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

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Key points

- The service sector is a key contributor to gross domestic product (GDP) and employment in most developing countries, providing essential inputs and public services for the economy
- International trade in services can improve economic performance, but services liberalisation also carries risks
- Appropriate regulation and other complementary policies are essential to ensure that liberalisation delivers the expected benefits in the long-run

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The service sector makes a key contribution to gross domestic product (GDP) and employment in most developing countries. It also provides essential inputs and public services for the economy. International trade in services can improve economic performance and provide a range of traditional and new export opportunities.

However, as the global financial crisis has highlighted, trade in service liberalisation also carries risks. Appropriate regulation and other complementary policies are essential to ensure that liberalisation delivers the expected benefits in the long-run.

With funding from the UK Department for International Development (DFID), the Overseas Development Institute has examined the role of regulation and trade liberalisation in services and development. The research consisted of literature reviews on six service sectors and more specific case studies of health services, financial services and tourism. It aimed to find answers to two broad questions. First, what is the role of services in development? Second, is it possible to provide a narrative on the effects of service liberalisation and regulatory reform on development to inform developing country governments and regulators, as well as donors and development practitioners who are not necessarily specialists on service issues?

This paper summarises the overview of the literature on these issues in the six service sectors: tourism, financial services, energy services, information and communications technology, health and temporary migration (Mode IV – trade in services through the temporary movement or migration of people). This included additional primary research on three of these services: tourism, financial services and health (Cali, Ellis and Te Velde, 2008).

The role of services in development

The service sector often accounts for over 50% of GDP in low income countries, while the process of development usually coincides with a growing role of services in the economy. Therefore, services constitute an increasing percentage of GDP in nearly all developing countries. Services accounted for 47% of economic growth in sub-Saharan Africa over the period 2000–2005; industry contributed 37% and agriculture 16%. Recent economic growth in Africa has relied on services as much as natural resources or textiles, even in countries benefiting from trade preferences in these products, such as Kenya.

In addition, employment is shifting out of agriculture and into services, and the service sector accounts for more than half of all employment in many countries. This employment can be relatively unskilled, such as in tourism and retail sectors, thus benefiting the poor in particular. Financial services, tourism, distribution, health and education are all important sectors for developing countries, in terms of their contribution to GDP and/or employment.

While some of these services already constitute an important proportion of exports for some developing countries (e.g. tourism, financial services and transport), new opportunities are arising in other sectors. In the health sector, for example, Indian companies are now providing scanning services for hospitals in the USA, and the South African tourism sector has reported escalating numbers of patients from developed countries participating in surgery and tourism packages. There are also growing opportunities in the provision of IT-enabled services, such as call centres, back-office functions and software development, particularly in countries like India,

the Philippines, South Africa and Mauritius.

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

Not only are services important for the economy, but they also have a direct impact on social development, providing health and education services for example. While social services are often run and funded largely by the public sector, there may well be scope for carefully managed private sector participation in these sectors to contribute to efficiency gains and innovation. For instance, increased involvement of the private sector in health service provision could reduce the total burden on public sector resources, which could be reallocated towards priority services for the segments of the population not served by the private sector. As many developing countries lack the domestic capital, foreign direct investment (FDI) may fill this gap.

Potential benefits of trade liberalisation of services

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

However, in many low- and middle-income countries, service providers will not be competitive enough to succeed in world markets, and services trade will also take the form of imports. Imports of services can significantly improve the performance of the sector, by introducing greater competition, international best practice and better skills and technologies. When this happens, the entry of foreign service providers may yield better services for domestic consumers, and improve the performance and competitiveness of domestic firms. Given that most imports of services are brought about through FDI, they can also bring much-needed capital into the country. They can help to stimulate investment in infrastructure development, for example, where government or domestic private sector funding may have otherwise been difficult to secure, given budget constraints and limited access to international capital markets.

The benefits from services liberalisation can be large, as confirmed by previous research. Economic models suggest global gains in economic welfare of around $250 billion per annum would be generated by a 50% cut in service trade barriers over a five- to 10-year period. One analysis of the impact of Mode 4 liberalisation modelled an increase in migrant quotas equivalent to 3% of the total labour supply in importing countries, and calculated that it would generate a rise in world welfare of $156 billion.

Potential risks of services trade liberalisation and the need for regulation

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

A common argument has been that allowing foreign providers into the market may crowd out domestic providers, and instead allow foreign firms and shareholders to capture the profits for themselves, taking the money out of the country. While it is possible that foreign providers will out-compete the weakest domestic providers, perhaps as a result of greater efficiency or the use of more sophisticated technologies, the evidence also shows that foreign firms can improve the performance of domestic firms, by stimulating competition and by exposing them to superior business practices from which they can learn. It is often argued that the limitations in supply-side capabilities common in many developing countries provide an argument for protection that would give domestic firms the chance to develop before they are exposed to international competition. However, firms with capacity constraints cannot be protected forever behind a regulatory wall. Other policy instruments, such as investing in skills, or improving access to credit, are more efficient in supporting the development of a sector.

If foreign investors (or domestic investors) are operating in a competitive market, then their profits should be just enough to cover the cost of capital required for the investment – the scope for excessive profits should be constrained by competition. This highlights the importance of creating a competitive market environment, which is also important to ensure that the benefits of efficiency gains delivered by trade liberalisation are passed on to consumers. However in some service sectors, competition is unlikely without appropriate regulation. In the electricity and telecommunications sectors, for example, regulation is important to ensure that new entrants have access to the national grid or network – which all operators have to use – at a reasonable price. Otherwise the owner of the network

may be able to exploit a significant monopoly over power.

Moreover, there is a risk (evident in the financial and energy sectors, for example) that private providers will 'skim off' the most profitable clients and 'red-line' (i.e. cease to serve) certain groups of consumers or geographical areas that are deemed unprofitable. Such concerns can, potentially, be addressed by universal service obligations in contracts, or in the licensing conditions given to all new entrants, or through regulatory provisions.

The design of appropriate mechanisms is a delicate and context-specific task. Specific interventions have the potential to improve access, but they can also distort the market and may raise costs considerably, jeopardising potential profitability and hence new entry. Less directive and more market-friendly mechanisms might be more appropriate, for example encouraging providers to agree on codes of conduct or targets in relation to widening access to services, and then publishing their performance against these targets. One example can be seen in South Africa, where the Financial Sector Charter appears to have contributed to significant improvements in financial access over recent years. Alternatively, providing output-based aid can help to support social objectives without sacrificing efficiency. In Chile, subsidies for expanding electrification have been allocated in such a way that it has increased access to electricity in rural areas by almost 50% in the first five years.

There are sector-specific risks, such as:

- **Risks of financial sector instability:** The recent global financial crisis highlights the risks associated with financial sector openness, as integration into world financial markets can increase vulnerability to contagion. There is evidence to show that the presence of foreign banks actually improves financial stability and reduces the likelihood of banking crises, on average, over the long term. But it seems likely that developing countries that have been more dependent on foreign lending will, in the short to medium term at least, be hit harder by the current financial crisis than countries that had a more closed financial sector. It is now recognised that, although financial sector liberalisation can be very beneficial in the longer term, it needs to be undertaken in a carefully sequenced manner, with a stable macroeconomic framework, adequate financial supervision, and regulation and privatisation now seen as prerequisites that are crucial to minimise associated risks.
- **Risk of brain drain:** The temporary movement of persons to provide a service can exacerbate skills shortages in developing countries. This is particularly problematic when education and training of these individuals is partly funded by public revenue, some benefits of which will then accrue to developed countries. The risk of brain drain has been most widely recognised in the health sector. However, our work suggests that increased migration opportunities for Indian nurses promoted the nursing profession within India itself, which has, in turn, resulted in rapid growth in demand for nursing education and a related supply response. The 'brain gain' channel often offsets the possible 'brain drain'.
- **Risk of environmental degradation:** Poorly managed tourism could lead to deforestation and erosion; degradation and depletion of biological diversity; disruption of natural habitats; and over-consumption of resources like freshwater and energy. Trade liberalisation is not the only factor here, as degradation would relate to the whole sector, but liberalisation might lead to further development of the sector with additional environmental impacts. Some form of environmental regulation may be needed in order to manage any negative environmental effects.

Role of regulation in service liberalisation

While there are a number of risks associated with liberalisation, it does not follow that service liberalisation should be abandoned, as the potential benefits are substantial. Owing to the nature of services (sometimes characterised by elements of natural monopoly and informational asymmetries), regulation is usually required to ensure that service markets work properly. Appropriate regulation is crucial to realise the benefits of service liberalisation. This can incorporate a wide variety of objectives, including:

- the need to create a level playing field and ensure competition between market players (e.g. in ensuring a sufficient number of telecommunication providers);
- to maintain quality of the services provided (e.g. by specifying qualification requirements for service providers);
- to protect consumers (e.g. from fraud);
- to ensure sufficient provision of information (e.g. about the features of competing services);
- to prevent environmental degradation (e.g. arising from high levels of tourist development);
- to guarantee wide access to services (such as electricity and health); and,
- to maintain financial stability and protect consumer savings from excessive risk-taking by financial institutions.

However, regulation can also be unnecessarily burdensome and distorting, and can sometimes represent a major barrier to services trade. This can be an unintended consequence of the regulation, e.g. where the professional qualifications required are available only from national educational establishments, which prevents service providers who qualified abroad entering the market. In these

cases, it may be possible to adjust the regulation to make it less discriminatory against foreign providers by, for example, introducing mutual recognition agreements (MRAs) or cross-border harmonisation of rules.

Some regulations represent similar barriers to all firms, such as limitations on the number of new bank licenses that are available. However, others are established deliberately to manage foreign entry, including limits on foreign equity participation, requirements for foreign entrants to form joint ventures with domestic companies, citizenship requirements for board members, and limits on the number of foreign providers that can be licensed in the market. Liberalising trade in services usually involves some degree of deregulation or regulatory reform to make it easier for foreign firms to enter the market. But it is also the case that new or more sophisticated regulatory frameworks are often required to ensure that liberalisation delivers the expected benefits. And the establishment of an appropriate regulatory framework can also be important in enabling a country to take advantage of potential export opportunities, by developing well-functioning domestic service sectors that meet world standards of provision. For example, by facilitating the development of a safe and reliable health care system, a good regulatory framework promotes exports of health services.

Regulation often involves complex trade-offs between market and social objectives. Regulatory frameworks are likely to need refining and adapting over time, as markets develop. This suggests that World Trade Organization (WTO) commitments in relation to service regulation should be made in a way that does not preclude future revision if necessary, to maintain policy 'space' going forward. Many of the poorest developing countries have made relatively few service commitments at the WTO, despite undertaking considerable liberalisation in many service sectors. Under these circumstances, binding commitments that are less onerous than the status quo may have limited immediate impact. If, however, it encourages a country to consider the development of service sectors more strategically, this may have longer-term benefits.

A more coherent approach is important at a national level, as service liberalisation is complex and involves close coordination among business, regulators and trade negotiators. This is often lacking – given lack of capacity in developing countries – and may give rise to measures being adopted before sufficient thought has been given to the implications for wider policy objectives.

Capacity requirements for the development of a strong regulatory framework (and the ability to enforce it) are often high, and perhaps beyond the reach of some developing countries, so the scope for donors to assist in this process is considerable.

While regulation is important as a barrier to trade, supply-side capacity constraints are often a more binding constraint on developing country exports. In these cases, removing regulatory barriers may not generate the expected increase in service trade. Thus, a broader approach to maximising the opportunities for service trade and identifying and addressing the binding constraints is needed, embedded in an overall growth strategy.

With all these caveats in mind, it is still the case that service trade liberalisation can bring great benefits to a country. Not liberalising at all may be more risky than trade liberalisation itself.

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References and project information

Cali M., Ellis K., Te Velde D.W. (2008) The Contribution of Services to Development and the Role of Trade Liberalisation and Regulation, ODI Working Paper 298. Overseas Development Institute, London. Please refer to this paper for additional references.

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