focus on Tour Operators, Travel Agencies and Other Suppliers*, TD/B/COM.1/17 and TD/B/COM.1/EM.6/3, 7 July, at 10.

¹⁰⁰ *Ibid.*, at 14-15.

rates and it is sensitive to exogenous factors. During the last five years, international tourism growth showed stagnant or decreasing trends as a result of the sequel of 11 September events and the subsequent war against terror. Natural disasters which have affected LDCs and many other important tourism destinations in the Middle East, the Caribbean, Africa and the Asia-Pacific region have magnified the negative trend. Sustainability problems are appearing in some JITAP and Central American countries and LDCs, where mass tourism has created pressures on local resources, while local communities have not benefited from this activity. Moreover, local communities have been affected by rising prices triggered by foreign demand of goods, services and infrastructure, with lodging problems due to the increase of housing prices and rents featuring as main concerns.

The subsectors of hotel and restaurants and travel agencies and tour operators services are included in the collective request on cross-border supply.

CONCLUSIONS

The assessment of the welfare impact of services trade liberalization is a rather recent area of concern and, as in the case of trade in goods, there are still a number of theoretical and methodological issues to be addressed. Among those, there is the fundamental issue of whether the theoretical assumptions for justifying reform in the goods sector can be directly and fully transferred to the services sector and what could be the possible implications of such a transfer for welfare, equitable public policies and democratic sustainability. This paper holds the view that trade in services has some specificities, above all the movement of factors of production, that makes it rather different from trade in goods.

Considering that quantitative analysis provides important insights into the effects of services trade liberalization, there is a need to refine estimating techniques and economic modeling to capture the specificities of trade in services. There is an equally urgent need to improving data on services as the basis for formulating policy recommendations to developing countries.

Liberalizing trade in services, under appropriate regulatory and policy frameworks, is expected to contribute to enhancing global welfare through increased efficiency, lower prices and a greater choice of services, as well as increased competition at the country level. It is also expected to be instrumental to expand access to basic services and contribute, therefore, to achieving the MDGs.

However, developing countries face a number of structural weaknesses that are common to all services sectors, namely poor or inexistent regulatory frameworks, the difficulty in putting in place the right sequencing of policy reforms and liberalization initiatives, inability to compete with TNCs, numerous and fragile SMEs, poor access to capital and technology, pressure from investors and trade partners, and huge fiscal deficits. This may jeopardize the achievements of the above-mentioned results.

Empirical studies on the development implications of trade in services liberalization in developing countries remain anecdotal, with examples concerning a rather limited number of countries and services sectors. Quantitative assessment has produced inconclusive results.

Lacking a coherent and broad picture of the overall impact of services liberalization on sustainable development, a cautious approach to liberalization seems in order. Such an approach would contrast with the call for broad and far-reaching liberalization commitments included in the plurilateral/collective requests tabled at the WTO in early 2006 in the framework of the GATS negotiations.

Negotiations on investment-related issues were officially excluded from the Doha Work Programme. However, services negotiations, be they multilateral, regional or bilateral, are increasingly and clearly becoming investment negotiations. While developing countries have traditionally used the flexibility of the GATS to anchor the commercial presence of foreign services suppliers to their domestic development strategies, foreign companies seem to be increasingly unwilling to accept any conditionalities linked to their establishment in foreign countries.

Available evidence shows that in all services sectors the establishment of domestic regulatory frameworks is by and large a necessary precondition for liberalization to yield development-oriented results. This is particularly true for infrastructure services where access to the networks on fair and transparent terms is necessary for competition to take place and for consumers to be able to choose among different suppliers.

The ever-changing nature of markets and technologies, which is a key feature of several services sectors, can easily render the regulatory regime outdated, this characteristic demands continuous and systematic fine-tuning of the regulatory and de-regulatory framework. Sequencing of policy reforms and flexibility of regulators to constantly update, adapt and innovate the legal framework are then preconditions for liberalized services sectors to function properly.

Evidence shows that market liberalization may bring about different results, according to the specific services sector and the specific country/region at stake. In some cases evidence also demonstrates that the results are more the consequence of flanking domestic policies than of services liberalization. In some sectors market liberalization provokes “big bang” results, in others it only accelerates structural changes which would have happened in any event.

Moreover, given the increasing concentration of many services industries worldwide, there is a real risk that the liberalization of services sectors in developing countries can fall short of producing the expected beneficial outcomes, due to industries structures and behaviors.

Because of the technological changes, some services sectors are becoming increasingly difficult to define – as it is the case for audiovisual and telecom services – with the related complexity of establishing appropriate policies.

The evident conclusion from all available evidence is that the “one-size-fits-all” approach is inappropriate to deal with services trade liberalization. Applying the best practices developed in one sector to another sector may not lead to the expected results. While countries may indeed learn from each other, and reproduce successful solutions and avoid repeating mistakes incurred by other countries, the specificities of each country should not be overlooked: the level of development and income, cultural and historical factors,

consumer tastes and geographic and demographic factors, as well as the overall regulatory environment influence the structure and evolution of the services markets and require country-tailored solutions.

The level of liberalization commitments expected from developing countries should reflect the above-mentioned conclusions. In fact, the perceived “knowledge gap” on the impact of trade in services liberalization on the sustainable development prospects of developing countries was among the factors hampering progress in the WTO services negotiations. The overall Doha Round negotiations were suspended on 24 July 2006. GATS Article XIX indeed recognizes that different levels of liberalization may be expected from different groups of countries enjoying varying degree of economic development. It is worth recalling that the final goal of the GATS is not the expansion of international trade in services *per se*, but rather the economic growth of all trading partners and the development of developing countries.

Work in the area of assessment of services liberalization in developing countries has to continue, including in UNCTAD, with increasing emphasis on the possible policy options available to developing countries to strengthen their domestic services sector, their export capacity and to link the liberalization of trade in services with sustainable development, including the achievement of the MDGs. Hopefully, such work will contribute to move the analysis from an anecdotal picture to a full-fledged picture.

QUESTIONNAIRE

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*Study series no. 2 - Challenging Conventional Wisdom:
Development Implications of Trade in Services Liberalization*

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