

Trade in Services for Sustainable Development

Summary

This part of the report shows that services trade has the potential to be a driver of sustainable development in developing countries. However, trade liberalization in and of itself will not ensure that such trade will work for sustainable development. Developing countries need to have an adequate institutional environment in order for trade to work towards development and therefore it is imperative that the space for such institutions is made ample room for in trade agreements. Among the key findings of this part of the report are:

- Services exports are among the fastest growing in the world economy, faster than goods exports.
- Developed countries still enjoy the vast majority of services exports, exporting more than 73 percent of total service exports in 2002.
- In the developing world, the top ten exporters of services export 69 percent of all services exports among developing nations—the top twenty export 95 percent of the developing country share.
- Least developed countries export a less than one percent of global services exports and even that amount is shrinking
- Foreign investment in services is outpacing foreign investment in goods
- Trade and investment agreements are no substitute for the sound economic policies that attract investment and agreements alone do not attract additional investment.
- For services liberalization to fully benefit the developing countries, emphasis on mode 3 and 4 liberalization should be given priority.
- States need to play a key role in serving as a buttressing environment for services trade, especially in the realm of competition, distributional, and environmental policies.
- GATS and other services trade arrangements must ensure that developing countries have the policy space to put the proper institutional mechanisms in place to make services trade work for sustainable development.

1. Introduction

In the face of increasing poverty, inequality, and environmental degradation across the developing world, the world community has reasserted the need for development through the Millennium Development Goals and the global commitment to sustainable development signed at the World Summit for Sustainable Development. At the same time, most of the world's nations have also embarked on a new round of global trade negotiations—Doha Round under the World Trade Organization (WTO). Citing the fact that developing countries gained very little from the Uruguay Round, developing countries agreed to enter a new round of trade negotiations only on the condition that development would be the centerpiece. There are growing concerns that this promise will go unfulfilled. Key among those concerns is the notion that additional commitments will not give the developing world the “policy space” to use the very instruments and tools that many industrialized nations took advantage of to reach their current levels of development.

With such concerns in mind, this first part of this study discusses the relationship between trade in services and sustainable development for developing countries. We show that the developed countries still enjoy the majority of the benefits from services trade and stand to benefit most from liberalization under the Doha Round. However, developing countries also have a large and growing potential to benefit from services trade in the near future. Such benefits will only accrue to the developing world if:

- liberalization includes factor movements as well as the liberalization of developed country manufacturing sectors;
- development-oriented institutions are established to prepare services markets, manage their liberalization, and continuously monitor and maintain services markets in the aftermath of liberalization;
- trade rules give nation-states the policy space to establish those appropriate non-market institutions.

The global commitment to sustainable development runs long and deep. Sustainable development was defined most clearly in Agenda 21, the document that accompanied the United Nations Conference on Environment and Development in 1992. Article 3 says that “the right to development must be fulfilled so as to equitably meet developmental and environmental needs of present and future generations.” Agenda 21 also stresses that sustainable development should be development not only from an economic perspective, but from environmental and social perspectives as well. Key among the core goals of sustainable development is the eradication of poverty and to give special treatment to the developing world.

Principle 4 states that “in order to achieve sustainable development, environmental protection shall constitute an integral part of the development process and cannot be considered in isolation from it.” Principle 5 follows by saying, “all States and all people shall cooperate in the essential task of eradicating poverty as an indispensable requirement for sustainable

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development, in order to decrease the disparities in standards of living and better meet the needs of the majority of the people of the world.” Principle 6 stresses the need for special and differentiated treatment: “the special situation and needs of developing countries, particularly the least developed and those most environmentally vulnerable, shall be given special priority. International actions in the field of environment and development should also address the interests and needs of all countries.”

In September 2000, nations of the world forged the Millennium Development Goals (MDG) to, among other things, eradicate extreme poverty and hunger, and ensure environmental sustainability. Countries have committed to halving the proportion of people who live on less than a dollar a day and suffer from hunger, and to half the proportion of people who live without access to safe drinking water. The MDGs recognize that trade policies can play a role in achieving these goals, but only if done properly and with recognition of special and differentiated treatment:

“We believe that the central challenge we face today is to ensure that globalization becomes a positive force for all the world’s people. For while globalization offers great opportunities, at present its benefits are very unevenly shared, while its costs are unevenly distributed. We recognize that developing countries and countries with economies in transition face special difficulties in responding to this central challenge. Thus, only through broad and sustained efforts to create a shared future, based upon our common humanity in all its diversity, can globalization be made fully inclusive and equitable. These efforts must include policies and measures, at the global level, which correspond to the needs of developing countries and economies in transition and are formulated and implemented with their effective participation.” (UNDP, 2000).

Moreover the MDGs recognize that success will be a function of good governance in the trading system, “We are committed to an open, equitable, rule-based, predictable and non-discriminatory multilateral trading and financial system.” The MDGs also reaffirm the global commitment to Agenda 21 of 1992.

Parallel to these efforts at the UN, the WTO has been working to further liberalize trade. The Uruguay Round of world trade negotiations was completed in 1994 and culminated in the establishment of the WTO in 1995. It is estimated that the annual gains from the Uruguay Round were approximately \$200b annually. However, it has also been estimated that 70 percent of those gains have gone to the developed countries and most of the rest has gone to a small handful of developing countries. Indeed, in the first six years following the Uruguay Round, it is estimated that the 48 least developed countries (LDCs) were worse off by \$600m per year (Stiglitz and Clayton, 2004). When the developed world proposed another round of global trade talks in 2001 in Doha, Qatar, the developing countries accepted on condition that development form a core part of the negotiations. The Doha Declaration makes explicit reference to sustainable development:

“We strongly reaffirm our commitment to the objective of sustainable development, as stated in the Preamble to the Marrakesh Agreement. We are convinced that the aims of

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upholding and safeguarding an open and non-discriminatory multilateral trading system, and acting for the protection of the environment and the promotion of sustainable development can and must be mutually supportive. We take note of the efforts by members to conduct national environmental assessments of trade policies on a voluntary basis. We recognize that under WTO rules no country should be prevented from taking measures for the protection of human, animal or plant life or health, or of the environment at the levels it considers appropriate, subject to the requirement that they are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, and are otherwise in accordance with the provisions of the WTO Agreements. We welcome the WTO's continued cooperation with UNEP and other inter-governmental environmental organizations. We encourage efforts to promote cooperation between the WTO and relevant international environmental and developmental organizations, especially in the lead-up to the World Summit on Sustainable Development to be held in Johannesburg, South Africa, in September 2002. (WTO, 2001)

The theme of sustainable development and globalization also formed a core part of the World Summit for Sustainable Development in Johannesburg, South Africa in September of 2002. The WSSD declaration made explicit reference to the “mutually reinforcing pillars of sustainable development — economic development, social development and environmental protection — at the local, national, regional and global levels.” The WSSD declaration re-commits the global community to sustainable development but also recognizes that globalization can be a challenge:

“Globalization has added a new dimension to these challenges. The rapid integration of markets, mobility of capital and significant increases in investment flows around the world have opened new challenges and opportunities for the pursuit of sustainable development. But the benefits and costs of globalization are unevenly distributed, with developing countries facing special difficulties in meeting this challenge” (WSSD, 2002).

Although there is a clear paper trail of commitments toward sustainable development, thus far the Doha Round has failed to make progress in this area. High expectations for additional commitments were dashed when the Cancun Ministerial meetings collapsed in September of 2003. Developing countries expressed that they were being required to take on a myriad of new implications whose benefits for development were highly ambiguous, especially among the “Singapore Issues” such as investment. In addition, developing countries expressed that developed countries were failing to offer convincing proposals on market-access for developing country manufacturing and agricultural goods.

As will be shown in this study, services trade offers great promise for sustainable development in the developing world—but only if managed with strategic care. This section of the report has four sections in addition to this short contextual introduction. First, we define services and services trade in economic and legal terms, and then discuss the potential links between services and sustainable development. Then we provide an analysis of global trends in services

trade and investment and conduct an examination of what determines competitiveness in such trade. Next is an analysis of both ex-ante predictions of the possible gains from further services trade liberalization and an analysis of ex-post assessments of the key factors that have contributed to cases where services trade liberalization has benefited developing countries. The final section in this part outlines the key characteristics that are necessary for services trade to work for sustainable development and poses questions to be answered in the following parts of this study.

2. Services and Sustainable Development

Services provide the public and private environment to foster sustainable development. Recent rapid changes in technological capabilities have made trade in services a new and promising possibility for development. Yet, without the proper policies in place a poorly performing service sector can have adverse effect on economies as a whole with serious implications for sustainable development. It is even more important to have the proper policies in place when trading services. This section defines services in economic terms and in terms of the General Agreement on Trade in Services (GATS), discusses the linkages between services and sustainable development, and highlights the unique position and challenges of the developing world in terms of services trade.

a. Defining Services

In economics, services have been defined as elements of economic transactions that are largely intangible, invisible, or non-storable. Goods transactions, which are more straightforward are seen as the opposite: tangible, visible, and storable (Matoo, 2001). You buy a shoe that you put on your foot, you can see it, you can put it in the closet when you are not using it! Services on the other hand include such intangibles as telecommunications, transportation, hotels and restaurants, health care, environmental protection, financial services, education, accounting, and so forth. What characterizes these types of economic elements are that they usually require simultaneous production and consumption (World Bank, 2004). Because of this, in almost all cases proximity is required between the producer and consumer.

One of the earliest classifications of services economics was done by Bhagwati (1989) and has been largely mimicked in the GATS. Bhagwati classified four different types of services, one that does not require physical proximity and three that do. The type of services that do not need physical proximity are “long distance” services such as banking, legal services and other purchases that can largely be conducted over the telephone, and now over the internet. Regarding services that require proximity, one type involved an immobile user and a mobile provider of a service. An example of this type of service would be construction. For Indian contractors to bid on a construction project that entails a highway in Boston, the user (those of us who will drive on the highway and pay for the project) is immobile but the provider (the contractors from India) are mobile. With other services the reverse can occur: mobile users and immobile providers. I am a mobile user if I visit an eco-tourism site in Costa Rica, but of course the Costa Rican biological reserves can’t come to me. Or, when Africans go to Europe

for college they are mobile users but of course the universities are immobile. Instances also occur when both the user and the producer are mobile. A lecturer can either go to a location to present information or people can come to the lecturer.

The early notions of trade in services laid out by Bhagwati are largely embodied in the GATS. GATS, which will be discussed and analyzed at length in the next part of this study, has defined four “modes” of services supply:

- **Mode one: cross-border supply**, the most similar to goods trade, occurs when services cross national borders. These are the long-distance services outlined by Bhagwati such as the purchase of software, insurance or other services either electronically or by telephone;
- **Mode two: consumption abroad**, analogous to the mobile user, immobile provider classification, happens when the consumer travels outside of the country to access a service such as tourism, education, health care, and so forth;
- **Mode three: commercial presence** occurs when the user is immobile and the provider is mobile. This mainly takes place in the form of foreign direct investment (FDI). For example, when an insurance company, bank, or telecommunications firm in one country established a branch in another.
- **Mode four: presence of natural persons**, are when services are supplied by individuals of one country in the territory of another. This can be in the form of temporary workers in developing countries working in developed countries, or staff members of multi-national corporations moving to developing countries on a temporary basis.

b. Services and Sustainable Development

What contribution can services make toward sustainable development? Services, whether provided by the public or private sphere, lay the foundation for the larger economy. Educational, health, ecosystem, telecommunications, and transport services provide the basic network and infrastructure for the economy as a whole. Moreover, services serve as the inputs or ingredients for successful manufacturing, agricultural and mining activities in an economy. Without healthy people with the education to use technologies to monitor, use, trade and transport goods across the world to meet human needs, goods would not be put toward their highest value use. Some of the fruits of that development feed back into the economy in the form of social services. Governments often use the benefits of economic transactions to address areas that markets, when left to their own devices, often do not function properly such as environmental protection, providing health care, and education.

Recall that Agenda 21 stresses that sustainable development have economic, social, and environmental dimensions. From an economic perspective, services trade can affect economic growth in three ways. First and most directly, services transaction generate income and welfare in and of themselves. Services also contribute to economic growth by serving as inputs into other parts of the economy. Better education services make efforts toward

innovation and research and development more productive, healthier workers make labor more productive, strong telecommunications networks make knowledge diffuse faster, better transport make goods get distributed faster. Finally, social and environmental services can often correct markets to make them function better and therefore grow more sustainably.

Services also play vital social roles. Health and education are core components that allow us to live up to our capabilities and potential. In addition, states create social services to distribute the benefits of growth. Anti-poverty programs, educational and health care systems, are all essential services that both help an economy grow and empower those that don't immediately reap the benefits from growth that does occur.

Of course, the natural environment is the playing field for the entire human economy. Markets do a notoriously poor job of valuing the services that the environment supplies to the economy. Therefore, environmental policies are established in order to internalize those values into economic-decision making. When the proper policies are in place, economies work more efficiently.

c. The Special Case of Developing Countries

In developing countries where markets are by definition less developed, special attention needs to be paid toward the role of services and the regulations that support them. Markets fail to work properly in the face of imperfect competition (when large private or state-run firms control a significant portion of a market), imperfect information, and environmental externalities, among others. Non-market institutions such as government are essential to correcting these market failures and thus setting the stage for balanced growth and sustainable development. Indeed, it has been shown that the presence of such institutions, more so than geography or trade liberalization, is the key to economic development in the developing world (Rodrik, Subramanian, Trebbi, 2002).

However a number of barriers exist in the developing world that make it more difficult to establish the proper institutions to buttress services trade. In order to establish good policies governments need finance, capabilities, and technology. However the developing world is saddled with enormous external debt and macroeconomic instability, with the poorest 40 countries owing over \$300b to external creditors. On top of that, many developing countries are characterized as having very weak institutional capabilities and poor governance. These factors are compounded by the fact that much of the developing world is far from the technological frontier for the majority of technologies, and is therefore forced to purchase them or attract them through FDI where the benefits are not as clear (Amsden, 2001). Finally, many developing countries seldom transfer some of the net benefits of economic growth to the poor and aggravate social strife (Kanbur, 2001).

d. Regulatory Environment for Services

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Domestic regulations for services in developing countries should be separated into regulations for private sector service development and the provision of public services. For the development of private domestic service firms, countries rely on an array of programs for planning, tariffs, import licensing, quotas, exchange rate controls, wage controls, and direct government investment and ownership in key sectors. Government subsidies and international protection, in addition to loans from national development banks, are given to industry in exchange for concrete results. Lending and support is conditional on local content requirements, price controls, technological innovation, capacity, and exports. Through this process, nations create “national leaders” (Amsden, 2001).

Many of these measures have been shown to be economically efficient in a second-best world. Rodrik (1987) has shown that performance requirements on FDI are often necessary to maximize welfare benefits in the context of imperfect competition. Dasgupta and Stiglitz (1985) have shown that industrial policies are important for dynamic learning effects and correcting for market failures. Other economists have argued for such policies on justifications beyond efficiency. Amsden (2001) and Krugman (1990) have shown that some protections may “get the prices wrong” but can be beneficial for countries looking to enter new markets. In this volume, Stiglitz, Lall and Singh stress that the theoretical justification for such interventions is even stronger in today’s global economy.

Intervening policies alone however will not ensure success. The notion of ‘reciprocity’ has been shown to be a key to success. Amsden has shown how a select group of developing nations industrialized through pure learning (rather than through proprietary innovation) by creating control mechanisms whereby subsidies and other forms of support were allocated to certain industries in return for monitorable performance standards that were redistributive and results oriented (Amsden, 2001). In a comprehensive volume on the development of national high technology industries in Brazil, India, and South Korea, Peter Evans showed that getting the right balance between state and market was often very tricky. To Evans, success required “embedded autonomy,” where states and private sectors acted together but with enough distance as to not erode innovation and development. In addition to laying basic “custodial” rules and institutions in an economy, Evans witnessed that success was determined by: states also playing roles as producers of certain types of goods; states acting as “midwives” to assist in the development of new entrepreneurial groups; and states performing “husbandry” activities in the form of “greenhouses” that provide firms with opportunities to experiment with innovation protected from international competition (Evans, 1995).

The regulatory environment for public services is markedly different. Policies for health, education, sanitation, energy and environmental services are development oriented policies aimed at correcting for market failures and ensuring that citizens have the opportunities and capabilities to thrive in society.

First, there are services that nations deem as being fundamental rights that should be provided at very low cost or even free. Some of these services are considered ‘natural monopolies’ whereby very high fixed costs are required and accompanied by economies of

scale in production and distribution. Examples include the provision of water and electricity, wastewater treatment and other sanitation provisions. In such cases it does not make much sense to have competition, but therein lies the central challenge for states to maintain cost-effectiveness in the provision of such goods. When natural monopolies are privatized, often a private monopoly takes the place of the public monopoly. The private firm often does not have the incentive for universal access and low prices and citizens are denied such services. Such government services are provided not only for direct public use but also to create and enhance positive externalities (Bifani, 2004).

Second, some services are a function of the need to eradicate negative externalities from the production and consumption processes. Some forms of production are overproduced because they do not reflect the true social costs of production. Such is the case of highly polluting fossil fuel energy sources and means of transportation, and other forms of pollution. Prices do not reflect the costs to human health and the environment so government intervention is needed to help markets more accurately reflect the social costs of production.

In the presence of high debt, poor institutions, and a general lack of technological capabilities, how can services trade contribute to sustainable development. In order for services trade to work for sustainable development nations will have to strike a delicate balance between state and market-based policies. Perhaps most importantly, it is of vital importance that those state-level policies be given the policy space to function under the GATS and other regional and bilateral service trade arrangements.

3. Trade in Services and the Global Economy

Services have become one of the most dynamic aspects of the world economy. Though numerous analysts argue that the current wave of globalization is far from spectacular, citing the fact that goods exports as a percentage of GDP are not dramatically different than in the later part of the 19th Century, the same can not be said of services. Services are fast becoming a large and growing part of national economic and export profiles. Aside from a very interesting handful of exceptions however, the majority of services activity and trade occurs in and benefits the developed countries.

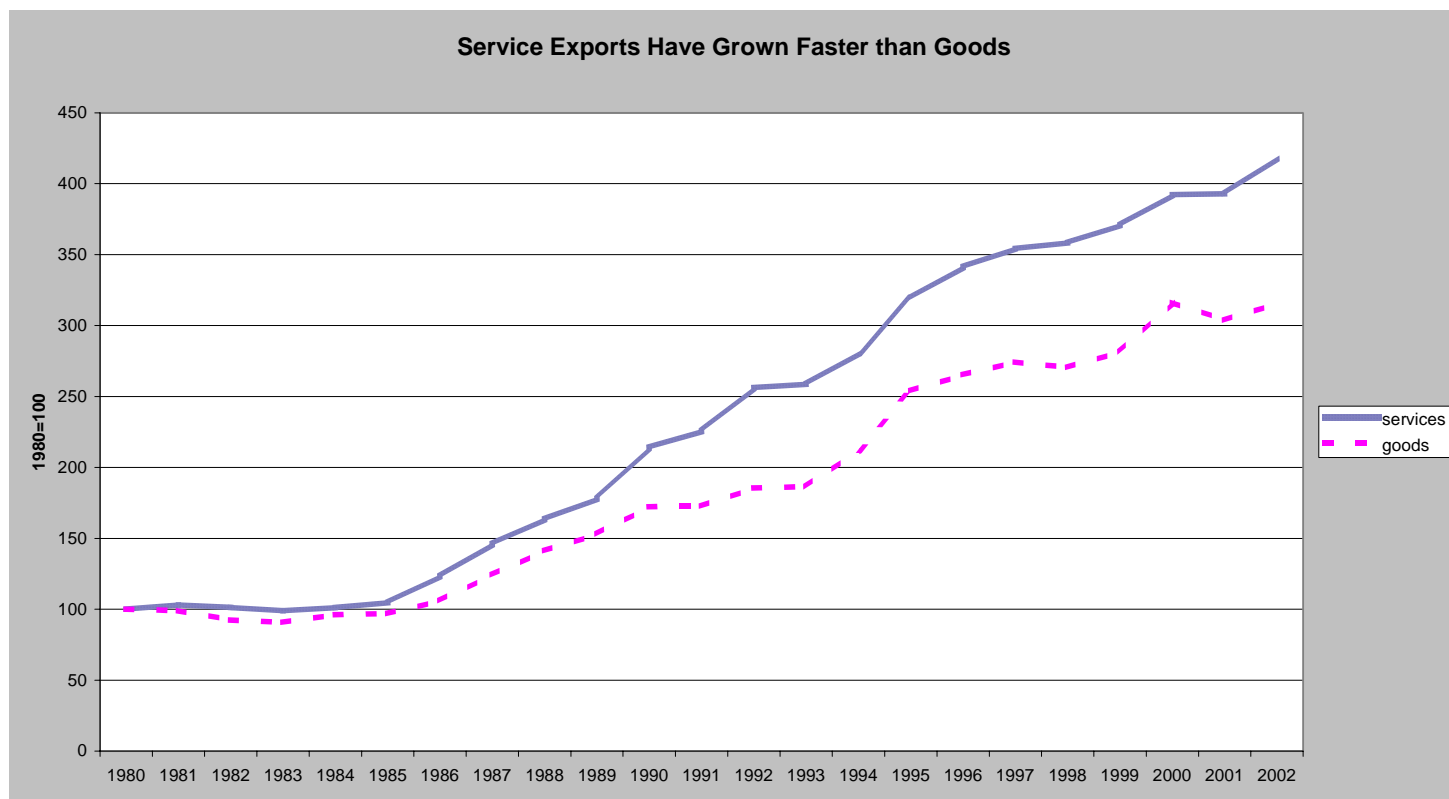
This section of the report is divided into two parts. With a particular focus on developing countries, this section analyzes the prevailing trends in global services activity, and then conducts an analysis of the determinants of services trade in the global economy.

a. Trends in services trade in the world economy

Services are increasingly becoming a core part of national economies in the developed and developing world alike. One of the most cited figures in services discussions is the fact that services comprise 60 percent of GDP and 50 percent of total employment in the world economy. What is sometimes overlooked is the fact that services trends in developing countries are often very different than in their developed country counterparts.

Figure 1.1 shows how dynamic the services industry has become in the world economy. Although the volume of goods exports tripled between 1980 and 2002, the volume of services exports increased by a factor of 4.5 during that same period. Services exports are growing faster in the developing world versus the developed world, but services exports in developing countries are growing at the same rate as goods exports. Average annual growth in services exports between 1990 and 2002 was 5.7 percent—4.9 percent in developed countries and 7.6 percent in developing countries. Growth in goods exports during the same period were only 5.1 percent on an annual basis, but developing country growth in goods exports stood at the same rate as in services at 7.6 percent (see also Langhammer, 2002).

Figure 1.1



Source: UNCTAD (2004)

Although the growth of services trade is extraordinary, it must be remembered that volume of goods trade still dwarfs that of services. In 2002, world goods exports stood at over 6 trillion dollars, or roughly one-fifth of the entire world economy. In contrast, services trade as shown in Table 1.1 was only 1.7 trillion dollars in 2002.

Developed countries export the lion’s share of services, accounting for over 73 percent of all services exports. Developing countries as a whole are responsible for just over 22 percent of services exports. What is striking is the fact that the least developed countries (LDCs)—those countries with incomes of \$800 or less in 1995—export a miniscule amount of services and their shares are actually declining. For over twenty years LDCs have exported less than one percent of world services exports, 0.83 percent of the total in 1980 and 0.44 percent in 2002.

If these trends continue at current growth rates, developing country exports of services stand to triple their exports and comprise of 30 percent global services exports by 2015, up from the 22 percent in 2002. Under the same assumptions though, the

situation for LDCs would be even more bleak. By 2015 the LDC share of world service exports would actually fall to 0.004 percent.

Table 1.1

Services in the World Economy

	<u>1980</u>	<u>1990</u>	<u>2002</u>
<u>Services/GDP</u>			
<i>Developed</i>	59.36	64.58	71.99
<i>Developing</i>	41.06	48.82	52.22
<i>(LDC)</i>	41.05	43.06	43.22
<u>Services Exports (millions)</u>			
<i>Developed</i>	304,634	658,720	1,179,682
<i>Developing</i>	68,952	149,394	363,549
<i>(LDC)</i>	3,212	3,996	7,031
<u>Services Exports/World Service Exports</u>			
<i>Developed</i>	79.05	79.87	73.24
<i>Developing</i>	17.89	18.11	22.57
<i>(LDC)</i>	0.83	0.49	0.44
<u>Services Exports/Total Country Trade</u>			
<i>Developed</i>	19.6	21.17	22.95
<i>Developing</i>	11.34	15.93	15.21
<i>(LDC)</i>	15.85	18.08	15.35

Source: Author's calculations based on UNCTAD (2004).

Another trend of concern is the share of developing country services exports in total country trade. Table 1.1 shows that over the period 1990 to 2002—a period of extensive trade liberalization in the world economy-- the developing country (and LDC) share of total developing country trade has decreased while the developed country share has continued to increase.

Table 1.2 examines the distribution of services exports among developing countries in more depth. This table exhibits the distribution of developing country services exports as a percentage of world exports from 1980 to 2002. The second row of percentages corresponds with the third set of figures in Table 1.1, showing that in 1980 developing country service exports were nearly 18 percent of total services exports, and just over 22 percent in 2002. The table then exhibits the composition of those shares

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from the major geographical regions that comprise the developing world. The shares in bold sum to the developing country share of world services exports in the second row.

Asia accounts for the largest amount of world services trade among the developing areas, and it is the fastest growing. Conversely, Africa accounts for the smallest share of world services exports, just 2.1 percent—a figure that is down from 3.5 percent in 1980. Perhaps not surprisingly, Sub-Saharan Africa's share of African services exports is the smallest and has shrunk by more than fifty percent since 1980. Latin America and the Caribbean (LAC) services exports are also a relatively small and shrinking share of world services exports. In 1980, LAC services exports were almost 5 percent of the world total, in 2002 the LAC share of total services exports was down to 3.7 percent. Interestingly, Central America and the Caribbean enjoy the bulk of LAC services trade, and the decreases in that region have not been as stark as in South America during the period under examination. Data for Central and Eastern Europe has been scarce until recently, but there is some indication that this region has a growing share of world services exports.

Table 1.2

Services Exports in the World Economy

	1980	1990	2000	2002	1980-2002
	<i>(percent of world total)</i>				<i>(ave. annual growth)</i>
World	100	100	100	100	8.1
Developing countries	17.9	18.1	23.1	22.6	9.4
Africa	3.5	2.6	2.2	2.1	5.6
North Africa	1.3	1.3	1.1	1.1	6.6
Sub-Saharan Africa	2.1	1.3	1	1	4.7
Sub-Saharan Africa less South Africa	1.5	0.9	0.7	0.7	4.6
America	4.8	3.8	4.1	3.7	7
Central America and the Caribbean	2.5	2.2	2.4	2.2	7.2
South America	2.3	1.6	1.7	1.5	6.7
Asia	9.5	11.7	16.8	16.8	11
West Asia	2.7	2.1	2.4	1.9	6.8
Central Asia ..	..	..	0.2	0.2 ..	..
South, East and South-East Asia	6.8	9.5	14.2	14.6	11.9
South, East and South-East Asia less China	6.3	8.8	12.2	12.2	11.5
Oceania	0.1	0.1	0.1 ..	..	..
Countries in Central and Eastern Europe ..	..	..	3.6	4.2 ..	..
Developed countries	79.1	79.9	73.2	73.2	7.6
North America	14.3	20.1	22.2	20.2	9.1
Europe	57.6	52.7	44	46.9	7.1
Others	7.2	7.1	7.1	6.1	7.3

Source: Author's calculations based on UNCTAD (2004)

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In Tables 1.3 and 1.4 we present an analysis of North-South trade in services that may imply that the majority of developing country growth in services exports is in the realm of South-South trade. Table 1.3 exhibits trends in the imports of services in the United States between 1989 and 2002. Other developed countries form the vast majority of U.S. services imports, and that share is growing. Developed country imports by the U.S. were 60 percent of the total in 1989, and by 2002 that percentage had risen to 70 percent. Conversely, developing country exports of services to the U.S. declined by ten percentage points during this period. Latin America exports to the U.S. remained stagnant but Asia and Pacific imports have declined significantly. Unfortunately, the U.S. data does not separately report imports from Central and Eastern European countries, so it is difficult to estimate their contribution to imports into the United States. This figure also shows the sectoral contribution of developing country exports of services into the United States. Insurance and telecommunications are the largest source of imports, followed by education imports. Financial and business service exports comprise a relatively smaller share of developing country service exports. Comprehensive data for Africa only exists for 1998, and implies that Africa exports a very small amount of services to the U.S. In 1998 Africa's exports comprised of a only 2 percent of total imports of services by the U.S., mainly in the form of education and some telecommunications.

Table 1.3

Share of Developing Regions in US Imports Services 1989, 1998, 2002 (%)

Region	Year	Total	Education	Financial Services	Insurance	Telecom	Business Services	Other Services
All Developing Countries	1989	40	25	7	47	35	15	11
	1998	34	32	20	49	64	18	16
	2002	30	28	19	42	60	18	19
Latin America	1989	27	17	3	46	30	6	11
	1998	26	27	15	48	36	7	6
	2002	27	24	11	42	36	8	8
Africa	1989	NA	NA	NA	0	2	1	NA
	1998	2	3	1	0	5	2	2
	2002	(D)	3	1	0	4	3	(D)
Asia and Pacific*	1989	13	8	4	0	5	7	0
	1998	6	4	5	0	24	10	9
	2002	3	3	8	0	22	9	11

*Not including Australia, Japan, Malasia, New Zealand, or Singapore

(D) Suppressed to avoid disclosure of data of individual companies

Source: Bureau of Economic Analysis, U.S. International Transactions Data (2004)

While exactly comparable data for the U.S. and the European Union (EU) does not exist, Table 1.4 reveals that the general story is the same for the EU. Eighty-five percent of all EU services imports come from other OECD countries, only 14 percent of EU imports originate outside the OECD. Only 2 percent of EU imports come from LAC, and 3 percent each from Africa and Eastern Europe. Asia and Oceanic countries outside the OECD lead all non-OECD countries with 6 percent of total OECD imports of services.

This short analysis of South-North trade between the U.S., EU, and developing countries may suggest that the majority of developing country growth in services exports has been in the form of South-South trade. We cannot be entirely sure of this because we do not have a long enough time series for EU imports, nor of course do we have direction of trade statistics for the majority of developing countries. The hypothesis arises from the U.S. data and is clearly a subject for future research.

Table 1.4

EU Services Imports, 1999 to 2001

	<i>Average (99-01)</i>	<i>Share of Total</i>	<i>Net Exports</i>
World	615,596	100%	8,999
OECD	525,644	85%	13,515
Non-OECD	82,952	13%	-7,182
<i>Africa</i>	17,341	3%	-886
<i>Americas</i>	13,730	2%	101
<i>Asia and Oceania</i>	34,418	6%	314
<i>Europe</i>	18,619	3%	-3,967

Source: Eurostat (2004)

Which countries in the developing world comprise the majority of developing country services exports? Table 1.5 reports the ten largest services exporters in the developing world between 1990 and 2002. What is striking from this table is the fact that many of these nations could hardly be categorized as developing countries by 2002. Nevertheless, these ten nations account for close to 70 percent of all developing country services exports.

Table 1.5

10 Largest Services Exporters in the Developing World, 1990-2002

<u>Country</u>	<u>\$US millions (ave.)</u>	<u>Annual growth rate</u>	<u>% world services exports</u>
China	59,153	16.9%	4.2
Singapore	21,480	6.7%	1.8
S. Korea	20,104	9.3%	1.6
Taiwan	14,464	9.6%	1.2
Turkey	13,831	5.2%	1.1
Thailand	12,054	7.5%	1.0
Russia	11,244	5.0%	0.8
Mexico	10,540	3.8%	0.9
Malaysia	9,702	12.7%	0.8
India	8,119	14.7%	0.7
Top 10	180,689	9.1%	14.2
Total for Developing Countries	262,518	7.6%	21.69
Top 10 Share	69%		

Source: Author's calculations based on UNCTAD (2004)

It is questionable to include South Korea, Taiwan, and Singapore in a list of developing countries, as each of them has a level of income over US\$9,000. Regardless, the top 10 services exporters in the developing world that are exhibited here have export growth rates that are much faster than the growth rate for developing countries as a whole. These top 10 are growing at a rate of 9.1 percent per annum, compared to 7.6 for the developed countries as a whole. China, India, Malaysia, Taiwan, and South Korea are all growing at a rate much faster than the average for developing countries.

What is perhaps more striking is the list of the next ten highest services exporters among developing countries: Egypt, Poland, Czech, Philippines, Brazil, Indonesia, South Africa, Ukraine, Argentina, and Chile. Together these ten countries exported an annual average of US\$ 70 billion between 1990 and 2002. Added to the top 10, the top 20 countries export 95 percent of all developing country services!

The full-page Table 1.6 exhibits the top 10 service exporters by type of service.

ICTSD Policy Paper on Trade in Services and Sustainable Development

Prepared by Kevin Gallagher

Draft – not to be quoted

Table 1.6

Top 10 developing-country exporters of services, by sector*

	1990		2000		1990-2000 annual growth rate	
	Million US\$	% of country's total	Million US\$	% of country's total		
Transport						
	Korea, Republic of	3 179	33	13 687	44.8	15.4
	China, Hong Kong SAR	.. ..		12 772	31.3 ..	
	Singapore	2 225	17.4	5 336	19.9	8.9
	China, Taiwan Province of	2 323	33.1	4 063	20.4	5.1
	China	2 706	46.2	3 671	12.1	3.2
	Thailand	1 327	20.7	3 250	23.4	9.3
	Turkey	920	11.5	2 955	14.5	13.8
	Malaysia	1 198	31	2 802	20.1	8.7
	Egypt	2 410	40.4	2 645	27	-0.3
	Chile	714	38.6	2 188	53.6	12.9
Travel						
	China	1 738	29.7	16 231	53.3	24.8
	Mexico	5 527	68.3	8 294	60.3	3.6
	China, Hong Kong SAR	.. ..		7 930	19.5 ..	
	Turkey	3 225	40.2	7 636	37.4	10
	Thailand	4 325	67.4	7 483	54	5.7
	Korea, Republic of	3 161	32.8	6 834	22.4	11
	Singapore	4 650	36.3	5 394	20.2	0.6
	Malaysia	1 684	43.6	5 011	35.9	9.6
	Indonesia	2 153	86.5	4 974	95.4	8.4
	Egypt	1 100	18.4	4 345	44.3	12.9
Communications						
	China	159	2.7	1 345	4.4	14.9
	Mexico	.. ..		1 213	8.8 ..	
	Korea, Republic of	395	4.1	387	1.3	3.2
	China, Hong Kong SAR	.. ..		362	0.9 ..	
	Egypt	.. ..		306	3.1 ..	
	China, Taiwan Province of	315	4.5	294	1.5	1.8
	Jamaica	.. ..		209	10.3 ..	
	Chile	17	0.9	207	5.1	29.2
	Pakistan	.. ..		190	13.8 ..	
	Philippines	.. ..		182	4.6 ..	
Construction						
	Turkey	741	9.2	1 033	5.1	8.1
	China	.. ..		602	2 ..	
	China, Hong Kong SAR	.. ..		338	0.8 ..	
	Malaysia	.. ..		314	2.3 ..	
	Thailand	.. ..		230	1.7 ..	
	Brazil	.. ..		228	2.4 ..	
	China, Taiwan Province of	31	0.4	119	0.6	11.2
	Philippines	3	0.1	97	2.4	44.7
	Egypt	.. ..		93	0.9 ..	
	Tunisia	.. ..		50	1.8 ..	
Financial services						
	China, Hong Kong SAR	.. ..		2 677	6.6 ..	
	China, Taiwan Province of	.. ..		805	4 ..	
	Korea, Republic of	1	0	705	2.3	80.6
	Brazil	.. ..		376	4 ..	
	Turkey	.. ..		368	1.8 ..	
	Malaysia	.. ..		160	1.1 ..	
	Philippines	.. ..		80	2 ..	
	China	.. ..		78	0.3 ..	
	Barbados	.. ..		75	6.9 ..	
Insurance						
	Mexico	335	4.1	1 799	13.1	11.5
	Singapore	88	0.7	957	3.6	23.6
	China, Taiwan Province of	146	2.1	607	3	11.7
	South Africa	355	10.4	451	9.2	9.5
	China, Hong Kong SAR	.. ..		443	1.1 ..	
	Brazil	115	3.1	312	3.3 ..	
	India	123	2.7	249	1.4	8.9
	Malaysia	3	0.1	156	1.1 ..	
	Iran, Islamic Republic of	17.. ..		118	8.5 ..	

*Ranked by year 2000 values

Many of the same countries that comprise the top 10 list in Table 1.5 also show up under each sector in Table 1.6, but not in every case. For transportation services, Egypt and Chile are in the top ten, though the growth rate for Egyptian transport service exports was -0.3 per annum for the period 1990 to 2002, whereas Chile has a growth rate of 12.9 percent. Egypt is also in the top 10 for travel, and experienced a healthy growth rate of 12.9 percent over the period. Indonesia is also in the top 10 for travel.

For communications, Egypt, Jamaica, Chile, Pakistan and the Philippines all appear in the top 10, with Chile posting an enormous growth rate of 29.2 percent between 1990 and 2002. Some of these nations may appear on the list because of data limitations. It is well-known for example that India is a powerhouse in communications exports, but disaggregated and comparable data for India does not exist.

Brazil, Egypt and Tunisia all rank in the top 10 for financial services, along with Philippines who saw a 44 percent annual growth rate. Although the top 10 exporters of financial services only comprise approximately \$US 5.3 billion in world financial services exports and half of that sum comes from Hong Kong, Brazil and the Philippines have considerable financial service exports and South Korea's have grown by 80 percent. The same holds for Insurance, and South Africa, Brazil and Iran stand out as nations not in the overall top 10 list that appear in the top 10 for insurance service exports.

The last section showed that in large part the developed world is the most competitive in terms of services exports but that some developing countries are gaining ground. The developing countries do not have comparative advantages in services exports because they have trouble achieving economies of scale, macroeconomic stability, and have lower capital-labor ratios.

A thorough review of the literature reveals that the following are seen as the most important determinants of services exports in the global economy:

1. **Economies of Scale:** The economies of scale associated with large domestic markets are cited by Sapir and Lutz (1981) as important in freight transport and insurance. Dick and Dicke (1979) also suggest that market size is important in order to capture scale factors while Lewis (1999) discusses the importance of a large domestic market for strength in financial services.
2. **State of Development:** Moshirian (1993) discusses the importance of disposable domestic income in determining trade in travel and passenger transportation services and Moshirian, Li, and Sim (2003) identify the differences between per capita income among countries as an explanatory variable in intra-industry trade in insurance. Dick and Dicke (1979) discuss a state-of-development variable, measured by per capita income.

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3. **Human Capital Endowment:** All of the authors discussed here stress the enormous importance of human capital in services trade. Katouzian (1970) finds that specificity of knowledge in services is an important element in the development of comparative advantage. Skill endowment is also identified by Lall (1986) particularly in technology-intensive services. Again, he focuses on specificity of skills, which may be a particular advantage for developing countries. Sapir and Lutz (1981) find human capital to be important in insurance services. Riddle (1986) states that human capital should be included in revised versions of the theory of comparative advantage. Engelbrecht (1991) also found human capital intensity to be positive and statistically significant in determining comparative advantage in services exports in Japan. Dick and Dicke (1979) and Daniels (1993) discuss the role of the pattern and level of existing development—defined as investment in education—as important to specific types of services industries. Daniels (1993) goes further to discuss the need for interactional skills (such as languages) and the increased need for a labor force that can identify and solve problems at all levels of institutional hierarchy.
 4. **Information Endowment:** Stiglitz and Charlton (2004) stress access to, and effective use of, knowledge and information. Riddle (1986) also suggests that the importance placed on human resource development in countries contributes to them being “information rich” or “information poor” and that this dichotomy is an important concept in the development of a new understanding of comparative advantage.
 5. **Technology Endowment:** Dick and Dicke (1979) identify the availability of productive knowledge, or the propensity of a country to spend resources on science and technology, as important in determining services exports. Engelbrecht (1991) finds research and development expenditure to be positive and statistically significant in his study of comparative advantage in Japan. Daniels (1993) includes investment in research and technological development as an important aspect in the existing development of a country.
 6. **Capital-labor Ratio:** Sapir and Lutz (1981) find the positive influence of capital to be significant in several categories of services trade, including freight transport, passenger transport, and insurance.
 7. **Legal Framework:** The importance of a stable legal environment is discussed by several of these authors. Van Ark, Monnikhof, and Mulder (1999) state that the legal framework is one of the more important determinants of services trade. Lewis (1999) identifies peaceful conditions and effective law enforcement as among the most essential elements for the efficient performance of financial services.
 8. **Political and Economic Stability:** Economic stability is cited by Lewis (1999).
 9. **Degree of Openness to Trade:** Dick and Dicke (1979) discuss the share of government in total GNP as an important element. Li, Moshirian, and Sim (2003) state that a more open economy will encourage internationalization of insurance products in their study of the determinants of intra-industry trade in insurance services. Daniels (1993) suggests that the degree of government regulations is an important factor.

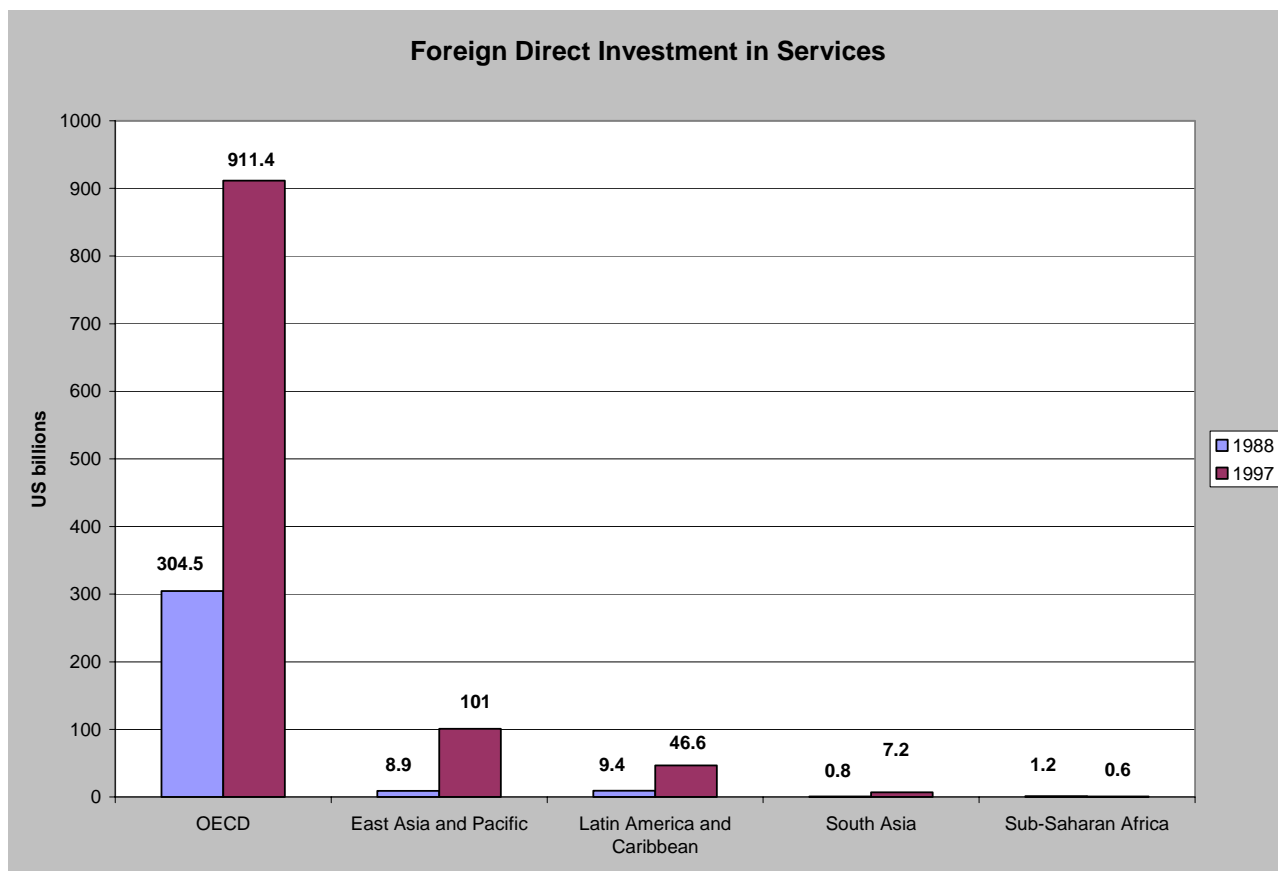
-
10. **Endowment of physical capital:** Lall (1986) finds that a main determinant of trade in services is experience and infrastructure in trading, particularly in transportation services, for which shipping was used as a surrogate for all types. Daniels (1993) also mentions physical capital as a traditional element in determining comparative advantage.
 11. **Location:** Riddle (1986), Daniels (1993) and Nachum (2000) discuss the importance of location in several different ways. In financial services location may matter in terms of time zones, while in tourism there are a variety of location-related aspects including difficulty accessing a country, climate, lack of pollution, etc.

In summary, with high levels of GDP and income, with high capital-labor ratios all enjoy larger shares of services exports in the world economy. And, nations that experience macroeconomic instability were less apt to be competitive—the higher the current account balance as a percentage of GDP, the lower the export shares of services in the world economy. We can confirm much of the findings in previous literature with some confidence. Economies of scale, income, technology and information endowments, and macroeconomic stability are all key ingredients to service export competitiveness. At this writing, as is confirmed by our analysis, it is largely the developed countries who share these traits, and therefore share the majority of benefits from global services trade.

b. Trends and determinants of services investment in the world economy

The globalization of services is not only about trade, however investment also forms a large part of services activity in the global economy. Indeed, mode three in the GATS is almost exclusively dedicated to investment in services. In terms of flows, FDI in services is very similar to trade in services: the majority of FDI in services flows to and from developed countries. In terms of determinants, there are less similarities between FDI and exports: FDI is largely market seeking. Moreover, there is no evidence that investment agreements such as the GATS will bring additional FDI in services to developing countries.

Figure 1.2



Source: World Bank, 2004

Figure 1.2 exhibits the distribution of FDI in service industries across the globe and shows that OECD countries receive the vast majority of FDI in services. However, in each case except for Sub-Saharan Africa, FDI developing country services grew faster than in developed. Table 1.7 exhibits similar data in terms of the share of total FDI into each region.

Table 1.7**Regional Distribution of FDI in Developing Countries**

Country/Region		Primary	Industry	Services
Developing Countries				
	1988	13.7	65	20.7
	1999	5.4	54.5	37.3
Africa				
	1988	51.8	20.8	27.4
	1999	13.6	43.4	42.9
Asia				
	1988	13.1	68.9	17.1
	1999	3.5	60.2	33.6
Latin America				
	1988	9.6	65.8	24.6
	1999	12	32.8	52.2
C. and E. Europe				
	1988	n.a.	n.a.	n.a.
	1999	2.5	43.5	50.1
World				
	1988	10.7	42.4	43.9
	1999	5.5	41.6	50.3

Source: UNCTAD World Investment Report, 2001

This figure exhibits the sectoral composition of FDI inflows to developing countries in 1988 and 1999. For each region of the developing world, the share of FDI inflows in each sector is shown for 1988 and 1999. For the developing countries as a whole, FDI has been shifting into the service sector, but manufacturing remains the largest recipient of FDI inflows. In 1988 services accounted for only 20.7 percent of FDI inflows, but by 1999 FDI inflows into services were 37.3 percent of the total. In 1988 manufacturing captured 65 percent of all FDI to the developing world, but shrank to 54.5 percent by 1999. This table shows that each region follows a similar trend, but in some areas it is more pronounced than others. Africa's share of manufacturing FDI has increased from 20.8 percent in 1988 to 43.4 percent in 1999, while all other regions saw a declining share of investment in manufacturing relative to the earlier period. Most regions also saw a relative decline of investment in the agriculture and mining sectors. The exception is Latin America, where agriculture and mining received 9.6 percent of FDI in 1988, but 12 percent in 1999 (primarily due to investments in the mining sector). In addition, Africa

still receives a double-digit share of primary sector investment, although that share is down considerably from 1988.

Table 1.8

Sectoral Composition of FDI in Services

	1997			2001		
	<u>Developed</u>	<u>Developing</u>	<u>World</u>	<u>Developed</u>	<u>Developing</u>	<u>World</u>
	<i>(share of total FDI)</i>			<i>(share of total FDI)</i>		
Total FDI	100	100	100	100	100	100
Primary (Ag and Mining)	7.6	3.8	6.3	10.2	7.6	9.6
Manufacturing	33.4	59.5	42.5	16.6	33	20.5
Services	55.9	34.7	48.5	64.9	58.4	63.3
<i>Electricity, Gas and Water</i>	1.3	2.7	1.8	1	4	1.7
<i>Construction</i>	0.6	2.2	1.2	0.4	1.3	0.6
<i>Trade</i>	13.8	3.5	10.2	4.9	7.6	5.6
<i>Hotels and Restaurants</i>	1.2	1.9	1.4	0.4	1.6	0.7
<i>Transport, Storage and Communications</i>	1.4	3.6	2.2	9.6	11.8	10.2
<i>Finance</i>	21.3	1.7	14.4	20.2	17	19.3
<i>Real Estate</i>	3.2	15	7.3	-	-	-
<i>Business Services</i>	9.3	2.2	6.8	20.7	9.9	18
<i>Other Services</i>	3.8	1.8	3.1	6.1	2.2	5.1
Unspecified	3.1	2.1	2.8	8.2	1.2	6.5

Source: World Investment Report, various years

Table 1.8 shows the composition of FDI in the developing world by sector between 1997 and 2001. For the developing world, finance and transport, storage and communications receive the most developing country FDI in services. In the developed world the majority of FDI has flowed to finance and business services.

The determinants of services FDI are different than those of exports. Since services are consumed at the point of production, FDI in services is market seeking (UNCTAD, 2004b). Evidence suggests that without large and growing markets, coupled with macro-economic stability, investment agreements (such as GATS) may not bring any additional investments.

Numerous studies confirm these findings. The first study to examine the role of bi-lateral investment treaties (BITS) to attract foreign investment was conducted in 1998 by UNCTAD. The study finds that BITS do not appear to have a major impact on FDI. UNCTAD concludes that the impact of BITS is small and secondary to the effects of other determinants, especially market size (UNCTAD, 1998). In 2003 the World Bank examines whether BITS determined the levels of FDI from 20 OECD countries flowing to 31 developing countries from 1980 to 2000. The Bank study concludes that BITS do not

stimulate additional investment. They find that market size and macroeconomic stability are the key drivers of foreign investment. The study stresses that BITs are no substitute for domestic institutions and to the extent that they work to increase investment at all they act as a complement to developing countries with existing strong institutions (Hallward-Dreimeier 2003).

A more recent study conducted by two researchers at Yale University looks at the relationship between BITs and investment flows in the world economy as a whole. In their fixed effects regressions the authors' dependent variable is FDI as a percentage of world FDI. Examining FDI for 176 countries from 1975 to 2000, they find that the total number of BITs by a country has no independent significant impact on investment flows into the country – except when such countries were seen to be politically risky. The authors conclude that an agreement can be a signal that a country wants to get back on track. The authors also look at flows of FDI from the United States and BITs with the United States. Here they find a negative relationship: those countries with BITs with the United States received less FDI. The authors say that “overall, these results indicate that signing a BIT with the US does not correspond to increased FDI flows” (Tobin and Rose-Ackerman 2004: 24).

4. Services Trade, Growth, and Economic Development

According to numerous economic estimates, the welfare gains from liberalization of the global service sector could be the most substantial of any of the sectors currently under negotiation in the Doha Round—though a large proportion of the gains will flow to the developed world. Moreover, the models also show that such gains could be small or unrealized if liberalization schemes do not include factor movements (modes 3 and 4), if corresponding liberalization occurs in developed country manufacturing markets, and if they are not coupled with institutions to ensure fair competition after liberalization. Policy-makers should take note that such estimates need to be understood with great caution because the modeling exercises used to generate such estimates are very simplistic and controversial. In this section we present economy-wide estimates of the impact of services liberalization on economic development and then review the case study evidence to assess the factors that have led to pro-development services trade in the developing world.

a. Economy-wide evidence for the world economy

Although the majority of discussions surrounding the Doha Round's prospects for economic development in poorer nations focus on agricultural liberalization, economic modeling efforts show that the potential benefits from services liberalization are even greater. Estimates for the welfare gains (that is, annual changes in GDP) of the Doha round are quite large, ranging from \$260b to \$487b or 0.9 to 1.8 percent annual growth in the world economy. These estimates are shown in Table 1.11.

Table 1.10

Rates of "Protection" are High in Services

Country/Region	Food	Manufacturing	Services			
			Construction	Financial	Transport	Government
North America	5	3	10	8	69	34
Western Europe	8	1	18	9	84	40
Japan	58	2	30	20	71	32
China	18	20	41	19	96	42
Indonesia	5	8	10	7	85	43
India	40	35	62	13	96	41
Brazil	4	16	57	36	71	44
South Africa	8	8	42	16	58	26

Source: author's adaption from Stiglitz and Carleton, 2004

Table 1.10 shows estimates of rates of protection in selected regions and countries. This table reveals that on average, services protections are seen as being two to five times larger than food and manufacturing tariffs. In addition, except for in construction services and for some cases financial services, developed countries enjoy similar rates of protection as in developing countries. In both cases however, it should be noted that what some may see as protections may be domestic policies to provide public goods and correct for other market failures.

Table 1.11

Potential Gains from Services Liberalization are the Largest on Doha Agenda

	Services	Manufacturing	Agriculture	Total	Services Share of Total
	<i>(billions)</i>				
Dee and Hanisow (2000)	130	50	80	260	50%
Hertel (1999)	55	130	164	349	16%
Brown et al., (2002)	413	163		576	72%
Hertel et al (2000)	348	69.5	69.3	487	71%
Robinson (1999)	277	55		332	83%

Source: Individual Studies, Stiglitz (2004), (OECD, 2004)

Because the developed world enjoys a comparative advantage in services trade the most gains will flow to the developed countries, however the gains to developing countries are not insignificant. Brown et al., (2002) estimate that the gains from services liberalization alone could be \$413b. In their study, only \$81.7b of those benefits will flow to the developing countries.

Aside from the modeling problems discussed in the appendix, the variation among these studies is largely due to the assumed level of barriers to services trade in the world economy, and the corresponding level of liberalization. The Dee and Hanslow study assumes a full reduction in barriers to services trade, the Hertel et al. study assumes a 40 percent reduction, and Brown et al., assume a 30 percent reduction. However, Brown assumes the highest level of barriers, and Dee and Hanslow the least (OECD, 2004).

What is often not highlighted is the fact that projected welfare benefits will not accrue unless they are coupled with strong mode 3 and mode 4 liberalizations in FDI and natural persons. In all but one of the studies in Table 1.11, there is liberalization of services regimes across modes. The one study that only includes mode 1 liberalization is by Hertel (1999). Correspondingly, the benefits from services liberalization are much lesser than in agriculture and mining. Indeed, in a review of the economic evidence for services liberalization the OECD writes, “in conclusion, literature explicitly modeling modes 3 and 4 of supply suggests that if services are liberalized with no accompanying liberalization of factor markets, as in goods, trade gains are small” (OECD, 2004, 109).

A number of studies have specifically looked at mode 4 liberalization, where the potential gains are the largest—especially for developing countries. Winters (2001) and Winters et al. (2002) have done the most comprehensive work on the subject. The developing world has a comparative advantage in low-skilled workers and therefore has proposed allowing at least temporary schemes where such workers can work in the developed world. Because there are so many restrictions on temporary flows of low-skilled workers from the south who work in the north, the current value of benefits from such flows is only \$30b annually (Chanda, 2004). These gains come in the form of wages, many of which are sent back to families and villages in the form of remittances in the developing world. Table 1.2 exhibits the top 20 countries worker remittances as a percentage of total trade. The vast majority of these nations are among the LDC and remittances play a major role (in some cases majority) in foreign exchange generation and development. It has been shown that remittances begin to dwindle after approximately 15 years of stay in a new country, and that therefore migration is far from a development strategy (Orozco, 2002). Of course this is true, but temporary work visas for only 3 to 5 years would get around this nicely.

It should be noted that the majority of these studies rely on computable general equilibrium (CGE) modeling, a form of estimation that is quite controversial and exposed to serious limitations especially when used in estimating the benefits of services trade. Under numerous simplifying assumptions, CGE models attempt to present a quantitative picture, at one point in time, of the full interaction of markets and industries throughout the economy. One of the more controversial assumptions necessary for CGE models to work properly is the assumption that there is no technological change in the economy. The assumption that is perhaps most unrealistic is the assumption that there is perfect competition in the economy. In other words, there are no barriers to entry among buyers and sellers (Munk 1990; Stanford, 1993; see also Tims 1990). In essence, there is no

room for oligopolistic multinational corporations in these models. These models also have to hold all other aspects of economic activity, such as inflation, exchange rate fluctuations, full-employment, and so forth, constant. In most developing countries unemployment, inflation, and exchange rate fluctuation are rampant. Moreover, these models will only examine the effects of tariff reductions, not investment and factor mobility factors related to further liberalization. Although the economic impacts of such provisions are forming a growing part of world trade, it is difficult to model them in a CGE framework. An appendix to this paper provides a guide to the limitations of such techniques.

Table 1.12**Worker Remittances as a Percent of Trade**

Country	Remittances (1990-2002, ave.)
Lesotho	206
Albania	127
Tonga	96
Cape Verde	95
Bosnia and Herzegovina	79
Samoa	73
Yemen	62
El Salvador	51
Uganda	47
Sudan	43
Georgia	43
Jordan	40
Burkina Faso	37
Kiribati	35
Bangladesh	31
Egypt	30
Comoros	30
Yugoslavia, SFR (former)	29
Armenia	25
Morocco	25
Mali	23

Source: UNCTAD (2004)

The studies by Winters and others have shown that the potential benefits of mode 4 liberalization for low-skilled workers could range between \$150b and \$300b on an annual basis, depending upon whether temporary work from developing countries amounted to 3 or 5 percent of industrial country workforces respectively. Another study that looked at the possibility of a 3 percent quota estimated that annual gains could be \$200b annually.

The same study stresses the fact that such gains go directly to those individuals in the developing world who need the funds the most. Thus an added benefit is the need not to wait for the gains from trade to “trickle down” to the poor (Rodrik, 2004).

It is also essential to understand that the benefits that could come to the world economy estimated in these studies may only occur if liberalization is managed to the extent that competition among firms is enhanced, not diminished. It has already been pointed out that there is a real danger of FDI and privatization schemes to transfer monopoly conditions from the public sector to the private sector. Such transfers can be disastrous, because at least in the domestic monopoly sense there is a guarantee of universal access in some cases. Francois and Wooton (2001) show that the gains from services liberalization depend critically on whether the proper competition policies are in place. When firms are more collusive after liberalization, there are less gains.

For services liberalization to benefit the poor it should include mode 4 liberalizations and should be coupled with strong competition capacity building in developing countries. Indeed, in a comprehensive assessment of service trade estimates, economists Joseph Stiglitz and Andrew Charlton (2004) conclude that:

- The liberalization of labor markets in the form of temporary work schemes for developing country workers in the developed world, offers the largest benefits for the developing world.
- Significant gains from services liberalization will come from reducing tariffs in South-South trade.
- Poorly implemented liberalization in the service sector will have negative effects on the poor.

This section has looked at forward-looking or ex-ante predictions of services trade. Consistent with the last section it shows that by-and-large the developed countries will solidify their comparative advantage in service trade. The next section then reviews the ex-post literature to examine the factors that determine success and failure rates for developing country service industry trade.

b. FDI in Services: Need for Strategy

It is impossible to model the possible flows of FDI in services that might result from further liberalization efforts, but it is clear that further liberalization will lead to significant amounts of new FDI in services to a select group of developing countries. There is a great potential for FDI in services to help nations toward their development goals, but there are many risks involved as well. Without the proper national institutions in place and the policy space to ensure that such institutions can flourish, FDI can jeopardize development goals. The potential benefits of FDI in services can fall into four categories: balance of payments, crowding in domestic investment, generating positive spillovers, and creating employment (UNCTAD, 2004b).

FDI in services has the potential to improve balance of payment problems in many developing countries. Although nowhere near at the scale of the deficits in the 1980s and 1990s, many developing nations are still experiencing large current account deficits and increased FDI can help alleviate associated risks. FDI is seen as more stable than portfolio investment because it will be less apt to rapidly move out of a host country. Moreover, an indirect balance of payment benefit could occur when services from FDI serve as inputs to make goods production and exports more productive. On the other hand, FDI in services could just as easily accentuate existing balance of payments problems. UNCTAD reports that profit remittances flowing out of developing countries and back to home countries can be very high –reaching 35 percent of the total income of U.S. foreign services companies in 2002 and 53 percent of Japanese firm profits. Finally, a large foreign presence in the financial service sector could also be detrimental. During macroeconomic crises developing countries may have less control over convincing foreign banks not to pull their investments out of a host country (UNCTAD, 2004b).

Services FDI also has the promise of crowding in domestic investment. If foreign firms enter a market and make it more vibrant, domestic investors may be triggered to invest in the sector as well. East Asian countries were able to steer FDI in such a way that it crowded in domestic investment during the 1980s and 1990s, yet in Latin America the opposite occurred (Agosin and Mayer, 2000). In the financial services sector, foreign firms serving large and increasingly international markets don't always have the incentive to give favorable credit to small and medium sized domestic firm and thus create a crisis environment for such firms UNCTAD, 2004b). In Latin America, similar conditions have led to the erosion of the domestic sector. The crowding out issue can also be of grave concern for public services. When powerful foreign monopolies take over a market and crowd out their domestic counterparts, they can charge higher prices that deny segments of society from receiving the benefits of public services.

Another area of promise for FDI in services lies in knowledge spillovers. Foreign firms can link with local suppliers and demonstrate new technological ways of doing business. Moreover, foreign firms can hire local employees who may later leave the firm and work for local firms where their newly acquired skills can lead to productivity improvements. The service industry by its very nature is very close to the markets they serve and therefore tend to require higher skill levels among workers, and tend to employ more local workers than goods producers (UNCTAD, 2004b). Although the potential for such spillovers exist, the consensus in the economics community is that by and large spillovers do not occur unless the proper institutions are in place to foster them (Gorg and Greenaway, 2004).

FDI in services also has the potential to create employment in developing countries. UNCTAD (2004b) states that employees in foreign service jobs are better paid and receive higher levels of training than employees in foreign goods firms. However, in terms of numbers manufacturing creates more jobs than services.

Finally, there is no guarantee that signing a services agreement will bring more FDI into a services sector. The majority of studies cited earlier on the role of investment agreements and FDI flows show that investment agreements themselves do not bring investment. The size and growth of markets is the single most important determinant of attracting investment. These studies suggest that the additional benefits of an investment treaty such as the GATS may be outweighed by the costs of potential balance of payments, spillover and crowding out problems. Countries need policies to ensure that policies are in place to preserve the ability of domestic producers and consumers to have access to credit, markets, and vital public services.

c. Country and sector-level evidence in developing countries

Quantitative modeling estimates of the benefits of services trade liberalization clearly show that services liberalization can benefit developing countries. However, liberalization alone is not enough. The modeling efforts also hint to the fact that liberalization needs to be managed in such a way as to ensure that estimated benefits actually accrue to developing countries. This notion was especially true in the case of competition.

What other factors might also be important for expanding services trade for sustainability in the developing world? To answer this question, we turned to the case study evidence. We compiled over 90 case studies on service industry trade that were previously published in the peer-reviewed literature, by national and international agencies, and by independent think-tanks and ngos. As we read these case studies we asked ourselves, “what were the elements of success (or failure) in this particular sector our country?”

Consistent with the findings in the previous section, we found that non-market institutions are the key to the successful expansion of services trade in developing countries. Specifically, we learned that non-market actors such as the state have played three key roles in fostering services for sustainable development. These roles are:

- i. foster and initially develop services industries and markets;
- ii. ensure that policies to correct market failures are in place, well monitored and well maintained.
- iii. liberalization processes are conducted in a gradual, legitimate and transparent manner;

It is beyond the scope of this study to report on each and every case study examined, but we will discuss those that amply illustrate these three key roles.

- i. *helping to foster and initially develop services industries and markets*

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It should not be taken for granted that a service industry should actually exist and be fairly well functioning before it is liberalized. Whether the case is information technology in India, telecommunications in Singapore, or tourism in the Caribbean, the state has played a key role in acting as the facilitator of private-sector development.

Telecommunications services, or information and communications technology (ICT) services in particular, in India are widely seen as a services export success story. Over the past decade India's ICT sector has grown more 45 percent per year. Exports of ICT are destined for 133 countries and now comprise one-fifth of total exports in India (Kumar, 2004). What is often overlooked is the fact that ICT in India is a classic case of where the government laid the foundation and created the environment for ICT to flourish in India.

Almost thirty years ago India singled out electronics as a key industry for its overall development strategy (Evans, 1995; Kumar, 2004). Since that time the government has orchestrated a series of efforts that along with private sector development has resulted in India's comparative advantage in key segments of the global ICT market. Numerous studies highlight the importance of different aspects of India's strategy, but the key factors were a general commitment to the development of the industry and a commitment to building higher education.

India orchestrated a national network of institutions, both public and private, and the policy initiatives for the development and diffusion of various technologies. In addition to a network of science and R&D centers, India established a Department of Electronics (DoE) in 1972 that set up Regional Computer Centres run like public utilities, attached to educational institutions. Since the late 1980s, the DoE has concentrated on providing Research and Development, data communication and networking infrastructure to the educational and research community and to the software industry. A notable institutional intervention has also been the establishment of Software Technology Parks (STP) to provide the necessary infrastructure for software export. Other parts of the government supported the industry through government procurement policies and the nation's Export-Import Bank began supporting loans to private companies and supporting market research in industry (Kumar, 2004). In addition, information is easily transmitted via satellite links paid for by the government (Balasubramanyam, 1997).

In terms of education, India developed specialized university programs, technical institutes, and other programs aimed at building an ICT workforce. Proficiency in computer programming mandatory for undergraduates and science post graduates of all major universities in the country Private investment training in IT has also been allowed since 1980. DoE set up the Computer Manpower Development Program at 400 institutions of learned that produced 150,000 personnel by 1996. In the private sector, private firms successfully lobbied the U.S. government (on what would now be called mode 2 and mode 4 concessions) who made it easier for Indians to receive visas for

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attendance and teaching at institutions of higher learning in the U.S (Balasubramanyam, 1997; Arora, 2001; Kumar, 2004).

While these two factors may be replicable for other developing countries with well functioning government, three other factors that were instrumental in India may not be. In India, having an English speaking labour force at a wage rate much lower than that of the developed countries was key, especially to the phone services and technical support parts of the ICT services industry (Kumar, 2004). Abroad, the large Indian diaspora supported the sector in the form of remittances and investments. Secondly, when the dot com boom ended, many expatriates returned to India with contacts with U.S. firms and a knowledge of business know-how and culture in the industry (Balasubramanyam, 1997; Arora, 2001). Alongside all these reforms and occurrences, India reduced tariffs and allowed for 100 percent ownership by foreign firms (Kumar, 2004).

Although India is clearly a success story, it is often asked if it is an outlier beyond replication (Langhammer, 2002). Although it is true that the spectacular success of India's ICT has not been replicated, more modest successes have occurred in the telecommunications service industries in Singapore and South Korea. Singapore now has one of the most significant telecommunications infrastructures in the world, a trait largely credited to the development of a sound National Computer Board and Telecommunications Authority (Warf, 1995). The Korean government has maintained firm control over a gradual deregulation process, which has taken place over 15 years (Lee, 2004).

The lesson from India is that mere liberalization is not enough. Nations need to have comprehensive policy and vision for the development of a service sector for export. There are some signs that Vietnam is an example of one country who is attempting to develop such a strategy but others, such as Cambodia, Laos, Myanmar, and Mexico are yet to (Kumar, 2004; Gallagher and Zarsky, 2004).

- ii. *ensure that policies to correct market failures are in place, well monitored and well maintained.*

As discussed in Section 2 of this part of the report, markets rarely function well when left to their own devices. Drawing from the case study evidence, it becomes clear that in order for services trade to work for development a host of policies need to be in place to make sure that liberalization does not exacerbate existing or create new market failures. In addition to the R&D and human capital-based investments just discussed, it is also necessary for the state to ensure that policies for ensure for competition, for the distribution of benefits to the poor, and for environmental protection.

The importance of maintaining competition after liberalization has already been stressed, but turns up significantly in the case study literature as well. If liberalization simply results in turning a national monopoly over to a foreign monopoly (or oligopolist) then

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the benefits of liberalization are much more ambiguous. Indeed, one article that surveyed the impact of services trade liberalization in Africa concludes that “it is not just structuring the reform that is complex, it is also the continued regulation of conduct after the reform has taken place to ensure that anti-competitive practices do not occur.” (Hodge, 2001). If liberalization simply results in turning a national monopoly over to a foreign monopoly (or oligopolist) then the benefits of liberalization are much more ambiguous.

There are numerous studies on this phenomenon, and they should not be ignored. In a comprehensive review of services liberalization across Latin America, Alexander and Estache (1999) stress that success is a function of having the proper competition policies in place. Successful liberalization should end in higher competition and therefore lower prices. Lower prices will guarantee more accessibility for the poor (unless of course state monopolies were providing such services for free). However, they found that when competition policies are not in place the benefits of liberalization flowed to foreign firms. Wallesten (1999) and Hodge (1999) found this to be true in the telecommunications industry, World Wildlife Fund (2001) in the tourism industry, and Social Watch (2003) in the social services industries such as health care and education. If India is the most famous success story perhaps Bolivian water privatization is the most famous failure, where both NGOs and the World Bank have called the Cochabamba privatization of water services a disaster (Social Watch, 2003; World Bank 2002). This poses a clear challenge for developing countries. According to UNCTAD, only 34 nations in the developing world even have competition laws, and none of them have much jurisdiction over foreign firms (UNCTAD, 2004).

It is also imperative to ensure that policies are in place for the benefits of liberalization to work toward the poor. Mosely (1999) examined the impact of financial services liberalization on the rural poor in four African countries, Kenya, Malawi, Lesotho, and Uganda. In three out of the four countries the result was a decrease in access to rural credit. The exception was Uganda, who coupled liberalization with regulation focused on access and poverty reduction.

Chilean’s liberalization of its telecommunications market is also interesting. Chile only gradually and partially liberated its market and was careful to foster local competition in all its segments. In addition, the Chileans made accessing poor rural areas a key part of the strategy. Chile initiated an auctioning process to distribute subsidies for service in rural areas. The government sets aside a certain amount of subsidies to encourage access to rural areas. Carriers then bid for construction of services using the subsidy. This creates a significant incentive to have low cost universal service because the lowest bidder is often taken and also makes the subsidy to carriers more competitively neutral, because the auction gives rivals a chance to bid away potentially high rents (Cowhey and Klimenko, 2001).

Though it is too early to tell, perhaps the case of natural gas in Bolivia will turn out to be a success. By public referendum, Bolivians permitted their nation to export natural gas

on condition that the state maintain control over reserves and that a significant portion of the profits be earmarked toward education, health, and other social services (Economist, 2004).

Another cornerstone of carefully managed liberalization is the need to internalize environmental externalities that may arise from the liberalization process. One key area in need of focus is in transport services. A study commissioned by the North American Commission for Environmental Cooperation found that the cross-border freight from Mexico under the North American Free Trade Agreement (NAFTA) is responsible for 3 to 11 percent of all mobile source NO_x emissions and 5 to 16 percent of all mobile source particulate matter emissions in the United States. The study also found that truck idling associated with border crossing also seriously affects carbon monoxide emissions (NACEC, 2001).

iv. liberalization processes are conducted in a gradual, legitimate and transparent manner

When liberalization does occur it needs to be conducted in a transparent manner in order to ensure true competition and legitimacy.

One case that is often held up as a success is the Buenos Aires water concessions in 1992. It is a rare example of where the concessions led to improved water and sewage services, more efficient operations of the company, attracted more investment, provided wider coverage for water, and a reduction in waste. The liberalization was a success because the rules of the bidding process were very well spelled out and the process was very transparent, allowing for relatively competitive bidding process. Second, the government provided signals that the contract would be enforced. Third, quality improvement occurred because the government/contract set a number of targets in terms of water quality, access and coverage, and upkeep of the system. Finally, the contract made limits to ensure that water services would be affordable. In addition to the higher quality services, it has been estimated that the welfare benefits from the concession were close to \$1.6b with the majority of the benefits going to consumers in the form of lower prices. The second largest recipients of the benefits were foreign investors, followed by domestic investors and workers (Alcazar et al., 2003).

The Argentina example shows that a lot of effort, especially by the state, needs to go into the concession process to ensure that liberalization brings economic, social and environmental benefits. All too often the concession process is done in haste without the proper attention, and the results can be quite negative. The United Nations has documented how this has negatively affected health care services in Estonia and Guyanna (United Nations, 1999). In Bangladesh, a lack of transparency in the liberalization process resulted in economic hardship. In the privatization of jute, an alliance between policymakers and bidders resulted in very low prices for jute firms. Later, 40 percent of jute mills were closed and over 89,000 workers were laid off. In the firms still in operation, employment has been reduced by 25 percent (Social Watch, 2003).

5. National Public Policies, Services and Sustainable development

This part of the report has shown that there is great potential for services trade and investment to become an effective tool toward sustainable development in the developing world. It has also shown that trade agreements alone will not automatically enable services to work to such an end. In order for services trade to work for sustainable development nations will have to strike a delicate balance between state and market-based policies. Perhaps most importantly, it is of vital importance that those state-level policies be given the policy space to function under the GATS and other regional and bi-lateral service trade arrangements.

This part of the study has shown that the developing world is behind the developed world in terms of services trade. Sustainable development in such trade is paramount on widening the set of modes that are reformed in the world economy—particularly in the area of mode 4 natural persons of temporary low-skilled work. In addition, any liberalizations need to occur in an environment buttressed by non-market institutions that can ensure that competition is enhanced in national economies, that the benefits of liberalization are distributed to the poor, and that the environmental costs of development are incorporated into economic decision-making.

Without these institutional mechanisms in place, it has been shown that economic development is a much greater challenge. It is therefore of vital importance that the GATS and other regional and bi-lateral service trade arrangements give developing countries the policy space to develop the proper institutional environment for services trade. The GATS states that it provides “the right of members to regulate and to introduce new regulations on, the supply of services within the territories in order to meet national policy objectives, and given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise that right.” The next part of this report will address this is possible in a GATS and GATS plus world.

Appendix:

The Limits of CGE Modeling for Estimating the Benefits of Services Liberalization

The studies reviewed in this paper on the benefits of trade liberalization in general and services liberalization in particular, have some serious limitations. It is important to note and understand that the majority of these estimates that look at the possible gains from services liberalization rely on results generated from computable general equilibrium models (CGE model) of the world economy and should therefore be understood with a grain of salt. Drawing on prevailing economic theory and numerous simplifying assumptions, CGE models attempt to present a quantitative picture, at one point in time, of the full interaction of markets and industries throughout the economy. CGE models not only provide estimates regarding the expansion and contraction of exports and imports, but also how such changes affect the supply chains of intermediate goods

producers. Moreover, CGE models estimate equilibrating changes, as markets readjust to these changed conditions and prices rise and fall, and labor moves from contracting to expanding industries.

One can think of a CGE model as a series of equations (connected to massive collections of real data) representing these complex sectoral relationships of the economy. To generate estimates from the model, these equations are solved twice in a recent base year for which data is available. The model is run once without the trade policy and once with the trade policy change. The results are a series of numerical estimates regarding the possible effects of the Doha Round on the world economy. It is important to note that the estimates represent changes in a hypothetical base year economy, holding all other aspects of the economy, and time, constant.

It is very important to understand that there are limitations of CGE modeling. First, the modeling efforts that look at the trade-related changes are seen as controversial in and of themselves. Second, the current approach is very removed from the negotiations themselves because they are limited to providing estimates related to changes in tariffs and trade, not the range of issues in the negotiations such as mode 3 investments and mode 4 movement of persons.

The accuracy of CGE models, even for estimating trade-related economic effects, have long been called into question. The limitations of these models are often grouped into two categories. First, too many assumptions need to be taken in order to make such models perform. Second, there are high information and financial costs to utilizing these models, and they lack transparency (Gallagher and Ackerman, 2004).

One of the more controversial assumptions necessary for CGE models to work properly is the assumption that there is no technological change in the economy. The assumption that is perhaps most unrealistic is the assumption that there is perfect competition in the economy. In other words, there are no barriers to entry among buyers and sellers (Munk 1990; Stanford, 1993; see also Tims 1990). In essence, there is no room for oligopolistic multinational corporations in these models. These models also have to hold all other aspects of economic activity, such as inflation, exchange rate fluctuations, full-employment, and so forth, constant. In most developing countries unemployment, inflation, and exchange rate fluctuation are rampant.

All of these assumptions, and more, are embedded in the equations that represent the economy in these models, and are then hinged together by further empirical information (called “elasticities”) that represent the interchanges within the economy. Unlike other sciences, there is a lack of established empirical relationships regarding such elasticities, and they are often not available for every sector. Thus, in some cases very dated figures have to be used and adjusted to make the models work (Hinajosa-Ojeda, 2000). Second, CGE models will only examine the effects of tariff reductions, not the mode 3 and 4 investment and factor mobility factors related to further liberalization. Although the

economic impacts of such provisions of modes one and two, it is difficult to model them in a CGE framework.

In the end, the results of these exercises also ignore the some of the distributional consequences of trade liberalization. On the one hand, CGE models will provide estimates about which sectors will gain or experiences losses from a particular measure. Moreover, if the net benefits (where the winners win more than the losers lose) are positive then there is the potential for real development benefits—the increase in net welfare can be used to benefit the poor. However, it is well known that in developing countries that a redistribution of the net benefits often does not occur, a factor that explains much of the resistance to globalization (Kanbur, 2001;2002).

Many of these limitations are even more problematic when modeling services. Too often these studies treat services like goods and estimate the effects of percentage decrease in barriers. However, in most services trade barriers are in the form of whole “measures” that need to be reformed or eliminated. Some of those measures also may be important programs to correct markets and make them more competitively and efficiently (Stiglitz and Charlton, 2004).

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