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SERVICES SECTOR REFORM AND DEVELOPMENT STRATEGIES:  
ISSUES AND RESEARCH PRIORITIES

by

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## ABSTRACT

The implementation of strategies for domestic policy reform, for General Agreement on Trade in Services (GATS) negotiations and for business development in the services sector of developing economies can be supported by the empirical work which is examined or proposed in this paper. The paper makes the case for a more coherent approach to the design of reform policy in the services sector. It stresses the importance of considering the interaction between services activities, between modes of supply and in some cases between goods and services. It also identifies limits to the progress towards the goal of coherent policy making in the services sector. These include lack of information and political economy constraints.

Moreover, the paper contains a review of recent work on the measurement of impediments to trade and investment, including research on banking, telecommunications, engineering, architecture, accounting, legal services, distribution and maritime services. There is evidence in this work of significant impediments to entry into services activities by all modes of supply and of significant discrimination against foreign suppliers. The implied price effects of these impediments in banking and telecommunications are high in some economies.

Furthermore, the paper also presents one set of modelling results of the effects of liberalization. These results highlight the value of a horizontal approach to policy making and the value of a focus on market access compared to national treatment issues. Suggestions are made about the next steps in a work programme on the nature of services sector policy and its impact. This includes wider participation by developing economies in empirical projects, more testing of methodologies being employed in those projects and the development of a framework for the consideration of issues of domestic regulation and the design of competition policy. All this work will have important spinoffs for the effectiveness of participating economies in GATS negotiations.

## **ACKNOWLEDGEMENTS**

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## I. INTRODUCTION

Some years ago, a developing economy policy-maker or business-person looking at export opportunities in services might have concentrated on transport and tourism. They might also have expected to export labour services. However, recent developments in technology and in the organization of international business have broadened the scope of developing economy interests. Moreover, this year, negotiations on services commitments in the GATS have recommenced. This paper outlines some issues for decision-makers to consider and a series of related research projects to initiate, as they respond to shifts in the market place and as they plan their approach to the services negotiations.

The opportunities for developing economies in services markets were highlighted recently by the Global Services Network (GSN). This group identified a number of areas in which developing economies have “gained a foothold in knowledge-based and labor-intensive services”. GSN concluded that entry into these markets was facilitated by the opportunities created by new information technologies and subsequently by e-commerce. GSN cited the experience of some economies in establishing data processing sectors, or call centres, as well as software supply groups. In these cited examples, services were provided in the cross border mode of supply, that is, without the movement of either producer or consumer. GSN went on to list other areas which are “ripe for cross border trade.”<sup>1</sup> These areas included:

- Software programming;
- Data capture and repair;
- Management of electronic medical records;
- Translation services;
- Technical online supports services;

- Database management;
- Research & development;
- Inventory management;
- Website design and management;
- Medical transcription;
- Legal transcription;
- Backoffice services for airlines, brokerage firms, and credit card processing.

UNCTAD, for some time, has worked on the scope for developing economies to expand services exports through all modes of supply. The UNCTAD secretariat (1998) paper examined how globalization, liberalization and new information technologies are providing new opportunities for trade in services. Case studies included computer services, back office services, environmental services, health care services and tourism services. Moreover, UNCTAD has undertaken a series of expert group meetings in relation to these services.<sup>2</sup> The paper also examined the conditions required for developing economies to take advantage of new opportunities in the services sector. This included reference to developing economies’ participation in the negotiations associated with the GATS. It also included mention of a variety of measures that could be taken at the domestic level.

Despite the emerging opportunities, some commentators remain concerned that developing economies have yet to establish themselves among the leading services exporters. Mashayekhi (2000) for instance stresses that since the adoption of the GATS, the developing countries’ share of world services exports has only increased by 6 per cent and that this share is mainly due to the competitiveness of Asian developing economies.

Furthermore, Mashayekhi stresses that developed economies still account for three quarters of world services exports and that most of the top 20 exporters are developed economies.

While their aggregate shares may be low, there is evidence of the competitiveness of developing economies in many global services markets. Karsenty (1999) shows that many developing countries, including some least-developed economies already have a relatively high presence in services transactions by various modes. He shows this group has a relatively high specialization not just through the movement of natural persons but also in terms of the delivery of services across borders and the export of services in the mode of consumption abroad.<sup>3</sup>

Many issues are involved in expanding the ability of developing economies to take advantage of these emerging opportunities in the services sector. Market access is one issue. But also the openness of domestic services markets can help build the capacity to participate in global markets. Liberalization increases the efficiency of the operations of suppliers in intermediate services to all export sectors. Liberalization also brings in capital and technology. New business opportunities are not only influenced by policies affecting market access at home and offshore, but also by other national policy initiatives.

The effective participation of developing economies in the current services negotiations will be a contributing factor to maintaining reform in the services sector. A number of papers, including those by Hoekman and Messerlin (1999), Mashayekhi (2000), Mattoo (2000), Hoekman (1999) and Sauve (2000), have discussed the priorities in the developing economies' agenda in these negotiations.

Apart from participation in multilateral negotiations and national policy initiatives, there are other elements in a portfolio of strategies for

services development. These include the use of regional strategies and regional cooperative arrangements. These are topical and there is considerable work in progress in the application of regional arrangements. Important ground-breaking work, for example, is in progress in APEC. However, detailed examination of specific regional approaches to reform is a comprehensive topic and is beyond the scope of this paper.<sup>4</sup>

The purpose of this paper is to review some of the empirical work which can provide relevant inputs to the implementation of strategies for use in the GATS negotiations and for domestic policy reform. Section II provides a framework for the consideration of that information. It reviews a series of issues related to reform strategies in the services sector: it stresses the importance of considering the interaction between services sectors, between modes of supply and in some cases between goods and services. Section III identifies some issues in making progress toward the goal of coherent policy making in the services sector. These issues include lack of information and political economy constraints. The final section examines, in more detail, a series of practical matters for further attention by decision makers in Government and in business.

## ENDNOTES

<sup>1</sup> This material was distributed by e-mail to members of GSN on 15 August, 2000. Subscriptions to this e-mail service are available at [www.globalservicesnetwork.com](http://www.globalservicesnetwork.com).

<sup>2</sup> A much wider range of issues is involved in the development of e-commerce. For a detailed discussion, see UNCTAD (2000).

<sup>3</sup> Data on services FDI was not used in this study.

<sup>4</sup> For a review of different regional approaches to reform within APEC, see Stephenson (2000a). Stephenson (2000b) contains further discussion of regional approaches to reform in the western hemisphere.

## II. ISSUES IN SERVICES SECTOR REFORM

### A. Interactions between services activities

It was noted above that UNCTAD has nominated areas such as computer services, back office services, environmental services, health care services and tourism services for attention by developing economies. One of the key issues in the reform of the services sector is dealing with the interactions that exist between elements of that sector. A successful outcome for one service activity will usually depend on a package of initiatives or a cross-sectoral approach to the design of policy. The UNCTAD secretariat (1998) has also examined these sorts of linkages. It held that success in the nominated areas requires access to “world class telecommunications infrastructure”, alongside financial support, the ability to move people temporarily and access to skilled staff. Failure to develop telecommunications infrastructure will prevent developing economies from gaining access to international markets through electronic commerce.<sup>1</sup>

There are other examples of these sorts of linkages. Reform of the air transport system, for example, irrespective of policies applying to airport infrastructure may not change market outcomes.<sup>2</sup> UNCTAD (1998) also cites a similar issue within tourism sectors. Even when tourism operations in developing economies are competitively designed they may nevertheless lose market share due to the “pricing practices of monopoly transportation providers bringing tourists to their markets.” A further example, cited in the same paper, arises in health insurance, where reform of the international health insurance market can help promote health tourism.<sup>3</sup>

Linkages between services activities mean that outcomes of services negotiations might be more effective if appropriate bundles of services are considered in association with each other.<sup>4</sup> Industry

groups make this connection. They argue for a better grouping of activities in services negotiations. For example the appropriate scope of energy services has been debated, with United States firms promoting a wide definition. There has also been developed a concept of an express freight activity that includes not just the transport component but also complementary on-ground services.<sup>5</sup> Debate about the appropriate scope to be considered in the definitions of tourism, health and environment has also emerged during the UNCTAD expert group meetings on those activities.

The presence of interactive effects have led to proposals for treatment in the policy making process of clusters of activities. Groups of services (and possibly goods as well) should be considered together in order to design a comprehensive reform programme. Clearly, some judgement on how to package activities together and how to measure the significance of various forms of impediments will be required.

### B. Interaction between modes of delivery

Not only are there important interactions to consider between services activities, but also links between the modes of supply. Neutrality in terms of mode is important in both static and dynamic terms. Liberalization of one delivery mode without attention to others will divert activity through the more open mode.<sup>6</sup>

The UNCTAD secretariat (1998) has argued that the main emphasis under the GATS has so far been on improving market access conditions for the establishment of commercial presence. It is suggested the reason for this is that commercial presence could contribute to building domestic capacity and expanding services exports. The secretariat maintains that this mode also allows for



“more effective macroeconomic management and supervisory and regulatory control.” Moreover, it observes that most:

“Developing countries have not made use of the possibility of imposing conditions of access (e.g. performance requirements) on foreign services and service suppliers, provided for under Article XIX.2. In granting further access to their markets, developing countries need to make full use of these capacity building conditions to ensure expansion of services exports.”

Biases induced by different treatments of the modes of supply will be especially important for some sectors where there are more options for supply. One example is education where consumption abroad, cross border supply, movements of natural persons and establishment are all important, some becoming more so. Tight restrictions on one mode will shift consumers into others; for instance, restrictive rules on foreign establishment will push students offshore, with implications for other policy issues, such as net movements in foreign exchange and the extent of “brain drain.”

It is also clear that technological change is creating more scope for substitution between modes. As noted earlier, these changes are the basis for some of the new opportunities for developing economies. Restrictions on other modes of delivery will drive more people into using distance education, the quality of which is improving.

The UNCTAD secretariat (1998) has provided a useful illustration of the importance of the complementarities in the linkages between modes of supply. Just as in trade in goods, there are complementarities between investment and trade flows. In this particular example, activities in one mode lead to further activities in other modes:

- “...contract work in other economies (mode 4) is often used to build domestic capacity by encouraging professionals to

take short-term assignments in economies where skills are more highly specialized and in-service training is available.

- Returning professionals (in mode 4) with enhanced skills can then launch cross-border exports (mode 1) or meet foreign visitors’ service expectations (mode 2) more successfully.
- Business travel (mode 4) is also used to complement cross-border supply (mode 1) in order to meet customer needs for personal contact. Similarly, mode 3 (commercial presence) is often used to build capacity for mode 2 (where the consumer moves) or mode 1 (cross border supply) by leveraging soft technology transfer.
- In addition, by attracting targeted foreign direct investment (mode 3) in areas such as software customization or health facilities management, developing countries can build a reputation for quality that can be translated into cross-border supply.” (UNCTAD, 1998).

In summary, it is valuable to pay attention to the linkages between modes. A simple principle is to seek neutrality between all modes of supply.

### C. Movement of natural persons

While neutrality between modes is important, developing economies retain their traditional strong interest in mode 4. In Contrast, Adlung (1999b) notes that full bindings in the GATS on mode 4 are rare. He observes that the most frequent entries in this mode are “unbound” to which some narrowly defined exceptions are added. He says the focus of these exceptions is on senior executives and other experts who transfer within a company, but that only limited commitments are made to untrained or self employed people. He notes, therefore, that most members have turned the negative approach generally used for scheduling modal commitments into a positive or bottom-up

approach. The WTO secretariat (1998) provides more details of the commitments in this mode.

Pakistan, in a paper to the WTO on this issue (WT/GC/W/131), noted the modest extensions to commitments since the outcome of negotiations in the Uruguay Round and argued the case for further coverage of this mode. Pakistan stressed the difference between GATS provisions and migration (a distinction which is also consistent with the Annex to the GATS on the Movement of Natural Persons Supplying Services under the Agreement). In order to facilitate further progress, Pakistan recommended:

- a) There should be a horizontal approach to economic needs tests applied to this mode;
- b) A review of the design and implementation of visa regimes would be useful;
- c) Developing countries should participate in the design of disciplines on qualifications and licensing.

Mashayekhi's (2000) assessment of progress on liberalization of this mode, is that a feature of the GATS is the "lack of commercially meaningful commitments (except on intra-corporate transferees) on the movement of natural persons". Moreover, she argues for greater transparency with respect to measures affecting this mode of supply. An issue of particular concern is not just the presence of the economic needs tests but the manner of their implementation. Her comments and those from the Pakistan paper support the case for further work on the analysis of policy regimes, and their operation, applying to this mode.

#### **D. Goods and services interactions**

Deardorff (1999) indicates how trade liberalization in what he calls "trade services" (e.g. transport) can create benefits, by facilitating trade in goods or other services, that are larger than might otherwise be expected. Moreover, he points out how lower cost services can facilitate the fragmentation of production and participation of

economies in production processes according to much finer definitions of activities. This observation applies to goods production and also to services production itself. An example is the application of internet technology that will enable developing economies to participate in services sector activities.<sup>7</sup>

The interaction between goods and services sector reforms is also important. For example, the scope to pursue competitiveness in data processing or analysis will be inhibited if the cost of the hardware required is increased by protection. Removal of impediments to trade in goods may have little effect on economic welfare if the distribution system for the product is protected by legislation restricting market access.

There are many examples of the importance of an efficient services sector for effective agricultural reform, especially in developing economies (Anderson, 1999). A major trade reform programme in India in the early 1990s removed biases against agriculture. However, Gulati (1998) argues that the agricultural supply response was weak due to policies that remained in place and which led to restrictions in the supply of credit, transport and communications services. Similar conditions are expected in an agricultural reform programme in China. The programme removed restrictions on farmer choice of agricultural production but failed to create a policy environment in which the international market system, for fruit and vegetables for example, was invigorated (Findlay and Watson, 1999).

The APEC process provides an illustration of these linkages between goods and services issues and their impact on policy development. APEC members are focussing on the notion of an APEC food system. This system is designed to remove barriers to the growth of two-way trade in agricultural products. It considers explicitly the services whose supply at world prices is required to maximize and bring forward the advent of benefits to local communities in importing economies from the liberalization of product markets. It proposes, in particular, to integrate

the construction of infrastructure with the liberalization process in importing economies.<sup>8</sup>

### **E. Qualification**

The theme of the remarks so far is that widespread reform and a movement toward uniformity in the application of policy, is a valuable principle. There is a qualification to this argument, since some services sectors might contribute in a special way to growth and development. In other words, there is a qualification due to the presence of externalities.<sup>9</sup> Differential levels of support might be justified on the grounds that some sectors produce costs or benefits that are not taken into account by decision-makers operating in markets for those activities. This support might be implemented in a variety of forms. The obvious form is to subsidize the activity which is generating the external effect.

Even where specific sectoral support is justified, trade policy is rarely the best instrument to use. Anderson (1999) stresses this observation, among others. He summarizes “five lessons of relevance” for dealing with non-trade concerns, namely:

- Where there are several policy objectives, an equal number of policy instruments is typically required to deal with them;
- The most efficient instrument for dealing with a particular objective, such as solving a market failure problem, is that which addresses the concern most directly;
- Trade reform will be welfare improving when optimal domestic interventions to deal with non-trade concerns are in place;
- Trade measures are rarely the best instrument for dealing with non-trade concerns;
- Whenever Governments intervene there is a risk of Government failure (due to many factors, including insufficient information or deliberate action in response to lobbying).

These general principles are relevant to the assessment of all policy choices, proposed on market failure grounds. However, even if these principles are met, options remain for an instrument of intervention. Some judgement will still be required about whether the policy chosen is a reasonable response to an identified problem, or whether it is more interventionist than necessary and as a result, protectionist.

For example, licensing and other accreditation schemes are often imposed to deal with problems associated with consumers’ lack of information regarding services suppliers. A number of questions arise. Are these actually solving the problems or are they unreasonable impediments to market access? Should foreign suppliers go through a more stringent accreditation process than domestic suppliers?

### **F. Interaction with competition policy**

UNCTAD has stressed its concern over risks associated with the lack of competition in some international services markets. For example, the UNCTAD secretariat (1998) argued that:

“Many markets for services are dominated by relatively few firms and the trend in mergers, acquisitions and strategic alliances has exacerbated this situation. There is a need to develop national competition rules as well as multilateral mechanisms to strengthen cooperation amongst competition authorities to deal with transfer pricing, exclusive dealing arrangements, alliances, mergers and acquisitions and export cartels. To provide for competition safeguards, the example of the reference paper on basic telecommunications services could be followed in other services sectors.”

UNCTAD’ s expert group meeting on air transport was also concerned with competition policy issues (UNCTAD, 1999). One of its conclusions held that the WTO reference paper on telecommunications be examined as a model of how competition policy issues might be dealt

with in air transport. Issues in air transport include the use of subsidies, denial of access to essential services, rules on the allocation of airport space and so on.

Fink, Mattoo and Neagu (2000) conclude that while unilateral policy action in the maritime sector can remove trade restrictions and while the GATS can be used to bind those commitments, “there is also a need to deal with the possible private anti-competitive practices of international maritime cartels.” They observe that although larger countries may be able to effectively deal with these issues through their own competition laws, smaller countries without enforcement capacity will be at a disadvantage. These conclusions are based on an analysis of bilateral data on trade in textile products on shipping routes to the United States. They find that removal of restrictive cargo policies would reduce transport prices by 11 per cent. But removing the price-fixing agreements between carriers would reduce prices by 38 per cent.

Francois and Wooton (1999a) report similar results with respect to shipping services. They build a model in which they simulate both tariff cuts on goods shipped (agricultural exports from developing economies, for instance) and changes in the extent of competition in the shipping sector. They examine the effects of a reduction in tariffs and find that when tariffs are cut, shippers with market power can replace the trade-tax wedge to some extent with a higher mark-up of their own. They also examine some numerical examples. At one extreme, they find that “approximately one-half of the gains from full and unconditional market access can be lost by producers to the shipping industry when the latter is concentrated and fully exploits its market power.”

Although liberalization, in some cases, might remove regulatory constraints on the operation of firms with market power, it can also remove constraints on entry. An important feature of service reform is therefore that changes in rules, for example, on the terms of market access will affect the structure of the market in which the

services are provided. A greater degree of openness (across all modes of delivery) is expected to lead to more competitive markets.

The effect of reform on the nature of competition was modelled in air transport markets by Johnson *et al* (2000). In a partial equilibrium model, the authors captured the effects of entry not only on the costs of supply but also on the mark-ups which were observed in those markets. Costs of supply were affected in this model by comparative advantage factors and also by dynamic efficiency effects (a consequence of competition was to force competitors closer to their cost frontiers). They were also able to capture the opportunities for greater flexibility and therefore the efficiency gains that more open markets created (by removing the constraints on networking associated with bilateralism).

## G. Overview

In summary, some of the principles which emerge from this review of the issues are:

- It pays to aim to pursue a top-down approach to reform, that is, to work harder to reduce the levels of assistance provided to highly assisted activities;
- It pays to seek neutrality between modes of supply;
- It pays to consider bundles of activities which are closely related to each other. Moreover, the appropriate bundling may well include some goods producing activities.

Because of their nature, services also attract a considerable regulatory load. This being the case, attention to regulatory reform, including the building of institutional capacity, which complements liberalization is important. There are also important interactions with competition policy. Openness can also contribute to competition policy goals, however more efficient instruments for

dealing with competition policy issues may have to be developed.

As the UNCTAD secretariat (1998) stated: “these features increase the importance of coherent policy and regulatory frameworks for both the different services sectors and the interlinkages between the goods and services sectors.” While the case for greater coherence in policy design is undeniable, significant constraints are encountered before getting to that outcome. The next section examines a number of such issues.

## ENDNOTES

<sup>1</sup> See Thompson (1999) for a thorough discussion of classification issues in the GATS related to e-commerce.

<sup>2</sup> Issues in the reform of air transport systems have been examined by UNCTAD (1999).

<sup>3</sup> Health services has also been the topic of an experts group meeting – see Zarilli and Kinnon (1998).

<sup>4</sup> This point is the same as the argument for the consideration of effective rates of protection, or assist-

ance. Hoekman and Messerlin (1999) also stress the value of an “effective rate of assistance” perspective on the design of services reform. This approach would take account of impediments to trade and investment applying to all inputs to particular activities.

<sup>5</sup> The World Services Congress included a session on “How the Energy Services Industry Can Use Trade Negotiations to Secure and Expand Markets” in which the abstract of the session read “Energy services are for the first time being considered subject to multilateral trade negotiations both in the US and EU. But issues of definition need to be resolved: which services and products should be defined as energy services? What are the most important goals for energy services companies and energy producing countries?” The Congress also considered the definition of express freight services.

<sup>6</sup> See for example, UNCTAD’s work on digitizable products.

<sup>7</sup> The Chairman’s summary of the UNCTAD expert group meeting on international trade in health services provides more illustrations.

<sup>8</sup> An update on the APEC Food System is available at the site of the APEC secretariat at [www.apecsec.org.sg](http://www.apecsec.org.sg) (in Task Forces under APEC Fora in APEC Activities).

<sup>9</sup> The same issue is highlighted in UNCTAD (1998).

### III. PROBLEM – HOW TO GET THERE

#### A. Policy transparency

One problem associated with formulating a more coherent approach to policy-making is the lack of transparency of current policy. Although a number of methods have been used to assess the extent of protection afforded various services sectors, more work remains to be done.

One method for assessing the extent of protection in services is to look at gross operating margins in different sectors. Hoekman (1999) cites the results from a study of margins in sectors (using the *Worldscope* database). As Hoekman observes, a number of factors will affect margins and not just high barriers due to Government policy. However, a correlation between barriers and margins across countries can be expected. Hoekman uses manufacturing margins as a reference point, but as he also points out, foreign entrants in many cases have to establish a new base to supply services and so margins in services can be expected to be higher to some extent. The results show that operating margins in the services sector are generally 10-15 points higher than in manufacturing. Furthermore, after a review of the sectoral data he concluded that “in many developing economies (services) margins are significantly higher than in industrialized nations.”

Another methodology, used by Francois and Hoekman and also quoted in Hoekman (1999), was to apply a gravity model to trade in services. They used data for trade between the United States and its partner countries. By comparing observed trade with benchmarks, they estimated tariff equivalents in trade by sector. They found considerable variation between economies in implied tariff equivalents in business and financial services and much higher rates in construction services.

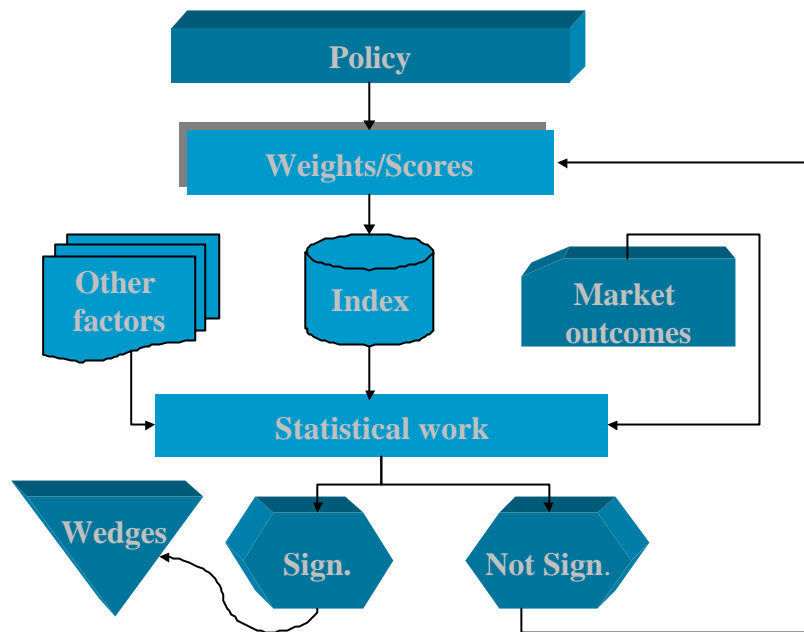
Another much simpler approach, used the commitments documented in the GATS to develop inventories of impediments. Recent examples of this approach include the work by the OECD in a number of services areas including wholesale trade, retail trade, tourism and environmental goods (OECD 2000a, b, c and d).

Further work has extended the earlier research of Hoekman (1995) which examined the frequency of occurrence of various types of impediments, based on information in the GATS. For example, PECC (1995) reported the application of this methodology to APEC economies and Marko (1998) used this approach to evaluate the telecommunications agreement under the GATS.

Work of this type has been extended in joint research at the Australian National University and the Australian Productivity Commission (see Findlay and Warren, 2000).<sup>1</sup> The methodology used in these impediments to trade in services studies is summarized in Figure 1.

Policy information is collected from a variety of sources, including from the GATS and other industry information sources. Policy applying to a services activity is then broken down into a number of dimensions (for example, restrictions on establishment, rules on on-going operations, restrictions on movement of natural persons, etc). Each dimension is given a weight for the calculation of an index. The weight represents the researchers' view of the economic significance of the rule from the perspective of the supplier of the services. The degree of restrictiveness of each aspect of policy for each economy included in the sample is then given a score of zero for open or one for most restrictive. An index value is calculated using the weights for each element of

**Figure 1**  
 Research methodology in studies of impediments to services trade and investment



*Source:* Derived from work reported in Findlay and Warren (2000)

policy. In some cases it is possible to go further and relate the calculated index values to market outcomes, such as prices of services in each economy or quantities traded. This statistical work allows for the influence of other factors likely to affect those variables. If the policy variable is significant in these questions, its coefficient can be applied to work out the likely effects of liberalization on prices in each economy. If the policy variable is not significant, then alternative weights or a new scoring system can be developed and the model tested again.

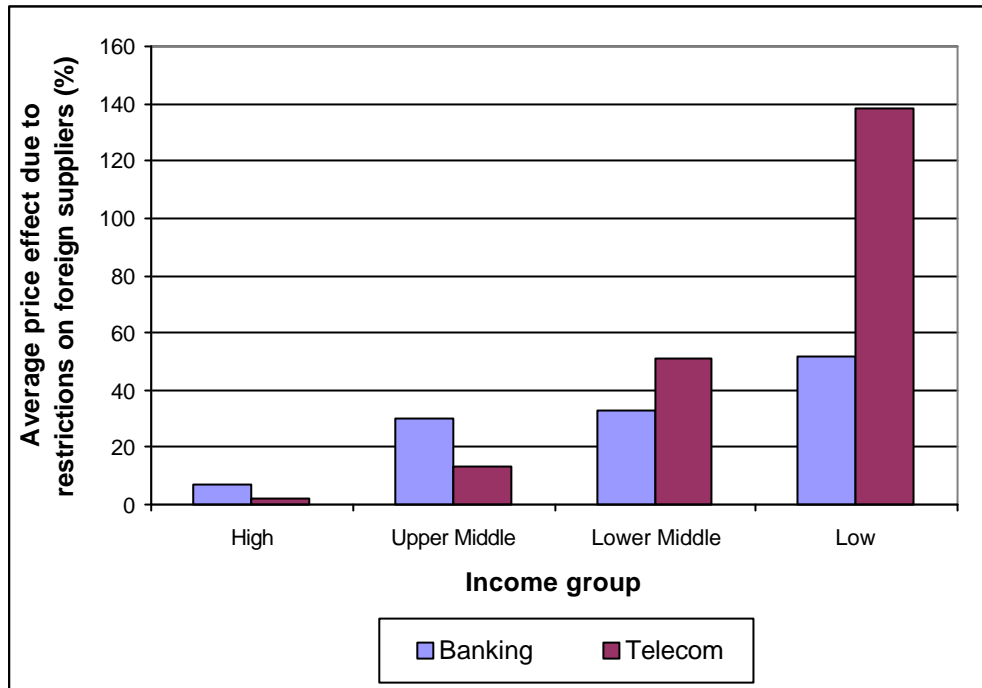
Figure 2 shows the estimates of the effects on prices of restrictions on trade and investment by groups of economies on banking (in 1997) and telecommunications (in 1998) services derived from this approach.<sup>2</sup> Economies are grouped according to categories used in the World Bank's World Development Report. The sample sizes are generally largest for the high income economies and then fall to small numbers of the low income economies. Therefore, the reliability of results vary between income groups.

The results indicate that the price effects of the impediments are significant. They range from 5 per cent to 55 per cent in banking and from 0 per cent to 138 per cent in telecommunications. Out of a sample of 38 economies, 11 in banking and 4 in telecommunications had price effects over 30 per cent.

A striking feature of the chart is that the average price effect within each income group rises as the category of the economies shifts from high to low income. Therefore, according to the data, the impact of impediments is much higher in lower income economies.

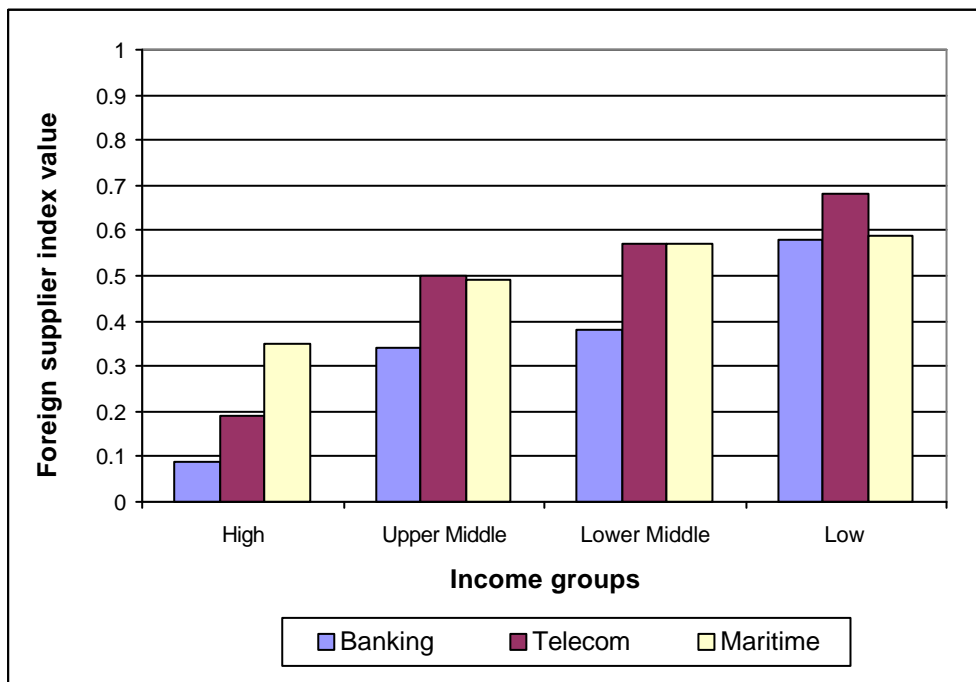
The majority of work on price effects, has so far concentrated on banking and telecommunications. However, index values have been estimated for a number of other service activities. Figure 3 shows the values of the policy index measuring the extent of impediments applying to foreign suppliers in banking, telecommunications and maritime services. The index values for banking and telecommunications were used to

**Figure 2**  
Price effects in banking and telecommunications services



Source: Productivity Commission (1999a).

**Figure 3**  
Index of impediments to foreign suppliers of services



Source: Productivity Commission (1999a).



calculate the price effects in Figure 2. Price effect estimates in this format are not available for maritime services necessitating index values to be presented instead.

Figure 3 shows the rising trend in the index values of restrictiveness for banking and telecommunications as the income category shifts to lower levels. The index values for maritime services follow the same trend. The columns indicate higher degrees of restrictiveness in lower income economies.

Policy indices have also been estimated for professional and distribution services. These are shown in Figure 4. The levels of restriction appear to be similar for all income groups in the case of engineering, architecture and legal services. There is, however, some evidence of rising degrees of restrictiveness in impediments applying to foreign suppliers of accounting services and distribution services.

The structure of policy impediments is similar in all the listed professions, making it possible to

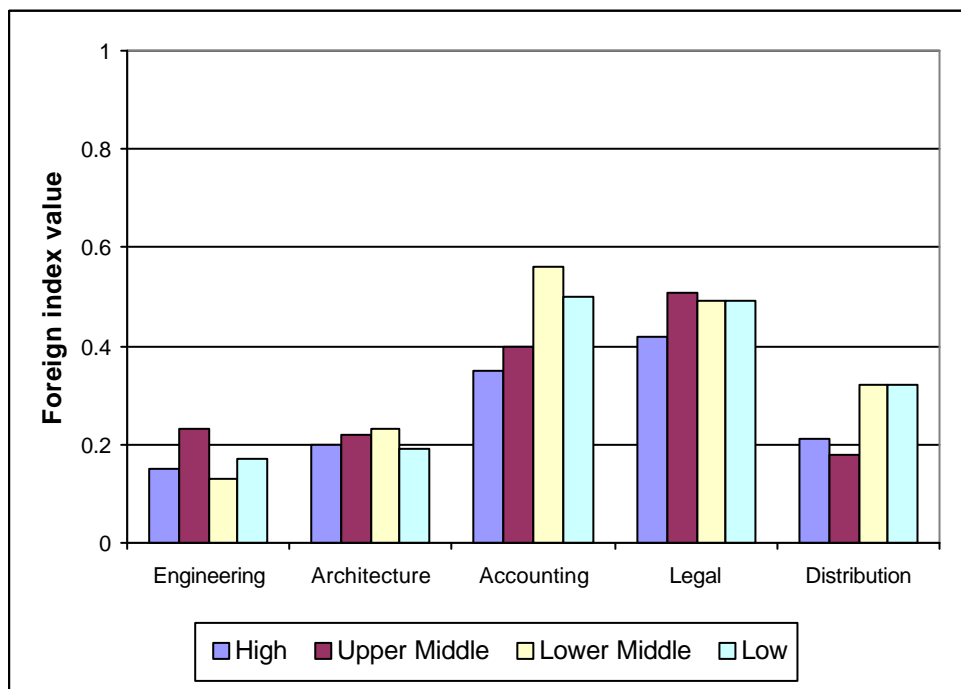
use the indices to formulate comparisons across activities. The data reported in Figure 4 indicate that the degree of restrictions applying to foreign suppliers is relatively low for engineering and architecture but higher for accounting and legal services.

The methodology applied allows impediments to be divided into two groups, those applying to establishment and those applying to on-going operations. The contribution of these types to the average scores over all economies for all activities covered in this work is shown in Figure 5.

The data indicate that typically the relative importance of these two types of impediments is similar for banking, telecommunications and distribution services. But for all other services, the restrictions on establishment tend to be the more important contributors to the overall index values, while for maritime services a larger contribution comes from restrictions on on-going operations. However this variation is mainly a reflection of the weights used in the calculation of the indices, and these weights reflect the judgement of the

**Figure 4**

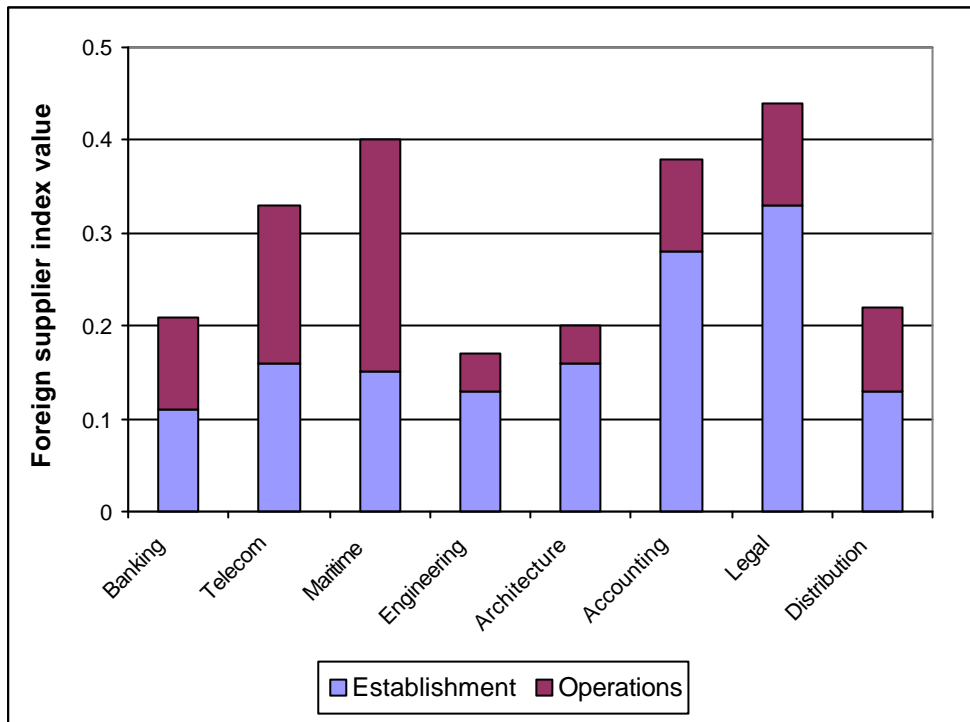
Foreign supplier index values for listed professions and distribution by income group



Source: Nguyen-Hong (2000) and Kalirajan (2000).

**Figure 5**

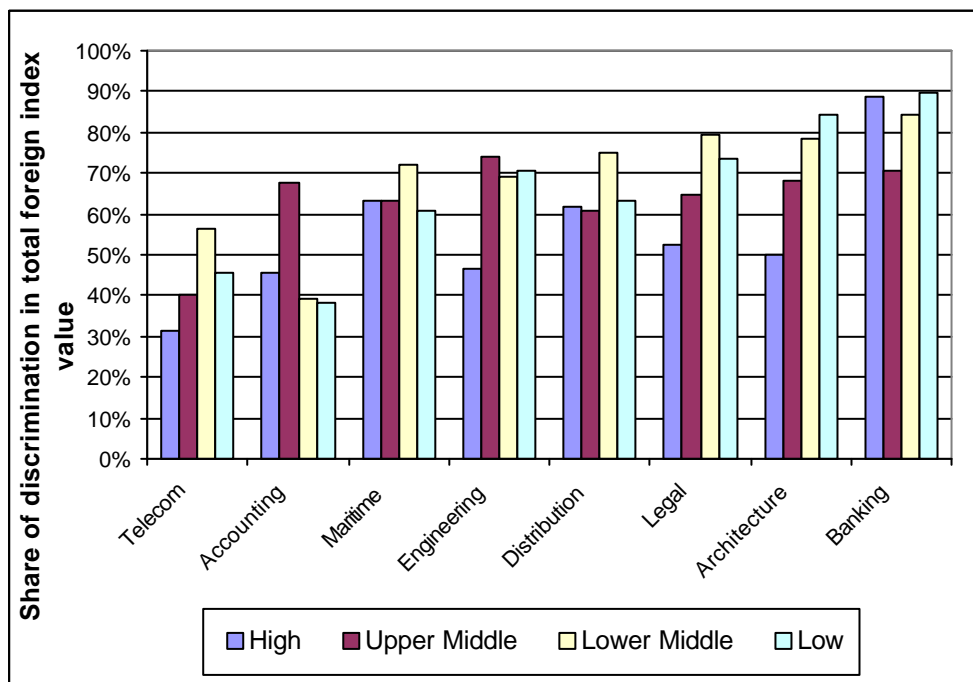
Contributions of restrictions on establishment compared to operations to average index values



Source: Author's calculation based on Figures 2-4

**Figure 6**

The share of the discriminatory component of the total foreign index value



Source: Author's calculation based on Figures 2-4

researchers about the importance of various types of impediments.

Trade negotiations on impediments to trade and investment in services made a distinction between impediments to market access which apply to all suppliers, domestic and foreign and those which discriminate against foreign suppliers. The index methodology also captures this distinction. The foreign index scores include impediments which apply to all potential entrants and also includes any special provisions applying to foreigners. Figure 6 summarizes the contribution of the discriminatory component to the total foreign index value.

Figure 6 shows that in most cases the discriminatory component accounts for the bulk of the overall value of the index representing the degree of restrictiveness applying to foreigners. For a number of sectors (maritime, engineering, distribution, legal and architecture), this element accounts for about two thirds of the total value. Its contribution is especially high for banking. However, the discriminatory element is relatively low for telecommunications and accounting. The significance of the discriminatory element in professional services is similar to the weight placed on those sorts of measures in the index calculations. The significance of the discriminatory element for distribution, banking and maritime service is much higher than its weight in the index. In those sectors therefore, the impediments observed are relatively highly concentrated among the discriminatory instruments.

Similar methodology has been applied in other research on the effect of policy on the performance of various activities within the services sector. The work of Fink, Mattoo and Neagu on maritime services has already been referred to and the impact of restrictive trade policies on prices was reported to be significant and of the order of 11 per cent. In another transport sector study, Gonene and Nicoletti (2000), the performance of the air transport industry in OECD economies is examined. They found that stricter regulatory regimes are associated with higher values of

estimates of the degree of inefficiency in the industry in particular economies. A number of economies have highly restrictive regimes which are associated with expected inefficiency levels of the order of 40 per cent. Higher inefficiency is expected to be correlated with higher prices. At the route level, they find that the policy environment also contributes to significant effects on fares through its contribution to actual and potential competition.

The following key observations are results from research which is relatively new. There is a substantial research agenda which can help confirm these results and the final section of the paper outlines some options for its development.

- There are significant impediments to trade in services, particularly in telecommunications, banking and transport as well as some of the professional services. High levels of impediments in these fields are likely to have significant effects on other goods and services exporters. A services sector reform programme which ignores the highly protected sectors could even reduce the efficiency of the allocation of resources;
- In policy applying to the services sector, there is usually significant discrimination against foreign suppliers, although in telecommunications, general market access conditions are relatively more important;
- The relative importance of barriers to establishment and operation vary between sectors, with establishment barriers being more important in the professions;
- In general, impediments to international services transactions tend to fall as income rises, except in some professional services activities. Thus, developing economies, even if they wish to focus on various cross border activities, also face some important domestic policy challenges to reduce the burdens that are now carried by those exportable sectors.

## B. National treatment versus market access

Impediments to trade in services may be divided into market access restrictions and derogations from national treatment.<sup>3</sup> Part III of the GATS explicitly introduces the concepts of market access and national treatment into the international services trade architecture. Surprisingly, as Warren and Findlay (2000) point out, the GATS does not specifically define market access. Article XVI (1) of the GATS, simply obliges members to grant market access to scheduled industry sub-sectors, while article XVI (2): (a)-(f) contains a list of measures considered to be limitations on market access. Article XVII (1) defines national treatment as treatment no less favourable than that accorded to like domestic services and services providers subject to the limitations and conditions set out in the country's schedule of commitments.

The implication of Part III is that market access and national treatment are broader in scope than were the corresponding market access and national treatment provisions in the GATT. To begin with, the GATS provision on national treatment does not draw a distinction between frontier and internal constraints but embraces all policies that might discriminate between domestic and foreign suppliers. In contrast national treatment in the GATT extended to matters of internal taxation and regulation only. In effect, the GATS article on national treatment encompasses both national treatment and market access as normally defined.

More importantly, the GATS article on market access extends beyond traditional concerns of access for foreign services suppliers to encompass all policies which restrict access to a market. This is a major extension of multilateral trade disciplines into the realm of domestic policy, in particular, competition policy.

Within the GATS structure, commitments are sought in both areas of market access and national treatment. Are there priorities? Some indication of the impact of the different priorities in a reform programme is available in the modelling work by Dee and Hanslow (2000).<sup>4</sup> As previously explained, impediments can be divided into those affecting establishment and those affecting ongoing operations. The barriers affecting establishment are modelled as a tax on capital. Barriers to operation apply to foreign owned firms who supply the services sector in the host economy. They also affect foreign firms who supply services across national borders and also affect local firms supplying their home market. These impediments are modelled as a tax on output.

There is a further two-way split between barriers affecting access to the market whether by local or by foreign firms, that is, impediments to entry into services markets by whatever mode which are non-discriminatory and barriers which are discriminatory. Box 1 contains examples of the types of impediments that might be involved, with reference to accounting services.<sup>5</sup>

The results of simulations of various patterns of reform examined by Dee and Hanslow are

**Box 1**  
Examples of impediments (in the accounting services sector)

|                                | Market access   | National treatment  |
|--------------------------------|---|---|
| Barriers to establishment      | Rules about the form of corporate organization for accounting firms                     | Restrictions on who can be an owner of an accounting firm                         |
| Barriers to on-going operation | Requirements that particular services be provided by staff with specific qualifications | Restrictions on the services that foreign accounting firms can and cannot provide |

**Table 1**  
 Partial reform in the services sector:  
 gains as a percentage of the gain from comprehensive reform

|                               | Market access | National treatment | Both |
|-------------------------------|---------------|--------------------|------|
| Barriers to establishment     | 43%           | 3%                 | 48%  |
| Barriers to ongoing operation | 20%           | 8%                 | 29%  |
| Both                          | 76%           | 13%                | 100% |

*Source:* Dee and Hanslow (2000)

reported in Table 1. Four partial reform programmes are examined, reflected by the cells of the table where the percentage refers to the size of the gain relative to the gain from comprehensive reform.

The data in Table 1 underscore that widespread reform is more efficacious than partial reform, since the returns to joint reforms (the column or row marked “both”) are greater than the sum of the parts. If a more specific choice is necessary, then the modelling results illustrate the following possibilities:

1. The largest gain is available from the reform of market access rules relating to establishment, followed by market access rules affecting ongoing operations.
2. Relatively large gains are available from reform of all arrangements that violate market access compared to those which affect national treatment.
3. Reform of policies affecting both establishment and operations for either market access or national treatment (that is, down the columns) are much greater than the sum of the parts.

As Dee and Hanslow note, it is surprising that the returns to market access reform are so high,

given the relatively greater significance, in general, of the distortions to national treatment (evident in Figure 6). The problem is that removing distortions on national treatment in the presence of distortions elsewhere can shift resources in the wrong direction. For example, this occurs when policy applied to domestic firms does not change but extra distortions are removed from foreign firms. The foreign sector gets bigger, supply increases, market price falls and the domestic sector could shrink even further.<sup>6</sup>

Furthermore, this set of results suggests there is greater benefit in applying a reform programme that affects a category of barriers (especially market access) and applying the reform to all modes of delivery (that is, moving down the columns in Table 1). The relative size of these payoffs is clearly an interesting topic to monitor as further modelling results are released.

### C. Political economy

A familiar argument for a commitment to uniformity is that it helps constrain the forces of political economy that will otherwise bias policy choices. As Tarr (1989) explains, in the context of tariff policy:

“A uniform tariff conveys a number of advantages, the most important of which is

that if the tariff is uniform, the gains to industry lobbying are much smaller (and may be negative), creating a kind of free-rider problem for the lobbying industry and dramatically reducing the incentive to lobby for protection. Then: (1) the level of protection is likely to be lower; (2) there is a direct saving of resources from the reduced lobbying; (3) the reduction to the gains from lobbying for protection provides a vastly improved signal to valuable entrepreneurial talent which will thus be encouraged to create better and cheaper products; and (4) the reduction in resources devoted to lobbying will result in less corruption in Government, which may have positive spillover effects into other dimensions of Government activity.”

Impediments to services transactions, because of their quota characteristics, tend to create rents for incumbent suppliers. Barriers of the type usually used to protect the services sector will create privileged positions for insider suppliers. Incumbents retain the revenue that might have accrued to Governments through a tariff, if one had been applicable. Governments could capture the rents in protected services by auctioning the rights to supply, although this option is rarely chosen. The presence of these rents will strengthen the incentive of incumbents to argue to retain protection.

The “insiders” in these markets include not only local firms but also foreign firms. Liberalization of all modes of a services sector in a developing economy will create efficiency gains, reduce rents earned by incumbents and also reduce rents earned by foreign suppliers (through cross border trade and establishment). Conversely, partial liberalization can have offsetting effects; for example a removal of restrictions on establishment while retaining restrictions on cross border supply (and also impediments to market access by local firms) might simply transfer rents to foreigners and reduce national welfare.

A topic for further empirical work is to establish the size of the rent transfer in various circumstances and to consider the implications of

the results for the design of reform strategies.<sup>7</sup>

The political economy of services negotiations is more complicated than simply an alignment of domestic interests against the owners of foreign capital. The current structure of protection can lead to the formation of alliances between domestic and foreign incumbents, both opposed to further reform.<sup>8</sup> This situation is similar to that which arose in relation to quota protection in textile and clothing markets or where foreign investors have established plants behind tariff barriers.

In the situations just described, there could be constraints from the political process to reform. At the same time, the interactions discussed earlier between goods and services markets, and amongst services markets, create opportunities to mobilize political support for reform. This support could come from those with interests in other markets and who gain from reform, for example in markets in which they buy inputs. Packaging of sectors, or clustering of activities, is also important for these political economy reasons. Overall, therefore, the political economy considerations reinforce the case on efficiency grounds for a uniform approach to policy making.

## ENDNOTES

<sup>1</sup> Some key results were recently summarized for the OECD in a note by the Commission; see the OECD paper TD/TC/WP(00)26. The World Bank has launched a programme of research on trade in services, including a data base on measures affecting trade in services which can be used in further quantitative work on their impact (see the World Bank’s note to the OECD TD/TC/WP/RD(00)7). UNCTAD is developing a data base of policy measures called MAST.

<sup>2</sup> The Productivity Commission reports data in a standard format. The original sources are McGuire and Schuele (2000) and Kalirajan, McGuire, Nguyen-Hong and Schuele (2000) for banking and Warren (2000a and b) for telecommunications.

<sup>3</sup> For an early example of this kind of distinction in services see UNCTAD and the World Bank (1994), chapters 4-7.

<sup>4</sup> The OECD (2000e) has recently provided a review of a number of modelling projects of different types.

Here, the focus is on one of the modelling exercises which uses the impediment measures described in the previous part of this section.

<sup>5</sup> For more detail, see White (1999) and Colecchia (2000)

<sup>6</sup> This possibility is illustrated in Dee, Hardin and Holmes (1999). Dee and Hanslow point out that the results summarized in Table 1 do not apply to all economies but that for 13 of the 19 regions in the model, the removal of market access restrictions on establishment

(the top left cell in the table) is the best partial reform option.

<sup>7</sup> Dee and Hanslow under extreme assumptions about the distribution of rents find significant losses from services sector reform for the prominent home economies of services sector foreign direct investment.

<sup>8</sup> The distribution of rents earned by foreign and local suppliers in various policy scenarios is modelled by Francois and Wooton (1999b).

## IV. CONCLUSION

As previous work in UNCTAD has stressed, developing economies are offered new opportunities for gains from trade and investment in services. There are a number of issues involved in taking up those opportunities, including the terms of access to international markets for suppliers and investors from developing economies. However, market access at home also matters. The discussion in this paper has focussed on the contribution of the openness of the domestic services sector in developing economies to the competitiveness of the outward oriented producers. For the purpose of achieving greater gains from a move towards a higher degree of openness, some principles of services sector reform were stressed, including the value of a “top-down” approach, the importance of neutrality between modes and the value of bundling activities. Interactions between services reform and policy development in other areas were also highlighted, especially the importance of policy in relation to competition and regulation. Impediments to domestic reform were noted, included the lack of policy transparency and political economy constraints. Recent empirical work on the patterns of impediments was reviewed. Some points on selecting policy priorities between initiatives related to market access and national treatment were also made, based on modelling results.

A theme of the paper is that the key to the development of coherent policy is to make more transparent the effects of current policy and of the likely impacts of alternatives. Some work on assessing services sector policy and assessing its impact has been completed and part of that body of work has been reviewed above. There are some directions in which it would be useful to extend that work

### A. Sample sizes

The first of these steps is to increase the size of the samples of economies in the empirical work linking policy indices to market outcomes. The data sets are dominated by developed economies, since they tend to have more transparent policy regimes. Greater participation by developing economies will provide their policy-makers more information about the nature of policy in their economy and its impact on other services sectors. It will help policy-makers establish priorities for attention, negotiation and commitment. For example, a tourism promotion strategy might have as its first step national initiatives to reform the air transport and telecommunications sectors. This work will also facilitate developing economies’ participation in the negotiations in WTO processes, or in regional arrangements, on market access.

### B. Impact study coverage

Another target is to study the impact of impediments in a larger number of services activities. So far, as noted already, this work is more extensive in relation to banking and telecommunications. Further work on transport sectors to yield country specific results would be useful. Other sectors can be added to the list. These could include not only the professions and distribution but also the areas nominated by UNCTAD for special attention. Education services could also be added to the list. Further work on impacts will also help the design of clusters of services to be considered concurrently.<sup>1</sup>

### C. Sensitivities

Changes in the specifications of the policy indices could have significant effects on results of



impact studies. Nevertheless, the sensitivity of the results to these changes has not been tested extensively. Changes in weights or scoring systems could be tested against a wider range of opinion, including business people with a knowledge of the markets. The weights should also be compared between the perspectives of developed and developing economy business sectors. The statistical work could be extended to test for changes in results, under different assumptions about the importance of the various elements of policy.

#### **D. Templates**

A further possibility is to focus this activity to promote transparency by developing a negative list reporting exercise. Hoekman and Martin (1999) observe that negotiators are not likely to change the way that commitments are scheduled in the GATS to a negative list and that indeed such an approach could be counter-productive. Instead they suggest that a less binding reporting process might be possible. The process of constructing the policy indices used in the work reported here will facilitate the implementation of this reporting approach. It will help the reporting of impediments, for example, in the form of model templates. One of the benefits of moving toward an index approach to describe a set of policies is that it forces the adoption of the “three c’s” - consistency, comparability and completeness into the collection and recording of data. The weights and the scoring systems applied to the calculation of the indices can always be debated, although if these are not agreed, a key contribution of the overall index approach is its contribution to transparency through the “three c’s.”

#### **E. Mode 4**

Policy indices, constructed so far, record impediments at aggregate levels. Further disaggregation is possible. A key interest of developing economies is to break down impediments by mode of supply. Particular attention could then be paid to mode 4. Even using the existing data, this disaggregation could be

provided and the extent of impediments compared across policy areas.

#### **F. Domestic regulation**

A further impediment to reform is the set of genuine concerns about the sequencing and design of services sector reform. Some of these concerns relate to the design of domestic regulation and whether the appropriate regulatory structure is in place. Aspects of the application of domestic regulation to the service sector were discussed previously.

The challenge is to design the right sequence of change in reform policies, without losing the momentum of reform. A prescription that all the right policy institutions must be in place before liberalization occurs will only provide excuses to “go slow”.

Case studies of successful reform, in whole economies or particular sectors, are one method of transferring knowledge about the sequencing and institution building challenges in services sector reform.<sup>2</sup> This is particularly important in relation to the design of policy to deal with market failure problems, such as lack of information among consumers about service supplier characteristics, or market power problems. There are important spin-offs from this work for the GATS negotiations on issues related to domestic regulation.

#### **ENDNOTES**

<sup>1</sup> Hoekman and Messerlin (1999) outline how this approach might be implemented.

<sup>2</sup> The Pacific Economic Cooperation Council in conjunction with the APEC Studies Centres prepared two services sector studies, one on telecommunications in the Philippines and the other on the financial sector in Peru. These studies included details of the experiences of particular firms that could be used to illustrate the impact of reform and the business opportunities created. These studies can be downloaded from the site of the Australian APEC Studies Centre. Chadha (1999) and Tohamy (1999) report other interesting case studies at economy level.

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