



EXPERIENCE OF THE BALTIC STATES

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Promoting Trade in Services

EXPERIENCE OF THE BALTIC STATES



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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

In recent years, the service sector has made a growing contribution to output and employment in most countries, and international trade in services has expanded rapidly. The Baltic States, like other countries that were formerly saddled with centrally planned economies, remained largely unaffected by the dynamic growth of the service sector until they undertook market reforms. Modernisation of the service sector and the expansion of international trade in services have become important elements of the reform process in the three countries. With small, open economies and limited natural resources endowments, the governments of the Baltic countries assigned a particularly important role to development of service industries. Their experience in rapidly overcoming the initial economic setback of the early transition period and promoting the development of services in their domestic economies and foreign economic relations provide valuable insights and lessons for other transition or developing countries facing similar challenges.

The analysis of the Baltic countries' experience reveals critical policy ingredients that have contributed to the rapid growth of service industries and the expansion of trade in services. It shows, in particular, the necessary interaction between autonomous liberalisation pursued by national authorities and multilateral and regional liberalisation commitments. Whereas the accession of the Baltic countries to the WTO essentially consolidated the liberalisation measures that were already underway and improved overall policy coherence, the EU accession process has succeeded in furthering liberalisation and regulatory harmonisation. The stronger impact of EU-related disciplines is due to more detailed and comprehensive regulatory guidelines and to the close monitoring procedures associated with the implementation of EU commitments.

This study summarises the work carried out by the Trade Directorate in 2000 within the Baltic Regional Programme of the OECD Centre for Co-operation with Non-Members. The project included a number of specific studies prepared by the OECD Secretariat and by consultants, mostly from the Baltic countries. It also greatly benefited from discussions with Baltic trade officials in several meetings that took place in Tallinn and in Paris. The final draft of this study was co-ordinated by Mrs. Blanka Kalinova with helpful contributions and comments of her colleagues of the Trade Directorate, especially Mr. George Holliday.

The volume is published under the responsibility of the Secretary-General.

Eric Burgeat
Director
Centre for Co-operation with non-Members

TABLE OF CONTENTS

Executive Summary.....	9
<i>Chapter 1</i> Development of the Service Sector in the Baltic States	13
Economic Role of Services	14
Trade in Services	19
Main Trends	19
Foreign Direct Investment in Services	24
New Trends in Services Development	26
References	30
<i>Chapter 2</i> Business Environment for Trade in Services	31
Introduction	32
Results of OECD Business Surveys	32
Access to Information, Transparency and Consultations with the Business Community	32
Issues Related to Commercial Presence.....	36
Transport, Telecommunications, Financial and Customs Services	37
Movement of Natural Persons	39
Government Procurement.....	40
Other Problems.....	41
External Barriers to Trade in Services.....	42
Concluding Remarks on the Results of the OECD Business Surveys.....	44
International Comparisons.....	45
Notes.....	48
References	49
<i>Chapter 3</i> The Role of Regional and Multilateral Disciplines in Services Trade Liberalisation	51
Introduction	52
The Baltic States' GATS Commitments	52
General Issues Related to Measuring Trade Liberalisation in Trade in Services	52
MFN Exemptions	54
Horizontal and Sector Specific Commitments	54
Cross-country Comparisons of GATS Commitments	57
Concluding Remarks on GATS Commitments	58
Services Trade Liberalisation within Regional Integration Agreements.....	58
Main Provisions of the Europe Agreements Regarding Trade in Services	59
Impact of Regional and Multilateral Disciplines on Services Trade Liberalisation.....	60
Experience of the Baltic States with Managing Multilateral Negotiations	61
Estonia	62
Latvia.....	63
Lithuania.....	63
Comparison with OECD Member Countries.....	64
Notes.....	74
References	75

<i>Chapter 4 The Economic and Regulatory Environment for Services: A Sectoral Perspective...</i>	77
Introduction	78
The Banking Sector	79
The Creation of a Two-Tier Banking System	80
The Impact of the Banking Crises in the Region.....	81
Main Characteristics of the Banking Sector	82
Regulatory Framework.....	84
Impact of Multilateral and Regional Disciplines.....	85
Telecommunications.....	87
Current Situation in the Telecommunications Sector	87
International and Regional Commitments in Telecommunications	89
Liberalisation and Privatisation Processes in Telecommunications	90
Regulatory Bodies and their Status	93
Concluding Remarks	96
The Electricity Sector	96
Electricity Sectors in the Baltic States.....	97
Market Structure.....	98
Domestic Policy and Legal Framework	99
Regulatory Environment	100
Multilateral and Regional Disciplines Relevant for the Electricity Sector.....	102
The Common Baltic Electricity Market	104
Concluding Remarks	105
Airfreight	106
Recent Trends in the Airfreight Sector.....	106
Liberalisation Strategies in the Airfreight Sector	108
International, Regional and Sectoral Disciplines and Commitments	111
Future Challenges.....	112
Concluding Remarks	113
Notes.....	115
<i>Chapter 5 Market and Trade Liberalisation in Services: The Baltic States' Experience</i>	117
Introduction	118
Market Development Strategies for Services	119
The Regulatory Framework for Services.....	119
The Potential Impact of Regulatory Policies.....	120
OECD Regulatory Reform Reviews	121
The Role of Regulatory Agencies	122
Benefits of Services Trade Liberalisation	124
The Role of Regional Integration and Co-operation in the Area of Services.....	126
Pros and Cons of Regional Integration in Services	126
Regional and Multilateral Commitments of the Baltic States in the Area of Services.....	128
The EU Impact on the Regulatory Framework for Services in the Baltic States	129
Implementation of the EU Acquis Communautaire	129
Recent Changes of the EU Acquis Communautaire.....	130
Implementation of the Acquis Communautaire by the Baltic States.....	131
Intra-regional Co-operation within the Baltic States.....	133
References	135

<i>Chapter 6 Lessons from the Baltic States' Experience and Policy Proposals</i>	137
Main Lessons from the Baltic States' Experience.....	138
Policy Proposals for Further Development in Trade and Services.....	140

Tables

Table 1.1 Shares of Major Sectors in GDP in the Baltic Countries, 1993-2002	14
Table 1.2 Employment by Major Sectors and Services, 1997-2002	15
Table 1.3 Shares of Services Sectors Gross Value Added (GVA) and Employment.....	17
Table 1.4 Labour Productivity, 2000.....	18
Table 1.5 Selected Indicators of Services Trade in the Baltic States, 1993-2001	20
Table 1.6 Trade in Services of the Baltic States: Geographical Structure.....	21
Table 1.7 Revealed Comparative Advantage Index of the Baltic States (1994-2001).....	24
Table 1.8 Total Foreign Direct Investment in the Baltic States	25
Table 1.9 Foreign Direct Investment in the Service Sector of the Baltic States.....	25
Table 1.10 Major Investing Countries in the Service Sector of the Baltic States 2000.....	26
Table 1.11 Results of the European Innovation Scoreboard 2002	28
Table 1.12 Selected Indicators	29
Table 2.1 Evaluation of the Economic and Business Environment in the Baltic Countries.....	47
Table 3.1 MFN Exemptions	54
Table 3.2 Comparison of GATS Commitments in Mode 1, Mode 2 and Mode 3	57
Table 3.3 Comparison of Sectoral GATS Commitments in Market Access	58
Table 3.4 Main Aspects of Intra-governmental Co-ordination and Consultations.....	64
Table 4.1 Development of the Banking System in the Baltic States	80
Table 4.2 Banking Crisis in the Baltic States	82
Table 4.3 Main Characteristics of the Banking Sector in the Baltic States.....	83
Table 4.4 Regulation and Supervision of Banks in the Baltic States (1999).....	86
Table 4.5 Telecommunications Sector in the Baltic States	88
Table 4.6 Mobile Operators in the Baltic States.....	89
Table 4.7 Foreign Investment in the Baltic States, Mobile Market.....	89
Table 4.8 Incumbent Operators in Baltic States	93
Table 4.9 Foreign Investment in Baltic States, Fixed Telephony Market.....	93
Table 4.10 Regulatory Institutions in Telecommunications in the Baltic States.....	95
Table 4.11 National Regulatory Authorities (NRA) in the Baltic States.....	95
Table 4.12 Telecommunications Prices in the Baltic States.....	95
Table 4.13 Electricity Generation and Consumption in the Baltic States, 1992-2001	97
Table 4.14 Electricity Exports and Imports in the Baltic States, 1992-2001.....	97
Table 4.15 Main Characteristics of Foreign Trade of the Baltic Countries.....	107
Table 5.1 Regulatory Agencies in the Baltic States	124

Figures

Figure 1.1 Services Employment in Total Employment	16
Figure 1.2 Trade in Services of the Baltic States, 1997 - 2002	19
Figure 1.3 Trade in Services by Sectors in the Baltic States, 1994 and 2001 (EURO millions). 22	
Figure 2.1 Availability of Up-to-Date Information on Governmental Policies.....	33
Figure 2.2 Information on Changes in Regulations.....	33
Figure 2.3 Main Sources of Information on New Government Regulations.....	34
Figure 2.4 Government Regulations Not Consistent with Business Interests	34
Figure 2.5 Consultations with Business Entities Prior to Introducing New Laws	35

Figure 2.6 Overall Government Programme for Regulating Service Sectors	35
Figure 2.7 Restrictive Licensing Procedures	36
Figure 2.8 Ineffective Appeals and Arbitration Procedures	36
Figure 2.9 Inadequate Infrastructure	37
Figure 2.10 Inefficiency of Regional Transport Services.....	38
Figure 2.11 Difficulties in Obtaining Bank Credits	38
Figure 2.12 Expensive Red Tape.....	41
Figure 2.13 Existing Government Incentives to Promote SMEs' Activities.....	41
Figure 2.14 Barriers to Entering Export Markets	42
Figure 2.15 Insufficient Market Openness in Export Market Country.....	43
Figure 2.16 Inadequate and Untimely Information on Requirements in Export Market.....	43

Annex Tables

Annex Table 3.1 Slovenian GATS Commitments, by Type of Limitation	66
Annex Table 3.2 Slovenian GATS Commitments, by Service Sectors.....	67
Annex Table 3.3 Estonian GATS Commitments, by Type of Limitation	68
Annex Table 3.4 Estonian GATS Commitments, by Service Sectors.....	69
Annex Table 3.5 Latvian GATS Commitments, by Type of Limitation.....	70
Annex Table 3.6 Latvian GATS Commitments, by Service Sectors	71
Annex Table 3.7 Lithuanian GATS Commitments, by Type of Limitation.....	72
Annex Table 3.8 Lithuanian GATS Commitments, by Service Sectors	73

Boxes

Box 1.1 Statistics on Trade in Services	23
Box 2.1 Work Permit Regulations in the Baltic States.....	39
Box 2.2 Public Procurement Laws in the Baltic States	40
Box 3.1 The General Agreement on Trade in Services (GATS).....	53
Box 4.1 The EU <i>Acquis Communautaire</i> in the Banking Sector	85
Box 4.2 The EU <i>Acquis Communautaire</i> in the Telecommunications Sector	90
Box 4.3 The EU <i>Acquis Communautaire</i> in Electricity.....	103
Box 5.1 Measuring the Impact of Services Trade Liberalisation	125
Box 5.2 Measuring Trade Restrictions in Services	126
Box 5.3 The EU <i>Acquis Communautaire</i>	130

EXECUTIVE SUMMARY

In 2000, the Trade Directorate launched a project on trade in services within the Baltic Regional Programme of the OECD Centre for Co-operation with Non-Member Countries (CCNM). The project encompassed various research studies, prepared by the OECD Secretariat and consultants, and several meetings in Tallinn and Paris with Baltic trade officials. The work focussed on the external and internal obstacles that inhibit the full exploitation of comparative advantages in the service sector and on the economic and regulatory environment for trade in services in the Baltic region. At the outset, the programme addressed broader policy implications, such as the **relevance of the Baltic countries' experience for other transition economies** and, more generally, the effects of the interaction between multilateral trade liberalisation and domestic regulatory policies on the development of the service sector. This publication summarises the work carried out in the project and draws policy proposals for promoting the service sector and expanding trade in services in the Baltic countries as well as in a larger context of transition economies.

Recent developments in the Baltic countries' service sector and trade have been in many respects exemplary. Rapid privatisation and domestic liberalisation enabled them to overcome, in a short lapse of time, the backwardness of their service sector that was inherited from the Soviet system. The expansion and modernisation of the service industry have been facilitated by **external opening**, underpinned by the **acceptance of multilateral and regional disciplines**. Both multilateral commitments within the General Agreement on Trade in Services (GATS) and EU-related rules have played a similar role. They contributed to the quality, transparency and coherence of the legal and regulatory system as well as its efficient enforcement. They have also helped national authorities maintain a trade liberalisation policy stance against domestic protectionist pressures. However, except in some sectors, such as telecommunications and financial services, where multilateral disciplines were reinforced, regulatory guidelines are generally less developed in the multilateral context than in the regional framework. As a result, regional disciplines embodied in the Europe Agreements and those resulting from the adoption of EU regulations have exerted a stronger impact on individual service sectors in the Baltic States. Their experience thus provides valuable insights for assessing various elements of development strategy, notably the role of autonomous liberalisation and external opening.

Available statistical data on the service sector confirm its growing contribution to the national economies of the three Baltic countries, measured by the **increasing shares of services in both GDP and employment**. The sectoral structure of GDP and employment in the region is now similar to that observed in many OECD countries. In parallel, between 1995 and 2000, labour productivity in the service sector grew relatively rapidly in the Baltic States, though in general their overall average remains below that of EU-15 countries. **Trade in services** of all three countries also developed rapidly after 1992 and became an important vehicle for their integration into the world economy. In line with the generally observed trends, the share of services in their total trade increased to a level comparable to most OECD countries. Since 1997, the three countries have recorded surpluses on their services trade accounts that partially offset their merchandise trade deficits. Within the region, Estonia is the largest service exporter and importer and has the highest services surplus. Another general trend reflecting the growing importance of services is their increasing share in foreign direct investment inflows, dominated by the neighbouring Scandinavian investors.

The dynamic development of the service sectors in the Baltic States has been made possible thanks to the improvement in the general **economic and regulatory environment for service firms**. Compared to the first regional surveys carried by the OECD in 1995, the three business surveys

commissioned in the region in 2001 found that the majority of respondents considered that previously serious trade-inhibiting problems were no longer relevant or had been significantly alleviated. For instance, infrastructure services are more readily available and of better quality; transparency in the legal and regulatory system has improved; and complaints about ill-adapted laws and regulations significantly decreased. The main issue raised by respondents was that prior consultation procedures between the governments and the business community are not yet sufficiently developed. The remarkable improvement in business conditions for service providers in the Baltic region is also confirmed by a number of international comparisons and available indicators assessing the business climate and the progress of reforms in various countries.

Since their accession to the WTO, the Baltic States have actively participated in the multilateral trading system and, as candidates to the EU accession, they have been directly involved in this major regional economic integration initiative. Although the analysis of **GATS commitments**, based on countries' national schedules, gives a limited indication of the extent of countries' opening, it provides a basis for an international comparison of disciplines accepted by different countries. Within the framework of the OECD project, the Baltic countries' GATS schedules were compared to the national schedule of Slovenia, which acceded to the WTO/GATS before the Baltic States. This comparison reveals that the scope and depth of GATS commitments undertaken by Slovenia is considerably lower than that of the Baltic States. Their more ambitious GATS commitments cannot be explained only by the different timing in submitting their national schedules. The more positive attitude towards liberalisation reflects the region's efforts to accelerate the process of modernisation and improve labour productivity in the service sector by encouraging greater international competition through a more open regime for trade and foreign direct investment.

The Baltic States participate in several regional agreements. **The Europe Agreements (EAs)** concluded in 1995 with the European Communities have been the most far-reaching initiative, providing a framework for the gradual integration of candidate countries into the EU. The EAs provisions cover a large number of areas and disciplines, which go beyond current international disciplines, including in the area of services. They entail gradual liberalisation in cross-border supply of services, the right of establishment of EU firms, national treatment in setting up operations of subsidiaries and branches of EU companies, as well as temporary movement of specified categories of natural persons.

Several factors explain why the EU accession process, based on the acceptance of the EU rules and disciplines designated as *the EU **acquis communautaire***, has played such a key role. First, the adoption of the EU regulations has been a high political priority in all candidate countries. Second, the EU commitments cover a larger spectrum of disciplines than GATS obligations and, in contrast to the multilateral system, they encompass stricter regulatory guidelines. Finally, the EU accession process relies on a regular and efficient monitoring mechanism that controls the progress made in adopting the requested disciplines.

The project on the Baltic States also considered their **experience in managing multilateral trade negotiations**. A survey based on a common questionnaire reviewed the experience that OECD and certain developing countries had with intra-governmental co-ordination and consultations with domestic stakeholders when preparing international trade negotiations. As other transition countries, the Baltic States had to handle simultaneously complex negotiations on the multilateral and regional levels with limited administrative resources. Despite their recent external exposure and limited experience, they have developed well-functioning and efficient procedures especially for co-ordination within the government. In their consultations with the business community, the authorities have nevertheless encountered a relatively limited feedback from many service providers. This attitude of the business community might be attributed to the fact that most companies do not see a clear

relationship between the language of the GATS and their own interests and concerns. Another source of difficulties may be the diversity of interests among different categories of services: some sectors are more interested in opening markets in other countries, while others are primarily interested in protecting their domestic market.

Although most described challenges and problems are common to the entire service sector, any analysis in this area should also address **specific sectoral issues**. To take into account the sectoral heterogeneity of services, the present project focussed on four sectors: telecommunications, banking, electricity and airfreight. Multilateral disciplines within the GATS and regional regulatory guidelines have been stronger in telecommunications and banking, partly because of their economic weight and importance for general economic development. In **telecommunications**, the Baltic countries rapidly privatised important segments of the sector, attracted large foreign direct investment inflows and adopted diligently the regulations complying with EU guidelines. As a result, the Baltic telecommunications operators have been able to benefit from recent exceptional growth opportunities in this sector.

The development of an efficient **financial system** has been an integral part of market economy reforms in all transition countries. This has been a particularly challenging task for the former planned economies, which lacked even basic institutions and legal instruments and had almost no experience with financial intermediation. Despite serious financial crises, the Baltic countries have succeeded in developing well-functioning banking systems that ensure macroeconomic stability and carry out intermediation functions efficiently. Their experience shows the need for overall policy coherence at two main levels. First, there is a need to co-ordinate financial sector related policies within a general economic strategy, especially regarding privatisation and opening to foreign direct investment. Second, the monetary authorities should pursue efficient supervision and make it coherent with entry and exit procedures. The main challenges are to create conditions for competition between state-owned financial institutions and emerging private banks, and also to establish better transparency and credibility of the banking sector.

The energy and electricity sectors have not yet been subject to significant international commitments and disciplines, partly because the governments' withdrawal from dominant ownership in these sectors is quite recent. The main objectives in the electricity sector have been to promote competition and comply with demanding EU regulatory requirements in this area. Although many challenges remain, the sector has been considerably transformed and the regulatory framework adapted to the new economic environment. In parallel, the Baltic countries have pursued their regional co-operation and created the Common Baltic Electricity Market. This initiative is expected to allow further trade expansion, improve the security of electricity supply and promote specialisation and efficiency improvements. In the **air transport sector**, its growing internationalisation contrasts with a still predominantly bilateral approach to managing international relations in this industry. In spite of limited multilateral liberalisation and regional regulatory guidance, airfreight has also undergone considerable transformation in its ownership structure and the domestic regulatory framework.

The Baltic countries' overall development strategy and concrete experience in selected service sectors offer a unique opportunity to assess the **interaction between domestic reforms and trade liberalisation**. Although both processes are closely interrelated and carried out simultaneously, it is important to distinguish between the two concepts. Domestic reforms involve market liberalisation and structural transformations such as privatisation and deregulation, which aim at opening up monopolistic or government-controlled industries to competition. Services trade liberalisation means external opening of the domestic market to foreign services providers. While privatisation and deregulation programmes are primarily the responsibility of individual countries, services trade liberalisation has been pursued under the WTO/GATS auspices. The GATS imposes several basic

principles to be respected by member countries, in particular non-discrimination. It recognises a country's sovereignty in shaping its own regulations, but contains a limited number of regulatory requirements concerning in particular the transparency of regulations and their non-discriminative administration and implementation.

In addition to multilateral and especially EU liberalisation and regulatory disciplines, countries may also decide to co-operate in a narrower **regional framework**. The governments of the Baltic countries decided not to institutionalise their intra-regional integration in the area of services. However, their co-operation has developed both in some specific sectors, such as electricity, and on a horizontal level, for instance in trade facilitation related issues such as customs procedures. Intra-regional co-operation has usually been initiated by the governments and then often reinforced by business community initiatives and sector specific interests. These trends are likely to intensify in the future, due to market conditions of these countries (*i.e.* relatively small national markets), the need to develop a regional strategy for attracting foreign investors and join their efforts to avoid regulatory restrictive practices.

The Baltic States' experience in developing the service economy and in promoting their trade in services suggests **useful lessons for other countries**, especially developing and transition economies that are in an earlier stage of their market and trade liberalisation. Recent developments in the Baltic service sector and trade are also of great interest for the ongoing research and policy debate on potential benefits of external opening and the contribution of multilateral and regional disciplines in designing regulatory policies in the service sector. They confirm in particular the key role of effective domestic regulations and institutional regulatory settings and the need for overall policy coherence, especially between domestic regulatory reform and external opening. The following factors appear particularly determinant: the right sequencing and coordination of domestic reforms and external opening, the importance of multilateral disciplines for consolidating liberalisation achievements and the leading role of regional commitments in providing the regulatory guidance in the service sector. Finally, the case of the Baltic countries also shows that, whereas the interaction of multilateral and regional regulatory disciplines remains critical, it is the determination of national authorities to put in place a business friendly and pro-competitive environment that is the key to success.

Despite the recent dynamic development of their service sector, the Baltic countries now face challenges similar to those of other economies with mature services industries and trade. The key issue is to ensure that liberalisation achievements continue to bring expected economic benefits and that the service sector maintains its efficiency in an increasingly competitive environment. This next stage of development requires continuous efforts for improving a pro-competitive regulatory framework and setting up appropriate regulatory institutions.

Chapter 1

DEVELOPMENT OF THE SERVICE SECTOR IN THE BALTIC STATES

Abstract: Rapid growth of the service sector and its growing contribution to world trade represent important characteristics of the post-war economic development. In recent years, transition economies have had to overcome a major handicap as the share of the service sector in their national economy was generally lower than in other countries at a similar level of development. In addition, their participation in world trade in services was way below their potential. Available data show that during the last ten years the contribution of the service sector to GDP and employment has grown rapidly in the Baltic States. Their integration into international services trade, supported by considerable foreign direct investment inflows into the sector, has also intensified.

Economic Role of Services

The dynamism of the service sector - one of the salient features of world economy and trade as well as an important indicator of the economic level of each country - left most centrally planned economies almost untouched. Due to a traditional preference of former policy makers for “productive” (manufacturing) activities, transition economies inherited an underdeveloped service sector, often unable to fulfill even basic economic functions such as financial intermediation. The beginning of 1990s, when these countries launched radical economic reforms, was marked by important technological and policy transformations in the service sector. In particular, technological progress has changed the scope and operating conditions in many services sectors and brought about significant revisions in public policy regarding ownership and regulation, especially in network industries like telecommunications, energy and transport. The transition economies that have adopted radical and rapid reform strategies have been able to seize the opportunities stemming from recent economic and policy transformations in the service sector.

In the Baltic countries, the contribution of the service sector to GDP and employment has been growing steadily during the last ten years. By 1993, only Estonia recorded a share of services over 60% in its GDP. Between 1993 and 2002, the increase in the proportion of services in GDP was the most impressive in the case of Latvia (a gain of 19 percentage points), followed by Lithuania (17 percentage points). In the three countries, the sectoral shift towards services resulted from considerable reductions in both agriculture and industry (see Table 1.1). After the initial catch up, the share of services in Baltic countries' GDP has stabilised in recent years at levels comparable to most OECD Member countries. In 2002, services played the most important role in Latvia's economy (almost 77% of GDP), followed by Estonia (almost 72%) and Lithuania (close to 69%).

Table 1.1 Shares of Major Sectors in GDP in the Baltic Countries, 1993-2002

(In % of GDP at Current Prices)

Estonia	1993	1995	2000	2001	2002
Agriculture and fishing	11.1	8.7	6.1	5.6	5.4
Industry	25.9	24.6	22.4	22.5	22.7
Service sector	63.0	66.7	71.5	71.9	71.9
• Construction	6.4	6.4	6.1	6.2	6.6
• Wholesale, retail trade, hotels	16.6	16.1	15.4	15.4	15.9
• Transport and communication	12.9	10.9	16.2	16.4	15.5
• Financial services	11.6	13.9	15.1	15.7	15.8
• Other services	15.5	19.5	18.7	18.2	18.1
Latvia					
Agriculture and fishing	11.8	10.8	4.9	4.7	4.7
Industry	30.7	28.1	18.6	18.7	18.6
Service sector	57.5	61.1	76.5	76.6	76.7
• Construction	4.3	5.1	6.7	6.1	6.1
• Wholesale, retail trade, hotels	9.6	12.4	19.2	20.1	21.1
• Transport and communications	23.1	16.0	15.4	15.5	14.5
• Financial services	7.8	9.9	15.8	16.0	15.7
• Other services	12.7	17.7	19.4	19.0	19.3
Lithuania					
Agriculture and fishing	14.2	11.7	8.0	7.2	7.2
Industry	34.2	26.1	24.3	25.4	24.2
Service sector	51.6	62.2	67.7	67.4	68.6
• Construction	5.1	7.1	6.0	6.1	6.5
• Wholesale, retail trade, hotels	15.3	19.3	18.1	19.1	19.6
• Transport and communications	9.8	9.4	12.5	12.6	13.7
• Financial services	11.5	10.5	10.7	10.6	10.4
• Other services	9.9	15.8	20.4	19.0	18.4

Source: CANSTAT Statistical Bulletin 2003/1 (Review of socio-economic indicators published jointly by EU candidate countries).

In parallel, employment in services has also developed rapidly, reaching over 68% of total employment in Estonia and almost 62% in Lithuania in 2002. In addition to the decline of employment in agriculture, the shift from industrial employment in favour of services was particularly substantial in Latvia (see Table 1.2). In Estonia, which reports the highest proportion of employment in services, the level is comparable to Finland and higher than in some other transition economies, such as the Czech Republic, Hungary and Poland. Compared to the sectoral employment structure in OECD countries, Estonia's distribution is very close to the one observed in Finland. In both countries, service employment represents more than two-thirds of total employment, followed by industry with approximately 25%. Lithuania's sectoral employment is close to that of Greece, and to a lesser extent to Poland, which has a similar proportion of the population working in agriculture (more than 18%), but proportionally more people employed in industry than Lithuania.

Table 1.2 Employment by Major Sectors and Services, 1997-2002

(In % of total employment)

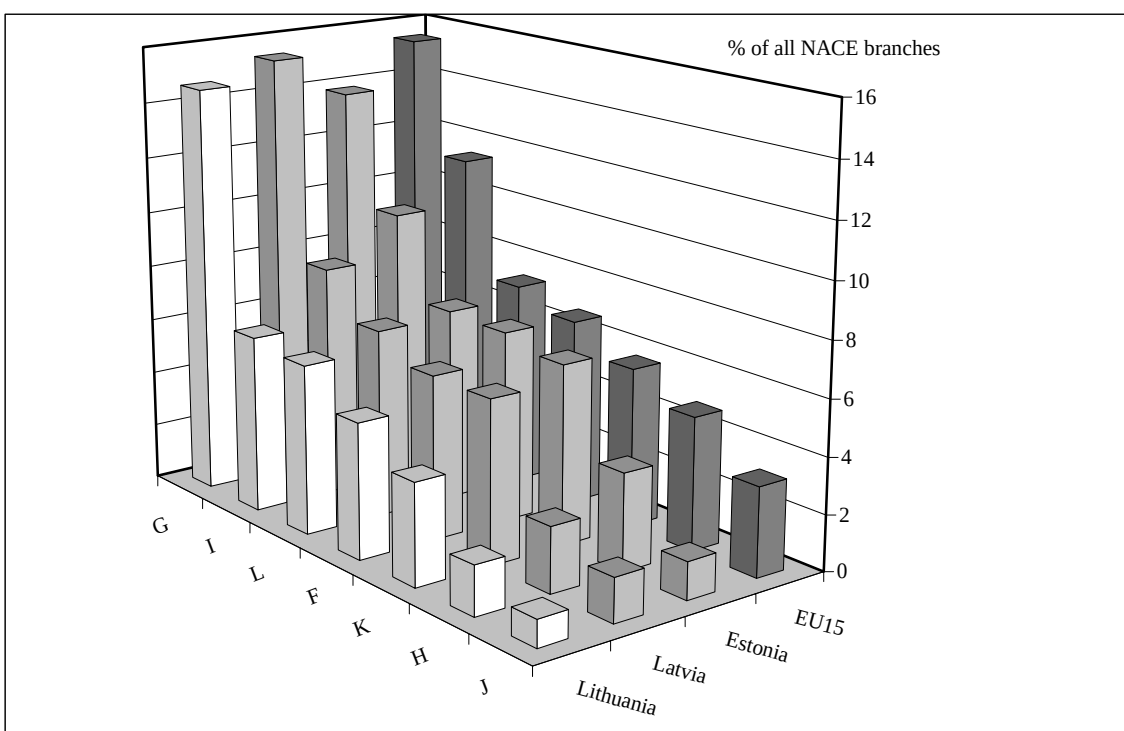
	1995	1997	2000	2001	2002
Estonia					
Agriculture	10.2	9.2	7.2	6.9	6.9
Industry	28.8	26.0	26.5	26.3	24.8
Services	61.0	64.8	66.3	66.8	68.3
• Construction	5.5	7.2	7.0	6.9	6.7
• Wholesale, retail trade, hotels and restaurants	15.3	16.2	17.4	17.6	17.9
• Transport, storage and communications	10.1	9.2	10.0	9.4	9.3
• Real estate, renting and business activities	4.9	5.5	6.9	6.4	7.5
• Financial intermediation	1.1	1.1	1.4	1.2	1.4
• Other services	24.1	25.6	23.6	25.3	25.6
Latvia					
Agriculture	7.5	21.5	14.5	15.1	n.a.
Industry	25.9	20.6	20.4	18.3	n.a.
Services	66.6	57.9	65.1	66.6	n.a.
Construction	5.0	5.2	6.0	7.1	n.a.
• Wholesale and retail trade, hotels and restaurants	12.5	15.0	17.7	18.9	n.a.
• Transport, storage and communications	10.7	8.3	8.4	8.1	n.a.
• Real estate, renting and business activities	4.6	2.7	4.8	4.3	n.a.
• Financial intermediation	1.7	1.1	1.3	1.5	n.a.
• Other services	32.1	25.6	26.9	26.7	n.a.
Lithuania					
Agriculture	23.8	21.8	18.7	17.3	17.8
Industry	21.2	20.0	20.8	20.8	20.9
Services	55.0	58.2	60.5	61.9	61.3
• Construction	7.0	7.1	6.0	6.3	6.6
• Wholesale and retail trade, hotels and restaurants	14.0	16.4	16.3	17.1	17.0
• Transport, storage and communications	5.8	5.7	6.5	6.4	6.2
• Real estate, renting and business activities	3.0	3.2	3.1	3.0	3.9
• Financial intermediation	1.2	1.0	1.0	0.8	1.0
• Other services	24.0	24.8	27.6	28.3	26.6

Note: n.a.- data not available.

Source: National statistical offices.

Figure 1.1 shows the relative importance of individual service sectors in total employment in the Baltic countries compared to the EU average. Whereas both groups of countries have similar shares in wholesale and retail trade, public administration and construction, the Baltic countries employ proportionately fewer people than the EU-15 in transports, hotel and restaurants as well as in financial intermediation. Measured in terms of gross value added (GVA) and employment (Table 1.3), wholesale and retail trade and transport, storage and communications are the largest service sectors in the Baltic countries, representing more than 40% of GVA in services and more than one-third of total service employment in 2001. Between 1998 and 2001, the share of construction in GVA decreased in all three countries and, with the exception of Latvia, it also diminished in employment. The contribution of transport, storage and communications to GVA became more important in Estonia and Lithuania, though employment in this sector remained proportionately stable (in Estonia) or even decreased (in Lithuania). In Latvia, the importance of transport and communications decreased both in terms of their shares in GVA and employment. In 2001, financial services represented 6% of GVA in services and approximately 2% of employment in services in Estonia and Latvia, but less than 4% of GVA and below 2% of service employment in Lithuania.

Figure 1.1 Services Employment in Total Employment



Notes: F refers to construction; G refers to wholesale and retail trade, repair of motor vehicles and personal and household goods; H refers to hotels and restaurants; I refers to transport, storage and communication; J refers to financial intermediation; K refers to real estate, renting and business activities; L refers to public administration, defence and compulsory social security.

Source: Eurostat, Economy and Finance, National Accounts - Breakdowns (by Branch of Activity).

Table 1.3 Shares of Services Sectors in Gross Value Added (GVA) and Employment

	GVA		Employment	
Estonia	1998	2001	1998	2001
Services total	100	100	100	100
• Construction	9.5	8.3	11.2	10.2
• Wholesale and retail trade	21.2	19.9	21.6	21.7
• Hotels and restaurants	1.8	2.0	3.5	4.5
• Transport, storage and communication	20.3	23.0	13.9	13.9
• Financial intermediation	5.1	6.0	2.0	1.8
• Real estate, renting and business activities	15.9	15.8	9.5	9.9
• Other services	26.2	25.0	38.3	38.0
Latvia				
Services total	100.0	100.0	100.0	100.0
• Construction	9.4	8.1	9.2	10.9
• Wholesale and retail trade	23.2	24.5	24.6	24.0
• Hotels and restaurants	1.7	1.7	3.0	3.5
• Transport, storage and communication	23.0	20.0	13.4	12.4
• Financial intermediation	5.0	6.0	2.0	2.2
• Real estate, renting and business activities	10.7	14.9	5.8	6.5
• Other services	27.0	24.8	42.0	40.5
Lithuania				
Services total	100.0	100.0	100.0	100.0
• Construction	13.2	9.4	12.2	10.0
• Wholesale and retail trade	24.7	24.0	25.1	25.0
• Hotels and restaurants	2.1	2.1	2.6	3.0
• Transport, storage and communication	14.5	19.2	10.1	9.8
• Financial intermediation	3.5	3.8	1.5	1.6
• Real estate, renting and business activities	11.7	12.3	5.8	6.0
• Other services	30.3	29.2	42.7	44.6

Source: National statistical offices.

Table 1.4 provides data on recent developments in labour productivity in the Baltic States, measured in terms of output (GVA) per unit of labour (number of persons), expressed in (thousands) purchasing power standards (PPS). This indicator allows comparison across countries and sectors. It shows, in particular, that in 2000, the Baltic countries achieved the highest productivity in two sectors: financial services (Estonia and Latvia) and real estate (Lithuania). However, despite a relatively rapid growth of labour productivity between 1995 and 2000 (especially in construction, transport and communications and also in financial services), the level of labour productivity in the Baltic countries remains below the average level of other EU candidate countries overall as well as in most individual services sectors. The only sectors where the Baltic countries achieved (in 2000) a productivity level higher than, or close to, the average productivity level of other EU candidate countries were financial services (in case of Estonia and Latvia) and transport and communications (in case of Lithuania).

Table 1.4 Labour Productivity, 2000

Branch	Estonia		Latvia		Lithuania		EU candidates average
	GVA/employment (in thousands PPS per person employed)	Growth 1995-2000 (constant prices) %	GVA/employment (in thousands PPS per person employed)	Growth 1995-2000 (constant prices) %	GVA/employment (thousands PPS per person employed)	Growth 1995-2000 (constant prices) %	GVA/employment (in thousands PPS per person employed)
Agriculture	16	0	4	-6	6	12	10
Manufacturing	14	46	12	26	19	19	20
Utilities	23	-15	31	-9	27	-25	53
Construction	15	44	15	56	16	-7	20
Trade & repair	19	28	15	66	16	21	20
Hotels & restaurants	7	56	7	31	12	43	16
Transport and communication	28	58	27	27	31	37	30
Financial services	57	35	42	9	37	11	45
Real estate	29	30	26	69	41	30	52
Public goods	15	8	14	16	24	8	28
Education	13	4	9	7	10	13	16
Health and & social	14	12	7	-6	8	15	15
Other	17	25	11	52	10	34	18
Total	18	29	14	26	16	17	22

Notes: PPS: Purchasing Power Standard – the basis of the estimates in PPS are the 1999 European Comparison Programme (ECP) results published by OECD/Eurostat. GDP-level Purchasing Power Parities are used to calculate figures in PPS.

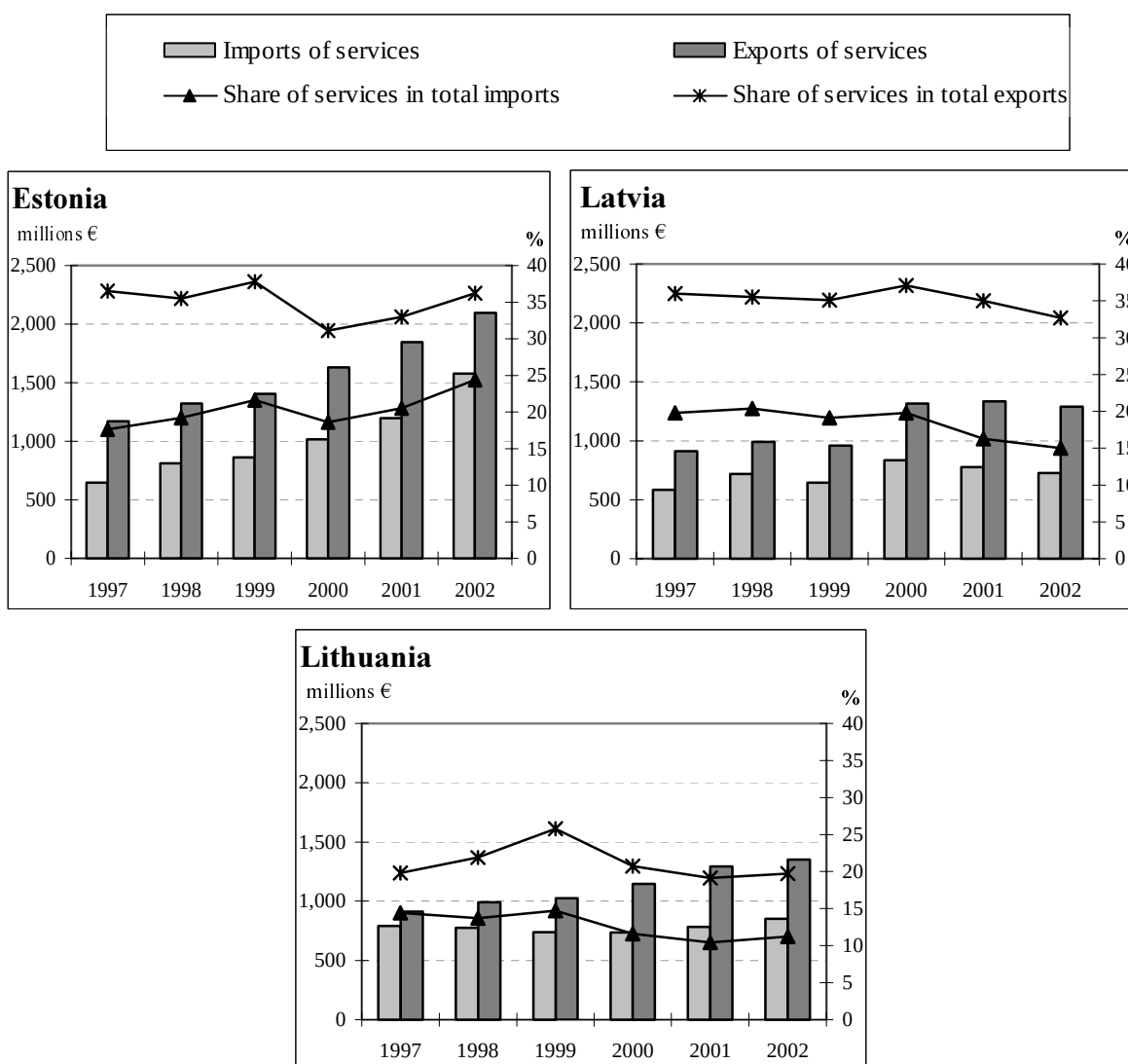
Source: Eurostat, Statistics in focus, Candidate countries' national accounts by industry, Theme 2 -17/2002, EC, 2002.

Trade in Services

Main Trends

Since 1992, the Baltic countries' trade in services has rapidly developed and become an important vehicle of the region's integration into world economy and trade. The three countries have seen the share of services increasing in their total trade to a level comparable to most OECD countries. As a result of a dynamic export growth, they have recorded surpluses in their service accounts, which partially offset their deficit in merchandise trade. Among the three countries, Estonia is the largest exporter and importer of services and also records the highest surplus. In Latvia, trade in services has followed a less regular growth, as service imports decreased in 1999, and once again in 2002. However, the country continues to record an important services trade surplus. Due to steady export growth, Lithuania's services surplus has also regularly increased since 1997 (Figure 1.2).

Figure 1.2 Trade in Services of the Baltic States, 1997 - 2002



Several indicators, summarised in Table 1.5, confirm the favourable development of trade in services in the Baltic countries during the last decade. The services trade-to-GDP ratio, which expresses the importance of international exchange of services relative to domestic output, tends to be higher for small economies and countries situated in a region where open trade regimes dominate, compared to large, relatively self-sufficient or geographically-isolated economies. With over 40% of GDP in 2001, services trade is the most important for the Estonian economy. Latvia's share (over 20% of GDP) is also above the average for Central Eastern European countries, while Lithuania falls slightly behind. For the three countries, the share of services trade in GDP reached peak values in 1997, and decreased in the following years.

The share of net services in total trade indicates to what extent a country can compensate for its deficit in trade in goods by its services trade surplus. For Estonia and Latvia, the shares have decreased since 1995, whereas for Lithuania the share has risen steadily. The steady growth of the net services-to-GDP ratio of Lithuania underscores the positive development of the services sector: the positive balance of trade in services has increased faster than total GDP. The index, calculated as net trade in services divided by total trade in services, shows considerable variation during the observed period. Lithuania was the only net services importer in 1993, but in 2001, its index reached a level similar to other Baltic countries. The indicator is significantly higher for all Baltic economies compared to Central Eastern European countries (Table 1.5).

Table 1.5 Selected Indicators of Services Trade in the Baltic States, 1993-2001

	(ln %)			
	1993	1997	2000	2001
Estonia				
Total Services Trade / GDP	40.8	47.9	42.2	41.5
Net Services Trade / GDP	5.2	13.9	9.3	8.9
Net Services Trade / Total Trade	8.6 ¹	7.6	5.7	5.7
Net Services Trade / Total Trade in Services	12.7	28.9	22.0	21.3
Latvia				
Total Services Trade / GDP	30.2	31.1	27.3	23.5
Net Services Trade / GDP	13.4	6.8	6.1	6.2
Net Services Trade / Total Trade	15.1 ¹	6.0	6.2	6.5
Net Services Trade / Total Trade in Services	44.4	21.9	22.3	26.4
Lithuania				
Total Services Trade / GDP	15.6	20.0	15.5	15.6
Net Services Trade / GDP	-1.9	1.4	3.4	3.8
Net Services Trade / Total Trade	-0.2 ¹	1.2	3.5	3.6
Net Services Trade / Total Trade in Services	-12.2	7.0	21.9	24.6
Memorandum Item: Central Eastern Europe² 2000				
Total Services Trade / GDP	16.8	Net Services Trade / Total Trade		2.2
Net Services Trade / GDP	1.9	Net Services Trade / Total Trade in Services		11.2

¹ 1995

² Czech Republic, Hungary, Poland Slovakia.

Source: UNCTAD, IMF, calculations based on data in USD.

Table 1.6 shows the geographical structure of trade in services of the three countries. The main trend has been the shift from eastern to western partners: Russia, which was still the major market for the Baltic countries in the middle of 1990s, has lost its leading position, especially in case of Estonia and Latvia. For Lithuania, Russia still represented more than 12% of its exports and over 21% of its imports in 2002. In parallel, the EU has become the main export outlet and the main origin of the Baltic countries' imports, with the highest share reached by Latvia (60% of its exports and 53% of its total imports in 2002). The three Baltic countries' trade has a strong regional focus, notably for Latvia. While Finland clearly dominates Estonia's services trade flows, regional distribution seems more balanced in the case of Lithuania.

Table 1.6 Trade in Services of the Baltic States: Geographical Structure

(In %)

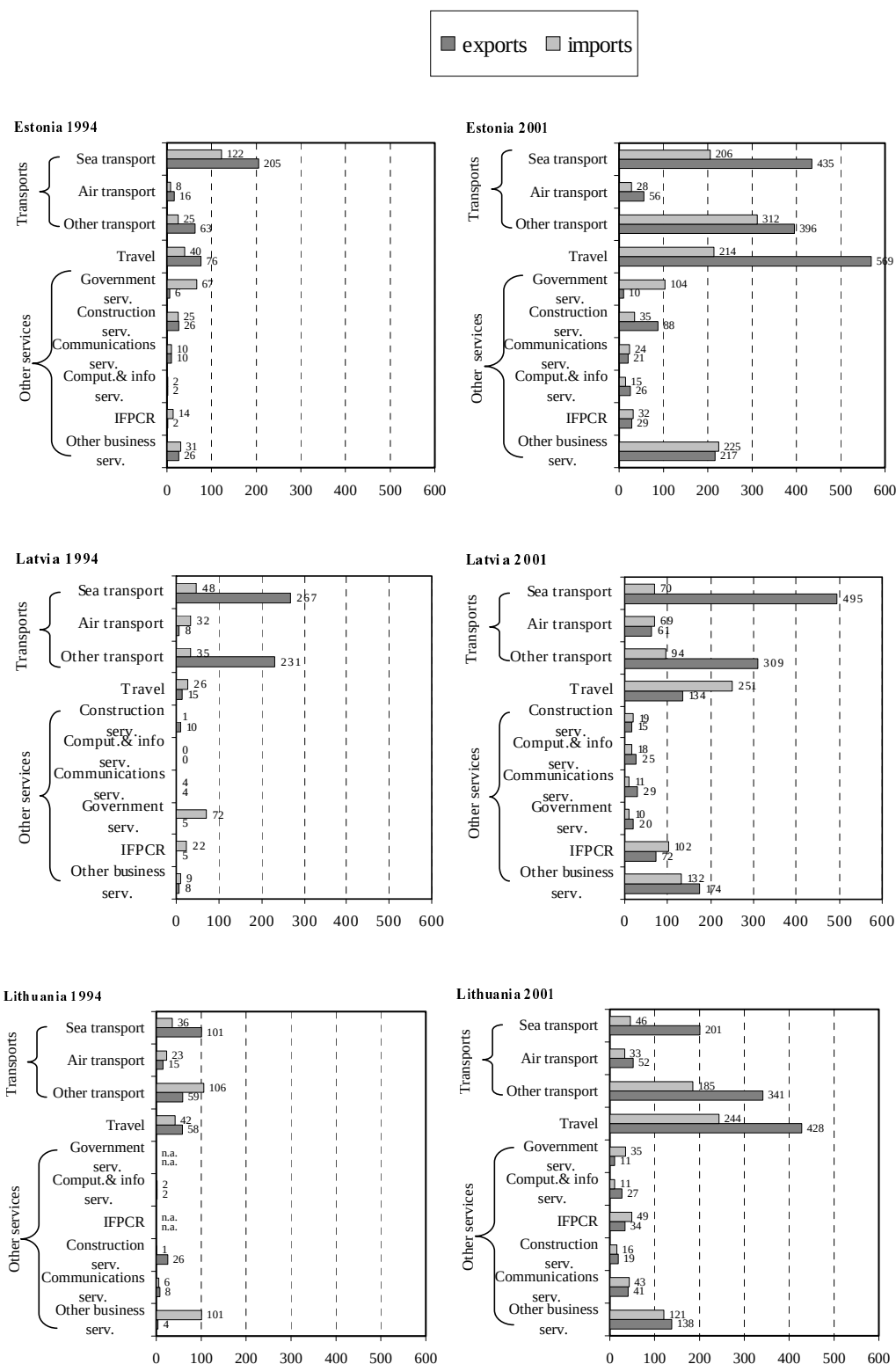
	Exports						Imports					
	1994	1996	1998	2000	2001	2002	1994	1996	1998	2000	2001	2002
Estonia												
Lithuania	5.4	5.7	4.4	2.8	3.0	3.5	2.6	1.6	1.6	1.6	2.6	3.3
Latvia	8.2	8.3	9.4	7.0	6.9	7.4	1.5	1.9	2.1	2.6	2.2	2.4
Russia	23.1	16.5	5.9	2.4	2.7	3.3	n.a.	n.a.	7.8	8.5	8.1	7.4
Sweden	10.8	11.6	20.8	20.5	14.0	15.3	8.9	8.2	10.7	9.9	9.2	9.5
Denmark	3.4	3.5	4.3	3.4	3.5	4.4	2.6	2.8	3.0	2.5	2.5	2.4
Finland	17.9	18.3	23.6	32.3	33.9	24.8	29.9	29.1	25.8	27.4	18.0	17.1
Other Countries	31.2	36.1	31.6	31.5	36.0	45.7	54.5	56.4	48.8	47.5	57.3	57.8
Latvia												
Lithuania	5.5	7.4	7.4	7.6	8.1	8.4	5.9	6.3	6.3	7.6	8.5	9.8
Estonia	2.6	3.7	4.5	5.3	5.7	6.0	3.5	5.7	6.6	6.2	6.3	6.2
Russia	28.1	22.8	12.1	4.2	5.9	5.9	23.6	20.2	11.8	11.6	9.2	8.8
European Union	28.0	45.0	57.0	65.0	61.0	60.0	25.0	49.0	55.0	52.0	53.0	53.0
Other Countries	35.7	21.1	19.0	17.9	19.3	19.8	41.9	18.8	20.3	22.6	23.0	22.2
Lithuania												
Latvia	n.a.	9.2	11.1	15.0	12.6	9.6	n.a.	1.7	1.8	1.6	1.5	1.6
Estonia	n.a.	2.5	2.6	2.3	3.2	3.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Russia	n.a.	24.0	16.5	7.1	11.0	12.2	n.a.	29.0	21.1	27.4	25.3	21.3
European Union	n.a.	32.9	38.0	47.9	47.8	48.4	n.a.	39.8	47.2	43.3	44.0	44.5
Other Countries	n.a.	8.8	31.8	7.8	6.4	25.9	n.a.	29.5	29.8	27.7	29.2	32.6

n.a.-data not available

Source: National statistical offices.

For all Baltic countries, transportation services represent by far the largest and most dynamic import and export items and the main contributor to their trade surplus. Within this category, sea transport dominates in Estonia's and Latvia's trade, whereas Lithuania specialises in other transportation services. Travel, which has also recorded rapid growth, is the second largest service category in Estonia and Lithuania. The exports and imports of other categories, such as communications, insurance and financial services, have also increased significantly. However, they continue to represent a relatively minor share of the Baltic countries' total trade in services (see Figure 1.3).

Figure 1.3 Trade in Services by Sectors in the Baltic States, 1994 and 2001 (EURO millions)



Source: Eurostat, Theme 2: Economy and Finance, accession countries. Note: IFPCR refers to Insurance, financial, personal, cultural and recreational services and royalties and license fees.

As defined in GATS terms, trade in services includes consumption abroad (corresponding mainly to travel), foreign direct investment and the presence of natural persons, in addition to cross-border trade. These trade flows have traditionally been covered by different sets of statistical data, which, despite recent international efforts, are generally less reliable and less readily available (see Box 1.1). A proxy for developments in GATS mode 2 (consumption abroad) is the movement of tourists and tourism revenues. In terms of the number of tourists, Estonia with 1.3 million visiting tourists in 2001 is the leading tourist destination among the three Baltic States, closely followed by Lithuania. Accordingly, tourist revenues are also important for these two countries, representing one-third of total services revenues in 2001. In contrast, Latvia attracted fewer tourists, and corresponding revenues amounted only to 10% of its services exports in 2001.

So far, the movement of natural persons has not played a significant role in services trade of the Baltic countries, but the EU accession may change the situation. In recent years, net compensation of employees and workers' remittances remained negligible and negative in Estonia. The corresponding amounts are comparatively more important in Lithuania, but the balance also remains generally negative (with the exception of 2000). Only Latvia records a positive balance on these two items of the balance of payments, which reached its highest level in 2000 (almost USD 100 million).

Box 1.1 Statistics on Trade in Services

Compared to statistics on trade in goods, the available data for trade in services capture less satisfactorily existing flows. The main shortcomings are the limited country coverage, insufficient breakdown by individual service sectors and the absence of data recorded according to GATS four modes of supply. Available balance of payments statistics provide proxies for the following modes of supply and sectors:

- Cross-border supply (GATS mode 1) is recorded for service transactions in transport, communications, insurance and financial services;
- Consumption abroad (GATS mode 2) is mainly covered by data on travel;
- Commercial presence (GATS mode 3) is best captured by data of Foreign Affiliate Trade in Services (FATS) statistics, which are, however, available only for some 20 countries;
- Presence of natural persons (GATS mode 4) is partly covered by balance of payments statistics concerning compensation of employees and workers' remittances.

This still imperfect statistical coverage means that currently available statistics probably underestimate actual trade in services. The implementation of the Manual on Statistics of International Trade in Services, currently developed jointly by the IMF, the OECD, Eurostat, WTO, UN and UNCTAD, will improve considerably the current unsatisfactory situation.

Table 1.7 shows the Revealed Comparative Advantage Index (RCA) for the three Baltic States. This index shows the trends in countries' specialisation in individual services and therefore their comparative advantage. It is calculated as the share of a country in world exports in a given sector, divided by the share of this sector in total world exports. With the value of a RCA above one, a country is considered to have a comparative advantage in a given sector. These calculations confirm the strong role of the transportation sector and the comparative advantage of the Baltic States in this area. However, their RCA value in this sector has declined in recent years. Since the middle of 1990s, Estonia and Lithuania have developed a comparative advantage in travel services. In communications, the position of Estonia seems to be declining, while both Latvia and Lithuania have increased their specialisation in this sector. Another interesting trend is the increasing value of the RCA in computer and information services in the three countries, though its value still remains less than one.

Table 1.7 Revealed Comparative Advantage Index of the Baltic States (1994-2001)

	1994	1996	1998	2000	2001
Estonia					
Transportation	3.30	2.04	2.59	2.21	n.a.
Travel	0.56	1.81	1.18	1.11	n.a.
Construction	2.46	2.11	1.39	1.01	2.76
Communication	1.48	0.61	0.44	0.81	0.65
Financial services	0.06	0.20	0.19	0.12	0.22
Computer and information	0.95	0.33	0.28	0.65	0.62
Insurance	0.09	0.09	0.07	0.22	0.17
Royalties/licenses	0.04	0.02	0.01	0.03	0.02
Other services	0.28	0.30	0.36	0.43	0.54
Latvia					
Transportation	4.55	3.19	3.55	3.00	n.a.
Travel	0.09	0.79	0.53	0.35	n.a.
Construction	0.71	0.23	0.19	0.62	n.a.
Communication	0.48	1.32	1.27	2.19	n.a.
Financial services	0.27	0.70	0.75	0.50	n.a.
Computer and information	0	0.16	0.46	0.76	n.a.
Insurance	0	n.a.	n.a.	0.37	n.a.
Royalties/licenses	0	0	0.04	0.03	n.a.
Other services	0.09	0.43	0.39	0.49	n.a.
Lithuania					
Transportation	3.21	2.31	2.14	2.14	n.a.
Travel	0.67	1.66	1.35	1.22	n.a.
Construction	3.77	2.82	0.87	0.72	0.86
Communication	1.94	1.69	1.79	1.92	1.79
Financial services	0	0.17	0.12	0,05	0,18
Computer and information	0	0	0.32	0,66	0,92
Insurance	0.15	0.19	0.95	0.16	0.55
Royalties/licenses	0	n.a.	0	0	0
Other services	0.05	0.13	0.40	0.37	0.55

Note: The RCA index is calculated as the share of a country in world exports of a sector, divided by the share of this sector in total world exports. Values above one indicate a comparative advantage of a country in a given sector.
n.a.- data not available.

Source: Calculations from UNCTAD statistics.

Foreign Direct Investment in Services

The growing economic importance of services is also reflected by their increasing share in foreign direct investment (FDI). The Baltic States, which started receiving FDI only at the beginning of the 1990's, have succeeded in attracting relatively significant FDI inflows. In absolute terms, Lithuania is the major FDI recipient in the region, but Estonia has the largest amount by per capita, followed by Latvia (see Table 1.8). Available data do not allow differentiation between FDI inflows coming through the privatisation process and greenfield (or *ex novo*) investments in services. However, it is likely that the pattern in services has been similar to the general situation in transition

economies, *i.e.* with the assets available for privatisation having been gradually exhausted, greenfield investment as well as merger and acquisitions have become the typical form of FDI.

Table 1.8 Total Foreign Direct Investment in the Baltic States

(In USD millions and %)

	Annual FDI inflows (mn USD)			Annual FDI inflows in 2002		Cumulative FDI inflows 1989 - 2002	
	2000	2001	2002 (estimate)	Per capita	In % of GDP	Total (mn USD)	Per capita (USD)
Estonia	324	342	152	113	2.3	2 503	1 846
Latvia	400	151	388	166	4.6	3 040	1 304
Lithuania	375	439	714	207	5.2	3 540	1 024

Source: EBRD Transition Report 2003.

The service sector absorbs the major and increasing share of total FDI inflows to the Baltic States. In 2000, services represented almost three-quarters of total FDI, both in Estonia and Latvia, and 70% in Lithuania. In Estonia, trade and repair activities, which were the main beneficiary of FDI in 1997, were replaced in 2000 by financial services (one-third of total FDI in services), followed by transport and communications. In Latvia, transport and communications remained the largest service sector with FDI presence both in 1997 and 2000, followed by financial services. In Lithuania, FDI inflows are concentrated mainly in trade and repair activities (almost 50% of total FDI in services in 1997) and this sector continued to be the main FDI beneficiary also in 2000. However, other sectors (*i.e.* transport and communications and financial services) also started attracting a significant amount of FDI, representing 29% and 22% respectively of total FDI in services in 2000 (see Table 1.9).

Table 1.9 Foreign Direct Investment in the Service Sector of the Baltic States

(In USD millions and %)

	Estonia		Latvia		Lithuania	
	1997	2000	1997	2000	1997	2000
Total services in millions USD		1 952		1 006		1 589
Total services in % of total FDI	62.0	74.0	68.0	74.0	60.0	70.0
Total services	100.0	100.0	100.0	100.0	100.0	100.0
• Construction	0.9	2.0	0.4	0.5	0.6	0.9
• Trade and repair	36.1	21.0	17.6	21.9	49.7	32.4
• Hotels and restaurants	3.2	2.7	2.0	2.3	6.5	3.2
• Transport and communication	27.1	29.3	44.9	30.9	19.6	28.8
• Financial services	18.5	33.6	26.7	29.1	10.7	22.3
• Real estate and business	5.2	9.2	2.7	10.9	7.3	6.6
• Education, health and culture	0.2	0.0	1.1	0.6	3.8	2.0
• Other	8.8	2.2	4.6	3.8	1.8	3.8

*Data on 2001.10.01

Source: OECD Reviews of Foreign Direct Investment in Estonia and Lithuania (2001); Statistical Bureau of Latvia: Investment in Latvia, No. 2(26)2002.

In 2000, Swedish firms were the major investors in Estonia's service sector, and Danish firms were the major investors in services in Latvia and Lithuania. Swedish FDI in Estonia was mainly oriented to financial services (65% of Swedish FDI in services in this country) and transport and communications (27%). In Latvia and Lithuania, the majority of Swedish FDI also went to financial services, but the total amounts involved are lower than in Estonia. Estonia's service sector also

absorbed the bulk of Finnish FDI, particularly transport and communications (almost 43% of Finnish FDI in services in Estonia). This sector was also the major FDI beneficiary of Finnish services investment in Lithuania. Trade and repair dominated Finnish FDI in Latvia. Within the Baltic States, FDI from the US is concentrated in Lithuania, particularly in transport and communications, which also attracted the major share of Danish FDI in the Baltic countries (see Table 1.10).

Table 1.10 Major Investing Countries in the Service Sector of the Baltic States 2000

(In USD thousands)

	Sweden	Finland	United States	Denmark
Estonia				
Construction	7 587	20 538	67	n.a.
Trade and repair	42 293	194 815	45 972	20 216
Hotels and restaurants	3 424	2 711	3 258	n.a.
Transport and communications	242 968	232 859	2 179	25 477
Financial services	580 311	40 054	4 563	n.a.
Real state and business service	10 331	43 562	10 903	4 325
Education, health and culture	5	549	n.a.	n.a.
Other	5796	9 024	4 293	184
Total	892 715	544 112	71 235	50 202
Latvia				
Construction	856	55	960	1 111
Trade and repair	18 160	32 109	59 923	6 072
Hotels and restaurants	766	n.a.	10 817	402
Transport and communications	28 655	224	6 426	158 376
Financial services	59 906	6 100	27 997	4 923
Real state and business serv.	942	1 514	4 469	4 818
Education, health and culture	871	17	173	2
Other	555	14	431	3
Total	110 711	40 033	111 196	175 707
Lithuania				
Trade and repair	25 561	72 586	78 180	21 133
Hotels and restaurants	522	n.a.	16 619	578
Transport and communications	67 713	101 642	107 214	220 389
Financial services	67 370	4 918	37 106	12 044
Other	78 695	3 441	23 093	22 045
Total	239 861	182 587	262 212	276 189

Note: n.a. - data not available.

Source: National statistical offices; data in national currencies converted at the official exchange rates.

New Trends in Services Development

Although they have rapidly and successfully overcome the historical handicap of undersized and outdated service sectors, the Baltic countries now face new challenges in seizing the opportunities resulting from ongoing structural changes in the service sector in general. This new stage of development is usually designed as the passage from *tertiarisation*, which characterised economic and sectoral development in the twentieth century and brought up unprecedented dynamism of services compared to agriculture and manufactures, towards “*quaternarisation*”, marked by the growing

importance of technology and knowledge-intensive services (Pender *et al.*, 2003). In general, knowledge-based sectors are defined as intensive users of high technology and/or employing a relatively high skilled workforce. They often devote higher than average expenditures to research activities. Among the services, the main sectors concerned are communications, finance, insurance, real estate and business services and community, social and personal services.

The increasing role of technology and knowledge-intensive services reflects the reinforcement of trends that were already responsible for the initial development of services. The main features of the so-called service economy are the growing sophistication of products that necessitate the contribution of complementary services, and the trend towards contracting out certain services that were previously provided within the individual enterprises, such as legal, commercial and consulting services. These trends further reinforce the dynamic role of services as an important engine of growth in quantitative and qualitative terms. The impact of new services on the economy is direct, as their growth increases overall income and employment. They also represent the major source of innovation and productivity growth. As intermediary products entering into a number of other products and services, these new activities might potentially increase and improve the economic performance of other sectors within the economy. However, in the Baltic countries, the employment structure does not yet reflect these developments, and traditional activities such as wholesale and retail trade, hotels and restaurants (in all three countries), real estate, renting and business activities (in Estonia and Lithuania) and transport, storage and communication (in Lithuania) continue to provide major shares of employment (see Table 1.2).

The Baltic countries have succeeded in increasing their participation in trade in some technological and knowledge-intensive services quite considerably, bearing in mind that they are relative newcomers in international trade in services. For example, the rapid growth in productivity and relatively satisfactory productivity levels in financial services indicate that the Baltic countries might be well placed to develop their involvement in international trade.

Another new challenge facing service providers and traders is the development of e-commerce, which offers further possibilities to expand trade in traditional and new services and change their modes of delivery. In this context, it is necessary to differentiate between infrastructure aspects or e-enabling services that consist mainly in telecommunications networks and infrastructure services (*e.g.* computer application services, delivery and payment services), and content-related aspects that deal with the availability and competitiveness of services that can be traded electronically. While it can be considered that most transition economies, including the Baltic countries, are rapidly closing the gap in terms of the spread and the technical level of e-enabling services, their position as regards the export portfolio of e-services seems to be less favourable (Stare, 2003). Whereas traditional sectors, such as transport and tourism, offer relatively limited scope for e-transactions, the main opportunities for e-commerce are in communications, financial, computer and information services and other business services. Available trade statistics show that, although these potentially promising sectors have increased their share to some extent, traditional sectors continue to represent the bulk of the exports for the Baltic countries.

The countries' capacities to develop their competitiveness in new services and increase their participation in corresponding trade flows depend to a large extent on the skill of the workforce, technological levels in relevant sectors and innovative abilities. The European Innovation Scoreboard, developed by the European Commission, monitors strengths and weaknesses of the innovation performance of EU member and acceding countries (see Table 1.11). Among the three Baltic countries, Estonia appears to have the strongest innovative capabilities. The values of its indexes are higher than, or close to the average of, ten candidate countries in most cases, with a few exceptions, such as business expenditures on research and development. In several cases, Estonia records even

higher index values than the EU average, for example for the share of population with tertiary education and the share of information and communication technology expenditures in its GDP. Although the other two countries have generally less impressive results, they also score better than the EU member average in some cases, for example for the participation of the population in life-long learning (Latvia) or SMEs in-house innovating activities or the proportion of high-tech venture capital investment in GDP (Lithuania). Therefore, the Baltic countries seem to have considerable potential for innovation, but the current level of innovation activity and the transmission of existing knowledge still fall short of this potential.

Table 1.11 Results of the European Innovation Scoreboard 2002

Indicator	Estonia	Latvia	Lithuania	EU	Candidate Countries
Human resources for innovation					
New S&E ¹ graduates (% of 20-29 years age class)	6.83	5.52	9.35	10.26	6.60
Population with tertiary education (% of 25-64 age classes)	29.42	18.15	45.03	21.22	17.50
Participation in life-long learning (% of 25-64 years olds)	5.30	16.30	3.70	8.50	5.40
Employment in medium-high and high-tech manufacturing (% of total workforce)	4.79	1.72	3.18	7.57	5.40
Employment in high-tech services (% of total workforce)	3.38	2.19	2.10	3.61	2.60
Creation of new knowledge					
Public R&D ² expenditures (% of GDP)	0.53	0.29	0.53	0.67	0.41
Business expenditure on R&D (% of GDP)	0.15	0.20	0.07	1.28	0.32
All EPO ³ patent applications (per million population)	6.90	2.50	1.10	152.7	7.10
Transmission and application of knowledge					
SMEs ⁴ innovating in-house (% of manufacturing SMEs)	33.20	--	51.00	44.00	--
Manufacturing SMEs involved in innovation co-operation	13.00	--	12.00	11.20	--
Innovation expenditures (% of all turnover in manufacturing)	2.40	--	--	3.70	--
Innovation finance, outputs and markets					
High-tech venture capital investment (% of GDP)	--	0.62	0.90	0.24	0.27
New capital raised on stock markets (% of GDP)	--	--	--	--	1.73
'New to market' products (% of sales by manufacturing firms)	6.00	--	--	6.50	--
ICT ⁵ expenditures (% of GDP)	9.60	7.90	5.90	8.00	6.00
Internet access (% of population)	30.10	7.20	6.80	31.40	14.80
Stock of inward FDI (% of GDP)	53.20	29.10	20.60	30.30	31.30

¹ S&E: Science and Engineering

² R&D: Research and Development

³ EPO: European Patent Office

⁴ SMEs: Small and Medium Sized Enterprises

⁵ ICT: Information and Communication Technology

Source: European Commission.

The Growth Competitiveness Index, established by the World Economic Forum (see Table 1.12), assesses factors related to the macroeconomic environment and the quality of public institutions. The ability of a country to innovate is indicated by the Technology Sub-index, which comprises factors such as innovation, information and communications technology and technology transfer. Estonia

reached the highest rank among 13 Central and Eastern European countries examined and belongs to the top 15 countries as regards the Technology Sub-index. The Networked Readiness Index focuses on the potential of a country to participate in the world network and benefit from developments in information and communication technologies (ICT). It encompasses the following components: the market, political and infrastructural environment for ICT; the readiness of the society's stakeholders (*i.e.* individuals, businesses and governments) to use ICT; and, the actual usage of ICT by these stakeholders. With a rank of 24, Estonia is again the leader among Central and European countries. Another benchmarking methodology used to assess countries' progress in establishing a knowledge economy was developed by the World Bank. Its "Knowledge Economy Index" ranks the countries according to their scores in four relevant areas: education, innovation, information society and economic and institutional framework. The corresponding results, presented in recent publication on Lithuania (World Bank, 2003), are similar to the indicators of the World Economic Forum.

Table 1.12 Selected Indicators

Country	Global Competitiveness Report 2002/03 (Total: 80 countries)		Global Information Technology Report 2002/03 (Total: 82 countries)			
	Growth Competitiveness Rank	Technology Sub-index	Networked Readiness Index Rank	Sub-indices Ranks		
				Environment	Readiness	Usage
Estonia	26	14	24	28	21	21
Latvia	44	29	38	41	38	39
Lithuania	36	40	46	45	41	52
<i>Memorandum Item: Central European Countries</i>						
Czech Republic	40	20	28	31	25	29
Hungary	29	21	30	30	28	36
Poland	51	36	39	47	45	34
Slovak Republic	49	34	40	37	39	45

Source: World Economic Forum.

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Chapter 2

BUSINESS ENVIRONMENT FOR TRADE IN SERVICES

Abstract: To assess regional developments in the regulatory and economic environment for trade in services, the OECD commissioned business surveys in each of the three Baltic countries. The replies to the common questionnaire confirm that the business climate in the region has evolved favourably, though respondents raised some problems, notably the lack of prior consultations between the governments and the business community on envisaged legislative and regulatory changes. Available international indicators, comparing the progress in economic reforms and business conditions in the Baltic States with other countries, confirm the results of the regional business surveys showing that the region has succeeded in a relatively short time in creating an environment conducive to economic development and international trade in the service sector.

Introduction

Available statistical data provide a convincing picture of rapid development of the service sector and trade in services in the Baltic countries. Reflecting its growing economic importance, the service sector has been subject to considerable regulatory changes as state intervention in this traditionally highly regulated sector has diminished and competitive pressures have intensified. In order to assess how service providers view the economic and trade environment for their operations in these countries, the OECD commissioned three business surveys. The surveys carried out by local consultants in early 2001 collected the responses from 56 companies in Estonia, 70 companies in Latvia and 65 firms in Lithuania. The survey questions addressed both domestic impediments encountered by service providers and external obstacles faced by the Baltic States' service exporters within the region and in other countries¹.

Where possible and applicable, the outcome of the 2001 survey was compared with the results of previous business surveys, which were undertaken by the OECD in the region in 1994-1995². In addition, several other studies were used as benchmarks, including the reports of specialised agencies in the region and recent analyses that provide a basis for comparing the situation in the Baltic States with other countries (Business Advisory Council, 2002).

Although business surveys contain useful indications of problems faced by the business community in a given period, it is important to keep in mind the general and inevitable biases of such studies. They usually reflect the specific socio-political environment, the momentary economic situation, the structure of respondents' sample and the particular ways the questions are interpreted by the respondents. Moreover, the respondents often tend to highlight problems rather than positive developments in the business environment. All these factors are difficult to control for and complicate international and time comparisons based on business surveys. For this reason, the examination of the OECD business surveys is supplemented by an overview of several international indicators, which have been developed to assess progress in the reform process and compare specific aspects of the business climate in different countries. Several such indicators are considered, in particular the European Bank for Reconstruction and Development (EBRD) transparency index and the results of the World Bank's surveys on administrative and entry barriers. Both the OECD business surveys and the international comparisons convey that the business climate in the region improved considerably between 1995 and 2001, and that the situation in the Baltic countries compares favourably with the business environment observed in many other countries, especially in other transition economies.

Results of OECD Business Surveys

Access to Information, Transparency and Consultations with the Business Community

Effective long-term business planning and decision-making require easy access to information on government policies, transparency of laws and regulations, and dependable enforcement. The major outcomes of the 1995 OECD surveys were strong criticism expressed by Baltic exporters concerning the lack of available information on existing governmental policies and general complaints about the isolation of the business community from the decision-making process. By 2001, most of these previously observed problems had been considerably reduced, but some others seem to persist.

More than two thirds of the companies interviewed in the three countries did not report any problem in accessing relevant and up-to-date information on governmental policies and information on regulatory changes (Figures 2.1 and 2.2).

Figure 2.1 Availability of Up-to-Date Information on Governmental Policies

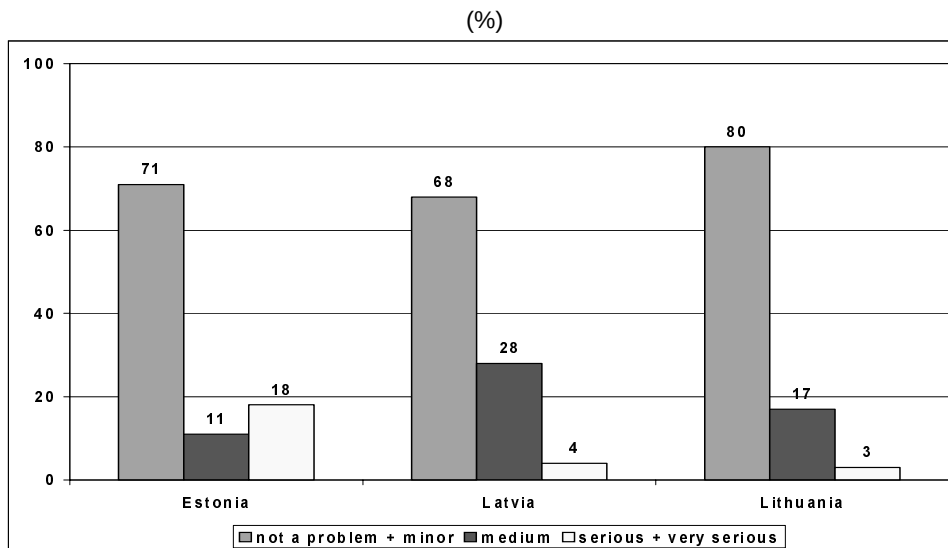
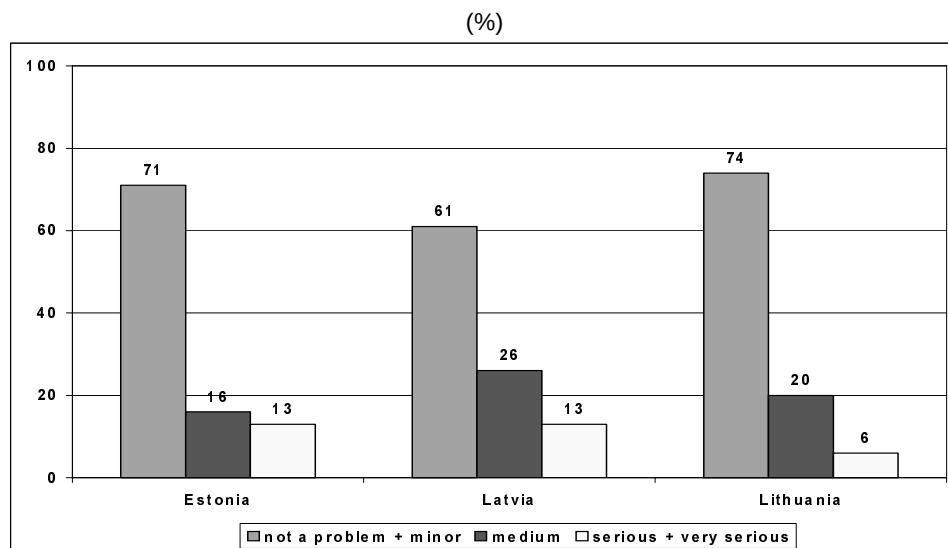
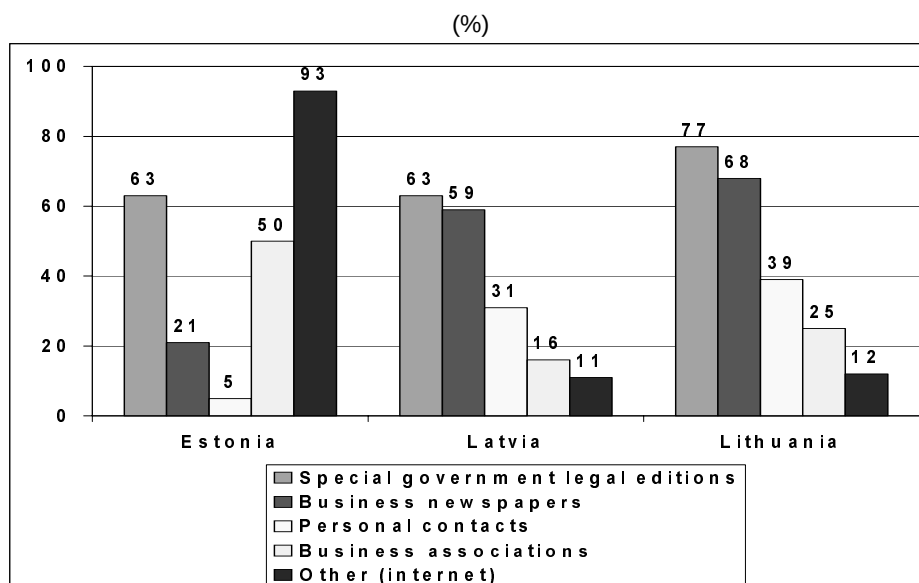


Figure 2.2 Information on Changes in Regulations



The fact that government legal publications are an important source of information on new regulations in all three countries suggests that the governments have been active and successful in channelling relevant information to the business community. While business newspapers also seem to be an important source of information for Latvian and Lithuanian service companies, Estonian respondents use this source less and rely much more on the Internet. Personal contacts seem to be comparatively more important for Latvian and Lithuanian companies (Figure 2.3). According to a survey carried out by the Latvian Development Agency, the greater reliance on personal contacts may signal the lack of standardised information or inadequate dissemination of such information (Latvian Development Agency, 2001).

Figure 2.3 Main Sources of Information on New Government Regulations



Despite greater transparency and easier accessibility of legal and regulatory information, many respondents continue to think that governmental regulations are not always consistent with business interests. The issue seems to be more acute in Estonia, where 61% of surveyed firms rate government regulations as a serious problem, than in Latvia and Lithuania (41 and 46% respectively). Similarly, prior consultations with the business community about new laws and regulations are still judged inadequate, especially in Estonia (75% of respondents), but relatively less in Lithuania (52%) and Latvia (44%) (Figures 2.4 and 2.5). Although these differences may reflect the different expectations of businesses rather than differences in the actual situation, the problem has also been mentioned in other surveys, for example by the Baltic Business Advisory Council (2002).

Figure 2.4 Government Regulations Not Consistent with Business Interests

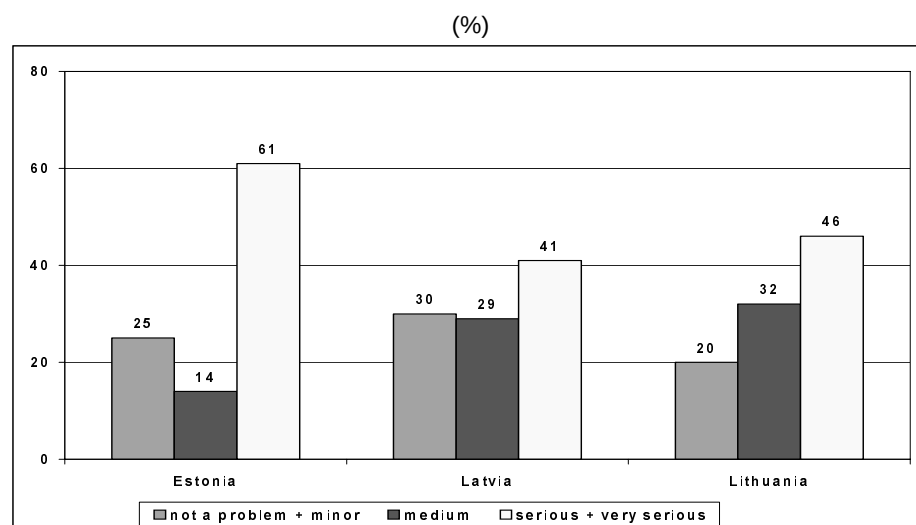
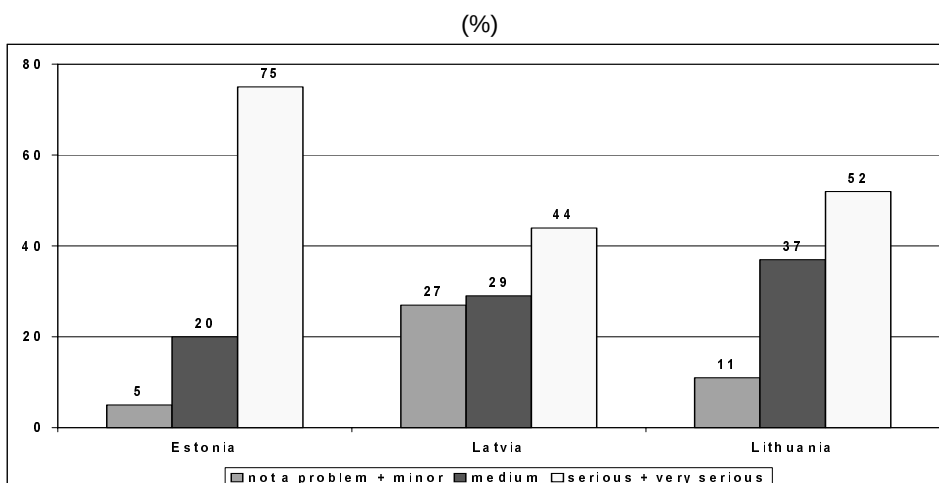
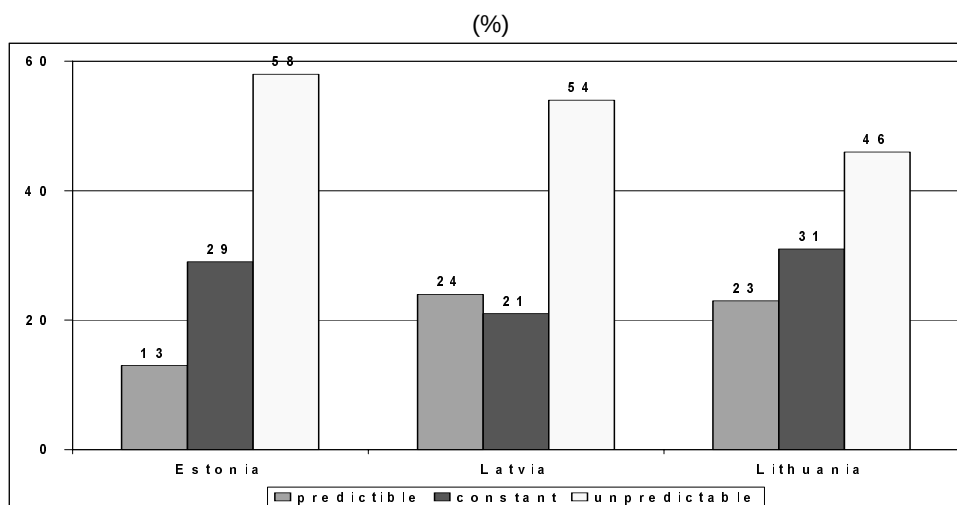


Figure 2.5 Consultations with Business Entities Prior to Introducing New Laws



The predictability of the regulatory environment, which is another factor that favourably influences firms' operations, remains a problem for 58% of respondents in Estonia, followed by Latvia (54%) and Lithuania (46%) (Figure 2.6). According to a survey by the Central Chamber of Commerce of Finland, however, foreign companies think that the actions of Estonian authorities have become more predictable in 2001 than previously (Central Chamber of Commerce of Finland, 2001).

Figure 2.6 Overall Government Programme for Regulating Service Sectors

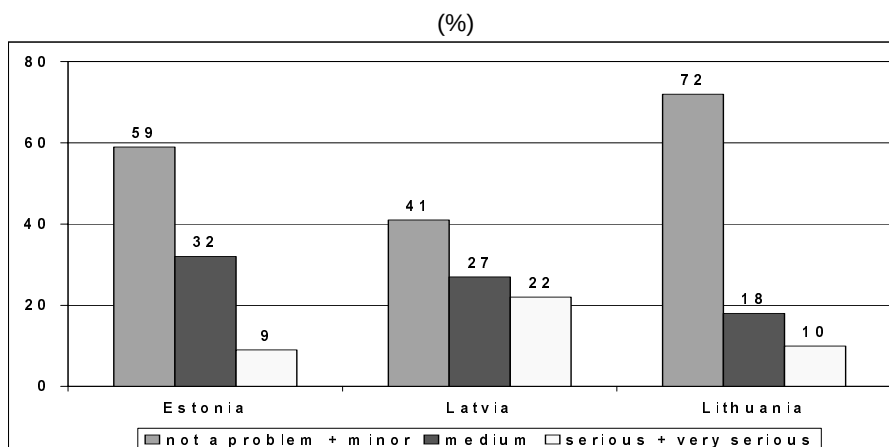


Many respondents criticised governmental regulations that contradict the interests and needs of the business community and judged them ambiguous or poorly thought out. Many surveyed companies felt that they, or their representative associations, did not have real opportunities to make their concerns heard within the government and regulatory agencies. During the interviews, several concrete examples of inadequate or duplicative regulations were mentioned, such as the Estonian government's introduction of a deposit requirement applied to tourist agencies and tour operators.

Issues Related to Commercial Presence

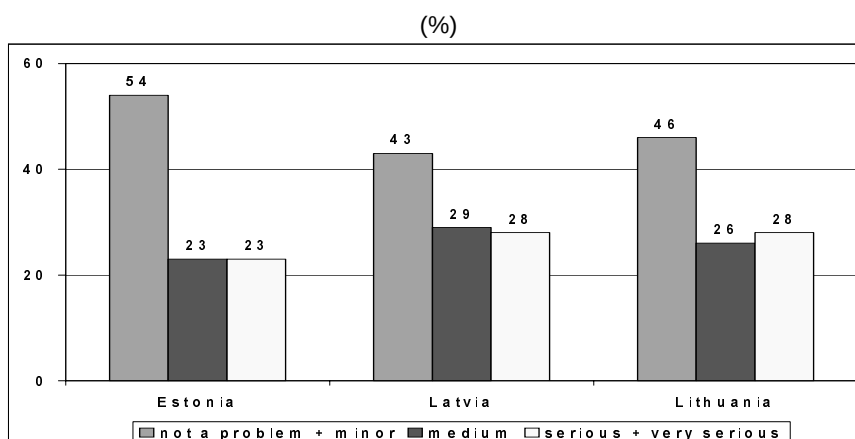
The restrictiveness of licensing procedures was not singled out as a major problem in the 2001 OECD business surveys: the highest rate of complaints was recorded by Latvia, where 22% of respondents consider restrictive licensing procedures as a serious or very serious issue (Figure 2.7). This relatively positive assessment of the forthcoming attitude of the Baltic States' authorities in this regard is generally shared by foreign investors: they report few foreign ownership restrictions for service companies. For example, approximately 60% of Finnish companies evaluate Estonia's economic policy environment as "non-problematic" and stress the country's liberal trade policy and income tax exemption for reinvestments as sufficient incentives to attract foreign investment.

Figure 2.7 Restrictive Licensing Procedures



A number of respondents thought, however, that licensing procedures were in several cases either too bureaucratic or too costly, especially in industries such as telecommunications and transportation in Lithuania. Latvian companies ranked restrictive licensing procedures as the second most serious problem related to commercial presence and judged inadequate enforcement of existing laws as the most important barrier. Over 20% of respondents in the three countries mentioned ineffective appeals and arbitration procedures as a serious problem (Figure 2.8).

Figure 2.8 Ineffective Appeals and Arbitration Procedures



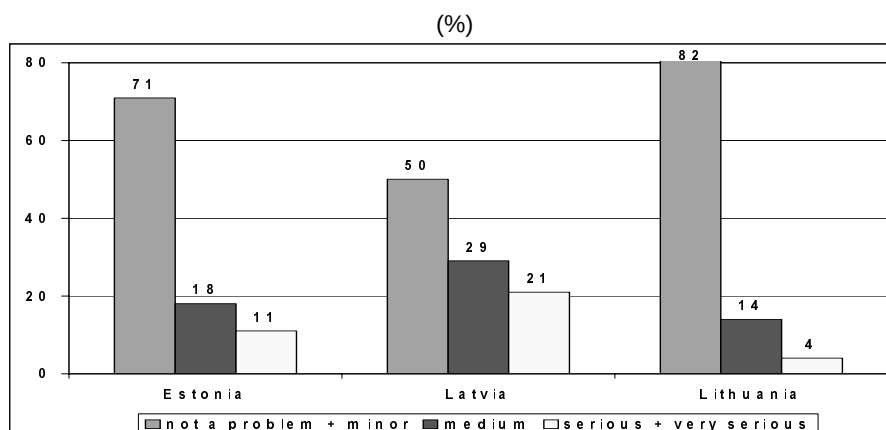
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As in many other countries, opinions of domestic and foreign companies in the Baltic countries on some issues might differ. Whereas foreign firms are often critical of existing investment incentives, domestic firms usually consider them sufficient; some domestic firms even view the local market as too open and request more regulations on imported services. For example, some Estonian and Latvian companies in the construction sector complained about the unfair competitive advantage of some of their competitors due to their use of undeclared workers.

Transport, Telecommunications, Financial and Customs Services

Infrastructure services, such as transportation, communications, finance, energy and distribution services, play a critical role in enhancing the productivity and growth of the entire economy. The surveyed service companies in the Baltic countries evaluate mostly positively the state of infrastructure. In contrast to 1995, when exporters cited a number of infrastructure problems, in 2001, respondents indicated that infrastructure problems had been largely overcome. Lithuanian service companies report the highest degree of satisfaction with the existing infrastructure (82% expressed a favourable opinion) and Latvian companies, the lowest (50% of respondents) (Figure 2.9).

Figure 2.9 Inadequate Infrastructure



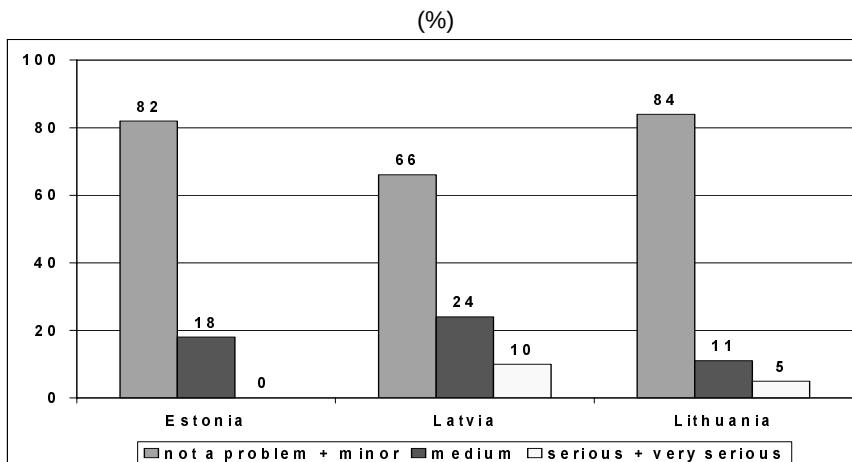
Source: OECD Business Surveys, 2001.

Estonian firms, for example, cited specific infrastructure-related problems, such as unfair competition and predatory pricing in the market for delivery of small packages by the state-owned company *Eesti Post* or high tariffs, undermining firms' competitiveness, charged by *Eesti Raudtee* (Estonian Railways) and the Port of Tallinn. Foreign companies are often even more critical of the state of infrastructure. Compared to 1995, the most significant favourable change took place in the telecommunications sector. Remaining complaints concern the rates applied in the sector. For example, the imposition of a flat rate on all phone calls within the *Eesti Telefon* fixed network increased the price of local calls by one third, adversely affecting telemarketing and tele-research companies that have mostly local clients in Tallinn.

Regional transport services obtained a large degree of satisfaction in all three Baltic countries (Figure 2.10). This situation reflects mainly the increased competition in transport services between

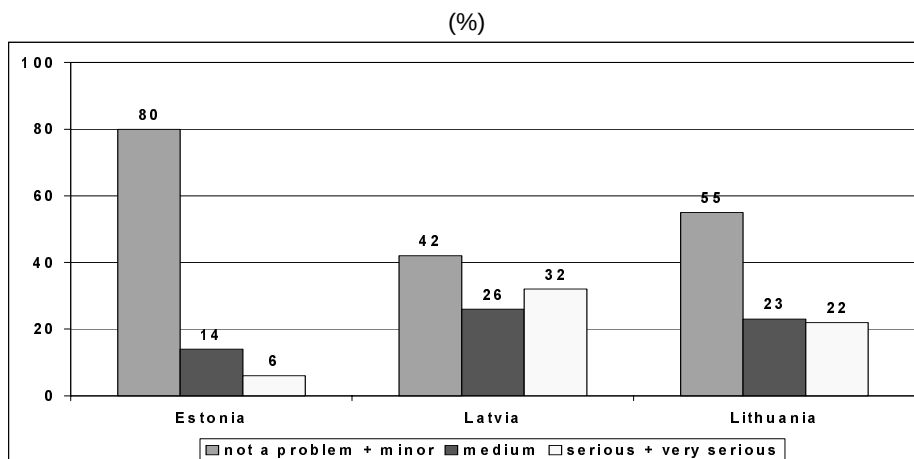
domestic and international providers, which has contributed to lower prices. The quality and accessibility of transport services, including in road transport, has also improved, though some service providers in rural areas note persistent problems, especially in winter. Problems in obtaining necessary permits and the costs of permits were of concern, particularly to Estonian and Lithuanian companies, while Latvian companies seemed to be relatively more satisfied with the situation. Estonian transport companies complained about the stringent legal requirements applied to Estonian road carriers, which necessitate large investments in these companies, while foreign truckers with sometimes lower standards enter freely.

Figure 2.10 Inefficiency of Regional Transport Services



Some surveyed companies complained about monopoly control of the Tallinn-Stockholm route, which has resulted in high prices and poor service. The respondents observed that trucks often had to wait for days on the pier to get a ride. The company does not deploy more vessels on the route, they said, because it is interested in maximising profits through full capacity. At the same time, no complaints were made about the Tallinn-Helsinki route, where several shipping companies are in operation.

Figure 2.11 Difficulties in Obtaining Bank Credits



Respondents gave relatively high marks to the financial sector. Whereas, the 1995 survey revealed serious shortcomings in banking services, obtaining credit in 2001 was not a serious problem for 80% of Estonian, 55% of Lithuanian and 42% of Latvian firms (Figure 2.11). Credits with relatively low interest

rates are available to companies that are able to prove a sound economic standing and present a comprehensive business plan. The favourable change is due to rapid reforms in the banking sector with many inefficient banks disappearing and the surviving banks becoming more efficient.

The Baltic countries' authorities acknowledge the need to facilitate and modernise customs clearance procedures at both the national and regional levels. In Estonia, tourist and shipping companies expressed dissatisfaction with the pace of customs and immigration procedures at the Port of Tallinn. Estonian importers of medical drugs and supplies also considered related customs procedures somewhat arbitrary and too bureaucratic. The Tallinn Customs Office implemented a pilot project that enables companies to declare goods electronically, thus allowing goods to be cleared in a few minutes. According to the survey by the Latvian Development Agency, there has also been a remarkable improvement in all aspects of customs procedures and clearance in Latvia. Moreover, "Via Baltica", creating a Baltic Transit System, should further facilitate and simplify transit formalities for cargo traffic between the Baltic countries. Following the decision of the Ministerial Conference on Trade and Economic Co-operation in the Baltic Sea region in 2000, the clearance time for border crossing within the region was reduced to less than two hours. According to the Central Chamber of Commerce of Finland, Finnish companies consider that clearance problems have diminished significantly and the product certification has improved in Estonia.

Movement of Natural Persons

According to the 2001 OECD surveys, barriers to the movement of natural persons have not represented a major obstacle to Baltic service firms. This situation probably reflects relatively liberal and clear regulations for working permits in the region (see Box 2.1). Estonian service companies were, however, relatively more dissatisfied, possibly because of the greater share of service exports in their activities. They complained especially about slow processing and red tape but less about the cost and general requirements. The Estonian survey mentions the case of a company that had to abandon a project because it did not get work permits for 15 engineers and workers from Russia. A survey carried out by the Latvian Development Agency shows that foreign-based companies tend to be more critical of immigration procedures.

Box 2.1 Work Permit Regulations in the Baltic States

Estonia's Aliens Act imposes an annual immigration quota, which shall not exceed 0.05% of the permanent population of Estonia annually. The immigration quota does not apply to citizens of the EU, the USA, Norway, Iceland, Switzerland and Japan. The minister of internal affairs may exempt specific persons from the immigration quota if their arrival in Estonia is necessary for economic, educational, scientific or cultural development. A business visa may be issued to persons arriving in Estonia in connection with a long-term official assignment, to make a foreign direct investment, for establishing a branch office of a foreign company in Estonia or for the management of a firm relocated and registered in Estonia and belonging to an international business group.

Under Latvian law (Regulation on the Procedure for the Employment of Foreigners and Stateless Persons in the Republic of Latvia), it is quite easy for foreign citizens to enter Latvia for temporary business activities (up to three months in a half-year period). For businesspersons wishing to reside and work in Latvia for longer periods, it is necessary to obtain residence and work permits. Regulations on employment of foreign nationals and regulations on issue and registration of residence permits have been simplified. The number of documents to be submitted has been reduced and fees for certain categories of jobs have been abolished (for example, for managing directors of companies). Work and residence permits can be obtained simultaneously at the Departments of Citizenship and Migration Issues Board.

According to the Lithuanian Law on Legal Status of Aliens, the government establishes an annual quota of foreign employees, in accordance with the Regulation on Temporary Employment of Foreigners. Employers apply to the Lithuanian Labour Exchange, which issues special visas and work permits for foreigners. This regulation is not applied to intra-corporate transferees (managers, executives and specialists) working one to two years with a possibility of extension, or to business visitors working no longer than three months, for purposes related to the negotiation of contracts, training of staff, installing equipment and similar activities.

In Latvia, the main obstacle remains the lack of adequate information on existing requirements. However, more than 80% of Latvian respondents did not find restrictions on business visas or permits restrictive or qualification requirements unreasonable. Most firms did not consider the costs of visa and work permits too high, nor as a serious problem. In Lithuania, the process of obtaining a business visa, work permit or temporary residence permit seemed to cause some - but not major - problems to service companies.

Government Procurement

The 2001 surveys reveal few major difficulties related to government procurement. Most Estonian companies find information on the rules and regulations for tenders to be readily available and adequate, though in some cases, transparency of specific tenders seems to be questioned. In Estonia, there are no specific requirements as to the firm's location (see Box 2.2), but local companies felt that when financing comes from foreign sources, there is discrimination in favour of foreign companies and against Estonian firms. Another problem for participants in tenders was the new Procurement Act, which stipulates that, instead of arbitration, companies now have to turn to the courts for dispute resolution. That route is considered more bureaucratic, expensive and time-consuming. Some respondents believe that government procurement via tenders is counterproductive in some areas, such as medical drugs and hospital supplies. In general, Estonian companies did not complain about the timetable for responding to government tenders.

Most Latvian respondents did not cite serious problems with discrimination against non-local firms, procedures for appeals and arbitration, corruption, or undue delays. The main obstacle identified is lack of transparency in tendering procedures. This seems to contradict the previous responses indicating that, in general, the respondents did not consider inadequate information to be a serious problem. This result suggests that businesses may not have full trust in governmental procedures. The lack of experience in participating in tenders may also explain the perception of lack of transparency.

Box 2.2 Public Procurement Laws in the Baltic States

Estonia's Public Procurement Act, which came into force on 1 April 2001, does not contain any provisions that limit the rights of foreign tenders as opposed to domestic tenders. According to the Act, a contracting authority shall treat all persons participating in a public procurement tendering procedure equally. There are no provisions in the legislation that accord more favourable treatment to domestic supplies and suppliers than that accorded to foreign supplies and suppliers.

In Latvia, the Government and Municipal Procurement Act, which came into force on 1 January 1997, provides that tendering with participation of foreign competitors is mandatory if the expected value of construction works or the expected value of other works or supplies exceeds LVL 104 000. National treatment is applied in the field of government procurement.

Lithuania's Government Procurement Act entered into force on 1 October 1999. The law aims at ensuring open and transparent public procurement procedures, equality of participation for suppliers (domestic or foreign), effective competition, and more effective use of state funds. The law allows the government to give preference to goods, services and works (in connection with construction and renovation) produced, effected or provided by enterprises, including foreign-owned, registered in Lithuania, when this supply is important to the state for economic or social reasons. However, such a decision should be passed, in compliance with Lithuania's obligations under international agreements.

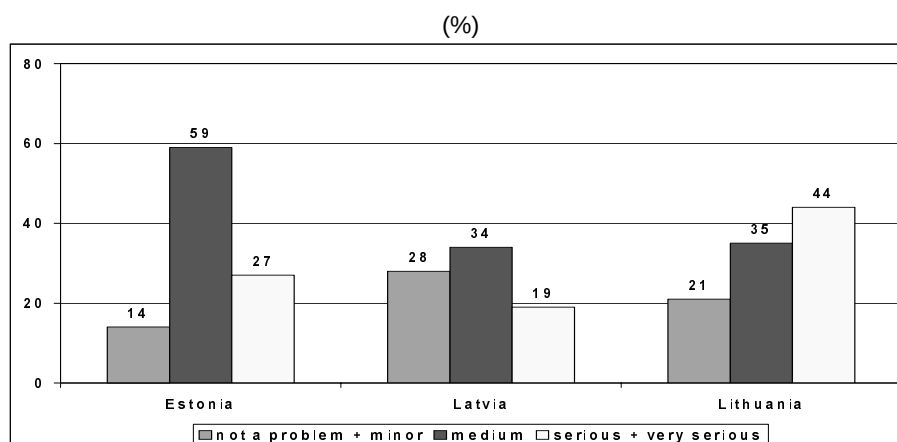
Although government procurement was not identified as a major problem in this survey, 86% of Lithuanian respondents noted that they face minor or more serious problems in selling their services to state agencies. The greatest concern of Lithuanian companies is lack of transparency in tendering procedures. Although 23% of the respondents identified untimely or inadequate information about the rules and requirements for tender as a serious or very serious problem, most respondents consider the information system for state tenders in Lithuania to be effective. A significant number of companies

that participate in public tenders face serious problems of delayed payments for the services delivered. More than 10% of respondents identified this factor as a very serious obstacle for their business.

Other Problems

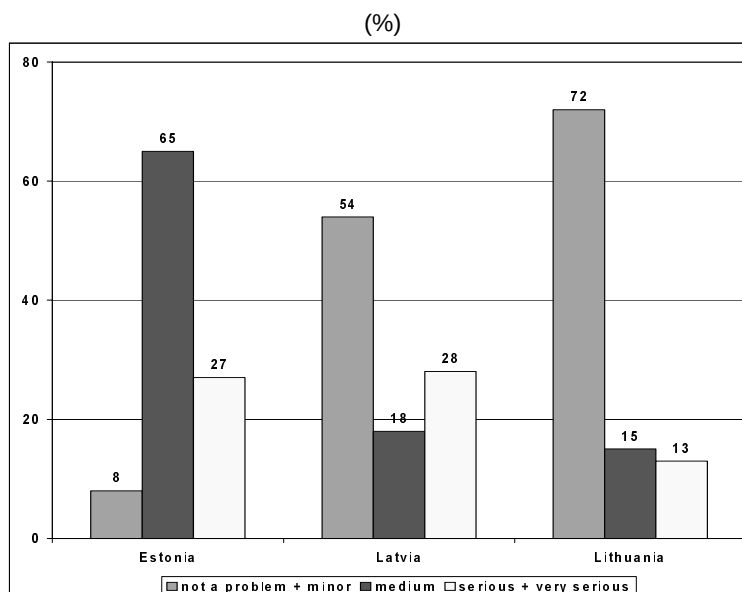
The 2001 OECD surveys identify relatively few general obstacles imposed by governmental or professional associations. A subject of great concern for Baltic service companies is excessive red tape and cumbersome and difficult procedures in state agencies (Figure 2.12). The responses suggest that even though the government usually does not formally impose obstacles, business operations suffer from delays or inaction in official procedures.

Figure 2.12 Expensive Red Tape



The surveys show certain dissatisfaction with government support and incentives for small and medium sized enterprises (SMEs), especially in Estonia (Figure 2.13). In addition, 17% of Estonian, 56% of Latvian and 22% of Lithuanian companies considered that existing incentives were “not enforced”.

Figure 2.13 Existing Government Incentives to Promote SMEs' Activities



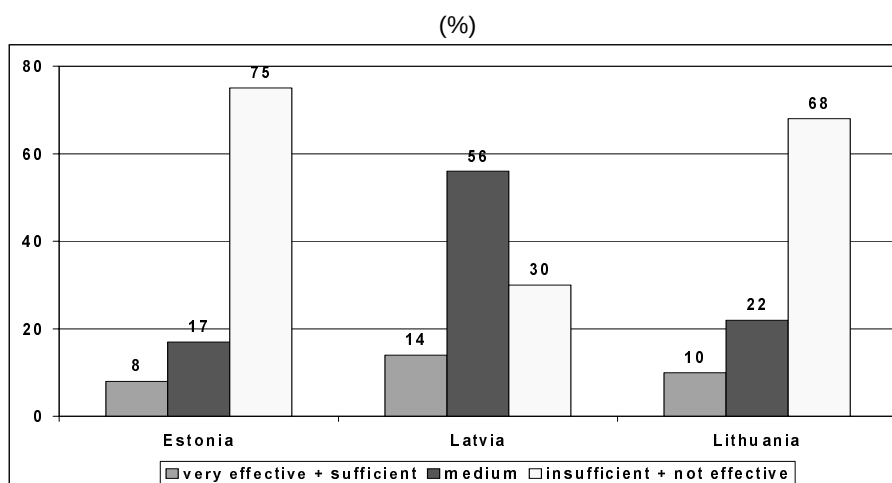
Major problems cited by SMEs are a lack of information, support systems, and governmental financial support. Other significant problems for SMEs include infrastructure problems, inadequate foreign language skills and sketchy marketing and finance expertise. Training in these areas is either unavailable, too expensive or of low quality. Estonian companies also mentioned that licensing procedures (for motels, catering companies, and hotels) are costly and somewhat confusing. Although many programs promoting SME activities have been implemented with the participation of EU funds, only a few service companies evaluated these efforts positively. This situation might be related to the lack of information about such programmes or their lack of relevance to the real needs of SMEs.

According to the 2001 OECD business surveys, service companies complained only marginally about corruption, which was considered to have limited adverse effects on the business environment. This finding seems to echo other specialised or general surveys, which show considerable recent achievements by some Baltic countries, especially Estonia, in combating corruption. In Latvia, the government also streamlined its commitments in this area, clarified the institutional set-up and started to implement practical measures to counter corruption. Lithuania has problems related particularly to administrative corruption, but recent efforts in enhancing administrative capacity have allowed the improvement of this situation.

External Barriers to Trade in Services

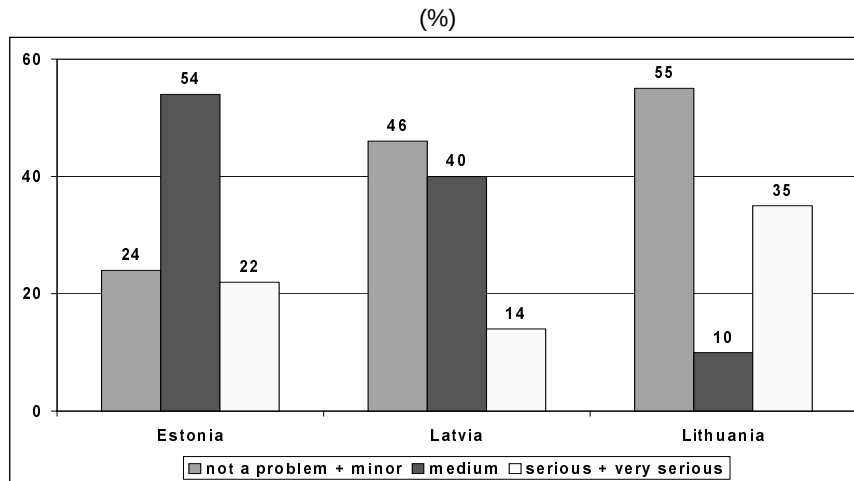
In the 2001 OECD business survey, the Estonian sample included 66% of firms exporting their services, while the share of service-exporting firms in the Latvian and Lithuanian surveys was half as much. This structure explains to a large extent the results of the survey: Estonian and Lithuanian companies consider external obstacles relatively more important, while Latvian firms generally viewed internal obstacles as more significant (Figure 2.14).

Figure 2.14 Barriers to Entering Export Markets



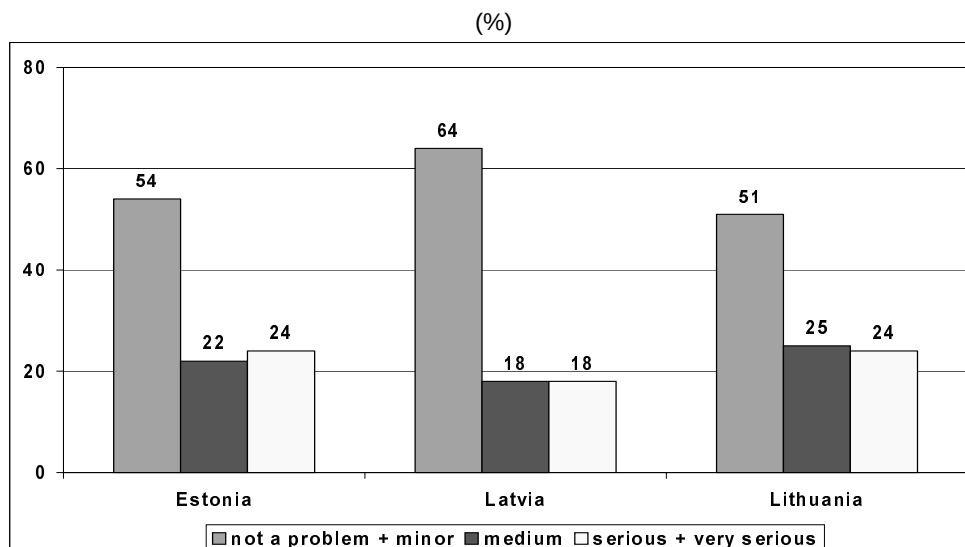
In Latvia and Lithuania, few respondents thought that barriers to entering export markets, recognition of skills and professional qualifications, or restrictions imposed by professional bodies were serious problems. Estonian respondents were the most critical, identifying barriers to entry in export markets as a medium problem (Figure 2.15). For Lithuanian exporting companies, the main obstacles to their trade were complex, costly and time-consuming export procedures, the absence of clear legal guidelines for exporting services, and high taxes.

Figure 2.15 Insufficient Market Openness in Export Market Country



In contrast to business information about domestic markets, which was considered as generally available, complaints about the lack of information concerning foreign markets were more frequent (Figure 2.16). Inadequate information on the requirements of export markets was ranked as one of the most serious problems for the export of services. In particular, access to information was limited for SMEs, which are frequently not familiar with information services provided by business associations and the government. SMEs also reported that they have insufficient foreign language skills to take full advantage of business opportunities abroad.

Figure 2.16 Inadequate and Untimely Information on Requirements in Export Market



External problems often reflect a particular country situation and are sector-specific. For example, Estonian construction companies operating in Latvia and Lithuania generally reported positive experiences, but companies seeking to enter the EU countries found it extremely hard, if not impossible. Rigid licensing requirements, high license costs and restrictions in obtaining work permits create very high entry barriers. Estonian companies report significant administrative problems in getting work permits for builders and other service providers, particularly in Germany. Russia was

also considered a difficult market for Baltic companies, especially as regards the long delays for obtaining a visa to Russia. Over one-third of the Lithuanian respondents said that insufficient market openness is a serious or very serious problem in their foreign operations.

Companies rendering international transport services in all three countries reported major problems in obtaining permits to cross other countries' territories. In particular, they noted the difficulty of getting permits to enter and cross Russia and Poland. Baltic service exporters noted numerous other problems, such as administrative measures that discriminate against foreign suppliers, instability and a risky business environment in the Russian market, and payment problems with Russia. Nevertheless, several respondents named Russia as one of the potential markets for expanding exports, suggesting that trade relations with this region could increase if the necessary conditions for a favourable trading environment are guaranteed.

Some Estonian respondents noted that an unfavourable image of transition economy countries and exporters (especially in the tourist sector) remains a difficult issue. Although these preconceived notions no longer accord with reality, it requires a major effort to change them. Consequently, tourism companies and related businesses thought there was a lot of room for improvement and suggested that the Estonian government take specific measures to promote the country's image. Insurance companies stated that whenever an accident occurs in a foreign country, the local police tend to shift blame to the foreign carrier. Insurance companies also reported serious problems in getting reimbursements to which they thought they were entitled in certain foreign countries.

Concluding Remarks on the Results of the OECD Business Surveys

The first major conclusion of the two series of business surveys carried out by the OECD in the Baltic States is that between 1995 and 2001, the economic and business environment improved considerably. Compared to the first OECD regional surveys, the majority of respondents reported that in 2001, many previously serious trade-inhibiting problems are no longer relevant or have been significantly alleviated. In particular, infrastructure services have become more readily available and of better quality, especially in telecommunications, transport and financial services. Most surveyed firms consider that transparency in the legal and regulatory system has increased. Also, complaints about ill-adapted laws and regulations, which figured prominently in the 1995 surveys, were rarely mentioned as a major problem in the 2001 surveys.

Another important finding of the 2001 surveys is that opinions expressed by the firms in the three countries are broadly similar. In particular, the responses regarding the level of satisfaction with current market conditions and the ranking of various internal and external obstacles are quite similar. The remaining differences concern specific issues such as the greater emphasis on inadequate prior consultation procedures in Estonia, complaints about ineffective appeals and arbitration in Latvia, and complaints about inadequate antidumping regulations in Lithuania. It is also interesting to consider to what extent the obstacles and their ranking differ according to individual sectors covered by the surveys. For example, for transport companies, the major problem is the difficulty of obtaining permission to cross other countries' territory and the high cost of the required permits. Among the specific problems highlighted in the survey are a lack of sufficient government support and incentives for SMEs and their difficulties in obtaining information. Another frequently expressed concern is the extensive red tape in state agencies.

As already mentioned, many companies consider that prior consultations of the governments with various stakeholders, especially with the business community, are not yet sufficiently developed. In responding to these concerns, Baltic government officials usually stress two main problems. First, recent simultaneous WTO and EU negotiations have stretched available administrative capacities,

especially in small countries that have recently achieved independence. Second, prior consultations have been difficult due to limited involvement and even a lack of interest of the business community. This could reflect insufficient expertise of business associations, especially in the area of services, which are in some cases less well organised and knowledgeable than the groupings lobbying for manufacturing industries' interests. However, the growing participation of foreign investors in some strategic services industries has gradually changed this situation since companies that include foreign investors generally have more experience and are better prepared to take part in consultations with governments. Finally, both government officials and business representatives observe that consultations may also be difficult, not because of the lack of available information, but because of the large amount of very complex and highly specialised information involved.

The surveys also reveal an interesting difference in the perception of the importance of external versus internal barriers. In contrast to the 1995 surveys, the respondents generally considered external obstacles less important than domestic barriers in 2001. One possible explanation could be the success of integration efforts in eliminating major trade barriers, following the WTO accession and increasing trade co-operation with the EU and other regional partners. For example, the Baltic governments put in place regional consultation procedures in the area of non-tariff barriers, providing that any new legislation that might affect trade flows should be sent two weeks before its enforcement to other regional partners. Such an approach reflects recognition that, while in some areas, the removal of trade barriers should start at the national level, it is increasingly necessary to seek the solution through regional and sometimes international co-ordination. An apparent lack of concern about external barriers might also be explained by the nature of the 2001 surveys, which cover mainly the service sector and do not differentiate sufficiently between the views of companies according to their orientation to domestic or international markets. It is likely that, as companies become more involved in foreign trade, they will also become more sensitive to market conditions in other countries.

International Comparisons

The OECD surveys show rather unambiguously the Baltic business community's positive perception of economic and regulatory conditions in the region. Keeping in mind frequent general reservations concerning a possible bias in business surveys, it seems useful to put the outcome of the OECD surveys in a broader international perspective. Table 2.1 refers to four often-cited international indicators and summarises the corresponding results of the Baltic countries.

As regards the EBRD transition indicators, which measure different elements of a market economy against the standards of industrialised countries, the Baltic countries belong to the best achievers among the transition economies, especially with regard to the progress in privatisation as well as in trade and foreign exchange liberalisation. In comparison, more efforts are required in the area of competition policy, particularly in Latvia and Lithuania (EBRD, 2002). The Baltic countries also realised significant progress in their ranking according to the index of economic freedom: Estonia is in fourth position among 156 analysed countries, and both Latvia and Lithuania have considerably reduced their gap with the leading countries (Index of Economic Freedom, 2003). Similar trends appear for the corruption perception index (Corruption Perception Index, 2003). Finally, the Economic Freedom of the World, which summarises various indexes for 123 countries, also shows that the situation in the Baltic countries compares favourably with that of the most advanced transition economies, and in some cases, especially Estonia, even with some market economies. This is the case for example of the situation regarding the business environment, measured by a number of administrative obstacles for new business, time spent with government bureaucracy and conditions for starting new business (Economic Freedom of the World, 2003).

Some other recent studies that examine business conditions in transition economies also put the Baltic countries in top positions. For instance, a survey analysing the impact of ownership, soft budget constraints and the general business environment on the performance of 3 300 firms in 25 transition countries (Carlin *et al.*, 2001) ranks Estonia first, Latvia ninth and Lithuania fifteenth in terms of best business environment. Another study focussing on conditions of entry (Djankov *et al.*, 2001) observed the number of required procedures governing entry regulations as well as the time and the costs of these procedures in 85 countries. According to this survey (which does not cover Estonia), the number of entry procedures varies from two (in Canada) to 21 (in the Dominican Republic). Latvia and Lithuania, both with seven procedures, are under the world average of ten procedures. Compared to the world average of 47 business days required for start-up procedures, the corresponding time period is 23 days in Latvia and 46 in Lithuania.

In sum, several international surveys comparing the economic and regulatory environments in various countries confirm the findings of the OECD business surveys: the Baltic countries have made remarkable progress compared with other transition countries. In many respects, the situation in the region now corresponds to standard conditions in other market economies.

Table 2.1 Evaluation of the Economic and Business Environment in the Baltic Countries

Index		Estonia		Latvia		Lithuania		Explanatory notes
Progress in transition (*)		1996	2002	1996	2002	1996	2002	
Governance and enterprises restructuring		3	3+	3	3	3	3	3: Significant and sustained action to harden budget constraints and promote corporate governance.
Trade and foreign exchange system		4	4+	4	4+	4	4+	4+: Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in the WTO.
Competition policy		3	3-	2	2+	2	3	2: Competition policy legislation and institutions set up; some reduction of entry restrictions; 3: Some enforcement actions to reduce abuse of market power and to promote a competitive environment; substantial reduction of entry restrictions.
Index of Economic Freedom (**)								
Economic freedom index	Rank	28	4	68	38	91	29	Ranking among 156 analysed countries
	Overall score	2.50	1.80	3.05	2.50	3.45	2.35	Less than 1.95: free; 2.00 to 2.95: mostly free; 3.00 to 3.95: mostly unfree.
Government intervention		2.0	2.0	2.0	2.0	2.5	2.0	2: Low level of government intervention in the economy (greater than 10% but less than or equal to 25% of GDP).
Barriers to foreign investment		1.0	1.0	3.0	2.0	3.0	2.0	1: Very low (open and impartial treatment of FDI, almost no restrictions on FDI). 2: Low (restrictions on investment in few sectors; efficient approval process). 3: Moderate (restrictions on many investments, bureaucratic approval process).
Corruption perception index (***)		1999	2001	1999	2001	1999	2001	
Corruption Perception Index	Rank	27	28	58	59	52	38	Ranking among 156 analysed countries.
	Score	5.7	5.6	3.4	3.4	3.7	4.8	The index ranges between 10 (highly clean) and 0 (highly corrupt).
Economic Freedom of the World (****)		2000		2000		2000		
Business regulation	Rank	25		51		37		Ranking among 123 analysed countries
	Score	7.1		5.8		6.2		Higher rating (maximum 10) means that countries refrain from regulatory activities that retard entry into business.
Administrative obstacles for new business		7.6		7.2		7.3		
Time spent with government bureaucracy		7.2		4.7		7.5		
Ease of starting a new business		8.0		5.0		4.2		

Notes: (*) EBRD Transition index assesses four main elements of a market economy: markets and trade, enterprises, infrastructure and financial institutions. The measurement scale ranges from 1 (little or no change from a rigidly planned economy) to 4+ (the standard of an industrialised market economy). Data available in EBRD Transition Report 1996 and 2002

(**) Economic freedom is defined as the absence of government coercion or constraint on production, distribution or consumption. It covers 50 independent economic variables, falling into 10 broad categories, including trade policy, government intervention in the economy, regulations and black market activity. The scales run from 1 (policies most conducive to economic freedom) to 5 (least conducive policies). Index of Economic Freedom is available at www.heritage.org/index

(***) The Corruption Perceptions index relates to perceptions of the degree of corruption as seen by business, academics and risk analysts. The index ranges from 10 (highly clean) to 0 (highly corrupt). This index is available at www.transparency.org

(****) Economic Freedom of the World measures the degree of economic freedom in five major areas: size of government expenditures, legal structure, sound money, freedom to trade with foreigners and regulation of credit, labour and business. Corresponding data are available at www.freetheworld.com

NOTES

1. The three business surveys of the service sector were carried out in Estonia (by Ms. Elin Saks), Latvia (by Ms. Erika Sumilo) and Lithuania (by Mr. Jonas Butautis) at the beginning of 2001, and were discussed with Baltic trade officials at the meeting organised by the OECD in Tallinn in December 2001.
2. The business surveys were conducted in 1995 in each of the three Baltic States by Ms. Elin Saks and were discussed with Baltic trade officials in the meeting organised by the OECD in Helsinki in June 1995.

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Chapter 3

THE ROLE OF REGIONAL AND MULTILATERAL DISCIPLINES IN SERVICES TRADE LIBERALISATION

Abstract: This chapter examines the scope of the commitments accepted by the Baltic States under the General Agreement on Trade in Services (GATS) and compares them to the national schedule of Slovenia, which had acceded to the WTO/GATS earlier than these countries. It also describes the main aspects of liberalisation of trade in services resulting from the EU accession process and analyses their scope and coverage compared to relevant multilateral commitments. Finally, it highlights the unique negotiation experience and consultation procedures of the Baltic countries, which despite their limited administrative capacities have succeeded in conducting simultaneously complex multilateral and regional trade negotiations.

Introduction

Since their independence, the Baltic States have become active participants in the multilateral trading system and regional trade initiatives. In parallel with rapid trade liberalisation undertaken as part of their overall economic reforms, they accepted ambitious commitments in their negotiations for accession to the WTO and, as candidates for EU membership, they have been directly involved in a major regional integration initiative. They have also take part in several agreements at the plurilateral level, such as for example the OECD Declaration on International Investment and Multilateral Enterprises, as well as in the sectoral framework.

In general, multilateral and regional disciplines have played a similar role: they helped the Baltic countries consolidate their trade and investment opening achievements and contributed to improvements in the quality, transparency and coherence of their legal and regulatory systems. They have also encouraged national authorities to pursue trade liberalisation despite domestic protectionist pressures. An analysis of the Baltic countries multilateral commitments under the GATS and a comparison of those commitments with other transition economies (Slovenia in this case) reveal the considerable scope and depth of their undertaking. The main motivation of these countries has been to accelerate the process of modernisation and improve productivity of their service sector through international competition, fostered by a more open regime for trade and FDI.

However, except in some specific sectors, such as telecommunications and financial services, in which multilateral liberalisation commitments were reinforced, regulatory guidelines are less developed in the multilateral context than in the regional framework. As in other EU candidate countries, the Baltic countries' service sector has been mainly influenced by EU-related legal harmonisation and liberalisation, embodied in the EU *acquis communautaire*. Despite their recent external exposure, the Baltic countries efficiently managed complex multilateral and regional trade negotiations and developed efficient procedures for intra-governmental co-ordination and consultations with domestic stakeholders. Their experience in this area might be useful for other countries facing similar negotiating challenges.

The Baltic States' GATS Commitments

General Issues Related to Measuring Trade Liberalisation in Trade in Services

Measuring the scope of services trade liberalisation and comparing it internationally represent difficult analytical tasks due to the complexity of the service sector itself and to the scheduling modalities of market access commitments under the GATS (see Box 3.1). There is a growing body of literature exploring methods for analysing market access conditions and trade barriers for services in general or for specific sectors (OECD, 2003). Some studies assess restrictiveness of barriers to trade in services, using weighting methodologies or alternative approaches based on price-impact and quantity-impact measures. Various restrictiveness indices have been developed for different modes of service supply or specific services sectors, by incorporating information on the type of barriers and their likely economic impact. Other empirical, sectoral and economy-wide studies try to determine the welfare effects from the removal of barriers to trade in services. Nevertheless, cross-country and cross-sectoral comparisons remain difficult given the lack of reliable and comparable data for individual countries and sectors.

This chapter provides a general overview of the Baltic countries' GATS schedules, comparing them to those implemented by Slovenia, which acceded to the WTO/GATS before the conclusion of the Uruguay Round.¹ It considers GATS commitments of these countries regarding market access and national treatment for service sub-sectors in each of the four modes of supply. It takes into account most favoured-nation (MFN) exemptions, horizontal and sector specific commitments of the Baltic States² as well as their commitments under the Fifth Protocol on Financial Services and the Agreement on Basic Telecommunications negotiated after the conclusion of the Uruguay Round. (In case of

Slovenia, only financial services are covered as it has not signed the Agreement on Basic Telecommunications, partly because the new law on telecommunications was then in preparation.) This analysis allows the cross-country analysis of the Baltic States' commitments and their comparison with Slovenia, but does not permit analysis of the scope of liberalisation or the relative policy restrictiveness prevailing in their service industries.

Box 3.1: The General Agreement on Trade in Services (GATS)

The General Agreement on Trade in Services (GATS), established as a part of the Uruguay Round Agreements, came into force on January 1, 1995 as the first multilateral agreement for the liberalisation of trade in services. The GATS covers all services except services provided by the government and part of air transport services. The GATS consists of a set of general principles, specific commitments and member countries schedules. The GATS core principle is the most favoured-nation (MFN) obligation, which secures equal treatment by member country to services and service suppliers of any other member country. GATS members are nevertheless allowed to list (in principle time-limited) MFN exemptions granting more favourable treatment to some trading partners. Two specific commitments are national treatment, by which a member guarantees treatment no less favourable than that accorded to its own like services and service suppliers, and market access limitations defined in Article XVI of the GATS, which cannot be maintained unless specified in countries' schedules.

The GATS builds on a sectoral approach: market access and national treatment commitments are valid only for scheduled service sectors. Schedules of commitments are horizontal and sector specific. Horizontal commitments refer to all sectors, while sectoral commitments refer only to the scheduled sectors. The GATS identifies four modes of supply:

- Mode 1: cross-border supply,
- Mode 2: consumption abroad,
- Mode 3: commercial presence
- Mode 4: movement of natural persons.

For each mode of supply and for each service sector, the member country has to specify the limitations or conditions regarding market access (MA) and national treatment (NT), specifying one of the following commitments:

- **None:** meaning that there are no limitations on MA or NT for a given service sector and mode of supply.
- **Unbound:** meaning that for a given sector and mode of supply, the country remains free to introduce laws or regulations that limit MA or NT.
- **Limitations** (to MA or NT) indicating partial commitments and listing specific limitations. As recently acceding WTO members, the Baltic States have been included in recent assessments comparing GATS commitments, notably the 2001 WTO study (WTO, 2001). This study analysed only market access commitments that were considered economically more significant than national treatment commitments. It calculated that, of possible commitments in 161 service sub-sectors, GATS members undertook on average commitments in approximately 25 service sub-sectors. The number of countries with commitments in tourism, financial and business services is highest, while the number with commitments in health and education services is lowest. As to the modes of supply, mode 2 (consumption abroad) appears the most open, and mode 4 (movement of natural persons), the most restrictive. Commitments in mode 3 (commercial presence) are bound to a much larger extent than in mode 1 (cross-border supply), reflecting the interest of governments in attracting foreign direct investment into services sectors.

The 2001 WTO study notes that “all the nine countries that have joined the WTO since 1995 (*i.e.* between January 1995 and July 2000, which include also Estonia and Latvia) have assumed higher levels of commitments in terms of sectors included than current members at comparable levels of development. Also, the commitments assumed by acceding countries are generally deeper” (WTO, 2001, p. 99). Several possible reasons for such ambitious commitments by new members have been suggested: the awareness on the part of new members of the benefits of services liberalisation; a more careful examination of proposed commitments of acceding countries by current members; and insufficient understanding of GATS mechanisms and the impact of concessions by some negotiating countries.

MFN Exemptions

In general, MFN exemptions by the Baltic States and Slovenia, which reflect their regional or bilateral commitments, are similar to those scheduled by most WTO/GATS member countries. Although the range of their MFN exemptions is broadly similar, there are some differences among their schedules (Table 3.1). All the Baltic States and Slovenia have exempted audio-visual services and road transport services from MFN treatment and, with the exception of Estonia, also the sale and marketing of air transport services and computer reservation systems (CRS). In the case of audio-visual services more favourable treatment has been extended primarily to European countries in line with the EU accession process. MFN exemptions in road transport reflect the existence of numerous bilateral agreements signed by the four countries, which specify transit conditions, transport permits, road taxes and levies. The declared aim of these exemptions is to protect the transport infrastructure and the environment. Deviation from the MFN treatment in air transport services is also due to reciprocal provisions in existing bilateral agreements.

Latvia and Slovenia scheduled MFN exemptions for the same three sectors. In addition to two common sectors (audio-visual and road transport services), Estonia scheduled MFN exemption for all sectors, but grants permits for entry, stay, and work in Estonia to natural persons on the basis of reciprocity with countries with which such agreements are, or will be, established. This provision allows flexibility in the Estonian services-related labour market. Lithuania's GATS schedule indicates MFN exemptions in six categories of services, including, in addition to the three services already mentioned, legal services, tourist guide services and purchase of land. In the first two cases bilateral agreements enable more favourable treatment to partner countries of such agreements. The conditions for the purchase of land were set in constitutional law providing for more favourable treatment of member-states of OECD, NATO, EU and EU associated countries.

Table 3.1 MFN Exemptions

Sectors	Slovenia	Estonia	Latvia	Lithuania
Audio-visual services	X	X	X	X
Road Transport Services	X	X	X	X
Sale and Marketing of Air Transport Services, Computer Reservation System (CRS)	X		X	X
Legal Services				X
Tourist Guide Services				X
Purchase of Land				X
All Sectors		X		
No. of Sectors with MFN Exemptions.	3	3*	3	6

*In the case of Estonia one of MFN exemptions refers to all sectors.

Source: National Schedules of the Baltic States and Slovenia.

Horizontal and Sector Specific Commitments

The following analysis is based on a template that was established for each country using its GATS national schedule of commitments. This template covers 154 service sub-sectors³, with entries for each of the four modes of supply and for different types of impediments to market access and national treatment. The maximum possible number of entries for each country is 616 for market access and 616 for national treatment (154 sectors multiplied by four modes of supply). In the second phase, three entries (none, unbound and limited) were assigned to every sub-sector in accordance with the national schedules of commitments. Horizontal and sector-specific commitments were aggregated to allow assessments and comparisons of commitments across the four countries.⁴

While “none” and “unbound” entries may be compared across sub-sectors/modes/type of barriers in the sense that the extent of openness is clear and comparable, the entries with specific limitations

might differ substantially across sub-sectors/modes/type of barriers, ranging from almost no restriction to almost full restriction. The assignment of entries is further complicated by horizontal limitations, which concern all sectors specified in the national schedule. This has to be taken into account particularly in cases where no limitation (a “none” entry) is scheduled in sector-specific commitments. Horizontal limitations, although of minor importance, change the entry into partial commitment. Consequently, comparative data on the frequency of partial commitments for different sectors/modes/type of barriers or cross-country comparisons have to be seen only as a rough approximation of openness or restrictiveness of the service sector or individual services.

For the purpose of this analysis, GATS commitments of individual countries are assessed on the basis of the following indicators:

- *Coverage ratio*: the share of scheduled sub-sectors in the total number of sub-sectors. This indicator reflects to what extent sub-sectors were excluded from scheduling.
- *Full liberalisation ratio*: the share of total entries binding full market access and national treatment in the maximum possible number of entries. This ratio indicates the scope of liberalisation in a given sector.
- *Share of different types of commitments* (none, unbound and partial) in total number of commitments for market access and national treatment.
- Share of schedule entries binding full or partial commitments in market access and national treatment in the maximum possible entries for major service sectors.
- Coverage ratio and full liberalisation ratio for 12 major service sectors.

As in the case of other WTO members, horizontal commitments of the three Baltic countries and Slovenia for mode 4 are largely confined to the movement of intra-corporate transferees. Estonia, Latvia, Lithuania and Slovenia have introduced similar limitations to market access for mode 4 and, with the exception of Latvia, also to national treatment for mode 4. Since market access limitations in mode 4 provide an effective barrier for the limitation of national treatment, it is assumed that the degree of Latvian openness in mode 4 is similar to the other three countries. Given the particularities of mode 4, the present analysis focuses on the first three modes of supply.

Slovenia scheduled 76 out of 154 service sub-sectors, which is approximately half of the total. As to the type of commitment, it scheduled full binding (entry none) in 60% of all entries for modes 1, 2 and 3, partial bindings in approximately 29% of entries, while it refrained from any binding in almost 11% of entries (Annex Table 3 1). When the degree of liberalisation of different modes of services delivery is measured by the percentage of entries with no limitation to market access and national treatment, mode 2 appears as the most liberal in the Slovenian schedule. Entries with no limitation account for approximately 83% of all entries for market access and 97% for national treatment, followed by mode 3 with 65% of entries with no limitation to market access. Mode 1 is the only mode with unbound entries, modes 2 and 3 provide at least partial binding of commitments. Overall, the full liberalisation ratio for Slovenia’s GATS commitments accounts for approximately 30% of all entries.

Slovenia’s commitments in different service sectors in modes 1, 2 and 3 measured by different ratios are provided in Annex Table 3.2. According to the *coverage ratio*⁵, which indicates the percent of scheduled sub-sectors in total number of sub-sectors for 12 service sectors, Slovenia has scheduled all sub-sectors in construction and related engineering services, in environmental services and in financial services. The lowest coverage ratio is observed for transport services, for recreational, cultural and sporting services. *Full liberalisation ratio* indicates the share of sub-sector entries with no limitation in modes 1, 2 and 3 (full binding) as a percentage of all of sub-sector entries in each major service sector. This indicator shows distribution services as the most open sector, followed by environmental, educational and construction services. In contrast, transport, communication, financial

services, health and social services appear the least liberalised. If partial binding commitments are added to full binding commitments financial services have the largest degree of binding, followed by distribution services, construction and environmental services. Transport services remain the sector with the lowest share of full and partial bindings.

Estonia scheduled 96 sub-sectors, which account for approximately 62% of total service sub-sectors, while 58 sub-sectors were not scheduled. Among commitments entered in modes 1, 2 and 3, a large majority (89%) are with no limitation and full binding, almost 5% with partial limitation and less than 6% of entries do not provide for any binding. The distribution of entries by type of commitment is almost identical for market access and for national treatment. Mode 2 is the most liberal since all entries contain no limitations. Although mode 3 and mode 1 also display a large degree of openness, a few entries assume no binding (Annex Table 3.3).

As regards sectoral indicators (Annex Table 3.4), the *coverage ratio* is 100% in construction, educational, environmental, financial, health and social, and recreational, cultural and sporting services. (That is, Estonia has scheduled all sub-sectors.) Transport services have the lowest coverage ratio. In construction and environmental services, the share of sub-sectors with no limitation (*full liberalisation ratio*) for modes 1, 2 and 3 accounts is 100% and in financial services almost 98%. These three sectors show the largest extent of openness.

Within the total of 154 service sub-sectors, **Latvia** scheduled 115 or almost 75%, which is probably among highest coverage ratio of all WTO members (Annex Table 3.5). Approximately 77% of commitments in modes 1, 2 and 3 have no market access limitations, and partial restrictions concern only 9% of commitments. The share of no limitation entries is even higher for national treatment (87%). As expected, mode 2 provides for the largest extent of openness, as 94% of entries are free from any limitation on market access and 99% are free from limitations on national treatment. Mode 1 is much less open, with no limitation in approximately 57% of entries while no binding commitments are scheduled for 37% of entries regarding market access.

From the sectoral point of view, Latvia scheduled all sub-sectors in four out of 12 major service sectors (construction, environmental, financial, tourism and travel related services). In business, distribution and educational services, the *coverage ratio* is 80%. Unlike the other three countries, transport services have a quite high coverage ratio (60%). The *full liberalisation ratio*, which indicates the share of entries with no restrictions to market access in all entries for modes 1, 2 and 3, is the highest in tourism (92%), followed by distribution and educational services (80%). These three service sectors are also highly open with respect to national treatment, though less than financial services, which appear as a fully open sector (Annex Table 3.6).

Lithuania scheduled 108 service sub-sectors, which account for 70% of all service sub-sectors (Annex Table 3.7). The commitments in modes 1, 2 and 3 are quite liberal, as 80% of entries for market access and national treatment refer to no restrictions. Partial commitments account for a further 10% of entries. Mode 2 contains the largest share of entries without restrictions in market access (98%) or national treatment (97%) whereas mode 1 is the most restricted, with unbound entries accounting for approximately 23% of all entries.

Regarding the *coverage ratio* in major service sectors, Lithuania has scheduled all sub-sectors in construction, environmental and financial services compared to 40% of sub-sectors in transport services. The *full liberalisation ratio* with respect to market access, indicating the share of entries with no limitation in modes 1, 2 and 3, is the highest for environmental services. As regards national treatment, financial services is the most open sector, while in transport services, the share of entries with no limitation accounts for only 28% (Annex Table 3.8).

Cross-country Comparisons of GATS Commitments

National schedules of GATS commitments allow for cross-country comparisons, though some inconsistencies in the scheduling process⁶ reduce to a certain extent the relevance of such a comparative assessment.⁷

Despite some differences among the four examined countries, all accepted more significant commitments than the average WTO member, which, according to the WTO analysis, scheduled 25 services sub-sectors representing 15% of all sub-sectors. Among the four countries, Latvia has the highest share of commitments (in almost 75% of all sub-sectors) and fully liberalised entries (over 60% of all entries in modes 1, 2 and 3), whereas Slovenia has the lowest share in both indicators (50 and 30% respectively). Lithuania's coverage ratio and full liberalisation ratio are both close to Latvia's corresponding indicators. Estonia ranks first in terms of the number of sectors with a high degree of liberalisation (five service sectors), followed by Latvia and Lithuania (three service sectors) and Slovenia (only one service sector). In line with the general patterns observed in other countries' GATS commitments, the four countries accepted the highest number of commitments under mode 2, followed by mode 3 and mode 1. Estonia displays the smallest deviation between the three modes of services supply and Latvia the largest differentiation among the three modes (Table 3.2).

Table 3.2 Comparison of GATS Commitments in Mode 1, Mode 2 and Mode 3

	Estonia	Latvia	Lithuania	Slovenia
No. of scheduled sub-sectors	96.0	115.0	108.0	76.0
Coverage ratio (CR): no. of scheduled sub-sectors in total, in %	62.3	74.7	70.1	49.4
Full liberalisation ratio (FLR) in %	55.4	61.1	56.3	29.7
No. of service sectors with CR $\geq$ 80%	7.0	7.0	7.0	4.0
No. of service sectors with FLR $\geq$ 80% in market access	5.0	3.0	3.0	1.0
No. of service sectors with FLR $\geq$ 80% in national treatment	4.0	4.0	3.0	0.0
FLR in mode 1, market access, in %	51.3	42.2	47.4	25.3
FLR in mode 2, market access, in %	62.3	70.1	68.8	40.9
FLR in mode 3, market access, in %	53.9	59.1	47.4	31.8

Source: National Schedules of the Baltic States and Slovenia.

In terms of the sectoral coverage, Estonia is the only country, which accepted full liberalisation of several service sectors (*i.e.* construction and engineering services, educational services and environmental services) or only marginal limitations regarding market access limitations (financial services). The highest degree of liberalisation of individual service sectors is approximately 92% in Latvia, 83.3% in Lithuania and 80% in Slovenia. In market access terms, transport services have the lowest degree of commitments' binding and openness in Estonia, Lithuania and Slovenia, and communication services in Latvia. In general, construction, distribution, environmental and educational services are among the most liberalised sectors in the four countries as the share of full liberalisation entries exceeds 60% of total entries. In the Baltic States, financial services are also among the most liberalised service sectors (Table 3.3). In case of Slovenia, GATS commitments are relatively lower in the financial sector and communications, but in fact the actual liberalisation in these sectors is higher, reflecting new legislation introduced after the acceptance of GATS commitments.

Table 3.3 Comparison of Sectoral GATS Commitments in Market Access

Service sectors	Estonia		Latvia		Lithuania		Slovenia	
	CR	FLR	CR	FLR	CR	FLR	CR	FLR
Business services	58.7	55.1	80.4	72.5	80.4	73.2	56.5	50
Communication services	66.7	52.8	66.7	27.8	66.7	44.4	25	16.7
Construction & engin. services	100	100	100	66.7	100	66.7	100	60
Distribution services	80	80	80	80	80	80	80	80
Educational services	100	100	80	80	80	80	60	60
Environmental services	100	100	100	75	100	83.3	100	66.7
Financial services	100	97.9	100	66.7	100	66.7	100	16.7
Health & social services	100	66.7	50	33.3	50	33.3	50	16.7
Tourism & travel services	75	75	100	91.7	50	33.3	50	25
Recreational, cultural services	100	33.3	40	33.3	80	33.3	20	20
Transport services	20	20	60	46.7	40	27.6	20	15.2

Notes: CR: coverage ratio; FLR: full liberalisation ratio.

Source: National Schedules of the Baltic States and Slovenia.

Concluding Remarks on GATS Commitments

As already noted, any analysis of GATS commitments, based exclusively on national schedules cannot avoid significant shortcomings. The most important drawback is that GATS schedules give only a limited indication of the actual liberalisation or restrictiveness of existing barriers, especially for the sectors with partial commitment. Furthermore, as with tariffs in merchandise trade, the GATS schedules present restrictions applied at the time a country negotiated its GATS commitments, which may not correspond to current restrictions. Since the gap between scheduled commitments and the current situation for a given sector inevitably increases with time, this discrepancy might be significant, especially for founding WTO/GATS members like Slovenia.

Bearing in mind these important limitations, the comparative analysis of the four countries' GATS schedules reveals some interesting features. First, it shows that the scope and depth of GATS commitments undertaken by Slovenia are considerably lower than that of the Baltic States. Although this could be attributed to the different timing of the four countries' GATS negotiations, this is not the only explanation. In fact, compared to other Central and Eastern European countries, which also submitted their GATS schedules during the Uruguay Round, Slovenia's commitments are relatively liberal: the proportion of Slovenia's entries with no limitation on market access and national treatment ranks the second highest after Hungary (USITC, 1998).

The more ambitious GATS commitments of the Baltic States cannot be explained only by the different timing in scheduling of their GATS commitments. The Baltic States' trade representatives have confirmed on several occasions that they consider the liberalisation process not as a concession to other countries, but a crucial pre-condition for future development. A more positive attitude of the Baltic States towards liberalisation might also reflect their efforts to accelerate the catching up process through liberalisation and openness of their service sector to foreign direct investment.

The Baltic States, together with some other countries that recently acceded to the WTO, claimed that their considerable commitments should be taken into account in ongoing negotiations on further services trade liberalisation. Although such a right was not expressly admitted, the Decision of the Council for Trade in Services on "Modalities for the Treatment of Autonomous Liberalisation", adopted in March 2003 (WTO, 2003), established several criteria for assessing the value of autonomous liberalisation, such as sectoral coverage and liberalising nature of the measure concerned. The Decision also set up general procedures for considering credit for autonomous liberalisation.

Services Trade Liberalisation within Regional Integration Agreements

The Baltic States have been involved in several regional trade agreements, in particular the Baltic Free Trade Agreement (BFTA), the Central European Free Trade Agreement (CEFTA) and the Europe

Agreements (EAs). Although some preliminary discussions on services took place among the members of the BFTA and the CEFTA, none of them covers service-related provisions. In the CEFTA, the main issue was the problem of compliance with GATS Article V, which requires substantial sectoral coverage by preferential agreements. Discussions on services among the Baltic countries were also interrupted in view of more comprehensive services trade liberalisation foreseen in the context of the EAs.⁸ The EAs' provisions concern a large number of areas and disciplines relevant to services and go beyond current international disciplines, especially as regards movement of services, workers and freedom of establishment.

Main Provisions of the Europe Agreements Regarding Trade in Services

The structure and basic principles of the EAs signed by individual Central and Eastern European countries are similar; country-specific differences appear mainly in different annexes to countries' agreements. In the area of services, the EAs provide for gradual liberalisation in cross-border supply of services, the right of establishment of nationals and companies, national treatment of subsidiaries and branches of EU companies, and temporary movement of specified categories of natural persons.

The EAs provisions concerning establishment of companies apply to all sectors, with the exceptions of air transport, inland waterways and maritime cabotage transport services. The signatories of EAs mutually grant national treatment to their companies for setting-up operations and to the subsidiaries and branches of EU companies. Most commitments concerning the right of establishment and operations of subsidiaries and branches became effective with the entry into force of the EAs. The EU Member States excluded certain activities from national treatment for associated countries' companies, in particular legal acts related to real-estate property in frontier regions. The exemptions applied by Central and Eastern European countries are specified in the annexes, which stipulate the abolishment of these exceptions after a transitional period that generally ended by December 1999. In case of serious difficulties in certain industries and after prior consultations with the Association Council, the Central and Eastern European countries were allowed to derogate during the transitional period from commitments on establishment of EU companies and nationals.

In general, the EAs signatory countries provide mutually national treatment for the establishment and operation of their nationals only upon the expiration of the transitional period. Estonia granted such treatment to the EU nationals at the entry into force of its EA, without getting reciprocity from EU members. In this context, the establishment of nationals means the right to set up a business as a self-employed person and provide services in the other party's market, but does not allow access to the labour market of the other party. Supplying services by self-employed workers in EU member States requires mutual recognition of qualifications between the parties. Currently, corresponding legislation ensuring mutual recognition of professional qualifications has been introduced only in Estonia and Latvia. The EAs allow temporary movement of persons employed by companies that enjoy the right of free establishment, referring to key personnel or persons who negotiate the sale of services.

As regards the right of establishment of EU companies and nationals, Lithuania initially excluded the acquisition of land and activities related to natural resources, and organisation of gambling, betting and lotteries (Annex XVII a of the Agreement). Latvia's EA stipulates temporary exceptions to national treatment regarding the right of establishment for the following services: sale of weapons and explosives, organisation and performance of gambling operations, real estate transactions and ownership of port infrastructure (Annex XV of the Agreement). Lithuania's temporary reservations concern similar activities, namely exploration for and exploitation of mineral deposits, exploitation of natural resources, and operation of post and telecommunications (Annex XVII b of the Agreement). These national treatment reservations were terminated by the end of transitional period, *i.e.* in December 1999.

The EAs have provisions for cross border trade in services, which they refer to as supply of services between the parties. It is stipulated that the signatory countries shall take necessary steps to

allow gradually the supply of services by companies or nationals established in the EU member states and permit temporary movement of natural persons providing services. However, these provisions were not applied at the time of the entry into force of the EAs. The signatory countries agreed on a standstill commitment regarding the conditions governing the supply of services and directed the Association Council to take measures to liberalise services supply only eight years after the entry into force of the EAs after assessing the progress in the approximation of laws in associated countries, *i.e.* in 2006 in case of the Baltic States. This measure should allow the accession countries to strengthen competitiveness of their service sector and prepare better for subsequent free movement of services.

Supply of transport services is governed by specific provisions or specific agreements between the EC and associated countries. Concerning international maritime transport, the EA signatory countries apply the principle of unrestricted access to the market and traffic on a commercial basis. The Baltic States and the Community grant national treatment to the other Party's ships for access to ports open to international trade, the use of infrastructure and auxiliary maritime services of the ports. Free international sea-river services in inland waterways are provided to nationals and companies providing international maritime transport services. To ensure the transit of goods through the territory, the Baltic States and the EC concluded agreement on transit of inter-modal traffic through each other's territory. The Baltic States' EAs also stipulate that progressive liberalisation of transport between the parties concerning transport by road, rail and inland waterways and in air transport will be subject to specific agreements. Consequently, issues related to transport services were left for future special agreements or for the accession process.

To sum up, the EAs provisions had the following consequences for trade in services among the signatory countries:

- The EAs introduced major liberalisation in trade in most services sectors between the signatory countries via affiliates and branches. Several sectors have been excluded (air transport, inland waterways and maritime cabotage transport services). Remaining exceptions concerned a few sectors fully liberalised after a transitional period. Therefore, competition from EC service suppliers in the liberalised sectors comes predominantly from affiliates and branches of EC companies.
- The provision of services by self-employed persons was liberalised after the expiration of the transitional period. However, its effectiveness depends to a large extent on the mutual recognition of qualifications between the signatory countries. Otherwise, the EAs have achieved only a limited liberalisation of temporary movement of persons.
- Liberalisation in cross-border services trade between the EAs signatory countries has been relatively limited.

The EAs were designed as a part of the pre-accession strategy aiming at harmonisation of the legislative and institutional framework of candidate countries. The next step was the adoption of the EU *acquis communautaire* with the objective to establish necessary conditions for the integration and participation of these countries in the single service market.

Impact of Regional and Multilateral Disciplines on Services Trade Liberalisation

There are both similarities and differences in the two sets of international disciplines and commitments. Both the GATS and the EAs refer to the concepts of market access and national treatment, but they differ with respect to definition of the modes of supply. The GATS distinguishes four modes of services supply in international trade, while the EAs address trade in services in the framework of provisions on establishment (encompassing companies and nationals) and the supply of services.

Although more far-reaching than in case of many other WTO members, the Baltic States' GATS commitments are mostly of a standstill character, reflecting essentially market access conditions prevailing at the time of their accession to the WTO/GATS. This is due to the fact that the autonomous trade liberalisation process in these countries had been already considerably advanced at time of their WTO/GATS negotiations. It also reflects the main purpose of the GATS which sought to establish a multilateral legal framework for services liberalisation and introduce better transparency and predictability in trade in services. In contrast, the EAs imply a further step in liberalisation of trade in services, especially with respect to establishment and national treatment of companies and nationals providing services. However, the EAs define less precise obligations for cross-border supply of services and stipulate that liberalisation should take place only in eight years after the entry into force of the EAs. Therefore, it could be considered that the scope of liberalisation in the supply of services within the EAs does not exceed countries' GATS commitments under mode 1.

Commitments of the Baltic States regarding the movement of natural persons under the GATS (mode 4) and the EAs (movement of persons) are very similar. In both cases, the movement of persons is limited only to temporary movement of specified categories of natural persons, *i.e.* key personnel employed exclusively by companies, subsidiaries and branches. In addition, the EAs allow the provision of services by self-employed persons establishing a business. It is generally agreed that in this area the liberalisation process has not yet progressed significantly.

The main difference between commitments in the GATS and the EAs is the preferential character of the latter. GATS commitments apply to all WTO members in a non-discriminatory way, while concessions within the EAs are granted only to the parties to the agreements and therefore represent derogation from GATS rules enabled by Article V of the GATS on Economic Integration. Exemptions to MFN treatment by the Baltic States and other EU candidate countries reflect their commitments in the accession process and also reciprocal provisions in bilateral agreements signed essentially with EU countries. As the EU candidate countries progress in their legal and regulatory rapprochement leading to their integration to the EU, their positions in on-going WTO negotiations are to be harmonised with the EC global negotiating position, including in the GATS context.

The differences in the scope of liberalisation under the two sets of commitments also result from different approaches adopted by the GATS and the EAs. The GATS uses mainly a positive list approach in which only scheduled sectors are subject to commitments. The EAs apply an across-the-board approach (or a negative list approach), in which liberalisation commitments concern all sectors except expressly stated cases. These different approaches in negotiating and scheduling commitments make it difficult to compare precisely the sectoral coverage of the GATS schedules and the scope of liberalisation undertaken within regional integration initiatives, including the EAs.

With the exception of telecommunications and to a lesser extent financial services, both of which are subject to additional and deeper disciplines, the GATS provides relatively limited guidelines for domestic regulations. The EAs embody more precise regulatory guidance for domestic regulations, and this process has been further strengthened within the framework of the pre-accession process implying the adoption of the EU regulations, embodied in the EU *acquis communautaire*. As demonstrated in the next chapters of this publication, *the acquis* imposes a detailed and compelling blueprint for the regulatory and institutional framework in different sectors, which should be achieved by candidate countries within agreed deadlines.

Experience of the Baltic States with Managing Multilateral Negotiations

Although their involvement in the international trading system has been recent and therefore their negotiation experience limited, the Baltic States succeeded in handling simultaneously several exigent and time-consuming trade negotiations at the multilateral and the regional levels. Ongoing negotiations in the WTO/GATS represent a new challenge for WTO member countries. The negotiating technique used in negotiations on trade in services is the request-offer approach, based on

a country's submission of its request list of commitments to another country, which responds with an offer list of commitments it is ready to make. This process of preparations of GATS negotiations requires intensive intra-governmental co-ordination and consultations with different domestic stakeholders concerned by proposed GATS commitments. To share experience in this area, the OECD has undertaken a survey of country experiences in managing multilateral negotiations, in which the Baltic States had also taken part (OECD, 2002 b).

This section summarises the main elements of intra-governmental co-operation and consultations with domestic stakeholders in the three Baltic States, as described in countries' responses to the OECD questionnaire. This is followed by a brief analysis of the main similarities and differences in managing multilateral trade negotiations among the Baltic States and between the Baltic States and OECD Member countries. Although recent, the experience of the Baltic countries seems particularly relevant for other countries, which also have to manage simultaneously several trade negotiations and dispose of relatively limited administrative capacities.

Estonia

The agency responsible for *intra-governmental co-ordination* of WTO negotiations is the Ministry of Foreign Affairs (MFA). A delegation headed by the Minister for Foreign Affairs, which was formed by the Estonian Government in July 2002, includes the Deputy Under-Secretary for External Economic Policy Affairs (MFA) and high officials from different governmental agencies and heads of working groups, *i.e.* experts responsible for a specific issue of negotiations. The working group for the GATS negotiations is led by the Ministry of Economic Affairs (MEA) and chaired by the Head of its Foreign Trade Policy Division of Trade Department. Officials from various governmental agencies dealing with trade in services, including the Permanent Mission in Geneva, are in daily contact and meet on an ad hoc basis.

Parliamentary bodies, especially the Parliamentary Commissions for Economic Affairs and Foreign Affairs, are regularly briefed by relevant officials of the MFA and the MEA on the course of the negotiations, and the final result of the negotiations has to be ratified by the Parliament. According to the government, the structure of the governmental negotiating team co-ordinating the working groups enables them to achieve a clear division of tasks, fast and flexible process of consultations as well as efficient formulation and implementation of national positions.

The process for *consultation with domestic stakeholders* usually takes the form of ad hoc contacts (including e-mail consultation) with government officials. Officials from the MFA and the MEA have held lectures for industry associations to promote general knowledge of the WTO within the business community. A comprehensive website *Estonia and WTO* is run by the MFA where, among other information, an Estonian version of the *Business Guide to the World Trading System* is available. The website also gives an overview of the role of different governmental agencies in this process and provides their contact data.

Taking into account the relatively small size of the Estonian economy, the possibility of participating in the domestic preparations for negotiations exists for all interested parties, *i.e.* individual service exporters as well as industry associations. Consultations were held, for example, with representatives of the transport and financial sectors. Since there are no formal rules for consultations, the participants can be both self-selected and invited by governmental agencies and/or relevant industry associations. The basis for consultations is negotiating proposals and requests from WTO members, and Estonian draft requests. So far, however, input from industry has been limited. Although no formal process for consultations with other stakeholders has been established, all interested parties can visit the web page *Estonia and WTO* and contact relevant officials if they have questions and/or concerns.

Latvia

The Ministry of Economy (ME) is the main institution responsible for the GATS negotiations, including overall *co-ordination* with various governmental bodies and the business sector. In February 1999, the Cabinet of Ministers of the Republic of Latvia established an inter-Ministry body - the "Consultative Board for co-ordination of the participation of Latvia in the WTO". The Board is chaired by the State Secretary of the Ministry of Foreign Affairs (MFA) and includes officials from various ministries, such as the ME, Ministry of Finance, Ministry of Agriculture, Ministry of Transport, Ministry of Welfare, Ministry of Environmental Protection and Regional Development, Ministry of Education and Science, Ministry of Culture, Ministry of Interior and Bank of Latvia. The Consultative Board prepares and co-ordinates government positions in the multilateral negotiations, including GATS negotiations.

Meetings of the Board usually take place once in a month or more often if necessary. In addition, there are ad hoc contacts between the officials of relevant Ministries when necessary. Electronic communications are widely used among the relevant institutions. The Cabinet of Ministers of the Republic of Latvia approved a list of competent Ministries specifically responsible for GATS implementation and negotiations. The list includes the ME, Ministry of Finance, Ministry of Transport, Ministry of Welfare, Ministry of Education and Science, Ministry of Interior and Ministry of Environmental Protection and Regional Development. Parliamentary bodies are not involved in consultations.

Consultations with domestic stakeholders, in particular with representatives of different industries, take place generally within formal sectoral advisory groups, under the aegis of the "Expert Council at the Ministry of Economy", which involves the industry associations. Ad hoc contacts are also used, in particular for preparing position papers considering the interests of the industry associations. Electronic consultations are not yet used extensively. Individual exporters of services are not invited to the industry consultations, as industry associations are considered to provide an adequate overview of the situation and express current needs of the private sector. Representatives of foreign firms established in the local market can contribute to the preparations for negotiations via consultations with the Council of Foreign Investors. The invitees to consultations can be self-selected, or selected by the Ministries.

Position papers taking into account the interests of consumers and service suppliers can serve as a basis for consultations. Background papers drafted by relevant Ministries are also used during the course of consultations. In the view of the Government of Latvia, input from industry is of great importance, since it enables the negotiators to take into account the domestic objectives and commercial interests of Latvian companies.

Lithuania

The Ministry of Foreign Affairs (MFA) is the leading institution for co-ordinating *intra-governmental consultations* concerning WTO matters and questions concerning trade policy in general. The Permanent Commission for implementing Lithuania's WTO commitments and intra-institutional co-ordination for all matters related to the WTO was established after the country's accession to the WTO in May 2001. The Commission, in which the MFA plays the leading role, includes representatives from 29 different Ministries and other governmental institutions, in particular the Ministry of Economy, Ministry of Finance, Ministry of Communication, Ministry of Agriculture, Ministry of Culture, Ministry of Environment, Lithuanian Bank, State Patent Bureau, Customs Department, Competition Council, and Standardisation Department. The Commission is chaired by the Director of Economics Department of the MFA. Relevant Ministries are contacted on an ad hoc basis in order to explain the current situation and discuss their interests in specific issues. Where necessary, an ad hoc Task Force may be formed. Electronic communication is generally used, and ad hoc briefings may be organised if required.

The MFA, as the lead institution dealing with trade policy and the WTO, has close relations with relevant Parliament Committees, including the Committee on Foreign Affairs, Committee on Economics, Committee on Rural Affairs, Committee on Finance and Budgeting, Committee on Developing of Information Society and other Parliamentary bodies. These different institutions are regularly informed about the whole WTO negotiations process, implementation of Lithuania's commitments to the WTO and WTO requirements in relevant legislative areas.

The MFA has established stable and permanent *co-operation with domestic stakeholders*, in particular business associations and representatives of all industries, including the service industry. Permanent contacts and communication with business associations are a part of the Ministry's daily work. The MFA often initiates and/or takes a part in seminars or conferences or other meetings to disseminate information concerning export promotion, world trade and WTO-related matters. Information about Lithuania's trade policy and co-operation with the WTO is available at the Internet with e-mail addresses for feedback. Ad hoc consultations with interested parties via phone and e-mail, as well as face-to-face meetings, are a part of daily routine of the MFA.

In industry, consultations mostly involve the Confederation of Lithuanian Industrialists and specialised industry associations, such as the Association INFOBALT (its members are IT-related companies and education institutions), Lithuanian Association of Constructors, Lithuanian Association of Carriers, Lithuanian Commercial Banks Association, National Association of Hotels and Restaurants, etc. However, individual service exporters are also considered. Representatives of foreign enterprises in Lithuania established the Forum of Investors, which also closely works with the government. The consultations are held in different formats — briefings, ad hoc contacts, e-mail consultations or correspondence. Invitees may be both chosen by relevant Ministry or/and business association and self-selected.

Consultations with other stakeholders also involve the Lithuanian Free Market Institute (LFMI), which is a non-governmental and non-profit organisation established to promote the ideas of classical liberalism based on the principles of free market. LFMI's activities also include sociological surveys, publications, conferences, workshops, and lectures. The MFA, the LFMI and domestic consumer groups or other interested parties work in close co-operation, usually through ad hoc contacts, e-mail consultations and meetings. Periodic surveys by the LFMI are provided on an ongoing basis. (Table 3.4)

Table 3.4 Main Aspects of Intra-governmental Co-ordination and Consultations

	Estonia	Latvia	Lithuania
Lead agency for WTO/GATS negotiations	MFA/MEA	ME/MFA	MFA
Structures in place for intra-governmental co-ordination	Delegation	Consultative Board	Permanent Commission
Intra-governmental consultation process	Mainly <i>ad hoc</i>	Mainly regular meetings	Mainly <i>ad hoc</i>
Consultation process with industry	Mainly <i>ad hoc</i>	Mainly <i>ad hoc</i>	Mainly <i>ad hoc</i>
Representation of industry	Individual business operators and industry associations	Industry associations	Individual business operators and industry associations
Parliamentary involvement	Yes, briefings by government	No	Yes, briefings by government
Involvement of other stakeholders	No	No	Yes, LFMI

Source: Information provided by national authorities.

Comparison with OECD Member Countries

The MFA is the main institution in all three Baltic States with responsibility for overall co-ordination of preparation for the WTO negotiations. In Estonia and Latvia, GATS-related issues are handled by the Ministry of Economic Affairs, while in Lithuania they fall under the competence of the MFA. All three countries established intra-governmental bodies responsible for the co-ordination of

preparation for the WTO negotiations. In Latvia, the Consultative Board holds meetings regularly. In Lithuania, the Permanent Commission, including representatives from 29 governmental institutions, acts mostly on an ad hoc basis. In Estonia, the Delegation consisting of high officials from government agencies and heads of working groups also meets on an ad hoc basis.

In the three countries, the procedures of intra-governmental co-ordination appear to be more formalised than the mechanism for consultation with other stakeholders. Consultations with industry stakeholders take generally the form of ad-hoc contacts. The structure of consultations with industry and intra-governmental co-operation is influenced by the nature of specific negotiations issues, the complexity of the questions involved, the objectives to be achieved, etc. In Estonia and Lithuania, individual business operators can participate in preparatory work along with industry associations. In Latvia, business sector involvement is limited to industry associations.

In Estonia and Lithuania, parliamentary involvement in consultations is limited to government briefings of relevant parliamentary committees. Latvia responded that there is no parliamentary involvement in consultation procedure.

The Baltic States use information technologies extensively. Estonia and Lithuania have developed informative web sites on WTO-related issues, containing contact details of persons to whom questions could be referred.

All three Baltic States noted a relative lack of interest on the part of many domestic stakeholders in the process of preparation for GATS negotiations. In Estonia and Latvia, stakeholders other than representatives of business association rarely intervene in the preparatory negotiation process. In Lithuania a private non-profit organisation (Lithuanian Free Market Institute) serves as a relay to the government to communicate its policy objectives and obtain a feedback from the public at large. In all countries, the co-ordination and consultation procedures seem to be of a rather informal nature, which is probably due to a relatively limited number of actors in the Baltic States.

The comparison of existing practices in the Baltic States reveals many common features with procedures observed in OECD countries, in particular as regards the role of a lead agency in WTO/GATS negotiations and the emphasis on informal and direct ad hoc communication during the preparatory process. The role of parliamentary bodies in consultation procedures is also similar, generally limited to government briefings of relevant parliamentary committees. Although not always explicitly pointed out, the Baltic States also acknowledge a “two-way” nature of consultations, providing an opportunity to encourage a greater understanding of the GATS issues and to collect information for the negotiations. However, like most OECD countries, the Baltic States governmental officials face difficulties in attracting sufficient involvement of services industries into the GATS negotiation process. The main distinctive feature of the Baltic States in comparison to some OECD countries is a more extensive reliance on information technology in co-ordination and consultation procedures. Compared to some OECD countries, the Baltic States seem to use relatively fewer background papers on GATS-related issues prepared for example by the OECD or the UNCTAD.

The survey of the Baltic countries’ experience with managing international negotiations on trade in services shows that, despite their recent external exposure and involvement in such negotiations, these countries have developed well-functioning and efficient procedures for intra-governmental co-ordination and consultations with domestic stakeholders for preparation of WTO/GATS negotiations. However, as in many other countries, the involvement of the business community and other stakeholders in the consultation process on WTO-related matters has remained rather limited, despite the governments’ efforts. The relatively limited feedback from most service providers might be attributed to the fact that most companies do not see a clear relationship between the language of the GATS and their own interests and concerns. Another source of difficulties might be the diversity of interests among different categories of services, as some sectors are more interested in opening markets in other countries, while others are primarily interested in protecting their domestic market.

Annex Table 3.1 Slovenian GATS Commitments, by Type of Limitation

	Market access (MA)				National treatment (NT)				MA+NT
	mode 1	mode 2	mode 3	Total	mode 1	mode 2	mode 3	Total	
Number of sub-sectors scheduled	76	76	76	228	76	76	76	228	456
<i>none</i>	39	63	49	151	49	74	0	123	274
<i>partial</i>	13	13	27	53	6	2	73	81	134
<i>unbound</i>	24	0	0	24	21	0	3	24	48
Number of non-scheduled sub-sectors	78	78	78	234	78	78	78	234	468
Total number of sub-sectors	154	154	154	462	154	154	154	462	924
% of scheduled in total	49.4	49.4	49.4	49.4	49.4	49.4	49.4	49.4	49.4
Scheduled, % by type of limitation	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>none</i>	51.3	82.9	64.5	66.2	64.5	97.4	0.0	53.9	60.1
<i>partial</i>	17.1	17.1	35.5	23.2	7.9	2.6	96.1	35.5	29.4
<i>unbound</i>	31.6	0.0	0.0	10.5	27.6	0.0	3.9	10.5	10.5
Scheduled , % in total, by type of limitation	49.4	49.4	49.4	49.4	49.4	49.4	49.4	49.4	49.4
<i>none</i>	25.3	40.9	31.8	32.7	31.8	48.1	0.0	26.6	29.7
<i>partial</i>	8.4	8.4	17.5	11.5	3.9	1.3	47.4	17.5	14.5
<i>unbound</i>	15.6	0.0	0.0	5.2	13.6	0.0	1.9	5.2	5.2

Source : The Republic of Slovenia, Schedule of Specific Commitments, GATS/SC/99, GATS/SC/99 Supplement 1.

Annex Table 3.2 Slovenian GATS Commitments, by Service Sectors

	Entries in mode 1, mode 2 and mode 3									
	MA or NT			Market access (MA)				National treatment (N		
			%	None		None+Partial		None		None
	Total	Scheduled		Number	% of total	Number	% of total	Number	% of total	
	1	2	3=2/1	4	5=4/1	6	7=6/1	8	9=8/1	10
1. Business services	138	78	56,5	69	50,0	74	53,6	47	34,1	73
2. Communication services	72	18	25,0	12	16,7	17	23,6	11	15,3	17
3. Construction and related engineering services	15	15	100,0	9	60,0	10	66,7	5	33,3	10
4. Distribution Services	15	12	80,0	12	80,0	12	80,0	8	53,3	12
5. Educational services	15	9	60,0	9	60,0	9	60,0	6	40,0	9
6. Environmental services	12	12	100,0	8	66,7	8	66,7	4	33,3	8
7. Financial services	48	48	100,0	8	16,7	45	93,8	29	60,4	47
8. Health services and social services	12	6	50,0	2	16,7	4	33,3	1	8,3	4
9. Tourism and travel related services	12	6	50,0	3	25,0	5	41,7	2	16,7	5
10. Recreational, cultural and sporting services	15	3	20,0	3	20,0	3	20,0	2	13,3	3
11. Transport services	105	21	20,0	16	15,2	17	16,2	8	7,6	16
12. Other services not included elsewhere	3	0	0,0	0	0,0	0	0,0	0	0,0	0
TOTAL SCHEDULED SERVICES	462	228	49,4	151	32,7	204	44,2	123	26,6	204

Source: The Republic of Slovenia, Schedule of Specific Commitments, GATS/SC/99, GATS/SC/99 Supplement 1.

Annex Table 3.3 Estonian GATS Commitments, by Type of Limitation

	Market access (MA)				National treatment (NT)				MA+NT
	mode 1	mode 2	mode 3	Total	mode 1	mode 2	mode 3	Total	
Number of scheduled sub-sectors	96	96	96	288	96	96	96	288	576
<i>none</i>	79	96	83	258	84	96	74	254	512
<i>partial</i>	6	0	6	12	0	0	15	15	27
<i>unbound</i>	11	0	7	18	12	0	7	19	37
Number of non-scheduled sub-sectors	58	58	58	174	58	58	58	174	348
Total number of sub-sectors	154	154	154	462	154	154	154	462	924
% of scheduled in total	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
Scheduled, % by type of limitation	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>none</i>	82.3	100.0	86.5	89.6	87.5	100.0	77.1	88.2	88.9
<i>partial</i>	6.3	0.0	6.3	4.2	0.0	0.0	15.6	5.2	4.7
<i>unbound</i>	11.5	0.0	7.3	6.3	12.5	0.0	7.3	6.6	6.4
Scheduled , % in total, by type of limitation	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
<i>none</i>	51.3	62.3	53.9	55.8	54.5	62.3	48.1	55.0	55.4
<i>partial</i>	3.9	0.0	3.9	2.6	0.0	0.0	9.7	3.2	2.9
<i>unbound</i>	7.1	0.0	4.5	3.9	7.8	0.0	4.5	4.1	4.0

Source: The Republic of Estonia, Final List of Article II MFN Exemptions, GATS/EL/127, 5 October 1999, own calculations.

Annex Table 3.4 Estonian GATS Commitments, by Service Sectors

	Entries in mode 1, mode 2 and mode 3										
	MA or NT			Market access (MA)				National treatment (NT)			
			%	None		None+Partial		None		None+Partial	
	Total	Scheduled		Number	% of total	Number	% of total	Number	% of total	Number	% of total
	1	2	3=2/1	4	5=4/1	6	7=6/1	8	9=8/1	10	11=10/1
1. Business services	138	81	58.7	76	55.1	77	55.8	71	51.4	76	55.1
2. Communication services	72	48	66.7	38	52.8	48	66.7	48	66.7	48	66.7
3. Construction and related engineering services	15	15	100.0	15	100.0	15	100.0	10	66.7	15	100.0
4. Distribution Services	15	12	80.0	12	80.0	12	80.0	12	80.0	12	80.0
5. Educational services	15	15	100.0	15	100.0	15	100.0	15	100.0	15	100.0
6. Environmental services	12	12	100.0	12	100.0	12	100.0	12	100.0	12	100.0
7. Financial services	48	48	100.0	47	97.9	48	100.0	47	97.9	48	100.0
8. Health services and social services	12	12	100.0	8	66.7	8	66.7	4	33.3	8	66.7
9. Tourism and travel related services	12	9	75.0	9	75.0	9	75.0	9	75.0	9	75.0
10. Recreational, cultural and sporting services	15	15	100.0	5	33.3	5	33.3	5	33.3	5	33.3
11. Transport services	105	21	20.0	21	20.0	21	20.0	21	20.0	7	6.7
12. Other services not included elsewhere	3	0	0.0	0	0	0	0.0	0	0.0	0	0.0
TOTAL SCHEDULED SERVICES	462	288	62.3	258	55.8	270	58.4	254	55.0	255	55.2

Source: The Republic of Estonia, Final List of Article II MFN Exemptions, GATS/EL/127, 5 October 1999, own calculations.

Annex Table 3.5 Latvian GATS Commitments, by Type of Limitation

	Market access (MA)			MA total	National treatment (NT)			NT total	MA+NT
	mode 1	mode 2	mode 3		mode 1	mode 2	mode 3		
Number of sub-sectors scheduled	115	115	115	345	115	115	115	345	690
<i>none</i>	65	108	91	264	83	114	104	301	565
<i>partial</i>	7	7	17	31	0	0	4	4	35
<i>unbound</i>	43	0	7	50	32	1	7	40	90
Number of non-scheduled sub-sectors	39	39	39	117	39	39	39	117	234
Total number of sub-sectors	154	154	154	462	154	154	154	462	924
% of scheduled in total	74.7	74.7	74.7	74.7	74.7	74.7	74.7	74.7	74.7
Scheduled, % by type of limitation	100	100	100	100	100	100	100	100	100
<i>none</i>	56.5	93.9	79.1	76.5	72.2	99.1	90.4	87.2	81.9
<i>partial</i>	6.1	6.1	14.8	9.0	0.0	0.0	3.5	1.2	5.1
<i>unbound</i>	37.4	0.0	6.1	14.5	27.8	0.9	6.1	11.6	13.0
Scheduled , % in total, by type of limitation	74.7	74.7	74.7	74.7	74.7	74.7	74.7	74.7	74.7
<i>none</i>	42.2	70.1	59.1	57.1	53.9	74.0	67.5	65.2	61.1
<i>partial</i>	4.5	4.5	11.0	6.7	0.0	0.0	2.6	0.9	3.8
<i>unbound</i>	27.9	0.0	4.5	10.8	20.8	0.6	4.5	8.7	9.7

Source: The Republic of Latvia, Final List of Article II MFN Exemptions, GATS/EL/ 126, 16 April 1999, own calculations.

Annex Table 3.6 Latvian GATS Commitments, by Service Sectors

	Entries in mode 1, mode 2 and mode 3										
	MA or NT			Market access (MA)				National treatment (NT)			
				None		None+Partial		None		None+Partial	
	Total	Scheduled	%	Number	% of total	Number	% of total	Number	% of total	Number	% of total
	1	2	3=2/1	4	5=4/1	6	7=6/1	8	9=8/1	10	11=10/1
1. Business services	138	111	80.4	100	72.5	107	77.5	106	76.8	107	77.5
2. Communication services	72	48	66.7	20	27.8	34	47.2	34	47.2	34	47.2
3. Construction and related engineering services	15	15	100.0	10	66.7	10	66.7	10	66.7	10	66.7
4. Distribution Services	15	12	80.0	12	80.0	12	80.0	12	80.0	12	80.0
5. Educational services	15	12	80.0	12	80	12	80.0	12	80.0	12	80.0
6. Environmental services	12	12	100.0	9	75.0	9	75.0	9	75.0	9	75.0
7. Financial services	48	48	100.0	32	66.7	37	77.1	48	100.0	48	100.0
8. Health services and social services	12	6	50.0	4	33.3	5	41.7	5	41.7	5	41.7
9. Tourism and travel related services	12	12	100.0	11	91.7	11	91.7	11	91.7	11	91.7
10. Recreational, cultural and sporting services	15	6	40.0	5	33.3	5	33.3	3	20.0	4	26.7
11. Transport services	105	63	60.0	49	46.7	53	50.5	51	48.6	53	50.5
12. Other services not included elsewhere	3	0	0.0	0	0	0	0.0	0	0.0	0	0.0
TOTAL SCHEDULED SERVICES	462	345	74.7	264	57.1	295	63.9	301	65.2	305	66.0

Source: The Republic of Latvia, Final List of Article II MFN Exemptions, GATS/EL/ 126, 16 April 1999, own calculations.

Annex Table 3.7 Lithuanian GATS Commitments, by Type of Limitation

	Market access (MA)				National treatment (NT)				MA+NT
	mode 1	mode 2	mode 3	total	mode 1	mode 2	mode 3	total	
Number of sub-sectors scheduled	108	108	108	324	108	108	108	324	648
<i>none</i>	73	106	73	252	75	105	88	268	520
<i>partial</i>	10	0	31	41	9	0	16	25	66
<i>unbound</i>	25	2	4	31	24	3	4	31	62
Number of non-scheduled sub-sectors	46	46	46	138	46	46	46	138	276
Total number of sub-sectors	154	154	154	462	154	154	154	462	924
% of scheduled in total	70.1	70.1	70.1	70.1	70.1	70.1	70.1	70.1	70.1
Scheduled, % by type of limitation	100	100	100	100	100	100	100	100	100
<i>none</i>	67.6	98.1	67.3	77.8	70.1	97.2	81.5	82.7	80.2
<i>partial</i>	9.3	0.0	28.0	12.7	7.5	0.0	14.8	7.7	10.2
<i>unbound</i>	23.1	1.9	4.7	9.6	22.4	2.8	3.7	9.6	9.6
Scheduled , % in total, by type of limitation	70.1	70.1	70.1	70.1	70.1	70.1	70.1	70.1	70.1
<i>none</i>	47.4	68.8	47.4	54.5	48.7	68.2	57.1	58.0	56.3
<i>partial</i>	6.5	0.0	20.1	8.9	5.8	0.0	10.4	5.4	7.1
<i>unbound</i>	16.2	1.3	2.6	6.7	15.6	1.9	2.6	6.7	6.7
<i>Source</i> : Lithuania, Schedule of Specific Commitments, GATS/SC/133, 21 December 2001, own calculations.									

Annex Table 3.8 Lithuanian GATS Commitments, by Service Sectors

	Entries in mode 1, mode 2 and mode 3										
	MA or NT			Market access (MA)				National treatment (NT)			
			%	None		None+Partial		None		None+Partial	
	Total	Scheduled		Number	% of total	Number	% of total	Number	% of total	Number	% of total
	1	2	3=2/1	4	5=4/1	6	7=6/1	8	9=8/1	10	11=10/1
1. Business services	138	111	80.4	101	73.2	108	78.3	105	76.1	108	78.3
2. Communication services	72	48	66.7	32	44.4	48	66.7	32	44.4	48	66.7
3. Construction and related engineering services	15	15	100.0	10	66.7	10	66.7	10	66.7	10	66.7
4. Distribution Services	15	12	80.0	12	80.0	12	80.0	12	80.0	12	80.0
5. Educational services	15	12	80.0	12	80.0	12	80.0	10	66.7	12	80.0
6. Environmental services	12	12	100.0	10	83.3	10	83.3	10	83.3	10	83.3
7. Financial services	48	48	100.0	33	68.8	46	95.8	48	100.0	48	100.0
8. Health services and social services	12	6	50.0	4	33.3	5	41.7	4	33.3	5	41.7
9. Tourism and travel related services	12	6	50.0	4	33.3	5	41.7	5	41.7	5	41.7
10. Recreational, cultural and sporting services	15	12	80.0	5	33.3	7	46.7	3	20.0	6	40.0
11. Transport services	105	42	40.0	29	27.6	30	28.6	29	27.6	29	27.6
12. Other services not included elsewhere	3	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
TOTAL SERVICES	462	324	70.1	252	54.5	293	63.4	268	58.0	293	63.4

Source: Lithuania, Schedule of Specific Commitments, GATS/SC/133, 21 December 2001, own calculations.

NOTES

1. This survey comparing the GATS commitments of the Baltic countries and Slovenia and the analysis of the Europe Agreements were carried out for the OECD by Mrs. Metka Stare, Senior Research Fellow, Faculty of Social Sciences, University of Ljubljana (Slovenia).
2. The method was first developed by Hoekman (1995) and was used subsequently in other studies, for example in Hoekman et al., 1997.
3. The difference between the numbers of sectors (154) in GATS national schedules and the number of sectors in the 1991 Services Sectoral Classification List (155) is due to the fact that the latter includes 17 sub-sectors of financial services while the Annex on Financial Services covers 16 sub-sectors of financial services.
4. Horizontal limitations were not taken into account when they refer to sector specific commitments or when deemed irrelevant, as indicated in the analysis of individual countries' commitments.
5. Coverage ratio is identical for market access and national treatment due to the scheduling practice according to which countries were obliged to inscribe entries under each mode of supply for both market access and national treatment.
6. The entries of commitments were assigned to market access or national treatment as indicated in national schedules, although in some cases impediments to market access were inscribed under limitation to national treatment in national schedules and vice versa.
7. For example, Latvia, Lithuania and Slovenia scheduled entry unbound in mode 1 in construction services for both market access and national treatment, due to lack of technical feasibility for cross-border supply of construction services. Estonia scheduled entry none for the same mode implying that Estonia is more open in regard of construction services than Latvia, Lithuania and Slovenia. This is however not the case as technical feasibility differs across sectors and not across countries.
8. The Europe Agreements between three Baltic States and the EC were signed on 12 June 1995 and entered into force in February 1998. The transitional period, which applies to some provisions of these agreements, expired at the end of 1999.

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Chapter 4

THE ECONOMIC AND REGULATORY ENVIRONMENT FOR SERVICES: A SECTORAL PERSPECTIVE

Abstract: This chapter examines the economic and regulatory framework in four services sectors — banking, telecommunications, electricity and airfreight. For each of these sectors, the main aspects considered are market and trade liberalisation strategies and their results in terms of the current market structure and the involvement of foreign investors; the scope of international and regional commitments; and the regulatory framework, including the prerogatives of relevant regulatory bodies. These sectoral examples illustrate how the adopted reform strategies, international liberalisation commitments and the domestic regulatory framework have influenced economic performances in these service sectors.

Introduction

The previous chapters reviewed recent developments and general features of the entire service sector without systematically differentiating among individual services industries. To take into account the sectoral diversity of services, this chapter focuses on four specific sectors, which have in common their key role in national economies and foreign trade as vital intermediate inputs for other sectors and as network or trade-facilitating services. However, they differ in a number of specific characteristics, in particular, the extent of international and regional disciplines to which they are subject and the level of competition that prevails in individual sectors.¹

Two of the analysed sectors, telecommunications and banking, are covered by multilateral, sector-specific agreements in the WTO/GATS, which establish relatively detailed principles for sound regulation. The Agreements on Basic Telecommunications sets up international standards for regulation and defines best pro-competitive practices in this sector, introducing, in particular, competition safeguards, interconnection guarantees, transparency in licensing, independence of regulators, and a universal service mechanism. The Understanding on Commitments in the Financial Sector, which was negotiated after the Uruguay Round, led most WTO member countries to accept substantial commitments in this sector, which go generally beyond standstill commitments that characterise most national schedules in other sectors.

The two other sectors analysed in this chapter, electricity and airfreight, have not yet been subject to significant multilateral commitments. In the case of energy, only a few countries made limited specific commitments under the GATS, mainly concerning oil-field services, mining and energy-related consultancy services. This situation is essentially due to historical reasons: liberalisation and governments' gradual withdrawal from dominant ownership and regulatory interventions in the energy sector have been recent. Moreover, the limited coverage of the energy sector by international service-related disciplines is also due to procedural problems in defining and classifying energy-related activities as a product or service. Air transport is covered in a limited way by the GATS Annex on Air Transport Services, signed by less than 40 WTO members. The Annex covers aircraft repair, maintenance, marketing of air transport services and computer reservation services. Despite its growing internationalisation, airfreight continues to be managed essentially through specific international agreements and bilateral treaties.

Another difference among the service sectors is the scope of competition. In general, one can distinguish between structurally competitive sectors and network industries combining competitive market and naturally monopoly elements. Financial services and airfreight are generally considered as competitive sectors. The telecommunications industry is an interesting example of cohabitation of two sub-sectors: mobile telephony usually belongs to structurally competitive sectors, whereas fixed telephony often remains subject to restricted competition and stricter regulations. Finally, electricity supply and distribution, like railway and postal services, are typical networking industries, characterised by a mixture of competitive market and natural monopoly elements.

Despite these distinctive features and situations, the analysed sectors have undergone considerable transformations in their ownership structure and market opening. In banking, telecommunications and electricity, the transformation process has been largely driven by the EU accession requirements, which will continue to shape the regulatory environment in new Member States after their accession. In the airfreight industry, the situation differs. In the absence or the limited scope of multilateral and regional disciplines, the privatisation process and increased competition have essentially resulted from market pressures. In the future, the situation in different sectors will evolve, depending on the progress in market restructuring and regulatory adjustments in individual countries and on the level of ambitions of the EU regulatory agenda in specific sectors.

Banking services have undergone the most far-reaching restructuring. As a result, financial services in the Baltic countries now exhibit many similarities with the EU banking system. Concentration is already high, most banks are foreign-owned and future changes in ownership might result only from the consolidation of foreign firms. Deregulation, according to the EU standards, is also mostly completed. As in most new EU members, the banks in the Baltic States have relatively high profitability, though bad loans could still pose some problems. The main objective will be to develop retail banking and expand SME lending, while keeping quality and operating costs under control.

In telecommunications, the situation in the Baltic countries is quite similar to that prevailing in current EU Member States, especially regarding the ownership structure, participation of foreign operators, the scope of competition in different sub-sectors and the adoption of EU regulatory disciplines. Further challenges will concern, in particular, the continued liberalisation in fixed-line telephony and possible changes in foreign ownership in mobile telephony. Under such conditions, it will be particularly important for national regulatory authorities to maintain their impartiality.

As in many current members of the EU, the energy sector in the Baltic countries still has to go through important restructuring, as monopolistic structure, state ownership and highly regulated environment are still common. The Baltic States must address environmental concerns, and providers, who will operate in the context of more volatile energy prices and higher competitive pressures, will be confronted with increasing pressures for vertical disintegration. As in telecommunications, the capacity of national regulatory authorities to manage considerable regulatory changes will also be critical.

The transportation sector is probably the sector in which all candidate countries face the biggest challenges. They are due to often outdated and environment-unfriendly infrastructure, which requires substantial investments. However, some segments of the sector such as airfreight business have already been subject to important restructuring and ownership changes. Ongoing technological and organisational transformations in the airfreight industry will nevertheless entail further restructuring and consolidation in this sector as well.

The recent experience of the Baltic States in the four sectors contributes to an ongoing policy debate on best strategies to develop services and increase their international competitiveness as well as on the role of multilateral and regional commitments and their interaction with domestic regulation policies.

The Banking Sector

Both analytical studies and empirical evidence confirm that a sound financial system is a prerequisite for sustainable economic development and growth, due to its strategic role in achieving and maintaining macroeconomic stability and its key intermediation function in facilitating resource allocation. The establishment of an efficient financial system was therefore an integral part of the market economy reform in all transition countries. For former centrally planned economies the task was particularly challenging given that they had neither basic institutions nor legal instruments and almost no experience with financial intermediation. After more than ten years and a series of financial crises in the region, most Central and Eastern European countries have established solid foundations of their banking system. The developments in the Baltic countries are particularly instructive, showing basic ingredients of a successful strategy that led to the creation of a well functioning banking system, ensuring macroeconomic stability and fulfilling efficiently its intermediation functions.

The Creation of a Two-Tier Banking System

In all transition countries, the first step in the financial sector reform was the creation of a two-tier banking system — a central bank assuming responsibility for the regulation of monetary, foreign exchange and supervisory policies, and commercial banks, either domestic or foreign, providing financial services to companies and households and financing their investment projects.

The three central banks of the Baltic States were formally established even before the official independence of these countries: in Estonia, in December 1989, and in Latvia and Lithuania in 1990. The laws defining their roles, functions and principles of independence have been put in place progressively at a later stage. In Latvia, the main objective assigned to the central bank has been price stability, while in Estonia and Lithuania, which both introduced currency boards, the emphasis has been on currency stability. The main element of central banks' status is their independence vis-à-vis their governments. By definition, the establishment of currency boards implies a high degree of independence. In Estonia and Lithuania, the legal framework for monetary operations of the central banks was designed in a similar way, though the prohibition on providing loans to the government is more explicit in Estonia. The Bank of Estonia reports only to the Parliament and has operational independence in conducting monetary, credit and banking policy.

Despite some differences in the definitions of their functions, the central banks of the Baltic States have imposed tight monetary policies, managed successfully the gradual reduction in inflation and used the exchange rate efficiently as an anchor for monetary stability. They have contributed to macroeconomic stability and participated actively in the development of the domestic financial sector. The process of EU accession has imposed further legal adjustments, including changes in the role and functions of the central banks.

In parallel with establishing and improving the functioning of the central banks, the Baltic countries experienced a rapid development of commercial banks. In Estonia, there were six commercial banks by the end of 1989, and twelve one year later. The first banking crisis, which occurred there in 1992, was related to the difficulties in clearing operations with countries of the former Soviet Union. The Bank of Estonia announced a moratorium on the operations of the three largest commercial banks and considerably raised the minimum capital requirement. As a result, the number of commercial banks has decreased in Estonia from 43 in 1992 to 21 in 1993 (Table 4.1).

Table 4.1 Development of the Banking System in the Baltic States

Estonia	1992	1993	1995	1998	2000	2001
Total number of banks of which	43	21	18	6	7	7
a) Domestic-owned		20	14	4	3	3
• State-owned		1		1	0	0
b) Foreign banks		1	4	2	4	4
Total number of private banks				5	7	7
Latvia	1992	1993	1995	1998	2000	2001
Total number of banks of which	50	62	42	27	21	23
a) Domestic owned			31	12	9	13
• State-owned						
b) Foreign banks			11	15	12	10
Total number of private banks						
Lithuania	1992	1993	1995	1998	2000	2001
Total number of banks of which	27	26	12	10	14	13
a) Domestic owned		26	12	5	7	10
• State-owned						1
b) Foreign banks		0	0	5	7	3
Total number of private banks						12

Source: EBRD Transition Report, IMF International Statistics, European Central Bank

In Latvia, the central bank directly supervised 45 branches of the former all-Union bank. In 1993, nine of these branches were sold to private commercial banks and 15 units were consolidated into eight independent banks whose shares were sold to the public. The 21 remaining units have been merged into the Latvian Unibanka. Due to low capital requirements, the number of banks rapidly increased to 62 in 1993. In Lithuania, the growth in the number of commercial banks was less rapid, though it also increased from six in 1991 to 27 banks in 1992.

Until the middle of the 1990s, the commercial banking sector in the Baltic States was dominated by domestic banks. In Estonia, the first foreign bank - the Baltic Union Bank registered in Latvia — started its operations in 1991, but went bankrupt in 1993. In Latvia, the first foreign bank (Société Générale of France) opened a branch in 1995, followed by a representative office of the Dresdner Bank. The first foreign bank established in Lithuania was Kredyt Bank PBI S.A of Poland.

The Impact of the Banking Crises in the Region

The major banking crisis that affected the Baltic countries in 1994-1995 provided an important impetus for consolidation of the banking sector in the region. The crisis exposed problems that resulted from incomplete macroeconomic stabilisation — strong inflationary pressures, which led to high interest rates and serious debt-servicing problems for indebted firms. The crisis also showed fundamental weaknesses of the banks, which were burdened with growing non-performing loans and arrears, often from state-owned firms, fraudulent banking practices and mismanagement.

In contrast with the gradual and partial approaches adopted in some transition countries, such as Romania and Bulgaria, the Baltic countries opted for more radical solutions to solve the banking crisis and used the crisis to accelerate the restructuring of their banking sectors. Estonia strengthened banking supervision procedures and decided to open the banking sector to foreign participation. The two largest incumbent commercial banks, Hansabank and Eesti Ühipank, were taken over by Swedish Swedbank and Skandinaviska Enskilda Banken (SEB), respectively. As a result, foreign ownership, expressed in terms of banking assets, increased to 90%, and the ownership structure became highly concentrated, since the top five banks accounted for 99% of total assets by the end of 2001.

In Latvia, the main causes of the banking crisis were excessive currency exposure of some banks and their poor management practices. The government also liquidated some domestic banks, established consolidated supervision of credit institutions and introduced a deposit guarantee fund. The privatisation process was accelerated, resulting in a large decline in state ownership, which currently represents only 4% of the capital in Latvia's banking sector. Foreign ownership and concentration in the banking sector also progressed and, by the end of 2001, foreign banks owned 62% of banking assets.

Compared to its neighbours, who implemented rapid privatisation and a broad opening to foreign investment, Lithuania adopted a more gradual approach. However, the country also introduced stricter banking rules on lending to bank employees and shareholders, and greater responsibility for board members. The consolidation process was initiated by the merger of Bankas Hermis with Vilnius Banka, which became the largest bank in Lithuania. The involvement of foreign investment considerably increased in 1999, when Vilnius Banka was bought by the Swedish SEB. Following subsequent foreign acquisitions, mainly by foreign banks already present in the country or in the region, concentration in the banking sector is also high in Lithuania, with the top five banks accounting for 90% of total assets.

Although lower than in some other transition countries, such as Bulgaria or Romania, the costs of the banking crisis that occurred in the middle of the 1990s, represented a considerable financial drain on the

Baltic economies, estimated at 1.4% of GDP in Estonia and 2.5% - 3% in Latvia and Lithuania (Table 4.2). The banking crisis brought considerable changes in the whole banking sector and was a starting point for significant foreign investment inflows into this sector. The Baltic banking sector is now almost entirely foreign-owned, with Swedish Swedbank and SEB being the main investors in the region. By accepting large foreign investment in the banking sector, the authorities expected to improve financial resource allocation, efficiency and profitability, and bring better quality and a broader range of services.

Table 4.2 Banking Crisis in the Baltic States

Country	Period	Main problem	Measures taken	Costs (% of 1998 GDP)
Estonia	1992: three banks faced solvency problems.	Total bad assets: 40% of banking system assets.	Bond issued.	1.0
	1994: the country's second largest bank (Social Bank) faced solvency and liquidity problems and had a weak loan portfolio. It closed in 1995.	Withdrawal of more than 50% of Social Bank's deposits. Social Bank represented 20% of total banks' assets at the end of 1993.	Purchase of bad loans. Re-capitalisation of the Central Bank.	0.04 0.3
				Total: 1.4
Latvia	1993-1994: restructuring of two state-owned banks.	Non-performing loans: 5% of total banking system assets.	Bond issued.	2.5
	1995: closure of the largest private bank (Baltija). Three small and medium banks declared insolvent.	Total compromised assets: 40% of total banking system assets.	Deposit compensation.	0.04
		15 bank licenses revoked.		Total: 2.5
Lithuania	1995-1996: wide-spread solvency problems in the whole banking system.	Non-performing loans: 32% of banking system assets.	Bank restructuring.	1.7
			Deposit compensation.	1.3
				Total: 3.0

Source: Edda Zoli: Cost and effectiveness of banking sector restructuring in transition economies; IMF, Working Paper, WP/01/157, October 2001.

Main Characteristics of the Banking Sector

Despite its impressive progress during the last ten years, the banking sector in the Baltic countries remains relatively small in terms of the value of assets or the value of domestic loans in GDP. In 2001, banking assets represented between 77% of GDP (Latvia) and 32% of GDP (Lithuania), compared to the average of 250% of GDP in the euro area banking system. In terms of per capita deposits, the Baltic countries, with an average of USD 1 385 deposits/per capita have not reached the level of some Central European countries (USD 1 800 deposits/per capita). The foreign currency deposits of non-residents — mainly from corporate clients — represent an important funding source, especially in Latvia. A relatively low share of assets and domestic loans in GDP in the Baltic countries reflect the economic downturn of the early years of transition and the impact of the deep financial crisis, which affected the ability of domestic banks to channel financial savings into investment.

Another characteristic of the Baltic financial system is its relatively high concentration: in Estonia, the two largest banks (out of seven) account for 85% of total assets of the banking sector. In Latvia, three quarters of assets and bank deposits are in the hands of eight banks. The Lithuanian banking system is also heavily concentrated: in 2001: the major banks accounted for 87% of the total banking assets.

As already mentioned, the financial crisis in the region prompted massive foreign investment inflows needed for bank restructuring. Facilitated by liberal entry regulations, the share of foreign banks increased particularly in Estonia, where 86% of equity of credit institutions belonged to foreigners in 2001. Growing regional economic and trade integration encouraged the banks of Scandinavian countries, especially Sweden and Finland, to expand their operations in the Baltic States.

The entry of foreign banks facilitated the introduction of new banking technologies and financial innovations, including transfer of good banking practices, know-how, accounting skills, a sound risk-management system and transparency. The presence of foreign banks also increased the amount of funding available to domestic projects by facilitating capital inflows and diversifying the capital and funding base. Foreign banks' dominance might, however, raise some problems, in particular, as regards the credit allocation to domestic versus foreign firms. Possible differences in regulatory regimes between home and host countries could also be an issue, though only temporarily, since differences will disappear when the legal and regulatory harmonisation with the EU framework is accomplished by the candidate countries.

A relatively high concentration in the Baltic countries' banking sector has inevitably affected the level of competition. However, the negative impact of high concentration is probably mitigated in the Baltic States, given the relatively small size of their economies and their considerable external opening. The range of banking services has improved and even if domestic financial intermediation is still relatively low in these countries, the corporate sector, at least in Estonia and Latvia, has access to cross-border financing and benefits from strong FDI inflows. One possible indicator of the improved functioning and better quality of assets of the Baltic banking sector is the share of non-performing loans, which declined between 1995 and 2001 from 4% to 1.5% in Estonia, 6.8% to 3.1% in Latvia, and from 12.5% to 7.4% in Lithuania (Table 4.3).

Table 4.3 Main Characteristics of the Banking Sector in the Baltic States

Estonia	1993	1995	1998	2000	2001
Bank deposits (% of GDP)		17.2	22.8	31.3	35.5
Bank assets (% of GDP)			56	68	72
Total credits (% of GDP)					
Credit to private sector (% of GDP)	11.1	14.7	25.2	25.9	27.6
State-owned banks assets (% of total assets)	25.7	9.7	7.8	0	0
Non-performing loans (% of total loans)		3	4	1.6	1.5
Latvia	1993	1995	1998	2000	2001
Bank deposits (% of GDP)		14.6	17.2	20.4	22.9
Banking assets (% of GDP)					77
Total credits (% of GDP)					
Credit to private sector (% of GDP)		7.4	15.2	19.6	26.5
State-owned banks assets (% of total assets)		9.9	8.5	2.9	3.2
Non-performing loans (% of total loans)		19	6.8	5	3.1
Lithuania	1993	1995	1998	2000	2001
Bank deposits (% of GDP)		15.5	12.8	17.2	20.3
Banking assets (% of GDP)					32
Total credits (% of GDP)					
Credit to private sector (% of GDP)	13.8	12.6	9.6	10.1	11.5
State-owned banks assets (% of total assets)	53.6	62.5	45.3	38.9	12.2
Non-performing loans (% of total loans)		17	12.5	10.8	7.4

Source: Central Banks.

Recent developments in the banking sector in the Baltic States show an interesting phenomenon. At the beginning of the transition process and during the first stage of the financial sector reform, the number of commercial banks increased considerably, partly because of liberal entry policies and the lack of efficient prudential regulations. The proliferation of banks was not, however, a guarantee of high competition, and most banks were in fact unable to provide adequate services to households and corporate clients. The main reason for this unsatisfactory situation was the unchanged structure of the banking industry, which was still dominated by large state-owned banks with a high share of non-performing loans in their assets. Moreover, in the absence of adequate prudential regulations, new private banks often represented a systemic risk due to their low level of capitalisation and, in some cases, fraudulent practices. The predominance of inefficient state-owned banks associated with a great number of undercapitalised and badly managed private banks was the main cause of financial crisis in

many transition economies, including the Baltic States. The financial crisis prompted the Baltic countries to reduce the weight of state-owned banks, mainly by the sales to foreign strategic investors.

Regulatory Framework

Several indicators help to assess the regulatory environment of the countries' banking sector. The first group of indicators measures the status and activities of the central bank, in particular, its independence vis-à-vis the government and the modalities of its supervision of credit institutions. The Baltic countries have gradually put in place the legislation that ensures a high level of independence of their central banks, a process that has been reinforced by EU requirements. As a result, the supervisory regulations of the Baltic countries' central banks have become more sophisticated and similar to the functions exerted by the central banks in EU countries. They cover, in particular, regulations concerning the initial capitalisation of commercial banks, their capital adequacy, liquidity, and concentration of exposure, quality of credit portfolios, loans provisions and open foreign currency positions. Commercial banks are required to submit monthly, quarterly and annual reports to the central bank, which also has the right to inspect them regularly.

The reserve requirements for commercial banks, which must be maintained with the central bank, were set up at 8% of customers' deposits in 1997, and then raised to 10% in all the Baltic States. In Estonia, minimal reserve requirements, which amounted to 30% of reserves until June 1997, were subsequently reduced to 20%. All Baltic States have established a deposit insurance system. Lithuania amended its 1996 Law on Insurance of Deposits of Individuals in 2002, and this new version provides insurance for the deposits of legal persons and increases the amount of compensation. Estonia and Latvia already adopted similar laws in 1998.

Prudential regulations aim at limiting commercial banks' risk exposure and ensuring against potential losses. Accounting, auditing and financial disclosure rules that are consistent with International Accounting Standards (IAS) rules are legally required in Estonia and Latvia. Annual reports of commercial banks are prepared in accordance with IAS and the banks are audited by internationally recognised auditing firms. Supervision of commercial banks is, therefore, quite strict in the Baltic countries and bank inspections are even more frequent than in some EU countries. In parallel with rapid developments and the growing sophistication of financial markets, supervision modalities have evolved from the mainly mechanical controls of compliance with prudential ratios towards a more qualitative assessment.

Licensing also represents an important tool for controlling the banking system. In the early 1990s, the Baltic countries obviously used inadequate licensing requirements, which, together with poor bank supervision, led to the emergence of a large number of undercapitalised banks.

The recent experience of the Baltic States shows the need for overall policy coherence at two main levels. First, there is the need to co-ordinate financial sector-related policies with general economic strategy, especially privatisation and opening to foreign investment. Second, the monetary authorities have to ensure coherency between different supervision and regulatory policies and various prudential regulations. In particular, it is necessary to establish a close relationship between entry and exit procedures. The main challenge is to create conditions for fair competition between state-owned financial institutions and emerging private banks and improve transparency and credibility of the banking sector.

Impact of Multilateral and Regional Disciplines

As already noted, accession to the WTO has been an important step in trade liberalisation and market opening of the Baltic States. The overview of their GATS schedules in financial services showed that these countries accepted ambitious commitments, often more substantial than other transition countries and some developed countries, which negotiated their schedules during the Uruguay Round. In general terms, the traditional benefits of WTO/GATS liberalisation also apply to the financial sector. They allow for better transparency and locking in liberalisation achievements so as to neutralise potential protectionist pressures from incumbent firms. Despite these important general benefits, direct GATS effects are generally considered to be relatively limited because most commitments stabilised existing conditions. However, financial services represent, to some extent, an exception, since GATS liberalisation in this area goes beyond the mostly standstill commitments accepted in other services sectors.

The general findings on the influence of WTO/GATS commitments versus EU disciplines also apply in the financial sector. The EU accession process provided a strong impetus for EU candidate countries to harmonise their legal and regulatory framework with the relevant EU regulations. In the area of financial services, this implied the acceptance of free movement of capital and access to financial services and freedom of establishment for firms, contributing to price and financial market stability (see Box 4.1). The three Baltic States considerably liberalised their current and capital account transactions. There are no restrictions on capital movements, including operations in securities on capital and money markets, current and deposit accounts with financial institutions, financial loans and commercial credits. The only restriction on free movement of capital is a requirement for approval of real estate transactions of non-residents by the local municipality.

Box 4.1 The EU *Acquis Communautaire* in the Banking Sector

The Central Banks of the candidate countries are preparing their countries to join the Economic and Monetary Union (EMU) in 2006. All countries are required to comply with the Stability and Growth Pact, to refrain from direct financing of the government deficit by the central bank, to prohibit privileged access by public authorities to financial institutions and to liberalise capital movements.

Member States not taking part in the euro area conduct independent monetary policies and participate in the European System of Central Banks (ESCB) under certain conditions.

Central banks must be independent and their primary policy objective is to ensure price stability. Even though the EU accession entails the acceptance of the objective of EMU, compliance with convergence criteria is not a precondition. However, since those criteria are indicative of a macroeconomic policy geared to achieving stability, all Member States must, in due course, comply with them on a permanent basis.

- All applicants must fulfil a number of formal and substantial conditions before joining the euro:
- Maastricht convergence criteria of fiscal stability;
- Central Bank independence;
- Low inflation and interest rates;
- Monetary stability of their currencies by participating in the Exchange Rate Mechanism II for a minimum period of two years.

The key instrument in promoting banking market integration is Directive 2000/12/EC that consolidates earlier directives concerning the operations of credit institutions. In particular, it incorporates the 1989 Second Banking Directive that created a single EU banking license, allowing a bank to operate throughout the EU, but left the supervision to the home country supervisory authorities, subject to minimal harmonisation of regulations.

The New Financial Services Action Plan (FSAP) proposes 43 measures to be adopted at the EU level by the middle of 2004, and to be transposed into national legislation by 2005. The Plan has three strategic objectives:

- a single EU market of wholesale financial services;
- an open and secure retail market and
- state-of-the art prudential rules and supervision.

Source: European Commission, 2003.

The harmonisation with the EU legal framework necessitated a number of changes in the Baltic States' domestic legislation, in particular concerning the central banks (see Table 4.4). The new laws, adopted in 1999 in all three countries, strengthened the prerogatives of the central banks to enforce prudential standards and bring supervisory standards into compliance with the Basel Core Principles. New principles of licensing of commercial banks were also introduced in compliance with EU rules. A further important step will be the acceptance of European banking passports, which will become effective after the accession to the EU. The passport introduces the principle of mutual recognition and home-country control and allows the branches of foreign banks to be treated on a non-discriminatory basis.

Table 4.4 Regulation and Supervision of Banks in the Baltic States (1999)

Indicator	Estonia	Latvia	Lithuania	Comments
Body/agency supervising banks	Bank of Estonia: Banking Supervision Department	Bank of Latvia: Credit Institutions Supervision Department	Bank of Lithuania: Supervision Department	
More than one supervisory body?	no	yes	No	Of 107 surveyed countries, 89 have a single supervisory body
To whom is the supervisory body responsible?	Parliament	Not reported	Central Bank Board, which is accountable to the Parliament	
Total banks assets/GDP (%) (1)	59	n.a.	n.a.	Germany : 313 Poland: 54
Number of banks per 100 000 people	0.4	1.0	0.3	Germany : 3.9 Finland : 0.2 Hungary : 0.4
% of deposits accounted for five largest banks	95	n.a.	90	Germany : 12 Finland : 97 Czech Rep : 74
% of total bank assets government owned	0	n.a.	44	Germany : 42 Finland : 22 Hungary : 3
% of total bank assets foreign owned	85	n.a.	48	Germany : 4 Finland : 8 Hungary : 62
Overall bank activities and ownership restrictiveness (2)	2.0	2.0	2.3	Germany : 1.3 Finland : 1.8 Hungary : 2.3
Professional supervisors per bank	2.5	n.a.	0.8	Germany : 1.0 Finland : 0.1 Hungary : 1.0
Explicit deposit scheme	yes	yes	Yes	Of the 107 surveyed countries, 50 do not have a scheme
% of ten biggest banks rated by international agencies	33	n.a.	40	Germany : 100 Finland : 100 Poland : 80

Notes: (1) This indicator, which is a proxy to measure the size of industry, shows large variations among countries, e.g. 313% in Germany (bank-based system) as against 66% in the US (capital market-based system).

(2) Overall bank activities and ownership restrictiveness measures the degree of which banks are permitted to engage in securities, insurance and real estate activities and to own non-financial firms. It ranges from 1 to 4: the lowest value indicates that no restrictions are placed on this type of diversification by banks, whereas the highest value indicates that such diversification is prohibited.

Source: The World Bank database on the regulation and supervision of banks in 107 countries is available at <http://www.worldbank.org/research/interestweb.htm>

According to EU directives, the stability and reliability of financial markets is ensured through supervision by competent authorities, but the structure of this supervision is not imposed. In general, EU countries have taken financial supervision away from central banks, moving towards single supervisory authorities. This approach was adopted recently by Latvia (in 2001) and Estonia (in 2002), which both established a united supervisory agency for banking securities and insurance. Lithuania

(and also, for example, Romania and Bulgaria) continue to perform regulatory and supervisory task through separate entities for the banking, securities, and insurance sector. International standards and EU directives are implemented through memoranda of understanding between the supervisory authorities to address potential threats to the stability of the financial sector.

Telecommunications

Recent developments in the telecommunications sector have been quite similar in the three Baltic countries. The common features include extensive foreign direct investment inflows, the acceptance of significant GATS liberalisation commitments and considerable progress in adopting relevant EU requirements. However, some differences persist among the three countries, notably as regards the scope of privatisation, the degree of liberalisation in different telecom segments, the choice of a regulatory framework and functions of the national regulatory authority (NRA). Different liberalisation strategies adopted by the three countries will influence their future economic and regulatory challenges in this sector.

In Estonia, opening of the telecommunications market was achieved in 2001, and the positive effects of liberalisation due to increased competition are already noticeable. Following the entry of many operators into the market, consumer prices have decreased significantly. The government is introducing a new cost accounting model for interconnection pricing and is starting discussions with the network operators on assignment of significant market power (SMP) status and universal service obligation (USO). Estonia will nevertheless continue to face significant regulatory challenges in adopting the new EU rules, although they will probably be less acute than in the two other Baltic countries due to its longer liberalisation experience.

In Latvia, market liberalisation of the telecommunications market occurred in January 2003. The country has taken a different path of market regulation than Estonia and Lithuania and adopted a multi-sector regulatory model. The country needs to develop secondary legislation, but, given that the government will be obliged to introduce it simultaneously in other sectors, the legal and regulatory challenges will be considerable. In addition, the government must resolve the conflict with Tiltis Communications, a co-owner of the incumbent firm Lattelekom, over curtailing monopoly rights.

Lithuania completely liberalised its telecommunications market in January 2003. The new Law of Telecommunications was adopted, but secondary legislation must still be introduced. This process is taking place under a considerable time constraint and therefore with a certain risk of introducing inappropriate decisions or ill-adapted legislation. The Lithuanian National Regulatory Agency (NRA) lacks experience, adequate equipment and qualified staff and needs more financial resources to be able to deal with its increasingly complex and demanding tasks.

Current Situation in the Telecommunications Sector

Table 4.5 provides the key economic characteristics of the telecommunications sector in the Baltic States. The share of the sector in GDP is roughly similar in the three countries, but in absolute terms, Lithuania is the largest telecommunications market in the region. Since 1999, FDI inflows into telecommunications have been most dynamic in Estonia, both in absolute terms and proportionally as the share of total FDI inflows. Estonia records the highest indicators of mobile penetration and Internet use — almost double the corresponding figures for Lithuania and Latvia. In parallel with the rapid growth of mobile and Internet services, there has been a reduction in non-profitable activities, such as the operation of public telephones. Decreasing employment in telecommunications is another striking feature observed in all three countries. Foreign investors have penetrated the most liberalised mobile telecommunications market (see Tables 4.6 and 4.7).

Table 4.5 Telecommunications Sector in the Baltic States

		Lithuania	Latvia	Estonia
Telecommunications market value, million EUR, 2001		836	556	421
*Gross value added of communications sector, mill EUR	2000	359.85	315.7	211.3
	2001	491.52	-	241.4
	% of GDP 2000	2.9	4.,8	3.8
	2001	3.7	-	3.9
*FDI ; cumulative, end of the year, mill EUR				
	1999	342.86	-	683.61***
	2000	429.23	249.64	612.47***
	2001	437.85	207.46	803.88***
	% of total FDI 1999	17.7	-	14.5
	2000	17.0	10.9	14.,9
	2001	14.7	7.8	16.2
*Number of employees in communications sector				
	1999	10448	7434	10300**
	2000	9176	7120	10700**
	2001	8711	6738	9300**
	% from all the employees 1998	1.,0	0.7	1.8**
	1999	0.9	0.7	1.9**
	2000	0.9	0.7	2.0**
	2001	0.9	0.6	1.8**
Main telephone lines, thousand				
	2000	1180.1	735	522
	2001	1144.5	722	512
	Fixed lines per 100 inhabitants 2001	34.0	32	38
	Fixed lines per 100 households 2001	73	78	68
Public telephones				
	2000	7603	3704	2608
	2001	7223	3845	2531
Number of Internet service providers	2001	50	39	98
Number of cable and television operators	2001	54	37	135
Percentage of households passed by CATV operators	2001	47	50	26
Digitalisation rate	2001	65.0	69	72
Mobile customers, thousand	1999	267.6	167.5	249
	2000	508.9	401.3	557
	2001	1018.0	625.2	739
Mobile customers per 100 inhabitants	2001	29.,2	26.7	54
Internet users per 100 inhabitants	2001	14.0	10.0	39

* According to EUROSTAT, NACE 64.2 - ** according to EUROSTAT, NACE 64 (post and telecommunications) *** transport, storage and communications.

Sources: Association Infobalt, 2002; Telecommunications Association of Latvia, 2002; Association of Estonian Information technology and Telecommunications companies, 2002; Statistical Yearbook of Latvia 2001; CANSTAT Statistical Bulletin 2001/1.

Table 4.6 Mobile Operators in the Baltic States

	Lithuania			Latvia		Estonia		
2001	Omnitel	Bite	Tele2	LMT	Tele2	EMT	Tele 2	Radio linja
Turnover, mill Euro	143	66	17*	186	50,8	142	90	3,9
Number of clients (thousands)	579	256	183*	348	277	382,7	200	146,6
Market share, %	56	26	18	55	45	52	25	23
Investments to date	1 billion Lt	500 mn Lt				114 mn €		
Number of employees	500	359	70			293		

* Estimated, no official data available

Source: Communications Regulatory Authority (CRA) in Lithuania; Estonian National Communications Board (SIDEAMET); Latvian Public Utility Commission (SPRK).

Table 4.7 Foreign Investment in the Baltic States, Mobile Market

Owning company	Company Name	Owned Company	% Share	Owned Company Country
Denmark	TDC Mobile international AS	Bite GSM	100%	LT
Finland	Sonera	LMT	24%	LV
	Sonera	Omnitel	27,5%	LT
	Elisa	Radiolinja Eesti	100%	EE
Sweden	Telia	LMT	24%	LV
	Telia	Omnitel	27,5%	LT
	Net Com AB	Tele 2	100%	LT
US	Motorola	Omnitel	35%	LT

Source: Data provided by the operators.

International and Regional Commitments in Telecommunications

As already noted, the three Baltic countries accepted ambitious GATS commitments in this sector and signed the Agreement on Basic Telecommunications. In basic and value-added telecommunication services, Lithuania undertook commitments in modes 1, 2 and 3 with some limitations in modes 1 and 3 (Lietuvos Telekomas had exclusive rights in fixed voice telephony and network infrastructure until 1 January 2003). Latvia's schedule contains full commitments in basic and value-added services, but until 2003 all infrastructure and basic services were reserved to a national operator – SIA Lattelekom. Estonia has full commitments in the sector, with mode 4 unbound on all basic and value-added services.

Among regional disciplines, a trilateral economic agreement on the abolition of non-tariff trade barriers, signed by the three Baltic countries in November 1997 and effective since July 1998, has some implications for telecommunications. However, the most important regional disciplines result from the EU accession process. The EU Liberalisation Directive abolished all exceptional and/or special rights in telecommunications, except for fixed voice telephony. This Directive has been the backbone of telecommunications market liberalisation and the basis for subsequent regulations. In February 2002, EU legislation was updated (see Box 4.2) and this new regulatory framework entered into force in July 2003. However, the accession of the Baltic States to the EU is based on the previous legislation, *i.e.* not including the electronic communications regulatory package.

One of the most notable remnants of the 1998 EU regulatory package in the recent legislation of all Baltic States is the method of determination of operators having significant market power (SMP).

In the region, SMP status is legally assigned to any operator, who controls at least 25% of the market. In certain cases, the national regulatory authority can assign SMP status when a company has an even smaller market share. Estonia's experience shows that this principle is very contentious, especially for mobile operators. The markets are generally small and normal competition may exist with three or four operators in the market (*e.g.* each having 25% of the market).

Box 4.2: The EU *Acquis Communautaire* in the Telecommunications Sector

The EU telecommunications policy dates back to the 1980s. Rapid technological changes, globalisation of the world economy and international trends towards liberalisation encouraged the liberalisation process in the telecommunications market, considered as a key element of EU competitiveness.

The first to be liberalised was terminal equipment (1988), followed by gradual liberalisation of telecommunications networks and services (1990), satellite networks and services (1994), alternative telecommunication networks for telecommunication services provision (1995) and mobile communications (1996). Full market liberalisation, *i.e.* abolishment of any exclusive and special rights in telecommunications, including fixed voice telecommunication, intervened in January 1998.

The new EU regulatory package (2002) seeks to strengthen competition in electronic communication markets and adapt regulations to the requirements of the Information Society. It proposes in particular to:

- Liberalise the "last mile" of telecommunications markets by unbundling access to the local loop. This will lead to cheaper and faster Internet access over local copper-wire networks.
- Introduce flexible mechanisms in the legislation to allow it to evolve with future technology and market changes and to roll back regulation when markets become competitive.
- Create a level playing field across the EU by facilitating market entry through simplified rules and ensuring harmonised application through strong co-ordination mechanisms at the European level.
- Adapt regulations to increasing competition by limiting most of market power- based regulation to dominant operators, as defined in EC competition law.
- Maintain the universal service obligations in order to avoid exclusion from the Information Society.
- Ensure the protection of the right to privacy on the Internet.

The new regulatory framework significantly simplifies and clarifies the existing regulatory framework, bringing the number of legal measures from 28 to 8, namely:

- Five harmonisation Directives, including a Framework Directive and four specific Directives on authorisation, access and interconnection, universal service and user rights, and data protection in telecommunications services.
- A regulation on the unbundling of the local loop.
- A draft Commission Liberalisation Directive.
- A decision on Community radio spectrum policy.

Source: European Commission, 2002.

Liberalisation and Privatisation Processes in Telecommunications

In **Lithuania**, Lietuvos Telekomas, an incumbent operator, had the exclusive right to provide public fixed telephony services and fixed voice communication until January 2003. It is the largest Voice over Internet Protocol (VoIP) operator, providing services through a subsidiary called Voicecom. Leased lines are controlled by Lietuvos Telekomas exclusively, while eight companies have received data transmission licenses. Lietuvos Telekomas does not operate a mobile telephone network, since it had to abandon its licence and sell the shares of mobile operator. However, its

primary investor, Amber Teleholding, controls one of the strongest mobile operators, Omnitel. The existence of three GSM operators dilutes, however, Omnitel's market power. Although it is possible to enter into the market, the incumbent companies maintain a strong position, as evidenced by the situation of Tele2, the latest entrant into the mobile telephony market. Cable television is open for competition, and there are several service providers; 54 regional cable companies are licensed.

A new Law on Changes to the Law of Telecommunications, adopted in June 2002, established the National Regulatory Authority as the main supervisory institution in the telecommunications market. It also introduced the system of authorisations (instead of individual licenses) in order to reduce obstacles for new entrants to the market. A Significant Market Power (SMP) status has to be assigned to any operator, which holds at least 25% of a market in which no effective competition has been established. Such an operator will have a number of obligations, such as, providing access to its networks.

Lithuania agreed not to apply for any transitional period for harmonising its telecommunication legislation with the EU and adopted the former EU legislation. The 2002 Law is therefore valid for a limited period and should be replaced by a new Law on Electronic Communications that will take into account the recent changes in the EU *acquis communautaire*. In its evaluation, the EU Commission found that Lithuania has achieved a fair level of alignment, but that more work has to be done in the area of fixed line telephony regulation and with respect to administrative capacity of the national regulatory agency.

Latvia also completely liberalised its telecommunication sector in 2003. Following the critical assessment of the country's progress towards market liberalisation in this sector addressed by the Commission in 2001, the Latvian authorities pushed forward several essential issues identified by the Commission. In particular, a new Law of Telecommunications was adopted. It defines interconnection rules, tariff control principles, licensing, and obligations for market participants and sets the end of monopoly for January 2003. However, this decision put the government in a difficult situation, given that it agreed in 1994 to maintain the monopoly of the partially privatised firm Lattelekom in telephone services until 2013. Tilts Communications, the co-owner of Lattelekom, complained that losing the monopoly rights reduced its profits, while the State accused the company of failing to meet its obligations, as defined in the so-called Umbrella Agreement. Tilts asked for compensation of USD 380 million, while Latvia requested compensation for the company's failure to fulfil promises to modernise the national phone network. The two parties appealed to the international arbitration court.

In **Estonia**, liberalisation of the telecom sector is already considerably advanced. The initial concession contract, concluded between the government and the incumbent Eesti Telefon Ltd (ETC) in December 1992, gave special rights to the ETC for the international and long-distance telephone service market, with the exception of local telephone service that was free. In compensation, the company had to modernise, expand and improve the quality of the telecommunications basic network. Since opening the telecommunications market on January 1, 2001, international tariffs decreased three to six times, depending on the destination. As stipulated in the agreement terminating the ETC concession agreement, the ETC had to open its network to competitors and implement necessary upgrading by January 2004. However, the interconnection regime was not clearly defined by the Telecommunications Act, which raised disputes with new entrants. Following a number of complaints (especially by Tele2 and Uninet) to the national regulator — the Estonian National Communications Board (SIDEAMET) — and to the Competition Board, the Telecommunications Act was amended in February 2001, ordering the ETC to lower its interconnection tariffs.

Non-basic services, including data network services, cable television (CATV) and Internet, have already been liberalised in Estonia. The most dynamic sector is the CATV/broadband Internet segment, which is now taking the lead in challenging Eesti Telefon's monopoly in the voice market.

Since its beginning, the development of mobile telephony in Estonia has taken place in free market conditions. The EU Commission's regular report "On progress towards accession", published in November 2001, found that Estonia's progress in harmonising its telecommunication regulations with the EU *acquis* was considerably advanced, but noted that further progress was needed to enable affordable universal services and implementation of local loop unbundling.

In **Lithuania**, the fixed line incumbent firm, Lietuvos Telekomas, was privatised in 1998 by selling 60% of its shares to Amber Teleholding AS, a joint venture of Telia and Sonera. At the same time, 5% of the shares were sold to Lietuvos Telekomas's employees at the nominal value. A further step in privatisation of Lietuvos Telekomas was completed in June 2000, when the State sold another 25% of the shares in the stock exchange. Since June 2000, Lietuvos Telekomas shares are listed on the Official List of National Stock Exchange of Lithuania and its stocks are traded on the London Stock Exchange. Currently 10% of the shares are still controlled by the State. Lithuania is the only Baltic country where a strategic investor has a controlling interest in fixed telephony.

In **Latvia**, the state-owned enterprise, Lattelekom, was established as an independent telecommunications company in 1992, resulting from the separation of telecommunications structural units from the post offices. The state joint stock company Lattelekom was reorganised into a limited liability company, and in January 1994, the limited liability company Lattelekom — a company with foreign investment — was registered. In 1993, the government of Latvia organised an international tender for modernisation of the public telecommunications infrastructure and selected Tilts Communications as the strategic investor for Lattelekom. In the newly established limited liability company Lattelekom, 51% of the shares were acquired by the Republic of Latvia and 49%, by Tilts. In January 1994, the Republic of Latvia signed the Umbrella Agreement with Tilts — a trilateral agreement, among the Republic of Latvia, Lattelekom Ltd. and JSC Tilts Communications. Sonera presently owns 100% of Tilts. The Umbrella Agreement stipulated that Tilts will invest USD 160 million in the development of telecommunications and implement the modernisation plan within three years. The Agreement also stated that Lattelekom has exclusive rights to provide basic telecommunications services in Latvia until 2013.

In **Estonia**, the State owns 27.3% of the telecommunications holding company Estonian Telecom, which fully owns a fixed-line incumbent, Estonian Telephone Company. State ownership was transferred from the Ministry of Transport and Telecommunications to the Ministry of Finance. Sonera and Telia own 49% of the shares either directly or through a joint holding Baltic Tele AB (24.5% each). The remaining 23.7% of shares have been sold through the stock exchange. At the moment, there is no explicit decision about the date of further privatisation of the shares under the state control (see Tables 4.8 and 4.9).

Table 4.8 Incumbent Operators in Baltic States

		Lithuania	Latvia	Estonia
		AB Lietuvos Telekomas	SIA Lattelekom	AS Eesti Telefon
Turnover, mill EUR		306	257	184
Owners	State	10.03%	51%	27.28%
	Foreign investor (s)	60%	49%	49%
	Public	29.97%	-	23.72%
Number of employees		5749	4375	1552
Market size of fixed telephony, %		100	100	83
Investments up to end of 2001, mill Euro		505	719	220

Source: Operators data for 2001 - Communications Regulatory Authority (CRA) in Lithuania - Estonian National Communications Board (SIDEAMET) - Latvian Public Utility Commission (SPRK).

Table 4.9 Foreign Investment in Baltic States, Fixed Telephony Market

Owning Country	Company Name	Owned Company	% Share	Owned Company Country
Finland	Sonera	Eesti Telefon	24.50%	EE
		Lattelekom	49%	LV
		Lithuania Telecom	30%	LT
Sweden	Telia	Eesti Telefon	24.50%	LT
		Lithuania Telecom	30%	LT

Source: Operators data.

Regulatory Bodies and their Status

In **Lithuania**, the current Law of Telecommunications provides for several regulatory levels in the telecommunications sector. The government of the Republic of Lithuania or an institution authorised by the government is responsible for the first level of regulations. The second level of regulation is carried out by an independent regulatory institution — the Communications Regulatory Authority (CRA). In addition to these two levels of regulation, telecommunications used for specific purposes — such as state border control, civil aviation, security of railway traffic, energy system — are regulated by relevant state institutions.

Governmental institutions, in particular the CRA, have a right to regulate the prices for basic service to end-users, by setting maximum prices, which should be cost-based and include a reasonable return on investment. The governmental regulatory level of telecommunications is in charge of strategic matters, such as the development and implementation of state policy in the telecommunications sector and co-operation with telecommunications agencies in foreign countries. The government approves the list of universal services and, in the accordance with the Law of Telecommunications, it also issues licenses for establishing and operating telecommunications networks.

The initial Law of Telecommunications stipulated that the maximum price for fixed telephony communication and universal service must be established by the government. According to the new law “On Changes to the Law of Telecommunications,” which entered into force in January 2003, the price regulation and other tasks were transferred to the independent regulator, which, since the same date no longer has the status of a governmental institution. The regulatory agency is financed jointly

by the state budget and licences and fees and its 2002 budget was EUR 3.48 million. To ensure the independence of the regulator from the government, the director and members of the council are appointed by the President. In line with the new Law on Telecommunications and the EU guidelines, state regulations should follow the principle of “minimum legislative interference”. However, some business representatives think that regulatory institutions still maintain extensive controls over the market and that the risk of anti-competitive administrative interventions has not yet been completely eliminated.

Until 2001, two institutions were responsible for ensuring a competitive environment in the telecommunications market in **Latvia**: the Competitive Council responsible for regulating competition and the Telecommunication Tariff Council, established in 1993, which determined tariffs for basic telecommunication services. In 2001, an independent national regulatory agency, the Public Utility Commission (PUC), was created as a separate state authority responsible for all regulatory functions in four sectors — energy, post, railway and public telecommunications services. Latvia thus adopted a multi-sector regulatory model for market regulation, which is uncommon in Europe. The main objective of the PUC is to promote the development of efficient competition in all service market segments, and to oversee their transition to full competition. In order to meet the requirements of the EU *acquis communautaire*, the PUC is legally distinct and functionally independent from the ownership and management of the telecommunications network, services and equipment providers. The Latvian regulatory agency is financed by state fees for regulation of public services, which are fixed each year by the government. Lattelekom, which does not pay a licence fee, pays frequency fees under the same rules as other operators. According to the Constitution of the Republic of Latvia, the PUC must be under the government’s subordination and the agency is thus supervised by the Ministry of Economy, which might interfere with its independency and strategic decision making.

In **Estonia**, the national regulator, the Estonian National Communications Board (ENCB), is a government agency supervised by the Ministry of Transport and Communications, which became the part of the Ministry of Economy in 2003. The main functions of the Estonian regulatory agency are to regulate activities of telecommunications network operators and service providers including licensing and registration of activities, interconnection and access negotiations as well as tariff control. The Board also manages the use of telecommunications limited resources (frequencies and numbers) and implements state supervision over the performance of the telecommunications network.

The Estonian regulatory agency is financed from licence fees and the state budget. The incumbent pays regular licence fees under the same rules that are applicable to other market players. In order to avoid conflicts of interests between the NRA and the state, which owns 27.3% of Estonian Telecom, the shares have been transferred from the Ministry of Transport and Communications, which supervises the national regulatory agency, to the Ministry of Finance. (Tables 4.10 - 4.12).

Table 4.10 Regulatory Institutions in Telecommunications in the Baltic States

Institutions	Role		Competencies						
	Yes	No	Regulatory responsibilities for licensing			Inter-connection		Pricing	Service quality
			Issuance	Over-seeing of provisions	Mergers	Approval of charges set up	Dispute re-solution		
Ministry department	LT, LV, EE		LT*					LT	
Competition authority	LT, LV, EE				LT, LV, EE				
Sectoral regulator of which	LT, LV, EE		EE, LV	LT, LV, EE		LT, LV, EE	LT, LV, EE	LV, EE	LT, LV, EE
Head appointed by president or prime minister (vs. sector minister)	LT, LV	EE							
Decision cannot be overturned by executive branch	LT, LV, EE								
Funded by industry fees (vs. general government budget)	LV	LT, EE							

* Until January 2003.

Source: Established according to a model table published in OECD Economic Studies, No.32, 2001/1 Regulation, market structure and performance in telecommunications (Table 5, p. 112).

Table 4.11 National Regulatory Authorities (NRA) in the Baltic States

	LT	LV	EE
Operational Budget for 2001, EUR million	2.48	1.14	2.56
NRA employees, as of 03March 2002	113	13	129

Source: Monitoring of EU Candidates Countries, EC December 2002.

Table 4.12 Telecommunications Prices in the Baltic States

	Retail prices		Interconnection/access charges		
	Basic voice	Mobile	Basic voice	Mobile	Publicity of charges required
No regulation		LT, LV, EE			
Regulation	LT, LV, EE		LT, LV, EE	LT, LV, EE	LT, LV, EE
Incentive based				LT, LV, EE	
Cost based	LT, LV, EE		LT, LV, EE		
Discretionary					
Regulation applies to:					
All operators					
Dominant operators	LT, LV, EE		LT, LV, EE	LT, LV, EE	LT, LV, EE

Note: For Lithuania and Latvia, the statements for fixed telephony are valid starting from January 2003 (date of fixed telephony liberalisation).

Source: Established according to a model table published in OECD Economic Studies, No.32, 2001/1 Regulation, market structure and performance in telecommunications (Table 4, p. 111).

Concluding Remarks

The reasons for the dynamic growth in the telecommunications sector of the Baltic States are both of a general nature and specific to the sector. The three countries have recently enjoyed strong GDP growth and the sector has developed new services, in particular, mobile telecommunications and Internet services. The Baltic States implemented far-reaching multilateral disciplines, and restrictions on FDI presence are practically absent, partly because there is competition for FDI among the three States. In Lithuania and Estonia, the privatisation process is almost completed and the state now owns only a negligible stake in the incumbent firm. In Latvia, the state still owns a majority (51%) of the incumbent's shares.

All three countries have actively pursued the harmonisation of their regulatory framework with EU requirements, though the timetable of liberalisation has slightly varied. Estonia's fixed public telecommunications market was fully liberalised in January 2001, while fixed public networks and services were under monopoly in Latvia and Lithuania until January 2003. Estonia's example proves that market liberalisation, by bringing new players into the market and reducing prices, is beneficial to consumers.

The legislation in the telecommunications sector has been mainly based on the previous (1998-2000) EU regulatory package, but some guidelines, such as licensing, are based on the new (2002) regulatory framework for electronic communications. The main reason for delaying the implementation of the new EU package in its totality is the lack of experience of Baltic regulators and the risk of market destruction. However, the current intermediate situation also presents some inconvenience, especially in Lithuania and Latvia, bringing a lack of stability and predictability of the legal framework for foreign investors.

Given substantial liberalisation of telecommunications in the Baltic States, especially in the mobile sub-sector, and the significant progress achieved in legal and regulatory harmonisation with the EU standards, the EU accession will not require further adaptations in this sector. However, the operators in the Baltic States will face a number of new challenges stemming from ongoing intra-sectoral restructuring and technological innovations. The fixed-line market, increasingly saturated, will confront a more difficult financial situation, possibly leading to the withdrawal of some foreign operators from the region. Although more profitable, the mobile industry should manage further technological changes. In these circumstances, the role of sectoral regulators will remain important.

The Electricity Sector

This section examines recent developments in production and consumption in the electricity sector of the Baltic States and analyses their domestic reforms in this area. It highlights their efforts to restructure the electricity sector and bring its market structure into conformity with EU directives. Finally, it describes the main elements of the Common Baltic Electricity Market, which aims at enhancing cross-border intra-regional co-operation in this sector.

In the aftermath of achieving independence, the three Baltic countries inherited large state-owned, vertically integrated energy companies that enjoyed full monopoly powers in the electricity sector. As a part of their general reform strategy, the sector has been considerably transformed. National electricity generators and distributors have been commercialised, and privatisation and restructuring have been initiated, with varying degrees of success, throughout the region. At present, the main objective is to promote competition in this sector, by harmonising the legal and regulatory framework with EU requirements. All three countries established regulatory institutions to prevent abuse of monopoly power and ensure that services provided to customers are of an adequate quality and reasonably priced. Moreover, the Common Baltic Electricity Market is expected to encourage trade expansion, improve the security of electricity supply and promote specialisation and efficiency improvements.

Electricity Sectors in the Baltic States

The production and consumption of electricity in the Baltic States in the mid-1990s have stabilised at lower levels than under the Soviet system, due to the initial economic downturn and massive restructuring of all sectors (see Table 4.13).

Table 4.13 Electricity Generation and Consumption in the Baltic States, 1992-2001

(in billion kWh)

		1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Latvia	Net Generation	3.7	3.8	4.3	3.9	3.0	4.4	5.7	4.0	3.3	4.4
	Net Consumption	7.5	6.1	5.9	5.9	6.0	5.9	5.8	5.5	5.2	6.0
Lithuania	Net Generation	17.7	14.0	9.2	12.3	15.0	13.2	16.4	13.0	11.0	14.6
	Net Consumption	11.2	10.3	9.8	9.7	8.2	8.8	9.2	9.4	6.9	8.7
Estonia	Net Generation	11.1	8.6	8.6	8.2	8.6	8.7	8	7.8	7.1	7.9
	Net Consumption	7.1	6.6	6.9	6.8	7.1	7.1	7.1	6.6	5.4	6.2

Source: Central Statistical Bureau of Latvia, Estonian Energy Research Institute, Ministry of Economy of Lithuania, Lithuanian Energy Institute.

Table 4.14 Electricity Exports and Imports in the Baltic States, 1992-2001

(in billion kWh)

		1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Latvia	Exports	0.0	0.2	0.9	0.4	0.3	0.0	0.4	0.7	0.5	0.7
	Imports	4.1	2.7	2.7	2.7	3.4	1.8	0.9	2.5	2.6	2.7
Lithuania	Exports	10.6	8.5	6.0	7.0	9.3	8.1	6.5	3.3	6.3	6.3
	Imports	5.3	5.7	7.2	5.3	3.5	4.5	0.5	0.6	3.0	1.4
Estonia	Exports	3.5	1.6	1.5	1.0	1.1	1.2	0.5	0.7	1.2	1.2
	Imports	0.2	0.2	0.4	0.3	0.2	0.2	0.1	0.1	0.0	0.0

Source: Central Statistical Bureau of Latvia, Estonian Energy Research Institute, Ministry of Economy of Lithuania, Lithuanian Energy Institute.

Estonian production of electricity is predominantly from its oil-shale-fired power plants. In Lithuania, 76% of electricity is produced by the Ignalina nuclear power plant, and 20%, by thermal power plants. In Latvia, about 67% of total production is generated by hydroelectric power plants and the remaining 33%, by thermal power plants. Latvia is a net importer of electricity, whereas Lithuania and Estonia are net electricity energy exporters (see Table 4.14). The national grids of the Baltic States continue to run in parallel mode, allowing Latvia, whose power-generating capacity is mainly seasonal hydropower, to import electricity supplies from Estonia and Lithuania when necessary.

In 2001, representatives of Lithuania, Estonia, Latvia, Russia, and Belarus signed a multilateral agreement on the parallel work of their energy grids. The agreement gives Lithuania, which is also considering a direct link with Poland, the capacity to transit its electricity via Belarus to other markets

such as Slovakia. In addition, Lithuania and Russia signed a deal in 2001 on the export of Lithuanian electricity to the Kaliningrad Region and to Belarus. Estonia seeks to link its grid to the Western European grid. BALTREL, the Baltic countries' power co-operation organisation, has also proposed supplying Sweden and Finland with power generated in the Baltic States.

Market Structure

Despite considerable restructuring efforts, the state-owned companies dominate the market both in electricity transmission and distribution in the three Baltic States.

In **Latvia**, the national electricity company, Latvenergo, owns the integrated electric system. Regional sales are carried out by seven regional networks — the Eastern, Western, Central, Southern, Northern, North-Eastern, and Riga networks. In 2001, Latvenergo represented 96% of total country electricity production. The power supply company “Latvenergo” is currently structured in the form of a fully vertically integrated company. The company has the legal status of a joint-stock company, the shares of which are entirely owned by the Latvian State. The government developed plans to privatise Latvenergo in 1998, but due to political disagreements, the privatisation attempt failed. In 2000, another plan for the sale of Latvenergo was proposed. However, 23% of eligible Latvian citizens signed a petition for a referendum against privatisation and the parliament decided not to sell any parts of the company.

In October 2000, the Latvian government approved a plan for the utility's reorganisation. Following the EU directive on energy market liberalisation, the objective of this reorganisation is to prepare the utility for free market conditions. The EU directive requests that production, transmission, and distribution activities are separated to allow reviewing accounting reports and operations individually and transparently as if they were completely independent companies. Complete liberalisation of Latvia's electric power market is planned for 2007.

Several investment projects with international involvement have been undertaken in Latvia. The French company ALSTOM HYDRO participated in reconstruction of Kegums Hydro Power Station completed in 2001. The project benefited from the EBRD financial support. An international tender for the supply of safety systems for generators of the Riga HPS was won by the ABB Generation AB. The Riga City Centre Network and power grid in Riga Old Town were completely modernised in 1999. In 1995, the largest Baltic wind energy station, with at least 20 years operating lifetime, opened in Latvia.

In **Lithuania**, there are natural monopolies in the electricity generation, transmission and distribution as well as in foreign trade. The entire electric power sector of Lithuania is dominated by two state-owned companies — the Ignalina Nuclear Power Plant (INPP) and AB Lietuvos Energija. The Lietuvos Energija is the largest power company in Lithuania involved in generation and distribution of electric energy and heat production. The main shareholder of the company is the state, which owns 86.5% of shares. Remaining shares belong to private entrepreneurs, including Vattenfall, a Swedish Utility, owning 10.1%. In addition to electricity transmission and distribution, the company purchases all electricity generated in Lithuania, sells it to Lithuanian consumers and exports it to neighbouring countries. Part of the electric energy is generated by the company itself, which owns all major conventional fuel power plants.

In the first restructuring stage completed in July 1997, the district-heating sector was transferred from the public company Lietuvos Eenergija to the municipalities. The Vilnius and Kaunas thermal power plants were also taken over by the municipalities. The next restructuring stage includes reorganisation of the public company Lietuvos Eenergija by unbundling electricity generation,

transmission, distribution and auxiliary production and services. This would allow separate accounting for each sub-sector and create preconditions for further liberalisation and the creation of an internal electricity market. Since 2002, transmission and distribution companies have operated as separate entities. The distribution is split into two companies, one operating on the western part and the other one in the eastern part of the country.

The power sector in **Estonia** is dominated by the joint-stock company Eesti Energia, which is a public limited power company with all shares being owned by the state. Eesti Energia is in charge of electricity generation, transmission, distribution, sales and exports of electricity. In energy distribution the biggest private player in Estonia is Finnish Fortum, which owns controlling stakes in Viimsi Elekter, AS Läänemaa Elektivõrk and Viru Energia. The largest Nordic energy company Vattenfall is also present in Estonia, controlling several district heating companies. In 1996, the Government decided to restructure the electricity sector. The state-owned enterprise Eesti Energia was transformed into Eesti Energia AS, a fully state-owned joint stock company. Since April 1999, the new organisation executes three main functions:

- generation – carried out by two subsidiaries: Iru Power Plant and Narva Power Plants;
- transmission – carried out by the national power grid and dispatch centre; and
- distribution – carried out by the distribution company.

The existing combined heat and power plants were separated into independent companies. There are also some privately owned generation companies, producing electricity in small hydro and combined heat and power plants. The power transmission network and the main distribution networks is a part of Eesti Energia. Two small electricity distribution companies (Narva Elektrivõrk AS and Läänemaa Elektrivõrk AS) were separated from the Eesti Energia and privatised in 1998-1999.

The second stage of the restructuring plan of the electricity sector was approved by the Government in June 1999. The two largest oil-shale power plants in the Narva region were merged into one company, which became a separate legal entity/public limited company, with 100% of its shares owned by Eesti Energia. In August 2000, the government approved the terms and conditions of the agreement concerning the acquisition of 49% of shares in Narva Elektrihaamad AS by the US-based company NR Generating International B.V. (NRG). However, in January 2002, the government of Estonia cancelled the deal with NRG Energy, Inc. and asked the Minister of Economic Affairs to submit an alternative restructuring plan for the energy sector.

Domestic Policy and Legal Framework

Within the EU accession process, the Baltic States are committed to promote competition in the energy sector and harmonise their legal framework with EU-relevant requirements. Given that their electricity sector continues to be dominated by natural monopolies, all three countries established regulatory institutions to prevent abuse of monopoly power and provide consumers with services of adequate quality for reasonable prices.

The main objective of **Latvia's** policy in the electricity sector is to encourage the development of the energy industry in line with balanced and sustainable growth of the national economy. Other objectives include the creation of preconditions for the establishment of a common Baltic electricity market and the reorganisation of Latvenergo in compliance with the Energy Law adopted in 1998.

The 1998 Energy Law sets up the main rules and licensing procedures for energy industry with the general objective to promote competition, introduce transparent pricing, and develop new energy

sources. According to the law, qualified electricity users have the right to choose their electricity provider within the transmission license validity area and to conclude an agreement stipulating terms of electricity purchase, provided that the terms of such agreements do not discriminate against other energy users. Eight consumers (with annual consumption above 40 GWh) qualify for this procedure, but none has used this right, mainly because of the existing tariff applied in the distribution system, which are too high to allow the entry of producers into the market.

In **Lithuania**, the electricity sector is regulated by the Law on Energy, which defines the general rules for energy activities and their development, functioning, and management, based on the following objectives:

- creating competitive electricity market and ensuring fair competition;
- ensuring and promoting effective electric energy generation as well as the reliability of electric energy generation, transmission and distribution;
- promoting the development of the internal electricity market and electricity exports, the modernisation of infrastructure, and the clarity and transparency of energy pricing.

The Electricity Law, which entered into force in January 2002, abolished the state-controlled monopoly and introduced new conditions enabling consumers to choose their power suppliers on the basis of the quality of service and the price of electricity. The main goal of the Law was to create conditions for competition and effective management of the electricity sector. Under the provisions of the Electricity Law, customers with the consumption of nine GWh of electricity in 2002 (of which there are 12 eligible customers) have the right to choose their suppliers. After 2010, all electricity consumers in Lithuania will be eligible to choose their suppliers.

The main goal of **Estonian** energy policy is to provide a stable and high quality energy supply for consumers with optimum prices and minimal environmental impact. The policy aims to achieve this goal by improving efficiency in the use of energy, increasing the overall reliability of electricity generation and distribution, attracting investment capital where such capital can help finance needed infrastructure improvements, and allowing competition and diversity in areas where state-owned monopolies exist.

The Energy Act, in force since January 1998, provides for energy market liberalisation and transparency in prices and tariffs and aims at trading under free-competition conditions in the electricity, natural gas, and heating sectors. The law also regulates a system of licensing for companies that produce, process, store, transport, distribute and sell energy. It prescribes the creation of an electric energy management centre, which can issue binding orders to all energy companies of the electricity system. The law also sets up the rules for relations between consumers and energy companies. In 2001, the eligible consumers (those consuming above 40 GWh per annum) accounted for approximately 20% of the electricity market. As the qualified users have to obtain an import licence in order to enter international markets, only one consumer has used his rights and imports electricity directly from Ignalina.

Regulatory Environment

The regulatory environment in **Latvia** differs considerably from those in Lithuania and Estonia. The unified Law on Regulators of Public Services created a two-tier (state and municipal), multi-sectoral regulatory system. The state-regulated sectors are: energy (except heat supply), telecommunications, post and railway. Local government regulators regulate household waste management, water supply, sewerage and district heating industries.

The Public Utilities Commission (PUC) started its operations in July 2001, taking over the responsibilities of the Energy Regulation Council. The decision-making body of the PUC is its Board, which decides on behalf of PUC and issues administrative acts that are binding for specific public service providers and users. The Chairperson of the Commission, which is also the Chairperson of the Board, as well as four Commissioners, are appointed by the Parliament for a period of five years. The independence of the PUC is guaranteed by the fact that its decisions cannot be overruled by the government or other state institutions. The operations of PUC are financed by a state fee paid by the regulated enterprises. The duty is currently set at 0.2% of the net turnover of the public services provided by the enterprise (and 0.1% of the net turnover of the services provided by the public railway infrastructure operator to railway cargo carriers).

The objectives of the PUC are to ensure high-quality and reasonably priced services to consumers and stimulate effective operations by service providers with a guarantee of reasonable profits. For this purpose, PUC seeks to create a safe and stable regulatory environment for public services that is fair for both service providers and consumers. This goal is achieved by applying the principles of consistency, predictability, fairness, responsibility, and transparency.

More specifically, the Public Utility Commission performs the following functions in the electricity sector:

- Protecting the interests of the users and promoting the development of public service providers.
- Determining the method of tariff calculation: tariffs are set at the levels sufficient to cover the costs of public services and ensure the profitability of public services in conformity with licence provisions. If the factors that influence profitability change, the Regulator may propose to review the tariffs.
- Issuing licences for public services. The Regulator issues licences for a specified period of time to public service providers and supervises the fulfilment of licence conditions.
- Carrying out preliminary extrajudicial examination of disputes. The Regulator, as a compulsory preliminary extrajudicial court, considers disputes arising from the provision of public services and other disputed matters under its competence, except for disputes concerning debt collection from users of the public services.
- Promoting competition in the regulated sectors and supervising compliance of public service providers with the conditions of their licences, including quality and environmental protection requirements, technical specifications, standards and other contract provisions. Public service providers have to ensure the quality of public services in the conformity with technical specifications, relevant standards and contract provisions.

Lithuania established the National Control Commission for Energy Prices and Energy Activities (NCC) in 1997 in compliance with the 1995 Energy Law, which stipulated that the setting of energy prices must be the responsibility of an independent Commission. Five Commissioners, including the Chairman and Vice-Chairman are proposed by the government and appointed for five years by the President. The NCC, which began operating in 1998, is financed from the state budget.

The NCC's main functions are:

- Establishing the principles for price setting and the rules for calculating tariffs in the sector. It submits the prices and tariffs for electric energy, thermal energy and natural gas to the government of the Republic of Lithuania for approval.
- Controlling the quality of energy, its conformity to standards, and overseeing trade in energy raw materials and energy products.
- Issuing licenses and supervising the activities of the companies, which have been granted licences. These licenses have a double function: they authorise companies to participate in the market and provide a tool for controlling the quality of services, reliability of supply, and compliance with environmental and other standards.
- Settling disputes regarding the right to use networks, impose penalties for violations of laws.
- Approving the status of an eligible customer.

The **Estonian** Energy Market Inspectorate (EMI) was established on 22 January 1998 in accordance with the Energy Act. Like the Lithuanian regulator, it is financed directly from the state budget. The EMI is a government agency responsible for the supervision of the fuel and energy markets and has the following functions:

- Issuing fuel and energy market licences and supervising their compliance.
- Reviewing the financial performance of fuel and energy enterprises dominating the market.
- Fostering competition.
- Reviewing and approving the prices of fuel and energy and related services provided by enterprises dominating the market. Reviewing connection charges and the terms and conditions of connection contracts.
- Monitoring the compliance by fuel and energy enterprises with their obligations, including the quality of their sales.
- Co-operating with consumer protection associations to ensure the rights granted to such associations by the Consumer Protection Act in the energy sector.

Multilateral and Regional Disciplines Relevant for the Electricity Sector

The Baltic countries' legal and regulatory framework for the electricity sector reflects their obligations as members of the WTO, their commitments within the EU accession process, and their efforts to establish a Common Baltic Electricity Market.

In the WTO context, the production of energy from coal, oil, water and other energy resources is considered as a product and therefore covered by the GATT. Energy services are not included as a separate sector in the list of sectors covered by the GATS. However, several energy-related activities are considered as services and appear under different headings, in particular pipeline transport services and other transport services, distribution services, environmental services and energy-related consultancy and other business services. In the absence of an energy sectoral initiative in the Uruguay Round, specific commitments in energy services are very limited and rather sparse across all countries. Only a few countries have made commitments in energy-related sectors: pipeline transportation of fuels (a sub-sector of transport services); services incidental to energy distribution and services

incidental to mining (sub-sectors of other business services). A larger number of countries have listed specific commitments in energy-related services such as: general construction for civil engineering (which covers long distance pipelines, communications and power transmission lines, local pipelines and cables); wholesale of solid, liquid and gaseous fuels and related products, as well as retail sales of fuel oil, bottled gas, coal and wood.

Among the Baltic States, both Latvia and Lithuania listed specific commitments in services incidental to energy distribution. Also, Lithuania scheduled specific commitments in pipeline transport, and Latvia in services incidental to mining. In energy-related services sectors, Latvia listed commitments in construction for civil engineering.

Compared to the limited impact of WTO/GATS related disciplines, the EU accession process has direct and strong implications for the development of the electricity sectors in the Baltic States. The key elements of the *acquis communautaire* in energy are contained in the Treaty provisions and secondary legislation related to competition and state aid and the internal energy market, including directives on electricity, price transparency, gas and electricity transit, hydrocarbons, licensing, emergency preparedness as well as nuclear energy, energy efficiency and environmental rules (see Box 4.3).

Box 4.3 The EU *Acquis Communautaire* in Electricity

The key element of the energy *acquis* is the Electricity Directive 96/92/EC. Its objective is to create a common internal market in the EU by establishing a set of common rules for production, transmission and distribution of electricity and by introducing gradually competition in these sub-sectors where the competition is feasible. The main features of a common electricity market as defined by the Directive are the following:

- the unbundling of different stages of production of electricity (generation, transmission, distribution and supply) either as separate undertakings or as separate accounts in the case of integrated undertakings;
- transparency in licensing and tendering of new generation installations;
- a gradual extension of the rights of consumers to choose their supplier, either to buy directly from generators in the case of industrial consumers, or from alternative suppliers in the case of households;
- the right of access to the system;
- electricity undertakings must be operated on a commercial basis, although member states may impose public service obligation on them with respect to security, regularity, quality and prices.

A key objective of these measures is to avoid a situation in which the implementation of the Directive leads to separate liberalised markets in each of the member states. This has focused attention on cross-border issues such as interconnection, balancing, congestion and power exchanges.

Source: European Commission, 2002.

Latvia has no specific problems with the current EU requirements in the electricity sector. It has to gradually liberalise the sector, restructure the state electricity utility, and improve its administrative capacity. Some problems could arise from the need to reconstruct and increase the safety of dams of its largest hydro-power stations. The financing of these projects may increase the prices of electricity produced by hydro-power stations, which are currently considerably lower than the prices of imported electricity.

High nuclear safety standards in Europe impose considerable adjustments to **Lithuania**. One of the conditions for the country's accession is the requirement to close down both reactors of the Ignalina Nuclear Power Plant (INPP) at the earliest practicable date. Since Ignalina generates over 85% of the electricity generated in Lithuania, the first issue is to find new sources of electricity.

Lithuania does not have sufficient natural energy sources, and a shutdown of Ignalina implies a large dependency on foreign supplies. Some experts consider that with additional safety fittings and re-channelling, Ignalina's life can be extended beyond its original design. A project is currently under consideration to connect the Lithuanian and Polish power grids, which would enable Lithuania to export power surplus to the European market and generate substantial export earnings. Currently, Lithuania exports its surplus to Belarus, which has accumulated a debt of nearly USD 90 million.

In May 2000, the Lithuanian parliament adopted a law on the decommissioning of unit 1 of Ignalina to be closed by 2005. For this purpose, Lithuania obtained funding from some developed countries and international financial institutions, including the European Bank for Reconstruction and Development (EBRD). Lithuania agreed to close the Unit 2 of INPP by 2009. The EU declared its readiness to provide financial assistance through long-term financial assistance, structural funds and the Cohesion Fund.

The **Estonian** oil-shale exploitation will most probably be limited due to the environmental pollution it causes. Main pollutants include SO₂ and flue ash emissions, but untreated waste water discharge is also a problem. The situation is complex and politically sensitive because phasing out this production will have an adverse impact on local employment and make Estonia dependent on energy imports, especially from Russia. In 2001, the Estonian government adopted the Restructuring Plan for the Estonian Oil Shale Sector for 2001-2006, accompanied by the National Employment Programme for Ida-Virumaa (the oil-shale mining region), which should allow for gradual and smooth restructuring.

The Common Baltic Electricity Market

The three Baltic States have also sought to develop the regional energy market. The Common Baltic Electricity Market (CBEM) is considered as an important contributing factor to regional economic development and as such it has become a high priority. During the Baltic Council of Ministers in June 2002, the Heads of Government of the Baltic States signed a resolution, requesting the countries' regulatory bodies in the energy sector to agree on the basic principles of the CBEM regulations that would ensure equal conditions for all the CBEM participating countries. The agreement on common principles regarding the regulatory issues within the CBEM, based on the EU legal acts, was subsequently signed by the regulatory authorities of the three countries. It covers, in particular, issues such as pricing, regional market development, independence of transmission system operators, avoidance of non-justified trade barriers and abolishment of obstacles to competition.

These developments should be viewed in the context of the EU Electricity Directive, which requires open access to the grid for the major consumers. However, each of the Baltic countries separately is too small and the ownership of generation capacity too concentrated, to gain the maximum benefits from implementing the EU energy directives, *i.e.* open the market and create significant competition between suppliers. Although these measures should increase efficiency, improve quality of supply and lower overall costs, the opportunities might be greater within a larger regional market. The CBEM is therefore conceived as a voluntary contract market with a balancing pool, trading in parallel with the "captive" market supplying the franchise customers. Eligible consumers will be allowed to trade freely with existing generators or new Independent Power Producers (IPPs) in each country. The market will be opened gradually and the mechanisms for balancing energy and allocating the costs to market participants will evolve from simple to more complex methods.

Increased trade with other countries (Russia or western countries) has, for both technical and commercial reasons, limited possibilities in the short term. Therefore, the new trading will be

primarily between generators and eligible consumers in the three Baltic countries. The agreement proposes that a competitive market will expand in steps, as the size of market opening increases:

- Initial market opening will concern some 100 eligible customers representing about 15% of the market. Contracts would be mainly long term (annual or monthly) bilateral contracts and a simple market for balancing costs, which would be charged on an average basis.
- Increased market opening by lowering the threshold for eligible consumers to encompass about 25% of the market. This will open the market to some 500 to 1000 eligible consumers. Market rules and systems will become more sophisticated. Bilateral contracts would get shorter and more varied. A spot market could be established. Independent traders may appear. Balancing costs will be charged, based upon hourly imbalance quantities and prices, requiring the use of hourly meters or statistical profiles.
- Further increased market opening to 33% of the market in full compliance with the current EU Electricity Directive. The number of eligible customers will increase dramatically (more than 10 000), requiring considerably more investment in software and systems. Buyers for the franchise market may move from centralised to the distribution companies, establishing the bilateral contract market model.

Under such conditions, the CBEM is expected to promote competition in generation and customer supply, lead to lower consumer prices, more efficient provision of system balancing and provide better security of supply. These benefits for trading partners will mainly result from the opportunity to specialise and achieve economies of scale. The CBEM will allow a greater variety of products and permit the entry of more companies able to provide the services. The existing power trade system, which includes centralised dispatching operations through DC Baltija, well-developed interconnections and a diversified and complementary structure of power generation, provides a solid foundation for the further integration of the power markets. Benefits would be realised through increased specialisation and power-cost operation in the areas of wholesale electricity supply, balancing and transmission services, and security of supply.

The existing diversified structure of generation in the three countries represents an excellent opportunity to utilise the existing synergy potential by optimising system operations and coordinating regulatory frameworks. The variety of existing generating plants offers a potential for specialisation in the provision of power from different plants. This will require, however, better integration in terms of harmonising electricity trading rules, regulations as well as environmental and technical standards.

A major limiting factor in this arrangement is the absence of a control on frequency and the still-incomplete measurement of system use by outside parties. This means that costs and market distortions can be caused by an external party not bound by the disciplines of prices arising within a competitive balancing market. A further limitation on trading is the standard of metering within the Baltic area. This restricts the ability of the system to allocate costs and responsibilities to trading parties, and hence, to measure properly delivery in a bilaterally traded market. A liquid trading market will emerge in the Baltic States only when clear and transparent market prices are established. Efficient trading will occur with costs and risks being properly allocated between the trading parties to allow competition on the basis of genuine differentiation in service and price.

Concluding Remarks

With the progress in market opening in each of the Baltic countries, the existing co-operation between the incumbent state-owned operators will be transformed into cross-border trade involving a

number of participants. These developments will be facilitated by the creation of a common market in electricity.

Trade in electricity will also develop under the influence of the integration of the Baltic States in the European Union. Single market requirements and the model proposed by the EU Electricity Directive stimulate the restructuring of former monopolies. Requested restructuring of existing production facilities in Estonia and Lithuania will affect the trade potential of these countries and as a result, the need for trade in electricity will further increase.

The Common Baltic Electricity Market is expected to improve the security of supply, allow for specialisation and efficiency improvements, and develop the existing co-operation among the countries in securing energy balance. Its success will, however, depend on progress in restructuring in each country as well as on the development of institutions necessary for the market to operate.

Airfreight

This section explores the transformation process and reform strategies in the Baltic airfreight sector. It considers the possible impact of relevant multilateral and regional commitments, the competition situation, external and internal impediments inhibiting business opportunities and future options and challenges in this area. In contrast to the three previously analysed sectors, the airfreight industry appears to be mainly influenced by market developments rather than by multilateral and regional disciplines.

The Baltic States offer equal entry and operating conditions to foreign and local companies in airfreight and courier business, and the market is largely free from restrictions and discrimination. This development has taken place rather spontaneously, as the airfreight and courier activities have developed in an international environment, with only minimal regulatory guidance from the WTO or the EU. The sector has primarily focused on ways to cope under the tough competition from both local and foreign companies. The openness of the market in the Baltic States, in fact, exceeds that prevailing in many European countries. Some observers, however, consider that, as local companies have become sub-suppliers to international companies, the national development in the sector is now frequently based on decisions taken in headquarters of foreign firms.

The main opportunity for the Baltic companies can be seen in establishing a gateway position in airfreight and express services, developing the eastwards routes and transit business with higher value-added services. Such development supposes the creation of a strategic logistics/supply chain, which requires considerable know-how and infrastructure investments. Current trends in the sector include the further development of courier/express companies, which are expected to overtake a number of the functions of import-export companies as well as airfreight-forwarding business. The uniformed approach and the fragmented service offerings on a global basis will allow such companies to become strategic partners for firms distributing higher value commodities in the Baltic countries. The courier/express companies will have to offer additional services, including invoicing, factoring, and other services, so as to become integrated partners with exporting firms.

Recent Trends in the Airfreight Sector

The development of the airfreight sector depends mainly on the type of exported/imported commodities as well as the countries of origin and destination of trade flows. As the major trade partners of the Baltic States are nearby countries, and exports consist mainly of lower value-added products (see Table 4.15), the extent of airfreight activity is comparatively lower than in neighbouring countries, such as the Scandinavian countries and Poland. The situation is, however, likely to change

in the near future as the local industries make efforts to upgrade and diversify their exports. At the same time, such a development requires the availability of transport infrastructure for high value-added commodities and access to cost-effective international air transport services. In order to be able to sell to foreign clients, the firms need to control the distribution, time of delivery and modes of transport. On the import side, which currently represent two thirds of the total airfreight, the majority of transport decisions are made by foreign sellers.

Table 4.15 Main Characteristics of Foreign Trade of the Baltic Countries

	Exports				Imports			
	Main partners (%)		Main product groups (%)		Main partners (%)		Main product groups (%)	
Estonia	Finland	24.8	Machinery and equipment	24.8	Finland	17.2	Machinery and equipment	29.7
	Sweden	15.3			Germany	11.2	Vehicles, transport equipment	10.8
	Germany	9.9	Wood and products thereof	15.1	Sweden	9.5		
	Latvia	7.4	Textiles	12.1	Russia	7.4	Agricultural products and foodstuff	9.7
Latvia	Germany	15.5	Wood and products thereof	33.6	Germany	17.2	Machinery and equipment	21.3
	Great Britain	14.6			Lithuania	9.8	Chemicals	10.5
	Sweden	10.5	Base metals and articles thereof	13.2	Russia	8.8	Vehicles, transport equipment	9.8
	Lithuania	8.4	Textiles	12.8	Finland	8.0		
	Estonia	6.0	Foodstuffs	7.2	Sweden	6.4	Mineral products	9.7
Lithuania	Great Britain	13.4	Mineral products	18.9	Russia	21.3	Mineral products	17.6
	Russia	12.2	Vehicles, transport equipment	16.0	Germany	17.0	Machinery and equipment	17.3
	Germany	10.4			Italy	4.9	Vehicles, transport equipment	16.2
	Latvia	9.6	Textiles	15.1	Poland	4.8		
	Denmark	5.1	Machinery and equipment	10.0	France	3.9	Textiles	7.9

Source: National statistical offices of the Baltic States.

Recent developments in the aviation sector of the Baltic countries have been similar to general trends observed in Europe. In particular, national airlines companies were rapidly privatised, especially in Estonia and Latvia, and the airlines attracted massive foreign direct investment flows. The foreign investments in the transport sector count for a relatively high portion of total investments. Nordic and North European companies are the major investors in the three countries, and, as a result, they have a certain degree of control over the market, especially in the airfreight and courier/express services, either through subsidiaries or via shareholding. The foreign companies involved in airfreight activities are mainly interested in point-to-point activities. Following the development in overland transport, it can be expected that the freight/courier/express hub model will also be introduced in the airfreight sector.

Discussions concerning the creation of a United Baltic Airlines, which could permit development of the Baltic aviation industry and create a regional platform for new routes, have not come to fruition. The initial expectations regarding local aviation development have not been fulfilled. A number of direct airline operations to/from the major Baltic cities were terminated, and the air traffic transferred to central partner hubs (Helsinki, Copenhagen or Stockholm). This outcome is due to the lack of cost effectiveness, a relatively poor market basis at the local level and the interest of foreign strategic partners in consolidating the traffic.

These general developments have also influenced the airfreight sector. The domestic import/export airfreight loads do not qualify for freighter services or the utilisation of passenger aircraft with cargo capacity. Although a number of international destinations are served, the freight capacities often tend to be limited or restricted to a single piece of freight. The airfreight tonnages are generally small, partly because the majority of so-called airfreight moves by truck to and from the main European main hubs. There are no freighter services, except for the cargo aircrafts run by courier/express companies. Moreover, some operating aircraft, such as Avro liners and Fokker 50 are not suitable for airfreight. Even on routes where Boeing aircraft could accommodate some freight volume, the freight compartments tend to be partly empty and freight is transported by trucks to and from major hubs like Copenhagen, Stockholm, Frankfurt and Amsterdam.

Sufficient freight capacity and relevant aircraft types can only be attracted if and when the Baltic aviation industry manages to present itself as a gateway/transit point to different destinations in the hinterland. Unless the Baltic countries can attract pure freighter services from the Far East (China, Korea, etc.) and Russia, which would use one of the countries as a consolidation point for freighter services, the airfreight development could only be based on passenger aircraft. A number of passenger aircraft types have in fact sufficient capacity and can accommodate containerised freight.

Liberalisation Strategies in the Airfreight Sector

Privatisation

Estonia adopted the fastest pace of privatisation among the Baltic States. The government foresees that, by 2006, the primary functions of the state will be limited to enforcement, legislation, certification and licensing. For the remaining functions, the decision on privatisation will depend on economic feasibility: in cases where private companies are capable of administering directly and managing more efficiently, functions should be privatised. Municipal as well as private capital is to be involved in privatisation. The national carrier, Estonian Air, is 66% privatised (Maersk Air, Cresco Investment Group) and the state share will further diminish.

All airports are currently state-owned. However, government strategy envisages the privatisation or municipalisation of regional airports, if feasible. The airfreight forwarding business and cargo handling are run by private companies.

In **Latvia**, the former state-owned airline Latavio disappeared in the mid-1990s. Since then, airline development has depended on SAS participation in the development of AirBaltic, in which State ownership is 52.6%. Cargo handling is currently operated by three companies at Riga airport. The most recently established is the Baltic Cargo Centre, a joint venture between SAS, Globe Ground and Air Baltic, which accounts for 45% of the regular flight handling activities.

Lithuania still has a state-owned airline, a situation that has been criticised for inducing uneven competition and restrictions. The preparation of privatisation started in 2000, when the shares of Lithuanian Airlines were transferred to the State Property Fund. Several airlines have expressed an

interest in shareholding or strategic partnership, for example SAS. It is expected that privatisation will lead to a merger with Air Lithuania, founded as a state-owned regional airline and operating out of Kaunas. Air Lithuania is a subsidiary of Lithuanian Airlines.

Lithuanian Airlines continues to run its own freight-forwarding department. Until recently, the airline was the sole handling company at the airport and enjoyed a certain comparative advantage. However, a new independent cargo handling facility was built recently, thus ending this monopoly situation.

Competition

In **Estonia**, government policy foresees further integration of Estonian aviation companies into alliances and unions, which will enable expansion of activities and a larger choice for customers. Currently, Star Alliance and Oneworld are active in the Estonian market. Aviation alliances and co-operation are monitored by the Competition Board, and in case of alliances between airlines from different European Common Aviation Area (ECAA) countries, by the Competition Directorate of the European Commission.

In **Latvia**, the government has followed aviation development closely, applying EU regulations in this area. Although the Star Alliance is dominant, almost all global alliances (Oneworld, SkyTeam, Wings, etc.) are also represented in Latvia. The status of Lithuanian Airlines (100% state owned company) has been under special scrutiny, as in certain cases, such as cargo-handling and freight-forwarding, it has a potential to control the market.

The forthcoming privatisation process in **Lithuania**, involving decisions on strategic partnership and shareholders, will determine which strategic alliance will dominate in the country, *i.e.* Star Alliance (in case of the privatisation by SAS) or Oneworld (in case of Finnair or British Airways). Among current code-sharing partners, CSA Czech Airlines is a member of SkyTeam, LOT is a member of Star Alliance, and Iberia of Oneworld.

Liberalisation

In the EU, where the liberalisation process started in the 1980's, market opening and liberalisation in the member states have been pursued in the framework of the European Common Aviation Area (ECAA), which aims at increasing liberalisation, market opening and competition. In parallel with their accession to the EU, the three Baltic countries will also join the ECAA. This will mean, in particular, that foreign carriers will have equal rights in the Baltic countries' market.

Another trend in the European aviation environment has been the decline in state interference, mainly in the form of state subsidies, which today are allowed only under certain conditions. The Baltic States' governments will be subject to the same disciplines. For example, the domestic routes linking the Estonian mainland and the islands can only be operated with government subsidies. Lithuania will have to introduce a more transparent system within the privatisation process to make it fully complying with EU rules.

Another aspect in international aviation liberalisation has been the establishment of alliances among airlines, using common frequent flyer programmes and cooperating in cost minimisation. In this respect, the effect of joining the ECAA will not induce any major changes in Estonia and Latvia, as these two markets already depend on the strategic alliances and foreign shareholders. In Lithuania, the outcome depends on the future partner and shareholder in the national airline. If SAS becomes a

partner, it is likely that SAS will put more effort in becoming a shareholder in Estonian Air and thereby gain a dominant position in aviation development in the Baltic States.

Price policies

Air traffic fees are based on International Civil Aviation Organisation (ICAO) tariff principles and other international obligations. According to the Chicago Convention, all member states have to ensure airport and air traffic control services based on ICAO standards and recommended practises for international air traffic in their territory. For air traffic fees (route navigation fee, terminal navigation and airport fees), the principles of ICAO tariffs are to be followed in accordance with a country's international commitments. Fees have to be based on clear, transparent and reasonable operating costs. The International Air Transport Association (IATA), which in the past was the controlling body for international air transport fares and prices, no longer has a significant role in fare and rate matters. Fares and freight rates are, in reality, based on free market competition, though they are not always transparent.

For freight, the official IATA rates have been replaced by contract rates, special rates and net rates. Previously, only IATA freight agents had access to rates and agreements with IATA airlines. In the Baltic countries today, about 15% only of the airfreight forwarders are authorised IATA agents. Most freight forwarders can, however, quote the airfreight rates and sell the airfreight services of all the airlines operating to and from the three countries. This development has been mainly influenced by the courier and express carriers, which have introduced full-package door-to-door rates. In the courier business, contract/volume-based pricing also exists.

Role of Regulatory Agencies

Administration and co-ordination of aviation activities are broadly similar in the three Baltic countries. The state administration of civil aviation is assigned to the Ministry of Transport and Communications and the Civil Aviation Administration (CAA), within the limits set up in the Aviation Act, and in accordance with the statutes of these institutions. In the three countries, the main tasks of the Ministry of Transport and Communications are to elaborate and implement state policy in the aviation sector. Its main functions include:

- elaboration of state policy in the aviation sector; implementation and co-ordination of development plans;
- drafting of legal acts and the related co-ordination, organisation and co-ordination of euro-integration activities;
- participation in the elaboration of price and tariff policies;
- preparation of intergovernmental transport agreements, joining and enforcement of international conventions;
- ownership functions in companies where the state is a shareholder;
- drafting of the state budget for institutions administered by the Ministry;
- co-ordination of activities related to aviation development and air traffic safety, legislation and euro-integration; and
- issuing of aviation licenses.

The Civil Aviation Administration (CAA) is responsible for state inspection and supervision over the implementation of national laws and regulations. The CAA ensures civil aviation safety, the implementation of aviation policy at the national level and the co-operation with other states and international aviation organisations at the international level. The CAA is financed from the state budget and has the following main functions:

- participation in the elaboration and implementation of aviation policies, state programmes in aviation safety, and enforcement of international agreements;
- elaboration of legal acts and control over their implementation;
- organisation of the use of air space and air traffic service regulation;
- certification;
- attestation of aviation staff and issuing of flight permissions;
- co-ordination of airports-related construction and development projects;
- organisation of investigations of accidents and aviation incidents; and
- aviation terminology matters.

The CAA governs the activities of the following state institutions: the Air Traffic Service, airports, the flight college and the border guard flight group. It also regulates and certifies private sector entities such as aviation companies, flight and parachute clubs. It plans to undertake a revision of the financing mechanisms of aviation-related institutions, based on international practises and the local needs for a more efficient system.

International, Regional and Sectoral Disciplines and Commitments

The documents governing developments in general aviation globally are the “ICAO Strategy Guiding International Civil Aviation to the 21st Century” and the European Civil Aviation Conference (ECAC) members’ Air Traffic Management for 2000 (ATM). The Baltic States’ governments have mainly focused on general aviation development and not on specific transport segments, such as airfreight. They have implemented the strategy of the European Civil Aviation Agreement and Convergence and Implementation Programme Document. The governments’ strategies should also take into account security-related requirements and co-operation between the military and civil aviation, as foreseen, in particular, by NATO plans and the Membership Action Plan with Annual National Programme.

In the airfreight industry, there are no restrictions on creating or operating businesses, and foreign companies are treated as local companies. The sector is therefore a unique example of transition from a planned economy to a market economy, where progress has been extremely rapid and the outcome, in fact, closer to free market than in a number of West-European countries. The opening has allowed large international firms to dominate the local markets and shape national developments.

Like other EU-candidate countries and similarly to other sectors, the main priority of the governments in the Baltic countries has been to harmonise aviation-related legislation with the EU legislation in accordance with the Joint Aviation Requirements (JAR). The European Common Aviation Agreement (ECAA), which involves the EU states, 10 Central and Eastern European countries, Norway and Island, will replace bilateral agreements between these countries, while bilateral agreements will continue to govern the aviation activities with the non-ECAA countries.

EEA accession is parallel to the EU accession, as both require implementation of certain EU legal acts.

In addition to these main legal acts, the three Baltic States are members to the following international aviation-related conventions: Chicago Convention; International Aviation Rules Unification Convention; Warsaw Convention and amendments; Warsaw, Hague and Guatemala protocols; International Air Transit Agreement, and Aircraft Ownership Recognition Convention.

Moreover, the three countries are also in the process of signing the Rome Convention, Paris Bilateral Agreement, Montreal Amendments to Civil Aviation Convention, and Montreal Convention on Unification of Rules. The Baltic countries are members (Estonia) or candidate members (Latvia, Lithuania) of the Joint Aviation Authorities (JAA), European Aviation Safety Administration (EASA). They are also members of European Civil Aviation Convention (ECAC), and the International Civil Aviation Organisation (ICAO) and are in the process of joining EUROCONTROL.

Future Challenges

The airfreight providers are forced to operate with rather small profit margins that in many cases restrain their prospects for further development. The airfreight industry will be further constrained by the courier/express companies' expansion into the traditional airfreight market. In selecting their transport provider, national companies do not pay attention to the geographic origin of the company. Although the firms claim to consider the quality of the service, their main concern appears to be the price level. In the short term, this situation is likely to remain unchanged, with the cost level in the three Baltic countries staying at the approximately same level. The increasing competition will also stabilise the cost structure in both the airfreight and the courier/express business.

Free competition in transport is generally considered beneficial for the local importers/exporters, but it can also have some adverse effects, especially when the transport structure is influenced mainly by cost-effectiveness rather than development-based considerations. After massive privatisation, implying in most cases foreign ownership, domestic firms have become unable to compete with international companies, especially because of their incapacity to mobilise sufficient financial resources. In addition, domestic companies have also been unable to benefit from public support, in contrast to some large foreign companies. External opening has been favourable to exports, but probably less so for developing a sustainable national transport environment.

The biggest challenge for the aviation industry will be to utilise the geographical position of the three Baltic countries as a value-added hub for eastward destinations. The main question here would be whether the companies will use one or more of the Baltic countries as their gateway to eastern customers on a point-to-point basis. In connection with EU accession, the countries will have the opportunity to utilise the gateway/hub opportunities that have often been discussed among different partners, but not really pursued. Such a development would require creating a proper infrastructure for passenger and freight transport. The national authorities have to play an important role in this development, in particular by creating an adequate legal framework and concluding agreements with neighbouring countries. The Baltic airlines will be acting primarily as feeders to international destinations of the strategic partner airlines. There will be some direct point-to-point services between the Baltic countries and some main destinations, but in the long run, they are likely to follow the development of the inter-European routes and similar to the situation in the Scandinavian countries.

Development of the airfreight industry will also depend on the evolution in passenger traffic development and the aircraft types introduced in the route network. The introduction of an Airbus-type aircraft could increase airfreight capacity and would accommodate containerised cargo. This will have

a positive influence, as the airlines can upgrade their airfreight promotion on scheduled flights. Full freighters services will increase only when the more value-added commodities represent a bigger share of the import/export shipments, and intra-regional trade develops sufficiently. An increase in express shipments could lead to a situation where the courier/express companies become freight carriers in direct competition with the regular carriers.

Airfreight forwarding will face a number of challenges in the future. Competition has been increasing from the forwarding business itself and from the courier/express companies. The demand for value-added services will intensify from international customers, and the forwarders must introduce such services to offset the decline in income from customs brokerage and similar services that will diminish mainly in connection with the EU integration. Airfreight forwarders will have to find new ways of making business, and identify alternative client services. The number of airfreight forwarders involved in the business is expected to decrease dramatically. The courier/express companies will further develop their service concepts and overtake a number of the functions of import/export companies. The uniformed approach and the fragmented service offerings on a global basis will make these firms the strategic partners for companies distributing high value commodities in the region.

The distinction between airfreight, courier and express services will further diminish as international clients focus less on the type of transport and more on time and price guarantees. It was expected that the pure airfreight forwarders would take up a substantial part of the third party logistics and take over the inventory control from customers. However, in most countries the integrated carriers have started to dominate the market, and similar situation is now also observed in the Baltic region. The integrators (courier companies and express companies) are investing in this field and are not limiting themselves to express parcels. The uniformed systems (including for example bar-coding and on-line facilities), equipment and facilities combined with transport vehicles allow them to capture a larger share of high-valued business and commodities.

The integrators will create new opportunities for exporters and importers and, in a way, leave the traditional airfreight forwarders behind to deal with ad hoc shipments. One-stop-shopping is a key word in international airfreight since customers want to minimise the number of suppliers. The integrators are starting to offer complementary services to customers, such as invoicing and factoring. In summary, there is still free competition, but opportunities for the traditional airfreight forwarders are diminishing.

Logistics development also means more frequent and smaller shipments, the final order tailored to the need of the customer and the use of “easy to access”, “uniformed approach”, “one stop shopping” and simplified cost structure. These global development trends will also apply on a regional basis and thereby reduce the importance of national borderlines in the air transport business. For freight services, this will mean that only global players will survive. It does not mean necessarily that Baltic airfreight forwarding will disappear, but that the local/national parties will no longer exist as significant players in the airfreight or express business.

Concluding Remarks

In the Baltic States, the level of restrictions for foreign companies in the airfreight, courier/express business is the same as for local companies; there is no discrimination towards foreign companies. This situation results from the interest of the three countries in ensuring access to international transport network and the need to cope with local and international competitive pressures. The resulting compliance with existing WTO and EU disciplines has been achieved through spontaneous development of the market rather than driven by well-defined government strategies.

In the future, existing operators should put more emphasis on using the existing strengths, in particular the presence of international airfreight and courier/express companies active in the region. They should seek to establish the long-discussed “gateway between East and West” for airfreight and express services. The future of the Baltic airfreight value-added service lies primarily in developing transit business towards the East. Becoming the outer EU border should encourage such a development. A pre-condition, however, is that the local skills are improved to meet the demands for expertise beyond the basic transport and courier activities. Vocational training, based on contemporary advanced training programs, is needed in order to cope with the total logistics chain demands, which will replace the currently used terms “airfreight” and “courier/express services”.

Given the critical importance of transport-related costs and their key contribution to overall trade competitiveness, development and modernisation of airfreight and related services must be an integral part of the trade expansion strategy in the Baltic States. This process has to be supported by adequate regulatory policies to reduce remaining policy-induced barriers and ensure that ongoing restructuring in the sector is pursued in accordance with the economic and social interests of the Baltic States.

NOTES

1. The surveys of the four sectors are based on the studies prepared for the OECD by Mr. Alari Purju, Tallinn University, Estonia (banking), Mr. Eitautas Bartuskevicius, CESIM Consulting Group, Lithuania (telecommunications), Mrs. Erika Sumilo, University of Riga, Latvia (electricity) and Mr. Stig Lofberg, Consulting Group, Denmark (airfreight).

Chapter 5

MARKET AND TRADE LIBERALISATION IN SERVICES: THE BALTIC STATES' EXPERIENCE

Abstract: This chapter reviews the main elements of the general policy debate and research on market and trade liberalisation in services and highlights their relevance for the Baltic countries. It summarises recent OECD work on the contribution of the regulatory framework to economic development and the role of regulatory agencies in this process. It briefly comments on recent analytical efforts used in assessing the impact of services trade liberalisation and measuring the restrictiveness of trade barriers in services. This is followed by a general overview of the role of services in regional integration and cooperation initiatives. The experience of the Baltic States provides valuable insights for the ongoing debate, confirming, in particular, the key role of effective domestic regulations and institutional regulatory settings and the need for overall policy coherence, especially between regulatory reform and external opening. Finally, this chapter highlights the decisive influence of the EU on their regulatory framework and trade liberalisation process and discusses the possible role of intra-regional (*i.e.* among the Baltic States and neighbouring countries) cooperation in the area of services.

Introduction

It is important to distinguish between reforms of the domestic market and trade liberalisation even when the two processes are closely interrelated and usually carried out simultaneously. Market liberalisation involves structural reforms such as privatisation and deregulation, which aim at opening up monopoly or government controlled industries to competition. Services trade liberalisation means external opening of the domestic market to foreign services providers. While privatisation and deregulation programmes are primarily the responsibility of individual countries, the GATS seeks to encourage services trade liberalisation and ensures that its basic principles are respected by member countries, particularly the non-discriminatory treatment of foreign services providers. The GATS, which recognises a country's sovereignty in shaping domestic regulations, contains basic regulatory requirements concerning the transparency of regulations and their non-discriminatory administration and implementation.

In assessing the degree of market and trade liberalisation in services, the inherent nature of service industries must be taken into account, notably their sectoral heterogeneity and the regulatory intensity of services trade. Sectoral diversity usually requires a differentiated approach in designing the regulatory and institutional settings for individual service sectors. Conducting cross-sector and cross-country comparisons therefore becomes quite complex. Compared to the still important role of border measures in merchandise trade, barriers to trade in services are characterised by the regulatory intensity or the prominence of governmental regulations affecting such trade. Taking into account national specificity in jurisdictions and preferences in standards, national authorities are responsible for designing the regulatory framework for trade in services and do not surrender their rights and obligations to regulate even if they accept far-reaching multilateral and regional liberalisation commitments. Recognising the importance of regulatory issues, the research and policy debates seek to identify good regulatory practices and consider their possible contribution to economic performance and international competitiveness.

The experience of the Baltic States confirms that a successful development strategy for the service sector requires coordination and careful sequencing of domestic reform, regulatory policies and trade liberalisation. Although external opening is critical for injecting competitive pressures and accelerating managerial and technological modernisation, it is not a substitute for active domestic regulatory policies. As multilateral regulatory disciplines are still rather rudimentary, the Baltic countries have relied on regulatory guidelines provided within the EU accession process. As EU candidate countries, the Baltic States adopted the EU *acquis communautaire* in different service sectors, and as EU members, they will join future EU regulatory co-ordination and harmonisation efforts.

The Baltic States' governments decided not to institutionalise their regional integration in the area of services. However, their co-operation has developed both in some specific sectors, such as electricity, and on a horizontal level, for instance in trade facilitation-related issues. Regional co-operation has usually been initiated by the governments and then pursued through business initiatives and sector-specific interests. This co-operation will continue to develop given the importance of regional services trade and investment flows and the need for the countries to act jointly to avoid regulatory restrictive practices.

Market Development Strategies for Services

The Regulatory Framework for Services

The growing importance of regulatory issues in services reflects both traditional and more recently emerging features characterising this sector. Services have been traditionally a highly regulated sector where close controls over entry, prices of output and restrictions on competition have been justified on economic grounds related to market failures but also by social and political reasons. Technological advances and inefficiencies resulting from highly regulated services have prompted governments to initiate market liberalisation and trade opening in this sector. However, the shift from strict regulation to market mechanisms and external opening has to be accompanied by effective domestic regulations. Most OECD countries have undertaken far-reaching regulatory reforms in previously uncompetitive infrastructure industries, replacing public policy instruments and public ownership with market mechanisms.

The research and policy debates have focussed on how to ensure the quality and efficiency of domestic regulations and how to enhance their contribution to harmonious economic development. Responding to these preoccupations, the OECD has started to monitor the regulatory patterns in OECD countries and examine their impact on economic performance and productivity. The OECD has also undertaken multi-disciplinary regulatory reform reviews of individual OECD countries, which examine the government's ability to design and implement regulatory reform, develop their administrative capacities, enforce competition policies and implement trade-related regulations encouraging market openness.

In 1998, the OECD developed the International Regulation Database (IRD), which provided a comprehensive and internationally comparable set of data on regulations and market structures in OECD countries (OECD, 1998). The main aspects covered by this database include the state control of business enterprises, the scope of governmental involvement in business operations, legal and administrative barriers to entrepreneurship, barriers to international trade and investment and competition policies. The 1998 database also contained information on sector-specific regulations in telecommunications, transportation, electricity supply and retail distribution.

Given rapid developments in the regulatory area, the OECD decided in 2003 to update the 1998 dataset using a new questionnaire addressed to all OECD member countries. The new OECD Regulatory Indicators Questionnaire covers general policies (concerning, in particular, the scope of public ownership and legal conditions for entry), regulatory and administrative policies (related especially to possible administrative burdens imposed by existing regulations). It also addresses regulations in three specific sectors, *i.e.* professional services, transportation industries and the retail distribution industry.

All OECD Member countries have undertaken considerable regulatory reforms over the past two decades, with the objective of enhancing economic growth and productivity by increasing competitive pressures. These reforms have encompassed privatisation, liberalisation of potentially competitive markets and implementation of pro-competitive regulations in remaining natural monopoly segments. Three main characteristics of the regulatory reform in OECD countries were identified (Gönenc *et al.*, 2001).

- Liberalisation of prices and access to markets that were previously restricted by legal and regulatory barriers.

- Shift to the private sector of some activities, which were previously run by the government. As a result, the share of the public sector has considerably diminished in most OECD countries.
- Designing a new regulatory structure, including the establishment of regulatory agencies and restructuring tariffs in order to reflect underlying costs.

Although OECD Member countries share the general goal of creating a more market friendly environment, their reforms have not necessarily led to converging regulatory patterns or similar regulatory policy approaches. The regulatory divergence also exists among EU Member countries, despite the European Commission's efforts to harmonise the business environment in the Single Market. In particular, the degree of state intervention in different sectors remains relatively differentiated across the EU states, implying potentially negative effects on competition within the EU (Nicoletti, Scarpetta, 2003).

The Potential Impact of Regulatory Policies

One important issue is to determine whether and how different regulatory patterns influence productivity and growth. The basic assumption is that regulatory policies might represent one of the important channels for improving productivity, in particular, by reducing the state's interference (through privatisation and less intervention in price setting) and increasing both domestic and international competitive pressures. Such regulatory policies will stimulate entrepreneurial incentives, enhance economic performance and encourage technology adoption and innovative activities. Available studies show, for example, a negative correlation between the strictness of national regulations and the average growth rate of GDP. These studies also establish that anticompetitive market regulations and strict regulations hinder the adoption of existing technologies and reduce incentives to adopt better technology. Stringent employment protection legislation appears to have a negative impact on productivity growth and discourages the entry of firms (Scarpetta, Tressel, 2002). The contribution of regulatory reforms to economic performance also operates through the channel of investment. Evidence suggests that regulatory reforms, especially when they substantially lower entry barriers in potentially competitive industries, spur private investment in corresponding sectors (Alesina *et al.*, 2003).

The strategic role of services in both national and international contexts implies that the effects of services liberalisation often reach beyond the sector itself. Eliminating barriers to entry and developing a pro-competitive environment bring up not only a greater diversity and quality of services offered with lower prices, but also generate further benefits in industries where producer services constitute an essential input. Moreover, since market opening of the service sector is usually associated with liberalising the movements of capital and labour, additional spillover effects in other parts of the economy can be expected.

The sequencing of reforms is also a much-debated issue. The key question here is how the changes in ownership, competition, opening and regulations should be coordinated to improve performance and bring expected benefits. One important aspect is that changes in regulations and institutional settings generally take more time to be implemented than transformations in ownership and competition that are relatively rapid. Also, privatisation without adequate competition policy is dangerous as it risks creating a privileged incumbent. However, in some sectors, such as retail and wholesale trade, opening usually entails enough competition pressure to discipline the price and investment decisions of firms. In other sectors, well-established regulations must be put in place prior to — or at least simultaneously with — opening to ensure a proper functioning of the market and adequate provision of services. This is particularly the case of financial services, where the

implementation of basic prudential regulations is a prerequisite. In some network industries, such as telecommunications and water supply, regulations are needed to ensure adequate pricing and universal service. The example of telecommunications and banking services in the Baltic countries shows that the strategy associating external opening with effective regulations and supervision, which are mutually reinforcing, can be successful.

OECD Regulatory Reform Reviews

In parallel with the cross-country and cross-sectoral evaluation of the effects of domestic regulations, the OECD has undertaken a series of regulatory reform reviews of individual OECD countries. The OECD horizontal and multidisciplinary project is based on a peer review process aiming to identify best regulatory practices and present policy recommendations for improving the regulatory policies in different countries.

In March 1995, the Council of the OECD adopted the “Recommendations on improving the quality of government regulation” (OECD, 2002a), which were developed by a network of regulatory policy officials from OECD countries as the first international standard on regulatory quality. Starting with a simple notion of deregulation, a more complex regulatory policy agenda has been established, covering three major elements: regulatory policies, regulatory tools and regulatory institutions. Recognising the importance of market openness and the need for broad regulatory consistency from domestic and international perspectives, trade-related regulatory issues have become an integrating part of the OECD regulatory reform project. A country’s regulatory regime and its contribution to market openness are assessed on the basis of six efficient regulatory principles: transparency, non-discrimination, avoidance of unnecessary trade restrictiveness, use of internationally harmonised measures, recognition of equivalence of foreign regulatory measures and competition principles (OECD, 2001).

Best regulatory approaches continue to be discussed both internally in different countries and in international forums, including within the WTO. One question concerns the right balance between meaningful horizontal rule-making and disciplines such as transparency or standardisation, and the need for sector-specific rules. Another issue is the relation between pro-competitive or market access friendly regulatory measures and potential additional administrative burdens, which could result from new regulations. In addition to the institutional design of regulatory agencies, the possible modes of their functioning are also subject to debate, in particular, whether to give preference to a legislative approach (*i.e.* via positive rule-making) or adjudicative procedures (*i.e.* via dispute settlement).

Different analytical insights and policy recommendations from the OECD analyses are greatly relevant in the context of transition countries in general and for the Baltic countries in particular. In former centrally planned economies, market structure was dominated by state-owned enterprises, and privatisation has been the first indispensable step in developing a market friendly structure and starting the restructuring process. After the initial enthusiasm for rapid and mass privatisation methods, the experience has shown, however, that in some cases political influence and economic concerns were dominated primarily by privatisation revenues. At the same time, sufficient attention was not always paid to other critical aspects such as the choice of strategic investors, the respect of sound corporate governance principles and the establishment of an adequate legal, institutional and market environment. In the Baltic countries, some of these disappointing aspects of the privatisation process have also occurred, but in general, their experience shows that it is possible to coordinate and harmonise the privatisation process with the establishment of a broadly adequate regulatory framework to ensure expected benefits of the privatisation process. Such co-ordination makes, in turn, market oriented regulatory policies easier to implement.

The Baltic countries' experience confirms the importance of a pro-competitive environment to avoid a transfer of monopoly rents from the state to private owners. Although competitive pressures in the domestic market have been strengthened in these countries, in particular, through active anti-monopoly policy, it seems that external competition in the form of imports and FDI inflows has played a comparatively more important role in the context of these small economies. Vigorous competition policies nevertheless remain critical in subsequent stages of the countries' development to prevent the abuse of dominant positions by incumbent firms.

The Role of Regulatory Agencies

The intensity of competitive pressures differs in individual countries and also varies within the countries according to different sectors. This explains why competition authorities in most countries, which control the implementation of basic competition disciplines throughout the economy, coexist with regulatory agencies, which supervise the introduction of competition rules in different sectors.

There are some important differences between competition authorities and regulatory agencies as regards their objectives, instruments and procedures. First, whereas the main role of competition authorities is ex-post examination of the application of competition rules, the responsibility of the regulators is to open progressively the supervised sectors to competition, by eliminating entry barriers and preparing general economic conditions for fair competition in previously state-owned and state-regulated sectors. Second, the two categories of institutions also dispose of different instruments to influence firms' operations. Competition authorities mainly rely on financial penalties against operators abusing their dominant position, without interfering directly with firms' operations. In contrast, regulatory agencies can directly intervene into firms' decisions, for example, by setting prices and defining activities and obligations of incumbent firms. Third, different roles and instruments also entail procedural differences: while ex-post intervention of competition authorities proceeds on a case by case basis, the ex-ante approach of regulatory agencies implies their permanent role in developing the economic and legal framework within the relevant sector (Parrot, 2003).

In many cases, national regulatory agencies also have to deal with the effects of market liberalisation and external opening of the service sector. For example, regulatory agencies might be requested to manage the gradual shift to cost-based prices and ensure, for some categories of consumers, the availability of and access to specific categories of services. Examples include services, such as local telephone calls or public transport, that were previously provided at administered prices, maintained at an artificially low level through cross-subsidisation or governmental financial support. Other specific tasks of regulatory agencies might be related to the impact on employment and wages and involve guaranteeing a level playing field for domestic and foreign firms.

Given the risk of regulatory capture by regulated firms and other interest groups, several general rules should be respected in designing regulatory institutions:

- Ensure independence of the regulator from the executive branch of government;
- Impose constraints on the regulators' discretion, for example, by allowing appeal procedures with general competition authorities;
- Enhance transparency of the regulatory process to limit information asymmetries;
- Ensure consistency of regulatory approaches across industries.

Despite the common objective of creating independent regulatory institutions, the OECD countries adopted different institutional designs, with most countries opting for sector-specific

regulators. Some other countries, such as Australia and Latvia, established an all-purpose regulator that cuts across all regulated industries. The third option, adopted by New Zealand, is to apply exclusively the general competition law (so-called “light-handed” regulation). In principle, an all-purpose regulator might be less subject to regulatory capture from the regulated industries, allow for economies of scale in information collection and reduce administrative costs.

In the Baltic States, national regulatory agencies have carried out additional tasks. They have contributed to developing a sound regulatory framework under conditions where the shift from state-owned monopolies to a private and competitive market structure has not yet been completed. They have also dealt efficiently with some remnants of the previous system, especially managing the gradual adjustment of administered prices for some services or certain users and preventing new entrants from targeting only the most profitable market segments.

The Baltic regulatory agencies have also greatly contributed to boosting investors' confidence, especially by containing political and administrative interference, which is still considered a significant risk in transition economies. The main factor in this confidence-building process has been to promote transparency, which is particularly important in the context of services characterised by regulatory intensity. By facilitating co-operation on regulatory issues and providing an opportunity for comments to operators affected by their decisions, the national regulatory agencies have also participated in enhancing openness in decision and policy-making.

In analysing the Baltic regulatory agencies (see Table 5.1), the main question concerns possible regulatory convergence first within the region and, second, between these countries and the EU. At first sight, formal convergence in this area seems rather limited. While Estonia and Lithuania have separate regulators for electricity and telecommunications, Latvia established a unified agency responsible for these two sectors as well as for gas, railways and postal services. Banking supervision in Lithuania remains with the central bank, whereas Estonia and Latvia have agencies that are responsible for supervising the whole financial services sector. The lack of formal convergence within the Baltic countries is not, however, unexpected, given that there is not a single model in the EU and no regulatory or supervisory body at the EU level.

Despite this formal difference in the number and sectoral coverage of national regulatory agencies, convergence in regulatory policies has nevertheless considerably advanced within the Baltic States. The structure and internal procedures applied by the Baltic national regulatory agencies are similar and close to the practices of EU regulators. Following the EU recommendations, the Baltic States have promoted regulatory transparency and ensured as much as possible the independence of regulatory agencies from the governments. Moreover, in the sectors where the EU directives are clearly specified, such as banking services, the agencies apply the same regulatory rules.

Table 5.1 Regulatory Agencies in the Baltic States

	Estonia	Lithuania	Latvia
Banking	From 1/1/2002 banking is supervised by the Financial Supervision Authority that merged three supervision agencies. The new agency is located at the Bank of Estonia, but it is autonomous and has a separate budget.	Banking continues to be supervised by the Bank of Lithuania .	Banking is supervised by the Finance and Capital Markets Commission , which is modelled on the UK Financial Service Authority.
Telecommunications	Since 1998 telecommunications are regulated by the National Communications Board , which has been shaped in line with the EU telecommunications framework.	Since 2001, telecommunications are supervised by the Communications Regulatory Authority , established in compliance with relevant EU directives.	Telecommunications and electricity are regulated and supervised by the Public Utilities Commission . It is financed by the fees on the net turnover of service providers.
Electricity	The Energy Market Inspectorate is the regulatory body responsible for electricity, including tariff setting, licensing and promotion of competition. It is funded from the state budget.	Electricity is regulated by the National Control Commission for Prices and Energy , established in 1997. Its role is to bring the country's energy sector in line with EU directives.	
Road haulage	The Ministry of Economic Affairs and Communications has overall responsibility for road transport issues including authorisations.	The body responsible for issuing international licenses is the State Road Transport Inspectorate under the jurisdiction of the Ministry of Communications.	Road haulage is administered by the Administration of Road Transport in accordance with EU directives and relevant international agreements.

Source: The Baltic National Regulatory Agencies.

Benefits of Services Trade Liberalisation

Methods and results of empirical cross-country research on the impact of merchandise trade liberalisation on economic growth have recently caused some controversies (Rodrigues, Rodrik, 1999). The research focussing on trade in services poses some additional problems due to limited data availability and some conceptual difficulties, reflecting the distinguishing features of services trade (Matoo *et al.*, 2001). There is nevertheless a general consensus that the contribution of services trade to economic growth might be important and potentially increasing, given the growing share of services in countries' output and employment, their strategic economic role as intermediate inputs and as a trade enabling element. The multiple modes of supply characterising trade in services might also bring out additional spillover effects. Like the estimates measuring the impact of liberalising trade in goods, the estimated benefits of services trade liberalisation also indicate that countries should expect greater benefits from the removal of their own trade restrictions than from market access concessions granted by their trading partners.

Market opening with increased competition is expected not only to bring lower-cost and better-quality services directly to domestic consumers, but also to encourage the development of more competitive backbone services, such as banking, telecommunications and transport, which will in turn contribute to better overall economic performance and the expansion of trade capacities. However, these potential longer-term benefits of trade liberalisation might entail some adjustment costs resulting from greater exposure of incumbent services providers to competitive pressures (see Box 5.1).

Box 5.1 Measuring the Impact of Services Trade Liberalisation

Two main quantitative approaches are generally used to estimate this impact. The first methodology, which is based on calibrated (or computable) models of international trade, quantifies the effects of services liberalisation on global welfare and on individual economies, taking into account how barriers in one sector influence other sectors and the whole economy. This approach can distinguish whether the projected gains are coming from improved access to foreign markets or from enhanced home market contestability and more efficient provision of services to users. It also shows the extent and nature of likely adjustment costs, in terms of output and employment. The main limitations of this approach are that they do not provide a sector-specific analysis and identify essentially static gains from reducing services trade barriers.

The second type of analysis is based on econometric studies, which either quantify the overall effects of services trade barriers on a particular economy or quantify the impact of services trade barriers on a specific sector.

Due to the high policy relevance of these issues in national and international contexts, the economic research in this area has been very active, benefiting from ongoing efforts for better coverage and reliability of data on trade in services and constant improvements in the theoretical underpinnings and empirical techniques for measuring the impact of services liberalisation.

Source: TD/TC/WP(2003)23/FINAL, "Services trade liberalisation: Identifying opportunities and gains" Key Findings

One of the major problems in analysing the impact of trade liberalisation in services is to measure the degree of openness of the service market or, in other terms, the degree of restrictiveness of trade barriers in services. Like trade in goods, trade liberalisation in services cannot be measured only by a formal removal of border obstacles since its scope greatly depends on "behind the border" measures and accompanying policies dealing with internal impediments to competitive pressures. This is especially true in the area of services where market access in services is shaped by domestic policy interventions, be it at the moment of entry of foreign suppliers or after their establishment in the host country.

To respond to the growing awareness of trade policy decision-makers and trade negotiators of the role of trade barriers in services, various quantitative methods have been developed to measure the restrictiveness of services trade barriers. These estimates are based on analyses of the impact of regulatory patterns on economic performance and productivity and on research into best practices within regulatory reforms. Specific features of services trade nevertheless make such quantitative studies of services trade barriers and the impact of services trade liberalisation particularly complex. First, it is necessary to consider the different modes through which services could be traded, including foreign direct investment and the movement of natural persons. Second, the complexity of the role of regulations and the degree of their restrictiveness in the context of services should also be taken into account (see Box 5.2).

Box 5.2 Measuring Trade Restrictions in Services

Compared to trade in goods, where the main concern is border measures, notably tariffs, restrictions on trade in services usually take the form of governmental regulations, which are often justified by the need to meet some legitimate regulatory objectives. Such regulations cannot automatically be identified as trade barriers or restrictive measures. Following the classification of the GATS schedules of commitments, two main categories of restrictions can be distinguished.

Based on the four modes of supply as defined by the GATS, the first classification distinguishes the restrictions applied to:

1. *Establishment*: such restrictions affect the ability of service suppliers to establish physical outlets in a country and supply services through those outlets. They include licensing requirements, restrictions on foreign investment and on the movement of people. Restrictions on establishment (or commercial presence) affect services delivered via FDI.
2. *Ongoing operations*: Related restrictions affect service suppliers after their entry to the market and usually include restrictions on pricing of services and the temporary movement of people. They concern services delivered by cross-border supply, consumption abroad or the presence of natural persons.

The second classification makes the distinction between:

1. *Non-discriminatory* restrictions, which apply equally to domestic and foreign service suppliers, are in fact similar to the GATS limitations on market access.
2. *Discriminatory* restrictions, which apply only to foreign services suppliers, are similar to GATS limitations on national treatment.

A trade restrictiveness index measures the number and severity of restrictions on trade in services in a given country. A foreign index takes into account all discriminatory and non-discriminatory restrictions on establishment and operations of foreign services firms. A domestic index covers non-discriminatory restrictions applied to all services firms. The difference between the foreign and domestic index scores is a measure of discrimination against foreigner service suppliers.

The trade restrictiveness indices can be used to estimate the effect of restrictions on the economic performance of service suppliers, in particular, on their prices, costs and their combination.

Source: Greg McGuire: Trade in services – Market access opportunities and the benefits of liberalisation for developing economies, UNCTAD Study Series No. 19, 2002.

The Role of Regional Integration and Co-operation in the Area of Services

Pros and Cons of Regional Integration in Services

Regional integration, albeit not recent, has now considerably spread and deepened. New integration initiatives have become more numerous and complex, dealing with issues beyond traditional trade policy concerns (OECD, 2002b). As trade in services is increasingly covered by regional integration agreements, the debate on the role of regional integration and its interaction with multilateral liberalisation has also become relevant for services. In general terms, the debate on multilateral versus preferential liberalisation of trade in services refers to similar concepts and policy considerations as those used in conventional analyses of the merits and demerits of regional agreements for trade in goods. Potential advantages of regional liberalisation are viewed in the gradual exposure to international competition (as opposed to generalised liberalisation on a MFN basis) and in a supposedly easier harmonisation of standards and regulations in a regional rather than multilateral context.

One important issue to consider is whether conventional analyses of preferential agreements in trade in goods, which examine the extent of trade creation/diversion and the potential economic gains resulting from economies of scale and increased competition, also apply in the case of services. Some recent studies argue that preferential access in services can be expected to bring substantial economic gains to countries participating in such agreements, though non-preferential liberalisation is likely to produce even larger gains. The positive impact of preferential agreements may be explained by the specificities of services trade barriers (consisting mainly in domestic regulations and national standards) and more diversified modes of supply (including cross-border trade and the movement of capital and labour). However, the sequencing also matters. Preferential liberalisation that precedes non-preferential liberalisation, risks giving privileged market access to less efficient regional service suppliers and making this pattern durable, it discourages the entry of new more efficient producers (Mattoo, Fink, 2002).

The inclusion of services makes new regional trade agreements more complex, involving a number of elements of so-called deep integration, i.e. provisions regarding investment, competition, labour and regulatory issues in general. Both the obligations and expected benefits resulting from such deep integration agreements are more far-reaching: the agreements often impose a sort of blueprint for countries' development and liberalisation strategies in different key areas. In parallel, growth and welfare gains of deep integration are also expected to be more important than the benefits of traditional trade agreements. Trade-related growth effects realised through additional foreign direct investment flows and productivity increases also represent a considerable incentive for domestic policy reforms, embodied in deep regional integration agreements. Some observers consider that this positive impact might even outweigh the negative trade diversion effects of traditional trade agreements.

Observed patterns of services trade development seem to reinforce further the case for regional cooperation. Services providers, after having reached a critical size in the domestic market, usually start exporting to regional markets and countries with which they have historical, cultural or linguistic linkages. The development of regional markets encourages the process of learning by doing and facilitates the emergence of firms capable of becoming global players (OECD, 2003).

Despite these potentially positive aspects of regional integration, the traditional argument in favour of multilateral versus preferential liberalisation should not be disqualified, especially in the area of services. Since location-specific sunk costs are high in some categories of services, such as telecommunications and financial services, even a temporary preferential access granted to some service providers usually gives them a long-term advantage in the market, making more difficult the subsequent entry of other potentially more efficient suppliers. The potential risk of preferential liberalisation to reinforce incumbents' vested interests should therefore not be underestimated. A non-preferential approach to market opening negotiated multilaterally remains important for overall efficiency, since it opens access to the most competitive providers and avoids conferring an advantage to less efficient domestic or regional suppliers.

The proliferation of regional agreements covering trade in services is sometimes attributed to the structural weakness and other constraints of the GATS (Stephenson, 2002). Despite its proclaimed objectives, the GATS has achieved relatively limited results in improving transparency, stability and enhancing trade liberalisation in trade in services. The relative lack of transparency and generally modest liberalisation achievements reflect the positive list approach for scheduling countries' commitments. This approach has generally allowed countries to bind existing market access conditions and leave "unbound" a great number of sectors and modes of supply. In addition, there are no notification obligations in the GATS, except for changes affecting existing schedules.

Compared to the GATS, the record of most existing regional agreements is better in terms of transparency, liberalisation and sectoral coverage. This is natural as it corresponds to the necessity to comply with Article V of the GATS, which requires all integration agreements to have substantial coverage regarding sectors, volume of trade and modes of supply affected and thus go beyond countries' GATS commitments. However, the achievements of most regional agreements in the area of services are not only due to the need for formal legal compliance but also reflect the ambitions and specific approaches proper to the regional initiatives. In general, regional integration agreements are more pro-active as regards investment flows, the move of natural persons and government procurement. This is facilitated by the negative list approach adopted by some agreements, which lists only non-conforming measures and reservations. Such an approach brings more transparency to existing situations for outside investors and service providers and represents implicitly the incentive for members to remove listed reservations. Moreover, from an operational point of view, transparency is also easier to promote at the regional level through regular consultations and exchanges of information.

Most regional agreements seek to deal with regulatory barriers, which are often the most serious impediments to regional trade in services. In the regulatory area, regional settings clearly have important advantages over the multilateral framework, due to the inherent nature of services and the specific character of services trade barriers. First, regulatory issues can be more easily negotiated among a limited number of countries with a similar regulatory framework and institutions. Second, for the same reasons, regional co-operation in the form of harmonisation and mutual recognition can also be more easily carried out among like-minded countries, which can have additional political and security reasons to co-operate. Such regional co-operation can be undertaken at a horizontal level, dealing, for example, with different modes of supply (e.g. commercial presence or the movement of natural persons). However, the sectoral heterogeneity of services, implying considerable regulatory divergence and specific trade impediments characterising individual sectors, usually requires a sector-by-sector approach.

These general observations on the potential advantages of regional integration in trade in services apply fully in the case of the Baltic States and their experience with trade liberalisation and the development of a regulatory framework for services within the EU accession process.

Regional and Multilateral Commitments of the Baltic States in the Area of Services

For the Baltic countries, coordinating WTO negotiations and the EU accession process has been difficult, not only because the two events proceeded simultaneously, but also because of some overlapping and complex interrelationships between the two sets of disciplines. A commitment in the EU that is not extended to all GATS members theoretically contradicts the MFN principle, but it is not a violation of the GATS if it complies with Article V. The Baltic trade negotiators have been generally successful in avoiding conflicts and contradictions between different commitments, mainly because of the flexible and voluntary nature of GATS commitments (Vanags, 2003).

Generally speaking, countries have several ways to avoid contradiction between their regional and multilateral commitments. One option is to make no commitments for some relevant parts of the GATS. This has been the strategy primarily for mode 4. Thus the Baltic countries allow free movement of EU citizens on their territory, but make this mode unbound under the GATS. Another option to avoid contradiction is to accept within the GATS no limitations in the relevant sector. This solution was adopted in the telecommunications sector, where there are no limitations once the monopoly rights of incumbents have expired. Consequently, free trade in the EU is compatible with free trade under the GATS.

Possible contradictions between multilateral and regional commitments can occur when a country has agreed to free trade within the EU but has placed limitations on it under the GATS. For example, the Baltic States restricted under the GATS mode 4 the length of stay of business visitors and specialists, though EU citizens cannot be restricted in this way. Another potential conflict with free movement of persons in the EU is Lithuania's restriction of market access for banking in the GATS. Lithuania requires that at least one manager of a bank be a Lithuanian citizen. Potential conflict might also arise in mode 3 related to horizontal GATS commitments by Lithuania and Estonia that limit national treatment and allow subsidising firms established in Estonia and Lithuania. However, this practice is unlikely to be allowed under EC rules and therefore Estonia and Lithuania might be unable to apply this limitation under GATS.

It should be emphasised again, however, that, even though the GATS commitments of the Baltic countries appear less ambitious when compared to EU obligations, they remain extensive compared to most other WTO members.

The EU Impact on the Regulatory Framework for Services in the Baltic States

Implementation of the EU *Acquis Communautaire*

As already analysed in the previous chapters, the EU *acquis communautaire* represents the key reference for the regulatory framework for different service sectors in EU candidate countries. Sectoral examples analysed in Chapter 4 show that the much more detailed EU legal and regulatory blueprint imposed far-reaching liberalisation obligations and high domestic regulatory standards, including in sectors such as telecommunications and financial services, in which multilateral disciplines within the GATS are the most advanced.

The importance of the *acquis communautaire* and its influence on EU candidate countries are due not only to its content, but also to the process of its adoption and implementation. After reaching the agreement on the principle and main criteria of EU accession of some Central and Eastern European countries in 1993, several strategic papers and decisions set out the overall orientation and main steps for legal and regulatory harmonisation, in particular the "White Paper on the Adaptation of Central and Eastern European Countries to the Requirements of the Internal Market" (adopted at the Cannes European Summit in 1995) and "Framework Strategy for Enlargement", proposed in 1997 within the "Agenda 2000". These policy resolutions have been accompanied by financial aid and technical assistance from the EU to candidate countries to support this process. In parallel, each candidate country established its National Programmes for the Adoption of the *Acquis Communautaire*. The European Commission, in consultation with these countries, set up the Partnership for Accession, which outlined short and medium term integration strategies of EU candidate countries. These agreements have been regularly evaluated for each country by the European Commission in "Regular Reports on the Progress toward the Accession". The adopted procedures combine an *ex ante* approach, defining the objectives and the way to achieve and a *posteriori* control mechanism, which entails regular monitoring and an assessment of progress achieved with implicitly political consequences for the whole accession process (Neumayer, 2002).

Since opening negotiations for EU accession in 1998, the process of the adoption of the EU *acquis communautaire* has gained momentum and a new dimension, related to specific modalities of the negotiating process of 31 chapters covering all areas of the *acquis communautaire*. The length and difficulty of negotiations of individual chapters have depended on the degree of complexity of the *acquis communautaire* in relevant areas and related financial implications. In 2000, when most associated countries started negotiating the most difficult chapters, the European Commission agreed on an indicative calendar and "road map" for the further stages of negotiations.

Given the constantly evolving character of the *acquis communautaire* (see Box 5.3), the new EU acceding countries will - after the adoption of the current highly demanding *acquis* - join other EU members in their further efforts to develop a pan-European services market, a necessary and natural complement to the single market for goods. A report by the European Commission highlights a number of serious impediments, which still hamper the establishment and operations of EU service providers in current EU members' markets (EC, 2002). The report differentiates between legal barriers, caused essentially by divergent national regulations, and non-legal barriers, which are due to the lack of information and transparency of national rules as well as to cultural or language impediments. These barriers occur during different stages of the business process, including the establishment of the service provider, the use of necessary inputs, promotion, distribution and the after-sales phase. These barriers, which imply considerable costs for service providers, especially SMEs, and welfare losses for European consumers, prevent the European service sector from realising fully its production, employment and trade potential. For this reason, a second stage of the service strategy has been launched in consultations with the European parliament, Member states and interested parties.

Box 5.3 The EU *Acquis Communautaire*

The "*acquis communautaire*" is the body of laws and obligations common to EU members, which must be accepted by the candidate countries before their accession to the EU. The *acquis* includes:

- the content, principles and political objectives of the EU treaties;
- the legislation adopted in application of these treaties and the case law of the Court of Justice;
- the declarations and resolutions adopted by the EU;
- measures related to the common foreign and security policy as well as to justice and internal affairs;
- international agreements concluded by the EU and those concluded among the Member States between themselves in the field of the EU's activities.

According to the European Commission estimates, the total *acquis communautaire* (including the secondary legislation) comprised in 2001 about 80 000 pages, with about 2 500 new pieces of legislation generated each year (see Communication from the Commission to the European Parliament and the Council: Codification of the *Acquis Communautaire*, COM(2001)645 Final, Brussels, 21 November 2001).

In the case of the Central and Eastern European countries, the "Global Strategy" (adopted in 1994 in Essen) and the White Paper (presented in June 1995 in Cannes) defined the main steps of the associated countries for their integration into the EU internal market. The White Paper contains the programme for the alignment of the internal Central and Eastern European countries' legislation with that of the internal market. It stipulates that these countries will be helped in this work by technical assistance and that the Commission will regularly evaluate the execution of their national programmes. Exemptions and derogations from the *acquis* are granted only in exceptional circumstances and are limited in scope.

Source: www.europe.eu.int

Recent Changes of the EU *Acquis Communautaire*

Additional complications in adopting the EU *acquis communautaire* by the candidate countries result from its evolving character, especially in the service sectors, due to considerable technological transformations, which require relatively frequent regulatory adjustments.

In the **electricity sector**, there has been some slippage in the original timetable for implementation of the single electricity market, partly because of amendments to the Directive related to cross-border exchanges. In spring 2003, the Commission published a Working Paper of the Second

Benchmarking Report on the Implementation of the Internal Electricity and Gas Market (EC, 2003). This paper assesses progress towards the effective opening of the electricity (and gas) market, and identifies remaining problems. For the first time, this study also includes an assessment of the progress made by the accession countries towards implementation of the Directive. Among the accession countries, Slovenia with 64% had the highest market opening share. The shares of open markets in the Baltic States are lower: 21% in Lithuania, 11% in Latvia and 10% in Estonia.

The new amended legislation, introduced in 2003, sets up the timetable for market opening in the EU-15: all non-household consumers should be able to change supplier by 1 July, 2004, and all customers by 1 July 2007. Other introduced measures include: legal unbundling of network activities from generation and supply; obligation to establish a regulator with well defined functions; requirement to publish network tariffs; reinforcement of public service obligations especially for vulnerable customers.

Since cross-border trade in electricity represents only 9% of total consumption, the recently enacted (amended) electricity directive is accompanied by a regulation that establishes common rules for cross-border trade in electricity. A regulatory committee will decide on guidelines on compensation of transit flows, harmonisation of national transmission tariffs and allocation of cross-border interconnection capacity.

The experience of the first EU liberalisation package in **telecommunications**, introduced in 1998, and the convergence of various sub-sectors of electronic network services led to the development of a new regulatory regime for all electronic communications and network services, thereby eliminating many previous sectoral distinctions. The new Framework Directive, applicable from July 2003, establishes the overall structure for the new regulatory regime and aims to apply competition law principles in this sector in an ex-ante regulatory fashion rather than an ex-post manner as normally done in competition policy. The new Directives also regulate the access, authorisation, universal service and privacy issues in electronic communications and network services.

In **banking**, the implementation of the core 2000 Directive has not really allowed for full integration of financial services. The EC developed a Financial Services Action Plan (FSAP), consisting of 43 specific measures to be adopted at the EU level by the middle of 2004, and transposed into national legislation by 2005. The 2003 report by the European Commission indicates that 34 of the measures proposed in the FSAP had been adopted by June 2003. Other measures are either under negotiation or a Commission proposal is pending. In banking, the most important ongoing action is a revised capital adequacy framework. This is being developed in collaboration with the Basel Committee. At present, the financial market is considered strongly integrated as far as the predominant unsecured instruments are concerned, but at the retail level, national markets remain segmented.

Implementation of the Acquis Communautaire by the Baltic States

Regulatory reform, at the beginning, was a rather difficult concept for the transition countries' policy makers. In rejecting the over-regulated economic systems, their main priority has seemed to be de-regulation, while the EU accession process has brought considerable regulatory requirements. The main EU concern has been to build a regulatory framework in key sectors, such as electricity, banking and telecommunications, consistent with EU development strategies. Given the risk of regulatory capture, judged particularly high in these countries, the EU also insisted on establishing regulatory agencies and respecting the basic regulatory principles of transparency and independence.

In adopting the EU *acquis communautaire* in specific sectors, the Baltic countries have obtained some adjustments, in particular, longer transitional periods (Vanags, 2003).

For **electricity**, **Estonia** has a transitional arrangement until 31 December 2008 to implement the market opening provisions of Article 19(2) in the Electricity Directive. According to the Declaration on oil shale, the EU, “while noting Estonia’s reservations regarding future *acquis*, recognises in this respect the specific situation related to the restructuring of the oil shale sector which will require particular efforts until the end of 2012, and the need for gradual opening of the electricity market for non-household consumers by that date”. **Latvia** and **Lithuania** have no transition periods or derogations in the electricity *acquis*. However, Lithuania has special obligations with respect to decommissioning the Ignalina nuclear power plant.

The Baltic countries have not been granted any transition period in **telecommunications**.

In **banking**, the *acquis* has been negotiated in Chapter 3 on Freedom to Provide Services, and **Estonia**, **Latvia** and **Lithuania** have transitional arrangements until 2007 to reach the minimum level of guarantee under the Deposit Guarantee Scheme and also until 2007 to reach the minimum level of compensation under the Investor Compensation Scheme.

Although, at the formal level, the Baltic States do not seem to be facing serious difficulties in accepting the *acquis*, some specific implementation problems have emerged in different sectors.

In the **electricity** sector, Baltic consumers do not have great incentives to push for fast changes. While in the present EU member countries, market opening and increased competition are expected to lower energy prices, in the Baltic countries, integration with the EU market will actually imply an increase in energy prices. The current relatively low price level is due partly to available cheap local and Russian energy and to the fact that the Baltic countries do not have an interconnection to the common European grid. Thus, Baltic markets remain segmented and the prevailing low prices do not make the Baltic region an attractive place for energy imports from the EU. As current generating capacity becomes obsolete, prices will experience upward pressure to provide resources for construction of new generation capacity and this may offer opportunities to create interconnection facilities with the rest of the EU.

In **telecommunications**, the Baltic countries comply with the *acquis*, embodied in the 1998 package, but implementation has not been easy. In **Latvia**, the fixed line incumbent, *Lattelekom*, was established with an Umbrella Agreement in 1994, under which it was granted a fixed line monopoly until 2013, which has become incompatible with the EU *acquis*. In WTO negotiations, Latvia made a commitment to reduce this period by 10 years to 1 January 2003. When renegotiating its deal with the foreign shareholders of *Lattelekom*, the Latvian government faced a compensation claim and the dispute has not yet been settled. This situation also prevents the sale of the remaining 51% state holding in *Lattelekom*. In **Lithuania**, a similar problem was avoided because *Lietuvos Telekomas* was not privatised until 1998, and then the fixed line monopoly was granted only until 1 January 2003. **Estonia** also avoided the problem as it ended the fixed line monopoly by 1 January 2001.

In **banking**, there are no significant country-specific issues. However, the Baltic banking sector differs significantly from that prevailing in the EU-15 by the high degree of foreign ownership. As already noted, for example, 85% of the capital of Estonia’s banking sector is foreign owned. SEB and Swedbank are the major owners in all three countries. Without a 2001 EU competition ruling that withheld approval for a proposed merger between these two institutions, the ownership concentration would be even higher. The strategy of foreign bank entry in the Baltic countries has been acquisitions and mergers rather than the establishment of branches.

Convergence in regulatory policies within the region has considerably advanced. The structure and internal procedures applied by Baltic national regulatory agencies are similar and close to the practices of EU regulators. The Baltic authorities have followed the EU recommendations and the advice of some international organisations such as the World Bank, and sought to promote regulatory transparency. They also ensure as much as possible the independence of regulatory agencies from the governments. Despite the absence of a unified EU regulatory model, the EU accession process has therefore provided the candidate countries with general guidelines for regulatory settings and regulatory policies. The EU and international organisations have also helped in training future regulators. Although the experience of the Baltic countries' regulators is recent, they will be able to participate actively in the further development of the EU regulatory framework and will bring some original insights, for example, regarding the possible advantages of a multi-sectoral regulator established in Latvia.

Intra-regional Co-operation within the Baltic States

The Baltic countries have several common characteristics, in particular their recent historical experience, geographic proximity as well as many similarities in their economic developments. After 1992, intra-regional co-operation has been mainly motivated by shared goals at the international level, notably the efforts to integrate into global political and economic institutions such as the WTO, European Union and the North Atlantic Treaty Organisation. To achieve these objectives and promote regional economic development, the three Baltic countries have created several trilateral institutions such as the Baltic Assembly, the Baltic Council of Ministers and the Baltic Council. They have also participated in wider regional organisations including other neighbouring countries, for instance the Council of the Baltic States and the Nordic-Baltic 8. Initiated by the governments, these different institutions have started by focussing on political issues, but increasingly the economic agenda has become more important. These developments have reflected the Baltic countries' common understanding of the key role of regional infrastructures and the need to remove trade and regulatory barriers within the region. Despite inevitable intra-regional competition in some areas, especially for FDI, the countries have realised that future developments in each country depend on joint efforts to enhance the integration of the region into global markets. The most important achievement in this area was the establishment of the Baltic Free Trade Agreement that was signed in 1993 and became effective on 1 April 1994.

The EU accession process has had a considerable impact on Baltic intra-regional co-operation. The demanding pre-accession agenda and follow-up requirements placed on new EU members have mobilised considerable economic and administrative resources in the Baltic countries and put therefore in doubt economic rationale and institutional feasibility of additional regional initiatives among a subgroup of countries. However, several emerging problems and challenges have changed the perception and the policy stance towards intra-regional integration both of national authorities and the business community. Whereas traditional free trade agreements usually address conventional trade barriers, such as tariffs, regional co-operation can deal efficiently with "behind-the border" measures, regulations and trade facilitation issues, which -- even in the absence of tariffs -- can considerably hinder trade relations among neighbouring countries.

In merchandise trade, reducing transaction costs have been traditionally an integral part of commercial strategy and the expansion of production sharing activities has further highlighted the need for timely and reliable deliveries within the supply chains. In services trade, transaction costs and trade facilitation issues in general have also drawn increasing attention as a critical factor susceptible to determine the comparative advantage of service providers and their capacity to sustain their credibility in foreign markets.

The entry of the Baltic States into the EU considerably changes their overall trading and economic environment. Many trade and transaction barriers will disappear (*e.g.* customs clearance procedures in relation to other EU member States) or will be significantly reduced (*e.g.* product licensing). At the same time, trade relations with some neighbouring countries, which will stay outside of the EU single market, in particular Russia, Belarus and Ukraine, will be transformed. Some emerging problems will be treated at the EU level, through the initiatives such as a “new neighbourhood” initiative, launched in March 2003, and the proposal to negotiate a new cooperation agreement with Russia (CDI, 2003).

In some other areas, regional cooperation within the Baltic region appears to be the most appropriate vehicle to avoid any deterioration of regional trade relations. For instance, intra-Baltic consultations and exchanges of best practices currently focus on procedures for setting up businesses, tax reporting and inspection, external customs clearance and anti-corruption initiatives. Regional co-operation can also contribute to improve regulatory transparency within the region. A portal on trade-related regulations established by the Council of the Baltic Sea (which includes Russia) is especially helpful to for small and medium firms interested in developing their activities in the region. Increasingly, the business community, such as the Association of Baltic Sea Chambers of Commerce, is taking a leading role in regional co-operation with the aim to promote local economies and improve regional transportation links.

In sum, during its recent and relatively short history, intra-regional co-operation among the Baltic countries has considerably evolved. Initially, the main impetus for regional co-operation came from the governments, often motivated by political rather than economic reasons. With the increasing importance of economic issues in the intra-regional context, the interest of the business community in different regional initiatives has intensified. As a result, the business community has become a driving force behind a number of sector-specific or horizontal projects currently developed within the region.

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Chapter 6

LESSONS FROM THE BALTIC STATES' EXPERIENCE AND POLICY PROPOSALS

Abstract: The Baltic States succeeded in a very short time period in overcoming the weaknesses of their undersized and outdated service sector inherited from the Soviet past and in expanding considerably their trade in services. Based on their experience, this concluding section draws possible lessons for other countries, especially developing and transition economies, which are in an earlier stage of developing their services industries and liberalising trade. Several aspects of the Baltic States' experience -- their development strategy, domestic market and trade liberalisation, and the contributions of autonomous, multilateral, and regional trade liberalisation -- are considered. Despite their impressive progress, the Baltic States face new challenges in making their service sector internationally competitive. This chapter also suggests several policy options for the Baltic States to further enhance the development of their service sector and trade in services.

Main Lessons from the Baltic States' Experience

The Baltic States' recent experience in developing the service sector and trade in services is in many respects exemplary and therefore useful for other countries seeking to modernise their service sector and expand their trade in services. It provides insights for policy makers and trade negotiators in other countries in the early process of formulating their national priorities and designing their liberalisation strategies at the national, regional and international levels. The main lessons from the development strategy of the service sector and services trade as implemented by the Baltic States can be summarised as follows:

- **Political will and public support matter.** The Baltic countries' governments used the exceptional historical situation created by their emergence as independent States to put in place bold reform strategies, associating macroeconomic stabilisation and radical enterprise restructuring, based on privatisation and price and trade liberalisation. This reform strategy has proved to be particularly beneficial to the development of services. The so-called small privatisation, politically less controversial and easier to implement than large-scale privatisation of state-owned enterprises, often concerned traditional service activities such as retail trade. Rapid privatisation and liberalisation were also facilitated because the governments faced less resistance from vested interests and protectionist pressures in most services industries than in some other sectors, such as agriculture or heavy industry. Even in the absence of an exceptional historical and political environment comparable to the situation at the beginning of 1990s, the experience of these countries proves that a radical and coherent reform package can be implemented with widespread public support.
- **Economic dividends from services liberalisation can be significant and generated quite rapidly.** The example of the Baltic States shows a growing contribution of the service sector to national income and employment. These rapid and widely visible gains reinforce public support for reforms. Although the subsequent opening of domestic service markets to foreign competition might have some adverse effects and impose labour market adjustments in specific service industries, these adjustment costs appear generally lower than in other sectors. Despite such temporary problems, a modern service sector is able to generate considerable income and employment in further stages of its development.
- **Trade in services offers important revenue potential.** In the Baltic countries both exports and imports of services have grown rapidly, and they have generally recorded a durable surplus on the service account, partly compensating for the structural deficit in merchandise trade. Although traditional services, such as transport, continue to represent a major share in exports, other categories of services have started to develop and contribute increasingly to the favourable developments of services trade balance.
- **The right sequencing and coordination of reforms, while relatively straightforward in theory, is often difficult to implement in practice.** There is a general consensus that privatisation and competition policies need to be coordinated. However, in some cases it has been difficult to avoid, at least initially, the transformation of public monopolies into private monopolies. This is partly because the process of developing efficient competition policies and institutions inevitably takes longer than launching privatisation. It is, therefore, critical to remove rapidly restrictions on the entry of new operators in the early stages of privatisation and to create adequate conditions for competitive markets.
- **Reliable statistical data on services and trade in services are important for conducting governmental policies and international negotiations as well as for communicating**

effectively with the business community and the general public. The governments' capacity to put in place effective policies also depends on the availability of reliable data, which in turn are prerequisites for undertaking any relevant policy analysis. This statistical and analytical underpinning is also necessary for conducting both international trade negotiations and internal political debates. Governments should devote sufficient human and financial resources to the collection of reliable statistical data and their critical assessment. In the case of services, the task is particularly demanding given the complexity of the GATS structure and its distinction of four modes of supply.

- **Access to reliable and inexpensive infrastructure is essential for services development.** The series of business surveys conducted in the Baltic region show that improvements in infrastructure, especially transportation and telecommunications, have a strong impact on the overall development of the service sector and on the decision of foreign investors to envisage entry into host countries. This primary role of basic infrastructures should be taken into account in governmental policies, and governments should pay particular attention to infrastructure development in the early stages of reforms and consider it as an integral part of foreign direct investment promotion policy.
- **A strong domestic market facilitates the development of export capacities.** As in merchandise trade, services exports are usually preceded by a strengthened position of service providers in their domestic market. Expanding domestic sales can reflect the sector-specific factors, such as technological innovation (*e.g.* in telecommunications), and/or an increase in consumers' incomes, but sales growth is often due to intensified competition, in particular through service imports or the commercial presence of foreign services providers. Good export performance in FDI beneficiary countries may be facilitated by commercial links between foreign investors and their home country. The most durable impact of foreign investors results, however, from their contribution to managerial and technical know-how and their participation in the competitive environment in the host countries' markets.
- **The first wave of services exports often targets regional markets.** As for trade in goods, geographical proximity also plays an important role in fostering services trade flows between neighbouring countries. Geographical proximity, which often implies historical links and a certain degree of familiarity with regional market conditions, represents a further advantage in services trade, in which the capacity to adapt to specific consumer needs is traditionally important.
- **Autonomous liberalisation and external opening of the service sector are the starting points in a strategy for development of services.** In the Baltic States, the lack of openness of the service sector was one of the main reasons for its backwardness. Hence the liberalisation of services trade has been viewed not as a concession to the trade partners, but as a necessary step in accelerating the development of this previously neglected sector. The initial impetus to liberalisation came from the autonomous decision of national authorities and was strengthened by WTO negotiations and the EU accession process.
- **The WTO accession process should be used for locking in liberalisation achievements and improving overall policy coherence in the area of services.** Multilateral commitments accepted by the Baltic States within the GATS represent essentially the consolidation of their autonomous liberalisation achievements. They are nevertheless comprehensive and more extensive compared to most developing, transition and even developed countries. Their main significance lies in binding the results of liberalisation, allowing the governments to resist subsequent domestic protectionist pressures, preventing the risk of policy reversals and therefore enhancing their credibility with trading partners and investors. WTO negotiations

have also been a learning process involving considerable administrative resources. They necessitated the establishment of co-ordination procedures within the governments and consultations between the governments and stakeholders that were affected by international services commitments.

- **The EU accession process provides strong guidance for designing and implementing a regulatory framework for the service sector.** The EU *acquis communautaire* goes beyond traditional trade liberalisation targets and covers a wide range of economic, social and other areas for which it imposes far-reaching legal and regulatory harmonisation. It is not only a political imperative as an integral part of the EU accession process; it also has practical influence because it imposes detailed and comprehensive guidelines for long-term market liberalisation strategies, including the sequencing of reforms. The EU accession process also embodies a precise timetable for the implementation of requested measures and strict performance criteria, which are controlled through regular monitoring procedures with possible political sanctions in cases of non-fulfilment. The EU integration process concerns most service sectors and, though its conceptual approach differs from the GATS, it affects all modes of supply, including those, such as the movement of natural persons, for which the GATS has not provided strong discipline.
- **Although intra-regional integration in services has not been institutionalised within the Baltic States, regional cooperation has developed in many areas, usually initiated by the governments and then reinforced through business community initiatives and sector-specific interests.** The negotiations of a Baltic FTA in services at the beginning of the 1990s were abandoned, mainly because of possible difficulties in complying with Article V of the GATS (Economic Integration). However, market conditions of the Baltic countries (*i.e.* relatively restrained national markets) and the need to develop a regional strategy for attracting foreign investors have raised interest in intra-regional cooperation in some areas. These initiatives include sectors, such as electricity, with specific features that are particularly suitable for regional co-operation. In some cases, the focus has been on general and horizontal issues, such as trade facilitation. Although the governments have played a leading role in initiating Baltic regional cooperation, the involvement of the business community and sector-specific interests has increased.
- **Consolidation and modernisation of traditional services sectors are necessary to ensure export earnings and initiate the shift of comparative advantage towards higher value-added services.** By implementing a sound regulatory framework, encouraging foreign presence and developing certain segments in traditional services sectors, the Baltic States have maintained their export performance and facilitated the modernisation of these sectors. Examples include retail trade, which has developed regionally competitive wholesale chains, and transportation, which is increasingly relying on more sophisticated logistic services. This gradualist approach based on the development and modernisation of traditional sectors has helped the Baltic countries to shift progressively their initial comparative advantage towards higher value-added services.

Policy Proposals for Further Development in Trade and Services

After achieving remarkable results in the development of their service sectors and increasing their participation in international services trade, the Baltic States face a new situation stemming from their EU accession and additional challenges from technological changes and the emergence of knowledge-based services. In this context, several policy proposals may be highlighted:

- **The dual track process of market and trade liberalisation must be pursued especially in the sectors where reforms have not yet been fully completed.** The main reform targets are the sectors or sub-sectors still dominated by monopolistic providers, especially in energy and transport services. While international disciplines are generally limited in these areas, EU harmonisation policies provide generally strong reform and regulatory guidance in most sectors concerned, including a precise timetable for implementation.
- **When undertaking necessary liberalisation steps and domestic reforms, their social impact and specific national conditions must be taken into account.** Better market access and a stronger competitive environment might adversely affect employment and consequently threaten public support for reforms. It is therefore important that planned liberalisation and reforms are preceded or at least accompanied by campaigns to explain their rationale and active labour market policies, including training activities. If necessary, temporary social assistance measures should also be envisaged.
- **Maintaining services competitiveness on the domestic market remains the key for further service development.** Following their EU accession, the services markets in the Baltic States will become more open and competitive. Under such conditions, it is critical to maintain a favourable economic and business climate for both domestic operators and foreign investors. This requires general policies, such as the existence and enforcement of company law, ownership and intellectual property rights and competition policy. It also include specific sectoral measures targeting especially infrastructure services such as energy, telecommunications, transportation as well as financial and insurance services, which influence the cost and quality of most services sold domestically and exported.
- **Modernisation of the service sector and expansion of trade in services will continue to depend to a great extent on foreign investors' involvement.** Since most of the major privatisation operations have already been realised in the Baltic countries, new FDI inflows will take the form of greenfield investment or will result from mergers and acquisitions. EU accession is expected to have a positive impact on FDI inflows to the region, both from EU members and third countries. Although the Baltic countries will continue to maintain for some time certain competitive advantages, such as lower labour costs, their integration into the EU internal market means gradual homogenisation of their economic environment with other EU countries. At the same time, some neighbouring countries, especially Russia, may become relatively more attractive for foreign investors. These new phenomena must be taken into account in policies affecting FDI. The relatively limited size of national markets implies that more attention should be given to regional co-operation in the area of FDI, both at a horizontal level (for example with respect to tax issues) and a sectoral level. Existing institutional structures, such as the Baltic Business Forum, might play a useful role in promoting such co-operation.
- **Regulatory reforms remain high on the government agenda.** The objective is to put in place standards and prudential regulations necessary to protect the quality of services without being more burdensome than necessary for operators and traders. Although many such standards and regulations will be introduced through the EU harmonisation process, the governments remain responsible for a number of regulatory measures. To avoid trade restrictiveness of regulatory measures, the governments need to maintain regular consultations with the business community.
- **The institutional framework and functioning of national regulatory agencies should be further developed.** There is a general consensus on some basic principles to make national regulatory agencies function efficiently, in particular the need for their independence from governments and high transparency in their activities. Beyond these general principles, there

are relatively important variations in the design and modes of functioning of such agencies in individual countries, including within the EU. The Baltic States have already adopted different approaches in this area and will continue to determine autonomously the sectoral responsibilities and concrete prerogatives of such agencies. Several elements, such as the level of independence of the agencies vis-à-vis the executive and legislative branches, the qualification and remuneration of their staff and the controlling instruments and possible sanctions left to regulators' disposal, will need to be clarified. With the increasing number and complexity of interventions by regulatory agencies and competition authorities, maintaining coherency between supervision, regulatory and competition policies and various prudential regulations will be a more demanding task.

- **The governments should encourage and participate actively in research and exchange of good practices on regulatory reform.** As international regulatory disciplines are still rudimentary and the EU guidelines relatively general, it is important for the Baltic countries' authorities to be aware of analytical studies and policy developments concerning regulatory reform issues and for their researchers to participate as much as possible in these studies. Furthermore, the exchange of best practices among regulators, in particular, those from countries that share similar historical, cultural and economic backgrounds, might be useful. Although such informal exchanges have already taken place among some Baltic regulatory agencies, they should further promote co-operation on regulatory issues.
- **The stakes of ongoing multilateral negotiations aiming at further services liberalisation are high for the Baltic States.** The Baltic countries have already taken an active role in ongoing negotiations, in particular, as regards the treatment of autonomous services liberalisation and commitments within the WTO framework. As current negotiations cover additional sectors and disciplines, they require considerable human resources and expertise within and outside of government. Procedures for intra-governmental co-ordination and consultations with stakeholders, especially business associations, should therefore be further developed. Moreover, ongoing negotiations leading to further multilateral liberalisation represent an opportunity for countries to diversify their trade in services. Indeed, one of the possible outcomes of current negotiations might be the reduction of the value of regional preferences, including in the area of services, which should encourage countries to develop their trade relations with other partners who do not belong to the same regional agreements.
- **In addition to close integration links with EU partners, there is room to develop intra-regional co-operation.** Intra-regional cooperation can be understood both in a narrow sense (*i.e.* among the Baltic States) and a broader context (*i.e.* among the neighbouring countries of the Baltic Rim, including Northern Russia). In addition to geographical, historical and linguistic/cultural links, regional co-operation is also justified on economic grounds as many operators and foreign investors have increasingly adopted a regional development strategy. Such intra-regional co-operation does not necessarily involve formal and institutionalised integration initiatives; it is often driven by concrete business and sectoral interests. Several areas--the exchange of best regulatory practices, the development of common strategies for some sectors in co-operation with the business community, and trade facilitation issues -- seem particularly suitable for such intra-regional co-operation.
- **Coping with structural changes in services, in particular the creation of a favourable environment for developing technology-intensive and knowledge-based services.** The growing sophistication of products and services, which reflects technological and organisational changes, increases the global demand for services (both from individual consumers and for public procurement of services), but can modify the demand for different categories of services. These changes can be accompanied by shifts in international patterns

of comparative advantage. As technology- and knowledge-intensive services represent the main driving force and principal beneficiaries of these transformations, governments need to focus on their development. Given that technology- and knowledge-intensive services are characterised by higher than average research expenditures and a highly skilled workforce, the countries should put in place an adequate economic, legal and regulatory environment for promoting innovation policies and encourage training activities.

- **Taking into account the impact of new technologies on the character of services and their delivery.** Information technologies make possible outsourcing of some service activities, such as administrative and customer support services. Technological changes also modify the relevance of different services trade barriers. For example, with the development of electronic commerce, barriers related to commercial presence (GATS mode 3) might become less important to some service providers because they can offer their services to consumers directly through cross border transactions (GATS mode 1). Regulatory policies should take these technological changes into account.
- **Maintaining efficient and appropriately sized public administrative services.** Although this study focused on services that are or could be traded, it is important to keep in mind that the service sector also includes non-tradable services such as public and administrative services. While it is generally agreed that traded services should be further developed and that an increase in employment in these services is desirable, the case of some non-tradable services is more complex. In particular, there is an important question about the adequate share and growth of administrative services within the economy. Another related problem is the risk of developing a two-tier services economy, which would consist of, on the one hand, modern and highly performing services and, on the other, underperforming and corrupt services. In this context, the experience of three Baltic countries appears valuable and constructive. The new States emerging after the disintegration of the Soviet Union did not inherit the cumbersome administrative structure of the previous regime and were obliged to build a new state apparatus. In so doing, the Baltic countries have generally succeeded in keeping the share of government services comparatively low. This feature of the Baltic countries is today considered to be an important factor in the dynamic growth of their service sectors.

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