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THE CONTRIBUTION OF SERVICES TO DEVELOPMENT AND THE ROLE OF TRADE LIBERALISATION AND REGULATION

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Overview[1]

The service sector makes an important contribution to GDP in most countries, providing jobs, inputs and public services for the economy. Trade in services can improve economic performance and provide a range of traditional and new export opportunities. However, services liberalisation also carries risks, and appropriate regulation and other complementary policies help to ensure that liberalisation delivers the expected benefits. We have reviewed the literature on these issues for 6 service sectors (tourism, financial services, energy services, information and communications technology, and Mode IV), and produced a summary Briefing Note on each.

The contribution of services to development

The service sector is an important component of any country's economy. It makes a direct and significant contribution to GDP and job creation, and provides crucial inputs for the rest of the economy, thus having a significant effect on the overall investment climate, which is an essential determinant of growth and development. Some service sectors such as the health, education, water and sanitation sectors, are also directly relevant to achieving social development objectives.

The service sector accounts for a significant proportion of GDP in most countries, including low income countries, where it frequently generates over 50% of GDP. The process of development usually coincides with a growing role of services in the economy (alongside a reduced role for agriculture). Thus services constitute an increasing percentage of GDP in nearly all developing countries. Services contributed 47% of growth in Sub-Saharan Africa over the period 2000-2005, while industry contributed 37% and agriculture only 16%. Recent growth in Africa is due to services as much as natural resources or textiles (even in countries benefiting from trade preferences in these products). The question is nor whether to move into services, but how and at what speed to move into services.

Many services are key inputs to all or most other business e.g. infrastructure services such as energy, telecommunications and transportation; financial services which facilitate transactions and provide access to finance for investment; health and education services which contribute to a healthy, well-trained workforce; and legal and accountancy services which are part of the institutional framework required to underpin a healthy market economy. These service sectors are thus a key part of the investment climate, and can have a much wider impact on overall business performance and the level of investment, and hence growth and productivity in the economy.

The potential benefits of services trade liberalisation

Trade in services can help create opportunities for countries to expand their outputs of services in sectors where they have a comparative advantage, thus creating jobs, contributing more to GDP and generating foreign exchange. This can be especially important for those countries which are relatively isolated from world goods' markets, e.g. due to poor transport infrastructure, or being landlocked, such as many sub-Saharan African countries. Services exports can be an important part of a developing country's growth strategy. For example, India has been capitalising on a boom in exports of IT enabled services as firms have increasingly outsourced certain administrative functions to lower cost countries. And (labour-intensive) tourism is now a significant part in the economy of many low-income countries.

In addition, imports of services can significantly improve performance by bringing greater competition, international best practice, better skills and technologies, and investment capital. The entry of foreign service

[1] This Briefing Note is based on work funded by DFID and written by Massimiliano Cali, Karen Ellis and Dirk Willem te Velde. The authors alone are responsible for the views expressed. This is a draft; comments are welcome to the authors of the main report (available soon) m.cali@odi.org.uk; k.ellis@odi.org.uk; dw.tevelde@odi.org.uk

providers may therefore yield better services for domestic consumers, and improve the performance and competitiveness of domestic firms.
Given that much trade in services is brought about through foreign direct investment, it can also serve to bring much needed capital into the country. Thus it can help to stimulate investment in infrastructure development for example, where government or domestic private sector funding may have otherwise been difficult to secure (given public sector budget constraints, and the fact that many developing countries have limited access to international capital markets).

The need for complementary policies and the role of regulation

However, experience has shown that services trade liberalisation also carries risks and potential costs e.g. that foreign providers might cherry-pick the most profitable customers and refuse to serve others; may leave the country at the first sign of financial difficulty exacerbating instability; may replace domestic providers, or may contribute to brain drain. Government intervention to regulate the market and to ensure there is sufficient competition is therefore crucial if the benefits of services liberalisation are to be realised.

Indeed, regulation is crucial in many service sectors regardless of whether the sector is open to trade. Due to the nature of services (which are commonly characterised by elements of natural monopoly, high barriers to entry, and informational asymmetries), regulation is usually required to ensure that service markets work properly. For example, regulation is required to:

- create a level playing field and facilitate competition between market players (e.g. by ensuring access to the grid or network for new entrants in the electricity or telecommunications sector),
- guarantee the quality of the services provided (e.g. by specifying qualification requirements for service providers such as doctors, engineers and architects),
- protect consumers (e.g. from fraud, or misselling)
- ensure sufficient provision of information (e.g. about the availability and features of services provided),
- prevent environmental degradation (e.g. arising from high levels of tourism development),
- ensure adequate access to services (such as electricity, health and education),
- maintain financial stability (in the banking sector),
- minimise disruptions in supply (in electricity).

However, regulation can be unnecessarily burdensome and distortionary, and can sometimes represent a major barrier to services trade. Barriers can sometimes be an unintended consequence of a regulation (e.g. where the professional qualifications required are available only from national educational establishments), or can sometimes be imposed deliberately to prevent or manage foreign entry e.g. through limits on foreign equity participation, or requirements for foreign entrants to form joint ventures with domestic companies. Thus liberalising trade in services usually involves some degree of deregulation or regulatory reform to make it easier for foreign firms to enter the market.

But it is also the case that new or more sophisticated regulatory frameworks are often required in order to ensure that liberalisation delivers the expected benefits. And the establishment of an appropriate regulatory framework can also be important in enabling a country to take advantage of potential export opportunities, by developing well-functioning domestic service sectors that meet world standards of provision. For example, by facilitating the development of a safe and reliable health care system, a good regulatory framework can enable a country to take advantage of new opportunities to sell health tourism services. Similarly an appropriate legal and regulatory framework in the financial sector can help to build consumer confidence in a new offshore financial centre.

Other complementary policies can also help to maximise the benefits and minimise the risks of service sector liberalisation. These vary from sector to sector, and may include: the provision of education and training (e.g. in IT, medicine, or languages), that will enable domestic firms as well as individuals to take advantage of service sector export opportunities; mechanisms to enhance spillovers and technological diffusion from foreign export providers; or a strategy to manage the temporary migration of individuals abroad to provide a service, to facilitate greater remittances and maximise the chance of return with enhanced skills etc.

Conclusion

Evidence shows the potential gains from service sector liberalisation are substantial. But there are also risks which need to be considered against the risks of not liberalising. A range of complementary policies, including appropriate regulation, the creation of competitive market conditions, the provision of specialised training of adequate quality and scale, and policies to protect health, environment and consumers and ensure adequate access to services, are crucial if liberalisation is to deliver the expected benefits.

Briefing Note 2, January 2008

Tourism[2]

Tourism is the biggest export service sector in many low-income developing countries. Its value is already significant (3.5% of GDP in Africa, 15% of employment in the Caribbean) and is set to increase further in all world regions, especially in developing countries, reflecting increased demand, comparative advantages and liberalisation. The tourism sector is already liberal compared to other sectors, but essential complementary reforms in air access and visa procedures are less well advanced There are also some specific tourism categories (e.g. tour guides, small hotel segment) where regulatory protection is preferred over policies to support competitiveness.

Tourism and development

International tourism receipts have more than doubled in the past 15 years, to USD 700 billion, and tourist arrivals nearly doubled to 800 million in 2005 (UN World Tourism Organisation). Average annual growth rates in arrivals over 2000-2005 were 5% in sub-Saharan Africa, 7% in East Asia and the Pacific, and 3% for the world. It is expected that Africa will see its market share in tourist arrivals increase from 3.6% in 1996 to a marked 5% in 2020. Tourism receipts in Africa, growing at 10% a year, account for USD 21.5 billion or 3.5% of Africa's GDP (there are wide variations within Africa: 20% of GDP in Mauritius, 10% in Namibia, Tanzania and Gambia, 5% in Botswana and Kenya and 2.5% in South Africa). The World Tourism and Travel Council (WTTC) finds that tourism contributes 15 percent to GDP and 16 percent to employment in the Caribbean region (including indirect effects).

Tourism benefits the poor through employment opportunities. Tourism offers labour-intensive and small-scale opportunities compared with other non-agricultural activities, employing semi-skilled and casual workers, small and medium-sized enterprises, a high proportion of women, and an opportunity for self-employment. Tourism also provides opportunities in remote areas and in places with a high value on natural resources and culture, all of which tend to favour the poor.

Econometric studies which capture the dynamic effects of tourism on growth support the hypothesis that growth can be tourism-led, and in some cases tourism contributes more to growth than some traditional sectors. The effects of tourism are greater the poorer the country. This would suggest that tourism is a first step towards diversification but as countries become more developed they move increasingly into higher value-added sectors. The effects on the rest of the economy work through infrastructure (e.g. air travel, or roads), human resource development (e.g. training of workforce), diversification and private sector development (especially SME development and entrepreneurship linkages).

The role of regulatory reform in supporting tourism

Tourism regulations govern the operations of hotels, restaurants, tour operators and tour guides, in the form of rules on the use of fiscal incentives, land tenure and health and safety issues in the destination country. Complementary regulatory factors include transport, immigration, environmental and education rules, as well as regulations and policies in source countries (e.g. health and safety, competition). The World Economic Forum compared countries on this and other factors such as environmental regulation, safety and security, health, government's prioritisation of tourism; air transport, ground, tourism and ICT infrastructure; and human, cultural and natural resources. It found that a tourism competitiveness index comprising the above was associated with more tourist arrivals.

There is evidence to suggest that a more streamlined administrative business environment would promote the development of the tourism sector, as it has happened in Zambia. Investment policies sometimes fail to include the

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tourism sector, although in practice many countries use fiscal incentives to attract hotels, cruise ships and other tourist enterprises (e.g. in the Caribbean). Despite their wide ranging use, there is little evidence on the effects. Better administration of investment incentives could be helpful and include better formulation and monitoring of the objectives.

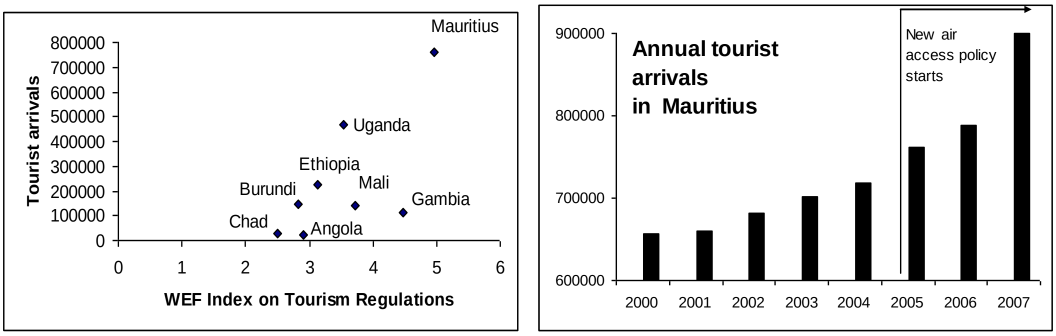
Tourism regulations such as air access, better visa arrangements and equal treatment of foreign and domestic hotels may help develop the sector (see box). Some countries restrict activities to locals (e.g. small hotels in some Caribbean countries, or recently, small scale tourist enterprises in Botswana). However, restricting to locals may fail to promote a vibrant tourism sector which is in need of skills, capital and marketing networks of foreign players. It is more efficient to promote domestic capabilities, and if required use transparent immigration procedures for tour guides or non-discriminatory competition policies for large hotels to secure the expected benefits. Promoting domestic capabilities includes better access to credit for local entrepreneurs and access to computerised marketing systems.

Box Tourism-related regulation, tourist arrivals and tourism development in Africa

The left panel of the chart below shows that African countries with more tourists also have a better score on the WEF tourism regulatory index. This regulatory index measures the extent to which foreign ownership and foreign direct investment are welcomed and facilitated by the country, how well property rights are protected, the extent to which visa requirements make it complicated for visitors to enter the country, and the openness of bilateral Air Service Agreements.

The panel on the right shows that annual tourist arrivals in Mauritius rise sharply from 2005 onwards after a new air access policy has been put in place which gradually liberalised bilateral air services agreements to key countries in Europe, Africa and Asia. Mauritius had long promoted high-spend, low volume tourism, but this changed recently and with the help of more liberal BASAs it is now aiming for a tripling of tourists to 2020.

Evidence on trade liberalisation, especially from Southern Africa and the Caribbean, shows that 1) air transport liberalisation is a channel for increased economic growth and employment, especially related to tourism; 2) a decline in market share and traffic of the national carrier is likely to be more than compensated by the benefits to the economy from increased air traffic to and from the country; and 3) the alternative to liberalisation is likely to prove much more costly to both a national carrier and the economy in the medium-term, with a probably increasing need for public subsidy to the carrier and an increasing opportunity cost for development of the national economy.



Sources: UNWTO, WEF and Mauritius CSO

Conclusions

Tourism is a key export service sector. Regulatory reform and liberalisation is already happening often with beneficial economic effects. Better visa procedures, liberalised air access and good business regulation promotes the tourism sector, but the effectiveness of fiscal incentives is less clear. Evidence suggests that promoting local capabilities is better than protection from foreign involvement.

The Financial Sector[3]

The financial sector plays a crucial role in the economy, and evidence shows that liberalisation can improve financial sector performance, with knock-on benefits for the rest of the economy. However, there are also risks associated with liberalisation, for example in relation to financial stability, and access to financial services. Careful sequencing of reform, appropriate regulation, and other complementary policies are required to ensure liberalisation delivers the expected benefits.

The role of the financial sector, and benefits of market opening

Evidence suggests that the financial sector plays a crucial role in the economy, underpinning private sector development, facilitating investment in businesses, technology, and training, and contributing to productivity, competitiveness and growth. Access to financial services also contributes directly to poverty reduction, enabling poor households to strengthen their livelihoods, e.g. by investing in microenterprises, and to better manage the risks they face.

Evidence also shows that opening up the financial sector to trade can significantly improve a country's overall financial sector performance, with important knock-on benefits for the rest of the economy. Openness to foreign financial services providers can result in greater efficiency, dynamism, and innovation. It can stimulate improvements in domestic banking performance, and has significant potential benefits for consumers through improved service delivery, and for the economy as a whole through a more efficient allocation of capital.

The benefits of foreign entry into the banking sector

Foreign entry is often through acquisition or joint ventures with local banks with a view to restructuring and improving their performance, and can bring significant benefits to the host country. Claessens (2006) describes how the acquisition of the government-owned Agricultural Bank of Mongolia ("Khan" Bank) by HS Securities of Japan in 2003 led to a turnaround in financial performance, expansion in its branch network and improvements in outreach and service. Foreign entry may also stimulate innovation, and the provision of new products or better services by both the foreign entrants and local banks. Bonin and Abel (2000) showed that competition from new foreign entrants in Hungary stimulated the main domestic bank to develop new products and better services for households, such as bank cards and ATMs.

Foreign banks can also use their international experience to introduce innovations. The World Development Report (2005) cites an example whereby Citibank overcame the lack of credit information on enterprises in many developing countries by introducing a new mechanism for establishing creditworthiness based on an estimate of growth prospects in particular industries. Mattoo et al (2001) found that countries that were open to trade in financial services achieved growth rates up to 1.2 percentage points higher than other countries over the period 1990–1999.

Complementary policies required

Opening up the financial sector to trade is often just one component of a package of financial reform measures which are undertaken together, and which may include the removal of government intervention in the financial sector, privatisation, domestic market liberalisation (allowing new entry by domestic financial providers), and capital account liberalisation.

Experience from across the world shows there are significant risks associated with this wider process of financial sector liberalisation, such as the risk of financial instability, bankruptcies, and the increased chance of financial contagion when other countries experience financial difficulties. Thus a range of complementary

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policies, and careful sequencing of reform is now seen as important to manage these risks, and maximise the benefits of market opening. Key components include:

- a stable macroeconomic framework – to minimise the risk of financial instability;
- adequate financial supervision and regulation to encourage prudent risk taking and financial discipline in the banking system;
- the necessary institutional infrastructure, such as an effective legal framework for insolvency, and adequate corporate governance and accounting systems;
- financial deregulation, where government controls over the actions of financial institutions are removed, such as directed lending policies and interest rate ceilings, which are likely to hamper performance and deter new entry;
- bank restructuring, to resolve problems associated with high levels of non-performing loans and put domestic banks on a sustainable footing, thus avoiding bankruptcies and creating a level playing field with new foreign entrants;
- commercialisation and privatisation, to create market incentives and improve the competitiveness and productivity of domestic banks.

Success and failure: the importance of an appropriate regulatory framework

World Bank (2007) describes how financial liberalisation in the early nineties in Zambia, which was implemented before a new legal and regulatory framework to encourage prudent risk-taking and market discipline in the banking system was established, led to a series of bank failures which caused losses to taxpayers and depositors equivalent to 7 per cent of GDP.

This contrasts with more positive recent experience in Kenya, where Arora & Ferrand (2007) argue that improved regulatory capacity and better macroeconomic management have been critical in stimulating improvements in financial sector performance, reflected in an increasing number of accounts, and growing bank branch and ATM networks.

Implications of liberalisation for access to financial services

There has also been a concern that foreign banks will 'cherry pick' the most profitable clients. Indeed, most foreign banks do focus on areas where local profit opportunities are perceived to be the greatest e.g. providing financial services to large firms in urban areas. But evidence suggests that increased competition in these market segments can still help to increase access by forcing other banks to move into new segments. At the same time, removal of directed lending, and privatisation of state-owned banks as part of an overall package of financial reform may reduce access to financial services for some segments of the population.

Governments need to create an enabling environment to reduce the costs associated with widening access by commercial banks, for example by establishing credit bureaux, creating a better legal framework to enforce contracts, and ensuring that regulation does not undermine incentives to widen access. Directive interventions which force banks to increase access are usually ineffective and counterproductive, but other, more market-friendly ways for governments to encourage access can be found. For example, the South African Financial Sector Charter, which set targets for improving access and was developed voluntarily by banks in response to moral suasion from the government, along with the introduction of a Basic Bank Account, which set the framework for banks to provide a simple, low cost, 'no-frills' bank account for lower income customers, appear to have contributed to significant increases in access to financial services in South Africa in recent years. Harnessing the market dynamism and innovation that financial liberalisation can bring is likely to be a great deal more successful than the state-led approaches of the past in tackling the problem of financial exclusion.

Briefing Note 4, January 2008

The Electricity Sector[4]

Access to electricity is central to practically all aspects of economic activity, yet service is limited or unreliable in many developing countries. Liberalisation of the electricity sector can bring performance improvements and much needed investment capital. However, the evidence also shows that the gains from liberalisation are by no means certain, and rely heavily on the establishment of competition and an effective regulatory framework.

Access to electricity is central to practically all aspects of economic activity, including private sector development and job creation, agricultural and industrial productivity, and access to water, health care and education. It is strongly related to growth and development. However, access to electricity is limited or unreliable in many developing countries. It is estimated that at least 1.6 billion people still do not have access to electricity.

Liberalisation of the electricity sector and market entry by private (often foreign) players can bring competition, innovation, technological know-how, managerial expertise, and much needed investment capital with which to improve service, expand access, and keep pace with expected growth in demand. It has generated substantial benefits in many countries, in terms of greater efficiency, lower prices, improved access, greater reliability of service and improved environmental impact. For example, evidence shows that electricity sector liberalisation in Chile in the 1980s resulted in lower prices and increased access, as well as improved productivity and reduced energy losses within the sector.

Box Electricity liberalisation – contrasting performances in Africa

Adenikinju (2003) explains how poor service from the government-owned National Electric Power Authority, caused severe problems for Nigerian manufacturers, who experienced power outages more than five times a week which cost them the equivalent of 88 working days per year on average, and led many of them to resort to investing in costly self-generation capacity, so as to ensure a constant supply of power.

In contrast, a study by Plane (1999) of the privatisation of the Cote d'Ivorie Electricity Company in 1990 to a French contractor, showed significant performance improvements, including a substantial price decrease, improvements in quality, and an increase in the number of customers supplied by over 16%. These improvements are deemed to have been achieved through organisational improvements including decentralisation, reduction of hierarchy layers and managerial incentives.

Complementary policies needed

However, the evidence also shows that the gains from liberalisation are by no means certain, and rely heavily on the establishment of competition and an effective regulatory framework in order to create the right incentives for appropriate investment and efficiency gains, and to ensure that these efficiency gains are passed on to consumers in lower prices. (For example, Mota (2003) showed that electricity reform in Brazil between 1993 and 2003 – where tariff restructuring and privatisation had occurred before a regulatory agency was established - had generated efficiency gains in the region of US$12 billion, but that only US$2.2 billion of that gain had been passed on to customers.) Key components include:

- The creation of competitive market conditions through privatisation, separation of power generation from transmission and distribution services, the introduction of commercial (cost-reflective) pricing,

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measures allowing market entry by both domestic and foreign companies and ensuring a level playing field (e.g. through appropriate regulation of access to the grid), and through the introduction of competition to the sector or certain parts of it by giving customers a choice of supplier;

- The establishment of a good regulatory framework for those parts of the supply chain (e.g. transmission) where competition is limited by the natural monopoly characteristics of production;

- The establishment of a market structure and regulatory framework which ensures real time balancing of supply and demand and thus avoids disruptions in supply and price volatility;

- Consumer protection provisions in the regulatory framework to ensure customers are treated fairly; and

- Measures to ensure adequate access to services. This may be through the regulatory framework, or through universal service obligations which prevent suppliers from 'red-lining' (i.e. ceasing to serve) certain groups of potentially less profitable customers.

In practice, ongoing subsidisation may well be necessary to ensure provision for those on low incomes and in rural and remote areas in many countries, and may also be necessary to avoid public opposition to liberalisation, which can result in costly policy reversals and contract renegotiations as has happened in Latin America. Private participation and some degree of competition for the right to provide the subsidised service can still be permitted, and can help to encourage innovation, efficiency, and cost savings for the government.

Box Ways of subsidising electricity services

In Chile, subsidies for expanding electrification have been allocated through annual competitions between suppliers which were judged on the basis of technical merit, amount of private investment to be contributed, and expected social impact. The aim was to minimise project costs and stimulate efficiency and innovation. A number of foreign companies participated in the market. The scheme is credited with contributing to an increase in access to electricity in rural areas by almost 50% in the first five years (Evans (2006), Jadresic (2000)). In Mozambique there were competitions for contracts providing exclusive rights to the winning company to expand electricity services in a particular area over a twenty year period, with the provision of a subsidy for each new household connected. This meant the winning company was able to decide how to expand access most cost effectively.

But subsidies need to be carefully designed to ensure they are reaching the intended beneficiaries in a cost effective manner. Wodon, Ajwad & Siaens (2003) examined the impact of 'lifeline' electricity tariffs in Honduras, under which the government subsidised the first tranche of household electricity consumption, and found that about 80 per cent of the subsidies went to households that were not poor.

Liberalising the electricity sector may also contribute to improved environmental performance, because of the increased incentives for energy efficiency and technical innovation created by competition, and because of the superior technology and know-how brought by private, foreign entrants. Independent power producers are more likely to introduce cleaner, gas-based combined-cycle gas turbine (CCGT) plants because of the low capital costs, rather than the conventional coal fired plants which have long been favoured by state-owned utilities. However, incentives to do this will again depend on the framework for competition and regulation, including environmental regulation, that are in place in the host country.

Thus, as with other service sectors, the potential gains from liberalisation appear to be substantial, but a range of complementary policies are required to ensure that liberalisation delivers the expected benefits. Whether there is adequate institutional capacity to deliver these complementary policies in many developing countries remains an open question, and suggests that significant capacity building may be needed in many countries to support an electricity reform programme.

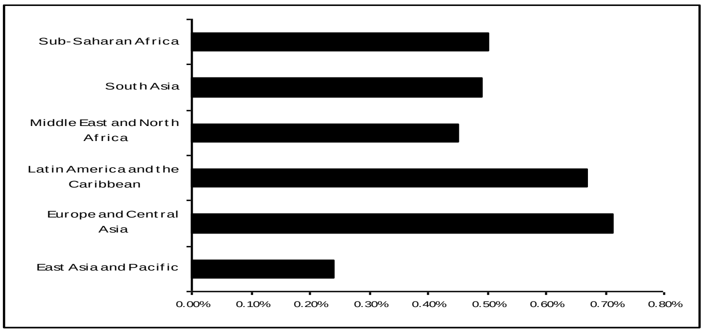
The ICT sector[5]

A well functioning information and communication technologies (ICTs) sector is not only important for development, as it improves the efficiency of households, firms, sectors and the country as a whole, but it also provides significant new opportunities for exports of services from developing countries. Appropriate regulation, trade liberalisation and other complementary factors (eg .good quality skills) play a key role in developing the ICT sector.

ICT and development: the role of regulation

Evidence suggests that a well developed ICT sector contributes to faster growth, better economic performance at the firm level and improved household welfare because it helps actors to engage in activities more efficiently. ICTs enable firms to access knowledge and information, reduce transaction costs, more easily supply markets remotely, improve decision-making across the value chain through better and easier communication, and improve the flexibility of firms to respond to consumer demand. However, ICT is not available everywhere (internet penetration was 1.8% in Africa, 8.4% in Asia-Pacific, and 28.2% in the Americas) with a (declining) digital divide amongst poor and rich countries. Development of the ICT sector depends on a good telecommunications system. Reform of telecommunications involves 1) market liberalisation (e.g. pricing) and competition;2) allowing private sector participation, 3) introducing effective regulation, and 4) trade liberalisation to foreign firms.

Chart 1Investment commitments to telecommunications projects with private sector participation, total value as % of GDP, (1990-2006), PPI database



Market reforms can boost productivity and stimulate investment in the sector, enhancing the performance of the ICT sector. Market-based strategies also allow governments to meet social and economic objectives, such as increasing access to ICTs and government revenues from telecommunication services. *Competition* has become more common in the ICT sector. Africa has introduced the least competition with 51% of countries with some form of competition in basic voice services (61% in America, 55% in Asia Pacific), and 75% in the mobile phones sector (76% in Americas, and 78% in Asia Pacific). *Private sector participation* in telecommunications was still lower in Africa in the 1990s (especially in terms of volumes) but has picked up in the last five years – and PPI investment is now similar when measured as a per cent of GDP (see chart). Some 78 developing countries have now privatised their operators raising close to US 80 billion over 1990-2006.
Effective regulation of telecommunication is important particularly in countries with small markets which due to natural monopoly characteristics might allow only one or few telecommunications firms to operate. When markets have been privatised, effective regulation is critical for benefits to be felt by households and

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firm, e.g. in the form of low-cost interconnection costs to broadband services. Practical evidence suggests that effective regulators have independence from political influences, and have the technical skills to monitor firms and the capacity to enforce regulation. Further, the spread of ICT benefits from a comprehensive ICT strategy to foster innovation and uptake of technology.

Box Trade liberalisation, complementary factors and the ICT sector

Country case studies show that *trade liberalisation* and openness to foreign firms has also helped the development of the ICT sector. Foreign-owned telecommunications firms posses more skills and capabilities than local firms, are at the forefront of the spread of ICTs and bring telephone and internet access to areas that were hitherto not serviced e.g. such as Morocco or Brazil. Trade liberalisation is more beneficial in the presence of complementary regulation. An appropriate domestic competition policy is important. For example, in the case of Chile and Brazil privatisation to several foreign firms led to large improvements in the spread of ICTs while in the case of Argentina, privatisation to a single foreign firm more or less continued a situation of limited competition, and thus had less dramatic effects on the spread of ICTs. While regulation could be used to enforce access to less profitable, rural areas, a more efficient way of ensuring coverage in such areas is by providing output-based subsidies, e.g. as in Peru.

ICT and offshoring of services

An efficient ICT sector opens up new export frontiers for developing countries, including those (landlocked) countries traditionally constrained by high transport costs. The adoption of ICTs enables specific services (and goods) to be traded, or offshored without the need for using traditional transport modes. The rise in call centres, online programmers and software developers from India provide key examples of the trend in offshoring to developing countries. Other opportunities for offshoring arise in a wide range of sectors including legal services, financial services and health services. Offshoring has begun to bring large benefits to those developing countries that have good ICT frameworks, ICT associations and good quality skills (varying from good managers in call centres, to practical engineering and computing skills), e.g. as in India and Mauritius. In India, IT-enabled services (USD 9.5 bn in 2007) are responsible for a third of the total. Valued added in exports of services increased Indian GDP growth by 0.2 and 0.6 percentage points annually over the 1980s and 1990s. The ITES sector in Mauritius is growing at 25% a year and employment at 7000 in 2007 tripled over 4 years.

Regulations in importing countries also affect offshoring opportunities. For instance, some US states have banned offshoring of services due to employee concerns about jobs. Protectionism has also been visible, but to a lesser extent, in Europe, where some groups feel threatened by the direct loss of job which would only be indirectly compensated by the gains. There are concerns about data protection issues constrained offshoring opportunities from developing countries. Such barriers to trade will be important offensive interests in trade negotiations for key developing country exporters of services.

Policy implications

The ICT sector is important for productivity growth and trade in developing countries, but the sector is still underdeveloped in the poorest developing countries although improvements are visible in many. The sector deserves strategic attention, e.g. in the form of an ICT strategy covering a number of issues:

- The establishment of good telecommunications infrastructure, with market-based pricing, private sector participation and appropriate regulation;
- An independent, and well-capacitated regulator;
- A suitable competition framework;
- An appropriate legislative framework e.g. in relation to data protection issues;
- An offensive approach to maintain and improve access for IT enabled services world wide;
- The provision of suitable education and training with more attention to vocational and technical tertiary education and to links with private sector needs.

Health services [6]

Developing countries are increasingly engaged in trade in health services internationally, although there are still many regulatory barriers to trade. While lifting these barriers is likely to further stimulate trade, there is insufficient evidence to suggest what the net effects of trade liberalisation may be for health systems. Preliminary evidence does suggest that the effects depend on the presence of domestic complementary policies, such as developing good public-private partnership, designing appropriate financing mechanism, strengthening skills and regulatory capacity, may harness the positive potential of liberalisation.

An efficient and equitable health services sector is not only a development objective per se, but it is also a fundamental driver of growth and poverty reduction at the macro and micro level.

Developing countries are increasingly important players in the international health services markets. Examples include countries like India, South Africa, China and Brazil in medical tourism (Mode 2), exploiting their cost advantage and quality of part of their health sector, and the Philippines in nursing services trade via temporary migration of health personnel (Mode 4). Filipino nurses constitute 76% of foreign nurse graduates in the United States. While these exports may become an important share of a country's foreign exchange earnings, it is important that development of a trade strategy complements the primary objective of government to provide universal coverage of health care to local communities. Thus domestic regulation could be welfare enhancing even if it were highly restrictive to trade.

The effects of trade-related regulation

Regulation of health services can play an important role for a country's development by affecting the efficiency and equity of the domestic health system as well as the economy directly (e.g. exports and employment).

Countries impose three main types of regulatory barriers to trade in health: approval requirements for clinics and hospitals; qualification and licensing requirements for professionals; and rules governing reimbursement from mandatory health insurance schemes. These rules are sometimes stringent and may represent binding constraints to trade (see Box below). For example, a number of East Asian countries, such as Malaysia, the Philippines, and Thailand, only allow minority foreign ownership for hospitals; and the UK Department of Health has set a policy which impedes the NHS to contract hospital treatment for NHS patients outside the maximum air travel time limit of three hours, thereby *de facto* ruling out most developing countries.

Removing these barriers is likely to stimulate trade in health services, with a number of potential risks and benefits for the country's health system. For example increased foreign investments due to the removal of barriers on foreign ownership may widen the range of services provided in the domestic economy but can also divert scarce human resources away from the public sector. While liberalisation of health services may yield the standard benefits of trade liberalization in terms of efficiency gains and increased investments, it can also worsen inequities in the distribution and quality of such services. Unfortunately we lack systematic empirical evidence (especially in developing countries) to assess the net effects of trade liberalisation on health systems.

The effects of trade liberalisation are likely to apply to a limited extent to very poor countries, as these are much less involved in health services trade than upper and lower-middle income countries. For example there are no least developed countries among the largest 15 'exporters' of doctors to the UK in 2004; on the other hand 8 out of the first 15 are developing countries. Although Laos is one of the most liberal East Asian

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countries with respect to foreign investments in the health sector, there are no foreign hospitals in the country. The reasons for the scarce participation of these countries into trade in health services are likely to be similar to those limiting their participation in goods' trade. These have to do more with domestic supply capacity constraints and market size rather than with regulatory barriers. To the extent that this is the case external assistance, such as aid for trade, could help address supply capacity constraints to allow very poor countries to reap the benefits of increased trade in health services.

Complementary policies

There is however a consensus suggesting that the effects of liberalisation of health on developing countries depend on domestic policies, regulations and institutions. Governments can adopt a variety of policies to minimise the potential costs of liberalisation and maximise the beneficial effects.

Adequate regulatory capacity in the health sector is crucial to ensure that the overall impact of liberalisation, whether domestic or external, is beneficial. In an environment with institutional and regulatory deficiencies, increased competition induced by liberalisation may have negative effects. For example evidence shows that in low-income ASEAN countries, patients in the private sector are adversely affected by poor quality medical treatment and sometimes even suffer abusive practices. Strengthening regulatory systems is a complex task, which would require political commitment by governments involved, combined with technical assistance from donor countries and specialised health agencies.

Governments can *promote linkages between the public and private* segments in order to increase the reach of health services provision within the country. For example, a German health care group is contributing equipment and expertise to what was a vacant wing in a public hospital in Cape Town and will provide public patients with specialist services that are currently unavailable from the state. Other ways of maximizing the benefits from private sector participation include the promotion of professional collaboration and exchange between the two segments, and the taxation of the foreign (and domestic) commercial segment to raise resources for the public segment.

Along with an appropriate regulatory, governments need also to find appropriate *financing mechanisms to widen access* to health services, which in low-income countries is often restricted for some population segments. Evidence from Cambodia suggests that a system of user fees with subsidies to those in need (e.g. via health equity funds) may represent a possible solution. A more implicit form of cross-subsidy is to require health care personnel to spend a certain period in public hospitals or remote areas, before they can be hired by the private sector. However this type of scheme needs to be carefully designed, as the fairly disappointing experience of the community service programme in South Africa shows.

A root cause of several of the possible negative effects of liberalisation is that *investment in the health sector* of developing countries is often neither sufficient nor efficiently deployed. For example, the problem of two-tiering in health care is mainly due to poor domestic factors such as low wages, poor working conditions and infrastructure in the public sector. This allows the private sector to attract skilled personnel, providing better pay and work equipment. The implication of such situations is that more resources should be allocated both to train a larger pool of health professionals and to improve their working conditions in the public sector (especially in rural areas). This is likely to involve considerable financial and organisational efforts in most developing countries (e.g. by revamping management procedures to increase efficiency).

Temporary movement of persons (Mode 4) [7]

Trade in services via Mode 4 is an increasingly important component of services exports for developing countries. This type of trade can benefit countries through remittances, return migration and by filling specific skill gaps, although concerns about brain drain remain. Several regulatory barriers still restrict much of trade via Mode 4. In order to reap full benefits from mode 4 trade, developing countries could: enhance their lobbying efforts to reduce these barriers in other countries; reduce their own barriers in areas where skills are scarce; and implement complementary policies, such as expanding the skill base and creating incentives for return.

Trade in services via the temporary movement of natural persons (or via Mode 4) may help developing countries exploit their comparative advantage in semi-skilled and unskilled labour and for some developing countries specialised skilled labour as well. This is an increasingly important component of services exports for many developing countries, which send abroad a number of different service providers, such as nurses, teachers, domestic workers, as well as more skilled ones, such as medical doctors, architects, engineers. This allows countries to receive remittances, which are the largest source of external capital in many developing countries, and to benefit from enhanced skills and resources of return migrants (in case migration is truly temporary). On the other hand data show that *skilled* individuals are more likely to emigrate, thus raising concerns about 'brain drain' for exporting countries.

These flows are mainly South-North, although South-South Mode 4 trade is increasingly important. The latter constitutes an effective way for developing countries to fill some of the gaps in specific skills via the temporary import of service providers. For example the number of foreign nurses in Botswana is roughly equal to that of Batswana nurses abroad, suggesting that imports of nurses in Botswana are helping mitigate the potential negative effects of migration on domestic capacity.

How restrictive regulation limits Mode 4

Mode 4 trade is still limited relative to its potential due to a number of regulatory barriers posed by countries with the aim of protecting domestic labour markets and of satisfying security concerns fuelled by substantial immigration. These barriers include *immigration rules, discriminatory treatment of foreign providers* and *recognition of qualification*. Virtually all countries impose *quantitative restrictions* on temporary migration and the quotas are usually substantially lower than the actual demand for entry. An example of this is the US quotas for H1B visas (for professional service providers) provided in the box. Rigid restrictions often apply to South-South migration as well. *Economic needs tests* are required by most countries in order to grant a work permit for a temporary supply of service. Such tests require a prior thorough search within the domestic market for a similar services supplier before accepting the visa application. A further barrier relates to the *wage parity requirement* between services providers, which countries sometimes impose on domestic employers. This often erodes the cost advantage of employing foreign suppliers, especially from developing countries, who may be willing to provide the service at a lower cost than domestic suppliers. Residency or even citizenship *requirements* are pre-requisite for services provision in several countries. These requirements clearly penalise foreign providers often making Mode 4 supply not viable. Finally, inadequate *recognition of formal qualification* and training may constrain the ability of certain service suppliers to provide their service abroad. Examples of this type of constraint abound both among developed and developing countries. For example South Africa requires a fairly cumbersome procedure in order to register as an engineer or an architect holding a related degree from other SADC countries. The implementation of mutual recognition agreements (MRAs) may facilitate this process especially in the context of regional trade agreements.

Further liberalisation of Mode 4 trade is constrained in developed (and often in developing) countries by security concerns (as in the case of recent restrictions in the number of H1B visa granted by **the** US), which tend to increase public opposition to immigration, fears about loss of jobs and lower wages etc.

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Box: Regulatory restrictions to Mode 4: the case of US H1B Visa

The H1B visa is the main US scheme for the temporary import of highly skilled professionals. The scheme was introduced in 1990 to allow US firms fill gaps in highly skilled jobs, which were not domestically available. Given the success of the programme (especially for computer-related jobs), the yearly quota of employer-sponsored immigrants grew rapidly from 65,000 to 195,000 at the beginning of the this decade. Once the programme became established, the cap was easily fulfilled with the number of applications far exceeding it. Following increased security concerns the cap visas was taken back to the initial level of 65,000 in 2003 (under which the US could not go due to its commitments in GATS). This new quota appears to be inadequate relative to the potential Mode 4 import of US of highly skilled services. The US Citizenship and Immigration Services currently receive the full quota of applications from companies various months in advance of the beginning of the financial year

Policy implications

Compared to permanent migration, the available evidence suggests that the benefits (in terms of remittances and return migration) of temporary migration through Mode 4 trade are higher, and the costs (in terms of loss of domestic capacity and gaps in domestic skills) are lower. Estimates show that an increase in OECD countries quotas equivalent to 3% of the total labour supply in importing countries would generate a rise in world welfare of US$156 billion, which would mainly accrue to developing countries. Developing countries could *lobby to lift barriers* in importing countries, in developed and developing countries alike. It is important that the latter also *recognise the importance* of this trade in filling their own economy's skill gaps in certain areas.

Complementary policies in exporting countries are often crucial in ensuring that positive potential effects materialise. Evidence indicates that the brain drain appears to have a negative impact on countries where the share of skilled migrants in total skilled population is high. A clear implication is that countries need to *expand the human capital base* in those professions whose services they are likely to export. The Philippines are a good example of creating these types of skills. Accredited training institutions for nurses have more than doubled between 1999 and 2006, with the private sector helping a rapid scaling-up of the education capacity. India has been doing the same with IT workers. The involvement of the private sector would require an effective education regulatory body (to oversee the quality) and a fairly open competition regime in the educational sector. Developed countries may also have the incentives to fund training facilities in developing countries as an effective way to improve their own access to skilled workers.

Developing countries need to *create incentives* for migrants' return in order to fully benefit from their skills. Policies such as the active institutional management of migration and systems that allow a returning skilled migrant to rejoin her industry at a level appropriate for her experience may help create these positive incentives. A relatively successful example of this is the Philippine Overseas Employment Administration, which was created in 1995 to promote the return and reintegration of migrants. This institution grants several privileges to returnees, including tax-free shopping for one year, loans for business capital at preferential rates and eligibility for subsidized scholarships. *Effective co-operation* between exporting and importing country is also crucial to increase the number of migrants returning. Co-operation may involve bonding schemes, where part of the wage of the temporary migrant could be paid upon return, or in an account based in the home country.