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ROLE OF TRANSNATIONAL CORPORATIONS IN SERVICES

Expansion of foreign direct investment and trade in services

Report by the UNCTAD secretariat

SUMMARY

As a result of a growing understanding among policy makers of the contribution of services to growth and development and the high costs that inefficiencies in the sector entail, many countries now perceive that sizeable economic benefits can be derived from fostering greater contestability of their services markets and that such process should involve also the opening of domestic markets to foreign competition. The present report examines experiences in this regard, drawing largely upon the experience of the joint UNCTAD/World Bank/UNDP technical cooperation project on the "Expansion of foreign direct investment and trade in services" (EFDITS), but also taking into account earlier work in this area, and suggests policy options for countries wishing to liberalize their services sectors in light of conflicting policy objectives that countries may face.

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INTRODUCTION

1. At its nineteenth session (E/1993/30, chap. IV, para. 7), the Commission on Transnational Corporations requested the Secretary-General to report to the Commission at its twentieth session on experiences in the liberalization of foreign direct investment in services, drawing upon the implementation of the joint UNCTAD/World Bank/UNDP technical cooperation project on the "Expansion of foreign direct investment and trade in services" (EFDITS). The present report has been prepared by the Programme on Transnational Corporations in response to that request.

2. Recent policy developments and pronouncements suggest that there is a growing recognition among a large number of developing countries that a healthy and expanding services sector is critical to the development of developing countries. This applies particularly to producer and infrastructural services that are critical for the efficiency and productivity of the various sectors of an economy. There is a similarly growing recognition that the rapid development of service industries demands financial, technological and human resources that are not always available to those industries in developing countries. Service industries may be starved for capital because national economic priorities tend to direct such resources towards other sectors (e.g., agriculture or manufacturing), or simply because of general shortages in a given country. Technology may be limited because monopolistic or oligopolistic situations that often prevail in service industries have tended to make firms in those industries complacent and unimaginative. Human resources may be insufficient because a country’s most skilled professionals tend to go and work for other sectors where rewards are higher. Finally, there is also a growing recognition that the contribution of the services sector to economic development can be increased by improving the efficiency of existing capacities; it is on this aspect that most of this report focuses.

3. In line with these observations, understanding is increasing that improving the contestability of service markets offers a major avenue to break through many bottlenecks and that, in a number of industries, foreign service providers should be allowed to contest domestic service markets as part of this shift in policy - be it through investment or through trade. Foreign participation in services markets takes place principally through foreign direct investment (FDI), since, characteristically, services are not tradable at arm’s length across borders. Many developed and developing countries have, therefore, initiated (typically unilateral) liberalization measures aimed at striking a new balance between more competition (including through FDI as well as trade) and continued protection of service industries through proper regulation, in the interest of increasing the efficiency of domestic service industries. In fact, a number of countries are doing what, a decade ago, would have been unthinkable: they are permitting transnational corporations into, for instance, their financial, air transportation, telecommunication and utilities industries. At the same time, there is a growing awareness that liberalization needs to be introduced and implemented with care, taking into account the different characteristics and role of different service industries and the prevailing situation of countries. 1/

4. In light of the above, the UNCTAD Programme on Transnational Corporations and the World Bank, with financial support from UNDP, launched a pilot technical assistance project focusing on the liberalization of FDI and international trade in services in developing countries. The project, entitled "Expansion of foreign direct investment and trade in services" (EFDITS) (see annex), has involved, thus far, the preparation of a volume, Liberalizing International Transactions in Services: A Handbook (ST/CTC/167), and the organization of field projects in Tunisia, Uganda and Uruguay. The Handbook provides the first comprehensive survey of instruments that are used by countries to regulate and restrict market access and national treatment of foreign service providers in their markets. It also provides guidance to policy makers as to issues that need to be considered in the process of liberalization. The field projects seek to take some of the recommendations of the Handbook to the implementation stage.

5. This report is an attempt to draw preliminary lessons from the EFDITS project, taking into account earlier work done in this area. 2/ The report is divided into four chapters, following this introduction. The next chapter (chap. I) summarizes the empirical findings and the arguments with respect to the increasing contribution of services to growth and economic development, drawing attention to the nature of contributions by different services in this regard. Chapter II presents some issues regarding the notion of efficiency in service industries, including the role of regulation and the place of domestic and international liberalization of markets. Chapter III reviews some of the key instruments used to regulate the contribution of foreign service providers to domestic markets; the chapter also reviews the advantages and disadvantages of liberalizing unilaterally or multilaterally. In chapters II and III, the emphasis is on the need to strike a balance between increasing the contestability of markets and finding a proper role for regulation. Chapter IV draws lessons from the field work. The emphasis of that chapter of the report is to identify steps countries may wish to consider if they want to increase the efficiency of their service industries by increasing the contestability of their markets through macro-institutional and sectoral reforms.

I. SERVICES GROWTH AND DEVELOPMENT

6. The growing contribution of services to the economy of both developed and developing countries is, by now, well documented. The share of services in gross domestic product (GDP) has increased in nearly all countries in recent decades, while the employment share of the sector has grown in an even more consistent fashion. Between 1965 and 1990, for example, the GDP share of services in all developing countries on average rose from 40 to 47 per cent. The equivalent figure for the developed countries was a growth in share from 54 to 61 per cent over the same period. 3/

7. In large part, the recent growth of services reflects the continuing transformation in how economies produce and in what they produce. 4/ In terms of how economies produce, manufacturers and farmers are becoming increasingly dependent upon an expanding number of intermediate service inputs, which are used in other rounds of production and which must either be produced by user-firms themselves or be purchased from specialized service suppliers. These inputs, producer services, include such services as transportation, finance,

insurance, research and development, market research, marketing and advertising. They are increasingly critical to the efficient functioning of other sectors and the overall competitiveness of the economy - either undermining it or supporting it.

8. The observation of a strong relationship between producer services and the competitiveness of other sectors is not a new one. Simon Kuznets noted that the productivity increases observed in the manufacturing and agricultural sectors of many industrial countries during the ascent were, in reality, improvements in those countries' transportation and distribution infrastructures. 5/ The counterpoint to this observation is that an economy may pay a heavy price for a weak producer service infrastructure. For example, inefficient wholesale and transportation infrastructures may result in a failure to distribute agricultural products from farming areas to markets, aggravating problems of food shortages; and investment booms may lose steam because of inadequate support services ranging from bad roads, insufficient water or electricity supply, or unreliable telephone services. Still, the truly new development about producer services, of course, is not so much the existence of the aforementioned relationship as much as it is the fact that the share of such inputs in the production process has been growing relative to other inputs and that the range and sophistication of those inputs is fast expanding.

9. On the whole, the point about the growing importance of producer services is both about growth and about development. Growing demand for producer services generates new jobs and new value added in those sectors. In turn, producer services may either strengthen or strangle the development of other services or other sectors of the economy, depending on their efficiency and availability.

10. The growth of services also reflects a transformation in what is being consumed. In part, this reflects the growth of income. As economies develop, more income can be diverted from simply paying for the basic necessities of life - food, clothing and shelter - towards other amenities, most of which are services: schooling, medical services and so on. But here, too, there are economy-wide linkages. The inefficient delivery of consumer services typically adds to the price consumers must pay and contributes to the inferior quality of what is being consumed. This translates into lost consumer welfare, reduced demand for other goods and services, and in turn, reduced GNP and employment opportunities associated with this unsatisfied demand.

11. The expanding contribution of services to the growth and development of developing countries is not limited to domestic transactions, but includes international transactions as well:

(a) Services may represent an important source of exports and foreign exchange. Indeed, a large number of developing countries already generates a substantial amount of foreign exchange through vibrant tourism industries, the remittances of expatriate workers (a form of service exports), or their export of transportation and shipping services, to name a few. Egypt, for example, points to its "four tigers" - three of which are services - as its principal sources of exports: temporary labour migration, tourism, petroleum and fees of the Suez Canal, in decreasing order of importance. Some developing countries are even building up bases of high value-added service exports: for example, India, the Philippines, Tunisia and others in software; Mexico, Brazil, the Republic of Korea and others in construction and engineering; and Singapore in biotechnology;

(b) International transactions in services may be an important way to acquire and develop technology. Many countries develop their tourism market with the participation of foreign hotel chains, foreign airlines and other foreign service suppliers. In addition to providing fresh capital and additional capacity where it might be lacking, they bring with them service technologies that might be needed. To take an example from the field of construction and engineering, several Mexican firms were able to acquire technology from foreign contractors during the first phase of the development of Mexico’s subway system. They were later able to apply such technology to the extension of the same subway network and, more recently, to the export of similar projects to other Latin American cities;

(c) By recognizing the existence of bottlenecks in the provision of producer services and opening domestic markets to foreign service providers, developing countries may be able to correct for costly inefficiencies and strengthen domestic development. In recent years, for example, many developing countries have found it necessary to open their telecommunications sectors to foreign providers in light of the huge investments required to upgrade their networks and the heavy cost to domestic producers of not having efficient networks.

12. In sum, a new understanding of the contribution of services to growth and development is emerging everywhere, and in developing countries in particular. This new understanding is based on a more sophisticated assessment of the linkages between services and other sectors, services and economic welfare and services and external transactions of a country.

II. EFFICIENCY AND THE CONTESTABILITY OF SERVICE MARKETS

13. In most countries, many service markets continue to be heavily regulated. Not unlikely, they are also characterized by a single producer or, at best, a few providers. This is so because many service markets are (or used to be) characterized by a situation of natural monopoly or imperfect information that does (or did) necessitate regulation. Unfortunately, this absence of competition is also often a major reason for the perpetuation of costly inefficiencies and bottlenecks that characterize many service industries. It is for these reasons that many countries have initiated the liberalization efforts in their services sectors mentioned above.

A. Regulation

14. Although there is a strong case on efficiency grounds for liberalization of policies with respect to market access of services providers - including foreign providers of services - several considerations, particularly those relating to

economic development, and the possibility of market failure can justify regulation and restrictions. However, while it is true that the nature of service markets often is such that some regulation is required for these reasons, the process of regulation can be fraught with pitfalls. Conditions of natural monopoly or imperfect information that attained at one time may no longer hold or may have changed. In telecommunications, for example, the dramatic reduction in the cost of technology has changed profoundly the level and nature of the barriers to entry that once existed, and hence the economics of that market, including in developing countries. Likewise, the increasing urbanization of populations in developing countries and the large concentrated markets that it creates, may make it more and more difficult for wholesalers and retailers to use the monopoly power they once held over more geographically scattered populations and lessen, if not altogether eliminate, the need for price regulation of many final commodities and services. And yet obsolete regulations may endure because regulators have been "captured" by the industries they oversee. Established producers are loath to see the regulatory framework of their industries change and to give away the monopoly rents they often collect as a result of restricted competition. The control they exert over the regulatory process may allow them to continue sheltering their market positions, however inefficient they may have become.

15. In short, policy makers must remain attuned to changes and carefully keep in mind that the principal target of regulation ought to be improving the welfare of all users and consumers of the regulated service, not that of individual producers. As a result, Governments that truly are interested in pursuing greater efficiency in services should often consider liberalizing competition and increasing the contestability of markets. Liberalization cannot be limited to opening up markets for other domestic producers but must involve foreign providers as well, however. This is so for a number of reasons, including the scarcity of local resources mentioned earlier and the fact that, increasingly, many services must directly or indirectly compete in world markets. For instance, Tanzanian tourism must compete with that of Kenya, Thailand or Indonesia; and exporters in Uganda are affected by transport prices as they compete with those of Zambia or Zimbabwe. The central policy issue for Governments thus becomes how best to combine regulation, wherever needed, with the discipline of competition through a reduction of barriers to entry, including entry of foreign providers through trade or investment.

16. In this respect, careful evaluation is necessary of arguments in favour of maintaining barriers to foreign competition, such as the infant-industry or industrial policy arguments, arguments for protection to preserve the balance of payments, or arguments on the basis of optimal tariffs and imperfect or strategic competition. There may be occasions in which development objectives can be considered more important than static efficiency objectives. For instance, in a dynamic context the long-term benefits of promoting indigenous capabilities in key industries may require careful consideration. Furthermore, the question of an equitable distribution of efficiency gains (so as to compensate the losers while leaving the gainers better off than before) warrants attention. Thus, the implications of liberalization in terms of the development process should be seriously evaluated.

B. Contestability of markets and allocative and technical efficiency

17. The efficiency gains that are derived from liberalization are likely to be of two sorts. Reducing trade barriers brings domestic prices in line with international prices and allows producers to adjust their mix of inputs and outputs accordingly. Domestic producers tend to specialize in those industries in which they are the most efficient (relative to other producers) and to use a combination of inputs - imported or produced domestically - that will give them the greatest amount of output at a given cost or the lowest possible cost for a given output, everything else being held constant. Overall welfare increases simply because more can be bought and more can be produced simply from shifting the mix. This increase in efficiency is essentially static; it is an increase in allocative efficiency.

18. But the adjustment to liberalization is never a static process. Faced with shifting factor prices and faced with new competition, firms will not simply adjust their mix of inputs or the nature of their output. They will respond by trying to change their way of doing business and increasing their productivity to reposition themselves in the market-place. These gains usually are referred to as increases in technical efficiency. Liberalization *per se* may not necessarily increase productivity directly, but it usually does so indirectly by providing incentives for greater entrepreneurial effort in the face of competition and the development and acquisition of know-how. In addition, economies of scale due to increased production for a wider international market, and innovation and growth stimulated by greater macroeconomic stability and credibility for government policy, may also lead to increased productivity.

III. INTERNATIONAL TRANSACTIONS IN SERVICES: LOWERING BARRIERS AND IDENTIFYING A CONTEXT FOR LIBERALIZATION

19. A peculiarity of international transactions in services is the lack of substitutability, in general, between cross-border trade and other modes of delivery by foreign providers as in the case of goods. Most services that are exchanged internationally are delivered through either FDI, the movement of service personnel to the importing country, or the movement of consumers to the exporting country. Pure "cross-border" trade exists but tends to be limited to a few services (most transportation services, some telecommunication-based services and a few others). Most international trade in services requires the use of any one of the three other aforementioned "modes of delivery", often in combination with one another. This is so simply because of the need of most services to be produced when and where they are being consumed.

A. Instruments restricting international transactions in services

20. Typically, countries restrict competition from foreign service providers in their domestic markets through an arsenal of barriers - more or less restrictive - that cover the four possible modes of delivery. These barriers, or instruments of protection, fall into three broad groups: those that affect

market access for foreign providers of services; those relating to the standards of treatment accorded to foreign providers; and those that relate to the general regulatory framework for services. The first two groups are explicitly directed towards foreign service providers, while the last one comprises measures that have an unintended but often significant influence upon market access or standards of treatment afforded to them.

21. A large part of international services transactions takes place through FDI. It is therefore only natural that many of the most important restrictions to international services transactions are rules and regulations on such investment. Barriers to market access for services provided through FDI often take the form of economy-wide prohibition, industry-specific prohibitions of foreign ownership or limitations on the extent of foreign equity permitted. These barriers are becoming much less common, although prohibitions in what are considered strategic sectors still exist. Prohibitions and restrictions on participation by transnational service corporations may be quite costly in terms of economic welfare; other alternatives, such as joint ventures, should be considered if a sector is thought to be too sensitive to allow foreign control. Experience shows that it is typically possible to find a less restrictive measure meeting an objective related to the protection of the national interest while at the same time taking advantage of efficiency gains permitted by FDI.

22. Measures that limit the national treatment of foreign providers are more common in the regulation of FDI than are outright prohibitions of entry. These include regulations that discriminate against foreign providers of services by denying them access to preferentially priced inputs and investment incentives; imposing performance requirements such as trade-balance or export targets, sometimes as conditions for receiving investment incentives; restricting external financial transfers; and imposing differential tax regimes on foreign as compared with domestic firms. These policies, often implemented in combination, may alter the comparative incentive structure for foreign and domestic firms considerably. Often, the existence of performance requirements, rules relating to external financial transfers and discriminatory taxes is at odds with incentives specifically implemented to attract FDI. Policies that encourage non-discrimination between domestic and foreign investors and among industries are almost always preferable if the objective is to promote a more efficient allocation of resources.

23. Even if policies that restrict market access or deny national treatment are absent, domestic regulatory policies may discourage FDI in services. The general regulatory framework, including the guarantee of property rights (intellectual and otherwise), regulations that restrict market entry and business behaviour generally (such as prudential regulations in the financial sector), and competition policy may contain elements that discriminate against new or foreign entrants and lead to non-competitive markets.

24. With respect to the movement of labour, a mode of delivery of services that is often complementary to FDI, instruments affecting market access include rules and regulations relating to visas, residence permits, work permits and professional or craft licensing requirements. While these instruments have legitimate uses in the context of a country’s immigration policy or in the

assurance of the quality of professional services (such as, for example, the licensing of doctors or lawyers), there are situations in which they could act as significant obstacles to trade in services. Some countries allow the temporary entrance of workers to alleviate shortages of unskilled labour, but it is less common for countries to allow the free flow of professional services providers. Professional, skilled and specialized work often is tightly regulated, and differences in regulatory systems across countries make international transactions in professional services more difficult. Some countries and professions follow a State-regulated licensing procedure, while others allow professional associations to regulate themselves. These differences create the necessity for either standardizing licensing requirements across countries or creating mechanisms for the mutual recognition of qualifications for licensing. Partial mutual recognition of licensing qualifications has been implemented between a number of countries in the European Union.

25. Restrictions that affect the national treatment of labour typically consist of rules that make it more onerous for foreign workers to reside in the importing countries than it is for domestic workers. Foreign workers may be restricted in where they may live or travel while residing in the importing country, may be forbidden to bring their families, may be taxed at higher rates than domestic workers, may be discriminated against in the workplace and so on.

26. Instruments that control the movement of services consumers are similar to instruments that limit the movement of labour for the provision of services. One significant difference is that the measures affecting the movement of consumers are often imposed by both the service-importing and the service-exporting country. With reference to tourism, for example, the movement of tourists can be restricted by exit visas in the country of the tourist (the importing country), or by entry visas in the receiving country (the exporting country). In addition, restrictions on the availability of foreign exchange for tourists and restrictions on the convertibility of a currency are instruments that may restrict international transactions in tourism services that take place through the travel of consumers.

27. Finally, there are the instruments that affect pure cross-border trade in services. The instruments that are applicable to this kind of services trade include quantitative measures affecting market access, price-based instruments affecting the relative competitiveness of imports, and others that are part of the general policy framework but have indirect effects on services trade. An example of market access or quota-like instruments are the local content rules that some countries impose on the production and distribution of television and radio programmes or conference market-sharing type of agreements that prevail in much of the international maritime transportation industry. Price-based instruments include taxes on cross-border imports of services and subsidies to domestic service providers.

B. Lowering barriers to international service transactions

28. In light of the above, the practical implementation of the liberalization of international services transactions raises the question of which barriers to

competition from international service providers should be lessened first, when it is impossible to liberalize completely.

29. International trade theory - developed mostly to look at trade in goods - teaches that, when limiting access or treatment of foreign service providers, some instruments are superior to others, either because they are less distortionary, thus more efficient, or because they are easier to implement and more transparent. For example, if the promotion of a domestic industry is the desired goal, a subsidy is usually superior to a tariff because it is targeted directly at the producers, while a tariff affects consumers as well as producers. Similarly, in most cases, a tariff (or some other price-based instrument) will be superior to a quota (or some other quantity-based instrument). This is especially the case when foreigners receive the scarcity rents that accrue from quantity restrictions. In general, also, if a restrictive policy must be implemented, one that raises government revenue is superior to one that does not.

30. Because of the nature of international service transactions, this traditional ranking of trade policy measures may be difficult to apply directly to services trade. Tariff measures are the exception, and it is not all that clear that many of the quantity-based measures found in the services sector (for instance, those associated with the licensing of professions) can easily be transformed into tariff-like measures. The majority of instruments used to limit international transactions in services would seem to fall under either quantitative-type restrictions (mostly restrictions on market access) or certain price-type restrictions (mostly domestic subsidies or hidden taxes which are limitations on national treatment). If this generalization broadly holds and if a similar rank-ordering of measures applies to services as it does to goods, then the broad rule might be that limitations on national treatment of foreign service providers are preferable to restrictions on market access because they are less distortive of overall efficiency, hence of overall economic welfare.

C. Unilateral or multilateral liberalization?

31. Liberalization of international transactions in the quest for greater efficiency in the services sector does not necessarily need to be pursued in a unilateral context. In fact, there are a number of benefits for developing countries in liberalizing their services through bilateral, plurilateral or multilateral agreements. One of the most palpable benefits is greater access to other countries' services markets as reciprocal liberalization takes place, enhancing the prospects for exports needed to compensate for the increase in imports likely to result from domestic liberalization, and thereby reducing opposition to liberalization initiatives. Another benefit stems from the added credibility that international contractual obligations confer on liberalization, by giving Governments more leverage to fend off interest groups wishing to erect barriers to international competition. A third benefit from multilateral efforts is that the procedures for liberalization and concurrent policy reform are better defined, and regulatory standards exist which help developing countries avoid unnecessary competition among regulatory systems.

32. The principal multilateral arrangement for liberalizing international transactions in services is the new General Agreement on Trade in Services (GATS) which is part of the multilateral framework for trade that has been negotiated during the Uruguay Round. The GATS presents the most comprehensive approach to the liberalization of international service transactions, and its concepts, principles and rules will serve as the point of departure for future rounds of negotiations. This will, inter alia, enable developing countries to negotiate reciprocal concessions from developed countries in return for granting access for FDI to their services sectors.

33. While GATS does not give developing countries preferential and differential treatment in the formulation of their commitment to market opening, it does recognize their need for gradual liberalization based on their degree of development. Furthermore, article 19.2 of the Agreement recognizes the right of developing countries to attach conditions (such as performance requirements) to the market access granted to foreign service suppliers. The Agreement also recognizes the possibility of a need for strengthening regulation at the same time that liberalization occurs. Other articles of the Agreement recognize developing countries' need for technology transfer in services, their need for technical assistance, and other issues of direct relevance to them.

34. In addition to the GATS, there are a number of other international agreements providing for liberalization in international transactions in services. Examples of these are preferential trading agreements among developed countries, among developing countries and among the two groups of countries. Such preferential trading agreements are second best when compared to multilateral agreements, since they inevitably involve some costs in terms of trade diversion. But they may lead to many of the benefits that multilateral negotiations confer. Moreover, they may act as "laboratories" for multilateral negotiations.

35. Other international mechanisms affecting international transactions in services include international agreements at the industry level. Examples of these are the International Civil Aviation Organization, the Basel Committee on Banking Regulation and Supervisory Practices and the International Telecommunication Union. These agreements are useful in that they set standards for the functioning of these industries which may facilitate international trade in services. International agreements at the industry level can, however, have anti-competitive effects in the international market under certain conditions.

36. While one of the major benefits of bilateral, plurilateral or multilateral liberalization might be to secure greater access to new markets, such mechanisms may also seriously limit the extent to which a given country ends up opening its own market to competition. After all, in a negotiated process, no one typically gives more than it needs to respond to the offers of other parties. The implication is that a country may end up holding back longer than it ought to regarding the liberalization of its own market simply because it is awaiting reciprocal opening from other parties. And this may come at the cost of perpetuating domestic inefficiencies longer than necessary. The implication of these observations may be that, in a number of cases, unilateral and multilateral (or bilateral or plurilateral) liberalization are not the neat alternatives that they might appear to be at first sight.

IV. PRELIMINARY LESSONS FROM THE FIELD PROJECTS

37. Six preliminary lessons derived from the field implementation of EFDITS are highlighted in the following sections:

1. Inefficiency in services entails significant economic costs for developing countries. This is especially true when inefficiencies are in producer-service markets. It is, therefore, useful to price the costs of inefficiencies.

2. In liberalizing services, special attention should be paid to the interaction among a multiplicity of sectoral policies. To avoid policy conflicts within the services sector, reform should often be carried out at the level of "service complexes", rather than individual service industries.

3. Liberalization of services supports broader objectives of macroeconomic adjustment and restructuring.

4. When liberalizing services, an optimal sequencing of policy reform includes some attention to macro-regulatory issues prior to attempting reform at the level of particular service complexes.

5. Liberalization of services can be achieved successfully only if a political consensus exists to back up reform.

6. The lack of appropriate complementary reforms, such as anti-trust or competition policies, may hinder the progress of liberalization reforms and diminish the efficiency or welfare gains that follow it. This is particularly true for services where experience with competition is often even more limited than in goods industries.

The first four lessons are key building blocks for forging the consensus discussed later. The last lesson, finally, covers a set of issues that can usually be taken up after the mechanics of service reform has been launched. Naturally, the applicability of each of the lessons depends on the concrete circumstances in each country and each service industry and needs to take into account that the introduction of liberalization often entails a number of risks. Liberalization should, therefore, be introduced with care. In particular, different service industries may need to be approached differently, keeping in view the specific situation and objectives of a given country, and recognizing that liberalization often also requires the simultaneous strengthening of various (e.g., prudential) regulations.

A. The cost of inefficiencies

38. As it has been pointed out earlier in this report, a key factor leading developing countries to consider reform in services industries is the recognition of the high costs of inefficiencies in those industries. Assessing

the cost of such inefficiencies may be an important ingredient in building a consensus for reform and in identifying where reform is most needed.

39. Costing inefficiencies in services is far from being a trivial exercise, however. Such costs are not only associated with the inordinately high prices of individual services that sometimes result from relatively protected markets, but may also include the poor quality of the services offered, the restricted range of services, the absence of innovation and the consequent low levels of productivity and low productivity growth in the sector. From the point of view of service consumers - be they final consumers or intermediate users - the cost of inefficiencies is the functional equivalent of a consumption tax that reduces their welfare or diminishes their competitiveness.

40. Field implementation of the EFDITS project confirms that inefficiencies that exist among producers services are of particular significance. This is so because inefficiencies in one producer service industry will often reverberate far and deep through a large number of other industries. Concrete examples encountered in the course of the field projects are numerous. For instance, it was noted in several countries that the absence of a reliable telephone system often denies commercial banks the ability to introduce a network of automated teller machines (especially if they are prevented by regulation from installing their own telecommunication networks independent of the State-monopolies) and, in turn, the productivity gains and cost reductions associated with such systems. Banking transactions in developed countries carried out by automated teller machines typically are associated with a nearly 75 per cent reduction in the unit cost of transactions compared to transactions carried out over the counter with a teller. Likewise, poor telephone communications may deny business people access to reliable facsimile transmission which has become a *sine qua non* of doing business in international markets. Similarly, inefficiencies in the transport infrastructure were also noted as having vast implications for an entire economy: for example, agricultural products languish and perish before reaching consumer markets; exporters are unable to ship their wares on time and at competitive prices; tour operators cannot bring visitors to demanded tourist sites within reasonably competitive price and time ranges, losing export opportunities to foreign competitors.

41. Field implementation of EFDITS suggests that there is a need almost everywhere to cost inefficiencies among key groups of producer services, because they are so pervasive and so costly to the economy at large. Examples of groups of services to be considered here include transportation and distribution logistics, including as they relate to import/export; financial and ancillary services (such as accounting, legal services, telecommunication services, financial markets, insurance markets); services to industrial and commercial investments including roads, water and electricity supply; and construction and engineering services and related services.

42. In the case of import/export logistics services, for example, producers and investors in developing countries are usually highly dependent on imported capital goods and intermediate products, and inefficiencies in the import infrastructure add considerable costs to domestic producers. In addition, many developing countries are highly dependent on the export of agricultural commodities as a major source of foreign exchange. Inefficiencies in the export

infrastructure act like a tax on exports. They make it more difficult for exporters to diversify away from traditional agricultural products. They translate into foregone exports and foreign exchange.

43. A concrete example of the costs imposed by such inefficiencies was developed for the case of transit trade to and from Uganda by examining the costs of different components involved. The country depends heavily on transit trade through Kenya and the United Republic of Tanzania for the bulk of its exports and imports, the great majority of it being by truck between Mombassa, Kenya, and Kampala, Uganda. The biggest problems are experienced on the import side.

44. Transit time for imports from arrival in Mombassa to the owner's warehouse in Kampala typically takes four weeks on average. One week on average is spent in Mombassa, waiting to unload cargo off the ship. As of the summer of 1993, only one of 22 cranes was in operation in Mombassa creating a massive queuing problem. Of the remaining three weeks of transit time, trucks are idle for a total of seven to nine days: two days in Kenya due to the system of guarded convoy used to avoid highway robberies; two days due to delays at the border crossing; and three to five days in the customs compound in Kampala awaiting inspection and clearance. At an estimated cost of approximately $300 per day (including costs of amortization and labour associated with a truck, financing of the idle inventory in the truck and related cost-functions), it is estimated that the overall cost of inefficiencies associated with the idleness of freight and transport capacity amounts to $36 million per year, which is close to half the $73 million in total road freight paid by the country's importers and exporters in 1992. In other words, freight rates could be reduced by almost half if these delays were avoided. Combining this cost of idle time with an estimated cost for "facilitation and attendance" fees of about $15 per metric ton (quite small relative to the costs of idleness), it is estimated that these combined inefficiency costs amounted to almost 10 per cent of the cost-insurance-freight value of imports.

45. In addition to these direct costs, there is an opportunity cost due to the loss of revenue that the trucks could earn if they were not idle. Reducing the idle time of trucks would mean that the country could transport the same volume with fewer trucks and would require a smaller investment in the fleet. This is important in light of the fact that, under the current conditions of transit by road, trucking capacity often falls short of demand. This confers some degree of oligopolistic market power to truckers and, most likely, allows them to charge prices above competitive market value. It also contributes to the current incentive not to invest in new capacity. 6/

46. The high cost of inefficiency is not exclusive to the transportation sector, as an example drawn from the telecommunications industry and based on the implementation of EFDITS in Tunisia illustrates. In most developing countries - and, until recently, in most developed countries - telecommunications services have been reserved to monopolies, usually State-owned. But in the light of rapidly changing demand and technology, most countries have begun to venture in directions intended to open part of the industry to competition. In Tunisia, the Government decided several years ago

to attempt a partial opening of the industry and to allow that construction work associated with the expansion of the telecommunications network be supplied by the private sector. Until that point, all of the work associated with laying out the wire network was carried out by the State-monopoly itself.

47. First, the Government spun off the old construction arm of the telecommunications monopoly. Shortly thereafter, it allowed new entrepreneurs to come in and bid on tenders. This shift in policy has proven to be a step in the right direction, especially by increasing construction capacity. However, this shift in policy towards liberalization has not yet yielded the results that were expected, for a number of reasons. First, telephone cable for the expansion of the network continues to be supplied by a local monopoly. The price is high, the quality is reported to be unreliable and production schedules may not match construction schedules so that construction teams are left idle, waiting for cable delivery. In addition, the private construction industry that has grown following the opening of the market thus far has consisted of a few small, largely inexperienced companies. Needed assistance, especially in the area of quality control, has not been provided to these firms; the end-result has been that the country’s significant investments in the expansion of the network in recent years has not resulted in the expected increase in the quality or the quantity of telecommunications services, or in additional revenues to the telephone company. The lessons from this particular case are not necessarily that the opening of the market was in the wrong policy direction, as much as that the degree of opening was probably insufficient. In particular, opening this particular market to foreign firms would most likely help set higher standards of performance and quality for everyone.

48. Thus, inefficiencies in the service sector entail significant economic costs for developing countries. This is especially true of inefficiencies in producer services. Assessing the cost of such inefficiencies may be an important ingredient in building a consensus for reform and in identifying where reform is most needed.

B. Service complexes

49. Services often are provided in conjunction with other goods or services. This is not only true of producer services, as it has been explained earlier, but of most other services. This suggests that policy reform in one service industry may turn out to be ineffective or to contradict policies in existence in another industry unless the needs for reform are examined at the level of a "service complex". A service complex may be defined as a subsystem of service activities closely linked by input-output relationships. The service complex concept is designed to capture a set of interrelated service industries and their interaction with other downstream industries, either in the production of goods or services. The technical challenges associated with the design of liberalization reform in services are likely to lie at the level of the service complex, though relevant experience with regulatory reform at that level is more limited.

50. Examples of service complexes abound. In addition to those already suggested in the previous section in the context of producer services, one might

point to tourism or retail distribution as other examples. The tourism product, by definition, is a composite service made of transport (air, road, rail etc.), lodging (hotels, lodges, camp sites etc.), eating, tour-operation and other services. Retailing, as a service complex, involves not only the stores that sell to the final consumers but also the wholesale and logistics infrastructure behind them.

51. The tourism service complex as examined in the context of Uruguay exemplifies the problem of conflicting policy objectives. The country has a well-developed tourism sector, though one based largely on a mono-product. The sector caters principally to a relatively well-to-do population of Argentinians vacationing in Punta del Este for long, family-oriented, summer vacations in individual villas or condominiums. One goal of the Government is to diversify the industry in part by developing services for the international market. A peculiarity of this market is that it demands both much shorter and much more service-intensive holidays (including greater demand for transportation, hotel, restaurant, retailing and entertainment services). In addition, recent changes in demand in Uruguay’s traditional market are also pushing some of its Argentinian clientele in the direction of looking for shorter holidays based on the use of rentals (rather than ownership).

52. A study of the tourism sector carried out in the context of the EFDITS project determined that there were a number of significant barriers to a transformation of the sector, and particularly its diversification along the lines envisioned by the Government or suggested by the market. Several main barriers were identified, especially in international air and land transportation and in certain entertainment services (in particular, casinos). Additional barriers were identified in the regulation of rental property (including time-sharing) and in local car rentals. For both international air and land (bus) transportation, existing national regulations that protect and promote domestic carriers at the expense of international competition constrain the flow of new tourists into the country. This is particularly problematic at a time when the capacity to transport tourists needs to increase rapidly since any tourism-product based on short-term stays implies more frequent flows of people in and out of the country. For casinos, certain existing regulations protect the first entrant into the market, essentially providing it with a local monopoly and thus limiting competition in that service. The resulting need for policy changes was identified, including a new policy framework for both road and air transportation that allows for a much greater participation of foreign firms in those industries, consistent with the country’s needs in the area of tourism.

53. Another example of the need to coordinate reform across several industries to avoid conflicts can be found in Tunisia’s experience with the liberalization of its import and export logistics service complex. Until recently, the existing set of policies that regulated freight forwarding and international transportation restricted the volume of available capacity for the country. There was a shortage of transportation and freight clearing capacity, with commensurate high shadow prices and, more often than not, low quality. Partly as a means to address this bottleneck, foreign investors that had been attracted to the country specifically to develop an export sector, began looking for an

opportunity to put in place their own freight clearing and forwarding capacity. But, as it turned out, the Government had, unintentionally, laid down requirements that were lower for foreign firms than for domestic ones, putting the latter at a competitive disadvantage. One burden on domestic firms consisted of a requirement that domestic firms have a minimum amount of hauling capacity, half of which had to be two years old or less. In contrast, no such requirement applied to foreign firms. In addition, restrictions instituted by the Central Bank on capital export by Tunisian entrepreneurs prevented the latter from opening agencies in major receiving countries, denying them the ability to offer point-to-point, one-stop service. No such limitation applied to foreign firms. While the entry of foreign firms into the sector brought much-needed capacity to the sector, the immediate impact of these policies distorted the development of a domestic capacity. Only after these conflicts were detected and resolved was the domestic industry able to grow rapidly.

54. In liberalizing services, therefore, special attention needs to be given to the interaction among a multiplicity of sectoral policies. Specifically, to avoid conflicting policies, reform should often be carried out at the level of a group of services, or "service complexes", rather than individual service industries.

C. Broader macroeconomic objectives

55. Although some level of macroeconomic stability and macro-institutional reform is desirable before initiatives for the liberalization of services take place, services liberalization can also be important in solidifying reform, including in non-services sectors, in enhancing the credibility of government policy and in improving the chances that reform will lead to long-lasting macroeconomic stability and growth.

56. An example that illustrates this point can be taken from retail distribution. Retailing can be an important component in the success of trade and investment liberalization initiatives. As tariffs and duties on imports are lowered and as barriers to FDI are lessened, retailing distribution channels may slow or speed up the process of penetration of newly competing imports or goods and services domestically produced by foreign firms and their impact on the economy. Thus, if cheaper imports or new goods and services locally produced by foreign affiliates are allowed to reach the consumer faster, they may help in slowing down inflation at the same time that they contribute to increasing consumer’s welfare. In addition, if cheaper imports or locally produced foreign goods and services are allowed to compete with domestic goods or services more intensively, they put additional pressure on domestic producers to adjust and become more efficient. Conversely, if the retail distribution infrastructure slows down the penetration of imports and locally produced goods and services, the potential beneficial impacts of trade liberalization will likely be delayed. All of this is a function of how quickly or slowly the retail distribution system adjusts to accommodate the entry of new products and services. In part, this is likely to be a function of the competitiveness of the local retailing sector as defined by price levels, quality and diversity of products, quality and diversity of services rendered by retailers, and the ability of retailers to innovate and keep up with the latest trends. In turn, this might be influenced

by the degree to which the country allows foreign retailers to come in and compete. In the case of countries that have a long tradition of protecting their retailing sector, it most likely means allowing, in the market, newer and more efficient retailing technology.

57. The macroeconomic benefits of services sector reform are not restricted to the retailing sector, but can flow from reform in all areas of services, and, as it can be deduced from earlier discussions in this report, especially from reform in producer services. In general, reform in the services sector can help fight inflation, enhance the efficiency and export competitiveness of the economy and, perhaps most importantly, facilitate the adjustment of producers to a more open and competitive economic environment. In sum, the benefits of services sector reform go beyond the narrow confines of the sector itself.

D. Sequencing of policy reform

58. An essential element of successful reform of the services sector is a proper sequencing of policy changes. There are indications from the experience of individual developing countries, including those where field implementation of EFDITS is under way, that a number of macro-regulatory reforms ought to be in place before a Government can successfully address reform at the level of a service complex. These include, in particular:

(a) The implementation of an investment code (or an equivalent set of laws and regulations) that offers well-defined protection for private investors, no discrimination between domestic and foreign investors and minimal distortions among sectors;

(b) A reform of the tax regime consistent with the aims of the investment code, including non-discriminatory treatment among firms on the basis of nationality or industry, and an emphasis on a stable and predictable tax regime;

(c) Changes in the immigration law, especially that part of it that applies to the entry of staff of foreign firms;

(d) Changes in foreign exchange regulations geared towards the opening of the country's current and capital account;

(e) Changes in intellectual property laws;

(f) A privatization and/or deregulation programme;

(g) Changes in certain labour laws.

59. Perhaps the most important reason for these preconditions is that they establish a better environment for the entry of FDI into a country. Successful reform of the services sector that attempts to enhance the participation of foreign service firms will virtually require flows of FDI, since this is the principal mode of delivery for foreign service providers. To a great extent, each of the reforms listed above affects FDI, including FDI in services. This

is particularly true, of course, of the first reform listed here, namely the reform of investment laws or codes.

60. There is a growing agreement among countries that have liberalized their economies that the best investment law is one that discriminates least among investors (foreign or domestic) or among sectors. The alternative tends to create distortions that are either costly to Governments or to economic efficiency. For example, investment regimes that seek to provide incentives to a group of investors will more often than not result in a loss of fiscal receipts. Those that tend to channel foreign investors into a particular industry will usually limit the benefits of reforms even within the sector that has been liberalized. For example, a number of developing countries have followed export-driven development policies that focus on the creation of manufacturing exports enclaves with few links to production for the domestic economy. While such policies may have undeniable short-term benefits (creation of a new source of export, experimentation with limited liberalization with high-visibility value to assist in changing a country's political attitudes about foreign investment), they have longer-term limitations. Typically, they leave in place a highly protected services sector in the domestic economy. Since a protected services sector may suffer from a lack of investment and tends to be inherently inefficient, it hampers the development of the very export sector that the policies of limited liberalization are trying to promote. Typically, exports are constrained by a lack of local service capacity and the poor quality of services available locally. The multiplier effect of the export sector on the domestic economy remains minimal. Exporters lose potential markets and, not unlikely, are constrained in their ability to move up-market. Their production remains limited to low value-added items.

61. Investment policy typically goes hand-in-hand with the fiscal treatment of investors, thus the complementarity of these two reforms. Services firms are often heavily dependent on soft technologies that are based in their human resources and that can be transferred only to the extent that sufficient staff from overseas is allowed to implement those technologies in the importing country. Thus the need to provide for immigration rules that permit entry of firm-specific staff.

62. Foreign providers will invest in a foreign country only to the extent that they know they are offered sufficient flexibility to repatriate earnings or sell their investments as part of the normal course of doing business. Conversely, too strict a set of regulations on access to foreign exchange and the right of domestic firms to undertake foreign investment may put them at a considerable competitive disadvantage against foreign firms at the very same time that they are being asked to compete with them. Witness the example from the EFDITS work in Tunisia cited earlier. Of course, this does not deny that the opening of a country's current and capital accounts needs to be done in an orderly fashion, with due attention to key considerations of monetary policy, including the possible impact of such policy on inflation or overvaluation of domestic currency.

63. The absence of reasonable protection of intellectual property rights may be a serious disincentive to foreign firms to bring the most up-to-date technology.

This may be particularly important in the case of services that are dependent on software-driven computerized technologies.

64. Services liberalization cannot occur short of a political commitment towards deregulation and, in some cases, privatization. In line with views put forward earlier in this report, deregulation, as used here, does not mean a shift from a regulated to an unregulated environment, but rather from one kind of regulated environment to a new one that recognizes the need for competition wherever feasible. Deregulation, as used here, does not necessarily mean a frontal attack on the monopoly of a publicly owned enterprise or its immediate elimination through privatization. There often are many different possible paths to a more competitive industry structure, and determination of the optimal way often varies greatly from industry to industry or from country to country. Still, in view of the fact that most countries do have laws that establish the monopoly of the State in a wide range of economic areas, there is a need to establish a Government's commitment towards liberalization vis-à-vis private sector investors - foreign or domestic - by modifying key aspects of those laws. In some countries, this may also involve changes in labour laws whenever they are part of the legal apparatus that serves to establish the monopoly of the State over certain sectors of the economy.

65. Even if the above preconditions are in place, there is a further problem of the sequencing of reform in the services sector: how is it possible to choose among different service complexes for the continuation of reform at the micro level? There are two possible approaches. First, a Government may choose to liberalize service complexes in which it feels the country has a strong comparative advantage. In this case, competition will result in a further strengthening of the sector's comparative advantage through increased specialization or diversification of the services offered. A second option might be to liberalize those service complexes where inefficiencies in services production are the greatest and where widespread support can be mustered from various sections of the economy for reform. In other words, it is hard to draw hard rules from the experience of individual countries on this particular point, except that much of the choice is a function of the nature and depth of the political consensus that a Government can establish. Thus, when liberalizing services, an optimal sequencing of policy reform includes some attention to macro-regulatory issues prior to attempting reform at the level of particular groups of services.

E. The need for political consensus

66. Reform can proceed only to the extent that a Government succeeds in establishing some degree of consensus over the need for reform. This consensus is necessary not only to implement particular packages of policy reforms, but also to maintain the credibility of government policy, particularly with respect to the irreversibility of reforms and the stability of the policy environment. Lack of sufficient consensus about the need for liberalization or about the speed at which liberalization should take place can result in significant delays in government-sponsored reforms or in imposing an effective veto on parts of a Government's liberalization programme.

67. Of course, the need for consensus is not unique to services reform. But it is important to remember that services often constitute the one area of the economy of developing countries in which both heavy regulation and State ownership are the most pervasive. This is the case partly for historical reasons. In some countries, the need to break away from the former colonial Power led to an earlier, extensive nationalization of the economic interests of the former dominating Power. This, typically, involved widespread nationalizations in the services sector. In other countries, it was the absence of a service infrastructure at the time of the break with the former colonial Power that led to a strong involvement of the State. Faced with the need to develop key infrastructure and the absence of private capital to do so, the State had to step in to develop enterprises in a wide range of areas (utilities, road transportation, rail, banking, insurance, shipping etc.). The result is that there is often a near-total absence of experience with competition in services and a highly charged political sensitivity in defence of the strategic role of the State in developing the services sector (even at the cost of overlooking current inefficiencies). The issue, of course, is not whether a State-dominated development of the services sector was justified when it occurred, but rather whether it is still justified. Still, the influence of the past on current political approaches cannot easily be ignored.

68. Pressures for services liberalization often tend to come from two places: exporters and parts of the public sector. Exporters, who see their efforts constrained by lack of access to technology and adequate business services are often strong proponents of reform. This sector tends to be well connected to the international market and aware of the need for efficient services to compete internationally. But pressures for service liberalization may also arise from within the public sector as financial constraints put pressure on a Government to divest itself of deficit-producing service monopolies. In a number of developing countries, it is the coalition of this internationally oriented business sector with a Government determined to promote fiscal reform that has been able to develop programmes for macroeconomic reform, and liberalization in both goods and services.

69. Consumers can also be strong proponents of liberalization. This is especially true in small, middle-income developing countries where a large population of consumers has some exposure to consumer goods and services available, under better terms, in other countries.

70. Liberalization rarely remains unchallenged, however, from sources both within and outside the Government. From within, developing countries must deal with large and cumbersome bureaucracies that were, at one time, the implementers of the State’s dominance in the economy. These bureaucracies have a clear interest in maintaining their position, and are likely to fight any reduction in public sector employment that may result from allowing the private sector to take over some of the functions previously performed by the Government. In addition, even if there is widespread acceptance of the need to reduce the size of the public payroll and make the operations of government ministries more efficient and productive, there may be considerable political challenges involved in reforming wages and productivity in the public sector or laying off public sector workers.

71. In addition to objections from within, Governments wishing to allow a greater participation of foreign service providers in the economy may naturally face opposition from locally well-entrenched producers of these services who will see their dominant (and often monopolistic) positions in the domestic market challenged. Often these producers will be parastatal monopolies, as is common in the provision of telecommunications services, electricity generation and distribution, as well as transportation (State airlines or rail companies).

72. In some situations, the natural allies of Governments in promoting reforms - namely, exporters - may not stand strong in their resolve to push for reform. This is particularly the case when a Government has put in place an export-promotion policy that fundamentally subsidizes exporters. For that matter, this is one of the inherent risks of export-platform policies. Typically, such platforms are set up by giving fiscal incentives to potential exporters. These exporters may be both domestic and foreign investors. But if the size of the incentives is large enough, those investors may be willing to overlook the costs of an inefficient local services sector or adapt their production to match such inefficiency, in order to keep the fiscal benefits they receive. Over time, the result may be the formation of a new business class of exporters that ends up defending the status quo, rather than challenging it.

73. There is no single path to forming a political consensus around the need for services policy reform. To a very large extent, the situation is unique to each country. Still, the experience of the EFDITS project would seem to suggest that building a consensus demands everywhere that a Government integrates elements of all of the lessons already drawn up in this report. In order to enhance consensus, there is a need for a Government and those who support its position to demonstrate that the costs of inefficiencies are harmful to economic development and that the potential gains of reform for the economy at large ought to be seized. Governments must be able to identify groups of services where reform can be implemented in a way that will strongly demonstrate the benefits of services reform and strongly legitimate the contribution of further reform. But a Government must also concern itself with the need for certain basic macro-institutional reforms of the kind identified earlier in this report without which reform efforts, at the service-complex level, are likely to flounder.

F. Complementary anti-trust and competition policy

74. A further lesson, supported by the experience drawn from the implementation of the EFDITS project in several countries, is that regulatory reform and a relatively open investment environment do not guarantee freedom of entry for foreign service suppliers. Many countries may score high marks in terms of their treatment of foreign capital, their reform of the fiscal regime, the openness of their current and capital accounts and other needed reforms. Yet, these reforms accompanied by service-industry-specific reforms may not always result in significant new entry of foreign providers in service complexes targeted for liberalization. Two basic explanations may be offered for these limited results. The first is that the small size of the domestic market of these economies may present an obstacle for investors, who need to be guaranteed

that the market will demand a quantity of services consistent with a minimum efficient size of production before they can invest. An alternative explanation (not inconsistent with the small size of the market) is that collusive behaviour among firms already established in the market, a highly cartelized distribution system and other hidden anti-competitive barriers to entry (e.g., the social priorities of the State-owned enterprises and other large producers) may effectively bar the entry of foreign providers into the production of selected services, thus limiting the contestability of the markets involved.

75. The experience with the field implementation of the EFDITS project suggests that anti-competitive barriers almost always manifest themselves in the early phase of reform. Quite simply, when confronted with an environment to which they are not accustomed, old or new entrepreneurs alike will simply try to recreate the old environment, with which they are most familiar, under a new guise. Price collusion is usually the most benign form of anti-competitive behaviour. Producers simply agree to collude and recreate the industry price structure that existed before deregulation. In some cases, foreign providers already present in the market may be willing accomplices to this collusion. Stronger collusion may also involve market-sharing agreements as well as agreements to shut new entrants out of existing distribution networks.

76. One must be careful in over-generalizing lessons out of these cases. In some cases, the collusive behaviour that may have been provoked by the initial liberalization of a complex of service industries does not withstand very long the pressure of competition from new entrants. In other cases, however, the further implementation of some type of competition policy may be important to ensure that the benefits of liberalization are widespread throughout the economy.

V. CONCLUSIONS

77. There is a marked increase in the number of developing countries that are either contemplating or experimenting with liberalization in FDI and trade in services. This is the direct result of a growing understanding among policy makers of the contribution of services to growth and development and the high costs that inefficiencies in the sector would entail. More countries now perceive that sizeable economic benefits can be derived from fostering a greater contestability of their services markets and that such a process should involve not only new competition from domestic firms, but also from foreign service providers. The need to open domestic markets to foreign competition is based on a number of factors, including, in some cases, the scarcity of local resources that can bring new competition and the recognition that most services are increasingly competing in world markets, be it directly or indirectly.

78. To increase the contestability of service markets requires a reassessment of the way in which specific service industries are regulated so that new room can be made for some degree of competition where there often is little. That includes also a reassessment of long-standing barriers to entry erected against foreign service providers. The ensuing process of deregulation does not mean so much a shift from a regulated to a non-regulated environment, as much as an

attempt to strike a new balance between more competition and continued protection of legitimate needs for regulation.

79. Building a political consensus around the need for services liberalization is fundamental to the success of any services reform project. Field implementation of the EFDITS project suggests that a number of considerations are important elements in building such consensus and in ensuring that reforms do succeed. Specifically, pricing the cost of certain inefficiencies can go a long way in buttressing the case of those who are arguing in favour of liberalization. Demonstrating that the gains of liberalization need not be limited to the industries that are being reformed but can be widespread is also useful in that regard. Policy makers must also be cognizant of the fact that certain macro-institutional reforms need to be put in place early on for service reform to succeed. These are principally reforms that help define a new environment within which foreign service providers are guaranteed that they can compete.

80. When bringing reform to the micro-level, experience suggests that working at the level of service complexes ensures that the relevant policy and regulatory changes are made in such a manner as not to contradict each other. Finally, experience also suggests that once reform is under way, especially at the level of service complexes that have been targeted for liberalization, there may be a need to follow up with actions - policy or otherwise - to strengthen competitive behaviour.

81. The experience of the EFDITS project indicates that there is a definite need for technical assistance at the developing country level, particularly with identifying and mapping out needs for regulatory and policy reform at the level of service complexes. Those needs are often complex and typically uncharted. Unlike the situation for liberalization in the goods sector, there are still few rules or established best practices for liberalization in services. Benefits are most likely to accrue to those countries wishing to learn from the experiences of those that have already embarked on the reform process. A hands-on assistance programme, such as EFDITS, is positioned to do precisely that.

Notes

1/ See UNCTAD, Trade and Development Report 1992 (United Nations publication, Sales No. E.92.II.D.7), pp. VI-VII.

2/ See United Nations Department of Economic and Social Development, Transnational Corporations and Management Division, The Transnationalization of Service Industries: An Empirical Analysis of the Determinants of Foreign Direct Investment by Transnational Service Corporations (United Nations publication, Sales No. E.93.II.A.3); United Nations Centre on Transnational Corporations, Transnational Corporations, Services and the Uruguay Round (United Nations publication, Sales No. E.90.II.A.11); The Uruguay Round: Services in the World Economy (New York, United Nations and the World Bank, 1990); Services and Development: The Role of Foreign Direct Investment and Trade (United Nations publication, Sales No. E.89.II.A.17); Foreign Direct Investment and Transnational Corporations in Services (United Nations publication, Sales No. E.89.II.A.1); and Transnational Corporations and the Growth of Services: Some Conceptual and Theoretical Issues (United Nations publication, Sales No. E.89.II.A.5). See also United Nations Conference on Trade and Development, Trade in Services: Sectoral Issues (New York and Geneva, United Nations, 1989), and Services in Asia and the Pacific: Selected Papers (New York and Geneva, United Nations, 1990); and World Bank, The Contributions of Infrastructure to Economic Development (Washington, D.C., World Bank, 1993) and The Role of Support Services in Expanding Manufactured Exports in Developing Countries (Washington, D.C., World Bank, 1991).

3/ Based on World Bank GDP data at current prices. These figures understate the share of services in developing countries for two reasons. Utilities and construction, usually counted as part of the services sector, are excluded here. In addition, GDP figures undercount the importance of the informal economy, mostly services. See UNCTAD Programme on Transnational Corporations and the World Bank, Liberalizing International Transactions in Services: A Handbook (New York, United Nations publications, forthcoming), table 1.1.

4/ Thomas Stanback, et al., Services: The New Economy (Totowa, N.J., Allanheld, Osmun, 1981).

5/ Simon Kuznets, Modern Economic Growth: Rate, Structure and Spread (New Haven, Yale University Press, 1966).

6/ The UNCTAD Services Development and Trade Efficiency Division, with funds from various donors, is developing and installing a system called the Advance Cargo Information System (ACIS) to help improve the operations of the transport community in Africa.

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ANNEX

The EFDITS project

1. The project on "Expansion of foreign direct investment and trade in services" (EFDITS) was initiated partly as a counterpart to ongoing liberalization efforts of developing countries in the area of trade in goods. The project seeks to assist those countries with the reform and liberalization of their international transactions in services. It is a joint endeavour of the UNCTAD Programme on Transnational Corporations, the World Bank and the Division of Global and Interregional Programmes of UNDP. The project focuses principally, though not exclusively, on the issue of strengthening the domestic capacity of developing countries in the area of services through the increasing participation of foreign service providers to the domestic economy through investment, cross-border trade, and other modes of service delivery.

2. EFDITS' operating plan has been designed so that assistance can be custom-tailored to the individual needs of the participating country. Specifically, EFDITS consists of three phases: (a) a diagnostic phase; (b) a recommendation phase; and (c) an implementation phase.

3. The balance of efforts placed on each of these phases is based on individual country-needs, as determined by the Government, through its designated focal point for the project, and the project's executing agencies. As a rule, however, specifications for the diagnostic phase are drawn up in part based on some initial understanding of what the participating country wants to achieve at the implementation stage. In addition, given the close interlinkages between international transactions in goods and those in services, cooperation is sought with the UNDP-World Bank Trade Expansion Programme and similar projects wherever appropriate and feasible.

The diagnostic phase

4. By their very nature, many service industries are heavily regulated. One concern of EFDITS is to assess the extent to which the traditional objectives of policy and regulatory measures in individual service industries (such as correcting for market imperfections, protecting national sovereignty, ensuring consumer or environmental protection) may conflict with objectives of efficiency and competitiveness. Another concern is to review the extent to which measures that tend to cut across service industries and are likely to fall somewhat outside the scope of issues addressed by industry regulators may also conflict with those objectives. Such cross-industry or "horizontal" policy instruments include foreign-direct-investment laws, transfer-of-technology codes, temporary migration regulations, transfer payment regulations, or certain trade laws. Likewise, EFDITS seeks to identify the strengths of the existing regulatory framework or the possible limitations of its effectiveness that may arise from the use of policy instruments that, unknowingly, may conflict with each other.

5. Three diagnostic studies usually are launched in each country in which the project is implemented, based on an assessment of needs, including:

(a) A review and assessment of the existing horizontal framework regulating or excluding the contribution of foreign service providers to a country's domestic capacity. This assessment focuses, in particular, on a clear identification of the explicit or implicit objectives of these instruments, the degree of their effectiveness in achieving such objectives following their introduction, and the overt or hidden costs of such objectives. For each instrument, efforts are made to quantify their effectiveness and costs using a cost-benefit type of analysis. For example, if the objective of an investment-incentive policy is to promote the growth of FDI in a particular service industry in a particular location, an effort is made to measure whether or not, in practice, such policy has resulted in the expected surge in investment in the desired location; conversely, an attempt is made to estimate the costs of the policy instrument (tax revenues foregone, cost of infrastructure etc.) so that the discounted value of those costs can be compared to the measurable gains (e.g., annual value-added created by the foreign investors that have benefitted from the policy);

(b) Two separate reviews and assessments of the overall existing regulatory framework for international transactions in services in two distinct service complexes. As in the assessment of horizontal measures, the objectives of the individual policy instruments that are utilized to regulate the component service industries of the complex are clearly identified, as are the degree of their effectiveness and their explicit or hidden costs. Likewise, weak links or possibly conflicting policies in the regulatory framework that define the environment of the service complex are identified and analysed.

6. In selecting two service complexes for detailed analysis, several criteria are used. In particular, complexes may be chosen because they represent industries of strategic importance to the country and are areas in which the Government is contemplating reform or has begun implementing reform.

7. The preparation of the three diagnostic studies is done by mixed teams of local and international consultants, with assistance from headquarters staff from the two executing agencies. Selected field missions to the country are conducted by the designated international experts who work jointly with the local consultants in their areas of expertise.

The recommendation phase

8. As the outcome of the diagnostic phase, a country report is prepared summarizing recommendations emerging from the field work.

The implementation phase

9. Implementation of the recommendations that arise from the diagnostic phase of EFDITS varies from country to country, based on interests and needs so that no set pattern of implementation can be suggested. However, a number of suggestions might be made as regards some of the directions that implementation may take.

10. For example, the assessment of horizontal (cross-industry) measures may suggest the need to revise a country's foreign investment code, its foreign

investment incentive programme, its temporary immigration regulations, its technology transfer provisions, or aspects of its service trade regime. If requested, the executing agencies can identify and bring to this issue special expert resources to assist the country in these areas. Similar assistance can be provided if the case-studies of complexes revealed specific policy-formulation needs for some of the component industries of these complexes.

EFDITS’ institutional resources

11. EFDITS is executed jointly by UNCTAD’s Programme on Transnational Corporations and the International Trade Division of the International Economics Department of the World Bank. Through their respective past work and through the staff involved in the project, the two executing agencies bring considerable expertise to bear on the project in such key areas as foreign direct investment and cross-border trade in services, movement of labour, tax and foreign exchange treatment of foreign investors, intellectual property rights, or economics of services.

12. Execution of the project relies importantly on the input of mixed teams of local consultants and international experts that are assembled to develop each of the diagnostic studies involved in the project. The involvement of local consultants in EFDITS’ work is particularly important to the two executing agencies which attach high significance to using the implementation of EFDITS as an opportunity for building domestic policy-research and policy-making capacity in areas - services and development, international transactions in services, efficiency and competitiveness in services - which are relatively new areas of research and policy attention. Identification of the relevant case-studies for diagnosis is done during the reconnaissance missions that launch the project in the participating country. Diagnostic work is done by the consultants during a study mission to each of the countries scheduled several weeks after the reconnaissance mission. Implementation work is organized around a follow-up mission scheduled to take place once the diagnostic work has been completed.
