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The contribution of services to development and the role of trade liberalisation and regulation

Massimiliano Cali, Karen Ellis
and Dirk Willem te Velde

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Acronyms

ACP	Africa, Caribbean and Pacific
ACS	Association of Caribbean States
AGOA	Africa Growth and Opportunity Act
AIDS	Acquired Immunodeficiency Syndrome
ASP	Application Service Provider
ASEAN	Association of Southeast Asian Nations
ATM	Automatic Teller Machine
B2B	Business to Business
BDO	Banca de las Oportunidades (Colombia)
BHA	Belize Hotel Association
BMA	Border Management Authority (Belize)
BNTC	Belize National Tourism Council
BoP	Balance of Payments
BPL	Below Poverty Line
BPO	Business Process Outsourcing
BTA	Botswana Telecommunications Authority
BTC	Botswana Telecommunications Company
BTIA	Belize Tourism Industry Association
CARICOM	Caribbean Community
CCGT	Combined-cycle Gas Turbine
CGE	Computable General Equilibrium
CIE	Côte d'Ivoire Electricity Company
CPA	Cotonou Partnership Agreement
CPSS	Committee on Payment and Settlement Systems
CRA	Community Reinvestment Act (US)
DFID	UK Department for International Development
DSU	Dispute Settlement Understanding
EASSY	Eastern Africa Submarine Cable System
EC	European Commission
EDS	Electronic Data Systems (South Africa)
EIU	Economist Intelligence Unit
EPA	Economic Partnership Agreement
EPZ	Export Processing Zone
EU	European Union
FATF	Financial Action Task Force on Money Laundering
FATS	Foreign Affiliates Trade in Services
FDI	Foreign Direct Investment
FSC	Financial Sector Charter
G7	Group of 7
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GSB	Government Savings Bank (Thailand)
HIV	Human Immunodeficiency Virus
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
ICT	Information and Communication Technology
ICTSD	International Centre for Trade and Sustainable Development
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IFSC	International Financial Services Centre

ILO	International Labour Organization
IMF	International Monetary Fund
IOM	International Organization for Migration
IOSCO	International Organisation of Securities Commissions
IPP	Independent Power Producer
ISA	International Standards on Auditing
ISO	International Organization for Standardization
ISP	Internet Service Provider
IT	Information Technology
ITES	IT-enabled Services
ITU	International Telecommunication Network
KYC	Know Your Customer
LDC	Least-developed Country
LSM	Living Standards Measure
MDG	Millennium Development Goals
MFI	Microfinance Institution
MFN	Most-favoured Nation
MNE	Multinational Enterprise
MoU	Memorandum of Understanding
MRA	Mutual Recognition Agreement
MT	Mauritius Telecom
NABARD	National Bank for Agriculture and Rural Development (India)
NBC	Non Banking Correspondent (Colombia)
NCC	Nigerian Communication Commission
NEPA	National Electric Power Authority (Nigeria)
NGO	Nongovernmental Organisation
NHS	National Health Service (UK)
NPL	Non-performing Loan
NT	National Treatment
NTP	National Telecommunications Policy (Nigeria)
OECD	Organisation for Economic Co-operation and Development
OFC	Offshore Financial Centre
PPP	Public–Private Partnership
PWC	PriceWaterhouseCoopers
R&D	Research and Development
RTA	Regional Trade Agreement
SADC	Southern Africa Development Community
SAFE	South Africa–Far East
SCM	Supply Chain Management
SHG	Self-help Group
SIE	Small Island Economy
SME	Small and Medium-sized Enterprise
TAL	Technology Alert List
TMNP	Temporary Movement of Natural Persons
UAE	United Arab Emirates
UK	United Kingdom
UNICTRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
US	United States
USCIS	United States Citizenship and Immigration Services
VoIP	Voice over Internet Protocol
WTO	World Trade Organization
WTTC	World Tourism and Travel Council

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Executive summary

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

The contribution of services to development

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

The service sector accounts for a significant proportion of GDP in most countries, including low-income countries, where it frequently generates over 50% of GDP. The process of development usually coincides with a growing role of services in the economy (alongside a reduced role for agriculture). Thus, services constitute an increasing percentage of GDP in nearly all developing countries. Services contributed 47% of growth in Sub-Saharan Africa over the period 2000–2005, whereas industry contributed 37% and agriculture only 16%. Recent growth in Africa owes to services as much as natural resources or textiles (even in countries benefiting from trade preferences in these products). The question is not whether to move into services, but how and at what speed to move into services.

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

The potential benefits of services trade liberalisation

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

In addition, imports of services can significantly improve performance by bringing greater competition, international best practice, better skills and technologies and investment capital. The entry of foreign service providers may therefore yield better services for domestic consumers, and improve the performance and competitiveness of domestic firms.

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

The need for complementary policies and the role of regulation

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

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

- Create a level playing field and facilitate competition between market players (e.g. by ensuring access to the grid or network for new entrants in the electricity or telecommunications sector);
- Guarantee the quality of the services provided (e.g. by specifying qualification requirements for service providers such as doctors, engineers and architects);
- Protect consumers (e.g. from fraud or mis-selling);
- Ensure sufficient provision of information (e.g. about the availability and features of services provided);
- Prevent environmental degradation (e.g. arising from high levels of tourism development);
- Ensure adequate access to services (such as electricity, health and education);
- Maintain financial stability (in the banking sector);
- Minimise disruptions in supply (in electricity).

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

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

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

Sector summaries

Tourism

Tourism is the biggest export service sector in many low-income developing countries (via Mode 2). Its value is set to increase further in all world regions, and especially developing countries, reflecting increased demand and comparative advantages. The tourism sector (e.g. the hotel sector) tends to be liberalised in developing countries compared with other sectors, although there are areas (e.g. tour guides) where there are still sensitivities and protectionist elements.

Developing countries have already realised the importance of appropriate frameworks that are non-trade-distorting in tourism, helpful for making commitments in international service negotiations. The relevance of this in itself would need to be understood: can we identify the way in which trade liberalisation has taken place in tourism and could this be a role model for other sectors?

This relatively liberal stance has coincided with the large impact of tourism on development in terms of value added, incomes and employment in static terms, as well as dynamic effects on the rest of the economy. Rather than protecting the local tourism sector, especially the smaller players, from foreign involvement, it is more efficient to think about complementary policies to promote the (local) sector and its effect on development.

Governments can use a variety of policy and regulatory tools to enhance tourism and its impact on development:

- They can use tourism regulations, other regulations and complementary factors to raise the spending and development effects of each tourist. Some governments discourage all-inclusives (Gambia) but while this may have increased local spending it may have dampened the number of arrivals.
- They can encourage linkages, and while local content rules for services are more flexible than those for goods, there is little evidence that they work for the sector.
- They can promote grading and improve the quality of accommodation, but there are questions about the capacity of governments to monitor this. Useful complementary regulations include a more liberal retail and financial services sector (e.g. automatic teller machines – ATMs). Other complementary factors include improving local capabilities to supply the tourism sector, including agriculture and cultural services (e.g. artists or other attractions).

A review of tourism policy and regulations based on experiences in developing countries suggests:

- A more liberal stance to air access will help to increase tourist arrivals.
- A more liberal regime in the tourism support services (e.g. transport handlers and other business indicators such as access to finance) has been an important factor behind a more rapid increase in tourist arrivals.
- Despite weak regulatory frameworks for tourism some countries can attract more tourists by supporting a more diversified tourism product and accommodative air access policies.
- Poor human resources and economic infrastructure and weak local food supply chains and governance cause weak linkages between tourism and the poor.
- When the capacity to provide health services is available as well as the demand, then regulatory coordination can facilitate trade in health tourism;
- While incentives may have facilitated the attraction of hotels in some countries, they are often not monitored or linked to performance, weakening their impact.
- Governments in some countries have liberalised tourism services by transferring non-core functions of tourism departments to the private sector and privatising formerly state-owned

tourist parastatals. After such reforms, the development of tourism sector has often been positive.

- Although some countries have liberalised the tourism sector with success and have implemented community-oriented tourism plans, challenges remain in further developing the sector. Regulatory challenges relate to complementary issues such as business indicators, e.g. weak policies in the area of tax rates and costs to finance, tax administration, skills/education of workers and access to electricity and land.

The financial sector

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

However, in many developing countries, access to formal financial services is very limited, particularly for poorer households and small and medium-sized enterprises (SMEs), and it is likely that this lack of access to finance significantly constrains economic growth and reduces the ability of the poor to participate in markets, to increase their income and to themselves contribute to economic growth.

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

However, the recent global financial crisis highlights the risks associated with financial sector openness, as integration into world financial markets can increase vulnerability to contagion. Nonetheless, there is also evidence that the presence of foreign banks actually improves financial stability, and reduces the likelihood of banking crises on average, over the long term.

The financial sector in many developing countries has commonly been characterised by high levels of state ownership and government intervention, which have often seriously damaged the performance and efficiency of the sector and worsened access to finance. Thus, substantial reform programmes may need to precede or accompany financial sector opening, involving financial deregulation, bank restructuring and commercialisation and privatisation to create market incentives and to improve the competitiveness and productivity of domestic banks. However, experience has shown that financial reform must itself be carried out carefully, in an appropriately sequenced manner, and with the establishment of an effective regulatory framework as an important prerequisite, as it can otherwise lead to instability and financial crisis.

Key components include:

- A stable macroeconomic framework – to minimise the risk of financial instability;
- Adequate financial supervision and regulation to encourage prudent risk taking and financial discipline in the banking system;
- The necessary institutional infrastructure, such as an effective legal framework for insolvency and adequate corporate governance and accounting systems;
- Financial deregulation, where government controls over the actions of financial institutions are removed, such as directed lending policies and interest rate ceilings, which are likely to hamper performance and deter new entry;

- Bank restructuring, to resolve problems associated with high levels of non-performing loans and put domestic banks on a sustainable footing, thus avoiding bankruptcies and creating a level playing field with new foreign entrants;
- Commercialisation and privatisation, to create market incentives and improve the competitiveness and productivity of domestic banks.

There has often been an implicit assumption that financial opening promotes better access to financial services. However, most foreign banks have focused on areas where local profit opportunities are perceived to be the greatest – providing financial services to large firms in urban areas. Governments need to improve the enabling environment to reduce the costs associated with widening access, and provide stronger and more market-friendly incentives for banks to serve the lower-income end of the market. This should include:

- The creation of an enabling environment for banks, which allows and incentivises them to take advantage of new technologies that reduce the transactions costs associated with serving poorer customers;
- The regulation of the semi-formal sector appropriately, in a way that gives banks the confidence to engage with it more effectively to scale up services;
- The avoidance of subsidised credit schemes, which have often been unsuccessful and counterproductive and have undermined financial sector development;
- The use of market-friendly incentives for banks to widen access to services, which could include:
    - The adoption of a voluntary charter to improve access, which may include quantified targets, e.g. for the number of bank accounts provided;
    - The introduction of Basic Bank Accounts;
    - Monitoring and benchmarking schemes;
    - Legal requirements on banks to finance microcredit;
    - The establishment of an institution with a remit to promote access to financial services;
    - Regulatory measures and incentives, e.g. to do with licensing policy, Know Your Customer requirements or prudential requirements, etc.;
    - Promoting linkages between the formal and informal or semi-formal sectors;
    - The auctioning of a fixed subsidy to whichever financial institution agrees to provide the most micro-loans.

The energy sector: A focus on electricity services

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

Liberalisation of the electricity sector and market entry by private (often foreign) players brings competition, innovation, technological know-how, managerial expertise and much-needed investment capital with which to expand services and keep pace with expected growth in demand. It has generated substantial benefits in many countries, in terms of greater efficiency, lower prices, improved access, greater reliability of service and improved environmental impact. However, the evidence also shows that the gains from liberalisation are by no means certain, and they rely heavily on the establishment of competition and an effective regulatory framework in order to create the right incentives for appropriate investment and efficiency gains, and to ensure that these efficiency gains are passed on to consumers in lower prices.

In practice, prices have often increased after liberalisation, at least for some types of customers. This is because prices were often held artificially low prior to liberalisation, as a result of government subsidies or cross-subsidisation between consumers by the incumbent monopoly. Price rises after liberalisation have led to strong public opposition to reform and subsequent policy reversals in a number of countries, which have in turn led to contracts with private sector participants having to be renegotiated or rescinded. Thus, experience shows that strong commitment to reform is usually required for a prolonged period to ensure ultimate success. The continued provision of government subsidies to protect access for the poor and rural population may also be needed in many countries.

These kinds of problems have resulted in reduced participation by private players in electricity markets since the peak in the late 1990s.

> Attracting significantly more investment will require greater commercial viability, including cost-reflective tariffs, better collection ratios, well-targeted and sustainable subsidies, and improved quality and reliability of service. In most countries, a move towards cost-reflective tariffs will not be politically feasible unless it goes hand-in-hand with visible improvements in quality of service . . . Undoubtedly, retail tariffs are not cost reflective in most developing countries and subsidy schemes often do not cover the gap between tariffs and cost or reach the poorest.[1]

Thus, as with other services sectors, the potential gains from liberalisation appear to be substantial, but a range of complementary policies is required to ensure that liberalisation delivers the expected benefits. Key policy requirements include:

- The creation of competitive market conditions through privatisation, separation of power generation from transmission and distribution services, the introduction of commercial (cost-reflective) pricing, measures allowing market entry by both domestic and foreign companies and ensuring a level playing field (e.g. through appropriate regulation of access to the grid), and the introduction of competition to the sector or certain parts of it by giving customers a choice of supplier;
- The establishment of a good regulatory framework for those parts of the supply chain (e.g. transmission) where competition is limited by the natural monopoly characteristics of production;
- The establishment of a market structure and regulatory framework which ensures real time balancing of supply and demand and thus avoids disruptions in supply and price volatility;
- Consumer protection provisions in the regulatory framework to ensure customers are treated fairly;
- Measures to ensure adequate access to services. This may be through the regulatory framework, or through universal service obligations that prevent suppliers from 'red-lining' (i.e. ceasing to serve) certain groups of potentially less profitable customers.

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

The ICT sector

The ability to use ICTs is critical for development, because they improve the efficiency of households, firms, sectors and the country as a whole. The adoption of ICTs also enables specific services to be traded. Evidence suggests that ICTs bring faster growth, better economic firm performance and

[1] Public-Private Infrastructure Advisory Facility (2007) *Private Participation in Electricity: The Challenge of Achieving Commercial Visibility and Improving Services*, Gridlines Note 21. Washington, DC: PPIAF.

improved household welfare as they can enable more efficient organisation. ICTs enable firms to obtain better access to knowledge and information, to lower transaction costs, to supply markets at longer distances, to improve decision-making across the value chains and to improve flexibility of firms to respond to consumer demand.

ICTs also enable trade in 'IT-enabled services' through offshoring. The offshoring of services occurs when activities of companies are transferred to other countries through outsourcing (i.e. offshore outsourcing) or FDI. Call centres and online programmers are key examples of the offshoring of IT-enabled services to countries such as India and South Africa. Offshoring of services has begun to bring great benefits and new opportunities to those developing countries that have appropriate ICT and skills, including those that are landlocked. However, ICT is not available everywhere and there exists a digital divide between developing and developed countries in terms of access to ICT, although this divide has been reducing recently.

Development and reform in the ICT sector involves market liberalisation and competition, private sector participation and effective regulation. Competition has become the norm in the ICT sector. Private sector participation is still lower in Africa than in other regions. The number of countries with an established regulatory authority separate from the government and in charge of regulatory mechanisms to promote the use of ICTs has increased sharply, from a dozen in 1990 to around 150 in 2006.

Beyond regulations in the ICT sector, rules and regulations in developed countries affect the offshoring of IT-enabled services. For instance, some US states have banned offshoring of services owing to employee concerns about jobs. Anti-offshoring sentiment has also increased in other locations, with some emphasising the importance of legislation on data protection in offshore destinations.

Market reforms can boost productivity and profitability and stimulate investment, enhancing the performance of the ICT sector. Market-based strategies also allow governments to meet social and economic goals, such as increasing access to ICTs and revenue from telecommunication services. Effective regulation has also helped ICT to grow rapidly.

Different types of complementary policy help maximise the benefits of regulatory reform and liberalisation in the sector. In particular, liberalisation benefits from an appropriate regulatory framework embedded in an overall strategy that enhances technological development and supports innovation. Regulators are also important. Key complementary policies to promote offshoring and enhance the role of regulatory reform include promoting a high-quality and appropriate skills base.

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

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

Health services

An efficient and equitable health service sector is not only a development objective *per se*, but also a fundamental driver of growth and poverty reduction via its macro as well microeconomics effects. The health care sector is also important for a country's economy through its direct contribution to GDP (with a worldwide value of around US$4 trillion in 2005).

Several challenges and opportunities for development arise as health becomes a more tradable sector. Barriers to trade are still high, both in terms of capacity constraints (such as lack of capital and adequate technology) and regulatory barriers (health is one of the most heavily regulated services sectors). Some of these regulatory barriers, such as those related to the recognition of foreign qualifications, may be particularly stringent for developing countries, as highlighted by our work in India.

Removing these barriers is likely to stimulate trade in health services, with risks and benefits varying according to the modes of trade, the import and export nature of trade and the specific context in which trade takes place. To the extent that increased trade stimulates new technology adoption, more efficient systems, transfer of know-how and increase in resources available, developing countries may benefit from trade liberalisation. On the other hand, if increased trade drains resources out of the public sector and basic health care, if it helps to create a two-tier system, increasing the inequalities in health care provision within the population, if it reduces the support of the wealthy for better public health facilities, then the negative impact of liberalisation may prevail.

Such risks and benefits from liberalisation are likely to apply to a limited extent to very poor countries, as these are much less involved in health services trade than are upper- and lower-middle income countries. The reasons for the scarce participation of these countries in trade in health services are likely to be similar to those limiting their participation in goods' trade. These have to do with domestic supply capacity constraints and market size rather than regulatory barriers.

The implications of liberalisation on developing countries owe mostly to internal factors rather than liberalisation *per se*. Governments can adopt a wealth of policies to modify these internal factors in ways which could minimise the potential costs of liberalisation and amplify its advantages. These may include:

- **Promoting linkages between the public and private** segments in order to increase the reach of health services provision within the country. Examples include:
  - A health care group is contributing equipment and expertise to a public hospital and will provide public patients with specialist services that are currently unavailable from the state.
  - The promotion of professional collaboration and exchange between the two segments, and the taxation of the foreign (and domestic) commercial segment to raise resources for the public segment.
- **Strengthening regulatory capacity** in the health sector as a way to ensure that the overall impact of liberalisation, whether domestic or external, is beneficial. In an environment with institutional and regulatory deficiencies, increased competition induced by liberalisation may have negative effects.
- Finding appropriate **financing mechanisms to widen access** to health services, which in low-income countries is often restricted for some population segments. Possible ways include:
  - A system of user fees with subsidies to those in need (e.g. via health equity funds) may represent a possible solution.
  - A more implicit form of cross-subsidy is to require health care personnel to spend a certain period in public hospitals or remote areas, before they can be hired by the private sector.
- **Expanding health sector capacity**: for example, the problem of two-tiering in health care owes mainly to poor domestic factors, such as low wages and poor working conditions and infrastructure in the public sector. This allows the private sector to attract skilled personnel, providing better pay and work equipment. There are a number of possible ways to expand the sector's capacity:
  - More resources could be allocated both to train a larger pool of health professionals and to improve their working conditions in the public sector (especially in rural areas).
  - Foreign educational institutions could be involved in the expansion of health-related training capacity.

Mode 4

Trade via the temporary movement of natural persons (or via Mode 4) is an increasingly important component of service exports for developing countries. This type of trade may help developing countries exploit their comparative advantage in semi-skilled and unskilled labour and, for some developing countries, specialised skilled labour as well. At the same time, it is an effective way for such countries to fill some of the gaps in certain skills via the temporary import of service providers.

Mode 4 trade is still very limited relative to its potential owing to a number of regulatory and *de facto* barriers. In particular, the former include immigration rules, discriminatory treatment of foreign providers and recognition of qualifications; *de facto* barriers relate to the discretionary power of authorities granted in order to prevent unauthorised entry. Importantly, such barriers seem to be particularly high for South-South trade via Mode 4.

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

However, the available evidence seems to suggest that Mode 4 trade has the potential to increase several of the benefits from migration (e.g. remittances, return migration) and/or minimise its costs (e.g. loss of domestic capacity and gaps in domestic skills) for developing countries. Walmsley and Winters (2002) estimate that an increase in Organisation for Economic Co-operation and Development (OECD) countries' quotas equivalent to 3% of the total labour supply in importing countries would generate a rise in world welfare of US$156 billion.[2]

Complementary policies are often important in ensuring that such positive potential impact materialises. Such policies may include:

- **Promoting skills and education** for those professions whose services are likely to be exported by developing countries. Such an expansion would require, *inter alia*:
  - The involvement of the private sector;
  - An effective education regulatory body (to oversee quality);
  - A fairly open competition regime in the educational sector;
  - Developed countries may also have the incentives to fund training facilities in developing countries as an effective way to improve their own access to skilled workers.
- **Implementing incentives** for migrants' return in order to fully benefit from their skills. Policies towards this end could include:
  - The active institutional management of migration;
  - Systems that allow a returning skilled migrant to rejoin her industry at a level appropriate for her experience;
  - Effective cooperation between exporting and importing to increase the number of returning migrants.

[2] Walmsley, T. and L.A. Winters (2002) 'An Analysis of the Removal of Restrictions on the Temporary Movement of Natural Persons', Mimeo, University of Sheffield.

1. Introduction

The services sector plays a key role in an economy, but has received less attention than agriculture and industry as a source of growth. Work is underway on the role of agriculture and industrial development in the development process (the latest World Development Report is on agriculture, for example), but developing countries and donors have placed much less emphasis on services. This is partly because there is less recognition of the contribution that services make to the economy, and partly because there is less clarity about the types of measures – liberalisation, sequencing and regulation – that are needed to stimulate the services sector (and the wider economy) onto a more dynamic growth path, and how these relate to the trade liberalisation agenda.

This paper is the first phase output of a study attempting to answer two broad research questions (apart from identifying gaps – to be addressed in the next phase):

- What is the role of services in development?
- Is it possible to provide a narrative on the effects of services liberalisation and services regulatory reform on development that can inform developing country governments and regulators, as well as donors and development practitioners who are not necessarily specialists on services issues?

Section 2 provides background information to the study and covers the importance of services in development in broad terms, introducing a simple framework to examine the effects of regulation on services and development and distinguishing this from previous approaches to services. The bulk of this phase of the study reviews the role of regulation in five services sectors, as well as one way of delivering services across borders (Sections 3 to 8). Section 9 concludes, using lessons learned from the reviews and presenting these as a narrative on services and development and on the role of regulation and trade liberalisation in this. There are gaps in the research evidence; ideas for future research for the next phase are presented separately.

2. Background information and approach

This section is in two parts. It begins by reviewing the importance of the services sector in general, and how it relates to development. It then sets out the framework we will use in this study to address services and development.

2.1 Importance of services for development

Services affect development in four ways (see, for example, Adlung 2007; Mattoo and Payton 2007; Qureshi and te Velde 2007):

- Directly, through effects on national incomes and employment (services often constitute the majority or main source of incomes, even in low-income countries);
- Directly, through effects on range and quality of services, including social services, such as health and education;
- Indirectly, through effects on the 'investment climate', including through transport systems, communication services, energy services, etc. The World Bank's Doing Business reports[3] show that there are more obstacles to doing business in poorer countries, and barriers related to services play an important role in this; and
- By diversifying the economy.

The World Bank's Africa Development Indicators (World Bank 2007) note that many sub-Saharan African economies appear to have turned the corner and moved onto a path of faster and steadier economic growth, averaging 4.4% in the first half of this decade. Rapid growth over the past decade reverses the situation seen in the collapses of 1975–85 and in the stagnations of 1985–95. The International Monetary Fund (IMF) forecast for real growth in sub-Saharan Africa was 6.1% for 2007 and 6.8% for 2008 (IMF 2007). It has been suggested in the past that a 7% growth rate is what is needed for sustained poverty reduction.

Services are very important for promoting inclusive growth. Although agriculture might be more effective in reducing poverty than other sectors, it is more difficult to promote agriculture when other sectors have more promising growth prospects or when countries face preference erosion and competition from larger-scale producers. Services already provide many jobs for the poor (from distribution to tourism), form the backbone of the economy (from transport to finance, electricity and telecommunications), offer an opportunity to diversify and enjoy comparative and competitive advantages (from temporary migration to call centres).

We still know too little about the services sector. However, data for Africa available from the World Bank World Development Indicators show that, despite preference schemes (e.g. the Africa Growth and Opportunity Act – AGOA) targeting mainly African manufacturing, and despite rising demand for African natural resources, the share of services in incomes has recently increased.[4] Globally, over the period 1990–2005, the share of services in the incomes of low-, middle- and high-income countries grew by 10 percentage points, to 50%, 55% and 73%, respectively. This suggests that services contributed relatively more to growth, which is extremely important for poverty reduction (Figure 1). It would be hard to promote inclusive growth without also promoting inclusive growth in services. In fact, services value added grew by 4.3% per annum from 2000 to 2005 in sub-Saharan Africa, whereas agriculture value added grew by less (3.7%); although industry rose faster, it contributed less to growth, because industry is only 60–70% of services value added.

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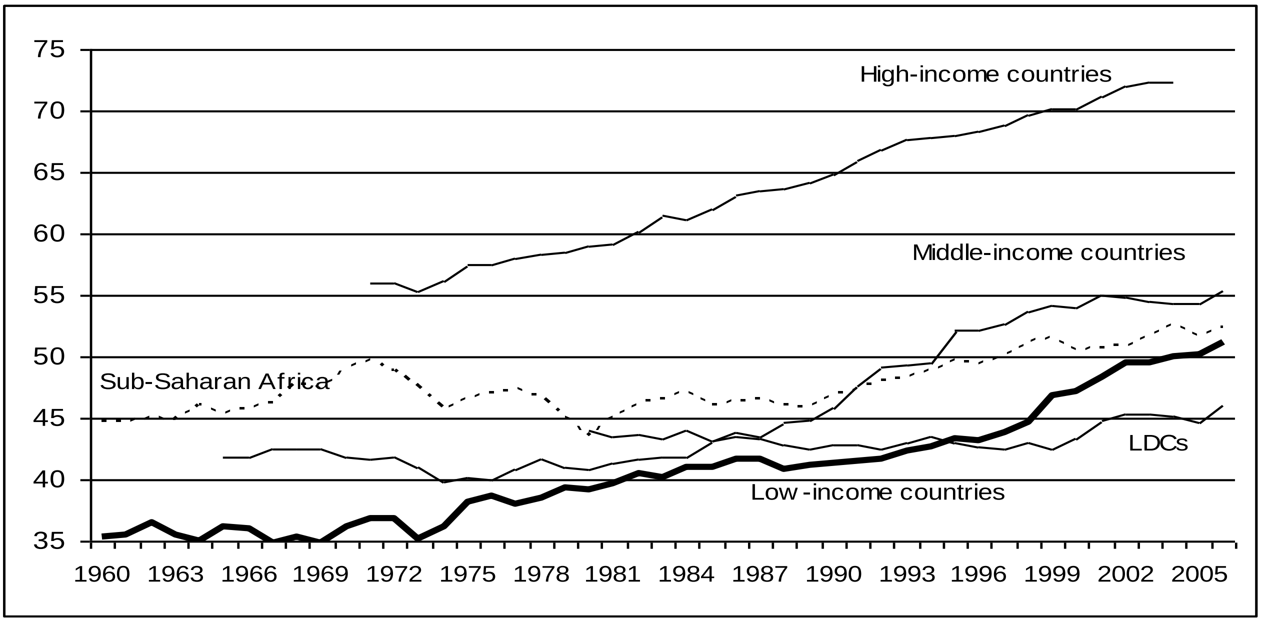
[3] See http://www.doingbusiness.org/.

[4] See http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20398986~menuPK:64133163~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html.

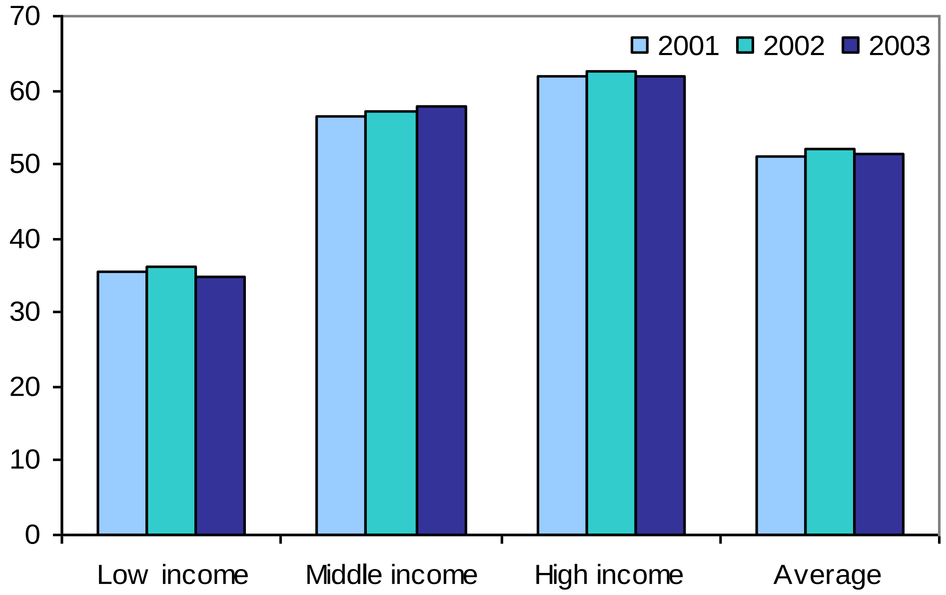
Figure 1: Share of services in value added, by country group



Source: World Development Indicators (2007), see http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20398986~menuPK:64133163~pagePK: 64133150~piPK:64133175~theSitePK:239419,00.html.

The services sector is also a major source of employment. Figure 2 focuses on small states and shows that, on average, 52% of the labour force is engaged in the services sector in small economies. Its contribution to total employment is 35%, 58% and 62% in low-, middle- and high-income small economies, respectively.

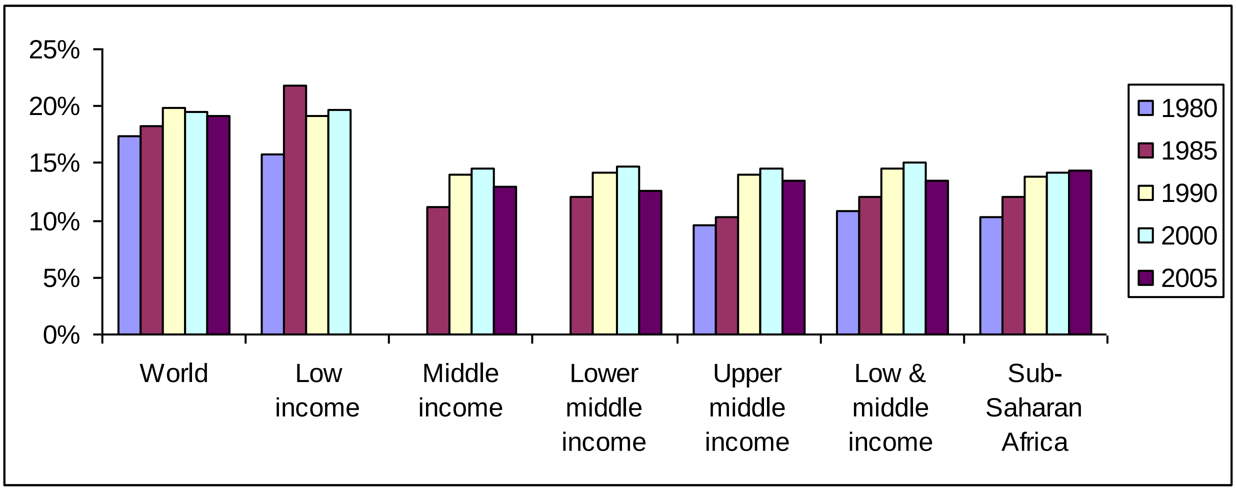
Figure 2: Distribution of labour force in services in small states (%)



Source: Commonwealth Secretariat. Small States Yearbook.

Trade in services is increasingly important, but this importance varies by country. Figure 3 shows that the share of services has increased since 1980, now accounting for around 20% (at least for those traded services that are measured in the Balance of Payments – BoP). The increase in the share has been faster in low-income countries and sub-Saharan Africa.

Figure 3: Share of services in total trade in goods and services



Source: World Development Indicators (2007), see http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20398986~menuPK:64133163~pagePK: 64133150~piPK:64133175~theSitePK:239419,00.html.

Available BoP data capture only part of services supply as discussed under trade negotiations. There are four different modes of supply of services: cross-border supply (Mode 1), services consumed abroad (Mode 2), services supplied via commercial presence abroad (Mode 3) and services supplied via temporary movements of labour (Mode 4).

Services data used to compute exports by mode are often based on proxies. For instance, Mode 3 exports of services are sometimes proxied by foreign direct investment (FDI). A better indicator would be sales of services by multinational enterprise (MNE) affiliates abroad, but such data are not always available. Similarly, Mode 4 exports of services should reflect sales by natural persons temporarily abroad, but this is proxied either by remittances (which may understate the true value, because sales may be higher than what is sent abroad, or overstate, as remittances includes permanent migrants) or by compensation of employees in subsidiaries of services MNEs, neither of which are correct. Table 1 shows a World Trade Organization (WTO) statistical approximation of sales my General Agreement on Trade in Services (GATS) modes of supply.

Table 1: Sales by GATS modes of supply (2000)

Mode	**Proxy**	**Rough estimate**
Cross-border supply	BoP: service exports (note this excludes travel)	US$1000 billion
Consumption abroad	BoP: travel (possibly excludes health, education, etc.)	US$500 billion
Commercial presence	Foreign Affiliates Trade in Services (FATS): turnover	US$2000 billion
Movement of natural persons	BoP: compensation of employees (understatement)	US$50 billion

Source: WTO (2002).

This distribution will be different for developing countries and will have changed recently. However, it is important to bear in mind that trade in services is broader in scope than trade in goods, and include sales of services by multinationals abroad.

2.2 Framework to address services and development

This paper examines the effects of regulation and liberalisation. We suggest that it is important to look at this by sector, so that we can build up evidence to contribute towards a narrative on services and development. We discuss services and development through the following individual sections:

- Overview
- The contribution of the services sector to development, growth and poverty reduction
- Sector liberalisation – what is involved?
- The benefits and risks of liberalisation and regulatory reform
- Complementary policies required to maximise the benefits to development

Several factors affect trade in services and the development of services sectors. We focus here on the role of regulatory reform and liberalisation, but there are complementary factors that help to maximise effects on development and that in some cases will be more important in promoting services and trade in services.

2.2.1 Domestic regulatory framework

Appropriate regulation is crucial to benefiting from trade in services liberalisation. For some sectors, regulation is required for services to be traded. In other sectors, regulation is vital, regardless of whether the sector is open to trade or not. Owing to the nature of services (which are commonly characterised by elements of natural monopoly and informational asymmetries), regulation is usually required to ensure that service markets work properly. However, regulation can also be unnecessarily burdensome and distortionary, and may constitute a major barrier to services trade.

2.2.2 External constraints (including trade barriers)

Following Hoekman and Braga (1997), trade barriers can be grouped into the following:[5]

- Quotas (for example, the number of flights on a route may be restricted);
- Local content and prohibitions (for example, production activities and supplies may be restricted to nationals only);
- Price-based instruments (for example, visa fees and entry/exit taxes or subsidies), which tend to hit small traders more than large-scale traders;
- Standards and accreditation requirements (for example, non-recognition of degrees/certificates/diplomas obtained in foreign countries);
- Licensing and procurement requirements;
- Discriminatory access to distribution networks;
- No commitment on Mode 4 of supply of services.

There are, of course, other external constraints, such as external shocks, competition from third countries, etc.

2.2.3 Supply-side constraints

Supply-side constraints on export capacity include:

- **Human resources:** Some services, such as professional business, financial and educational services, are skill intensive and require appropriately trained staff. However, most developing countries have a poor tertiary education record and/or high rates of skilled emigration, which severely limits the availability of human resources.
- **Infrastructure:** Low-income countries are typically characterised by a weak physical infrastructure (such as unpaved roads, underdeveloped ports, weak air connections, etc.) and

[5] Non-trade related external constraints also exist, such as the level of competition abroad.

poor information and communication technology (ICT). Poor infrastructural facilities restrict domestic as well as foreign investment in the economy.

- **Size:** The limited size of the domestic markets of developing countries raises the need to increase market access to reap economies of scale. Some services have a minimum efficient scale that is greater than the size of the domestic market.
- **Information:** A majority of exporters of services operate on a small scale and face a lack of information on markets and regulations. In addition, they are unable to market their products, which may lead to a lack of information on the consumer's side as well. Services products are often 'experience' goods, where sales depend on a track record of international credibility and profile. It can take time to build up international repute and credibility, particularly because the fixed costs of establishing credibility are relatively high for small service providers.
- **Technology:** Exporters in small states have limited access to (new) technology, which reduces their competitive edge.
- **Financial resources:** Service providers, especially those operating at a small scale, face constraints to accessing financial resources.

2.2.4 Sector sections

This study covers a range of sectors, including those offering significant export opportunities for developing countries, those likely to have a direct impact on development and those with the biggest potential impact on economic growth. These include:

- **Tourism** (because of the importance of this sector for poverty, employment and gross domestic product – GDP);
- **Financial services** (because this sector is the backbone of the economy and is an important contributor to GDP);
- **Energy services** (as an infrastructure sector with an important effect on the investment climate);
- **ICT** (which is also key for the investment climate);
- **Health** (which is a key social sector); and
- **Mode 4**, the presence of natural persons to provide a service (as a key interest and source of comparative advantage for developing countries).

The other modes are covered explicitly or implicitly in the sector sections. Financial services and energy services are dominated by Mode 3 considerations, and tourism and health by Mode 2 considerations. Opportunities for ICT services, on the other hand, depend mostly on Mode 1 supply of services.

There are other sectors that are not included. Although the key issues relating to these are covered in the sectors detailed here, additional coverage may be needed. We come back to this in the conclusions.

2.3 What is new in this study?

General reviews of trade liberalisation already exist (see, for example, Hoekman 2006; OECD 2002; Whalley 2004). Results of global computable general equilibrium (CGE) models suggest global gains in economic welfare of around US$250 billion per annum for a 50% cut in (all) services trade barriers, occurring over a 5- to 10-year period and equally distributed across all countries in proportion to their GDP (George and Kirkpatrick 2003; OECD 2002). Importantly, most gains are obtained through liberalising a country's own services sector (e.g. Mode 3), rather than obtaining further access to foreign markets. The various model estimates do not explicitly model different modes of services supply. However, some models do include FDI in services sectors (Mode 3), suggesting a global gain of US$60 billion per annum for this mode alone (but benefits skewed to Asians). Regarding Mode 4, if rich countries permitted movement of labour of up to 3% of the total labour force, world incomes would rise by US$156 billion (Winters 2002). Developing countries would be the main gainers and the net welfare for the home region for Africa would be US$14 billion.

Such quantitative studies are general. They are based on certain assumptions and suggest that complementary factors and regulations are already in place to support services trade liberalisation. Although it is important to know what the potential gains of trade liberalisation are, policymakers in developing countries will also need to know how these can be achieved, e.g. what type of regulations need to be put in place.

In addition, several studies have been carried out on the options for developing countries in services trade negotiations (by UNCTAD (the United Nations Conference on Trade and Development), ICTSD (the International Centre for Trade and Sustainable Development), South Centre and the World Bank). Each of these institutions also provides technical assistance and information to support these negotiations (te Velde 2005). We aim to enter the discussions on trade liberalisation and the role of regulation at a different level from that of trade negotiations.

There have also been studies that highlight the importance of other key factors influencing services and development, such as the supply capacity, including appropriate human resources systems in the specific case of small states (Qureshi and te Velde 2007). Here, we focus on other issues.

This paper seeks to understand how trade liberalisation can be made to work and to discuss the role of regulation and regulatory reform in the development of services sectors. The aim is not to cover services negotiations and options in detail (we will refer to negotiation issues only in the first sector covered), but to examine how liberalisation and regulation affect development at the level of the sector and to consider capacity issues as complementary factors. We will aggregate the information gathered from the sector studies into a narrative on trade in services liberalisation and the role of regulation.

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3. Tourism services

Tourism is the biggest export service sector in many low-income developing countries (via Mode 2). Its value is set to increase further in all world regions and especially developing countries, reflecting increased demand and comparative advantages. The tourism sector (e.g. the hotel sector) tends in developing countries to be liberalised compared to other sectors, although there are areas (e.g. tour guides) where there are still sensitivities and protectionist elements.

Developing countries will have realised the importance of appropriate frameworks that are non-trade-distorting in tourism, helpful for making commitments in international service negotiations. The relevance of this in itself would need to be understood: can we identify the way in which trade liberalisation has taken place in tourism and could this be a role model for other sectors?

This relatively liberal stance has coincided with the large impact of tourism on development in terms of value added, incomes and employment in static terms, as well as dynamic effects on the rest of the economy. Rather than protecting the local tourism sector, especially the smaller players, from foreign involvement, it is more efficient to think about complementary policies to promote the (local) sector and its effect on development. This involves regulatory issues such as air access, competition policies and heath, safety and quality standards, or helping to promote local capabilities such as skills and infrastructure.

3.1 Introduction

Tourism is the biggest export service sector in many developing countries. Its value is set to increase further in all regions of the world, a reflection of the fact that, as people become richer, they consume relatively more tourism services. Tourism already has an important impact on incomes, including for the poor. Appropriate regulation in the tourism sector and in other sectors can help to improve the impact of tourism on development.

Tourism services is a broad category, covering a wide range of activities, from hotels, restaurants, tour operators and guides, to cultural and health services consumed by tourists and cruise ship passengers and staff. In negotiation terms, tourism includes tourism and travel-related services (hotels and restaurants, travel operators and tour operators, tourist guide services, other). Outside this definition of tourism services, tourism comprises several transportation and other services. For example, the cruise ships industry does not fall under this definition of tourism services, but has begun to contribute revenue for many countries. There is also evidence of the relevance of other tourism-related activities, such as health tourism (Gonzales et al. 2001) and cultural services.

Tourism affects development in various ways. The direct effect of tourism on incomes is already considerable in several countries. In addition, there are important impacts for the rest of the economy in the long run, through linkages with local firms, externalities, human resource development and infrastructure development. The question relevant for this section is: what mix of policies can improve the impact of tourism on development and, particularly, what are the roles of services liberalisation and regulation?

A significant amount of trade liberalisation of tourism services has already taken place, e.g. allowing foreign hotels to invest in the country. Although these tend to be larger hotels, there have been questions as to how this relates to the local, often smaller, hotels and how it affects development more widely. Moreover, not all tourism-related services have been liberalised, e.g. tour guides often still need to be nationals. There are potential risks and benefits associated with further tourism liberalisation, although, in practice, development and liberalisation have gone hand-in-hand. Appropriate regulation affects the development of the sector in various ways, e.g. when developed countries impose health and safety standards in hotels used by their tour operators, or when developing countries design new regulatory frameworks to support the competitiveness of their tourism sector. Regulatory reform in other sectors, notably air transport, will help the development of tourism services.

3.2 Contribution of the sector to development, growth and poverty reduction

According to the World Tourism Organisation, international tourism receipts have more than doubled in the past 15 years, to US$700 billion, and tourist arrivals have nearly doubled, to 800 million. Average annual growth rates over 2000–5 in arrivals were 5% in sub-Saharan Africa and 7% in East Asia and the Pacific, much higher than the world average of 3%. It is expected that Africa will see its market share in tourist arrivals increase from 3.6% in 1996 to 5% in 2020 – remarkable given that Africa tends to diverge from other developing countries on other economic indicators. This section addresses the impact of tourism on development, reviews the channels through which this works and discusses some topical issues.

There are different ways in which the importance of tourism can be presented. The most common way is through the BoP: tourism receipts, often based on surveys, enter the BoP as 'travel-related services'. Another way is the direct contribution of tourism value added to gross domestic income, which normally includes the value added of hotels and restaurants. There are also more extensive attempts to account for the fact that tourism involves other sectors as well. Including such sectors using so-called tourism satellite accounts will no doubt boost the effect of tourism. Finally, there are attempts to examine the total effects of tourism on incomes from a dynamic perspective, which implicitly include externalities through the channels mentioned above.

3.2.1 Contribution to income and employment

Focusing on Africa, **tourism receipts** are growing rapidly, at nearly 10% a year, and account for US$21.5 billion or 3.5% of Africa's GDP. There are wide variations within Africa. For instance, tourism receipts represent nearly 20% of GDP in Mauritius, 10% in Namibia, Tanzania and Gambia, 5% in Botswana and Kenya and 2.5% in South Africa. Slightly different ratios show up when using GDP value added by sector, because this is a more limited classification. For example, the sector hotels and restaurants in Mauritius account for 7% of GDP and 20% of employment.

Tourism is extremely important for regions such as the Caribbean. Using tourism satellite accounts, which covers indirect effects, the World Tourism and Travel Council (WTTC) finds that tourism contributes 15% to GDP and 16% to employment in the Caribbean region. It is the main foreign exchange earner in many Caribbean countries and the revenues come from very different types of tourism, ranging from mass tourism (e.g. in Barbados) and cruise ships (several islands and Belize) to ecotourism (e.g. Suriname and Belize) and cultural tourism.

For some small states, tourism-related services are a very important or the most important foreign exchange earner. Tourism can be key for low- and middle-income small states, owing to their relatively less diversified services sector as compared with the high-income states. Tourism often accounts for over 50% of service exports for the middle-income small countries (Botswana, Mauritius, St Lucia and Vanuatu) but a lesser proportion for high-income small states, such as Singapore and the United Arab Emirates (UAE).

Tourism is also seen as an important sector for the poor (see the extensive overview in Mitchell and Ashley 2007). Tourism offers labour-intensive and small-scale opportunities compared with other non-agricultural activities, employing semi-skilled and casual workers and a high proportion of women (UNED-UK 1999), and an opportunity for self-employment and small and medium-sized enterprises (SMEs). Tourism also provides opportunities in remote areas and in places with a high value on natural resources and culture, all of which favour the poor.

3.2.2 Externalities to the rest of the economy

Lejarraga and Walkenhorst (2006) summarise 10 econometric studies on the effects of tourism on growth. Econometric regressions capture the dynamic effects as well as the externalities on the rest of the economy. Their review supports the hypothesis that growth can be tourism-led. Tourism can and often does generate economic growth –both in low-income and in OECD (Organisation for Economic Co-operation and Development) countries – and in some cases has outpaced the manufacturing and agricultural sectors in relative contribution to GDP growth. There is also empirical evidence that the effects of tourism are greater the poorer the region. This would suggest that tourism is a first step towards diversification but that, as countries become more developed, they move increasingly into higher value-added sectors (as we found earlier).

There are a number of channels through which the tourism sector affects the rest of economy (implicitly captured by the econometric regressions), including:

- Infrastructure (e.g. air travel or roads)
- Human resource development (e.g. training of the workforce)
- Diversification and private sector development (especially SME development and entrepreneurship, linkages)
- Other unspecified externalities

Infrastructure

Subramanian and Matthijs (2007) highlight the dynamic effects of tourism in Kenya. Increased air travel for tourism reduced the cost of airfreight to Europe and provided new transport opportunities for small quantities of fresh products. Tourism also increased local demand for high-quality fruit and vegetables and provided an outlet for produce not meeting export standards. More generally, the authors argue that, by positioning itself as a relatively close and attractive holiday destination, sub-Saharan Africa could make gains that are not just direct (in tourism services, hotels, restaurants, etc.) but also indirect: the fact that more and more direct flights arrive in African airports makes transport cheaper and export markets more readily accessible for African goods.

Human resource development

The management, entrepreneurial and other skills that the tourism sector, especially hotels with links to foreign business, provides are important long-run effects of tourism. Within the hotel industry, there is a trend towards greater investment in staff training, with up to 1% of revenue being earmarked for this purpose (ILO 2001).

Diversification, linkages and private sector development

The effects of tourism on development in the rest of the economy will depend on the type of linkages, forward or backward, direct or indirect. Hotels can source locally and promote local economic development or import from abroad. Generally, the extent to which linkages are formed depend on capabilities of local firms, sourcing practices of hotels, the type of tourism activities and domestic policies, such as the presence of a linkage promotion programme. It could be small differences that matter, e.g. a hotel in the Caribbean began to purchase more from local agricultural suppliers when it employed an employee with local knowledge of suppliers.

Other

There are further effects that determine the link between tourism and development. For instance, it is frequently argued that there are leakages of tourism spending; these are defined as the value of tourism receipts that does not benefit the host economy, but that flows to the international economy. This could be because profits are repatriated or because tourism spending boosts imports. It is likely that tourism visitor spending is not the same as value added to the country because of leakages, but it is not clear whether this is particular to tourism. This seems to be the case for many sectors (natural resources industries, infrastructure, etc.) Normal policies would minimise leakages by providing better investment opportunities, so that profits can be reinvested, and by fostering linkages with the local economy. Further, tourism provides significant foreign exchange, is often key to being able to finance import bills and reduces the need for a devaluation of the currency.

3.2.3 Different types of tourism

Much is made of the differential impact of different types of tourism. Broadly, we can distinguish between cruise ship, eco and mass tourism. The main form is mass tourism (searching for sun, sea and beach). This has become possible for many countries because of the growth in long-haul flights. However, other emerging forms of tourism can also affect development. For instance, the number of cruise ships has grown recently in several countries. After the 9/11 security threats, Americans decided to go on holidays in the local area. For example, cruise passenger arrivals in Belize have increased from 1998 to 2004 from 14,183 to 851,436, equivalent to a phenomenal 98% annual growth rate. Ecotourism and health tourism are also targeted by some countries. Other countries target shoppers and business visitors.

Another category, event tourism, helps a number of countries. For example, St Lucia has built up a basic institutional infrastructure to organise larger events (carnivals, jazz and flower festivals, sports events, etc.) with cultural inputs which, among other things, help to attract visitors. The St Lucia Jazz Festival has become internationally recognised and emerged from an idea to market the country in a period during which there are relatively few visitors. The organisation of such a festival requires contracting and coordination of several (local and foreign) groups and all other arrangements, such as arranging contacts with DVD/CD distributors. The St Lucia Tourist Board has taken this on. The costs are financed through merchandising, gate receipts and contributions from the St Lucia Tourist Board and government in the form of import duty exemptions. The St Lucia Jazz Festival was responsible for 8% of visitor expenditure in 2006 and around 2% of all visitors. The St Lucia Carnival is organised by the Cultural Development Foundation and is building up regional and international recognition, with agreements with neighbouring countries to participate in each others' carnivals. The St Lucia Carnival attracted about 0.5% of all visitors in 2003 and has been growing in importance since.

Although the impacts of the various types of tourism can differ, with different characteristics and beneficiaries, it does not seem to be the case that one type is always better than another type. Much will depend on how tourism spending is used.

3.2.4 Market structure

The tourism industry has been undergoing dramatic structural shifts. There has been a rapid consolidation in the industry in Europe. For instance, there are only four major tour operators (TUI, First Choice, MyTravel, Thomas Cook), each operating at various levels in a vertically integrated way. This consolidation has led to a concentration of power with the tour operators: they do destination marketing and determine which hotel to use. This leaves little bargaining power for local hoteliers. On the other hand, the internet has strengthened marketing tools for those actors that can use it and reduces the need for tour operators.

The literature on value chains distinguishes between supply-driven and buyer-driven value chains. Tourism activities may be best described by buyer-driven value chains, as the tour operators are the driver. Mitchell and Faal (2007) compute the share in revenues going to the different activities in the tourism value chain in Gambia (from the United Kingdom (UK)). International tour operators capture 12% in value, airlines 24%, passenger handling 4%, accommodation 19%, food and beverages 16%, shopping 5%, excursions 5% and local transport and other expenditure 5%. Such numbers cannot reveal whether it is the remuneration of input costs and quality of skills that is appropriate, or whether profits per unit of input vary. To the extent that buyer-driven value chains are unregulated, a higher share captured at the tour operator end might be a reflection of monopolistic competition, but this is not easy to show.

3.3 Tourism sector liberalisation: What is involved?

There are various relevant regulatory frameworks and trade policy rules affecting tourism activities. These include:

- Domestic regulation for hotels, tour operators and tour guides, and rules guiding the use of incentives, land tenure and other issues in the destination country
- Source country regulations, which affect destination country operations of tourism firms based in source countries and cover health and safety standards (e.g. the European Union (EU) Package Directive), competition policies (e.g. among the tour operators), the need to have a passport for United States (US) citizens, introduction of eco-taxes)
- Rules and commitments on tourism in regional and multilateral trade agreements (RTAs and GATS) affecting both source and destination countries

3.3.1 Relevant domestic regulations

Domestic regulation is seen as an important factor affecting the development of services (e.g. World Tourism Organisation 2004). Various studies include measures for domestic regulation in the tourism sector (e.g. WTO Trade Policy Reviews), with information on legislation (e.g. hotels acts) and whether this allows for non-discrimination among foreign and local hotels.

As an example, the Botswana Tourism Act regulates the tourism industry with a view to promoting its development. It provides for licensing of tourism enterprises and sets out the procedures with regard to applications for licenses, power of inspection, appeals, etc.; defines categories of tourism enterprises; provides for the introduction of a grading system for tourism enterprises; establishes a Tourist Industry Licensing Board; and provides for the possible introduction of a training levy and the establishment of a National Advisory Council on Tourism. The exact status of such acts and documents can be unclear, as regulations continue to be amended to exempt certain categories of enterprises from licenses and to put the grading system on hold (Leechor 2004).

There are key regulatory issues affecting normal operations in the tourism sector, as part of specific tourism regulation or as part of general legislation. These include:

- Incentives (tax holidays or investment allowances for capital investment)
- Land tenure and leasing (access to beaches, parks, etc.)
- Health and safety standards
- Environmental policies (sea front)

Although these regulatory issues do not form the core of this section, they do nonetheless affect the competitiveness of the sector.

3.3.2 Types of trade policies

There are various degrees of trade liberalisation. It is possible to liberalise the sector for hotels over a certain size, e.g. 50 rooms, to protect smaller hotels. One way is to include this limitation in the sector classification in the first column; St Lucia has used this in its GATS schedule: *Hotels and resorts in excess of 100 rooms, and restaurant services (CPC 641**, 642)*. Another way is to schedule it in a market access limitation for Mode 3 in Sector 9A, as in St Kitts: *Limited to development in excess of 50 rooms. Ownership of non-ethnic restaurants reserved for nationals.* Or in Grenada: *Subject to alien landholding regulations, exchange control regulations. Limited to the developments of hotels in excess of (100) rooms. Hotel development of less than 100 rooms may be subject to an economic needs test.* Some countries exclude small hotels from GATS commitments even though there is no evidence that discrimination is indeed the case for small hotels.

Countries can always revoke GATS commitments, so liberalising subject to the possibility of revoking commitments is always an option. If a country wants to backtrack and modify its GATS commitments, it can follow the procedures in Art. XXI procedures. A country wishing to reverse or add a further limitation can do so after a period of three years of the commitment being in place. Further, it needs to negotiate compensation with all affected parties – so it would need to find out who would lose out.

Compensation is ill-defined, but can be in the form of increased services access in other areas. We are not aware of the existence of any cases of developing countries asking to modify GATS commitments.

Tourism is often subsidised, but the use of subsidies is prescribed in the GATS (not as much as for trade in goods, of course). GATS Article XV deals with subsidies: ' . . . in certain circumstances, subsidies may have distortive effects of trade in services. Members shall enter into negotiations with a view to developing the necessary disciplines . . . ' The Article also recognises the role of subsidies in relation to development and the need for flexibility, and asks for an information exchange concerning all subsidies related to trade in services.

Subsidies are considered 'measures' within the meaning of the GATS, so most-favoured nation (MFN) obligations apply (GATS Art. II). However, governments may choose not to subsidise foreign firms only or to use MFN exemptions. National treatment applies to the subsidy practices to the extent that a sector has been listed in a country's schedule of commitments (GATS Art. XVII). Most countries have done this for tourism services. Limitations to commitments can be scheduled, some by sector, others horizontally. But if local content or subsidies are not mentioned for scheduled sectors, they are not permitted. Market access commitments are a precondition for binding effects in national treatment (NT) and MFN clauses, as without market access commitments there are no effects. GATS Art. XV(2) states that adversely affected members may request consultation; this shall be accorded sympathetic consideration but there are no guidelines on what to do and no reference to the Dispute Settlement Understanding (DSU).

There was no timetable initially for negotiations on subsidies, but the 2001 guidelines suggest that members aim to complete negotiations on Art. XV prior to conclusion on specific commitments. However, it is far from clear whether disciplines will really materialise. Not much has happened so far (and the Doha Round has now come to a standstill). It will be very hard to determine whether investment incentives are trade-distorting (more difficult than in the case of goods) and when they are legitimate for public policy reasons (recognised by Art. XV). It might be helpful to have an information exchange on the relevance of all trade-distorting subsidies before deciding whether and how to deal with subsidies in the GATS. This alone could lower the incidence of subsidies when governments realise that subsidies may not work as planned.

3.4 Benefits and risks of liberalisation and regulatory reform

There are benefits and risks associated with both liberalisation and regulatory reform, which we deal with separately below.

3.4.1 International trade liberalisation

Hoad (2002) outlines the GATS, examines its legal principles, explains the arguments of supporters and critics and considers its potential impact on tourism and sustainability and on issues such as local community participation and tourism governance. Hoad argues that the reason why many countries, both developing and otherwise, have supported the GATS is the expectation that it will lead to increased investment in tourism.

Perrin (2001) aims to identify and assess potential environmental and social effects of trade liberalisation policies on the tourism sector and, specifically, the role played by trade liberalisation policies in supporting or constraining opportunities for sustainable development. Increased inward investment is seen to have positive and negative effects on the sustainability of tourism. The GATS can lead to increased investment because it is in many respects both a multilateral investment agreement and an agreement to liberalise services. The GATS has important implications for investment through commitments concerning Mode 3.

In the case of Turkey, Perrin argues that GATS agreements and liberal domestic regulations in the tourism sector have led to increased foreign investment. Foreign investment in the tourism sector in

1997 constituted 14% of total FDI. Increased inward investment has led to a generation of employment opportunities, although the jobs are poorly paid and seasonal. However, tourism investment in Belek concentrated mainly on the beachfront and negatively affected the ecosystem.

PwC's (2005) Sustainability Impact Assessment assesses the potential economic, social and environmental impact on the Caribbean tourism sector as a result of an EU-ACP (Africa, Caribbean and Pacific) economic partnership agreement (EPA). The simulations conducted suggest that further Mode 3 liberalisation would lead to an increase of 10% in the physical capital of the tourism sector. This, in turn, would lead to an increase of 2% in total investment.

Dunlop (2003) sets out a regional negotiating strategy on tourism services in external trade negotiations and suggests that a challenge for negotiators is in striking the right balance between encouraging new foreign investments into the sector while maintaining local community involvement in tourism-related activities. He argues that WTO officials often overplay the importance of the GATS to investment. According to the officials, the existence of GATS commitments in tourism-related sectors can increase domestic and foreign investment by ensuring greater stability and predictability of government regulations and policies affecting tourism. However, as Dunlop points out, the existence of GATS commitments is one of many factors that encourage foreign investors to enter a market. More important factors are argued to be return on investment, political stability, currency fluctuations, ability to repatriate profits, revenue per available room, operating costs, national taxation and incentives provided by the government.

The World Tourism Organisation (2004) discusses FDI in the tourism sector, focusing on definitions, trends, measurement and assessment of impact of FDI in the tourism sector. The study suggests that recent growth in FDI in the tourism sector owes largely to the creation and approval of a regulatory framework, including international treaties and agreements, laws, decrees and standards, as well as aid policies and incentives for FDI within countries.

Te Velde and Nair (2006) make a statistical analysis, with panel data (1997–2003) on inward FDI in the tourism sector in nine Caribbean countries, correlating these with data describing the regulatory framework committed to in fora such as the GATS, and controlling for other factors affecting inward FDI. As far as we know, this is the only study that examines the effects of GATS commitments on tourism investment.

The regression results are indicative of a positive relationship between GATS commitments and inward FDI, controlling for other explanatory factors and instrumental variables to account for the endogeneity of making GATS commitments. The instruments include the number of WTO negotiators, which seemed positively related to the depth of GATS commitments. There are several caveats, which may make the results more tentative: with only 55 observations, results could be more credible with a larger sample (more countries and/or more data over time) with more explanatory variables.

The evidence reviewed here suggests that GATS commitments are related to more investment in hotels and restaurants – although this should be examined in more details. More investment can lead to more development, but there is the possibility that foreign hotels could displace local hotels. The evidence above does not examine this, but it is likely that foreign-owned hotels will bring with them their own marketing networks and skilled managers, and so expand the tourism market (and not displace local firms). It is possible that foreign-owned hotels lead to significant leakages of import revenues (Jules 2005), but this is no different than for other sectors, and it is not clear whether non-leaked revenues could be appropriated if the hotels were not there. In some countries (e.g. St Lucia), all hotels with more than 100 rooms are foreign-owned – and only foreign-owned companies began such big hotels. However, so far, there is little publicly available data that can help with assessing comprehensively how FDI affects development in the tourism sector, at least in contrast with the literature on tourism and development generally.

On the other hand, further tourism investment can have negative environmental effects, which would call for complementary environmental policies. Jules (2005) suggests that uncontrolled tourism development can have detrimental impacts on the physical and social environment. Poorly managed tourism leads to deforestation and erosion; degradation and depletion of biological diversity; disruption of natural habitats; and over-consumption of resources like freshwater and energy. Trade liberalisation is not the only factor here – it relates to the whole sector – but liberalisation might lead to further development of the sector and additional revenues gained would need to cover any potential environmental damage, at least indirectly.

3.4.2 Domestic regulatory reform

Domestic regulatory reform in the tourism sector is an ongoing effort, with some aspects less controversial than others. The key regulatory issues manifest themselves in tour guide regulations, tour operator regulations, hotel and tourist accommodation acts, cruise ship policies and tourism board acts. Most countries have in place a hotel act as well as a tourism board act (establishing the tourism board). Not all services sectors have a board or a key association, and the presence of a tourism board reflects the importance of the tourism sector. Hotel acts are mainly about they way hotels need to comply with standards, whether foreign hotels are welcomed and who is eligible for support or incentives. Such acts continue to be updated, but the principle of non-discrimination (on paper) seems to be well-established: in practice, domestic regulation has long allowed foreign hotels to operate, which is why further regulatory reform may not have a big impact as in other sectors. This also explains why there are so many services commitments in tourism by developing countries in the GATS.

Although this applies to many segments of the tourism sector, it does not apply to all sub-sectors. For instance, local tour guides still seem to be protected. This issue is more sensitive, as it relates directly to semi-skilled jobs. For instance, the Zambian National Tourist Board provides advice to the immigration department on the issuing of work permits. It is straightforward to grant limited numbers of work permits under the Investment Act; it is also relatively easy to grant permits for skilled personnel, such as managers or Chinese speakers (for a Chinese restaurant). It is more difficult for tour guides or workers who are not key skilled personnel, even though there is a lack of qualified tour guides. Granting work permits is currently being carried out on a case-by-case basis and this can lead to discrimination.

A recent example of regulatory reform comes from Botswana. The new tourism regulations (2006) state that the following tourist enterprises are reserved for citizens of Botswana or companies that are wholly owned by citizens of Botswana: campsites including caravan sites; guesthouses; *mekoro* (canoe) operations; mobile safaris; motorboat safaris; and transportation.

Restricting services companies to national citizens is not conducive to a vibrant services sector and would go against Botswana's policy to diversify the economy. It would be more efficient to promote domestic capabilities first, and then use immigration procedures rather than blunt restrictions on enterprises. A particular concern is the lack of access to credit for independent (indigenous) tour operators to set up their own business. The new regulations could limit the ability of foreign-owned tourist enterprises to operate, which may otherwise bring skills, marketing methods, finance, new tourists and employment for national citizens. The impact of the new regulations has so far been limited to promoting local enterprises. The number of nationally owned tourism enterprises increased by 11% to 247 last year.

General regulations also affect the tourism sector. Cattaneo (2007) suggests that the highest priority for policy action in Zambia is the elimination of impediments and distortions created by regulatory policy. Investment is hampered by too many administrative requirements. For instance, a five-room guesthouse needs up to 74 licenses, which can take 6 to 12 months, and the costs of compliance are high. The quality of the grading system has meant that only one-third of tourism establishments are graded, which affects the way in which the rest can integrate with the formal sector and compete for tourists and possibly the reputation of Zambia.

Table 2 below provides examples of regulatory issues by type of tourism.

Table 2: Mapping regulatory issues by type of tourism, examples

	Sun & sea	**Cultural**	**Business**	**Medical**	**Visiting family and friends**	**Day tourists**
Tourism policy	Ownership requirements for large Hotels and tour operators	Nationality restrictions on tour guides				
Transport services and infrastructure		Competitive transport services to key sites	Efficient support services		Competitive local transport	Competitive local transport
Financial services	Access to credit for large development; Financial products for mass tourists					Spread of financial products (such as ATMs)
Business environment	Land policy	Land policy	ICT regulatory framework			Trade policy and duty free shopping
Air access	Air access for mass tourism					Air access for mass tourism
Health sector policy				Accreditation of health services; provisions for private ownership		
Migration policies			Visa requirements Work permits	Visa requirements (of health professionals)	Returning migrants	

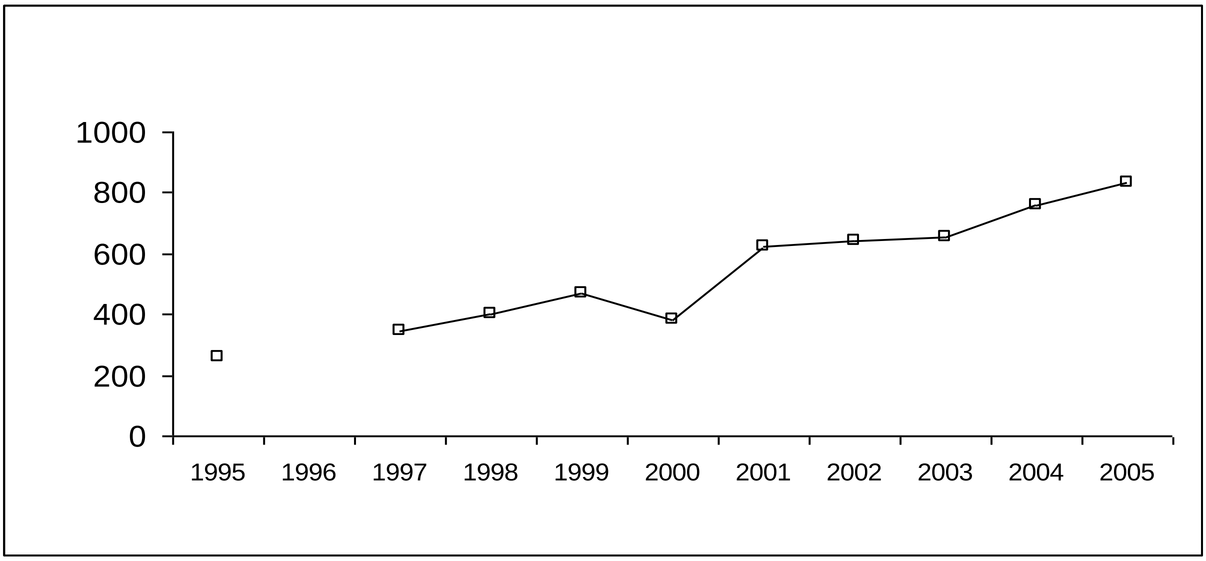
Source: Mitchell and Te Velde (2008).

Box 1 below discusses the effects of regulatory reform in Tanzania.

Box 1: General effects of regulatory reform in tourism in Tanzania

There has been an overall increase in tourism arrivals and spending in Tanzania. However, there was a dip in 1999, which might have been caused by political violence in neighbouring countries. The overall increase occurred at the time of the Tourism Master Plan of 1996–2005, which aimed to promote competitiveness and sustainability.

Tourism spending in Tanzania (US$ mn)



Source: World Development Indicators and national sources.

The government has liberalised the tourism services in three steps:

- Transferring of non-core functions of the Tourism Department to the private sector;
- Privatisation of formerly state owned tourist parastatals; and
- Enhanced capacity of the Tanzania Tourist Board.

After the reform beginning in the mid-1990s, the development of the tourism sector has been positive. Tourism has offered significant employment opportunities, directly and indirectly. In 1995, there were 120 tourism service providers, but this is currently at more than 300. Direct employment was around 29,000 in 2000, but by 2003 fulltime jobs were up to 245,000. In 2006, there were 349 establishments investing in accommodation. Cultural and nature tourism (local community-managed projects) have increased from nine projects in 1997 to 24 projects in seven regions (Tanga, Morogoro, Dar es Salaam, Arusha, Manyara, Kilimanjaro and Mbeya). The liberalisation and privatisation of the tourism sectors has been successful, although severe challenges remain, such as continued reforms (especially in other sectors) to attract investment and human resource development. There is no national airline, but the East African Community has begun to harmonise aviation policies, which should help to attract tourists.

3.5 Complementary policies required to maximise benefits for development

There are three types of complementary policy that can help improve the impact of tourism liberalisation on development: adjusting the scope of trade liberalisation; promoting capabilities and development of the tourism sector using government and business policies targeted at the tourism sector; and reform and complementary policies in other sectors. The appropriateness of the type of complementary policies will depend on initial economic conditions as well as the type of tourism attracted, and this differs by country and over time (e.g. Mauritius is shifting gradually from high-quality to high-volume tourism).

3.5.1 Types of trade policies

First of all, it is possible to limit liberalisation or provide limitations to liberalisation and, as such, eliminate some of the risks, but this will also reduce the potential benefits (one could argue whether this is a complementary policy at all, but we have included it here because there are limiting measures that can coincide with other liberalising measures).

3.5.2 Promoting domestic capabilities

However, as discussed in the case of tour guides in Botswana, it is more efficient to promote local capabilities in tourism than to protect local operators behind regulatory walls. There are a number of ways in which local capabilities can be promoted and these do not vary significantly from normal development policies, although there could be a targeting element. The government can:

- Promote education and skills development related to tourism
- Provide infrastructure
- Ensure a sufficient amount of credit is available to the local hotels, or those that supply it, and
- Help local hotels with marketing using tourist associations and their presence abroad

Local hotels face more difficulties in marketing because they are not tagged into global booking systems. They depend on marketing through the internet. Further, there is often a mismatch between the supply of the education sector and the demand of the tourism sector. Often, countries still do not promote the tourism sector as a growth sector with good careers, resulting in managers needing to be imported and a lack of entertainers, artists, cooks and restaurant managers.

Qureshi and te Velde (2007) discuss how government promoted the development of tourism in St Lucia. There are various views on what caused the emergence of the tourism industry, but there is consensus that the government did play a useful role over the years, including proactive use of infrastructure. Public sector representatives point to the commercial interest of individuals in setting up hotels in the 1970s as the kick-starter of the tourism industry. Some significant government support for tourism followed; e.g. marketing budgets have increasing markedly over the past decade.

Private sector representatives are quick to point out that the government (with development finance support and private entities) played a useful role in developing the north of the island in the 1970s, where most hotels are currently located, reinforcing the importance of tourism. Before 1965, there was no tourism industry, but the government was willing to offer tax incentives and access to the beaches and to provide infrastructure, paving the way for more hotels and initial development of a marina and a yachting sector. This set the tourism sector off in order to reduce dependence on bananas (and sugar before that). New hotels were built, fuelling a construction boom. Tourism is now more than four times the size of the banana sector.

The private sector can also help with the development of the tourism sector. In many cases, the private sector already provides training to its workers, with possible externalities to other activities, although the tourism sector will depend on a minimum scale and quality of basic education. Most countries have an association of hoteliers that can lobby on behalf of the hotels, in some cases complemented at regional level (e.g. in the Caribbean). This is something that can be supported by the private sector. Table 2 shows tourism associations in Belize as an example.

Table 2: Tourism associations in Belize

Belize Tourism Board	Statutory board within the Ministry of Tourism which functions as a strategic partnership between government and the private sector to develop and implement tourism programmes in Belize.
Belize Tourism Industry Association	Formed in 1989, the BTIA is a private sector organisation aimed at promoting sustainable tourism.
Belize National Tourism Council	BNTC comprises the presidents of various public and private organisations, such as the Belize Hotel Association (BHA), the Belize Tour Guides Association, etc. The aim is to enable the government, private sector and community groups to work together and develop an integrated national tourism policy and plan.
Border Management Authority	Formed in 1999, the BMA works in association with the Belize Tourist Board. The BMA administers the border points and provides professional services to tourists arriving at Belize's two inland entry points.
Belize Hotel Association	The BHA is a non-profit nongovernmental organisation (NGO) whose members comprise primarily hoteliers, with a category of allied members who actively service the hospitality industry. The BHA encourages and supports the sustainable growth of member hotels through lobbying efforts, national and international linkages, marketing initiatives and training opportunities.

Source: BTB (2001).

More generally, public and private sectors can promote the development of backward linkages between hotels and agriculture in terms of procurement. Linkages depend on local economic conditions, government policies, strategies of the hotels and the institutional framework. Institutions can be set up to improve linkages between hotels and groups of farmers (see Timms 2006).

Such options are sometimes supported by international donors (te Velde 2005). The Cotonou Partnership Agreement (CPA) Article 24 deals with tourism:

> Cooperation will aim at the sustainable development of the tourism industry in ACP countries and sub-regions, recognising its increasing importance to the growth of the services sector in ACP countries and to the expansion of their global trade, its ability to stimulate other sectors of economic activity, and the role it can play in poverty eradication. Cooperation programmes and projects will support the efforts of ACP countries to establish and improve the countries' legal and institutional framework and resources for the development and implementation of sustainable tourism policies and programmes, as well as *inter alia*, improving the competitive position of the sector, especially small and medium-sized enterprises (SMEs), investment support and promotion, product development including the development of indigenous cultures in ACP countries, and strengthening linkages between tourism and other sectors of economic activity.

Some of this has happened (e.g. Suriname and St Lucia) but more could be done. Box 2 shows the differential impact of tourism in Cambodia and Vietnam.

Box 2: Building local linkages for an enhanced impact of tourism

Vietnam and Cambodia have experienced significant tourism only in the last decade. Despite a weak enabling environment in many respects, tourism is growing rapidly, but in very different ways in the two countries. Beyond arrival numbers and the magnitude of the tourism economy, there is an interesting contrast in the developmental impact of tourism in Cambodia and Vietnam. Cambodia is highly dependent upon tourism, with tourism receipts worth 17.2% of GDP. However, the development impact of these resources is limited and tourism is demonstrating a financial and political economy impact which resembles some of 'worst practice' of the extractive industry. The tourism sector is dominated by a single attraction at Siem Reap, the location of the Angkor Wat temples. An IFC analysis of the tourism value chain at Siem Reap indicates that about 8% of tourist expenditure at the destination remains in the local economy. This reflects the poor state of Cambodian complementary policies. The lack of local economic linkages with tourist destinations reflects the low levels of human development, poor infrastructure and governance issues. On the latter point, the exclusive access of Bangkok Airways on the lucrative Phnom Penn – Siem Reap flight; the capture of almost all the US$20m temple entrance fund by national government; and the 'land grab' going on around Siem Reap are particularly striking examples.

In neighbouring Vietnam, the developmental impact of tourism is quite different and more positive. Tourism only comprises 6% of GDP in Vietnam, mainly because the non-tourist economy is much better developed. This allows much stronger linkages between the tourism and non-tourism economy and, as labour becomes scarce, tourism wages are increasing rapidly. The development of the non-tourist economy is also critical in generating a form of tourist demand that is unaffected by external factors, which can have serious negative impacts on long-haul tourism, such as terrorism or SARS or avian flu – namely, domestic tourism. A tourism value chain study in central Vietnam, using a similar methodology to that applied in Siem Reap, found the pro-poor 'local content' of tourism was about one-quarter of total tourist expenditure (and much of the remainder benefited Vietnam rather than 'leaking' beyond the national economy).

There are two relevant implications. First, tourism is growing quickly in these new destinations – notwithstanding their quite adverse regulatory environment – because they are cheap and safe destinations located in a rapidly growing regional economy. Second, although tourism is a larger and more important share of the Cambodian economy, tourism activities have a greater developmental benefit per unit of activity in Vietnam because of better developed linkages with the rest of the economy. This non-tourism economic growth is, in turn, fuelling the growth of domestic tourism which is as important financially as international tourism.

Source: Mitchell and Te Velde (2008).

3.5.3 Complementary reforms in other sectors

There are a number of reforms that will complement tourism liberalisation (see also Box 3).

Air access policy

Tourism arrivals depend on air access, which depends on air access policies (and other transport policies). Many developing countries maintain a national air carrier and protect it from competition with other airlines. However, more and more countries have begun to liberalise and sign 'open skies' agreements. The move towards open skies agreements received a significant boost through the US Department of Transportation after 1992 and its bilateral air services agreements. Bilateral open skies agreements allow for unrestricted air services by all airlines between and beyond the two countries concerned, including entry on all routes, unrestricted capacity, frequency and tariff rights (including fifth freedom rights pertaining to picking up passengers in third countries destined for the two countries concerned) and a liberal view on pricing. The US is currently operating more than 58 such agreements.

Open skies policies are successfully being used by the EU, Australia, New Zealand, Dubai, Hong Kong, Kuala Lumpur and Singapore. Dubai hosts the fastest-growing airport as well as one of the fastest-growing airlines, Emirates, launched in 1985 with a profit every year since and which flies to 70 destinations around the world. Dubai airport accommodates 100 airlines connecting to 145 destinations. Dubai and the airline have helped each other grow and bring the tourists. Generally, the number of airlines serving the airport varies considerably, ranging from 10 in New Zealand and Mauritius, to 20 in Barbados, 30 in Jamaica and the Dominican Republic and 50 in Singapore, in part reflecting the degree of open skies policy.

Reviewing evidence worldwide, Richman and Lyle (2005) argue that:

- Air transport liberalisation has been successful as a channel and catalyst for increased economic growth and employment, especially related to tourism.
- A decline in market share and traffic of the national carrier is likely to be much more than compensated by the benefits to the economy from increased air traffic to and from the country.
- The alternative to liberalisation is likely to prove much more costly to both a national carrier and the economy in the medium term, with a probably increasing need for public subsidy to the carrier and an increasing opportunity cost for development of the national economy.

Myburgh et al. (2006) perform a statistical analysis of the effects of liberalisation on prices of flights and the number of visitors by air. They argue that, on 56 routes in the Southern Africa Development Community (SADC) (including Botswana), airfares are 18% lower on liberalised routes, which could have increased passenger volumes by 14–32% (if capacity is available). The presence of a low-cost airline on a given route has reduced prices by an average of 40%, which could have increased passenger volumes by 32–72%.

The Caribbean has had some experience with open skies agreements with the US. For instance, in a World Bank report (Jha 2005), it is argued that the US/Dominican Republic open skies agreement has led to relatively low airfares per kilometre to Miami.

Jamaica has had an essentially open skies agreement with the US since 1979 (with the new 2002 agreement providing for a similar regime in addition to code-sharing) and, over time, Air Jamaica has increased the number of points services from four in 1979 to 12 in 2002, accounting for the highest market share for a single carrier. During the period, there was a 12% annual increase, from 450,000 to 1.2 million passenger arrivals. While code-sharing with Delta was successful, the new more liberal regime for code-sharing was regarded as a threat.

Multilateral agreements have also been concluded among members of the Caribbean Community (CARICOM) and the Association of Caribbean States (ACS). CARICOM has also had a longstanding desire to conclude an open skies agreement with the US, though the US wants this on a country-by-country basis (58 in addition to the US).

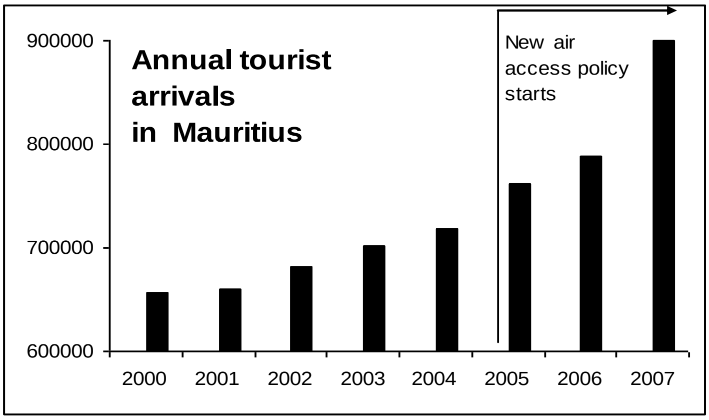
Evidence for Botswana shows that air access is relatively constrained and more expensive than in other countries. Richman and Lyle (2005) compare prices of flights for destinations under 1200km from Johannesburg. The costs of flights on relatively unconstrained routes where British Airways (BA)/Comair competes with the national carrier and Comair's no-frills carrier kulula.com has entered the market tend to be lower, at SA Rand 0.52 per km to Windhoek and R0.65 per km to Harare. This is in contrast with R1.57 per km to Maputo and R2.01 per km to Gaborone. Both of these latter are more constrained routes, along with only the national airlines of each country are allowed to fly. This indicates the relatively high price of flights to Botswana.

In Swaziland, air transport is a key component of passenger transport, especially concerning links with the regional hub of Johannesburg. One company (Airlink Swaziland, a joint venture between the government and South African Airways) operated the principal link between Manzini and Johannesburg five times a day and a second (the privately owned Swazi Express) had recently started to operate the same route twice a day. This was the first form of competition in the Swazi air transport sector, and it had lowered prices by two-thirds. When Airlink operated a *de facto* monopoly on the route, its yield per passenger (R800) and profitability (14%) were high.

Box 3: Air access policy

The experiences of air access policies by Mauritius, South African and Botswana clearly show the effects of liberalisation. The first chart below shows that annual tourist arrivals in Mauritius began to rise sharply after 2005, when a new air access policy was put in place which gradually liberalised bilateral air services agreements to key countries in Europe, Africa and Asia. Mauritius had long promoted high-spend, low volume tourism, but this has changed recently and with the help of more liberal BASAs it is now aiming for a tripling of tourists to 2020.

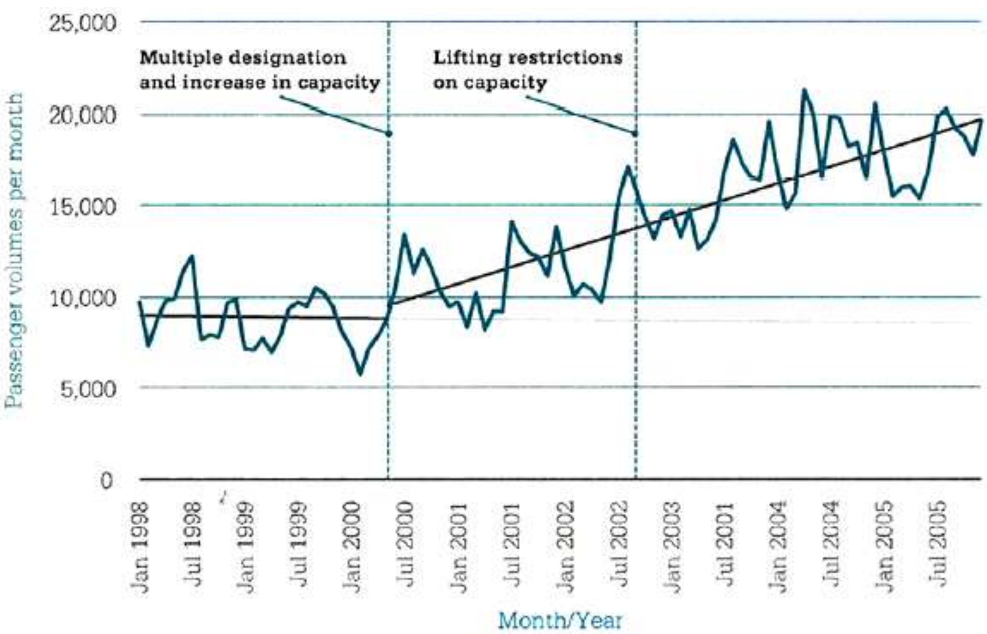
Air access and tourist arrivals in Mauritius



Source: UNWTO, WEF and Mauritius CSO.

In South Africa, liberalisation of domestic air routes in the early 1990s – and partial liberalisation of international routes in the early 2000s – has seen a sharp drop in air fares, and corresponding increase in passenger volumes (Genesis Analytics 2005), see chart below. Air transport liberalisation on SADC would lead to half a million additional foreign tourists – bringing an additional US$0.5bn tourist expenditure into the wider economy. Including the multiplier effect, this spending would increase GDP in Southern Africa by US$1.5bn – or 0.5%.

Passenger volumes on the Johannesburg – Nairobi route 1998–2005



Source: Genesis Analytics

Competition policy

The tourism industry has become increasingly concentrated, which has led to a fear that tour operators will abuse their monopolistic power, which could drive down compensation paid to local hotels (Jules (2005) suggests that developed country tour operators claim 75% of the value of a package, though this by itself is not evidence of the abuse of monopoly power). A Dominican Republic proposal for a new tourism annex to the GATS includes three provisions: the need for multilateral competitive safeguards to counter anti-competitive practices in the international tourism sector; the need to promote sustainable tourism development in the GATS; and the need to expand the definition of tourism under the GATS agreement. Thus, one possibility is to include provisions on competition policy (in GATS or economic partnership agreements – EPAs) so that the Caribbean can make a case when large tour operators operating from developed country markets behave uncompetitively.

Other complementary regulations relate to:

- Health and safety standards and food hygiene (because the developed country operators demand this)
- Consumer protection (e.g. against bankruptcy; depends on the home country of the tourist) and
- Environmental regulation

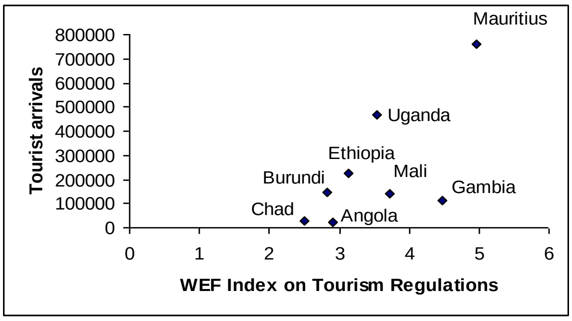
Overall, the tourism sector (e.g. the hotel sector) tends to be a liberalised sector in developing countries compared with other sectors, although there are areas (e.g. tour guides) where there are still sensitivities and protectionist elements. Developing countries will have realised the importance of appropriate frameworks that are non-trade-distorting in tourism, helpful for making GATS commitments. The relevance of this in itself would need to be understood: can we identify the way in which trade liberalisation has taken place in tourism and could this be a role model for other sectors? This relatively liberal stance has coincided with a very important static effect of tourism on development in terms of value added, incomes and employment as well as dynamic effects on the rest of the economy. Rather than protecting the tourism sector, especially the smaller and local players, from foreign involvement, it is more efficient to think about complementary policies to promote the sector and its effect on development. This involves regulatory issues such as air access, competition policies and heath, safety and quality standards, or helping to promote local capabilities such as skills and infrastructure.

Box 4: Effects of regulations – quick examination

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

A quick examination reveals a positive link between regulatory indices and tourist arrivals. The chart shows that African countries with more tourists also have a better score on the WEF tourism regulatory index. This regulatory index measures the extent to which foreign ownership and FDI are welcomed and facilitated by the country, how well property rights are protected, the extent to which visa requirements make it complicated for visitors to enter the country and the openness of bilateral Air Service Agreements.

Tourism regulations and tourist arrivals



Sources: UNWTO, WEF and Mauritius

Source: Mitchell and Te Velde (2008).

3.6 Conclusion

Tourism is the biggest export service sector in many low-income developing countries. Its value is set to increase further in all world regions, and especially developing countries, reflecting increased demand and comparative advantages. The tourism sector (e.g. the hotel sector) tends to be liberalised in developing countries compared with other sectors, although there are areas (e.g. tour guides) where there are still sensitivities and protectionist elements.

Developing countries have already realised the importance of appropriate frameworks that are non-trade-distorting in tourism, helpful for making commitments in international service negotiations. The relevance of this in itself would need to be understood: can we identify the way in which trade liberalisation has taken place in tourism and could this be a role model for other sectors?

This relatively liberal stance has coincided with the large impact of tourism on development in terms of value added, incomes and employment in static terms, as well as dynamic effects on the rest of the economy. Rather than protecting the local tourism sector, especially the smaller players, from foreign involvement, it is more efficient to think about complementary policies to promote the (local) sector and its effect on development.

Governments can use a variety of policy tools

- They can use tourism regulations, other regulations and complementary factors to raise the spending and development effects of each tourist. Some governments discourage all-inclusives (Gambia) but while this may have increased local spending it may have dampened the number of arrivals.
- They can encourage linkages, and while local content rules for services are more flexible than those for goods, there is little evidence that they work for the sector.
- They can promote grading and improve the quality of accommodation, but there are questions about the capacity of governments to monitor this. Useful complementary regulations include a more liberal retail and financial services sector (e.g. automatic teller machines – ATMs). Other complementary factors include improving local capabilities to supply the tourism sector, including agriculture and cultural services (e.g. artists or other attractions).

A review of tourism policy based on experiences in developing countries suggests:

- A more liberal stance to air access will help to increase tourist arrivals.
- A more liberal regime in the tourism support services (e.g. transport handlers and other business indicators such as access to finance) has been an important factor behind a more rapid increase in tourist arrivals.
- Despite weak regulatory frameworks for tourism some countries can attract more tourists by supporting a more diversified tourism product and accommodative air access policies.
- Poor human resources and economic infrastructure and weak local food supply chains and governance cause weak linkages between tourism and the poor.
- When the capacity to provide health services is available as well as the demand, then regulatory coordination can facilitate trade in health tourism.
- While incentives may have facilitated the attraction of hotels in some countries, they are often not monitored or linked to performance weakening their impact.
- Governments in some counties have liberalised the tourism services by transferring non-core functions of the tourism departments to the private sector and privatising formerly state-owned tourist parastatals. After such reforms, the development of tourism sector has often been positive.
- Although some countries have liberalised the tourism sector with success and have implemented community-oriented tourism plans, challenges remain in further developing the sector. Regulatory challenges relate to complementary issues such as business indicators, e.g. weak policies in the area of tax rates and costs to finance, tax administration, skills/education of workers and access to electricity and land.

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4. Financial services

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

However, in many developing countries, access to formal financial services is very limited, particularly for poorer households and SMEs, and it is likely that this lack of access to finance significantly constrains economic growth and reduces the ability of the poor to participate in markets, to increase their income and to themselves contribute to economic growth.

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

The financial sector in many developing countries has commonly been characterised by high levels of state ownership and government intervention, which have often seriously damaged the performance and efficiency of the sector and worsened access to finance. Thus, substantial reform programmes may need to precede or accompany financial sector opening, involving financial deregulation, bank restructuring and commercialisation and privatisation to create market incentives and to improve the competitiveness and productivity of domestic banks. However, experience has shown that financial reform must itself be carried out carefully, in an appropriately sequenced manner, and with the establishment of an effective regulatory framework as an important prerequisite, as it can otherwise lead to instability and financial crisis. The recent global financial crisis highlights the risks associated with financial sector openness, as integration into world financial markets can increase vulnerability to contagion.

There has often been an implicit assumption that financial opening promotes better access to financial services. However, most foreign banks have focused on areas where local profit opportunities are perceived to be the greatest – providing financial services to large firms in urban areas. Governments need to improve the enabling environment to reduce the costs associated with widening access, and to find ways to provide stronger and more market-friendly incentives for banks to serve the lower-income end of the market.

4.1 Introduction

Many countries, both developed and developing, have to a significant degree liberalised and opened up their financial sector to foreign financial providers. The extent of liberalisation is often not fully reflected in GATS commitments, perhaps because countries are unwilling to bind their commitments, which would potentially limit future policy space. Most developing countries have a relatively underdeveloped financial sector so, for many, exports of financial services are likely to be limited, even where trade is fully liberalised. For these countries, trade liberalisation is likely to result mainly in the entry of foreign providers establishing a commercial presence (i.e. Mode 3 imports), either as new players or by acquiring existing domestic banks. However, financial institutions from developing countries – particularly middle-income countries such as South Africa – are increasingly moving into foreign markets, often in other developing countries, and some developing country banks have established a regional presence.

For a number of developing countries, particularly small island economies (SIEs) like Mauritius and the Cayman Islands, the provision of offshore financial services has become a key export. Such trade is either through Mode 1 (cross-border supply) or Mode 2 (when clients travel to or take up residence in the offshore financial centre (OFC), usually on an intermittent basis in order to use the service). The development implications of these kinds of exports are significant and controversial, and are discussed further below.

Other countries, such as India, have benefited from increased outsourcing by developed country financial providers of certain functions, such as back-office administration and customer services call centres (Mode 1). Deloitte (2005) estimates that, by 2010, more than 20% of the financial services industry's global cost base will have shifted offshore, and this trend is likely to continue, given that significant opportunities remain for financial service providers to reorganise their operations more efficiently at a regional or global level.

This section focuses mainly on the development impact of market entry by foreign financial institutions, as this is the commonest form of financial services trade for most developing countries. It also focuses on the banking sector, given its role as the cornerstone of the financial sector, and its importance for the functioning of the economy generally. Other financial services, such as insurance, remittances and stock exchanges, are also important for development, but a detailed analysis of each individual financial service is beyond the scope of the current study. Banks also provide many of these services themselves.

4.2 Contribution of the sector to development, growth and poverty reduction

DFID (2004) sets out the crucial role the financial sector plays in the economy, facilitating private sector development, stimulating investment and growth and contributing directly to poverty reduction. It does this by reducing transactions costs between firms, facilitating capital inflows and remittances from abroad and mobilising domestic savings that can be productively reinvested, making credit available to finance business start-ups, expansion and investment (in new technology, for example) and allocating capital efficiently, ensuring it is used in the most productive way possible.

The financial sector also enables firms and individuals to better manage risks, through the provision of insurance or secure savings vehicles that can be drawn on when necessary, and by facilitating risk diversification. This additional security in itself serves to increase investment. Thus, the financial sector has a crucial role to play in facilitating investment in both physical and human capital, in stimulating technological progress and in increasing productivity and growth.

There is a large body of evidence showing the positive relationship between the level of financial sector development and growth. Indeed, many studies find the effect is likely to be large. King and Levine (1993) show that, if Bolivia had increased its financial depth in 1960 from 10% of GDP to the mean value for developing countries in 1960 (23% of GDP), then the country would have grown about 0.4% faster per annum so that, by 1990, real per capita GDP would have been about 13% higher than it was.

DFID (2004) explains how financial sector development can also reduce poverty, indirectly through its impact on growth and directly to the extent that it increases access to financial services for the poor. The provision of a bank account that enables an individual to accumulate funds in a secure place over time – not at risk of being stolen or plundered by other family members – or access to credit that enables them to borrow funds can strengthen their productive assets by enabling them to invest in micro-enterprises, in productivity-enhancing new 'technologies', such as new and better tools, equipment or fertilisers or in education and health. All of these can play an important role in improving productivity and income over time.

Savings, insurance or access to credit can also minimise the negative impacts that unexpected fluctuations in income or outgoings can sometimes have on longer-term income prospects, if income-generating assets (such as cattle) are sold at low prices out of necessity during a household crisis. Deaton (1991) argues that it can also reduce the proportion of low-risk, low-return assets (such as jewellery) held by households for precautionary purposes, and enables them to invest in potentially higher-risk but higher-return assets (such as education or a rickshaw), with overall long-term income-enhancing impacts.

Again, there is empirical evidence of the relationship between financial sector development and poverty reduction. For example, Honohan (2004) shows that a 10 percentage point increase in the ratio of private credit to GDP is associated with a 3 percentage point reduction in poverty. Jalilian and Kirkpatrick (2001) find that a 1% change in financial development raises growth in the incomes of the poor in developing countries by almost 0.4%.

However, in many developing countries, access to formal financial services is very limited, particularly for the poor, and it is likely that this lack of access significantly constrains the ability of the poor to participate fully in markets, to increase their incomes and to contribute to economic growth. Similarly, a lack of access to credit can reduce the ability of entrepreneurs to establish and expand their businesses, which may also hamper growth. The World Bank (2007) reports that over 40% of firms in three regions (Latin America and the Caribbean, the Middle East and North Africa and sub-Saharan Africa) cite lack of access to finance as a significant obstacle to firm growth. Thus, a well-developed financial sector is a crucial component of a good investment climate.

Quite a number of small island economies (SIEs), such as Antigua, the Cayman Islands and Mauritius, have established OFCs, which offer a combination of low tax rates, a light touch regulatory regime and strict secrecy laws to preserve the anonymity of investors. For these countries, alternative development strategies can often be fairly limited, given their small and distant markets, limited natural and human resources and vulnerability to natural disasters. Exporting financial services has given many of them a chance to diversify away from the production of primary commodities and instead to develop a role in a modern, growing market, which has contributed to greater foreign exchange earnings and government revenues, infrastructure development and improvements in human capital, with knock-on benefits for the development of the tourist industry.

> Small islands with OFCs have performed impressively and made substantial strides in their economic and social development. This, and the fact that these countries frequently and persistently inhabit the upper echelons of the UNDP's [United Nations Development Program] Human Development Index and the World Bank's Income Groupings, lent credence to the perception that offshore finance has been instrumental in lifting many of the 36 island economies that currently host OFCs 'from the poverty of the developing world to levels of affluence few would have believed within their grasp (Woodward 2006).

However, there are many concerns about the impacts of OFCs, or tax havens as they are commonly known, on development more generally, in relation to harmful tax competition (where corporations and high net worth individuals are able to avoid paying taxes, resulting in large losses of revenue for governments, which are forced either to reduce expenditure or to rely on more regressive forms of taxation), money laundering and possible implications for global financial stability. Oxfam (2000) estimates that tax avoidance by multinational companies in developing countries amounts to US$50 billion annually, equivalent to the entire flow of global aid programmes. This has led to measures in recent years designed to clamp down on OFCs, such as the EU Savings Tax Directive and the OECD's Global Forum on Harmful Tax Practices, which both have potentially significant compliance costs Woodward (2006) estimates that the EU Savings Tax Directive will cost financial service providers US$30 million a year in the Cayman Islands alone.

Hampton and Christensen (2002) argue that these measures represent a potentially serious threat for SIEs that have become overly dependent on income from their activities as OFCs, especially if such activities have crowded out other local industries (by driving up prices, which reduces their competitiveness in other markets, and by absorbing a high proportion of the skilled labour available in the economy, thus preventing the development of other industries).

It appears that the implementation of the measures has been weakened by opposition from strong vested interests, and the offshore sector has continued to grow, offsetting compliance costs associated with the Savings Tax Directive. Thus, Woodward (2006) argues that the outlook for many OFCs remains positive – particularly for the most developed and reputable centres, which cater for a wider and more sophisticated market, and which have benefited from efforts to improve transparency, making them more attractive to legitimate business clients. The authors concede, however, that there is some evidence that jurisdictions lying outside the remit of the EU and the OECD may have gained some business at the expense of SIE OFCs, and that there has been some consolidation among financial institutions, with some of the smaller, lower-margin OFCs suffering a significant decline as a result of higher compliance costs and the inability to compete on the basis of regulatory laxity.

4.3 Financial sector liberalisation: What is involved?

The main focus of this paper is liberalisation in the sense of opening up a sector to trade with foreign providers. However, the phrase 'financial sector liberalisation' is often used to describe a much wider process of financial sector reform, in which government controls over the actions of financial institutions are removed (sometimes called financial deregulation) and controls over international capital flows may also be removed (capital account liberalisation). These wider processes of financial sector liberalisation have not always had the desired impact on growth and have often contributed to financial instability. As a result, there has been considerable debate in the literature over their appropriateness in developing countries (reviewed in Demetriades and Andrianova 2003).

Although these wider reforms are often undertaken in parallel with an increased openness to trade in financial services, this is not a requirement. (Mode 3 financial services trade does not require an open capital account, although for most forms of Mode 1 financial services trade – excluding the provision of customer services – it is required.)

This section necessarily includes a discussion of the wider processes of financial and capital account liberalisation, and issues of sequencing, but the main focus is on the impact of removing barriers to trade in financial services. As such, in this section, the latter process is referred to as financial sector **opening,** rather than liberalisation, to avoid confusion with the more usual use of the phrase 'financial sector liberalisation' in the literature.

This much narrower process of financial sector opening usually involves the establishment of more liberal licensing policies for new banks and other financial institutions, the creation of a level playing field (in terms of regulation and taxation) between domestic and foreign financial service providers and the reduction of barriers to inward FDI in the financial sector.

Claessens and Glaessner (1998) elaborate on (and construct an index which measures) the specific types of barriers to entry and trade in financial services that exist. They include:

- Limits on the availability of new banking licenses;
- Limits on establishment by foreign banks or on equity participation by foreign financial institutions in domestic banks;
- Eligibility criteria/government approval required for establishment;
- Constraints on operational activities of foreign banks, such as the establishment of branches or automatic teller machines (ATMs) and the services that may be offered by foreign branches (e.g. foreign exchange, credit cards, deposit acceptance);
- Residency requirements for board membership or for membership of the stock exchange;
- Constraints on lending or the imposition of directed lending;
- Capital controls and constraints on access to offshore financial instruments.

4.4 Benefits and risks of financial sector opening

Openness to foreign financial service providers is expected to stimulate competition in the sector, resulting in greater efficiency, dynamism and innovation (as set out in Clarke et al. 2001a, for example). It can help to stimulate improvements in domestic banking performance and has significant potential benefits for consumers through improved service delivery and for the economy as a whole because of the more efficient allocation of capital that occurs as a result of improvements in the evaluation and pricing of credit risks.

This is particularly true in countries with the most underdeveloped financial sectors, which have often been dominated by state-owned banks and subject to high levels of government intervention.

> Foreign banks may be able to operate in a more efficient way than domestic banks, mainly because they are likely to have a longer experience operating in a competitive environment than domestic banks in African countries. Foreign banks are therefore, for instance, used to dealing with variable prices (e.g. interest rates, fees, commissions), to assessing the risk of projects and, more generally, they are used to choosing activities in a way as to maximise profits. They may also be aware of more sophisticated financial instruments than domestic banks and of more advanced management methods. As a consequence foreign banks are expected to provide different types of financial services to African clients and may be able to offer their services at a better price-quality relationship (Jansen and Vennes 2006).

Banking practices may also improve through the diffusion of new technologies, skills and best practice, as domestic banks imitate more efficient practices or acquire staff with more sophisticated skills from foreign entrants. Foreign banks may also be less politically connected and hence less likely to exert self-promotional influence on the regulatory authorities. Thus, the presence and influence of foreign banks may also help to build a better supervisory and legal framework and enhance overall transparency in the sector.

Foreign entry is often through acquisition or joint ventures with local banks with a view to restructuring and improving their performance, and can therefore bring significant benefits to the host country.

> In 1990, after many years of operating deficits, loan losses and a failed attempt at privatisation, the government-owned Agricultural Bank of Mongolia ("Khan" Bank) was placed in receivership. Today it is the financial institution posting the highest return on equity of any Mongolian bank. In March 2003 HS Securities of Japan bought Kahn Bank from the Government of Mongolia for US$6.85 million. Khan Bank now operates a network with 379 points of service throughout Mongolia, many more than any of the other 16 banks operating in the country (and up from 269 when the new management took over). One out of every two Mongolian households today is a client of Khan Bank and it continues to expand its branch network and services (Claessens 2006).

Empirical evidence supports the contention that financial sector opening contributes to improved financial sector performance and has important knock-on benefits for the rest of the economy. In a study of 60 developed and developing countries, Mattoo et al. (2001) found that countries that were open to trade in financial services achieved growth rates up to 1.2 percentage points higher than rates in other countries over the period 1990–9. A good number of empirical studies confirm that, in developing countries, foreign banks tend to be more efficient than their domestic counterparts (see, for example, Barajas et al. 2000; Bhattacharya et al. 1997; Clarke et al. 2000; Demirguc-Kunt and Huizinga 2000; Kiraly et al. 2000) and that entry of foreign banks increases the efficiency of the domestic banking sector by reducing the costs and profitability of domestic banks (e.g. Claessens et al. 2000). A range of country case study evidence supports these findings, including for Turkey, Hungary and the Philippines (see Denizer 2000; Hasan and Marton 2000; and Unite and Sullivan 2003, respectively). Claessens and Glaessner (1998) show that limits on foreign financial firms in Asia resulted in slower institutional development and more costly financial services provision.

There is a risk that the additional competition generated by foreign entry may result in bankruptcies for some local banks, leading to potentially substantial losses for depositors and employees. This raises questions of appropriate sequencing, with processes of bank restructuring or commercialisation, as well improvements in prudential regulation, perhaps needed before market opening is attempted, to minimise the probability of domestic bankruptcies and financial instability (this is discussed further below).

As discussed in Clarke et al. (2001a), this has raised concerns about the impact of market opening on access to finance for SMEs. Large multinational banks may not be very well-placed to provide relationship lending services to small businesses. They are likely to prefer standardised methods for assessing creditworthiness based on readily available information. Thus, if foreign competition forces some small domestic banks to exit the market, access to credit for small businesses, which have previously relied on relationship banking services with these smaller local banks, and which may not be able to provide the kind of standardised information that large banks require, could decline.

The evidence on this is mixed, with some studies (e.g. Berger et al. 2000) confirming that SMEs are less likely than larger enterprises to receive credit from large or foreign banks. However, in other studies, foreign banks have been found to improve access to credit for those firms. For example, Clarke et al. (2001b) and Clarke et al. (2003) show that, in Chile and Peru, foreign banks loaned more to small firms than domestic banks did; in Argentina and Chile, real growth in lending to small firms was higher for foreign banks. Increased data availability and advances in credit scoring methodologies and technologies that have been introduced by foreign banks are making it easier for large foreign banks to lend to smaller firms without establishing a commercial presence in each area.

Nonetheless, most evidence suggests that foreign banks tend to focus their efforts on specific lines of business (often in the corporate sector) and it is mainly in these sectors that competitive pressures drive down costs and profit margins for domestic banks. For example, Clarke et al. (2000) showed that in Argentina the impact of foreign competition was much greater in the manufacturing sector, where foreign banks undertook most of their lending, than in consumer lending, where foreign banks had not been heavily involved.

But even if foreign banks continue to focus on serving large, corporate customers, Clarke et al. (2001) show (using a survey of over 4000 enterprises in 38 developing and transition countries) that this can in fact benefit smaller borrowers indirectly, by stimulating such strong competition in the corporate sector that some banks are forced to move into new markets that they might not previously have served. Jenkins' (2000) study of banks across 78 countries shows that 44% of those banks that lent to small and micro-enterprises said that changed market conditions and stronger competition in lending to large and medium-sized enterprises were the two most important reasons for doing so.

Nonetheless, concerns remain about the impact on stability of 'cherry-picking' by foreign banks, where they focus on serving the most profitable clients and force domestic banks to serve less profitable customers and market segments. This may be seen as contributing to greater access for certain groups, but it may also result in higher levels of risky lending, which may in turn increase the fragility of the sector, potentially resulting in bankruptcies and instability. Thus, the existence of a strong regulatory framework is an important prerequisite for market opening, to ensure that banks do not take inappropriate risks and have adequate risk management arrangements in place (through capital adequacy requirements, etc.) This is discussed further in the next section below.

Foreign entry may also stimulate innovation and the provision of new products or better services by the foreign entrants themselves and by local banks. For example, Bonin and Abel (2000) show that competition from new foreign entrants in Hungary stimulated the main domestic bank to develop new products and better services for households, such as bank cards and ATMs. The bank was able to become the main player in that market, taking advantage of its existing branch network.

Foreign banks can also use their international experience to introduce innovations. The World Bank's World Development Report (2005) cites an example whereby Citibank overcame the lack of credit information on enterprises in many developing countries by introducing a new mechanism for establishing creditworthiness, based on an estimate of growth prospects in particular industries.

Financial sector opening may also facilitate much-needed capital inflows, as foreign financial institutions are likely to have access to larger and more internationally diversified funds. However, in order to take advantage of this, the capital account must also be at least partially liberalised, and this can bring financial instability if not managed properly, as discussed further below.

Opening up the financial sector to foreign banks may increase the risk of financial contagion from other countries experiencing financial difficulties, as the recent global financial crisis has highlighted. This represents a potentially significant risk associated with financial sector openness, as integration into world financial markets can increase vulnerability to contagion.

However, there is some evidence that the presence of foreign banks actually improves financial stability and reduces the likelihood of banking crises on average, over the long term (see, for example, Barth et al. 2001; Demirguc-Kunt et al. 1999; and Levine 1999). This may be because they are associated with lower incidence of non-performing loans, have internationally diversified asset portfolios that are less susceptible to economic difficulties in any one country and are less likely to retrench their lending significantly during financial difficulties in the host country. Schmukler (2004) also argues that, in the long run, volatility tends to decrease following liberalisation and integration with world markets, probably because of the impact on financial sector development.

In the short term however, it seems likely that developing countries that have been more heavily dependent on foreign lending to finance their growth will suffer more from the financial crisis than countries that had a relatively closed financial sector.

4.5 Complementary policies required to maximise benefits to development

4.5.1 Broader financial reforms

The financial sector in many developing countries has often been characterised by high levels of state ownership and government intervention, including directed lending (where banks are required by the government to make credit available to specific sectors or areas), interest rate ceilings (put in place to keep the cost of borrowing low), subsidised credit programmes and high reserve requirements. This has had perverse effects, often worsening access to finance and seriously damaging the performance and efficiency of the financial sector.

Government intervention has been largely aimed at increasing access to finance for particular favoured industrial sectors with a view to stimulating growth in these sectors (as happened in South Korea, and which some have argued succeeded in stimulating strong economic growth, but according to Hao et al. 1999 ultimately resulted in a financial sector crisis) or for underserved segments of the population, such as rural areas. However, in practice, it has become a tool which benefits well-connected incumbent firms at the expense of potential new entrants, and which is often used to prop up non-viable (often state-owned) enterprises, for example through the provision of the subsidised credit necessary to prevent their financial collapse. Banks may become locked into such relationships, as the bankruptcy and default of such firms may cause significant financial problems for the bank itself.

The evidence (as discussed in the World Bank's World Development Report 2005, for example) shows these interventions have been distortionary, destabilising and often counterproductive. By intervening in credit, governments have subverted one of the key roles of the financial sector, to identify and provide capital for the best possible projects or investments. Inefficiently allocated capital will result in slower growth in the economy as a whole, and although directed lending improves access to credit for certain favoured groups, it is distortionary and ultimately unsustainable and reduces access for everybody else.

Because directed lending policies have often meant that banks become reliant on the fortunes of weak and failing firms to repay their debts, banks have often ended up with many non-performing loans (NPLs) in their portfolio (where interest on the loan is no longer being repaid and repayment of the principle is also unlikely). It has also eroded effective credit evaluation and risk assessment policies in banks, because they have little incentive to screen and monitor the activities of corporate customers.

This means that domestic banks in developing countries may be in a very weak position to compete with foreign entrants following market opening, unless these problems have been addressed first. If they are not, there is a risk that opening will result in bankruptcies in the domestic banking sector, which can have very high costs in terms of widespread losses of savings, financial sector instability and a long-term loss of confidence in the financial sector, which may reduce the volume of savings deposited.

Thus, substantial reform programmes may need to precede or accompany financial sector opening, involving financial deregulation – the removal of interest rate ceilings, directed lending and high reserve requirements, bank restructuring to remove NPLs and commercialisation and privatisation to create market incentives and improve the competitiveness and productivity of domestic banks.

However, as set out in Demetriades and Andrianova (2003), experience in Latin America and Asia over the past three decades has shown that financial reform must itself be carried out carefully, in an appropriately sequenced manner, as it can otherwise lead to instability and financial crisis. This is partly because the removal of interest rate ceilings – which leads to higher interest rates, at least in the short term – and the reduction of banks' reserve requirements may lead to excessive risk taking by banks when inadequate regulatory constraints are in place. This may be exacerbated by the competitive pressure from foreign banks, which drives down the profits of domestic banks, which means that shareholders have less to lose from excessive risk taking.

The resulting increase in access to credit, particularly when it is accompanied by capital account liberalisation – has contributed to the formation of asset price bubbles; when borrowers have been unable to pay their debts, many banks have failed and governments have sometimes been forced to renationalise them, resulting in large fiscal costs. Many studies have shown the link between this kind of financial sector reform and financial crisis (reviewed in Demetriades and Andrianova 2003).

Box 5: Success and failure: The importance of an appropriate regulatory framework

The Zambian experience demonstrates the perils of market opening before an adequate regulatory framework is in place.

*The financial system was liberalized before establishing a new legal and regulatory framework for the banking system that would encourage prudent risk-taking and market discipline. Ten new bank licenses were issued between 1991 and 1994, increasing the number of commercial banks to 18. Between 1995 and 2001, nine bank failures were estimated to have caused losses to taxpayers and depositors equivalent to 7 percent of GDP . . . In the absence of an effective set of minimum prudential rules (in terms of proper loan classification and provisioning, internal controls, corporate governance, credit risk management, and so on) and the lack of risk-management capacity within commercial banks, the liberalization process of 1992–93 led to the rapid growth of financial institutions; a credit boom – bank credit to the private sector increased from 4.7 percent to 8.4 percent of GDP between 1993 and 1995; and, subsequently, a series of bank failures in 1995 and 1996 (*Mattoo and Payton 2007).

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

It is now recognised that liberalisation needs to be undertaken in a carefully sequenced manner, with a stable macroeconomic framework, adequate financial supervision and regulation and privatisation now seen as prerequisites. Liberalisation of the capital account – and particularly of short-term capital flows – is particularly risky, and full capital account liberalisation may be inappropriate until institutional and regulatory frameworks are well-developed. World Bank guidance on sequencing is set out in Box 6.

Box 6: World Bank guidance on sequencing of financial liberalisation

In the 1989 World Development Report, the World Bank provided a summary of sequencing strategies that should be followed in liberalising financial sectors, based on the experience of the 1980s. The key points were:

- Reform should start by getting the fiscal deficit under control and establishing macroeconomic stability.
- The government should then scale down its directed credit programmes and adjust the level and pattern of interest rates to bring them into line with inflation and other market forces.
- In the initial stage of reform the government should also try to improve the foundations of finance − that is, the accounting and legal systems, procedures for the enforcement of contracts, disclosure requirements and the structure of prudential regulation and supervision. It should encourage managerial autonomy in financial institutions.
- If institutional insolvency is widespread, the government may need to restructure some financial institutions in the early stages of reform. Measures to improve efficiency in the real sector − that is, more liberal policies towards trade and industry – also ought to be taken at an early stage.
- In the next stage, financial reform should seek to promote the development of a greater variety of markets and institutions to foster competition. Broader ranges for deposit and lending rates should be introduced.
- On the external side, foreign entry into domestic financial markets should be encouraged to increase competition and efficiency, but perhaps with restrictions, until domestic institutions are able to compete fully. Until such reforms are fully underway, it will probably be necessary to maintain controls on the movement of capital.
- If, however, a country already has an open capital account, the government should give priority to maintaining macroeconomic stability to avoid destabilising capital flows.
- After substantial progress has been made towards reform, the government can move to the final stage: full liberalisation of interest rates, the elimination of the remaining directed credit programmes, the relaxation of capital controls and the removal of restrictions on foreign institutions.
- In sequencing the removal of exchange controls, trade transactions should be liberalised first and capital movements later. In the end, internal and external liberalisation will be complementary, but external liberalisation should wait until internal reform and the recovery of the domestic markets are underway.
- When macroeconomic stability has been established and the domestic financial system has been liberalised and deepened, it will be safe to allow greater freedom for foreign institutions and capital flows, to link the domestic and international financial markets.

Source: DFID Economists' Guide

Thus, successfully implementing financial sector liberalisation is clearly a challenging task. However, there is a great deal of information now available internationally to guide the establishment of an appropriate regulatory and institutional regime for the financial sector. The Financial Stability Forum – a group of senior representatives of national financial authorities – has designated 12 standards as key for appropriate financial systems and deserving of priority implementation (see Table 3).

Table 3: Key standards for appropriate financial systems

Subject area	Key standard	Issued by
Macroeconomic policy and data transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard General Data Dissemination System	IMF
Institutional and market infrastructure		
Insolvency	Principles and Guidelines on Effective Insolvency Systems	World Bank (coordinating); United Nations Commission on International Trade Law (UNCITRAL) will help facilitate implementation
Corporate governance Accounting	Principles of Corporate Governance International Financial Reporting Standards (IFRS) (previously International Accounting Standards (IAS))	OECD International Accounting Standards Committee (IASC)
Auditing	International Standards on Auditing (ISA)	International Federation of Accountants (IFAC)
Payment and settlement	Core Principles for Systemically Important Payment Systems Recommendations for Securities Settlement Systems	Committee on Payment and Settlement Systems (CPSS) and International Organisation of Securities Commissions (IOSCO)
Market integrity	The Revised 40 Recommendations of the Financial Action Task Force 8 Special Recommendations Against Terrorist Financing	Financial Action Task Force on Money Laundering (FATF)
Financial regulation and supervision		
Banking supervision	Core Principles of Effective Banking Supervision	Basle Committee on Banking Supervision
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Supervisory Principles	International Association of Insurance Supervisors (IAIS)

Source: http://www.fsforum.org/compendium/key_standards_for_sound_financial_system.html.

4.5.2 Promoting access to financial services

As set out in DFID (2004), access to financial services can make an important contribution to poverty reduction, but in many developing countries access to formal financial services is very limited, particularly for the poor. In many countries, any access that the poor do have to financial services is through informal or semi-formal financial providers, such as moneylenders, microfinance institutions or credit unions. These providers are usually unable to mobilise and on-lend funds on a large scale, or pool risks over large areas in the way that formal financial institutions do. Thus, they are usually small in scale, patchy in coverage and offer a limited range of services, which can be relatively risky and expensive. The lack of access to the deeper formal financial sector constrains the ability of the poor to participate fully in markets, to increase their incomes and to contribute to economic growth.

Evidence from India (Burgess and Pande 2005) shows that better access to financial services made a significant impact on reducing rural poverty. Between 1977 and 1990, the Indian central bank mandated that a commercial bank could only open a new branch in a location with one or more existing bank branches if it opened four new bank branches in locations with no existing branches. This rule caused banks to open relatively more rural branches in Indian states with lower initial financial development during this period. The authors found that a 1% increase in the number of rural bank locations reduced rural poverty by 0.34% and increased total output by 0.55% by facilitating diversification out of agriculture. This policy was abandoned in 1990 because of the heavy costs to the commercial banking sector arising from the high default rates. So, while the study shows the significant beneficial impact on the poor of greater access to financial services, it also illustrates the high costs associated with more coercive forms of government intervention in the financial sector.

Other more traditional policies designed to promote access have also often failed or been counterproductive. Ananth and Mor (2006) argue that interest rate ceilings on lending to some sectors in India – such as small loans to farmers – have meant that no financial service provider is willing to service this market at all – they would only do so if they were able to charge higher interest rates. And although directed lending could in principle increase access to credit for certain favoured groups, it reduces it for everybody else, and is likely to undermine financial sector development more generally, with negative consequences for overall access to financial services.

The subsidisation of credit is another common policy that has been adopted in many countries in response to demands to improve access. Subsidised credit is often disbursed through semi-formal providers such as cooperatives and microfinance institutions, which are more accustomed than commercial banks to providing access to financial services for those on low incomes. However, such interventions are rarely successful, and can actually serve to weaken the providers involved, undermine market development and discourage even further the commercial banks from engaging at the low-income end of the market or establishing links with other kinds of financial providers that serve this end of the market (see Box 7).

Box 7: The poor performance of subsidised credit schemes

In 2006, the South African government set up the South African Microfinance Apex Fund (SAMAF) administered through the Department of Trade and Industry. One of the main objectives of the fund is to increase access to microfinance through funding to developmental financial intermediaries (FIs), which will then on-lend to the SME sector.[a] Despite the fund only being launched in 2006, its performance has been poor. Seven FIs have already defaulted and closed down.

Another example from South Africa is provided by the NGO FARM-Africa's Eastern Cape Smallholder Support Project (1998–2004), which aimed to optimise the community management of natural resources through a number of activities, including the setting up of self-sustaining revolving credit funds to support and develop agricultural enterprises. In its project completion report, the NGO documented that suboptimal credit performance of the revolving funds owed to provision of subsidised credit by the Department of Agriculture and the Municipalities. This is because grants to revolving funds were viewed by farmers as 'government therefore grant' funding, eroding the ability of the Funds to enforce repayment.[b]

There are also examples from Uganda. After the failures of two schemes – the Entendikwa small loan programme in 1997 and the highly subsidised Uganda Cooperative Bank in 1998, both of which were forced to close as a result of high levels of unpaid loans – the government of Uganda decided that its proper role should be oversight, not the direct provision of credit.[c]

Subsidised credit schemes result in high default levels, require ongoing use of scarce public resources, and encourage rent-seeking behaviour and government corruption. They also undermine and deter private market development. In fact, the evidence suggests that subsidised credit often reduces rather than enhances the access of the poor to microcredit. Because it creates unsustainably low interest rates, it deters market entry into this segment by private financial providers, and because it weakens the financial soundness of the sector (by encouraging increased default rates and reducing incentives to manage credit effectively), it discourages commercial banks from engaging with semi-formal institutions in a way that could otherwise help to promote their growth and improve their sustainability and impact.[d]

Source: a) SAMAF (2007); b) Ewbank (2005); c) CGAP (2004); d) Pearce and Helms (2001) http://www.gdrc.org/icm/apex-institutions.html.

There has often been an implicit assumption that financial opening promotes better access to financial services, by stimulating competition and hence reducing excess profits made by the banks and thus reducing the cost of credit, and by incentivising financial service providers to expand their client base as they compete for market share.

However, as discussed above, it seems that most foreign banks focus their efforts where local profit opportunities are perceived to be the greatest – providing financial services to large firms in urban areas. Clarke et al. (2001) provide evidence that access to credit for SMEs is improved indirectly by foreign entry, as the increased competition from foreign banks in the corporate sector forces domestic banks to seek new markets that they might not previously have served. This increase in competition does not appear to have much impact on the provision of financial services for poorer households – perhaps because they are harder to serve profitably – and the poor majority of the population often still has very limited access to formal financial services, even after opening.

Detailed demand-side data are now available, which give the proportion of the population with access to financial services from different banks and the proportion of them who are poor. These data serve to highlight the limited engagement to date by foreign banks in terms of providing access to bank accounts for the general population, and particularly in relation to engagement with the lower income segments of the market.

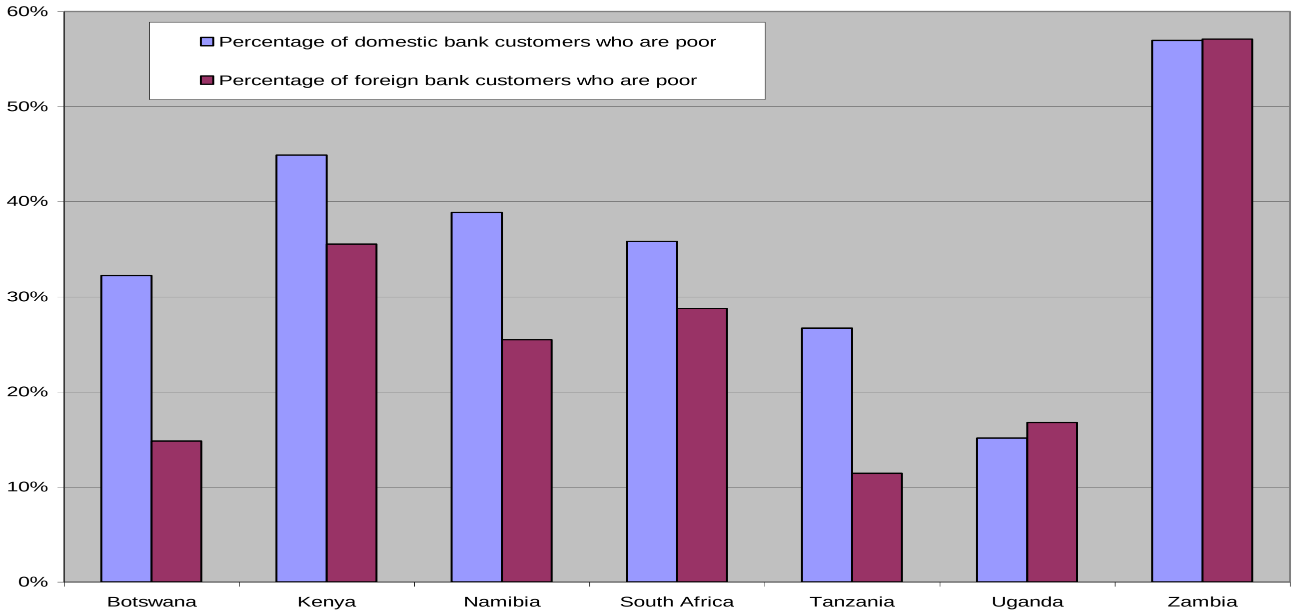
Table 4: Proportion of population served by foreign and domestic banks

Proportion of population served by	South Africa 2006	Kenya 2006	Uganda 2006	Zambia 2005	Tanzania 2006
Foreign banks	17%	3%	9%	9%	1%
Domestic banks	34%	10%	7%	10%	7%

Source: Finscope survey data.

Foreign banks have fewer poor customers in their client base than domestic banks in most countries.

Figure 4: Percentage of bank customers who are poor



Source: Eighty20 using Finscope survey data.

As the World Bank notes in relation to Zambia:

> The disappearance of past, inefficient instruments of providing the poor with access to financial services left a socially costly vacuum that is only now being addressed. Before liberalization, policy makers played an active role in promoting access to finance through the direct control of financial market and financial institutions, subsidies, and credit allocation. During the 1990s, policy makers refrained from any such intervention in the financial system with the expectation that foreign and private financial institutions would increasingly serve all segments of the population and private sector. It is now clear that the visible hand of the government is needed to use market-friendly instruments to promote access in the short run, until the fruits of ongoing institutional and fiscal reform are ripe (Mattoo and Payton 2007).

If traditional government interventions in the financial sector to promote access (through directed lending, subsidised credit programmes and interest rate ceilings – however damaging that may have been to the health of the financial sector) are withdrawn alongside opening, this may actually result in reduced access to financial services, either for specific groups or more generally. Market forces unleashed by financial opening may by themselves not provide sufficiently strong incentives to encourage banks to widen access.

There are many reasons why access to financial services may be limited in developing countries, even after opening. High levels of government debt have often constrained access to credit for private firms and individuals, and high inflation has discouraged saving. Poor physical and institutional infrastructure (e.g. intermittent electricity supplies, inadequate telecommunications services, weak institutions for contract enforcement, etc.) raise the costs of provision, particularly to poor and rural areas.

There are also many market failures contributing to the problem. For example, Stiglitz and Weiss (1981) emphasise the problems caused by imperfect information, i.e. because lenders do not know whether borrowers will repay loans. In developed countries, this problem is attenuated through the use of collateral and through credit scoring mechanisms, but in developing countries, many potential borrowers are unable to offer collateral and are unlikely to have built up a credit record, and many countries lack credit bureaux. All of these serve to deter lending.

Sern et al. (2005) argue that regulatory requirements such as 'Know Your Customer' (KYC) rules that have been introduced to guard against money laundering can also make it difficult for poor people to open a bank account, as they may not have the required identification documents (such as a utility bill showing their address, for example).

As argued in Ellis (2007), widening access to financial services may simply be unprofitable in many cases. Indeed, given the many types of market failures present in financial services – such as informational asymmetries, which in developing countries are often exacerbated by a lack of institutional infrastructure such as credit bureaux – the market is likely to under-provide. It may also be the case that weak competition policy in some countries has resulted in quite a concentrated financial sector, even after opening, allowing high spreads to persist, which blunts incentives to expand access to new, unfamiliar and risky market segments, even where they may be potentially profitable. A lack of detailed information about the characteristics of these market segments may make it difficult for financial institutions to correctly assess the costs and risks associated with expanding access.

Thus, in order to promote financial inclusion, governments need to tackle market failures and improve the enabling environment (for example, by establishing credit bureaux, creating a better legal framework to enforce contracts and ensuring that regulation – such as know your customer rules – does not undermine incentives to widen access).

One solution is to build greater linkages between the formal financial services sector and semi-formal providers such as microfinance institutions and credit unions, which use different operational methods to reach the low-income end of the market affordably and are the main source of access to financial services for many people in developing countries. There is a significant disconnect between these two different kinds of institutions in many developing countries, in terms of operational methods, the customers they serve and the regulatory constraints they face. As Mosley (1999) argues, this disconnect partly explains why liberalisation and additional competition in the mainstream banking sector has a limited knock-on impact on the parts of the market serving the wider population, including low-income clients. It also makes it difficult for these alternative financial providers to expand. Often, they themselves do not have adequate access to finance with which to scale up their operations.

Governments can develop a regulatory and incentive framework that facilitates greater linkages between these different types of financial providers, thus bridging the gap that prevents the realisation of the knock-on benefits of market opening in the formal financial sector. For example, policy, legal and regulatory changes can be introduced that i) enable formal financial institutions to more easily use informal and semi-formal agents as delivery channels, thus reducing the costs of expanding access, and ii) enable informal and semi-formal institutions to more easily access formal finance with which to expand their own operations.

It is possible for large foreign commercial banks to serve low-income customers directly but, according to Peachey and Roe (2006), the evidence suggests this is most successful when they have established relatively independent microfinance operations. They argue that banks with specialised independent microfinance units or subsidiaries find it easier to institute microfinance lending policies, procedures and methodologies and avoid interference from the larger bank culture. Some banks are now investing considerable resources in learning how to do business at the low-income end of the market (Box 8).

Box 8: Barclays Bank's linkages with Susu Collectors in Ghana

Barclays is exploring ways to increase the provision of financial services to a wider section of the population, including those on low incomes, by exploring alternative distribution channels and by building links with existing informal financial providers.

Barclays is expanding its activities in a number of African countries, and studying each country's financial sector arrangements separately, to determine the best way to engage at the lower end of the market. In a recent initiative, it has started working with Ghana's 4000 Susu collectors, who offer basic banking services to the poor. Susu Collectors personally gather the income of their clients on a regular basis for a small fee, and return it at the end of each month, providing greater security for their client's money. In addition, with finance from Barclays, the Susu Collectors will now be able to provide their clients with loans, helping them to establish or develop their business.

Because Susu Collectors have a personal relationship with their customers, they are much better placed than a bank to determine their customers' creditworthiness. Thus, personal relationships provide the loan security that is needed when people have limited collateral or credit record to prove their creditworthiness, thereby overcoming one of the main problems associated with banks expanding access to finance.

Barclays are also providing training to Susu Collectors to make sure that they undertake effective credit risk assessments, and are improving the financial literacy of the clients of the Susu Collectors by training them in basic financial issues. If it is successful, Barclays are considering rolling the model out to other African countries.

Claessens (2006) discusses other methods by which the government can help to promote access. For example, it may be able to facilitate the use of existing networks (such as post office branches or retail outlets) to allow the delivery of financial services without the need to establish expensive new bank branches in all areas.

New technology, including smart cards, mobile phones and the internet, can also help reduce costs and broaden access, if the appropriate infrastructure and regulation is in place. The growth in mobile telephony has opened up exciting new opportunities for branchless banking, in countries where more people have a mobile phone than a bank account. For example, Celtel, an African mobile-phone operator, introduced a service that allowed callers to use text-messaging to send airtime credit to other mobiles. As many people do not have bank accounts, the service has been adopted as a convenient and cheap way to transfer money. In villages, it has also emerged as a substitute for cash, with people using airtime to pay for their shopping. Shopkeepers can cash in their accumulated phone credits with people who make money by offering callers use of their mobile phones as a sort of public phone. This has led to the introduction of more formal money transfer services using mobile phones.

Governments can also encourage the use of formal financial services by making social transfer payments electronically. As this is likely to be cheaper than other methods of distribution, the savings could potentially be used to subsidise the establishment of additional access points, as has been tried in the US.

Additional interventions may also help to create stronger incentives for banks to serve the lower-income end of the market. Such intervention needs to be implemented carefully, however, and must avoid replicating the mistakes of the past. More market-friendly mechanisms need to be found. A variety of interesting approaches have been adopted in developed countries that could be considered. For example, the US Community Reinvestment Act focuses attention on access by monitoring banks on their performance in making loans to people with low and moderate incomes, and publishing each bank's rating in the hope of generating competition between the banks on this basis. Other countries, including the UK, have established a requirement or model for a Basic Bank Account, which sets the framework for banks to provide a simple, low cost 'no-frills' bank account for lower-income customers.

Voluntary charters or codes of practice developed by the banking sector itself can also help provide the necessary incentives. Even then, moral suasion from the government, perhaps accompanied by the provision of better information about lower-income market segments, may well be needed to help kick-start the process.

South Africa provides an example of the successful use of a voluntary charter to encourage banks to widen access to financial services. The South African government worked with banks to establish a voluntary Financial Sector Charter (FSC), which began in 2003. This was an agreement among the major players in the financial sector – banks, insurance companies, brokers and exchanges – on a set of service provision and empowerment targets, including on the provision of banking services to low-income populations. The agreement covered the period 2004–2014.

All financial services companies are expected to pursue these targets, to report periodically on their progress to a monitoring body (the FSC Council) set up under the Charter and to be graded on their performance in the form of a public scorecard. The Council publishes an annual report in which it tracks progress against the targets (FSC 2007).

The FSC seeks to increase financial access for those people in the lowest income market segments, which are categorised as Living Standards Measure (LSM) 1–5. In 2006, the LSM data suggested that there were 18.3 million adults in segments 1–5. This number of individuals translates into 59% of the adult population, who are mainly black and most of whom lack access to banking and financial services.

Table 5: Actual and target access to financial services

% of population in LSM 1–5 with 'effective access' to:	2003 actual usage	2008 access target
Transaction accounts	32%	80%
Bank savings products	28%	80%
Life insurance products	5%	23%
Collective investment savings products	Negligible	1% plus 250,000
Short-term risk insurance products	Negligible	6%

Source: FSC (2007).

The FSC Council reports that it has been unable to quantifiably measure performance against the 2008 access target, mainly as a result of two factors: inadequate measures in place to ascertain performance and poor submissions from the industry (FSC 2007). However, annual independent household surveys on financial service usage undertaken by the Finmark Trust[6] indicate that there has been a strong improvement in financial access – see Table 6. The FSC is undoubtedly responsible in large part for this improvement, along with the government's requirement that welfare recipients open bank accounts to receive electronically deposited child support and other social grants.[7]

Table 6: Changes in the proportions of the banked, never banked and banked black population in South Africa, 2004–2007

	2004	2005	2006	2007
% of adult population banked	45%	47%	51%	60%
% of adult population never banked	42%	41%	38%	30%
% of black population banked		40%	45%	56%

Source: Finscope survey data.

One of the initiatives flowing from the Charter was the introduction of the 'Mzansi' account, which is similar in concept to the Basic Bank Account that has been adopted in a number of other countries, including the UK; a low cost, no-frills bank account designed to be more suitable and affordable for those on low incomes. All that is required to open a Mzansi account is a valid ID number – none of the other documents often required by banks to open an account that effectively exclude many poor people.

Transactions are limited to deposits, withdrawals, transfers (anywhere in the country) and debit card payments. No management fees are charged, and one free cash deposit per month is allowed. All of South Africa's major retail banks offer the Mzansi account.

The South African Mzansi account was launched in October 2004, and has generally speaking been hailed as a success, with more than 1.5 million new bank accounts opened since its inception. Most of these accounts come in the form of a savings and/or transaction accounts. According to the Banking Association of South Africa:[8]

> 91.3% of the Mzansi accountholders are new to the institution at which they have opened their account, the account is achieving its aim of providing affordable and accessible banking to the previously unbanked population. The majority of account holders (62%) are between 25 and 54 years, and the largest take-up comes from black communities, which have the largest unbanked population. Between October 2004 and April 2005 an additional four percentage points of South African population have been banked via the Mzansi Account.

Household (Finscope) surveys show that all of the top three banks in South Africa (in terms of market share in retail banking) widened access to financial services for the poor considerably over the period 2003–2006 (see Table 7). Thus, early indications suggest that the South African Financial Sector Charter and the Mzansi account have been successful in generating significant growth in access to financial services, demonstrating that it can be profitable for banks to sell to lower-income groups.

Table 7: Growth in the number of people using each bank's services, 2003–2006

	Growth, total	Growth, poor clients	Growth, non-poor clients
ABSA	20%	69%	8%
Standard Bank	7%	35%	-3%
First National Bank	28%	87%	7%

Source: Finscope data.

[6] The FinMark Trust was established as an independent trust in South Africa in March 2002 with funding from DFID, with a remit to help make financial markets work for the poor in Southern Africa.
[7] http://www.sagoodnews.co.za/benchmarking_progress/more_south_african_citizens_are_banking_on_growth.html.
[8] www.banking.org.za.

A range of other kinds of policies have been tried by governments around the world to promote access to financial services.[9]

Monitoring and benchmarking

Another approach to incentivising wider provision of financial services relies on improving transparency and facilitating benchmarking to create incentives for banks to widen access. The Community Reinvestment Act (CRA) in the US provides a good example of this approach. Introduced in 1977, the CRA is designed to encourage banks to meet the credit needs of the local communities through which they mobilise deposits, and to expand credit to market segments that were previously denied access. It achieves this through:

- Requiring the disclosure of every bank's lending and investment levels, as well as retail banking services offered, broken down by geography, income, race, etc., in a manner which is also accessible to the public (and therefore can be used by community groups to apply pressure);
- Assessment and evaluation of these measures by bank supervisors as part of their regular supervision duties; and
- Specifically considering a bank's CRA performance when the bank applies for regulatory approval, e.g. for merger, acquisition or branch expansion.

There is some evidence to suggest that the CRA has had a positive impact on bank lending in certain areas. One study shows that, over the period 1993–2000, lenders subject to the CRA increased their lending for home purchases in target communities significantly more than lenders that were not covered by the CRA (Harvard University Joint Center for Housing Studies 2002).

Legal requirements on banks to finance microcredit

A more coercive approach has been adopted by Brazil, which has established a legal requirement that banks allocate 2% of their demand deposits to finance microcredit. If they do not, then the shortfall (the difference between 2% and the amount allocated to microcredit) must be deposited by the institution with the Brazilian Central Bank with no interest. However, the law does provide some flexibility as to how banks can meet the requirements, by enabling them to finance microcredit through either:

- Direct loans to the targeted end borrowers;
- Wholesale loans to other financial institutions that will, in turn, on-lend such funds as microcredit to the targeted end borrowers; or
- Secondary market purchases of microcredit loans (or portfolios of such loans) originated by other financial institutions.

There are four categories of microcredit end borrowers that are targeted by the law:

1. Individuals with no or low bank account balances (under US$600);
2. Other low-income individuals;
3. Micro-enterprises; and
4. Other entrepreneurs involved in small-scale productive activities with annual gross income of up to US$36,000.

The law imposes a cap on the opening fee of 1–4% depending on the term of the loan, and interest rate ceilings of 2% per month for individual micro-loans and 4% per month for enterprise loans. There are also caps on loan size, depending on the type of borrower and size of the enterprise.

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[9] The examples provided draw on a study that undertaken jointly by ODI and Bankable Frontier Associates for Finmark Trust. For source documentation see Porteous and Abrams (2008) and Ellis and Singh (2008).

The banks are required to provide technical assistance to recipient entrepreneurs, in terms of business planning and working capital management, as well as hands-on monitoring and guidance of the enterprise's activities during the loan term. They must also consider repayment capacity when determining loan amount and rate.

Establishment of an institution with a remit to promote access to financial services
In 2006 the government of Colombia launched Banca de las Oportunidades (BDO) to promote access to financial services for the unbanked. Intended activities of the BDO include:

- Designing and proposing targeted reforms to the financial institution regulatory framework in order to facilitate and promote improved financial access;
- Promoting expansion of the supply of microfinance through targeted subsidies (or other incentives) to entities already engaged in microfinance activities, as well as stimulating movement into this sector by entities not yet serving the low end (e.g. by supporting microfinance technology providers and credit bureaux);
- Promoting financial education programmes;
- Promoting the design of new financial products and instruments to facilitate financial access;
- Promoting the collection from and dissemination to financial sector stakeholders (government authorities, financial institutions and the public) of relevant financial sector data and information;
- Funding experts to prepare studies and reports diagnosing problems with Colombia's regulatory framework in relation to expanding financial access, prescribing solutions (e.g. regulatory amendments), and addressing other issues affecting financial access, such as market failures or market opportunities.

To avoid state provision of retail finance, the BDO is not permitted to grant loans directly, to issue guarantees or to make capital investments in financial institutions or companies.

The BDO is credited with catalysing a reform allowing 'Non Banking Correspondents' (NBCs) to be established, i.e. nonbanks which serve as agents of banks in providing financial services, which allowed the establishment of such entities in 396 municipalities, of which 50 had previously had no formal financial sector presence. It has also initiated the rollout of a national financial education programme.

The aggregate outstanding loan portfolio to micro-enterprises grew 74% in less than 18 months after BDO's launch, although it would be inappropriate to attribute all of this to the scheme, particularly as the interest rate ceiling for micro-loans was also lifted during this period.

Regulatory measures
Governments can use the regulatory framework to create incentives, or reduce disincentives, for banks to widen the provision of financial services for lower-income groups. For example, in India, in order to ensure that people belonging to low-income groups do not encounter difficulties in opening bank accounts, the KYC procedures (which were established to counter money laundering and terrorist financing, and place requirements on banks to check the identity of customers) for opening accounts have been simplified for people with balances not exceeding Rs.50,000 and credits not exceeding Rs.100,000 per year. This may help to overcome barriers to access relating to the documentation that is required to open a bank account, such as proof of address or of employment, which poor people cannot always provide. This reflects a 'risk-based approach' to regulation, reflecting the relatively lower risk of money laundering or terrorist financing associated with small financial transactions.

In Pakistan, the Annual Branch Licensing Policy has been used to incentivise banks to increase their coverage of rural areas. Since 2007, the policy has required commercial banks with 100 branches or more to open at least 20% of any new branches they set up outside large cities in districts where no branch of any bank exists. At the same time, the rules have been changed to allow banks to establish sub-branches, booths and service centres in regions where it is costly to maintain a full-fledged branch. These sub-branches can be managed by skeleton staff and can act as an extended arm of a nearby main branch, by performing limited banking functions such as deposits, withdrawals, telegraphic transfers and payment of home remittances. This should serve to mitigate the costs to banks associated with the new licensing policy.

Similarly, in the Philippines in 2005, the Central Bank approved a revised set of branching guidelines 'to enhance competition in the banking system and maximize the delivery of financial services especially in underserved areas' (Central Bank of Philippines 2005a). Under the new regulations, qualified microfinance banks and microfinance branches of regular banks may establish branches anywhere in the Philippines. Previously, the central bank had imposed more stringent requirements for microfinance banks in setting up or being able to open up new branches.

The revised guidelines also allowed for the servicing of deposits outside the bank premises. As long as the capital requirements are met, the safety and soundness of the bank is ensured and the area of operation is within one hour of normal travel time from the head office or branch, the bank may be authorised to solicit and accept deposits outside the banking premises. This is beneficial for microfinance institutions, whose loan officers typically go out into the towns and cities to service their clients.

The licensing regime is being used to promote access in Thailand, where new licenses are being provided to entrants who are committed to providing services to the underserved. A new type of license has been created that addresses specific problems or gaps in services within the system.

In addition, the Bank of Thailand has assigned lower risk weights for assets related to retail customers and SMEs as a market incentive for commercial banks to service these customer segments. This allows commercial banks highly skilled in credit scoring, risk management and diversifying their credit portfolio to apply lower risk weights to retail and consumer loans that fit the specified criteria.

The underlying rationale is that, because retail loan portfolios consist of many different types of small loans, this allows for natural diversification with a lower risk profile. This measure will help reduce capital fund requirements for commercial banks with expertise in retail and consumer loans, and should thus incentivise an increase in the provision of financial services for individuals (relative to corporate clients).

Promoting linkages with the informal sector

In India, the government has played a significant role in creating linkages between banks and self-help groups (SHGs). SHGs consist of groups of people – often women – who get together and pool their savings in order to provide loans to members of the group as needed. In 1996, the state-sponsored National Bank for Agriculture and Rural Development (NABARD) launched an SHG – Bank Linkage programme. This provides an element of subsidisation, as finance is provided to participating banks at below market interest rates for on-lending to SHGs, but has a number of other important features that have contributed to its success. Under the scheme:

- NABARD supports the formation of SHGs, linking them up with banks and intermediating NGOs, and promoting best practices.
- NGOs sometimes intermediate between the banks and SHGs, allowing banks to decrease the costs of identifying and assessing potential borrowing SHGs.
- The NGOs also help SHGs to prepare audited financial accounts for the banks.
- Technical assistance is provided to participating institutions in the form of grants to NGOs and the training of bank staff.

By using the existing rural financial infrastructure of 150,000 banking and cooperative retail outlets, and linking them to savings and credit groups with joint liability, there are economies of scale and scope, resulting in substantially lower transaction costs. The programme has grown rapidly since inception, with the number of participating SHGs standing at 687,000 in 2006–2007 (Government of India 2008).

The scheme's record in terms of loan repayment has been very good. An impact assessment of the scheme showed that it reduced reliance on moneylenders and other informal sources of finance, which often charged much higher interest rates (Puhazhendhi and Badatya 2002).

Another study found that the self-reliance of SHGs based on internal savings and retained earnings was growing rapidly, exceeding in older groups the volume of bank refinance by an increasing margin (Siebel and Harishkumar 2002). In addition, SHGs were depositing substantial amounts of savings voluntarily in banks as a reserve for bad debts. The same study found that, in addition to direct effects on bank profits, SHG banking has indirect commercial effects on banks in terms of improved overall vibrancy in banking activities. In addition, indirect benefits at village level included the spreading of thrift and financial self-reliance and of a credit culture among villagers, micro-entrepreneurial experience, growth of assets and incomes, the spreading of financial management skills and the decline of private money-lending. Intangible social benefits were also identified, including growing self-confidence and empowerment of women in civic affairs and local politics, improved school enrolment and women's literacy and better family planning and health.

In Thailand, the Government Savings Bank (GSB) and the National Village and Urban Community Fund Committee are collaborating to develop computer application software that will facilitate financial transactions between village funds, microfinance groups and state-owned banks. The hope is that the software's successful implementation will help prove that new technology can help generate reasonable returns from transactions between commercial service providers and low-income clients, essentially by lowering the cost of these transactions. Accordingly, the project's success may lead to the expansion of the software application to other underserved communities in the future.

In the Philippines, the government has developed a National Strategy for Microfinance, designed to strengthen the microfinance sector and promote linkages with the formal financial sector (Central Bank of Philippines 2005b). The strategy includes:

1. Establishment of a policy environment conducive to the effective and efficient functioning of the financial market:
   - Implementing a market-oriented interest rate policy in microfinancial intermediation (both on the savings and lending side);
   - Removing existing distortions in the financial market, e.g. loan quotas, earmarking of public funds for direct lending, etc;
   - Rationalising all existing government credit and guarantee programmes towards the objectives of implementing microfinance programmes in a market-oriented setting and encouraging greater private sector participation in the delivery of microfinance services.
2. Establishment of a market-oriented financial and credit policy environment which is conducive for the broadening and deepening of microfinancial services:
   - Provision of an appropriate supervisory and regulatory framework for microfinance institutions (MFIs) which will enable them to engage in the development of new and innovative product lines and services appropriate to the demand for financial services by poor households and micro-enterprises;
   - Establishment of standards of performance and business practices to guide the operations of MFIs;
   - Promotion of broad-based savings mobilisation, linkage banking technology and other microfinance technologies;
   - Provision of information and training on best practices in microfinance to MFIs;
   - Implementation of a capacity-building programme for MFIs covering: i) local deposit mobilisation; ii) financial and project management; iii) use of information technology; iv)

development and establishment of microfinance technology and innovative product/service lines.

Market-friendly use of subsidies
Chile has adopted an innovative approach to expanding access, whereby a fixed subsidy is auctioned off twice a year to those commercial banks that provide the largest number of micro-loans for the smallest subsidy (Kumar 2004). Since its inception in 1993, the amount of subsidy has fallen from US$240 to about US$80 on loans that average US$1200. Although participating banks are not specialised in microcredit, they are the largest microfinance providers in Chile. Because of their size and diversified loan portfolio, the institutional risk associated with microfinance has been reduced.

While it is not clear whether this scheme would result in sustainable improvements in access if the subsidy was removed, it is sometimes argued that a degree of subsidy is likely to remain necessary if banks are to serve the lowest income end of the market profitably. The auctioning of such a subsidy is likely to be a good way of maximising the impact achieved (in terms of widening access) for a given level of subsidy.

The policies discussed above exhibit varying degrees of 'market friendliness'. Unfortunately, detailed assessments of the impact and effectiveness of these policies are in most cases unavailable. Government intervention to incentivise a widening of access to financial services should be implemented carefully, in a market-friendly and non-distortionary manner; most governments are keen to avoid deterring new entry altogether. But harnessing the market dynamism and innovation that financial opening can bring is likely to be a great deal more successful than the state-led approaches of the past in tackling the problem of financial exclusion.

4.6 Conclusion

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

- A stable macroeconomic framework – to minimise the risk of financial instability;
- Adequate financial supervision and regulation to encourage prudent risk taking and financial discipline in the banking system;
- The necessary institutional infrastructure, such as an effective legal framework for insolvency and adequate corporate governance and accounting systems;
- Financial deregulation, where government controls over the actions of financial institutions are removed, such as directed lending policies and interest rate ceilings, which are likely to hamper performance and deter new entry;
- Bank restructuring, to resolve problems associated with high levels of non-performing loans and put domestic banks on a sustainable footing, thus avoiding bankruptcies and creating a level playing field with new foreign entrants;
- Commercialisation and privatisation, to create market incentives and improve the competitiveness and productivity of domestic banks;
- Creation of an enabling environment for banks which allows and incentivises them to take advantage of new technologies that reduce the transactions costs associated with serving poorer customers;
- Appropriate regulation of the semi-formal sector, in a way that gives banks the confidence to engage with it more effectively to scale up services;

- Avoidance of subsidised credit schemes, which have often been unsuccessful and counterproductive and have undermined financial sector development;
- Use of market-friendly incentives for banks to widen access to services, which could include:
  - The adoption of a voluntary charter to improve access, which may include quantified targets, e.g. for the number of bank accounts provided;
  - The introduction of Basic Bank Accounts;
  - Monitoring and benchmarking schemes;
  - Legal requirements on banks to finance microcredit;
  - The establishment of an institution with a remit to promote access to financial services;
  - Regulatory measures and incentives, e.g. to do with licensing policy, KYC requirements or prudential requirements, etc.;
  - Promoting linkages between the formal and informal or semi-formal sectors;
  - The auctioning of a fixed subsidy to whichever financial institution agrees to provide the most micro-loans.

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5. Energy services: A focus on the electricity sector

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

Liberalisation of the electricity sector and market entry by private (often foreign) players brings competition, innovation, technological know-how, managerial expertise and much-needed investment capital with which to expand services and keep pace with expected growth in demand. It has generated substantial benefits in many countries, in terms of greater efficiency, lower prices, improved access, greater reliability of service and improved environmental impact. However, the evidence also shows that the gains from liberalisation are by no means certain, and they rely heavily on the establishment of competition and an effective regulatory framework in order to create the right incentives for appropriate investment and efficiency gains, and to ensure that these efficiency gains are passed on to consumers in lower prices.

In practice, prices have often increased after liberalisation, at least for some types of customers. This is because prices were often held artificially low prior to liberalisation, as a result of government subsidies or cross-subsidisation between consumers by the incumbent monopoly. Price rises after liberalisation have led to strong public opposition to reform and subsequent policy reversals in a number of countries, which have in turn led to contracts with private sector participants having to be renegotiated or rescinded. Thus, experience shows that strong commitment to reform is usually required for a prolonged period to ensure ultimate success. The continued provision of government subsidies to protect access for the poor and rural population may also be needed in many countries.

These kinds of problems have resulted in reduced participation by private players in electricity markets since the peak in the late 1990s.

Attracting significantly more investment will require greater commercial viability, including cost-reflective tariffs, better collection ratios, well-targeted and sustainable subsidies, and improved quality and reliability of service. In most countries, a move towards cost-reflective tariffs will not be politically feasible unless it goes hand-in-hand with visible improvements in quality of service . . . Undoubtedly, retail tariffs are not cost reflective in most developing countries and subsidy schemes often do not cover the gap between tariffs and cost or reach the poorest (PPIAF 2007).

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

5.1 Introduction

The energy sector incorporates a wide range of activities and power sources, including oil, gas and electricity. As this paper is about services, which are commonly defined as things which are not storable, this section focuses on the electricity industry rather than oil and gas, which are by this definition goods rather than services.

The electricity industry consists of four vertically related businesses:

- Generation – where fossil or nuclear fuels or renewable sources (e.g. wind, solar or water) are converted into electricity
- Transmission – where electricity is transmitted over high-voltage networks to various hubs across the countries
- Distribution – where electricity is transmitted over low-voltage networks from the hub to final consumers such as factories or homes
- Supply – which includes metering, billing, enforcing payment and providing customer services

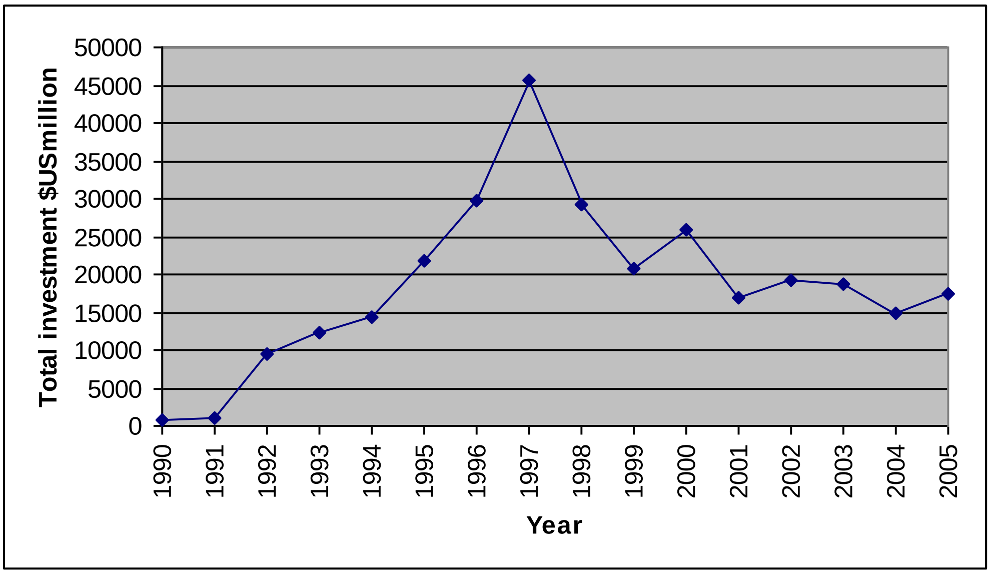
Historically, electricity, like other utilities, has been provided by the public sector, and has been seen as a natural monopoly, unsuited to private provision. However, in the past few decades, most developed countries have privatised, restructured and liberalised, part or all of their electricity sector. This owes partly to technological change in generation, which has reduced scale economies, making competition more feasible, and partly to growing recognition of the potential efficiency gains associated with private sector involvement in utilities, when properly regulated, even in the absence of full competition. Since the early 1990s, a large number of developing countries have started to undertake electricity sector reform at least in some parts of the market as well. Thus, private participation in electricity in developing countries grew significantly in the 1990s in the wake of privatisation and reform.

In the early years, much of the private investment was in East Asia and Latin America, but this has declined in the years since 2000. There has been an increase in investment in Eastern Europe and South Asia. Investment in sub-Saharan Africa has been small but relatively constant since the mid-1990s.

FDI by global power corporations (Mode 3) has been a major source of private capital coming into the sector, although these corporations have withdrawn from developing countries to some extent in recent years. Electricity companies from emerging markets are now becoming increasingly active in foreign countries.

Energy services are not currently included as a separate sector in the WTO. Although a few WTO members undertook sparse commitments in various energy-related services, the vast majority of the global energy services industry is not covered by specific commitments under the GATS.

Figure 5: Total investment in energy projects with private participation in developing countries, 1990–2005



Source: World Bank Private Participation in Infrastructure Database, see http://ppi.worldbank.org/.

5.2 Contribution of the sector to development, growth and poverty reduction

Access to electricity is central to almost all aspects of economic activity and development. It is crucial for private sector development and job creation, and for agricultural and industrial productivity. Electricity is important for almost all businesses, and it represents a significant part of overall costs for some industries, such as chemicals and steel manufacturing. Access to electricity is thus a crucial part of the overall investment climate, and contributes to the productivity of all firms in the economy.

For example, Calderón and Servén (2003) estimate that, in Latin America, a 10% increase in electricity-generating capacity per worker increased GDP per worker by around 1.5%. As reported in Dollar et al. (2003), the World Bank's Investment Climate Surveys found that more reliable power supply increased garment manufacturers' total factor productivity, and the growth rates of their output and employment in Bangladesh, China, Ethiopia and Pakistan.

Access to electricity also improves access to water, health care and education, and reduces time spent on domestic tasks such as collecting traditional fuels and processing food; it also reduces indoor pollution. There is therefore, unsurprisingly, a strong correlation between energy consumption, growth and development (see UN 2005, for example).

However, access to electricity is limited or unreliable in many developing countries, which means that many firms in small towns and rural areas have to supply themselves, which can be very costly. Power outages (temporary losses of supply) and fluctuations in voltage which can damage machinery are also common. The World Bank (2005) estimates that firms lose around 5% of the value of their annual sales as a result of such outages.

Access to electricity has increased considerably over the past three decades in many developing countries. According to UN-Energy (2005), more than 1 billion people have gained access to electricity during the past 25 years, yet at least 1.6 billion people still do not have it. Four out of five people without access to electricity live in rural areas of the developing world. In sub-Saharan Africa, it is estimated that only 8% of the rural population has access, compared with 51% of the urban population. Hence, a major increase in supply of electricity is needed in many parts of the developing world.

5.3 Electricity sector liberalisation: What is involved?

The energy sector was until the 1990s often a state-run monopoly, but since then technological changes have reduced economies of scale in generation, making competition more feasible. There has also been a growing recognition of the potential efficiency gains associated with private sector involvement in utilities, when properly regulated, even in the absence of direct competition. Thus, many countries, both developed and developing, have undertaken electricity sector reform, including some or all of the following:

- Privatisation;
- Separation of the various activities within the supply chain (i.e. separation of power generation from transmission and distribution services);
- Introduction of commercial (cost-reflective) pricing;
- Measures allowing market entry by both domestic and foreign companies and ensuring a level playing field;
- Introduction of competition to the sector or certain parts of it by giving customers a choice of supplier; and
- Introduction of regulation to govern the market and protect consumers.

These reforms have provided increased opportunities for private sector players to participate. The removal of restrictions on FDI is also sometimes necessary to facilitate participation by foreign players.

Most liberalisation and private and foreign participation have taken place in the generation segment of the electricity industry. The degree and form of liberalisation varies considerably between countries. Many countries have allowed private participation by permitting the state monopoly to subcontract the construction and/or operation of power stations to private players, often called independent power producers (IPPs). In this model, prices are set on the basis of competitive bids and long-term contracts are negotiated with the state utility, which often continues to hold a monopoly over selling the electricity to customers.

Alternatively, IPPs may sell into a power pool, managed by an independent operator which matches supply with demand on a continuous basis at least cost. This approach requires a more sophisticated regulatory framework, however, to deal effectively with the risks to effective competition associated with potentially high market concentration.

More extensive liberalisation permits IPPs to compete to sell power directly to final consumers, sometimes through the electricity grid. Choice of provider is often only available for large, industrial consumers or commercial consumers, although some countries have fully liberalised, giving residential consumers choice too. To work effectively, this model usually requires structural reform and careful regulation to ensure that providers have access to the grid on transparent terms.

Off-grid generation is also possible, where the generator is located near the final consumer and includes power sources like diesel engines, micro-gas turbines and renewable energy sources, such as wind, hydro, biomass and solar applications, which are growing in importance in light of concerns about climate change. This form of provision can be more accessible, reliable and cheaper than grid-based supply in some locations.

There is less scope for private competition in relation to transmission and distribution, as these have significant economies of scale which make them natural monopolies. However, these activities have also been privatised and regulated in some countries, most often in relation to distribution, where providers compete for contracts to supply particular areas. Foreign participation has been less common in this segment, however. Involvement in electricity distribution is inherently riskier, as it involves the provision of services to thousands of customers for whom issues of pricing and access can become politically contentious. This is discussed further below.

5.4 Benefits and risks of liberalisation and regulatory reform

According to Zhang et al. (2002), the motivations for liberalisation have included the poor performance of state-owned electricity operators, resulting in high costs; unreliable supply; limited expansion in access to the grid; limited investment and technological innovation; the inability of the state sector to meet the investment and maintenance costs and to keep pace with growing demand for energy; the need to remove or reduce energy sector subsidies owing to high fiscal costs; and the desire to raise immediate revenue for the government through the sale of state assets.

Thus, a key driver of energy sector reform has been the need to attract private capital to fund the investment needed to keep pace with the expected growth in demand. The International Energy Agency predicts that developing countries will need a more than US$5.7 trillion investment in the power sector to keep pace with demand over the next three decades. Private participation, including by foreign providers, is likely to be crucial for securing the capital investment required.

By stimulating competition, liberalisation should result in efficiency gains, greater innovation and improved service. Foreign investors often bring the technology and managerial expertise needed to improve electricity provision.

5.4.1 Welfare impacts

It is difficult to disentangle the effects of private – and especially foreign –participation in electricity markets, from the much wider reforms that are often introduced at the same time, such as privatisation and regulatory reform. Most studies examine the impact of electricity reform as a whole on market outcomes.

Evidence shows that electricity reform can generate positive impacts – for both developed and developing countries – in terms of efficiency, prices, access, reliability of service and environmental impacts. Much of the research has focused on the experience of the early reformers in Latin America. According to the World Bank (2005), wholesale prices fell by 37% and retail prices by 17% between 1986 and 1996 following electricity sector reform in Chile. Haselip (2004) showed that, between 1988 and 1998, the proportion of the poorest 10% of households with no access to electricity in Chile fell from almost 30% to 7% (although this can be attributed in part to the effect of wider economic growth and income increases). Jamasb et al. (2005) show that labour productivity in generation in Chile increased and energy losses declined.

The same study shows that, following reform in Argentina, the installed generation capacity increased and labour productivity improved. Ennis and Pinto (2002) in another study of Argentina show that access to service for the poorest groups rose sharply – residential service in the Buenos Aires area increased from 65% in 1985–6 to 99% in 1996–7. In Peru, Torero and Pasco-Font (2003) show that electricity reform between 1994 and 1997 resulted in higher prices, but also brought about significant improvements in access to services, labour productivity, quality of service and energy loss reduction.

> Country case studies carried out in Latin America in 2001 show that energy market liberalization has, on balance, been beneficial to countries that have implemented it. Both energy availability and the quality of the service have been enhanced, mostly through a rapid transfer of technology and systems and more efficient modern management (Abugattas Majluf and Zarrilli 2007).

Box 9: Electricity liberalisation: Contrasting performance in Africa

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

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

However, the evidence also shows that the gains from liberalisation are by no means certain. Some studies, such as Bortolotti et al. (1998) and Pollitt (1997), have found that effective regulation and the creation of a competitive environment is crucial to the success of reform, but that this can be a difficult and slow process. A study by Zhang et al. (2002) of 51 developing countries over the period 1985 to 2000 found that privatisation significantly improved performance, measured in terms of capacity, output and labour productivity, but only when accompanied by competition and independent regulation.

Appropriate regulation is also needed to ensure that the efficiency gains from reform are shared appropriately with consumers. For example, Mota (2003) shows that electricity reform in Brazil between 1993 and 2003 – where tariff restructuring and privatisation occurred before a regulatory agency was established – generated efficiency gains in the region of US$12 billion, but that only US$2.2 billion of that gain was passed on to customers.

> Many countries have experienced difficult in establishing regulatory regimes that extract the full benefits of private sector participation. The specific problems vary from market to market, but an important factor has been the state of a country's power sector prior to reform and how reform was approached. As might be expected, countries with more favourable pre-reform conditions have been more successful and have captured greater benefits. These conditions include the financial state of the utilities, the size of capacity reserves, the prevalence of cost-reflective pricing, and the strength of regulatory traditions (Evans 2006).

5.4.2 Difficulties with pricing and profitability

Prior to liberalisation, prices are often held artificially low, for some types of customers at least, through cross-subsidisation by state monopolies (where, for example, commercial customers may have been charged higher prices in order to keep prices low for residential customers), or government subsidy. Cross-subsidisation has also helped to pay for investment in extending the grid. Thus, prices rises are common after liberalisation when subsidies are reduced or eliminated, and when companies need to cover the cost of the new capital investment required. This can result in strong public opposition to reform, leading to subsequent policy reversals and undermining contractual agreements with private investors.

Although concerns about price rises sometimes revolve around the impact on the poor, in many cases it is other well-organised groups of people, such as those of farmers or industrialists, that are able to successfully lobby the government to keep prices below costs. These low prices benefit some groups, but can drive up prices for other groups (such as SMEs), distort the market and reduce incentives for energy companies to invest in improving electricity services.

Strong commitment to reform is usually required for a prolonged period to ensure ultimate success, and the continued provision of government subsidies to protect access for the poor and rural population is often necessary. This is discussed further in the next section. The inherent tension between achieving prices that cover the required capital costs to expand access but that also are deemed 'affordable' became increasingly evident in the late 1990s. This helps explain why private participation in the energy sector has fallen since then.

Haselip (2004) argues that, in Argentina, macroeconomic instability related to the economic collapse of 2001 and the devaluation of the peso against the dollar (to which it had previously been pegged) had a big impact on foreign utility companies, as the gap in value between company revenues and their dollar-denominated debts and foreign operating expenses led to significant losses. The Argentine government froze utility tariffs after the currency devaluation, and subsequent attempts to increase tariffs led to public protests.

In Argentina and elsewhere in Latin America, foreign energy companies have sought to rescind or renegotiate their contracts when market conditions have become more difficult, and governments have cancelled contracts in light of often strong public disapproval (including organised public non-payment campaigns, for example). This has led to a number of legal disputes. These kinds of issues and risks have contributed to the reduction in private participation in energy markets in recent years.

Liberalisation has been more successful in many developed countries, however, and this serves to highlight that the context within which liberalisation is undertaken can be very important to its success. Haselip (2004) argues that, in Latin America, reforms were often implemented at a time of political and economic weakness, as a way of alleviating fiscal problems associated with loss-making public utilities and securing much-needed new private investment. At times of crisis like this, government's bargaining power is not strong; contracts were often structured with a view to attracting foreign investors quickly, with relatively generous contract terms and little consideration given to social impacts.

This suggests that, to be successful, liberalisation needs to be undertaken carefully, for the right reasons, with the support of the public and with effective regulatory structures and perhaps ongoing subsidies in place to ensure access and affordability for vulnerable and low-income groups. This is considered in more depth below.

5.4.3 Environmental impacts

Liberalising the electricity sector may also contribute to improved environmental performance, because of the increased incentives for energy efficiency and technical innovation created by competition, and because of the superior technology and know-how brought by private foreign entrants. According to Perkins (2005), IPPs have been more likely to introduce cleaner, gas-based combined-cycle gas turbine

(CCGT) plants because of the low capital costs, rather than the conventional coal-fired plants that have long been favoured by state-owned utilities.

This is particularly evident in relation to the market entry of IPPs in a number of developed countries, which led to the commissioning of modern, clean generating plants, often substituting for older, more polluting installations. According to Pearson (2000), the introduction of CCGT plants led to significant reductions in CO_2 and SO_2 emissions in the UK. And Darmstadter (2002) argues that IPPs have been responsible for significant increases in the use of renewable energy sources.

A number of studies (e.g. Perkins 2005 and Blackman and Wu 1998) confirm that IPPs adopt more energy-efficient technologies than traditional utilities, although others suggest that this is not always the case in developing countries (e.g. Greenpeace 2002). In developing countries, the framework for competition and regulation (including environmental regulation) may be weaker, reducing incentives for innovation and energy efficiency by IPPs. Thus, the environmental benefits may be more limited than has been the case in developed countries, and are likely to depend to a large extent on the competitive, regulatory and institutional framework in place in the host country.

5.5 Complementary policies required to maximise benefits to development

5.5.1 Establishing competition

It is important to establish transparent conditions for competition to work in energy markets, including ensuring that market entrants are given access to the network at a fair price, for example. However, Pollitt (1997) argues that establishing effective competition in the electricity sector can be difficult, and that this has also proved challenging in developed countries; experience with early reforms in the UK and US demonstrated that appropriate regulation of access to networks and pricing is important to prevent incumbents from abusing their market power and ensure firms have an incentive to minimise costs.

> Many small countries have too few generators to allow real competition, while in larger countries individual electricity companies may still have market power if they own many generation plants. Even when electricity generators do not have market power at most times of the day, they may have it when demand peaks, and like sellers in many markets, they may collude to increase prices. Competition is fostered by separating generation from transmission, and distribution from retail supply, so that the owners of the transmission and distribution lines cannot use their monopoly in these industry segments to stifle competition in generation (World Bank 2005).

There are also trade-offs associated with giving private providers long enough contracts to incentivise them to make the necessary investments in infrastructure (which will yield adequate return only if they can secure the revenues from these investments over a relatively long period), versus the need to allow competition in the market to ensure cost reductions are passed on to consumers. An appropriate balance needs to be struck between these competing objectives.

5.5.2 Access to electricity

As set out in Evans (2006), there have been concerns that private providers will 'cream-skim' the most profitable clients and 'red-line' (i.e. cease to serve) certain groups of consumers or geographical areas that are deemed likely to be unprofitable. Such concerns can be addressed by universal service obligations in contracts, or through consumer protection provisions in the regulatory framework, or in the licensing conditions given to all new entrants.

Service and price guarantees may also be established, requiring at least one nominated provider, often the incumbent supplier, to provide a service at a capped price to customers who may not otherwise be served by new private entrants. If the price for this service is set too low, however (as there is often considerable political pressure to do), it can undermine competition by undercutting potential competitors and making new entry unfeasible.

In practice, ongoing subsidisation may well be necessary to ensure provision for those on low incomes and in rural and remote areas in many countries. However, private participation and some degree of competition for the right to provide the subsidised service can still be permitted, and can help to encourage innovation, efficiency and cost savings for the government.

Box 10: Ways of subsidising electricity services

Various models have been tried. Evans (2006) explains how, in Chile, subsidies for expanding electrification have been allocated through annual competitions between suppliers which were judged on the basis of technical merit, amount of private investment to be contributed and expected social impact. The aim was to minimise project costs and stimulate efficiency and innovation. A number of foreign companies participated in the market. The scheme is credited with contributing to an increase in access to electricity in rural areas by almost 50% in the first five years (Jadresic 2000).

In Mozambique, there were competitions for contracts providing exclusive rights to the winning company to expand electricity services in a particular area over a 20-year period, with the provision of a subsidy for each new household connected. This meant the winning company was able to decide how to expand access most cost effectively.

Alternatively, subsidies can be paid direct to low-income and vulnerable households through the country's welfare payments system. Subsidies for conservation measures designed to improve the energy efficiency of housing for particular groups can also be provided, as a way of tackling growing carbon emissions which are associated with climate change.

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

More generally, regulation will be necessary to ensure consumers are treated fairly.

> Since consumer protection may have been implicit or customary under monopoly provision, restructuring requires establishing explicit rules for minimum customer service standards which electric utilities must respect when providing electric service to the public. This includes articulating rules for payment of bills, late payment and non-payment (OECD 2006).

As explained in Birdsall and Nellis (2002), non-payment for electricity has been common in many developing countries, particularly among low-income residential households, as state-owned utilities have often had limited incentives to tackle the problem. This means that when private companies crackdown on this practice, it can serve to reduce electricity usage by the poor, unless subsidies are provided in order to maintain provision.

5.5.3 Reliability of service

Experience shows that liberalisation can improve the reliability of service, but that an appropriate market structure and regulatory framework is required to ensure a seamless supply. As electricity cannot be stored, avoiding price volatility and disruptions in service is a greater challenge than in most industries. There have been large-scale blackouts in a number of countries, including developed countries, such as in the Californian electricity sector in 2000–1. This arose from supply shortages and a surge in demand, and left many people without electricity and major power corporations facing bankruptcy. This demonstrates the complexities associated with managing a liberalised electricity market effectively, even in developed countries with strong institutions.

In many countries, reforms have encountered significant difficulties and policymakers have found the reform path considerably more complex than anticipated (World Bank 2003). This is partly because electricity markets are characterized by the need for real time balancing of supply and demand (due to a lack of storage) and hence are required to be better designed and regulated than most other deregulated sectors (Jamasb et al. 2005).

5.6 Conclusion

Access to electricity is central to practically all aspects of economic activity, yet service is limited or unreliable in many developing countries. Liberalisation of the electricity sector and market entry by private (often foreign) players can bring competition, innovation, technological know-how, managerial expertise, and much-needed investment capital with which to improve service, expand access, and keep pace with expected growth in demand. It has generated substantial benefits in many countries, in terms of greater efficiency, lower prices, improved access, greater reliability of service and improved environmental impact.

However, the evidence also shows that the gains from liberalisation are by no means certain, and rely heavily on the establishment of competition and an effective regulatory framework in order to create the right incentives for appropriate investment and efficiency gains, and to ensure that these efficiency gains are passed on to consumers in lower prices. Key policy requirements include:

- The creation of competitive market conditions through privatisation, separation of power generation from transmission and distribution services, the introduction of commercial (cost-reflective) pricing, measures allowing market entry by both domestic and foreign companies and ensuring a level playing field (e.g. through appropriate regulation of access to the grid), and through the introduction of competition to the sector or certain parts of it by giving customers a choice of supplier;
- The establishment of a good regulatory framework for those parts of the supply chain (e.g. transmission) where competition is limited by the natural monopoly characteristics of production;
- The establishment of a market structure and regulatory framework which ensures real time balancing of supply and demand and thus avoids disruptions in supply and price volatility;
- Consumer protection provisions in the regulatory framework to ensure customers are treated fairly; and
- Measures to ensure adequate access to services. This may be through the regulatory framework, or through universal service obligations which prevent suppliers from 'red-lining' (i.e. ceasing to serve) certain groups of potentially less profitable customers.

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

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6. Information and communication technology and trade in services

The ability to use ICTs is critical for development, because they improve the efficiency of households, firms, sectors and the country as a whole. The adoption of ICTs also enables specific services to be traded. Evidence suggests that ICTs bring faster growth, better economic firm performance and improved household welfare as they can enable more efficient organisation. ICTs enable firms to obtain better access to knowledge and information, to lower transaction costs, to supply markets at longer distances, to improve decision-making across the value chains and to improve flexibility of firms to respond to consumer demand.

ICTs also enable trade in 'IT-enabled services' through offshoring. The offshoring of services occurs when activities of companies are transferred to other countries through outsourcing (i.e. offshore outsourcing) or FDI. Call centres and online programmers are key examples of the offshoring of IT-enabled services to countries such as India and South Africa. Offshoring of services has begun to bring great benefits and new opportunities to those developing countries that have appropriate ICT and skills, including those that are landlocked. However, ICT is not available everywhere and there exists a digital divide between developing and developed countries in terms of access to ICT, although this divide has been reducing recently.

Development and reform in the ICT sector involves market liberalisation and competition, private sector participation and effective regulation. Competition has become the norm in the ICT sector. Private sector participation is still lower in Africa than in other regions. The number of countries with an established regulatory authority separate from the government and in charge of regulatory mechanisms to promote the use of ICTs has increased sharply, from a dozen in 1990 to around 150 in 2006.

Beyond regulations in the ICT sector, rules and regulations in developed countries affect the offshoring of IT-enabled services. For instance, some US states have banned offshoring of services owing to employee concerns about jobs. Anti-offshoring sentiment has also increased in other locations, with some emphasising the importance of legislation on data protection in offshore destinations.

Market reforms can boost productivity and profitability and stimulate investment, enhancing ICT sector performance. Market-based strategies also allow governments to meet social and economic goals, e.g. increasing access to ICTs and revenue from telecommunications. Effective regulation has also helped ICT to grow rapidly.

Different types of complementary policy help maximise the benefits of regulatory reform and liberalisation in the sector. In particular, liberalisation benefits from an appropriate regulatory framework embedded in an overall strategy that enhances technological development and supports innovation. Regulators are also important. Key complementary policies to promote offshoring and enhance the role of regulatory reform include promoting a high-quality and appropriate skills base.

6.1 Introduction

This section deals with ICT and development as well as with IT-enabled services. The ability to use ICTs is critical for development, because they improve the efficiency of households, firms, sectors and the country as a whole (UNCTAD 2006). The adoption of ICTs also enables specific services to be traded. Call centres and online programmers are key examples of the offshoring of IT-enabled services to countries such as India and South Africa. The offshoring of services occurs when activities of companies are transferred to other countries through outsourcing (i.e. offshore outsourcing) or FDI. Outsourcing is possible for many services, such as business (accountancy, legal services, computer-related), financial (insurance, banking), health, audiovisual and transport services. This opens up opportunities for developing countries, including landlocked countries, as long as they have good ICT.

This section begins by discussing the relationship between ICTs and development, finding compelling evidence that ICTs bring faster growth, better economic firm performance and improved household welfare, as they can enable more efficient organisation. Offshoring of services has begun to bring great benefits to developing countries, although ICT is not available everywhere and a digital divide exists between developing and developed countries in terms of access. This has been reducing recently.

Development and reform in the ICT sector involves market liberalisation and competition, private sector participation and effective regulation. Competition has become the norm in the ICT sector. Private sector participation is still lower in Africa than in other regions. The number of countries with an established regulatory authority separate from the government and in charge of regulatory mechanisms to promote the use of ICTs has increased sharply, from a dozen in 1990 to around 150 in 2006. Beyond regulations in the ICT sector, rules and regulations in developed countries affect the offshoring of IT-enabled services. For instance, some US states have banned offshoring of services owing to employee concerns about jobs. Anti-offshoring sentiment has also increased in other locations, with some emphasising the importance of legislation on data protection in offshore destinations.

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Different types of complementary policy help maximise the benefits of regulatory reform and liberalisation in the sector. In particular, liberalisation benefits from an appropriate regulatory framework embedded in an overall strategy that enhances technological development and supports innovation. Regulators are also important. Key complementary policies to promote offshoring and enhance the role of regulatory reform include promoting a high-quality and appropriate skills base.

6.2 Contribution of the sector to development, growth and poverty reduction

This section first focuses on the importance of ICT for development and then aims to understand how trade in IT-enabled services itself affects development. The latter is less well studied.

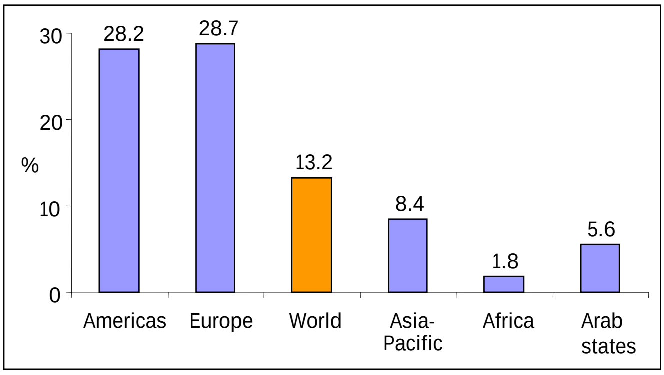
6.2.1 The importance of ICT and innovation for development

The ability to use ICTs is critical for development. ICTs boost a county's productivity, by improving efficiency and help firms and households to overcome constraints posed by limited access to resources and markets. ICTs enable firms to obtain better access to knowledge and information, to lower transaction costs, to supply markets at longer distances, to improve decision-making across the value chains and to improve flexibility of firms to respond to consumer demand. We discuss the spread of ICT and its effects at the macro and micro level.

ICT adoption

Fixed line, mobile and internet users are increasing in number globally, but there is a digital divide among countries with different levels of development. Europe had almost eight times the penetration rate of Africa, where fewer than one in 10 people subscribed to a mobile service (ITU 2007). Figure 6 shows similar patterns for internet penetration. These data highlight that access to, and use of, mobile services is unevenly distributed among regions.

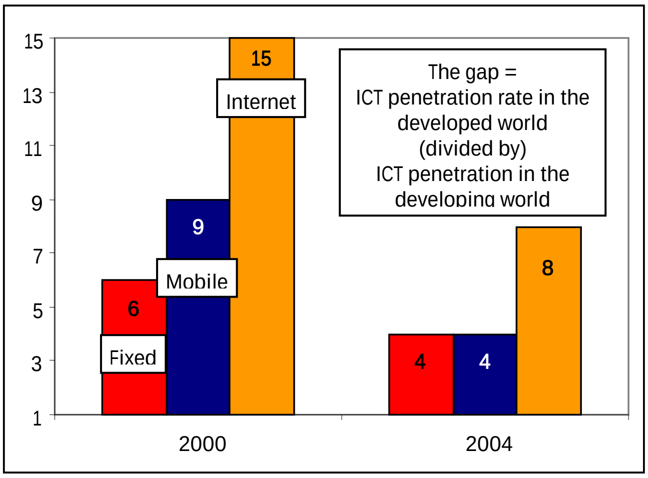
Figure 6: Major disparities in internet penetration across regions, 2004



Source: ITU (2007).

Although access to ICTs is unevenly spread, the digital divide is shrinking. International Telecommunication Network (ITU) statistics show that, over the past 10 years, the digital divide between developing and developed countries has been narrowing in terms of fixed telephone lines, mobile subscribers and internet users. Despite slower fixed line growth (the fixed line gap has been reduced from 11 to 4 over the past 10 years), rapid growth in the mobile sector in particular has been able to contribute to reducing the digital divide. See Figure 7 for data over the period 2000–4 (ITU 2006).

Figure 7: The shrinking digital divide, 2000–2004



Source: ITU (2007).

Given the empirical findings, which show that ICT is important for development, it has become of growing importance to address these divides. Sectors most affected include e-commerce, teleworking, e-education and health. This highlights the need for developing countries to pay special attention to broadband deployment and strategies. Countries ranging from Rwanda to Mauritius are now attaching high priority to ICT development.

Macro-level effects of ICT

At the macro level, ICT affects growth through the composition effect, as ICT industries are growing faster than others, and the way it fosters technological progress. The literature is much more established in developed countries. Jorgenson et al. (2005) find that that the IT-producing and IT-using industries in the US play a disproportionate role in the American growth resurgence. These industries account for only about 30% of US GDP but have contributed half of the acceleration in economic growth. They also find that differences in the relative importance of IT-producing industries in other Group of 7 (G7) countries contributed to wide disparities in the impact of IT on economic growth. ICT has increased total factor productivity by one percentage point over the period 1995–2001 in countries such as Finland, South Korea and Ireland.

There is less systematic evidence for the effects of ICTs in developing countries. Campos (2006) estimates the effects of ICTs on economic growth using panel data for 170 countries over the period 1960 to 2005. He finds that ICTs (proxied by mobile and fixed line connections) have a large impact on growth, even in the poorest countries, and the impact is robust to the inclusion of different regions. The effects of ICTs are greatest in Asia, followed by Latin America and then Africa. Such macroeconomic studies do not spell out the ways in which ICTs affect development, as this will include direct composition effects as well as indirect effects through the investment climate.

Torero and von Braun (2006) summarise multi-country multi-year results that find a positive link between telecommunications infrastructure and income. A 1% increase in the telecommunications penetration rate leads to a 0.03% increase in incomes. At the same time, telecommunications networks need to reach a critical mass to have a discernible impact on economic output. Growth effects are greatest when penetration rates are 5–15%; above this, growth effects were limited. Given that the average telecommunications penetration rate in low-income countries is very low, significant network investment and expansion are needed before ICTs can begin to affect growth.

Micro-level effects

At the micro level, there is evidence for the positive impact of ICTs on firm performance. Again, most evidence is for OECD countries (Bloom et al. 2006), but there is also some evidence for developing countries. Basant et al. (2006) present econometric evidence that finds a strong relationship between ICT capital and productivity in India and Brazil, after controlling for firm-specific effects. Specific types of organisational changes (new business processes, teamwork, decentralisation, changes in monitoring and hierarchies) matter for the return of ICT, but only for high adopters.

Torero and von Braun (2006) suggest that ICT adoption can be an element in firms remaining competitive, and discuss the use of ICTs by the Indian garment industry in to remain in contact with the rest of the global value chain. However, the effects of ICT adoption on firm performance may have been held back because of a lack of complementary factors: ICT penetration in this short period may not have reached threshold levels and complementary ICT infrastructure is not yet present.

Inequality and poverty effects

Technology has had a skill bias (i.e. making skilled workers relatively more productive than less skilled workers) in both developed and developing countries (studies on skill-biased technological change). As a result, without appropriate and high-quality education, this may increase inequality. Openness to FDI may accentuate this (te Velde 2004) because foreign firms are often at the forefront in introducing new technologies.

Torero and von Braun (2006) argue that ICTs have a positive effect on rural households, for example, because rural households can communicate more cheaply. Households in Laos with access to phone lines had a 20–25% higher expenditure than otherwise similar households. They also provide positive estimates for the implied welfare gain of a telephone call in poorest quintiles of rural areas in Bangladesh and Peru.

6.2.2 IT-enabled services and development

Developments in the ICT sector have enabled trade in specific services, such as call centres and online transactions. We will analyse this phenomenon and its impact on development. So far, there has been little systematic evidence of this because, for some developing countries, it is a relatively new concept; more generally, the concept of IT-enabled services or offshoring is not well-established in terms of economic statistics.

Offshoring of services

The offshoring of services from the richer industrial countries – where part of a company's work is subcontracted to other companies in other countries – can offer important opportunities to developing countries. Economic liberalisation, technical change and improved services, such as transport, ICTs and economies of scale, are increasingly affecting the services sector itself. The offshoring of IT-enabled services has now emerged as a powerful example of offshoring from Western Europe and the US, going far beyond call centres in India, Mauritius, Ghana and the Caribbean. Now it includes health services in Caribbean and South Africa, education services in South Africa, journalism, legal and other business services in India and shipping services using Philippine labour. Developing country exports of services are beginning to have a big impact on the economies of developed and developing countries alike.

The search for cheaper production costs has led global firms to relocate parts of the production process abroad, leading to fragmentation of **goods** production (e.g. electronics, automobiles) (see Feenstra 1998). Firms often maintain design, research and development (R&D) and marketing functions in the headquarters in developed countries, while relocating labour and less skill-intensive production processes, such as assembly, to low-cost developing countries. Integrated production processes could be characterised by a series of production blocks, connected by various service links enabled by ICT. There has also been an increase in networks of firms across borders through the emergence of global value chains (in textiles/clothing, flowers, canned fruit, coffee, furniture, etc.), often involving outsourcing rather than ownership of overseas subsidiaries.[10]

Although the services sector has facilitated both fragmentation of the production process and the emergence of global value chains in the goods sector (Jones and Kierzkowski 2001), it has itself been less associated with global outsourcing. This has probably been because services have needed to be provided directly to customers, on site, or at least within the country of the customer. This has all changed, thanks mainly to rapid changes in ICT.

The past decade has seen a dramatic rise in the offshoring of service across a range of sectors. India has been the leading offshore destination during this period, and now accounts for 65% of the global industry in offshore IT and 46% of the global business process outsourcing industry (Nasscom–McKinsey 2006). The Economist Intelligence Unit estimates the global offshoring market at around US$50 billion in 2005 (EIU 2006), and it is expected to continue to grow rapidly. If the sector keeps growing at 30% a year, as in previous years, this would mean that it will double to US$100 billion by 2008. The analysis by Nasscom–McKinsey (2006) indicates that the potential market for global offshoring exceeds US$300 billion, of which US$110 billion would be offshored by 2010.

Comparative and competitive advantages

The labour-intensive nature of many of the offshored services sectors (some business services and temporary movement of people) is a comparative advantage for several developing countries and can help to promote pro-poor growth. Offshored services include a range of different activities, from contact centres, back-office services and IT services, to (regional) headquarters and R&D activities. Some countries are better suited for some tasks than others, depending on the availability of numerical, clerical and communication skills.

However, competitiveness also matters a great deal. Even though some countries do not have a comparative advantage in the IT sector, they may still provide IT-enabled services, because their competitiveness (low wages, ease of doing business) is strong. Countries with an abundance of cheap labour with basic skills (language and clerical) are well placed to undertake relatively simple offshored services. Indian wages of call centre operators are one-tenth of UK wages – and double what a fully qualified local teacher can earn – but this has not prevented a low rate of retention common in both

[10] A value chain consists of a number of different enterprises, each specialising in different functions, but linked to each other by certain means of cooperation in a network facilitated by communication and services. It refers to a closer relationship among firms (see, for example, Kaplinsky 2000).

developed and developing countries. Caribbean wages are one-fifth of US wages but this location has the advantages of a similar time zone and easier connections.

Offshored services and employment

A key developmental gain from offshored services for the host country seems to be the number of jobs and derived incomes. The scale of the issue can be examined by looking at exports by developing countries and imports from developing countries by developed countries. To provide some developing country examples, at present 1.6 million workers are employed in the Indian IT sector, including software and call centre services. To name a few other examples, there are more than 400 call centres in South Africa, employing 80,000 people. The Caribbean has also become a major player in the market for offshoring, mainly to the US. Jamaica's export processing zones (EPZs) include 15 companies employing over 5000 workers in areas such as helpdesks, travel reservations and software development. Trinidad and Tobago has also entered the market for offshored services. It has a dozen call centres, employing around 1000 workers. The call centre industry in the Philippines employs 27,000 workers; companies include Microsoft, Safeway and Kodak. Over 60 (mostly US) companies have chosen Ireland as the base for their European call centres, employing 12,000 people.

From a developed country perspective, van Welsum and Reif (2006a and 2006b) and van Welsum and Vickery (2005) calculate the share of jobs that can potentially be offshored, and suggest that this could be up to 20% of jobs in OECD countries. Clerical (standardised) and non-clerical (skilled) are affected differently by international sourcing (van Welsum and Reif 2006b). This can translate into more than an equivalent increase in development countries if production techniques are more labour intensive than would have been the case if the jobs remained in developed countries. McKinsey Global Institute (2005) suggests that, from 2003 to 2008, an additional 2.6 million offshore services jobs will be created at the global level. Countries such as India have also begun offshoring to lower-cost locations.

Offshored services and capital

Most offshoring of services occurs through outsourcing contracts between companies without the transfer of capital. However, there are also cases of FDI in IT-enabled services, so that the host country gains capital inflows that alleviate BoP problems. In India, foreign-owned firms are responsible for 28% of employment in IT-enabled services. The largest call centres in South Africa are foreign owned, e.g. EDS (Electronic Data Systems). Most offshored services are labour intensive not capital intensive, which tends to make them more footloose than their manufacturing counterparts.

Offshored services and trade

There is no separate category in services trade statistics for offshored services, and trade in services statistics are of notoriously bad quality. Coverage is patchy on the import side. It is possible to examine the UK trade balance with India, which became negative in 1998, but only marginally. Imports of computer services from India grew after 2000, but the balance of this sector with the whole world is large and positive, and growing. It might be easier to examine the growing importance in trade on the export side in India, a country that has benefited significantly in this way. Table 8 clearly shows a large increase.

Table 8: Growth of Indian IT and ITES–BPO sector (US$ billion)

	FY 2004	FY 2005	FY 2006	FY 2007 (est.)
ITES–BPO	3.4	5.2	7.2	9.5
Exports	3.1	4.6	6.3	8.3
Domestic	0.3	0.6	0.9	1.2
Engineering services and R&D, software products	2.9	3.9	5.3	6.5
Exports	2.5	3.1	4.0	4.9
Domestic	0.4	0.8	1.3	1.6

Note: ITES = IT-enabled services; BPO = business process outsourcing.
Source: Nasscom.

The exports of services can directly affect growth and account for an increasing percentage of GDP in some countries. In India, IT-enabled services are responsible for one-third of the total. The IMF estimates that the valued added in exports of services increased GDP growth by 0.2 and 0.6 percentage points annually over the 1980s and 1990s (Gordon and Gupta 2004).

Technology, know-how and upgrading
In some cases, companies upgrade skills in their foreign subsidiaries. Offshored services now include financial analysis, IT and architectural and medical services, which require further skills. Companies can upgrade when they engage with local technology and training institutes, or when there is frequent and intensive communication between home and host country firms. For poorer countries, especially in Africa, call centres or business process operations may be the first step in formal employment.

Offshoring through temporary migration
Offshored IT-enabled services can be delivered by workers who deliver services through temporary migration. Well-known examples include Indian IT programmers who came to the West to solve the Y2K problem. The Philippines have long offered shipping services. There are also examples of offshoring of services such as those in the health sector, some of which are assisted by ICT. Non-UK health care providers, including Netcare of South Africa, provide fast-track centres offering surgery to UK National Health Service (NHS) patients, a contract worth a total of £2 billion. The providers also run mobile operating units, with Netcare bringing over surgical teams from South Africa on rotation.

Diversification through offshored services
Increased exports of key services offer a welcome diversification away from a development strategy based on agriculture and natural resources alone. Several small developing countries have few possibilities besides tourism, because their size and related operating costs do not enable a viable manufacturing sector. The emergence of offshored services is important to Caribbean countries, for example, in finding alternatives to manufacturing and agriculture where tariff preferences are eroding.

New offshored services activities can be attracted on the basis of the existing structure of comparative advantage. For instance, Jamaica transformed its EPZs effectively to attract offshore services. In other examples, such as Trinidad, it might well be appropriate to build on already successful insurance and financial services industries. Mauritius could move into sugar-related IT services.

Offshored services and opportunities for growth
The picture at present is still patchy. There have been few studies of the extent of offshoring in developing countries, and fewer still of the actual impact on development. What is clear is that this is a relatively new area, at least in terms of scope. For big developing countries, offshored services are only one element they need to build on to obtain pro-poor growth. But for small or landlocked countries with few other possibilities, offshored services can be an important way out.

In terms of pro-poor growth and productivity, ICT and IT-enabled services have added a significant amount to growth and export revenues in such countries as India and Mauritius. Although it is true that the poor are unlikely to gain directly, there are significant indirect effects on poverty in the form of remittances, dynamics of employment incentives, taxes and indirect consumption.

Although only a small step, any small externalities from IT-enabled services in terms of innovation activities are welcome because innovation activities in poorer developing countries are notoriously weak and a neglected factor in long-term growth (see Ndulo 2007).

The growth in knowledge-based industries contributes to a focus on education and skills upgrading, which can raise growth and investment in the long run. However, knowledge industries may not provide much work to the poorest rural workers directly, and there are limitations to the growth potential of the less skilled segments of IT-enabled services. More labour-intensive services, such as call centres, could provide many jobs, but there are limitations. In addition, there are likely to be few technological externalities and productivity spillovers from call centres, making it difficult to rely on these alone as the main source of growth.

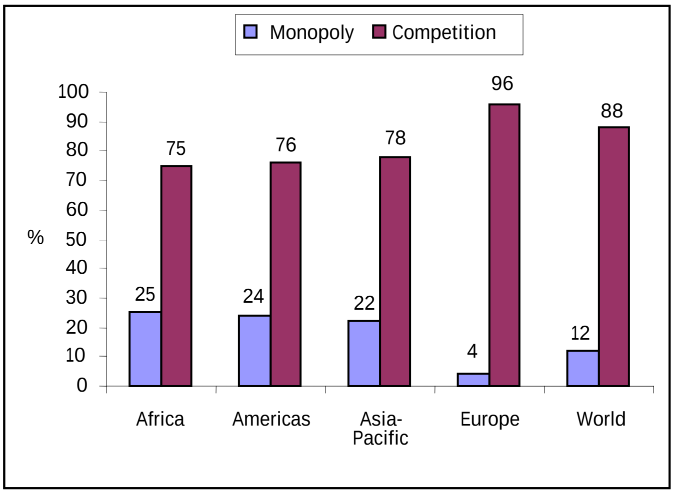
Nevertheless, the growth in call centres in addition to other IT-enabled services provides a welcome source for alternative development and is likely to have direct effects on growth and indirect effects on poverty reduction. Countries that have started with call centres have subsequently moved into technologically more sophisticated products.

6.3 ICT sector liberalisation: What is involved?

Development and reform in the ICTs involves market liberalisation and competition, private sector participation and effective regulation ((see, for example, ITU 2007).

Competition
Mobile and internet markets tend to be more competitive than fixed line markets, owing to the many new private entrants. Africa is relatively less competitive, although more than half the countries were open to some form of competition by 2006. However, there are several different forms of competition.

Figure 8: Competition in the mobile cellular market



Source: ITU (2007).

Private sector participation
Over the past three decades, global infrastructure markets have undergone unprecedented changes and institutional reorganisation. Rapid technological advances, particularly in the telecommunications sector, and deliberate changes in public policy have led to deregulation and competition in mature markets and liberalisation in the developing world. The private sector is now dominant in the telecommunications sector in most countries. Telecommunications in 150 countries were state-owned in 1991; by 2003, the number had fallen to 79. There was a wave of FDI to Latin American telecommunications in the 1990s followed by Asia and now Africa. Privatisation of incumbent public telecommunication operators in developing countries has raised US$83 billion between 1990 and 2006. Box 11 provides an example of a country considering further liberalisation and private sector participation in the telecommunications sector.

Box 11: Liberalisation of telecommunications in Botswana

Despite the market liberalisation in 1996, the telecommunication sector is a *de facto* monopoly, dominated by the only fixed line voice service provider BTC (Botswana Telecommunications Company). At the regulatory level, the government has considered the extent to which current competition in the telecommunication sector is sufficient to obtain the desired standard and efficiency of services. The Telecommunications Policy for Botswana, which was adopted in 1995, aimed to introduce competition in the telecommunications sector; it was followed by the Telecommunications Act of 1996. BTC used to have the monopoly, with a mandate to provide all the telecommunications services to all areas. The implementation of the Telecommunications Act led to the creation of the Botswana Telecommunications Authority (BTA), which has issued cellular licences to Orange Botswana (formerly Vista) and Mascom Wireless Botswana, internet service provider (ISP) licences and data licences. Future planned steps in liberalising the sector involve the following:

1) **The restriction on the provision of voice over internet protocol (VoIP) by value-added network service providers is lifted (1 August 2006).** This means allowing VOIP by issuing licenses to national and international ISPs, currently serviced only by BTC, Mascom and Orange.
2) **Mobile operators start self-providing (transmission links) (1 August 2006).** This allows Mascom and Orange to build their own backbone infrastructure to carry their traffic. Currently, they are compelled to use BTC infrastructure.
3) **Current fixed line and cellular operators may apply for service-neutral licenses (1 September 2006).** Service-neutral licenses are those which allow an operator to provide all telecommunications services, including voice and data and irrespective of whether the service is transmitted wirelessly or on a wire.
4) **New entrants may tender for service0neutral rural/district-level licenses (1 September 2006).**
5) **Liberalisation occurs of the international voice gateway (1 October 2006).** Liberalisation of the international voice gateway means allowing other players to provide international switching and transmission of voice services, a market that is currently monopolised by BTC.
6) **BTC attains a satisfactory level of tariff rebalancing (December 2007).** This allows BTC to complete its ongoing exercise of adjustment of its tariffs to align them with costs.
7) **New entrants may tender for service-neutral national licenses (1 July 2009).**

Source: te Velde and Cali (2007).

Regulation

Regulation can help ensure market competition, address market failures (such as dealing with possible abuse of monopoly position) and ensure access to networks. This is particularly important when the private sector will not deliver desired policy outcomes, such as universal access to ICT. According to the ITU, the number of ITU members with an established regulatory authority separate from government and in charge of regulatory mechanisms to promote the use of ICTs increased from 14 in 1990 to 147 in 2006. Regulatory authorities provide for issuing of licenses, spectrum allocation, interconnection settlements and dispute resolution and other issues.

Trade in IT-enabled services

IT-enabled services depend on reform in telecommunications, but there are other types of regulations, particularly in destination countries, that affect the sector. Several US states have prevented offshore companies in developing countries from doing government contract work, resulting in New Jersey and Indiana cancelling contracts with Indian offshore suppliers. The US federal government has done less, but the President signed a bill in 2004 preventing private companies which take over government contracts in the federal transport and treasury departments from moving such work offshore.

Provisions on data protection in developed countries affect developing countries. For example, the European Data Protection Directive (95/46/EC, data on individuals) prohibits data on individual Europeans from leaving the EU unless it goes to countries with full data protection laws. Apparently, countries such as India and Mauritius do not comply with minimum standards, although individual companies have signed contracts to comply with the Directive.

Table 9: IT-enabled services exported from India

1. IT-enabled computer and related services	
Software development and implementation services, data processing and database services, IT support services, application development, testing and maintenance, business intelligence and data warehousing, content management, e-procurement and business to business (B2B) marketplaces, enterprise security, package implementation, system integration, supply chain management (SCM), enterprise application integration, total infrastructure outsourcing, web services (internet content preparation, etc.), web-hosting and application service providers (ASPs), requirements engineering.	
2. IT-enabled BPO services	
Customer interaction services	Sales support, membership management, claims, reservations for airlines and hotels, subscription renewal, order processing, warranty administration, customer services helpline, handling credit and billing problems etc., telemarketing and marketing research services.
Back-office operations	Data entry and handling, data processing and database services, medical transcription, payment services, financial processing (financial information and data processing/handling), check credit/debit card processing, human resource processing services, payroll services, health care administration, warehousing, logistics and dispatch, inventory, supply chain services, direct and indirect procurement, ticketing, insurance claims adjudication, mortgage processing.
More independent professional or business services	Human resource services (hiring, benefit planning and payroll, etc.), finance and accounting services (including auditing and compliance, bookkeeping, taxation services, etc.), data analytics and mining, data/knowledge management, marketing services, product design and development.

Source: Based on Mattoo and Wunsch (2004).

Trade union leaders in the UK (e.g. Amicus) have already raised serious doubts over the security of personal data (going to India), urging the UK's privacy commissioner to examine offshore companies' data protection measures, so it is about not just legal implications but also perceptions and labelling. Indian BPO companies sign non-disclosure agreements with their clients and a number of mechanisms are established to protect data (OECD 2007), including dedicated offshore centres where:

- Only project staff are allowed
- The client's infrastructure and IT system are replicated
- All types of data transfers are encrypted
- Project staff are prohibited from carrying any devices that can store information
- Project staff are prohibited from interacting with project staff working for competing clients and
- Project staff are kept under video surveillance

A further set of sector-specific regulations affect trade in IT-enabled services. This becomes evident when examining the scope of services exported from one of the major providers. It involves software development delivery online, but also such areas as telemedicine or online design services. The destination country benefits from imports of such services but it may also want to ensure that services are provided according to standards and that, if consumers complain, there will be a way to challenge the providers.

Mutual recognition agreements (MRAs) to recognise the experience and qualification of especially professional services provide for another set of sector-specific regulations affecting trade in IT-enabled services. This would affect particularly those IT-enabled services that use the channel of temporary migration or cross-border services.

There are limitations to the temporary movement of people to the EU, such as quotas with regard to entry of certain categories of workers, economic needs tests or residency requirements and the need to recognise experience and diplomas. MRAs (in professional services) can lead to significant benefits (UNCTAD, 2005) because they can allow for easier migration, but they are time-consuming to negotiate.

6.4 Benefits and risks of liberalisation and regulatory reform

This section discusses a number of experiences of the effects of liberalisation, competition, privatisation and effective regulators in the ICT sector in developing countries. Below, we provide a number of short country case studies. On this basis, it is clear that market reforms can boost productivity and profitability and stimulate investment, enhancing the performance of the ICT sector. Market-based strategies also allow governments to meet social and economic goals, such as increasing access to ICTs and revenue from telecommunication services. Further, effective regulation has been part of ICT growth (ITU 2007).

Cross-country studies find that, after controlling for geographical region and income levels, countries with GATS commitments in basic telecommunications outperformed others without commitments with respect to fixed and mobile penetration as well as revenues as a percent of GDP (see Bressie et al. 2005 in Campos 2006). Liberalisation in financial services and telecommunication services can have a positive effect (around 1%) on economic growth (Mattoo et al. 2001).

Owing to rapid technical progress and regulatory reform, the average retail price of an international call dropped from US$1.57 in 1983 to US$0.42 per minute in 2001. In 2006, the ratio of international to local telecom tariffs was less than 10:1 in the EU compared with 50:1 in **Zambia**. **Mauritania** has undergone significant telecom reforms in recent years and experienced a falling ratio, from 60:1 in 1999 to 6:1 by 2004 (Adlung 2007; Mattoo and Payton 2007).

The ITU provides a number of country case studies of liberalisation in telecommunications. These tend to indicate that the liberalisation of telecommunications has coincided with the spread of ICTs, although the specifics differ by country. Country examples include:[11]

Peru's teledensity was 2.9% of the population when telecommunications were privatised in 1993. Thanks to private sector investment, infrastructure improved, teledensity increased (from 670,000 lines in 1993 to more than two million in 2001) and call charges fell.

The **St Lucia** ICT market has grown rapidly. Competition to the incumbent was introduced in 2003, when a second mobile company entered the market. Six months after the introduction of mobile competition, the telecom regulator reported 132,700 subscriptions, resulting in a penetration rate of 83% of the population. This is a remarkable result, considering that the number of mobile subscribers per 100 inhabitants stood at only nine in 2002. Competition has resulted in mobile tariffs that are among the lowest in the region.

Botswana's priority in the early 1990s was to improve the level and quality of basic telecommunications service provided to its citizens. Liberalisation improved teledensity (fixed lines from 59,673 in 1996 to 140,000 by mid-2001; mobile from zero in 1998 to 250,000 in 2001 – 16% of the population). The introduction of mobile technology helped to reduce the digital divide between urban and rural areas. However, as Box 11 indicated, much remains to be done.

Morocco had one of the lowest telephone access levels in the region in 1998. It then liberalised and licensed a second mobile operator for a record US$902 million, and a foreign company bought into the incumbent Maroc Telecom for a high price. Morocco has North Africa's most independent regulator. After five years, Morocco had the highest telephone access levels in North Africa, from 6.5 lines per 100 inhabitants in 1999 to 15.2 the following year, attributable to the development of mobile phones. The choice, availability and quality of service have all improved, and the reform process has attracted significant foreign investment. It shows the benefit of liberalisation with competition, as opposed to only privatising the incumbent (see e.g. World Bank 2003).

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[11] The examples below could be improved by including a number of other exogenous factors able to deal with the attribution problem.

Few **Tanzanians** were able to access a telephone prior to the liberalisation of the telecommunications sector in the 1990s, as monopoly landline prices were high and services were poor. Liberalisation led to an increase in mobile phone subscriber rates to almost 90% a year from 1998 to 2003. Other innovations include airtime vouchers and roadside line rental services, which save rural customers on the time and money costs of travelling to a landline, reducing the digital divide.

Nigeria launched the National Telecommunications Policy (NTP) in September 2000, at which time it had a very poor telecommunications networks. It licensed a number of new service providers. As a result of the liberalisation, Nigeria has one of the most competitive fixed and mobile markets in Africa. The population coverage of mobile networks increased from around 5% in 2000 to 75% by June 2006. Nigeria has licensed over 20 private operators, accounting for 71% of its 1.5 million fixed lines in operation in June 2006, far more than the incumbent. Nigeria has four mobile operators and the lowest industry concentration in Africa (ITU 2007).

Efficient and reliable telecommunication services are important for IT-enabled services. For instance, world-class telecommunications services would improve competitiveness of financial services and back-office operations in particular. Without an appropriate IT infrastructure, even favourable incentives cannot force companies to stay. The relatively poor quality of general IT infrastructure, including poor data exchange processes, is believed to have been a major cause of a bank's decision to relocate part of its back-office operations away from Botswana. Sometimes, regulatory challenges remain or are only partially resolved initially (Boxes 12 and 13).

Good data protection will be needed in source countries in order to maintain uninterrupted trade in IT-enabled services. For instance, more than 300 Indian IT services companies are located in Singapore, in part to pre-empt any adverse protectionist legislation in key destination markets. Singapore was regarded as a natural shelter because of its free trade agreement with the US, which included relevant provisions. In addition, Singapore's impressive telecom and physical infrastructure makes it a prime location for business data continuity and disaster recovery operations for Indian and other companies offering BPO services.

6.5 Complementary policies required to maximise benefits to development

This section discusses policies complementary to liberalisation, private sector participation and regulatory reform. A good regulatory framework is key. High-quality and appropriate skills are required for countries to make full use of ICT liberalisation in terms of IT-enabled services.

6.5.1 Regulatory framework of ICT

Moloney (2006) suggests that the lack of a regulatory framework of ICT impedes reaping the benefits of liberalisation. He compares three countries and suggests that ICT policies differ, with different effects.

The incumbent public telecom operator in **Ethiopia** has a monopoly over all telecom services. Although the number of mobile phone subscribers is growing, uptake in Ethiopia is among the lowest in Africa. About 60% of telephones and 94% of the 6000 internet accounts are concentrated in Addis Ababa. Moloney argues that this owes to the limited telecom infrastructure, low levels of computerisation outside the capital and lack of human resources.

The number of internet subscribers in **China** increased from 33 million in 2001 to 94 million in 2004. This growth owes partly to market forces, shown by market demand of online consumers and competition among service providers. Competition is fostered by the government because it regards the ICT sector as key for economic growth. Some argue that most growth is in urban areas, although 60% of the population lives in rural areas.

The Ministry of Communications and Information Technology played a role in **Egypt** in promoting ICT development in collaboration with the private sector. The transfer of internet subscription charges from consumers to Telecom Egypt and ISPs coincided with a sharp rise in new users: from 0.9 users per 1000 inhabitants in 2001, to 5.5 per 1000 in 2004.

6.5.2 Regulatory capacity

The examples provided by the ITU include a discussion of the role of regulators in **Peru**. In 1993, the regulator Osiptel became an independent and professional regulatory authority in a volatile political, social and economic environment. Osiptel has been supported by the President to preserve its independence in relation to other state bodies.

The regulator in **Nigeria**, the Nigerian Communication Commission (NCC), has played a key role in overcoming common complaints of ISPs about poor access to the main cable and high prices. Owing to the lack of progress among operators on mobile interconnection, the NCC established rates to be followed by the mobile industry. Nigeria became one of the first countries in Africa to adopt the unified licensing approach (February 2006). This will enable operators to deploy new infrastructure and services more rapidly.

Telecommunication multinationals operated monopolies in Caribbean countries when they committed the telecommunications in the mid-1990s. This involved translating the exclusivity contracts between the monopoly and governments into trade liberalisation schedules (e.g. exclusivity until 2020 for Dominica). The exclusive arrangements have now been revised and new legal and regulatory frameworks have been introduced. The telecommunications sectors in small Caribbean countries have been dominated by one or a few firms, so that their prices and services (including interconnectivity issues with ISPs) need to be monitored. Liberalisation without an appropriate regulatory framework in place may lead to unwanted consequences: one study suggests good policy practices such as having a national regulator in telecommunications, establishment of regulatory bodies for countries with private provision of electricity, independent regulation in water, regulation of tariffs and service standards for airports and aviation, etc. (World Bank 2005).

Box 12 offers another example of where regulators may play a key role in facilitating IT-enabled services.

Box 12: Regulating access to bandwidth from Mauritius

The regulatory framework in Mauritius seems generally conducive for development of the ICT sector. ICT policies have been updated recently. The legislations relating to the ICT sector include the Copyright Act (1997), Electronic Transactions Act (2000), ICT Act (2002), Computer Misuse and Cybercrime Act (2003) and Data Protection Act (2004). The main regulatory challenge for the ICT sector is perceived to be related to costs of access to bandwidth. Mauritius has been connected to a South Africa–Far East (SAFE) submarine fibre optic cable since 2002. Mauritius Telecom (MT) owns 3.4% of the SAFE cable, with exclusivity for the current stretch landing in Mauritius until July 2007. Some argue that telecommunications costs were too high, with the costs of using bandwidth from Mauritius to Paris three to five times more than the costs the other way. Telecommunications costs can represent up to 35% of BPO costs.

Prices are perceived to be high because MT, responsible for access to the SAFE cable, had a profit rate (before tax) of 33% in 2004, which may indicate that MT has already recovered much of the initial investment costs in the SAFE cable. Profits have been high ever since 2000. MT is owned 40% by French Telecom (since 2000), 41% by the Mauritian government and 19% by the Bank of Mauritius, so any decisions on the price structure will also affect the accounts of the government and French Telecom. There are two main routes to address the regulatory framework affecting telecommunications costs in Mauritius and deal with high prices of access to bandwidth: 1) lower prices to reflect an appropriate cost structure based on an effective regulator; or 2) introduce competition by signing up to a second cable, EASSY (the Eastern Africa Submarine Cable System).

The Joint Economic Council suggested in an Aide Memoire on EASSY (March 2006) that an EASSY cable is in line with long-term objectives to develop the ICT sector, because of the risks of having only one fibre optic cable (SAFE) with (slow) satellite communication as the only back-up to the outside world and because broadband rates continue to be competitive. It adds that the ownership structure should be such as to lead to real competition.

Source: Research and interviews in Mauritius.

6.5.3 Innovation systems and technological development

The design of an appropriate regulatory framework for ICT needs to be seen in an overall approach towards innovation and technological development, so national innovation systems need to complement good regulatory frameworks. The process of technological development entails innovative activity, most of which is undertaken in developed countries, including the identification and adoption of appropriate new technology. While the latter is most relevant to developing countries, especially the poorest countries, where very little innovative activity exists, knowledge appears to be lacking.

The process of technological development is associated with market failures in innovative activity and identification and adoption of new technology. These market failures centre on the externalities of the learning process and the public goods aspects of technological knowledge (Justman and Teubal 1995). First, uncertainty and externalities among early users learning about the application of the new technology, while acquiring information, is costly for individual firms to obtain and appropriate. Second, the codification and standardisation of experience and knowledge can offer social benefits, in that they permit rapid diffusion of the technology as well as knowledge about it, but individual firms will not be able to appropriate all benefits of developing a new standard. Finally, network externalities arise when new users of technology depend on the existence of a large user and support staff base.

6.5.4 Competition policy

The ability to introduce an effective competition policy helps to improve the effects of liberalisation with private sector participation. The introduction of competition helps to maximise the benefits of liberalisation. **Chile's** teledensity grew by 15.4% per annum on average in the 10 years after privatisation *with* competition; in the same period, **Argentina**, where privatisation was introduced but there was no competition, teledensity grew by only 8.6% on average (case study from ITU).

Mortimore (2004) compares **Argentina** and another country in the region to highlight the importance of a regulatory framework that introduces competition as a key complementary factor in benefiting from privatisation and attracting FDI. The regulatory framework for the telecommunications sector in Argentina was drawn up after the privatisation had taken place, whereas that in Brazil preceded it. Brazil introduced much more competition than Argentina. The sale of the Argentinean telecommunications company (Entel) aimed to convince foreign investors that Argentina was open for business. Entel was divided into two monopoly operations, which were given seven years of exclusivity (followed by a two-year extension) and beneficial operational guidelines that demanded few investment and price reductions. Competition was introduced only in 2000. The sector may have benefited from new investment and lower customer costs but costs still remained comparatively high and most service performance indicators improved less quickly than those of most other countries in the region.

In 1995, **Brazil** allowed for the licensing of service provision to private sector agents. Two years later, the regulatory framework was set up, including the industry's regulatory authority, Anatel, in association with the competition authority, Cade. In 1998, Telebras was privatised and divided into 12 different units (one long-distance provider, three fixed line providers, eight mobile operators) which ensured a reasonable degree of competition during the short transition period of 1998–2001, until fuller competition came into force. There was significant investment in building new infrastructure, with attention to development goals established by the telecommunications policy, such as universal service, better performance and lower costs. The relative performance of the telecom industry in Argentina and Brazil is demonstrated in Table 10.

Table 10: Indicators of telecoms service performance in Argentina and Brazil, 1990–2002

Indicator		1990	1995	2002
1. Main lines per 100 inhabitants	Argentina	9.3	15.9	21.8
	Brazil	6.5	8.5	22.3
2.Cellular telephone subscribers per 100 inhabitants	Argentina	0.04	0.98	17.7
	Brazil	0.02	0.83	20.1
3. Complaints per 100 main lines	Argentina	42.4	29.5	17.3
	Brazil	4.7	3.2	3.8
4. Charge for residential line connection (US$)	Argentina	2155	500	150
	Brazil		1215	43
5. Charge for business line connection (US$)	Argentina	5338	750	150
	Brazil		1215	43

Source: Mortimore (2004).

The World Bank (2003) shows that competition between an Egyptian-owned and a Jordan-owned telecommunications firm in **Jordan** led to a reduction in the price of mobile telecommunications.

6.5.5 Other factors to maximise the benefits of telecommunications liberalisation on IT-enabled services

The scale and scope of offshored services are increasing. A growing number of developing countries are involved. Consultancies and facilitators of offshoring point to the increasing numbers of jobs that are likely to be offshored (e.g. 3.4 million from US to low-income countries; 100–200,000 from the UK; 100,000 from Germany; 50,000 from the Netherlands; 10,000 from Ireland). However, there are a number of constraints to obtaining such service export opportunities from developing countries.

The attraction of labour-intensive offshored services will in part depend on trade rules and availability of skills and infrastructure. It depends on trade rules, because there have been developments primarily in individual US states but also at federal level to restrict outsourcing of services to firms located in the US. There is less direct intervention in EU countries, but EU data protection rules could have restrictive effects on developing country exports.

In the end, though, offshoring of services occurs only when there is a good business case. This will depend on sufficient and adequate work skills – which can be scarce – and an appropriate and high-quality (telecommunications and IT) infrastructure, which may be available in countries such as India, but not everywhere else. There are clear roles for government to overcome market and coordination failures in the market for skills and infrastructure. See Box 13 for human resources and IT-enabled services in Botswana.

Box 13: Human resources and IT-enabled services in Botswana

A key constraint to trade in financial services is the weak conditions for back-office operations. Two main types of complementary policies are required: developing skills and developing an appropriate IT infrastructure. Without these, even a favourable incentive framework cannot keep companies in Botswana. The relatively poor quality of general IT infrastructure, including poor data exchange processes, is believed to have been a major cause of a bank's decision to relocate part of its back-office operations away from Botswana (via the International Financial Services Centre (IFSC)). The bank was not able to get the right calibre of staff on an ongoing basis and the IT infrastructure did not match the requirements of the company. Small standalone units without appropriate support services do not work. The skills and IT framework needs to comply with international standards. Other banks also listed the lack of skilled labour as one of their primary concerns, an issue worsened by the strict immigration regime. The Standard Chartered back-office services for Africa are located in Kenya.

Finally, attracting offshored services needs to coincide with complementary conditions. The country needs to have an active approach to benefit from offshored services, e.g. by obtaining fiscal revenues and upgrading the skills base, because export-oriented services can be footloose. Factors behind recent growth in offshoring of IT-enabled services include:

- Average cost savings of 40% on labour and administration costs (in India as compared with the US and UK);
- The highly skilled workforce being willing to work for call centres, e.g. India as compared with many developed countries;
- Improved communications technology lowering the costs of calls and other communication;
- Improved business climate in key developing countries and zero corporation taxes for relevant operations in some.

Developed countries benefiting from cheaper imported IT-enabled services, rather than banning offshoring, can consider complementary policies, such as improving sectoral and regional competitiveness, improving industrial relations, fostering corporate social responsibility, opening up government procurement, and addressing taxation.

There is growing potential for a wide range of IT-enabled services, such as IT services and BPO. EU and US demand is rapidly evolving, but much is being imported from India and China. However, the nature of IT work allows even niche actors to be profitable. Caribbean locations, such as Jamaica, Trinidad and Tobago, Barbados and Guyana, are low-end call centre sites serving US and Canadian markets.

The AT Kearney Global Services Location Index compares the financial attractiveness, people skills and business environment of 50 countries worldwide. The 2006 version of the index suggests that, although cost advantage continues to be the most important determinant of the offshore location attractiveness, supply of specialised talent supply and quality of operating conditions are increasingly important. And cost advantages are being eroded quickly. While total compensation costs for positions such as IT programmers or call centre representatives rose by 5–10% in most developed countries, average wages for similar positions in India, China, the Philippines and parts of Eastern Europe and Latin America grew between 20% and 40%. At the same time, telecommunication costs in many emerging markets dropped by 25% or more, as competition and volumes in the telecom market increased. Similarly, there has been double-digit growth in university enrolment in countries like China, Brazil and Egypt, and the number of firms with quality endorsements like the ISO (International Organization for Standardization) 27001 data security certification almost doubled in several emerging markets.

Box 14: Global Services Location Index 2006

1. India	18. Poland	35. Canada
2. China	19. Vietnam	36. Morocco
3. Malaysia	20. United Arab Emirates	37. Russia
4. Thailand	21. United States	38. Israel
5. Brazil	22. Uruguay	39. Senegal
6. Indonesia	23. Argentina	40. Germany
7. Chile	24. Hungary	41. Panama
8. Philippines	25. Mauritius	42. United Kingdom
9. Bulgaria	26. Tunisia	43. Spain
10. Mexico	27. Ghana	44. New Zealand
11. Singapore	28. Lithuania	45. Australia
12. Slovakia	29. Sri Lanka	46. Portugal
13. Egypt	30. Pakistan	47. Ukraine
14. Jordan	31. South Africa	48. France
15. Estonia	32. Jamaica	49. Turkey
16. Czech Republic	33. Romania	50. Ireland
17. Latvia	34. Costa Rica	

Source: http://www.atkearney.com/main.taf?p=1,5,1,184.

6.5.6 Data protection

Nasscom is working together with the Indian government to draft an Information Technology Act which will set minimum industry requirements for data privacy and establish a penal code for companies or individuals breaching the rules. This is intended to enact a new data protection regime with the intention of bringing the data protection regime up to the standard required by the EU directive.

6.6 Conclusions

A well-functioning ICT sector not only is important for development, as it improves the efficiency of households, firms, sectors and the country as a whole, but also provides significant new opportunities for exports of services from developing countries. Appropriate regulation, trade liberalisation and other complementary factors (e.g. good quality skills) play a key role in developing the ICT sector. ICT is important for productivity growth and trade in developing countries, but the sector is still underdeveloped in the poorest developing countries, although improvements are visible in many. The sector deserves strategic attention in many developing countries, e.g. in the form of an ICT strategy covering a number of issues:

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

Market reforms can boost productivity and profitability and stimulate investment, enhancing the performance of the ICT sector. Market-based strategies also allow governments to meet social and economic goals, such as increasing access to ICTs and revenue from telecommunication services. Effective regulation has also helped ICT to grow rapidly.

Different types of complementary policy help maximise the benefits of regulatory reform and liberalisation in the sector. In particular, liberalisation benefits from an appropriate regulatory framework embedded in an overall strategy that enhances technological development and supports innovation. Regulators are important. Key complementary policies to promote offshoring and enhance the role of regulatory reform include promoting a high-quality and appropriate skills base.

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7. Health services

An efficient and equitable health service sector is not only a development objective *per se*, but also a fundamental driver of growth and poverty reduction via its macro as well microeconomics effects. The health care sector is also important for a country's economy through its direct contribution to GDP (with a worldwide value of around US$4 trillion in 2005).

Several challenges and opportunities for development arise as health becomes a more tradable sector. Barriers to trade are still high, both in terms of capacity constraints (such as lack of capital and adequate technology) and regulatory barriers (health is one of the most heavily regulated services sectors). Some of these regulatory barriers, such as those related to the recognition of foreign qualifications, may be particularly stringent for developing countries.

Removing these barriers is likely to stimulate trade in health services, with risks and benefits varying according to the modes of trade, the import and export nature of trade and the specific context in which trade takes place. To the extent that increased trade stimulates new technology adoption, more efficient systems, transfer of know-how and increase in resources available, developing countries may benefit from trade liberalisation. On the other hand, if increased trade drains resources out of the public sector and basic health care, if it helps to create a two-tier system, increasing the inequalities in health care provision within the population, if it reduces the support of the wealthy for better public health facilities, then the negative impact of liberalisation may prevail.

Such risks and benefits from liberalisation are likely to apply to a limited extent to very poor countries, as these are much less involved in health services trade than are upper- and lower-middle income countries. The reasons for the scarce participation of these countries in trade in health services are likely to be similar to those limiting their participation in goods' trade. These have to do with domestic supply capacity constraints and market size rather than regulatory barriers.

The implications of liberalisation on developing countries owe mostly to internal factors rather than liberalisation *per se*. Governments can adopt a wealth of policies to modify these internal factors in ways which could minimise the potential costs of liberalisation and amplify its advantages. We identify four key policy challenges that governments face in this respect: involving the private sector in health service provision to underserved sectors of the population; choosing financing mechanisms to promote the widest possible access to health services; developing adequate capabilities to provide health services (in particular human resources training); and strengthening regulatory capacity in the health sector.

7.1 Introduction

Although health services have been traded for a long time (at least since Europeans used to travel abroad for spa and thermal cures in the 18th century), only recently have they come to represent a well-established tradable sector. The introduction of new technologies has allowed health professionals to provide consultancies and services remotely; more efficient transport services and information flows have induced patients to move to health service providers and vice versa; mismatches in the availability of capital and labour across countries have generated flows of health-related factors across borders. All of these changes create new opportunities for countries to specialise in the provision of health services according to their comparative advantage, potentially improving the overall efficiency of global health systems. However, these changes also pose new challenges and threats to the efficiency, equity and quality of national health systems, which by and large are used to operate in a closed economy-type regime. Such opportunities and challenges may be particularly evident for developing countries, whose health systems are in most need. Regulation is key to both expanding trade in health services and reaping the benefits and accessing health services in-country.

This section aims to provide a developing country perspective on trade in health services, with the intention of identifying the main barriers to such trade, evaluating the impact on developing countries of lifting these barriers and suggesting ways to maximise the benefits and minimise the cost of trade liberalisation in health services. We discuss these issues in the context of improving the conditions of the domestic health sector. We note from the outset that, although Mode 4 supply (via temporary movement of health professionals) probably accounts for the largest share of health service exports for most developing countries, we devote little space to it in this section, as we extensively analyse Mode 4 supply of services elsewhere in the paper (Section 8).

It is often claimed that health services represent an area in which developing countries have the potential to become major exporters (Whalley 2004); such exports would mainly be via Mode 2 (attracting foreign patients to domestic health care facilities) and Mode 4. There are likely to be two main reasons for this type of modal pattern for developing countries: technological constraints impede the development of Mode 1 exports; and lack of capital constrains the development of Mode 3 exports. However, trade in these modes is expanding as well. Box 15 provides a description and some examples of trade in the four modes of supply.

Box 15: Trade in health services in the four modes

Cross-border trade (Mode 1)
Mode 1 includes electronic delivery of health services, such as diagnosis, second opinions and consultations (telemedicine), cross-border shipment of laboratory samples and clinical consultations via traditional channels. For example, telediagnosis services are provided by hospitals in China's coastal provinces to patients in Macao, Taiwan and some South-east Asian countries (Chanda 2002); the Indian company Wipro Ltd provides CT scan services for the Massachusetts General Hospital in the US; medical samples going for diagnosis to Mexico from Central America are increasingly common (Nielson and Taglioni 2004).

Consumption abroad (Mode 2)
This mode involves the movement of consumers to the country providing the health services they consume. It mainly refers to medical and wellness tourism and, at a general level, we can state that it aims to cost sensitive consumers in developed countries and wealthier ones in developing countries. A number of developing countries have made conscious efforts to promote these exports, such as Cuba, India, South Africa, Malaysia and Thailand. In Cuba, for example, the government has created a trading company (Servimed) to offer tourism/health packages. In 1995–6, 25,000 patients and 1500 students went to Cuba for treatment and training, generating revenues for Cuba of US$25 million in the year (Zarrilli and Kinnon 1998). Surgeon and Safari, one of the most successful combination surgery and tourism ventures in South Africa, reports 20–30 customers per month (from the UK and the US) and that these numbers are escalating (Nielson and Taglioni 2004).

Trade via commercial presence (Mode 3)
This trade refers to the establishment of a commercial venture in a foreign country in order to provide health services to residents of that country. Given the need for relatively large investments, high-income countries are the main exporters in this mode (with American and German companies leading in the market). The majority of developing countries are net importers in this mode, with countries such as India, Indonesia, Nepal and Sri Lanka becoming increasingly open to foreign investment. Low-income countries exporters via Mode 3 include India and China (especially across Asia), with the latter establishing wholly Chinese-owned or small joint venture clinics abroad (Nielson and Taglioni 2004).

Temporary movement of natural persons (Mode 4)
As noted, this is an important mode of supply for trade in health services, with plenty of examples of both permanent and temporary migration (strictly speaking, even permanent migration entails an export of services as long as the migrant remains citizen of the sending country). See Section 8 for more details.

7.2 Contribution of the sector to development, growth and poverty reduction

The health service sector lies at the very heart of any country development, being ultimately responsible for the health of the country's residents. Good health is considered one of the most important goals of any government, as confirmed by high levels of public spending on health: the (simple) average across countries of public expenditure on health was 3.5% of GDP and the median was 3% in 2003 (authors' calculations using data from UNDP 2006). These figures do not change substantially if we consider only countries below GDP per capita of US$5000 (mean of 2.9% and median 2.6%), confirming that health is perceived as important at all levels of development.

Health is considered a crucial development objective by the international community as well. Three out of the eight Millennium Development Goals (MDGs) centre on health (reduce child mortality; improve maternal health; combat HIV/AIDS, malaria and other diseases) and the health sector is one of the largest recipients of development assistance across all regions.

Not only does growth allow for better health care provision, and is good health a development objective *per se*, but also it represents a fundamental driver of growth and poverty reduction. A large part of the literature considers it one of the most important forms of human capital. Improvements in health can enhance workers' productivity by increasing their physical capacities, such as strength and endurance, as well as their mental capacities, such as cognitive functioning and reasoning ability; evidence of this link is increasing at the microeconomic level (Bloom and Canning 2005).[12] There are plausible pathways through which health can influence the pace of income growth at the macroeconomic level also, e.g. via its effects on labour market participation, worker productivity, investments in human capital, savings and population age structure (see Commission on Macroeconomics and Health 2001). Moreover, since growth is one of the most important determinants of poverty reduction, and since poor health often constrains the productivity of the poor, improvements in health are likely to be particularly beneficial for poverty reduction as well.

The health care sector is also important for a country's economy through its direct contribution to GDP. Given the actual importance of health on countries' as well as individuals' welfare, it is not surprising that health care is one of the largest sectors in the world. The sector was expected to generate around US$4 trillion worldwide in 2005 (Chanda 2002). The median country was spending 5.6% of GDP (from both public and private sources) on health-related goods and services in 2003, with a peak of 15.2% for the US. Again, this does not vary substantially between developing and developed countries, as the median for countries with GDP per capita below US$5000 was 5.4%. Trade accounted for a small proportion of the sector's value at the end of the 1990s, even in the most economically advanced countries (WTO 1998). Although, as we have seen, the sector has become more tradable in the past decade, health services are still likely to account for little of world total trade and proportionally less than their weight in GDP.

7.3 Trade liberalisation in health services: What is involved?

It is hard to think about a more regulated sector than health services. Concerns about the safety of a country's residents induce governments to intervene in a number of ways: by directly providing health services, financing health care through public insurance mechanisms and regulating private health services and private health insurance (Arunanondchai and Fink 2007). This greatly affects international trade in these services, which is often subject to regulatory restrictions that make it unviable. As argued by Diaz Benavides (2002), any trade strategy for health services 'must be founded on the principle of recognizing that the primary obligation of governments is to provide universal coverage of health care to their local communities'. The development of a trade strategy needs to be secondary to this obligation. Thus, unlike other services sectors, domestic regulation could be welfare-enhancing even if it were highly restrictive for trade.

The WTO (1998) identifies three main types of barriers: qualification and licensing requirements for professionals; approval requirements for clinics and hospitals; and rules governing reimbursement from mandatory health insurance schemes. These barriers apply to different extents and in different ways to the four modes of supply, thus it is useful to analyse the barriers by mode.

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[12] Bloom and Canning estimate that a one percentage point increase in adult survival rates increases labour productivity by about 2.8%.

7.3.1 Cross-border trade

This type of trade includes the electronic delivery of health services, such as diagnosis, second opinions and consultations (telemedicine), cross-border shipment of laboratory samples and clinical consultations via traditional channels. Governments generally do not impose noticeable restrictions on cross-border trade. There are two possible reasons for this. First, the impact of this type of trade may be particularly beneficial on domestic health systems, as we will discuss in the next section. Second, it may be technically difficult for governments to impose restrictions on a form of trade typically delivered via electronic networks. The main regulatory obstacle to most of this trade, including telemedicine and cross-border medical transcription services, is probably related to the laws protecting the privacy of patient data. To the extent that data protection standards and enforcement practices are weaker in developing countries' jurisdictions, regulators may constrain and even prohibit the sending of patient information to those countries. The little evidence available suggests that such barriers have not been curtailing trade via this mode yet. However, Arunanondchai and Fink (2007) note that privacy concerns may well become more important for cross-border services trade, as technology continues to widen the scope of tradable services and more countries participate in this form of international trade.

Recognition of foreign qualifications may represent potential barriers to trade as well. Imposing quality standards on health and education service suppliers that never physically enter the country poses additional challenges (VanDuzer 2005).

While regulatory barriers are not particularly stringent in this mode, technological constraints are likely to be so for many developing countries, and for all least-developed countries (LDCs). Installing the necessary equipment for telemedicine is very costly, and the infrastructure network necessary to trade the service is often not in place. We will explore in the last section the trade-offs implied by overcoming this barrier.

7.3.2 Consumption abroad

There are no explicit trade barriers to this type of trade in health services, and high-income countries have even been most liberal in their GATS commitments in this mode. According to Adlung and Carzaniga (2002), these types of commitments should provide a legally enforceable guarantee not to deter residents of these countries from consuming abroad.

However, indirect regulatory barriers to health tourism trade do exist, most significantly the lack of health insurance portability in foreign countries. Strictly speaking, this may not be a regulatory barrier, as private health insurers may **voluntarily** restrict coverage for treatment in foreign countries.[13] Nonetheless, a significant proportion of health insurers are public and generally subject to domestic regulation, which imposes constraints to the possibility of consuming health services abroad under the insurance scheme. Mattoo and Rathindran (2005) note that public health schemes in the US, such as Medicare and Medicaid, face institutional impediments from the Social Security Act to extending coverage for health care received abroad. The UK Department of Health (2007) has set a policy that impedes the NHS from contracting hospital treatment for NHS patients outside the maximum air travel time limit of three hours, thereby *de facto* ruling out most developing countries. In as much as this is a barrier of a regulatory nature, countries can negotiate on it. Thailand, in its negotiations on a free trade agreement with Japan, has requested that Japan's public medical insurance system cover the treatment of Japanese patients in Thai hospitals (Arunanondchai and Fink 2007).

Another route pursued by some developing countries to increase health exports is attracting retirees seeking to establish themselves outside their country of origin, who may then purchase health care services in-country. However, other potential barriers may infringe on the ability of countries to attract retirees, such as those related to visa and house purchase/registration restrictions (Whalley 2004).

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[13] This may occur, for instance, as a result of potential negative spillovers for the insurer if the quality of treatment in foreign hospitals is low or of the incentive to over-consume health care abroad because of moral hazard.

7.3.3 Trade via commercial presence

Foreign investments in the health sector are subject to severe limitations, such as economic needs tests, nationality requirements, equity ceilings, joint venture requirements and licensing procedures. As in the case of Mode 4, economic needs tests often impose important restrictions to the foreign commercial presence in this sector, especially in high-income countries. These tests require a prior thorough search within the domestic market for a similar service supplier before the visa application is accepted. In most cases, the criteria for these tests are not specified and their potential for discretionary application is high (Adlung and Carzaniga 2002). The US, for example, applies needs-based quantitative limits on the establishment of hospitals and other health facilities. Similarly, all EU countries impose some kind of economic needs test on the establishment of new hospitals, and many explicitly favour local firms over foreign investors (Stern 2006). Zarrilli and Kinnon (1998) provide a number of examples: in France, Italy and the Netherlands, new hospitals are only permitted if identified as necessary by a health services plan; in Sweden, there are limits on the number of private practices that can receive national health insurance cover. Arunanondchai and Fink (2007) summarise barriers to foreign investment for seven Association of Southeast Asian Nations (ASEAN) countries, noting that poorer countries seem to have more liberal policies than richer ones. In particular, Cambodia, Indonesia, Laos and Vietnam allow for full foreign ownership for hospitals (although other limitations, such as economic needs testing, may apply), whereas Malaysia, the Philippines and Thailand only allow minority foreign ownership. The authors argue that this difference in policy may partly reflect the desire of poorer countries to attract foreign investment as a means to develop their domestic health care systems.

The authors further note that the pervasive regulation of the private health sector applies in the same way to foreign investments. However, as the latter are usually more unfamiliar to such requirements than domestic players, this regulatory burden may represent a *de facto* barrier to commercial presence abroad. This argument does not seem to be supported by any evidence, and foreign groups are usually able to rely on high-level local expertise to deal with domestic regulation. Our recent work on India (see Box 16 below) confirms that regulation seems to have played only a marginal role in fostering trade via commercial presence in the Indian health services sector. This is true for both foreign and domestic private sector presence, whose growth has been driven by other factors, most importantly rising incomes, increased capital availability and unmet demand for quality health services by the public sector.

7.3.4 Temporary movement of natural persons

Regulatory barriers tend also to be very restrictive on trade via temporary movement of natural persons. Mode 4 exports of services from developing countries face severe **external constraints** in general (there are many individuals wanting to try and deliver a service temporarily across borders but who cannot do so) and some of these are trade constraints.

Section 8 covers the main types of regulatory barriers to Mode 4 trade: immigration rules, discriminatory treatment of foreign providers and recognition of qualifications. It is hard to gauge to what extent these constraints are binding in the health sector, as rigorous empirical evidence is lacking. As high-income countries are experiencing severe shortages of health-related personnel, they are increasingly willing to facilitate imports of health services via Mode 4. This is consistent with the increasingly larger shares of new nurses and doctors from developing countries in countries such as the UK (UK Nursing and Midwifery Council 2005; UK Register of Medical Doctors 2005 data on registration).

Nonetheless, as regulators in high-income countries are keen to ensure the quality of health service providers, the recognition of foreign qualifications seems to be the most important regulatory barrier to the temporary movement of health professionals from developing countries. Anecdotal evidence seems to confirm this. For example, nurses from several low-income African countries (e.g. Malawi, Zambia, Mozambique, Tanzania) are increasingly migrating to other African countries, such as Botswana and South Africa, to acquire the necessary recognition to migrate to European and North American countries. Qualification of health professionals from South Africa, for instance, is widely recognised in countries as the UK, the US, Canada and Australia. Recognition of qualifications in the UK has also become a much less stringent problem for nurses from Botswana and Swaziland, owing also to the large past migration flows from these countries. Our work in India (see Box 16) confirms the view that trade via movement of health professionals in India seems to be affected by current regulatory frameworks (in particular with respect to recognition of qualifications) in foreign countries. Factors that have helped to overcome regulatory barriers in third countries include the establishment of specialised agencies (for nurses) and previous migration flows, which may ease the recognition of qualifications process.

It is generally acknowledged that MRAs (in professional services) are time-consuming to negotiate but that there can be significant benefits. Unfortunately, European Commission (EC) directives on mutual recognition of diplomas do not apply to nationals of third countries and, even within the EU, there are still open-ended issues after such a long period of negotiation. Accreditation procedures exist specifically for nurses – although these can put nurses from outside the EU at a disadvantage.

7.4 Benefits and risks from trade liberalisation

Trade liberalisation of health services involves both benefits and costs for developing countries. For example, increased foreign investments owing to the removal of barriers on foreign ownership may widen the range of services provided in the domestic economy but can also divert scarce human resources away from the public sector. Evaluating this impact is a complex exercise, which to the best of our knowledge has not been extensively carried out in any country. We aim to summarise the possible costs and opportunities of trade liberalisation, which often underlie delicate trade-offs between equity and efficiency, between growth and access to health, between private and public sector development. These trade-offs represent crucial challenges for policymakers in developing countries attempting to maximise the performance of domestic health sectors.

Again, we find it useful to present the potential impact of trade liberalisation along the four modes of supply, as these entail analytically different ways through which liberalisation may impact on developing countries. We also need to distinguish between import and exports, as the implications of these two sides of the liberalisation process are likely to differ significantly.

Finally, there is an important distinction to be made within developing countries according to their level of development. Countries at low stages of economic development are much less involved in trade than countries at higher stages, and almost not at all involved in export activities, with the partial exception of Mode 4. However, even in these exports, very poor countries do not seem to be internationally competitive. For example, there were no LDCs among the largest 15 'exporters' of doctors to the UK in 2004; there was one (Sudan) in the first 30 and there were only three in the first 60; on the other hand, eight out of the first 15 are developing countries (UK Register of Medical Doctors 2005). A similar argument applies to nurses: only one (Zambia) out of the first 15 foreign countries for new nurses registered in the UK is an LDC, whereas 12 out of 15 are developing countries. Examples of the scarce competitiveness of very poor countries in trade in health services via other modes are plentiful. Although Laos is one of the most liberal East Asian countries with respect to foreign investment in the health sector, there are no foreign hospitals in the country (Arunanondchai and Fink 2007). The list of developing countries effectively competing in the medical tourism industry does not include any LDCs. On the other hand, several middle-income countries, such as South Africa, Brazil, China, Malaysia and Thailand, and a few lower-middle income countries, most notably India, are important players in the international market.

The reasons for the scarce participation of LDCs in trade in health services are likely to be similar to those limiting their participation in goods' trade, and have to do with domestic supply capacity constraints and market size rather than with regulatory barriers.

The crucial policy variables needed to stimulate trade in health services for LDCs are rather linked to the more structural interventions that may facilitate deep-seated changes of the whole economy. Unless very poor economies invest in infrastructure, capacity, etc., they are unlikely to reap the benefits of trade liberalisation in health services, just as they have not reaped the benefits of preferential access to wealthy markets in goods' trade. On the other hand, there may be scope for benefiting from trade via imports of health services that could absorb some of the unmet demand in the country. However, imports of health services are usually not affordable by governments in these countries, nor by the vast majority of their citizens.

7.4.1 Cross-border trade

Cross-border trade of health services may have beneficial effects on developing countries mainly by allowing health professionals and consumers to access knowledge that would otherwise not be available.

Expansion of cross-border imports could offer the chance for developing countries to cater to remote and underserved segments of the population; help alleviate human resource constraints; enable better surveillance of diseases; improve the quality of diagnosis and treatment; and help upgrade skills (Chanda 2002). Mandil (1998) provide some preliminary evidence that the installation of a telemedicine link in remote and rural areas leads to longer periods of retention of medical and professional staff there. These information systems allow health care staff to consult remotely with more experienced personnel located outside of the local area. The potential advantages of this type of import are important, but questions remain as to whether they could realistically materialise, given the paucity of the necessary infrastructure and the cost of serving the areas in most need. For example, a health post in a remote rural village in Uganda would potentially benefit if it could 'import' experts' opinions on complicate diagnoses. However, how likely is the health post to have the necessary equipment to send the radiological images to the expert abroad? And would such imports be financially sustainable? This is not to suggest that the expansion of this trade may not be beneficial, but policymakers need to evaluate the cost effectiveness of promoting this type of trade. In particular, the opportunity cost of investing in the necessary (expensive) technology requires careful analysis.

Developing countries that are competitive at providing cross-border health services may benefit from a rise in this type of trade through employment and foreign exchange generation and increase in output. Stern (2006) argues that the greatest opportunity for job creation in the South African health sector is through the subcontracting of diagnostic, data or other auxiliary services to South African-based service centres. Raising exports could help fund a wider range of additional health services for domestic consumption. However, there are risks that such exports could draw financial and human resources away from primary health care and into high-technology specialist centres serving foreign consumers (or wealthy nationals).

7.4.2 Consumption abroad

As imports via consumption abroad usually involve only a small portion of (usually wealthy) nationals of developing countries (health tourism), the impact of an increase in such imports on the importing economy is likely to be limited. They could serve to free up some scarce domestic resources to dedicate to assisting other residents of the country. Moreover, imports could expand the range and quality of services available to some of the country's nationals. However, increased imports may contribute to weakening political support for public health systems. As noted by VanDuzer (2005), if a wealthy and influential segment of the population does not see its direct interests being served by efficient public health services, its support for such services may erode.

Possibly the greatest interest of developing countries from an expansion of this mode of trade relates to an increase in foreigners visiting the country to receive health services. Liberalisation is likely to stimulate exports by a number of developing countries, which could exploit their competitive advantage in the provision of health services. Table 11 shows the cost advantage enjoyed by India and Thailand over the UK and the US in different medical operations of varying degrees of complexity. Given that the quality of service reached by the top health service exporters in these developing countries is similar to that of high-income countries, the increase in the exports induced by liberalisation is likely to be significant. Such an increase would be beneficial for employment, foreign exchange and output. Moreover, by expanding opportunities for the private sector, it may attract private domestic and foreign investments in new health facilities. Increase in exports may also be beneficial for retaining health professionals in countries, by providing them with complementary earning opportunities.

Table 11: Cost comparison of medical services

	Cost (US$)			
	US	Thailand	India	UK
Heart surgery	40,000	7500	6000	23,000
Bone marrow transplant	250,000	–	26,000	150,000
Liver transplant	300,000	–	69,000	200,000
Knee replacement	20,000	8000	6000	12,000
Cosmetic surgery	20,000	3500	2000	10,000

Source: Kumar (2007).

On the other hand, increased exports of health services through Mode 2 may have little impact on improved provision to the poor, unless some of the returns to local suppliers are used to fund health services to the poor (VanDuzer 2005). This is because investment to provide services to foreign clients will be most attractive in the most lucrative areas, which are unlikely to be relevant to poor patients (e.g. cosmetic surgery, orthopaedic operations). This 'cream-skimming' may create a two-tier system, with a higher-quality, expensive segment that caters to wealthy nationals and foreigners, and a much lower-quality, resource-constrained segment for the rest of the population (mainly poor) (Chanda 2002). This could drive resources towards the high-quality system at the expense of the public sector (e.g. health care personnel and structures).

7.4.3 Trade via commercial presence

Increased trade via commercial presence abroad is likely to generate similar effects to consumption abroad. The impact on developing countries of this mode is most likely to occur via imports rather than exports, as most countries do not have the available resources to invest abroad.[14]

The challenges posed by increased trade via commercial presence are similar to those of an increased private presence in the health sector. The types of potential effects are essentially the same. The difference probably lies in the scale of the investments. This is true especially in low-income countries, where the domestic private sector often lacks sufficient funding to undertake substantial investments.

Similar to the effects of Mode 2 exports, an increased presence of foreign operators in the health sector may generate additional resources for upgrading health care infrastructure and technologies (Chanda 2002); it could generate employment, reduce underemployment of health personnel and help retain scarce human capital in the country (who may otherwise migrate); and it could provide expensive and specialised medical services. Moreover, it could enhance technology and know-how transfers (e.g. domestic medical personnel may be exposed to more advanced techniques, which could be applied in the public sector as well). The availability of foreign private capital could reduce the total burden on the public sector's resources, which could be reallocated towards priority services for the sections of the population not served by the foreign investment.

These benefits have to be weighed against the risks involved in a more liberalised trade regime via commercial presence. As noted above, foreign services suppliers may also contribute to the development of two-tier markets for health services. Foreign investors are likely to try to cream-skim the most lucrative part of the market, causing a potential misallocation of resources, whereby those who need less but can pay more may be served at the expense of the poor who would be most in need (Chanda 2002). Also, foreign investments may poach scarce human resources from the domestic public

[14] A few exceptions, such as China, India and South Africa have been detailed above.

sector, as better-quality health care professionals flow from the public health care segment to the corporate segment, with its better pay and superior infrastructure. This 'internal brain drain' has occurred in countries such as Thailand, where the outflow of service providers from the public to the private health sector has increased partly in response to the emergence of private hospitals formed by local and foreign companies (Janjaroen and Supakankunti 2000). Moreover, by guaranteeing access to top-class health care facilities for the wealthiest part of the population, it may reduce its support for better public health facilities.

Our recent empirical work on India suggests that the overall impact of increased trade via commercial presence on domestic health systems is likely to be small but probably positive (see Box 16). This owes to a combination of a beneficial impact and limited costs in terms of internal brain drain (from public to private sector) of health professionals.

Box 16: The impact of increased corporatisation of health services on Indian health systems

India is one of the most active developing countries in trade in health services. This is particularly true for trade via commercial presence and via temporary movement of health professionals. Trade via these modes has grown rapidly in recent times, with increased foreign private participation in the hospital sector in India (particularly for tertiary care) and a rise in the emigration of health professionals, particularly nurses, to other countries. It has not been clear to what extent this growth has been driven by regulatory changes, nor what the implications of this growth are for domestic health systems.

We have examined these issues by collecting primary data as well as analysing secondary data. Our analysis suggests that the overall impact of increased trade via commercial presence on domestic health systems is likely to be small but probably positive. This owes to a combination of a beneficial impact and limited costs in terms of internal brain drain (from public to private sector) of health professionals. The table below summarises the main types of potential benefits and costs on the health system from an increased commercialisation in the provision of health services in India. The table includes the expected size of the benefits and costs for the country as a whole as well as for the poor in particular.

Potential benefits and costs of increased trade in health services via commercial presence in India

Potential benefits			Potential costs		
Type	for all	for poor	Type	for all	for poor
Reduce the burden on public sector structures	Medium	Small	Reduce the quality of and accessibility to health services for the poor	Small	Small
Expand the range and quality of health services	Large	Small	Internal brain drain (poaching of staff from public sector)	Small	Small
Help retaining health professionals in India	Medium	Small	Reduce support for quality public health services	Small	Small
Positive spillovers to public sector (e.g. via exchange of ideas, knowledge, imitation effects)	Unclear	Unclear	Reduce general public budget (through public subsidies to corporate sector)	Medium	Medium
Use of private sector to reach public sector objectives (e.g. PPP)	Large	Medium	Deteriorating quality of training owing to private sector-led expansion	Medium	Medium
Upgrade and expand health service infrastructure in India	Large	Small			
Expand health training facilities	Medium	Small			
Facilitate expansion of health insurance	Large	Medium			

An institutional environment with strong and effective regulation is crucial to minimise the possible negative effects of liberalisation. Regulation needs to ensure that new operators conform to the quality standards required by an efficient health system and that increased competition does not undermine public health systems. However, regulatory quality by itself is not enough. Regulatory capacity is also needed to ensure that regulation is effectively implemented.

7.4.4 Temporary movement of natural persons

The impact of increased trade via temporary movement of natural persons (TMNP) is very controversial: Section 8 details its main potential costs and benefits. The former mainly include the possible negative impact on the domestic skills base (international brain drain). The benefits entail remittance flows, increased trade in goods and services, incentives for human capital formation and skills upgrade during the period abroad to be used upon return.

The possible negative impact of TMNP on domestic capacity is a hotly debated topic, on which there is as yet no empirical agreement. As detailed in Section 8, Clemens (2007) finds that out-migration of doctors and nurses does not significantly affect domestic capacity in sub-Saharan African countries. However, a negative relationship seems to exist between the share of health professionals who migrate and the level of domestic capacity in the source country.

In order to understand the net impact of out-migration on domestic capacity, we should consider not only the direct loss of capacity but also what would happen to supply capacity in the absence of migration. This means that other elements ought to be taken into account, including the incentives that migration provides to increase the total supply of certain types of workers (see below) and the effectiveness with which skilled workers would be employed in the home country. One could think of countries in which the very elastic supply response to migration has multiplied the supply of specific skills (such as nurses in the Philippines), to the extent that growth in supply may be larger than growth in migration. Our own fieldwork in India suggests that increased migration opportunities for nurses have helped to raise the attractiveness of the nursing profession, which has in turn resulted in rapid growth in demand for nursing education, and hence an increase in the supply of qualified nurses in India.

The impact of remittances from health professionals temporarily migrating abroad may be an important one. Nurses in particular appear to have a higher propensity to remit than other categories of migrants, as suggested by a study on Tongan and Samoan migrants to Australia (Connell and Brown 2004). A significantly higher proportion of nurse households send remittances home (93.4% compared with the average of 82.1%), and on average remit more. Moreover, unlike the usual pattern, nurses' remittances do not appear to decrease with duration of absence. The authors argue that the cumulative value of remittances per nurse household during their stay overseas is likely to exceed the training cost of nurses within Tonga and Samoa. This higher remittance propensity of nurses is consistent with the hypothesis that women migrants are more frequent and more generous remitters than men and that nurses appear to be more altruistic and may also be more responsive to perceived needs of kin. Moreover, as argued in Section 8, the temporariness of migration is likely to increase the level of remittances (relative to permanent migration), other things being equal.

A potentially beneficial impact of Mode 4 trade is related to the fact that health professionals need to return to their home country. Calì and te Velde (2007) argue that the health sector is one where learning skills abroad may be particularly relevant, as migrants may have access to new technologies, career development schemes and more advanced management systems. This experience may be an invaluable source of ideas and expertise in the upgrade of the sending country's health sector. A study of migration of health workers from the Pacific region indicates some gains to migration, in that many health workers returned from overseas with additional skills (and with capital that was invested in housing and businesses), thus providing both individual and national benefits (Connell 2003).

We refer the reader to Section 8 for a more extensive discussion of the benefits and costs of increased trade via Mode 4.

7.4.5 Evaluating the net impact of liberalisation

From the discussion above, it appears that a more liberal trade regime in trade in health services involves complex trade-offs, on the basis of which the net effect of any trade liberalisation on the development of the country has to be evaluated. While liberalisation of health services may yield the standard benefits of trade liberalisation, in terms of efficiency gains and increased investments, it can also worsen or create inequities in the distribution and quality of such services (Chanda 2002). Unfortunately, there is a lack of good empirical evidence on the size of these trade-offs for the vast majority of the countries. Therefore, evaluating the net impact of liberalisation has necessarily to be a tentative exercise. It is important to interpret these trade-offs in a dynamic rather than a static way. For example, if an increased presence of foreign hospitals amplifies the internal brain drain process, would restricting trade via Mode 3 be a good response? In order to answer this question, it would be necessary to understand what would happen to the internal brain drain were foreign investments restricted. If the internal brain drain turned into an international one in response to lack of opportunities at home, then constraining foreign investments may not be the right response. A clear rule for the regulator should be to try to maximise the benefits from liberalisation while minimising its costs. Domestic complementary policies to trade liberalisation play a crucial role in achieving this goal. We deal with those in turn.

7.5 Complementary policies required to maximise benefits to development

As Chanda (2002) notes, the adverse implications of liberalisation on developing countries really owe to internal factors rather than liberalisation *per se*. Governments can adopt a wealth of policies to modify these internal factors in ways which could minimise the potential costs of liberalisation and amplify its advantages. We identify four key policy challenges that governments face in this respect: involving the private sector in health care provision, in particular to underserved sectors of the population; choosing financing mechanisms to promote the widest possible access to health services; developing an adequate base of factors of health services production (in particular human resources training); and strengthening regulatory capacity in the health sector.

7.5.1 Involving the private sector

Governments can promote linkages between public and private segments in order to increase the reach of health service provision within the country. Governments can agree with the private sector on cross-subsidisation schemes, requiring the reservation of some places for those in need in private institutions. For example, the German health care group Rhon-Klinikum is contributing equipment and expertise to what was a vacant wing in Groote Schuur Public Hospital in the new University of Cape Town Hospital, and will provide public patients with specialist services that are currently unavailable from the state (Stern 2006). The private sector could also be instrumental to the scaling-up of the provision of primary health care, either in partnership or in competition with the public sector.

A number of developing countries, such as South Africa, India and Thailand, enjoy relatively efficient private health sectors. In such countries, governments could increasingly outsource to the corporate sector parts of the health services they provide. Our work in India suggests that this could particularly be the case for those expensive services that the corporate sector is already providing, such as tertiary and super-speciality care services, but this could also be applied to most curative services. Along with secondary care, tertiary services take up most of the public health budget in India, thus even moderate efficiency gains in tertiary care may result in large savings in public resources. Such savings may allow the state to redirect resources towards areas where market failures lead to a suboptimal allocation of resources, such as primary health care, and in particular preventative health care. This focus would also be in line with a more efficient and effective allocation of public resources (see Filmer et al 2002). Soderland et al (1998) provide evidence of an already strong private presence in even the most remote rural areas of South Africa. This confirms the idea that it could be cost effective for the state to use the private sector's services to expand the reach of health services across the population.

In India, the most common form of public–private partnership (PPP) has been one involving the state's subsidy to a corporate hospital for land acquisition in exchange for a share of beds being reserved to be provided for free to public sector patients. The evidence on the success of this form of PPP is at best mixed. The problems range from non-compliance by the private hospitals in terms of share of beds, to poor quality services provided to public sector patients. These issues point towards the importance of reliable enforcement mechanisms, coupled by strong oversight systems, to guarantee the success of these initiatives. The Chiranjeevi Yojana scheme in Gujarat is considered a successful example of a PPP that has been able to fulfil these two conditions (see Box 17).

There are at least two necessary conditions for such strategies to be effective: an effective public oversight system on health services provision, and the design of a financing mechanism to guarantee more equitable access to health services. We discuss these conditions below.

Other ways of maximising the benefits from private sector participation include the promotion of professional collaboration and exchange between the two segments, and the taxation of the foreign (and domestic) commercial segment to raise resources for the public segment (Chanda 2003).

Box 17: The Chiranjeevi Yojana scheme in Gujarat

The scheme was launched as a one-year pilot project in December 2005 in five backward districts in Gujarat and covers all below poverty line (BPL) families. It aims to improve the rate of institutional birth delivery of BPL families so as to decrease maternal and child mortality rates. The scheme involves a combination of incentives given to public sector health workers to increase the number of deliveries via public health centres and the use of a panel of private providers to provide maternity health services to the families covered under the scheme. The financial incentives to public sector doctors are given for each delivery after the first 30 in a month at public health centres, and after the first 50 at community health centres. The private providers instead are directly reimbursed by the state a fixed rate for deliveries carried out.

The Block Health Officer is responsible for the identification and empanelment of the private gynaecologists. After the private practitioner agrees to join the scheme, a memorandum of understanding (MoU) is signed between him/her and the district health authorities. The District Project Management Unit handles all documentation work for the scheme and is also custodian of all the documents. The unit is also responsible for reporting the progress of the scheme to the State Health Directorate and for making the payments to the empanelled gynaecologists through the Chief District Health Officer and Drawing and Disbursement Officer.

The Medical Officers and the Auxiliary Nurse and Midwife of the respective sub-centres undertake the responsibility of motivating the community (BPL families) to take up the scheme. The client avails the services of the scheme from the empanelled practitioners. Every month, the empanelled providers present their filled-in vouchers and claim their reimbursement. The entire document for the reimbursement is submitted at the District Project Management Unit, which initiates the process of payment, which is made after the approval of the Chief District Health Officer and Drawing and Disbursement Officer

The scheme has been successful in increasing institutional birth delivery and reducing both maternal and child mortality rates and it has now been extended to the entire state. The success of the scheme relies on an efficient mix of dissemination of information via public health workers, reliable and timely payments to private and public practitioners and effective oversight systems.

Source: Bhat et al (2007) and own consultations.

7.5.2 Financing mechanisms to promote access

Provision of health care services is very costly and only a few countries can afford state-of-the-art medical services for every citizen. In low-income countries, access to health care services will often be unavailable or restricted for certain population segments. What is the best type of mechanism to promote wider access to health services?

Arunanondchai and Fink (2007) argue that, since patients derive a private benefit from medical treatment, a system of user fees would establish appropriate economic incentives, but it would be unequal as it would cut off from the system those who truly cannot afford it. The establishment of health equity funds that subsidise user fees to those in need may represent a possible solution to this dilemma. A successful example of such a fund is in the rural district of Sotnikum in Cambodia.[15]

The reach of health services can also be promoted through cross-subsidies, as has been the case for other service utilities. For example, user fees or insurance contributions can be established to vary with patients' income. However, the introduction of user fees in very poor countries needs to be evaluated with care. Hillary (2001) reports examples of countries (Zimbabwe and Vietnam) where the introduction of even low user fees has had a negative impact on the access to health services of the poor. A more implicit form of cross-subsidy is to require health care personnel to spend a certain time period in public hospitals or remote areas before they can be hired by the private sector. This type of scheme needs to be carefully designed in order to be successful. The community service programme in South Africa, requiring all graduates to undertake a year of service in a public institution (mostly in poor communities) to qualify as a medical doctor, is one of the most important in the developing world. In his evaluation, Reid (2002, quoted in Stern 2006) concludes that the programme has done little to address shortages of professionals in the neediest hospitals. Instead, it has raised the burden on existing senior staff to orientate and train a new group of graduates on an annual basis and it could also prove to be an additional 'push factor'.

The most appropriate forms of financing mechanisms for the health sector are likely to vary according to the context. It is beyond the scope of our analysis to evaluate what form is appropriate for what context. However, we note here that the choice of financing mechanism is likely to be a crucial factor in making trade liberalisation work.

7.5.3 Expanding health sector capabilities

A root cause of several of the problems discussed earlier is that investment in the health sector of developing countries is often neither sufficient nor efficiently deployed. If the availability and quality of human and physical resources in this sector are to be improved, expenditures on health care need to be increased and allocated more efficiently (Chanda 2003). For example, the problem of two-tiering in health care owes mainly to poor domestic factors such as low wages and poor working conditions and infrastructure in the public sector. This allows the private sector to attract skilled personnel, providing better pay and work equipment. The implication of such situations is that more resources should be allocated, both to train a larger pool of health professionals and to improve their working conditions in the public sector (especially in rural areas). This is likely to involve considerable financial and organisational efforts (e.g. revamping management procedures to increase efficiency) in most developing countries. See Calì and te Velde (2007) for a more complete discussion of such challenges. Our work in India also shows the potential importance of regulation in supporting the expansion of health sector capabilities (see Box 18).

Another potentially important strategy to expand the health sector's skills base relates to the possibility of involving foreign educational institutions in the expansion of health-related training capacity. A liberal regulatory framework along with sound oversight systems may allow for the use of renowned foreign expertise to improve the quality of teaching methods and to overcome financial constraints in expanding training facilities.

[15] Four years after its establishment, the fund helped with financial assistance on average 40% of the district hospital's inpatients, whom monitoring activities confirmed were actually poor (Arunanondchai and Fink 2007).

Box 18: Regulatory constraints to the expansion of health sector capabilities in India

Our work on trade in health services in India suggests that there is a widespread concern that requirements for both medical and nursing training institutions are too rigid in the country. Chanda (2007) notes that the Medical Council of India has outdated guidelines on the setting up of medical schools. Only government or trust hospitals can set up such educational facilities. This prevents corporate hospitals from setting up medical schools (unless they form separate trusts). Moreover, a rigid system of fees that medical schools can charge is pre-imposed by regulation. This system does not make medical training a financially viable undertaking. The idea underlying these restrictions is that medical education needs to be a subsidised activity, as it generates substantial positive spillovers. But returns to this activity are increasingly appropriated by individuals (through private practice and high wages for doctors in private institutions), and there are not sufficient resources to subsidise all the needed expansion in doctors' supply. Thus, relaxing these regulations to reflect the changing nature of the medical education system and to involve the private sector seems to be a crucial step.

Chanda (2007) argues that some guidelines for setting up medical colleges and training schools are also inappropriate, such as on the amount of land required, the number of classrooms and their size, etc. The approach is based on quantity of infrastructure and volume rather than value and does not focus on quality and functional excellence.

Likewise, the Indian Nursing Council has some restrictive regulations, which are also seen to be arcane, such as requirements on land and infrastructure (e.g. a 500 seater auditorium and three to five acres of contiguous land), which are difficult to fulfil in first-tier cities (Chanda 2007). However, there is some evidence that the Council has tried to make these requirements more flexible, especially in needier states.

As argued above, the expansion of the health professionals' base carries the risk of reducing the quality of the workforce. This is a very important challenge in the current Indian context, one which would need to be addressed by strengthening the oversight capacity of the responsible institutions, but also by making regulations more flexible to encourage high-quality private sector engagement. This would also involve an increased homogenisation of educational standards across states.

As noted above, an upgrade of health infrastructure would also be needed in order to maximise the benefits of cross-border trade. In particular, providing health centres with adequate telecommunication infrastructure networks is crucial to realise the potential of telemedicine. However, such investments are often fairly large and the public sector needs to evaluate whether these resources would be better invested in other areas, such as improving basic health care facilities for disease prevention and cure. The risk is that telemedicine may induce a focus on technologies that cater to the wealthy few in developing countries. This is more evident for public sector hospitals in low-income countries, which are often already overburdened by pandemics, such as tuberculosis, malaria and HIV/AIDS, for which high-technology and specialist treatment is not a priority.

7.5.4 Strengthening the regulatory capacity

Underlying the success of all of these policies is the need for an effective oversight system of health services provision. A potentially important cause for the possible negative effects of liberalisation on developing countries relates to increased competition in an environment with institutional and regulatory deficiencies. In such a situation, even limited opening up to only domestic private players may result in the kinds of distortions discussed above (Chanda 2003). Hence, the regulatory capacity in the health care sector is very important in shaping the overall impact of liberalisation, whether domestic or external. Unfortunately, regulations in many developing countries are underdeveloped and inadequately enforced; something that is confirmed by Arunanondchai and Fink (2007) for low-income ASEAN countries. Patients in these countries are adversely affected by poor-quality medical treatment and sometimes even suffer abusive practices.

Our fieldwork shows that revamping and scaling up the entire oversight system of health services provision is a crucial step to maximise the benefits of liberalisation of Indian trade in health services. This is a complex task, involving both regulatory and capacity-oriented interventions. The former would be needed, for instance, to update and streamline regulation on the mandate and competences of the institutions responsible for oversight and to make the enforcement framework more effective. More importantly, the capacity of the entities responsible for the oversight would need to be scaled up sensibly. There is currently a lack of resources and competence in these organisations to carry out their oversight activities. To the extent that the policies described above would allow possible savings of resources, part of these may be channelled towards this objective.

Strengthening regulatory systems would require political commitment by governments combined with technical assistance from donor countries and specialised health agencies.

7.6 Conclusion

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

Developing countries are increasingly important players in the international health services markets. Examples include countries like India, South Africa, China and Brazil in medical tourism, exploiting their cost advantage and quality of part of their health sector. While these exports may become an important share of a country's foreign exchange earnings, it is important that development of a trade strategy complements the primary objective of government to provide universal coverage of health care to local communities. Thus, domestic regulation could be welfare enhancing, even if it were highly restrictive to trade.

Regulation of health services can play an important role for a country's development by affecting the efficiency and equity of the domestic health system as well as the economy directly (e.g. exports and employment). Countries impose three main types of regulatory barriers to trade in health: approval requirements for clinics and hospitals; qualification and licensing requirements for professionals; and rules governing reimbursement from mandatory health insurance schemes. These rules are sometimes stringent and may represent binding constraints to trade.

Removing these barriers is likely to stimulate trade in health services, with a number of potential risks and benefits for the country's health system. Governments can adopt a variety of policies to minimise the potential costs of liberalisation and maximise the beneficial effects. These may include:

- **Promoting linkages between the public and private** segments in order to increase the reach of health services provision within the country. Examples include:
  - A German health care group is contributing equipment and expertise to what was a vacant wing in a public hospital in Cape Town and will provide public patients with specialist services that are currently unavailable from the state.
  - The promotion of professional collaboration and exchange between the two segments, and the taxation of the foreign (and domestic) commercial segment to raise resources for the public segment.
- **Strengthening regulatory capacity** in the health sector as a way to ensure that the overall impact of liberalisation, whether domestic or external, is beneficial. In an environment with institutional and regulatory deficiencies, increased competition induced by liberalisation may have negative effects.
- Finding appropriate **financing mechanisms to widen access** to health services, which in low-income countries is often restricted for some population segments. Possible ways include
  - A system of user fees with subsidies to those in need (e.g. via health equity funds) may represent a possible solution.
  - A more implicit form of cross-subsidy is to require health care personnel to spend a certain period in public hospitals or remote areas, before they can be hired by the private sector.

- **Expanding health sector capacity**: for example, the problem of two-tiering in health care owes mainly to poor domestic factors, such as low wages and poor working conditions and infrastructure in the public sector. This allows the private sector to attract skilled personnel, providing better pay and work equipment. There are a number of possible ways to expand the sector's capacity:
  - More resources could be allocated both to train a larger pool of health professionals and to improve their working conditions in the public sector (especially in rural areas).
  - Foreign educational institutions could be involved in the expansion of health-related training capacity.

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8.Mode 4: Temporary movement of people

Trade via the temporary movement of natural persons (or via Mode 4) is an increasingly important component of service exports for developing countries. At the same time, it is an effective way for such countries to fill some of the gaps in certain skills via the temporary import of service providers.

Mode 4 trade is still very limited relative to its potential owing to a number of regulatory and *de facto* barriers. In particular, the former include immigration rules, discriminatory treatment of foreign providers and recognition of qualifications; *de facto* barriers relate to the discretionary power of authorities granted in order to prevent unauthorised entry. Importantly, such barriers seem to be particularly high for South-South trade via Mode 4.

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

However, the available evidence seems to suggest that Mode 4 trade has the potential to increase several of the benefits from migration (e.g. remittances, return migration) and/or minimise its costs (e.g. loss of domestic capacity and gaps in domestic skills) for developing countries. Walmsley and Winters (2002) estimate that an increase in OECD countries' quotas equivalent to 3% of the total labour supply in importing countries would generate a rise in world welfare of US$156 billion.

Complementary policies are often important in ensuring that such positive potential impact materialises. These policies include widening the human capital base to minimise costs of brain drain and to take advantage of Mode 4 opportunities in areas of skill shortage in other countries. There is also scope for developed countries to fund training facilities in developing countries to minimise brain drain and improve the supply of skills.

8.1 Introduction

This section focuses on the supply of services via cross-border temporary movement of natural persons (TMNP). This is referred to as Mode 4 supply of services in GATS terminology and, broadly speaking, consists of a country importing a service supplied by a foreign person through his or her temporary presence in that country. Examples of this type of supply are frequent in services trade and involve a wide variety of professions, from engineers to health care workers, from teachers to tourism managers, from IT professionals to accountants. Although the focus of this section is not the GATS negotiations, we shall use this terminology to refer to services provided via the movement of natural persons.[16]

It is important to define from the outset the scope of this discussion. First, we focus only on services suppliers; as a result, we do not discuss temporary migrants in other sectors, such as agriculture or manufacturing. This is an important distinction, as it scopes out several temporary migration schemes, which may be similar to those regulating temporary movement of service providers. The focus on services sectors is justified by two considerations: it is in line with the rest of the paper and it seems to cover most temporary migrants into OECD countries.[17] Second, as importing countries have very different criteria for defining these categories of services suppliers, we follow GATS categories for the purpose of our discussion. These provide a common analytical definition of the type of suppliers involved in Mode 4 and include intra-corporate transferees, business visitors and independent services suppliers (e.g. foreign firms and professionals temporarily entering the country to provide a service). Most of our discussion will revolve around the last category, as it represents the largest Mode 4 category and the one facing the highest barriers. Individuals seeking access to the labour market of a foreign country are not included in the discussion.

[16] Note that, given the analytical similarity between Mode 4 and TMNP, we will use the two terms interchangeably.
[17] For instance Nielson and Cattaneo (2003) show that the first 10 industries of beneficiaries of the most popular temporary migration visa in the US (H1B) in 2001 were mainly services-related and the top five occupations of temporary migrants to Australia were services-related in 2000–1.

The most challenging definitional issue relates to the temporariness of the movement involved in Mode 4. There is no clarity on this in GATS or elsewhere. Countries specify the maximum duration of stay for which access is granted under a temporary scheme, but this varies widely across countries. Moreover, it is quite common for countries to extend the stay of temporary migrants, sometimes eventually turning them into permanent ones. These issues make the distinction between temporary and permanent migrants very difficult to draw. This blurred distinction applies to the data and empirical evidence available and is therefore going to be a recurrent theme throughout the section. Nonetheless, in practical terms this distinction is usually important for countries, as they are usually more prepared to accept immigration on a temporary rather than permanent basis

How large is current Mode 4 services trade? Unfortunately, owing to the nature of the transactions involved, i.e. services and payment carried out within the same country, there is no direct estimate of this type of trade, as it is not captured by BoP data. There are at least three approaches to proxy for Mode 4 trade. The first is the traditional one, through data on compensation of employees and remittances in BoP statistics. Data from IMF BoP statistics (quoted in Hufbauer and Stephenson 2007) indicate that immigrant remittances stood at US$151 billion in 2005, whereas income earned by temporary workers was another US$72 billion.[18] Contrary to what is argued by Hufbauer and Stephenson, these estimates are likely to be larger than the actual Mode 4 trade, as remittances also include permanent migrants. According to these estimates, Mode 4 trade has almost doubled between 2000 and 2005, with the ratio of Mode 4 trade to Mode 1 and 2 increasing from 7.6% to 9.2%.

Another approach is based on country records of temporary work permits mainly in developed countries, such as the US and the UK, showing a concentration in certain occupations (see e.g. WTO 2004). The US H1B visa is for 'professional workers in specialty occupation', such as computer specialists or fashion models from foreign countries. H1B visas are granted for an initial period of up to three years. In 2000, 136,800 new permits were approved for initial employment, mainly in computer-related occupations (Table 12). This increased further to 165,000 but then decreased to a new cap of 65,000 in 2004. The second-largest group was electrical/electronics sector workers, industrial engineers and architects, followed by specialised administrative occupations, such as accountants and specialist auditors in related services industries. The UK permits are for less than a year (one-third of the total number) and for up to five years (the rest).

Table 12: Number of temporary work permits granted

	US	UK
Total services	136,787	64,574
Computer-related (all), of which:	74,551	10,470
India	50,827	5973
China	5725	108
Philippines	1217	–
US	–	1404

Source: WTO (2004).

The last, more indirect way, of estimating the size of Mode 4 trade is to refer to the countries' schemes to admit temporary workers. Table 13 shows the number of countries that have special (temporary) admission schemes for different categories of workers out of 92 surveyed by the International Labour Organization (ILO 2004). The vast majority of the countries do not have special schemes allowing migrants. As the absence of such schemes is likely to constrain TMNP significantly (as we see below), this is an indication that the full potential for Mode 4 trade is far from realised. In particular, the survey shows that low-income countries are much less prone to admit foreign labour than high-income ones. When they have special schemes in place, they are only for priority sectors and regions, usually as a concession to foreign investors establishing operations in their export or free trade zones (Abella 2006). Only two of the 26 lower-middle income countries and one of the 18 upper-middle income countries have schemes to attract professionals, scientists and managers. This does not mean that the

[18] The estimate for remittances is slightly different from that of the World Bank (2006), which puts the figure at US$167 million.

developing countries do not admit such people; they do so, but have no special schemes for attracting them.

Table 13: Number of countries admitting workers under special schemes

	High-income	Upper-middle income	Lower-middle income	Low-income
Surveyed countries	31	18	26	17
Professionals, scientists, managers, other highly skilled	11	1	2	0
Contract workers	6	2	0	0
Seasonal workers, especially for agriculture	6	2	0	0
Trainees	16	0	0	0
Working holiday makers	7	0	0	0
For employment in priority sectors, especially exports and small industries	7	5	6	3
For employment in priority regions	1	1	2	0

Source: Abella (2006).

8.2 Contribution of Mode 4 to development, growth and poverty reduction

As Winters (2003) argues, Mode 4 trade may help developing countries exploit their comparative advantage in semi-skilled and unskilled labour. A corollary of this is that the liberalisation of visa quotas, such as the H2B for temporary non-agricultural workers, which caters for unskilled workers as well, is likely to be especially beneficial for developing countries. For several developing countries, this beneficial impact would apply to skilled labour as well, which would supply specialised services via TMNP. For instance, the International Organization for Migration (IOM 2005) notes that, according to BoP data, many developing countries have a 'revealed comparative advantage' (the ratio of a given export to a country's total exports, divided by a similar ratio for the world) in a number of high-skilled services sectors, including engineering, accounting, law, management consulting, nursing, software development and data processing.[19]

This means that, if properly managed, Mode 4 trade could have a highly beneficial impact on the exporting (developing) country. We follow Calì and te Velde (2007b) to review the main channels through which Mode 4 liberalisation may affect development, growth and poverty reduction in exporting countries. These include remittance flows, impact on domestic capacity, incentives for human capital formation, impact on trade and FDI and return migration. Most of the evidence available on these effects does not distinguish between temporary and permanent migration: the effects are analytically similar but tend to have different magnitudes. Thus, we try to make this distinction wherever possible, focusing on TMNP rather than on permanent migration.

8.2.1 Impact on domestic capacity

One strand of thought on migration focuses on the impact on the available supply of labour in the sending country, and in particular of skilled labour (the 'brain drain'). The traditional literature on migration emphasises that skilled emigration affects sending countries negatively, for instance, when education and training of skilled emigrants is partly funded by public revenues. In this case, migration will lower the social rate of return of public investment in education. Poor countries face limited availability of skilled labour, and emigration to the developed world might exacerbate skills shortages.

Precise data on effects on domestic capacity are scarce but some are beginning to emerge. Using US census data and OECD migration statistics for 1990, Carrington and Detragiache (1999), for instance, find that skill losses may be as high as 30% of a country's population with specific skills in small countries in the Caribbean, Central America and Africa. Carrington and Detragiache (1998) estimated

[19] It is noted that the same comparative advantage may explain the increasing interest by industrial countries' service industries in outsourcing high-skilled jobs to developing countries.

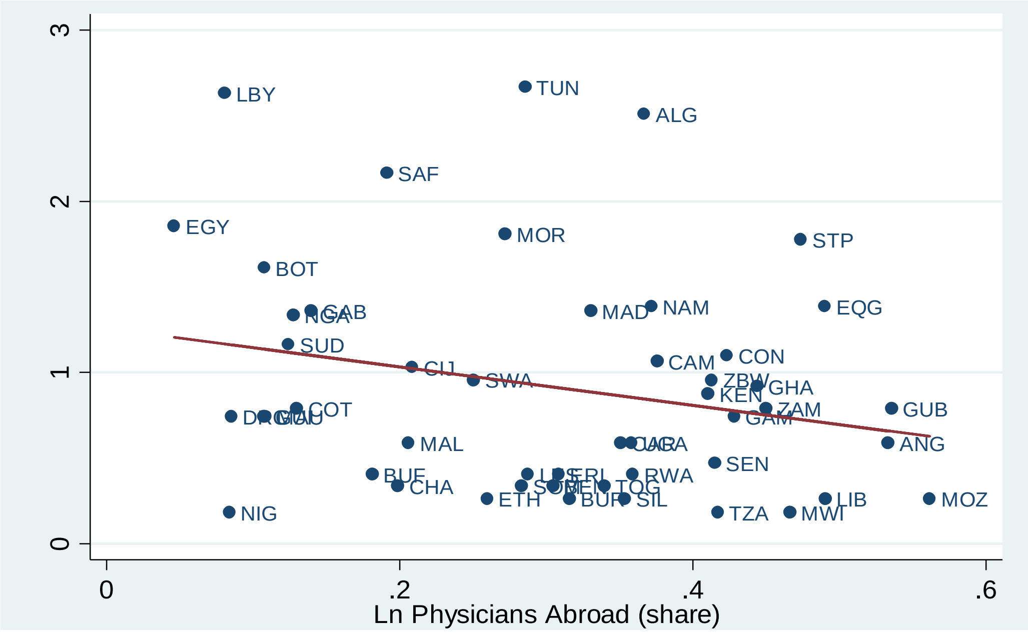
emigration rates (emigration/emigration and national labour force) for 61 developing countries in 1990 using immigration flows to OECD countries. Owing to data limitations, they applied the US structure of immigration by education level (based on US census-level data) to all other OECD countries. They found that individuals with little or no education had limited access to international migration, and migrants tended to be better educated than the rest of the population in their country of origin. It is thus more likely that **skilled** individuals emigrate. This can be because there is more demand for educated workers or because the skilled are less poor and more capable of planning and financing migration. South-North migration is usually by skilled workers, and there appears to be some historical evidence (see Clark et al. 2003) but also institutional reasons that the poor migrate less.

A prominent example of a specific sector affected by skilled emigration is the health sector. The World Health Organization (WHO 2006) identifies countries with a critical shortage of health workers, essentially concentrated in sub-Saharan Africa and South Asia. According to data gathered from nine receiving countries (which include the most important destination for medical doctors' migration) by Clemens and Pettersson (2006), at least 28% of total physicians from sub-Saharan Africa worked abroad in 2000. In countries like Equatorial Guinea, this percentage is as high as 86%, and 24 of the 53 African countries surveyed have percentages higher than 40%. Such figures are particularly worrying for countries with a high incidence of HIV/AIDS, which increases pressure on already weak health systems.

However, there is no agreement on the welfare effects of emigration on the exporting country. Clemens (2007), for example, uses these data to show that generally low staffing levels in Africa are not the result of the international movement of health professionals. In fact, he finds that emigration has caused a greater production of health workers in Africa, a result in line with the literature arguing for the positive effects of migration on human capital formation (see below). However, Figure 9, showing a negative relation for Africa between total physicians available and the physicians' emigration rate in the exporting countries, casts doubts on Clemens' findings.

Can temporary migration schemes alleviate these concerns about the brain drain? They can if such schemes reduce the stock of service providers abroad from the exporting country relative to the case of permanent migration and if they can stimulate greater human capital formation. As argued by Amin and Mattoo (2007), a mere rotation of migrants under a Mode 4-type scheme does not *per se* create any extra benefits for either importing or exporting countries as compared with permanent migration. If anything, the turnover costs are likely to be higher with constant rotation of workers. To illustrate, consider the case of Zambian nurses to the UK. While the current situation implies that the nurses are permanently settled in the UK, a Mode 4 scheme would involve all the nurses returning to Zambia and an equal number of new nurses leaving the country. If the numbers of nurses in Zambia and Zambian nurses in the UK are unchanged, the switch to a temporary scheme does not have a positive effect on the welfare of either country. In this case, the key condition for TMNP to be more advantageous than permanent migration is that the benefit of turnover to the exporting country dominates the cost of turnover to the importing country. The latter is likely to be low where immigrants acquire host-specific skills quickly and at little cost to the host. The benefits from turnover for the exporting country are likely to be high when remittances, and human capital spillovers, are larger and used more productively under temporary migration compared with permanent migration. We examine these benefits in turn.

Figure 9: **Total physicians vs. physicians' emigration rate in Africa**



Note: Coeff. = -1.123 t-stat = -1.79.
Source: Authors' calculation on Clemens and Pettersson (2006) and WHO Global Health Atlas (http://www.who.int/GlobalAtlas/).

8.2.2 Remittances

Most migrants (whether temporary or permanent) support their families at home by sending money and goods to the country of origin. The World Bank (2006) calculated that all migrants from developing countries officially sent home more than US$167 billion in 2005, which represents more than twice the level of international aid. Adding remittances through informal channels (over 50% of the official estimate) makes remittances the largest source of external capital in many developing countries. Data show that remittances have increased substantially in all developing regions, with East Asia and the Pacific having overtaken Latin America as the largest recipient.

At the micro level, remittances have positive direct (and possibly indirect) effects on the households that receive them. These would be part of the household income and may directly contribute to **poverty reduction**. At the country level, this would mean that increased remittances may lead to falling poverty rates. Such an association would be stronger the larger the share of poor households receiving remittances. Adams and Page (2003) argue that remittances have been among the key factors for the very low levels of poverty in the Middle East and North Africa. Estimates from the World Bank (2006) show that, in recent years, total remittances have led to reduced poverty levels in low-income countries, e.g. by about 11% in Lesotho, by 5% in Ghana and by 6% in Bangladesh.

Beyond helping to reduce poverty, remittances may also represent an important source of **insurance** against negative shocks. Lucas and Stark (1985), for example, found that remittances to households in rural Botswana were larger for those located in villages undergoing severe drought and where the families' livelihoods were vulnerable to the lack of rain.

Remittances can have **indirect** effects as well, in that they may help accumulate factors of production (human as well as physical capital) that could increase future income for the receiving household. For instance, Edwards and Ureta (2003) find that, in El Salvador, increase in remittances was associated with a more than proportional increase in education levels, in part because the demand for education is a positive function of income and remittances.

The impact of remittances on the exporting country goes beyond the receiving household and extends to the macro-economy. Given their size, and the fact that they seem more stable than other financial flows (World Bank 2005), remittances may have a substantial positive effect on economic growth. Straubhaar and Vadean (2005) argue that remittances may be more beneficial than official development assistance and FDI, as their use is not tied to specific investment projects with high implementation content, they do not entail interest payments and they are likely not to be repaid.

TMNP is likely to magnify these effects, as it tends to be associated with a higher share of remittances over total migrant income than does permanent migration. There is evidence that intended return migration increases remittances. This is especially true for low-skilled migrants, not accompanied by family members, who expect to return to their country of origin (Katseli et al. 2006). Connell and Brown (2005) suggest that the imminent return of temporary migrants provides an incentive for them to maintain (and eventually increase) their assets in the country of origin and therefore to invest their savings there (remitting more). Rozensweig (2005) finds that, after controlling for a number of household socioeconomic characteristics, the remittance level received by Indian households with a member migrant intending to return was about three times the remittance level of those with a member who had no intention of returning.

8.2.3 Incentives for human capital formation

By raising the expected return to investment in education (especially for certain skills), TMNP can act as a stimulus to human capital formation. If large enough, this incentive may translate into a net brain gain from migration. Beine et al. in a series of two studies (2001 and 2003) provide evidence of a net positive effect of migration on human capital and thus on growth. The authors find that the positive effects are limited to a handful of countries in the sample, which include the largest countries (India, Brazil and Pakistan, among others) and represent 80% of the sample population. The brain drain appears to have a negative impact on countries where the migration rate of the highly educated is higher than 20% and/or where the proportion of highly educated in the total population is below 5%. Such countries include Jamaica, Bolivia, the Philippines and Ecuador, among others. We must note that most sub-Saharan African countries, which are likely to be among the most affected by the brain drain, were not included in the analysis.

Despite this evidence, there seems to be no consensus on the issue yet. Based on static analysis, Schiff (2005) shows that the size of the brain gain and its impact on welfare and growth are likely to be significantly smaller than found in the literature and may even be negative. Empirically, Faini (2002) finds little indication of a positive impact of the brain drain on growth in source countries, whereas Lucas (2005) obtains a negative impact of the brain drain on education. Probably, the net effect of migration on education varies from country to country, and specific country evaluations have to be carried out in order to assess whether a country is likely to benefit from increased migration.

8.2.4 Impact on trade and FDI

Migration may have other more indirect positive effects on the source country via increasing its exports of goods and services. The diaspora helps to create business and trade networks (Dustmann and Kirchkamp 2002). The diaspora creates links with other countries by acting as an intermediary. The network effects and externalities of the diaspora have already been recognised for trade in goods (Rauch and Trindade 2002) but they are just as valid for trade in services. For example, this is the case with the promotion by migrants of inbound tourism and with well-known carnivals and other festivals in the Caribbean (see also Thomas-Hope 2002).

A case in point is the Indian software industry. Given that most software exports from India are in the form of IT services that involve visits to clients' sites (Kumar 2007), liberalising a scheme, such as the H1B, is likely to be beneficial not only to Mode 4 but also to other cross-border modes of services supply. Moreover, Indian migrants, particularly those in the US, have contributed significantly to the recent growth of the Indian software industry, not only through the transfer of knowledge and technology, but also by opening up new markets for Indian products and services. Other developing countries may benefit from the same type of development in other technology sectors if the quantitative barriers to Mode 4 trade are lifted.

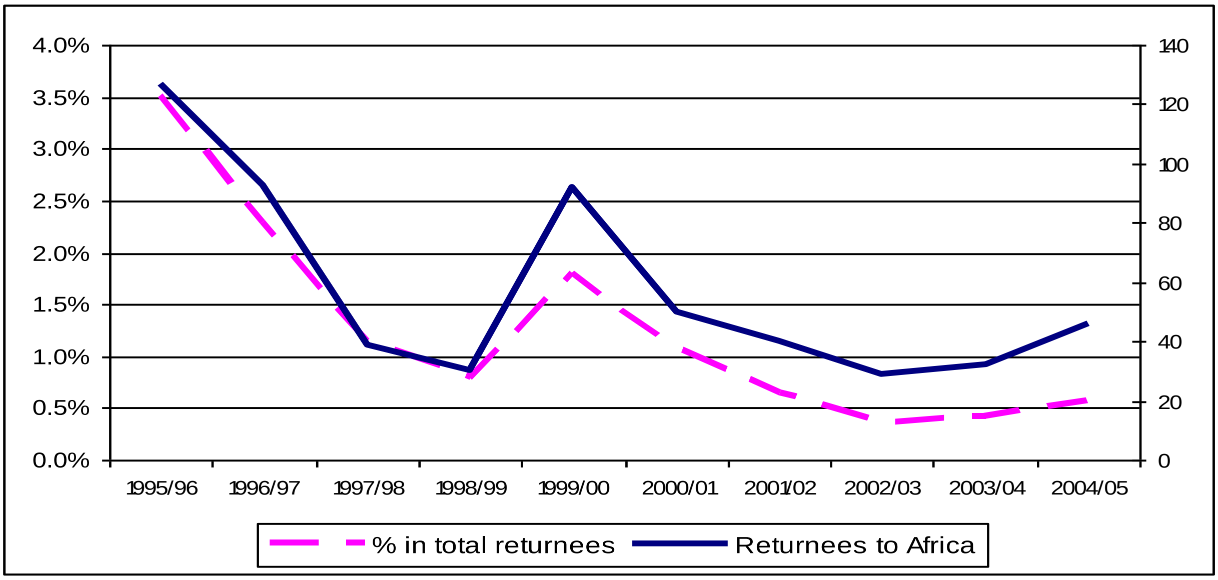
Would Mode 4 make these effects differ compared with permanent migration? Although there is no empirical evidence available, we can infer one way in which the transitory nature of migration may influence FDI and trade. To the extent that TMNP reduces the migrants' length of stay in (and possibly the links with) the host country, it may reduce the opportunity of trade and FDI occurring through migrants. However, this does not preclude that temporary migrants are more trade-intensive, reversing the effects. Jansen and Piermartini (2004) find empirically that Mode 4 agreements increase bilateral trade substantially.

8.2.5 Return migration

Migrants can learn valuable skills which can offer benefits to the sending country if and when migrants return (Domingues Dos Santos and Postel-Vinay 2003) and skills have been acquired abroad. Calì and te Velde (2007a) argue that the health sector is one where learning skills abroad may be particularly relevant, as migrants may have access to new technologies, career development schemes and more advanced management systems. This experience may be an invaluable source of ideas and expertise in the upgrade of the sending country's health sector. A study of migration of health workers from the Pacific region indicated that there were some gains to migration, in that many health workers returned from overseas with additional skills (and with capital that was invested in housing and businesses), thus providing both individual and national benefits (Connell 2003).

Return migration has reached quite a high rate for the Caribbean. Some estimate that 50% of immigrants into the UK have moved on within five years. However, return migration has been low and decreasing for areas such as sub-Saharan Africa. Figure 10 shows a declining number of registered nurses returning to Africa from the UK over the past decade. The average number of African nurses going back every year has decreased from over 100 in the mid-1990s to around 40 in the period 2003–5. The decline has happened in spite of the increasing number of African nurses employed in the UK.

Figure 10: Nurses returning to Africa from the UK



Source: UK Nursing and Midwifery Council (2005).

In as much as return migration, especially of the highly skilled, is beneficial to the sending country, Mode 4 may have a positive effect as it increases the return rate of migrants. Data on the return rate of migrants (both skilled and unskilled) are scarce. The little evidence available reveals higher and earlier return migration among migrants from higher-income countries (e.g. Borjas and Bratsberg 1996 on the US). TMNP schemes may be particularly helpful if they can increase the rates of return for lower-income countries, although this would be subject to the amount of 'leaks' (i.e. proportion of migrants who do not return to the home country at the end of the scheme).

8.2.6 South-South trade: Filling skills' gaps

Mode 4 trade could also be beneficial for developing countries by filling the gaps in the local labour force. For instance, countries such as South Africa and Botswana import health care services via Mode 4 from other African countries (e.g. Kenya, Zambia, Zimbabwe); Thupagayale (2006) conducted a survey of 289 nurses (around 5% of the total) and discussed how many nurses in Botswana were of foreign origin. Strikingly, this percentage (6.7%) is very close to that of Botswana nurses abroad (7%). This suggests that imports of nurses in Botswana are instrumental to mitigate the potential negative effects of migration on domestic capacity.

Other examples of South-South trade via Mode 4 include Mauritius importing accountancy services from India and South Africa and Botswana importing tourism workers from other countries in the region. Examples of these types are very frequent in developing countries (with South-South accounting for 24% of total migration), despite the lack of formalised Mode 4 schemes between them.

8.2.7 Effects in importing countries

Although, as already argued, Mode 4 trade has the potential to fill important skills' gaps in importing countries, its liberalisation is marred by opposition in such countries, owing to its perceived negative effects on them. The H1B case described above exemplifies one major obstacle to liberalising Mode 4 trade, relating to security and social integration issues of the importing countries. In most developed countries, these concerns have generated public opposition to immigration, which is likely to have important limiting effects on TMNP as well. It is not clear to what extent Mode 4 liberalisation may be connected to security concerns, but such barriers to the TMNP as those described above for the US have a certain negative impact on economic efficiency in importing countries. In these instances, it would be important for importing countries to use the same relative rate of substitution between security and economic efficiency as between their military spending and other expenditure that increases economic efficiency (Winters 2003).

The other major political economy barrier to Mode 4 liberalisation by importing countries relates to concerns about possible losses for the domestic labour force (e.g. decline in wages, job losses). This would be especially the case for unskilled and semi-skilled workers, those most exposed to increased competition from new temporary migrants. Dustmann et al. (2007) provide some support for this argument, finding that recent immigration to the UK has had on average a slightly positive wage effect, with significantly positive wage effects around the middle of the distribution and clearly negative wage effects at the lower end of the distribution. This is a similar effect to that produced by an increase in labour-intensive goods imports from developing countries (with losses for unskilled workers and gains for everyone else). As argued by Winters (2003), if Mode 4 reform 'is applied with the same policies and sensitivities that trade policy reform in goods has received in the past, TMNP offers less skilled workers a chance to reap some of the large gains described above'.

Moreover, the skills' gap which drives Mode 4 imports appears to be so large in certain services sectors of receiving countries that it is hard to see how Mode 4 liberalisation could have a significantly negative impact on the labour market of the importing country (e.g. health care sector, IT services in several OECD countries). Dustmann et al. (2007) provide evidence of modest wage effects of immigration in the UK relative to the large average yearly inflows of immigrants over recent years and to the average growth of real wages.

The above discussion has shown that Mode 4 trade appears to have the potential to increase several of the benefits of migration (e.g. remittances, return migration) and/or minimise its costs (e.g. loss of capacity) for developing countries. However, complementary policies are often important in ensuring that such positive potential impact materialises.

8.3 Mode 4 liberalisation: What is involved?

In his literature review of trade in services, Hoeckman (2006) concludes that most indices of services barriers reveal that the highest barriers are found to Modes 3 and 4. Such restrictiveness is in line with the low share of countries with special schemes for temporary workers reported in Table 13 and it is likely to be related to the common perception by countries of Mode 4 as a migration rather than as a trade issue.

Unlike the case of the services sectors reviewed in this paper, liberalisation of Mode 4 trade concerns mainly domestic regulation of importing countries. As the largest share of current and potential trade via this mode occurs between (importing) high-income countries and (exporting) middle- and low-income ones, the main focus is on the restrictions imposed by the former.[20]

Mattoo (2003) identifies three main types of regulatory barriers to Mode 4 trade, which a serious liberalisation effort should tackle: immigration rules, discriminatory treatment of foreign providers and recognition of qualifications.

8.3.1 Immigration rules

These are probably the most stringent barriers to Mode 4 trade. Virtually all countries impose **quantitative restrictions** on the TMNP, usually for concerns about security, domestic labour market and social issues. These quotas are usually substantially lower than the actual demand for entry. For example, in the US, quotas for H1B visas used to be exhausted within a few months every year when the cap was 195,000 visas per annum; since the quota has been restricted to 65,000, places are filled much quicker (see the discussion in the next section). Because these are effectively visa-related restrictions, they fall under the political authority of home affairs departments and outside the scope of trade negotiations. **Economic needs tests** are required by most countries in order to grant a work permit for a temporary supply of service. Such tests require a prior thorough search within the domestic market for a similar services supplier before the visa application is accepted. Not only does this procedure not usually consider the difference in the quality of the service but it also often undermines the stability of relations with trusted foreign suppliers. A further barrier relates to the **wage parity requirement** between service providers, which countries sometimes impose on domestic employers. This often erodes the cost advantage of employing foreign suppliers, especially from developing countries, which may be willing to provide the service at a lower cost than domestic suppliers. Finally, work permits are always issued for a **limited duration**, which is often fixed according to standardised systems that do not differentiate between works of different nature. Thus, services that require longer to be supplied than the duration of the visa allows would meet a further barrier in the often cumbersome and expensive extension procedure.

8.3.2 Discriminatory treatment of foreign providers

Residency or even citizenship requirements are sometimes a prerequisite for services provision in several countries. These requirements clearly penalise foreign providers, often making Mode 4 supply unviable. Other types of discriminatory practice concern tax-related issues. For example, Parikh (2003) notes that, in the US, foreign service providers have to pay social security and other taxes for which no adequate credits in the home country are available in the absence of a treaty between the two countries. Moreover, in the absence of such a treaty, the service provider continues to pay taxes in his or her home country as well as in the foreign country. Moreover, the government approval often required for foreign service providers to set up operations in the importing country and even to remit money back to their country may also be a barrier to Mode 4.

[20] We must note, however, that several middle- and a few low-income countries import services via Mode 4, and developing countries often have severe restrictions to Mode 4 trade.

8.3.3 Recognition of qualifications

Inadequate recognition of formal qualifications and training may constrain the ability of certain service suppliers to provide their service abroad. This is particularly true for professional services, such as legal, accounting and engineering-related services, and so on. Examples of this type of constraint abound, among both developed and developing countries. The former rarely recognise qualifications from the latter, but also developing countries often do not have an automatic recognition procedure for qualifications from other developing countries. For example, South Africa requires a fairly cumbersome procedure in order to register as an engineer or an architect holding a related degree from other SADC countries. RTAs have so far been the most effective arenas for implementing MRAs. This is the case for the EU, which is probably the most progressive regional agreement in this respect. However, Stephenson and Yi (2002) argue that even the members of RTAs in the Asia Pacific region have generally perceived the benefits of the development of MRAs. Incoming EPAs between the EU and ACP regional groups may help in developing the most potentially beneficial MRAs, those between high-income and low-income countries.

8.3.4 *De facto* barriers

Aside from formal barriers, *de facto* barriers constrain Mode 4 trade as well. These include barriers related to the discretionary power of authorities granted in order to prevent unauthorised entry. Self and Zutschi (2003), for example, report anecdotal stories about requests for information that seem clearly designed to discourage or delay the process of obtaining a visa for temporary entry. Moreover, many countries refuse to provide information about the status of a visa application. In several countries, such barriers appear to be of different magnitude according to the skills level. Parikh (2003) reports that the time required for processing visas for higher-level professionals is usually much less than that for lower-level professionals. There is a need for greater transparency and predictability in the entry application process to tackle these *de facto* barriers. Self and Zutschi identify elements that could be included in a 'best practices' set of commitments, such as the public availability of the full information on the visa application process, including the supporting documentation required, clear deadlines for the completion of the application, a full description of the limitations to market access and other procedures, such as wage parity requirements, quota restrictions and economic needs tests.

8.3.5 Barriers to South-South trade

Regulatory barriers to Mode 4 trade are possibly even more stringent in the case of South-South trade. According to Parsons et al. (2007), this type of migration is already substantial, accounting for one-fourth of total migration. However, given that distance is one of the most important explanatory factors for migration and that developing countries' neighbours are often other developing countries, the South-South share in total migration does not appear to be particularly high. One reason for this may lie in the high levels of regulatory barriers imposed on this type of migration.

Anecdotal accounts from the Southern Africa region indicate that visa and work permit issues are a major constraint to TMNP into most of Botswana's services sectors. This usually applies indistinctly to developing and developed countries, but is more stringent for the former, as they provide much higher numbers of prospective temporary migrants. Recognition of qualifications seems to be another important barrier to South-South trade via Mode 4, as is the case for imports in several services sectors in South Africa (detailed above).

8.4 Benefits and risks of Mode 4 liberalisation

Temporary migration is a natural response to widening demographic and economic differentials between countries (IOM 2005 and Winters 2003). The higher these differences, the higher the potential for gains from trade via Mode 4 should be.

Unfortunately, there is little available evidence on the effects of Mode 4 liberalisation on exporting or importing countries. There are two main reasons for this. First, and most importantly, countries have not substantially liberalised their Mode 4 import regimes. As shown in the previous section, this is still perceived as a migration issue, and a whole range of important barriers to the free circulation of services suppliers still remains. Such a situation is different from other services sectors analysed in this paper, where liberalisation has often occurred in full (e.g. financial services, communication, tourism). Second, even when some of the constraints to Mode 4 are relaxed, it is very difficult to isolate the channels described in section 2. This owes to problems in collecting data from temporary migrants and in distinguishing between temporary and permanent migrants. As a matter of fact, the current Mode 4-type schemes are often open to the possibility for service suppliers to extend their stay in the foreign country, turning them into permanent migrants.

Probably the most comprehensive evidence on the effects of Mode 4 liberalisation to date is that from simulation exercises, such as that by Walmsley and Winters (2002). The authors use a CGE model in order to simulate the impact of an increase in quotas for inflows of temporary workers into industrial countries. Based on 1997 data, they find that an increase in quotas equivalent to 3% of the total labour supply in importing countries would generate a rise in world welfare of US$156 billion. This gain is driven mainly by the increase in income of those becoming temporary migrants, who are employed more productively than in their home country. Permanent residents in developed countries also gain from this liberalisation, as both returns to capital and tax collected increase. On the other hand, those who remain in developing countries experience a net loss in welfare subsequent to the loss of labour which outweighs increased remittance flows. This result is likely to underestimate the positive effects on developing countries' economies, as dynamic gains from temporary migration, such as those from return migration and increased incentives to human capital formation, are not considered. However, the simulation results do point towards the risks of the skilled labour force out-migration in countries that have a tiny supply of this labour.[21] This is confirmed by the results for India, where the increase in remittances outweighs the loss of output from labour migration. As India is endowed with a large supply of labour, including skilled labour, the decline in output is relatively small at the margin.

This finding is consistent with the results of Beine et al. (2003), which indicate that large countries are more likely to benefit from migration than small ones, where the migration rate of the highly educated is likely to be higher. Such arguments point towards the crucial role of a wide human capital base in creating the conditions for exporting countries to benefit from a liberalisation of Mode 4 trade. This requires the development of different policies and institutions to accompany labour migration, which we will discuss in the next section.

To what extent do these regulatory barriers constrain the volume of Mode 4 trade and the possibility of these potential gains materialising? We could infer this by analysing the case of the most renowned temporary migration schemes for highly skilled workers: the H1B visa scheme run by the US for the temporary import of highly skilled professionals. The scheme was introduced by the Immigration Act of 1990 to allow US firms to fill gaps in highly skilled jobs. Given the success of the programme (especially for computer-related jobs), the yearly quota of employer-sponsored immigrants grew rapidly from 65,000 (which was bound in the GATS offer in 1995) to 195,000 at the beginning of the 2000 decade (Table 14). Once the programme became established, the cap was easily achieved, with the number of applications far exceeding it. Increased security concerns (also following the shock of 9/11) reversed this trend, first by increasing *de facto* barriers (lowering the number of visas issued with the same level of quotas: 2001–3); then by lowering the cap of H1B visas to the initial level of 65,000 (under which the US could not go owing to its commitments in GATS). This new quota appears to be very inadequate relative to the potential Mode 4 import of US of highly skilled services. The US Citizenship and Immigration Services (USCIS) currently receive the full quota of applications from companies various months in advance of the beginning of the financial year (Sweeney 2004).

[21] The simulation with migration of only unskilled labour leads to an increase in net welfare for the non-migrant population of source (developing) countries.

Table 14: H1B visas in the US

	Cap	No. issued	% filled
1992	65,000	48,600	75
1993	65,000	61,000	94
1994	65,000	60,300	93
1995	65,000	54,200	83
1996	65,000	55,100	85
1997	65,000	65,000	100
1998	65,000	65,000	100
1999	115,000	115,000	100
2000	115,000	115,000	100
2001	195,000	163,600	84
2002	195,000	79,100	41
2003	195,000	78,000	40
2004	65,000	65,000	100
2005	65,000	65,000	100
2006	65,000	65,000	100

Source: Department of Homeland Security, National Foundation for American Policy, American Council on International Personnel.

This indicates that this quota restriction is a stringent barrier to Mode 4 import by the US and lifting it would generate a much-needed temporary inflow of service providers into the country. This restriction has had a particularly severe impact on Chinese and Indian nationals, who significantly outpace the overall drop in H1B quotas (Paral and Johnson 2004). This owes mainly to the fact that foreign-born scientists and engineers from China are concentrated in two areas, life and physical sciences, which are most likely to involve sensitive technologies as defined by the Technology Alert List (TAL) – a list of technologies deemed sensitive to US national security (foreign-born applicants who work in any of the fields on the list are subject to additional background checks and processing delays).

The relatively large presence of illegal migrants in most OECD countries suggests that regulatory barriers appear to be a binding constraint to the orderly development of trade in services.

8.5 Complementary policies required to maximise benefits to development

Why has Indian migration of IT workers contributed to significant IT growth but migration of health care workers from Malawi and Zambia has further undermined the sustainability of domestic health sectors? Why do some temporary migration flows lead to virtuous and others to vicious circles for developing countries? The evidence so far assigns a crucial role to the ability of the exporting country to develop an adequate domestic human capital base in triggering a virtuous circle or at least in minimising the risks from out-migration. Policies aimed at expanding the domestic supply of nurses, for instance, are a necessary (but not sufficient) complement to the liberalisation of the TMNP providing nursing services.

This fairly general rule has different implications in different sectors. For instance, health care and IT differ in several respects. Governments strongly influence the demand and supply of health care services; IT services are largely produced and consumed by the private sector (IOM 2005). However, a case could be made for the crucial role of domestic policies in facilitating and, in some cases, subsidising education in sectors where the demand for Mode 4 service exports imposes strains on domestic capacity. This is certainly the case for education and health services in most of sub-Saharan Africa, but the same could be argued for other, non-social sectors as well. A set of policies and institutions needs to be in place to successfully scale up training activities without undermining quality. This requires substantial accreditation capacity, especially if training expansion is rapid. For example, in the Philippines, there is increasing anecdotal evidence of deteriorating quality of nursing graduates, as shown by the decreasing number of those passing 'leakage-marred exams' (The Northern

Dispatch Weekly 2006). This type of challenge points to the importance of effective domestic regulator in the educational sector.
We note here that the hiring of certain service professionals from low-income countries by high-income countries, especially in health care and education, may constitute a perverse subsidy to the public sector of high-income countries, which does not have to incur the costs of training. If severe, a subsidy may foster deep international inequalities, such as those in health and education access. If one is interested in reducing such inequalities, importing countries could consider paying exporting countries to compensate for this subsidy.[22]

Given the increasing international demand for health care workers, expanding their training and education can be an appropriate export strategy for countries with a comparative advantage in labour-intensive production. The Philippines are a good example in this respect. The country has been providing training to health workers, especially nurses, for migration for many years, as part of a larger policy to encourage worker migration. Filipino nurses constitute 76% of foreign nurse graduates in the US (Choy 2003). Similarly, Cuba has exported thousands of health workers as part of its bilateral relations with other countries (WHO 2006) and it retains some part of the incomes of doctors when working abroad. Some countries, including China, India, Indonesia and Vietnam, are either actively involved in or contemplating export strategies (Commander 2004). Connell and Brown (2004) argue that, given the shortage of nurses in Australia and New Zealand, investment by Pacific island governments and households in nurse training may constitute an efficient use of economic resources. Policies encouraging investment in source countries (including improving the investment climate for investors) may be more effective in fostering development than those directly discouraging emigration.

Not all countries will have the comparative advantage and institutional capacity to implement such export strategies. The WHO (2006) notes that 'these strategies have not been systematically evaluated, but experience indicates that they are resource intensive and require the establishment of institutional capacity for training and accreditation, and careful management of interactions with the internal or domestic health worker market'.

In low-income countries with tight fiscal constraints, the expansion of the skills base in services for Mode 4 exports is not likely to come without the involvement of the private sector (e.g. IT training in India). As this is fairly under-resourced in most low-income countries, foreign educational institutions may be important in expanding the training capacity relatively quickly. This involvement would require an effective education regulatory body and a fairly liberal competition regime in the education sector.

One of the major advantages of TMNP is that service providers may benefit the home country with increased skills and training upon return. However, as we have seen, it is very difficult to create schemes that can ensure the return of the temporary migrant at the end of the programme. Mode 4 schemes that are successful in ensuring return are generally based on effective cooperation between exporting and importing country and on positive incentives towards return by exporting countries. The former may involve bonding schemes, whereby a part of the wage of the temporary migrant could be paid upon return, or in a special account based in the home country, and the commitment by the importing country not to extend the work permit beyond the time agreed in the scheme. Exporting countries may create incentives for return through policies such as the active institutional management of migration[23] and systems that allow a returning skilled migrant to rejoin her industry at a level appropriate for her experience (see Calì and te Velde 2007b for a more complete review).

A key message that emerges from this review is that, while Mode 4 liberalisation by importing countries is important to facilitate trade in services between countries, complementary policies in exporting

[22] See Calì and te Velde (2007a) for a more thorough discussion on the form such payments may take with specific reference to the health sector.
[23] A relatively successful example of this strategy is the Philippine Overseas Employment Administration, created in 1995 to promote the return and reintegration of migrants. This institution grants several privileges to returnees, including tax-free shopping for one year, loans for business capital at preferential rates and eligibility for subsidised scholarships (WHO 2006).

countries are necessary to maximise the benefits and minimise the risks of Mode 4 trade for those countries.

8.6 Conclusions

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

Mode 4 trade is still limited relative to its potential, owing to a number of regulatory barriers posed by countries with the aim of protecting domestic labour markets and of satisfying security concerns fuelled by substantial immigration. These barriers include: immigration rules; discriminatory treatment of foreign providers; and inadequate recognition of qualification.

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

Complementary policies in exporting countries are often crucial in ensuring that positive potential effects materialise. Such policies may include:

- **Promoting skills and education** for those professions whose services are likely to be exported by developing countries. Such an expansion would require, *inter alia*:
  - The involvement of the private sector;
  - An effective education regulatory body (to oversee quality);
  - A fairly open competition regime in the educational sector;
  - Developed countries may also have the incentives to fund training facilities in developing countries as an effective way to improve their own access to skilled workers.
- **Implementing incentives** for migrants' return in order to fully benefit from their skills. Policies towards this end could include:
  - The active institutional management of migration;
  - Systems that allow a returning skilled migrant to rejoin her industry at a level appropriate for her experience;
  - Effective cooperation between exporting and importing to increase the number of returning migrants.

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9. Conclusions: Towards a narrative on services and development

The services sector makes an important contribution to the economy, both through its direct contribution to GDP and job creation, and because it provides crucial inputs for the rest of the economy and thus constitutes an important part of the overall investment climate essential for growth and development. Some services sectors, such as health, education and water and sanitation, are also directly relevant to achieving social development objectives.

9.1 Contribution of services to GDP

The services sector accounts for a significant proportion of GDP in most countries, including low-income countries, where it frequently generates over 50% of GDP. The process of development usually coincides with a growing role of services in the economy. Thus, services constitute an increasing percentage of GDP in nearly all developing countries.

Services contributed 47% of growth in sub-Saharan Africa over the period 2000–2005; industry contributed 37% and agriculture only 16%. Recent growth in Africa owes to services as much as natural resources or textiles (even in countries benefiting from trade preferences in these products, such as Kenya). Services' value added grew by 4.3% per annum over 2000–2005 in sub-Saharan Africa, compared with agricultural value-added, which grew by 3.7% per annum.

In addition, employment is shifting out of agriculture into services, and the services sector is responsible for more than half of all employment in many small states. In many countries, the tourism sector provides employment opportunities for a large proportion of the population, including the poor.

Financial services, tourism, distribution, health and education are all important sectors for developing countries, in terms of their contribution to GDP and/or employment. Other sectors, such as IT-enabled services, have emerged rapidly in some countries.

While some of these services already constitute an important proportion of exports for some developing countries (e.g. tourism, financial services and transport), new opportunities are arising in other sectors. In the health sector, for example, the introduction of new technology and a growing willingness to travel abroad to access cheaper health services are creating sectoral growth and new jobs in a number of developing countries. For example, Indian companies are now providing scan services for hospitals in the US, and the South African tourism sector has reported escalating numbers of patients from developed countries participating in surgery and tourism packages. In addition, Caribbean countries have found niches providing certain health services, such as health spas and nursing schools.

There are also growing opportunities in the provision of IT-enabled services, such as call centres, back-office functions and software development, particularly in countries like India, the Philippines, South Africa and Mauritius.

9.2 Services as an important part of the overall investment climate

Many services are key inputs to all or most other business, e.g. infrastructure services such as energy, telecommunications and transportation; financial services, which facilitate transactions and provide access to finance for investment; health and education services, which contribute to a fit, well-trained workforce; and legal and accountancy services, which are part of the institutional framework required to run a healthy market economy. These services are thus crucial to facilitate growth in other sectors, such as agriculture and industry.

These services sectors are thus a key part of the investment climate, and their performance can have a much wider impact on overall business performance and the level of investment and hence growth and productivity in the economy.

9.3 Contribution to social development

Health and education are key service sectors, with a direct impact on social development as well as growth. While social services are often run and funded largely by the public sector, there may well be scope for carefully managed private sector participation in these sectors to contribute to efficiency gains and innovation. For instance, increased involvement of the private sector in health service provision may generate additional resources for upgrading health care infrastructure and technologies; it could provide new employment opportunities for health workers (who would otherwise migrate owing to lack of good job prospects); moreover, it may enhance technology and skills transfers (e.g. domestic medical personnel may be exposed to more advanced techniques, which could be applied in the public sector as well).

The availability of foreign private capital could reduce the total burden on public sector resources, which could be reallocated towards priority services for the segments of the population not served by the private sector. Many developing countries lack the capital for domestic investment, and FDI may fill this gap.

9.4 Benefits of services trade liberalisation

The average degree of liberalisation inevitably varies by sector and country, but many developing countries have already liberalised many service sectors quite considerably. Trade in services can help create opportunities for countries to expand their outputs of services in sectors where they have a comparative advantage, thus creating jobs and contributing more to GDP and generating foreign exchange. Thus, service exports can be an important part of a developing country's growth strategy. For example, India has been capitalising on a boom in exports of IT-enabled services as more firms have outsourced certain administrative functions to lower-cost countries.

However, in many low- and middle-income countries, services sectors are relatively underdeveloped, and have in many cases been historically characterised by public provision through state-owned enterprises which have often performed relatively poorly. In these cases, it is unlikely that service providers will be sufficiently competitive to succeed in world markets, and services trade is more likely to take the form of imports from other countries (although there are of course exceptions with respect to some countries, and sectors such as tourism and modes of supply).

Imports of services can significantly improve the performance of the sector, by bringing greater competition, international best practice and better skills and technologies. When this happens, the entry of foreign service providers may yield better services for domestic consumers, and improve the performance and competitiveness of domestic firms.

Box 19: The effects of trade in ICT, Mode 4 and tourism services on development

The ability to provide **IT-enabled services** online improves prospects for service exports for small, landlocked countries whose exports were previously constrained by high transport costs and small domestic markets, such as Rwanda and Botswana, which have taken steps to move into services to overcome the constraints to trade in goods resulting from their landlocked position. And services trade can provide an opportunity for developing countries to diversify. For example, Mauritius is rapidly shifting into a services economy away from preference-dependent sectors, which is helping to offset employment losses – 40,000 jobs over the past five years have been lost in EPZ and agriculture schemes, but the same number of additional jobs has been absorbed in the services sector.

The ability to use ICTs is critical for development. ICT help firms and households to overcome constraints posed by limited access to resources and markets. It also enables firms to obtain better access to knowledge and information, to lower transaction costs, to supply markets at longer distance, to improve decision-making across the value chain and to improve the flexibility of firms to respond to consumer demand. Evidence shows a positive effect of the use of ICT on economic growth and firm performance.

Tourism receipts in developing countries are growing rapidly, at nearly 10% a year, and already account for US$21.5 billion or 3.5% of Africa's GDP, in some countries contributing as much as 20% of GDP. Tourism is also extremely important for regions such as the Caribbean, where it contributes 15% of GDP and 16% of employment and is the main foreign exchange earner. Tourism accounts for over 50% of service exports for many small, middle-income countries. It is also seen as an important sector for the poor, as it offers labour-intensive and small-scale opportunities, employing semi-skilled and casual workers and a high proportion of women, and an opportunity for self-employment. Tourism also provides opportunities in remote areas and in places which are rich in natural resources and culture, all of which favour the poor.

Trade via TMNP – **Mode 4** – may help developing countries exploit their comparative advantage in semi-skilled and unskilled labour, and in some cases in certain types of specialised skills. For example, the Philippines have taken advantage of the rising international demand for health care workers. The government has been providing training to health workers, especially nurses, for migration for many years as part of a larger policy to encourage worker migration. Today, Filipino nurses constitute 76% of foreign nurse graduates in the US, and the country is the third world's largest recipient of remittances.

Box 20: The benefits of service imports: Some sector examples

Evidence shows that financial sector opening contributes to improved financial sector performance, and has important knock-on benefits for the rest of the economy. Studies show that foreign banks tend to be more efficient than their domestic counterparts, and that entry of foreign banks increases the efficiency of the domestic banking sector, by reducing the costs and improving the competitiveness of domestic banks. Foreign-owned banks are also able to draw on their international experience to introduce new products and services, such as ATMs, mobile banking or innovative ways to assess credit risks. These techniques are often then adopted by domestic banks, in response to the increased competition that foreign banks bring.

Liberalisation of the electricity sector and market entry by private (often foreign) players brings competition, innovation, technological know-how, managerial expertise and much-needed investment capital with which to expand services and keep pace with expected growth in demand. It has generated substantial benefits in many countries, in terms of greater efficiency, lower prices, improved access, greater reliability of service and improved environmental impact.

Foreign-owned telecommunications firms have been at the forefront of the spread of ICT and bring telephone and internet access to areas that were hitherto not serviced.

Mode 4 imports can also be beneficial for developing countries by plugging labour shortages. For instance, countries such as South Africa and Botswana import health care services via Mode 4 from other African countries (e.g. Kenya, Zambia, Zimbabwe).

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

Given the benefits of services trade outlined above, it follows that trade liberalisation can be very beneficial. Indeed, the estimated welfare gains from services liberalisation are larger than for goods and agricultural liberalisation:

- Economic models suggest global gains in economic welfare of around US$250 billion per annum would be generated by a 50% cut in services trade barriers occurring over a five- to 10-year period.
- One analysis of the impact of Mode 4 liberalisation modelled an increase in migrant quotas equivalent to 3% of the total labour supply in importing countries, and calculated that it would generate a rise in world welfare of US$156 billion. This gain is driven mainly by the increase in income of those becoming temporary migrants, who are employed more productively than in their home country.

9.5 Risks of services trade liberalisation and need for complementary policies

However, experience has shown that services trade liberalisation also carries risks and potential costs, and that government intervention to regulate the market and to ensure competition is crucial if the benefits of services liberalisation are to be realised.

9.5.1 The risk of crowding out domestic providers and repatriating profits

A common argument has been that allowing foreign providers into the market may crowd out domestic providers, and instead allow foreign firms and shareholders to capture the profits for themselves, taking the money out of the country. While it is possible that foreign providers will indeed out-compete the weakest domestic providers, e.g. as a result of greater efficiency or the use of potentially more sophisticated technologies, etc., the evidence also shows that foreign firms can improve the performance of domestic firms, by stimulating competition and by exposing them to superior business practices from which they can learn (see Box 20).

It is often argued that the limitations in supply-side capabilities common in many developing countries provide an argument for protection to give domestic firms the chance to develop before they are exposed to international competition. However, firms with capacity constraints cannot be protected endlessly behind a regulatory wall. Other policy instruments (such as investing in skills, or improving access to credit, etc.) are likely to be much more effective in supporting the development of a sector. Indeed, without the competitive spur afforded by international competition, it is unlikely that domestic firms will ever develop the capacity to compete on world markets so, in the longer term, foreign entry may also facilitate greater service exports.

Second, while it is true that foreign firms will capture the profits from their business, it is not the case that they will necessarily repatriate them to their home country. They may instead reinvest them in order to expand services in the host country. Some profit reward will be necessary, however, in order to attract foreign investment in the first place. Nevertheless, t is still very likely that foreign investment will result in a net gain to the host country.

Without that profit reward, the foreign capital would not have been made available, and often domestic investment may not have replaced it, given the lack of competition and limited access to finance prevalent in many developing countries. Thus, the services may not have been provided, or at least not so cheaply or to such a good level of quality, had the foreign investment not occurred, and nor would the potential beneficial spillover effects to domestic firms have been generated.

9.5.2 The risk of excessive profits being made by private/foreign providers

If foreign investors (or domestic investors) are operating in a competitive market, then their profits should in any case be just enough to cover the cost of capital required for the investment – the scope for excessive profits should be constrained by competition.

This highlights the importance of creating a competitive market environment – which is also important to ensure that the benefits of efficiency gains delivered by trade liberalisation are passed on to consumers. But in some services sectors, competition is unlikely to be forthcoming without appropriate regulation. For example, in the electricity and telecommunications sectors, it is important to regulate to ensure that new entrants have access to the national grid or network – which all operators have to use – at a reasonable price, otherwise the owner of the network may be able to exploit significant monopoly power.

Thus, the establishment of an appropriate regulatory framework to oversee the market is often crucial to achieving competition and ensuring that the benefits of efficiency gains are passed on to consumers. For example, one study showed that electricity reform in Brazil between 1993 and 2003 – where tariff restructuring and privatisation had occurred before a regulatory agency was established – had generated efficiency gains in the region of US$12 billion, but that only US$2.2 billion of that gain had been passed on to customers.

Similarly, the introduction of competition into the ICT sector in Chile and Brazil led to a significant improvement in the spread of ICT, which was less evident in Argentina, where privatisation to a single foreign firm led to a much less competitive market outcome. And high concentration among international tour operators, which may give them an unfair degree of market power, has led to some concerns that profits in the tourism industry are going disproportionately to developed country operators, at the expense of locally owned hotels.

9.5.3 Impact on access to services

There is a risk (evident in the financial and energy sectors, for example) that private providers will 'cream-skim' the most profitable clients and 'red-line' (i.e. cease to serve) certain groups of consumers or geographical areas that are deemed likely to be unprofitable. Such concerns can potentially be addressed by universal service obligations in contracts, or in the licensing conditions given to all new entrants, or through regulatory provisions. For example, in Pakistan, a regulation has been introduced that a bank must open one bank branch in a rural area for every four it opens in urban areas. In South Africa, all graduates are required to undertake a year of service in a public institution (mostly in poor communities) to qualify as a medical doctor. However, this has done little to address shortages of professionals in the neediest hospitals. Instead, it has raised the burden on existing senior staff.

Thus, while these kinds of provisions can potentially help to improve access, they also distort the market and may raise costs considerably, jeopardising potential profitability and hence new entry, thus undermining the original objective of liberalisation. Less directive and more market-friendly mechanisms might be more appropriate, for example encouraging providers to agree on codes of conduct or targets in relation to widening access to services, and then publishing their performance against these targets (as has happened through the Financial Sector Charter in South Africa). Alternatively, providing output-based aid can help to support social objectives without sacrificing efficiency.

Ongoing subsidisation may well be necessary if governments want to ensure provision for those on very low incomes and in rural and remote areas in many sectors and countries. However, private participation and some degree of competition for the right to provide the subsidised service may still be possible, and can help to encourage innovation, efficiency and cost savings for the government. For example, in Chile, subsidies for expanding electrification have been allocated through annual competitions between suppliers judged on the basis of technical merit, amount of private investment to be contributed and expected social impact. The aim was to minimise project costs and stimulate efficiency and innovation. A number of foreign companies participated in the market. The scheme led to an increase in access to electricity in rural areas by almost 50% in the first five years.

There are also a series of more sector-specific risks, such as:

- **Risks of financial sector instability:** The recent global financial crisis highlights the risks associated with financial sector openness, as integration into world financial markets can increase vulnerability to contagion. There is evidence to show that the presence of foreign banks actually improves financial stability and reduces the likelihood of banking crises on average, over the long term. But it seems likely that developing countries that have been more dependent on foreign lending will, in the short to medium term at least, be hit harder by the current financial crisis than countries which had a more closed financial sector.

  Experience in many developing countries over the past three decades also shows that the process of financial liberalisation must be carried out carefully, in an appropriately sequenced manner, as it can otherwise itself lead to instability and financial crisis. The implications of bankruptcies in the banking sector are more serious than in other sectors, as they can have very high costs in terms of widespread losses of savings and financial sector instability. It is now recognised that, although financial sector liberalisation can be very beneficial in the longer term, it needs to be undertaken in a carefully sequenced manner, with a stable macroeconomic framework, adequate financial supervision, and regulation and privatisation now seen as prerequisites which are crucial to minimise associated risks.

- **Risk of brain drain:** The temporary movement of persons to provide a service can exacerbate skills shortages in developing countries. This is particularly problematic when education and training of these individuals is partly funded by public revenue, the benefits of which will then accrue to developed countries to some extent. In this case, migration will lower the social rate of return of public investment in education – although the option of migration increases the private return to education. The risk of brain drain has been most widely recognised in relation to the health sector, where skill shortages in developing countries are often acute, but where demand for those skills in developed countries is also high. However, our work suggests that increased migration opportunities for Indian nurses have helped to raise the attractiveness of the nursing profession, which has in turn resulted in rapid growth in demand for nursing education (and a related supply response). This is consistent with recent empirical evidence from developing countries showing that this 'brain gain' channel often offsets the possible 'brain drain' brought about by out-migration of skilled workers.

- **Risk of environmental degradation:** Uncontrolled tourism development can impose detrimental impacts on the physical and social environment. Poorly managed tourism could lead to deforestation and erosion; degradation and depletion of biological diversity; disruption of natural habitats; and over-consumption of resources like freshwater and energy. Trade liberalisation is not the only factor here, as degradation would relate to the whole sector, but liberalisation might lead to further development of the sector with additional environmental impacts. Thus, some form of environmental regulation may be needed to manage any negative environmental effects.

It is clear that there are a number of risks associated with liberalisation. This does not mean that services liberalisation should be abandoned, as the potential benefits are substantial. Instead, it is important to implement liberalisation carefully, and learn from the experience of others. There is already a great deal of information available about what works and what does not, reviewed in this paper, but further research and specific case studies in some areas would help.

9.6 Role of regulation in services liberalisation

From the foregoing discussion, it is clear that appropriate regulation is crucial if the benefits of services liberalisation are to be realised. Indeed, regulation is crucial in many services sectors, regardless of whether the sector is open to trade. Owing to the nature of services (which are commonly characterised by elements of natural monopoly and informational asymmetries), regulation is usually required to ensure that service markets work properly. As we have seen, this can incorporate a wide variety of objectives, including the need to create a level playing field and ensure competition between market players (e.g. in ensuring a sufficient number of telecommunication providers); to maintain quality of the services provided (e.g. by specifying qualification requirements for service providers); to protect consumers (e.g. from fraud); to ensure sufficient provision of information (e.g. about the features of competing services); to prevent environmental degradation (e.g. arising from high levels of tourist development); to guarantee wide access to services (such as electricity); and, in the financial sector, to maintain financial stability and protect consumer savings from excessive risk-taking by financial institutions.

However, regulation can also be unnecessarily burdensome and distortionary, and can sometimes represent a major barrier to services trade. This can be an unintended consequence of the regulation, e.g. where the professional qualifications required are available only from national educational establishments, which prevents service providers who qualified abroad from entering the market. In these cases, it may be possible to adjust the regulation to make it less discriminatory against foreign providers (e.g. by introducing MRAs or cross-border harmonisation of rules).

Some regulations represent barriers to entry to domestic as well as foreign firms (e.g. limitations on the number of new bank licenses that are available). However, others are established deliberately to prevent or manage foreign entry, e.g. limits on foreign equity participation, requirements for foreign entrants to form joint ventures with domestic companies, citizenship requirements for board members, limits on the number of foreign providers that can be licensed in the market, etc. And, in some cases, the implementation of rules can be discriminatory even if the rules apply equally to domestic and foreign firms, e.g. because it is difficult to find out the rules for firms based in a different country. Thus, liberalising trade in services usually involves some degree of deregulation or regulatory reform to make it easier for foreign firms to enter the market.

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

Regulation is difficult, often involving complex trade-offs between market and social objectives, and mistakes are made, in the developed as well as the developing world. Regulatory frameworks are likely to need refining and adapting over time, as markets develop. This suggests that WTO commitments in relation to services regulation should be made in a way that does not preclude future revision if necessary, so as to maintain policy space going forward.

Many of the poorest developing countries have made relatively few services commitments at the WTO, despite having in practice undertaken considerable liberalisation in many services sectors. Under these circumstances, binding commitments which are less onerous than the *status quo* may have limited immediate impact, although if it encourages a country to consider the development of services sectors more strategically this may have longer-term benefits. The adoption of a 'bottom-up' approach to services negotiations in the WTO is needed, based on an analysis of what is the best regulation for the development of the services sector.

This also suggests that a more coherent approach is important at a national level, as services liberalisation is complex and ought to involve close coordination among policymakers, regulators and trade negotiators. This is frequently lacking – especially given the capacity and time constraints faced by developing countries attempting to engage in many complex trade negotiations in parallel – and may give rise to measures being adopted before sufficient thought has been given to the implications for wider policy objectives. The reverse is also true; consideration should be given to the impact on services trade of any new regulations or pieces of legislation that are introduced.

Capacity requirements for the development of a strong regulatory framework (and the ability to enforce it) are often high, perhaps beyond the reach of some developing countries, so the scope for donors to assist in this process is considerable. While donors often support regulatory reform programmes already, these programmes do not always explicitly consider the impact of regulation on services trade. Thus, a more coherent approach to assistance in this area would be welcome.

Despite these caveats, it is still the case that services trade liberalisation can bring great benefits to a country, and not liberalising may itself be **more** risky than trade liberalisation.

Finally, it is worth noting that regulatory barriers will not always be the binding constraint to trade in services. Supply-side capacity constraints may limit developing countries' export capabilities in many cases, and a poor business climate may impede entry of foreign service providers. In these cases, removing regulatory barriers may not generate the expected increase in services trade. Thus, a more holistic approach to maximising the opportunities for services trade and identifying and addressing the binding constraints will be required in many countries, which should ideally be encompassed within an overall growth strategy.