



Working Party on Domestic Regulation

SERVICES-RELATED REGULATORY CHALLENGES FACED BY DEVELOPING COUNTRIES

NOTE BY THE SECRETARIAT¹

1 INTRODUCTION

1.1. At the request of the Working Party on Domestic Regulation, this Note discusses development-related challenges and issues that arise from regulating services sectors and modes of supply. It is intended to supplement earlier work by the Secretariat on "Regulatory Issues in Sectors and Modes of Supply" (S/WPDR/W/48) and builds upon the discussion of the importance of the domestic regulatory environment as a context for trade. As in the earlier Note, the focus will primarily be on those regulations under the mandate of the Working Party on Domestic Regulation, namely licensing and qualification procedures and requirements, and technical standards. In some cases, studies and descriptions of challenges faced in regulation may go beyond these measures. These have been included for the purpose of completeness, as the literature often does not make such a fine-grained distinction, and do not suggest that they are under the scope of Article VI: 4.

1.2. It should be noted that the Note does not seek to discuss the relative merit of private or public provision of services, nor does it seek to prescribe any particular model for regulation. This Note by no means pretends to be an exhaustive study of regulatory issues faced by developing countries but does attempt to provide a broad overview of the development-related challenges and opportunities that may arise. It is thus envisaged that Members will use this background Note to bring their own specific experiences, or contribute additional development perspectives, to the discussions, as appropriate.

1.3. The Note is divided into 3 sections. The first, examines the challenges faced by developing countries in establishing appropriate regulatory frameworks and institutions that best harness the gains from trade. The second section discusses trade and development implications that may arise from the absence of appropriate regulatory and institutional frameworks. The third section provides some concluding observations.

1.4. It should be noted that no judgement is intended on what might constitute restrictions, problems or barriers that are incompatible with the provisions of the GATS. Nor does the discussion in this Note imply any judgement, direct or indirect, on the need for, or content of, any particular regulation, rule, procedure or administrative action.

2 THE SERVICES REGULATORY CHALLENGE: OPPORTUNITIES AND CONSTRAINTS FACED BY DEVELOPING COUNTRIES

2.1. The services economy has been undergoing a major transformation over the last three decades, moving away from a model where services were provided often as a function of government to one where services are provided on a competitive and commercial basis. The degree of change, however, varies across regions and sectors. Historically, several infrastructural and social services, such as in telecommunications, transport and public utilities, as well as essential consumer services like education and health were directly provided by government entities, usually in monopoly situations.

¹ This document has been prepared under the Secretariat's own responsibility and without prejudice to the positions of Members and to their rights and obligations under the WTO.

2.2. In many of these sectors, governments have progressively moved back from their role of primary supplier and have increasingly had to take on new roles as the supervisor or regulator of competitive markets. On the other hand, in other sectors, where there has always been strong private sector involvement, technology and market globalization has made the task of regulation ever more complex with the emergence of either new services or the involvement of an expanded range of private actors.

2.3. The shift towards private or joint public-private provision of services has often resulted in more and not less regulation and has been described as the rise of the so-called "regulatory state".² Indeed, the experience of OECD countries has been that the regulation of services markets has expanded at the same time as sectors were privatised and opened up to competition.³ In developing countries the establishment of new regulations, laws, contracts, institutions, regimes and processes have also been an important feature of infrastructure reforms associated with telecommunications, transport and public utilities.⁴ Liberalization of services markets has thus required greater emphasis on formulating new regulation or re-regulation to ensure regulatory quality and efficiency, and transparent processes, as well as appropriately mandated regulatory bodies.

2.4. Through the regulatory framework, governments may wish to increase welfare by correcting market distortions, minimizing the impact of externalities and preventing anti-competitive practices. Regulations may also be used to ensure that societal values such as environmental protection, health and safety, universal access, and the like, are attained. Consumer protection assumes particular importance in services markets. Services are intangible and non-storable, and their supply often requires an interaction between the supplier and consumer. This implies that users frequently cannot easily assess the quality of the service until they have consumed it. Governments may seek to avoid that service suppliers exploit such information asymmetries. Unlike goods, it is difficult if not impossible to subject services to any form of *ex ante* physical testing. Thus regulations will often be attached to the competence and conduct of the service supplier.⁵ This explains why in services there is often greater emphasis on the qualification requirements of the service supplier as a way to indirectly control the quality of the services provided.

2.5. In the context of developing countries, in addition to the foregoing, a frequently cited concern is the need for some form of government intervention to ensure that markets contribute to poverty reduction and help bring about inclusive and sustainable development.⁶ This policy objective may sometimes be pursued through regulation which aims to ensure that services are available to all citizens at equitable conditions, no matter their location or income. In the case of infrastructure services, for instance, universal service obligations may sometimes require expansion of the network to remote areas or affordable pricing for poorer segments of the population.

2.6. At the same time, it has been well noted in economic literature that regulation may be captured by special interest groups, and thus flourish for reasons totally unrelated to addressing market failure or development needs.⁷ Rather, in such a situation, regulation may primarily serve to sustain the advantage of certain groups who are intent on promoting their own economic rents without making any contribution to productivity. Governments and its regulatory bodies are thus subject to lobbying by special interest groups seeking to ensure that privileges and rents

² Majone, G (1997), "From the positive to the regulatory state: causes and consequences of change in the mode of governance", *Journal of Public Policy*, 17 (2), 136-67; Glaeser, E and Shleifer, A (2003), "Rise of the Regulatory State", *Journal of Economic Literature*, Vol.XL, June 2003, pp.401-425.

³ Blundell, J and Robinson, C (2000), "Regulation without the State. The Debate Continues", Readings 52, London: Institute of Economic Affairs.

⁴ Eberhard, A (2007), "Infrastructure Regulation in Developing Countries: An exploration of hybrid and transitional models", Working Paper No. 4, 200, Public-Private Infrastructure Advisory Facility, available online at www.ppiaf.org

⁵ See WTO (2012a), "Technical Standards in Services", Note by the Secretariat S/WPDR/W/49, 3 September 2012.

⁶ UNCTAD (2011), "Services, development and trade: the regulatory and institutional dimension", Note by the Secretariat TD/B/C.I/MEM.3/11, 15 December 2011, p.7; Cook, P, Kirkpatrick, C, Minogue, M, and Parker, D (2004) (eds), *Leading Issues in Competition, Regulation and Development*, Edward Elgar, Cheltenham, UK, p.11.

⁷ See for instance, Stigler, G (1971), "The theory of economic regulation", *Bell Journal of Economics and Management*, 2, 3-21; Peltzman, S (1976), "Toward a more general theory of regulation", *Journal of Law and Economics*, 14, 109-48.

stemming from regulation are maintained. In such cases, even when regulatory intervention is warranted on public policy grounds, governments may be "bought" into relying on those measures that benefit the interests of a few at the expense of the general good. The complexity and diversity of services regulation also implies that regulators who are less experienced or less resourced might be more easily "captured" by special interest groups even if they intend to act in pursuit of the "public interest".⁸

2.7. With the market-oriented transformation of services sectors, establishing appropriate and effective regulatory and institutional frameworks has thus become one of the biggest challenges faced by governments. Very generally all regulatory bodies need to address two fundamental issues.⁹ Firstly, to regulate effectively, the competent authority will need to be able to obtain the necessary information on market practices, costs and revenues of service suppliers, consumer demand, changes in technology affecting the sector, the macroeconomic environment, and so on. Inevitably, the regulator will know less about the market environment and business practices than the firms or individuals operating within it. Those who are regulated will also have insider knowledge which they might not reveal. Secondly, there is the challenge of ensuring that the regulatory body is not subject to political or commercial capture. In other words, mechanisms are needed to avoid that regulations and decisions favour any particular group at the expense of the general economic good.

2.8. Overcoming these problems requires considerable resources, expertise and strong political commitment on the part of the government. In this respect, it is also important to note that one of the GATS most important conceptual bases is the distinction between liberalization and de-regulation. Apart from market access and national treatment measures, which are subject to scheduling, trade liberalization under the GATS does not impinge on governments' ability to regulate. This is because the Agreement distinguishes between three types of measures: (i) quantitative restrictions on the entry of, or outputs by, the service supplier including legal form requirements and foreign equity limits; (ii) discrimination against foreign services and service suppliers through the modification of conditions of competition in favour of own nationals; and (iii) domestic regulations. Measures in categories (i) and (ii) are defined as market access and national treatment limitations that are to be reduced or eliminated through successive rounds of negotiations.¹⁰ Domestic regulations in category (iii) are not considered 'trade restrictions' as such, but the GATS acknowledges that they may nevertheless have trade restrictive effects and mandates the establishment of relevant disciplines under Article VI: 4.

2.9. Thus, under the GATS, "liberalization" in sectors where commitments are made, means granting market access (Article XVI) and national treatment (Article XVII). These provisions have a defined legal scope that applies only to six types of market-access restrictions and any form of national treatment discrimination. Apart from that, governments and regulators have the autonomy to decide the shape and content of the remaining regulatory framework. Indeed, the Preamble of the GATS affirms that:

"Recognizing the right of Members to regulate, and to introduce new regulations, on the supply of services within their 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 this right".

2.10. The GATS explicitly recognizes the challenges faced by developing countries. While it does not directly provide guidance on how to pursue a sound regulatory approach, the Agreement does contain a number good governance provisions. These include obligations on transparency (Article III), as well as on domestic regulation (Article VI). The latter contains a general obligation on the availability of judicial, arbitral or administrative tribunals or procedures for review of decisions at the request of an affected service supplier, and appropriate remedies where

⁸ See discussion of political economy considerations underlying regulatory intervention in WTO (2012b), "World Trade Report 2012, Trade and public policies: A closer look at non-tariff measures in the 21st century", pp.75-76.

⁹ Cook, et.al (2004), op.cit, pp.8-10.

¹⁰ Articles XVI (market access) and XVII (national treatment), and Article XIX (progressive liberalization) of the GATS. See also discussion on when a services measure can be considered to be a "trade restriction" in the WTO (2012b), op.cit, pp. 78-79.

justified.¹¹ Where the procedures are not independent of the agency entrusted with the administrative decision concerned, Members have to ensure that procedures in fact provide for an objective and impartial review.¹² For sectors where specific commitments are taken, there are additional obligations to ensure that all measures of general application are administered in a reasonable, objective and impartial manner; that the competent authority informs applicants of the decision concerning the application or its status; and that there are adequate procedures to verify the competence of professionals of any other Member.¹³

2.11. These principles share much in common with the elements commonly cited in the literature on regulation and development as "good practices".¹⁴ These include the design of objective, criteria-based and transparent rules, which reduce the scope for discretionary decision making, and the establishment of institutions empowered with an independent mandate.¹⁵ The discourse on regulation has also seen calls for generating benefits through regulatory reform and audits, with some of them addressing the impacts that regulatory policies have on trade and investment.¹⁶ Key questions raised in an UNCTAD study have been the economic impact of regulation, the potential economic and trade costs of regulatory measures; the need for an efficient, transparent and impartial design of regulation; and whether the policy objective could be achieved through other means or in a manner that might lessen its restrictive impact on trade or investment.¹⁷ Such an approach encourages the adoption of market access friendly regulation, where feasible, that is supportive of both trade liberalization and privatization.

2.12. While regulatory issues are faced by all governments, developing countries do have particular structural weaknesses that should be taken into account. It has been noted by researchers in the field of regulation that many regulatory agencies in developing countries are still quite fragile or non-existent. It is generally well recognized that it takes time and resources to build governance, management and organizational systems, as well as to develop new professional capacity.¹⁸ Yet, for liberalization to produce the expected efficiency gains without compromising on quality and other policy objectives, effective regulation or re-regulation and enforcement is often needed. The Diagnostic Trade Integration Studies (DTIS), which are undertaken in the context of the Enhanced Integrated Framework, have, for instance, identified the importance of an enabling policy and regulatory framework, efficient institutions and good governance as building blocks for addressing supply-side constraints.¹⁹ Although the DTIS studies were undertaken for specifically least developed countries, the general conclusion that regulation may impose cost-raising restrictions on services providers or it may erect entry barriers is shared by other studies on other countries.²⁰ An important finding has been that cost-raising non-discriminatory regulations not only deter foreign suppliers, but also inhibit the competitiveness of local firms. Various studies based on the OECD product market regulation indices have also found that regulatory barriers have a negative effect on the local services sectors' export performance.²¹

2.13. How to address the regulatory challenge from the perspective of developing countries is a subject that remains at a nascent stage and is beyond the scope of this Note. Nevertheless,

¹¹ Article VI:2 of the GATS.

¹² *Ibid.*

¹³ Article VI:3 and 6 of the GATS.

¹⁴ See for instance, Lafont, Jean-Jacques (2005), "Regulation and Development", Cambridge University Press, Cambridge; Eberhard, A (2007), *op.cit.*; and "APEC-OECD Integrated Checklist on Regulatory Reform" available at <http://www.oecd.org/regreform/34989455.pdf>

¹⁵ Mamdouh, H (2010), "Services liberalization, negotiations and regulations", paper presented at the Liberalisation of Trade in Services Conference convened by the Cordell-Hull Institute and hosted by the Australian Department of Foreign Affairs and Trade, in Sydney, Australia, December 10-12, 2010.

¹⁶ UNCTAD (2010), "Implication of International Trade and Trade Agreements for Primary Health Care: the case of services", Geneva.

¹⁷ *Ibid.*

¹⁸ See for instance, Eberhard, A (2007), *op.cit.*

¹⁹ See for instance, WTO (2004) "Assistance to Address Supply-Side Constraints", Note by the Secretariat, WT/COMTD/LDC/W/33 and Add.1, 26 May 2004 and 28 February 2005.

²⁰ See for instance, *inter alia*, WTO (2012b), *op.cit.*, pp.122-126; and Kox, H and Nordås, Hildegunn K (2006), "Services trade and domestic regulation", OECD Trade Policy Working Paper No 49.

²¹ See for instance, Kox, H and Hildegunn, K (2006) *ibid.* It should be noted that the measure of domestic regulation used in this study is however broader than the categories under Article VI:4 of the GATS. The PMR indices mainly cover developed countries, and few large emerging markets. Economic literature that looks specifically at the effects of licensing and qualification requirements and procedures, and technical standards in services is very limited.

two important and inter-related aspects of the problem can be discerned, namely the rule-making machinery, and the design and mandate of the implementing institutions.²² The latter, in particular, raises significant issues of political mandate, resources and capacity. Proper sequencing of the regulatory framework and the opening of sectors to market competition have also frequently been cited as an important consideration and challenge for developing countries.²³ The sections below take a closer look at the issues that may arise under each of these aspects.

2.1 Rule-making and regulatory practices

2.14. With respect to the development of rules, one of the challenges to be addressed is the formulation of rules that can help improve the business environment and to the maximum extent possible, reduce the scope for discretionary decision-making. This often calls for rules to be coherent, clearly stated and drafted, and based on objective criteria. Another related issue is the choice of legal instrument, whether rules should be contained in general legislation or in other forms of regulation, decrees or administrative guidelines. This can be an important consideration for effective application and should take into account the need for possible future flexibility to adjust in the light of market and technological developments.

2.15. Services sectors are typically regulated at all levels of government, be it central, regional or local. Non-governmental bodies may also be part of the regulatory framework when they exercise powers delegated to them by the State. Thus, apart from the content of the rules, the jurisdictional interface between central and sub-central government levels, as well as non-governmental bodies, need to be taken into consideration. Ideally, all regulatory bodies should act in a coherent and complimentary way. These challenges are, of course, not unique to developing countries, but they may pose greater difficulty due to financial and human resource constraints. In addition to the governmental interface, each service sector has its specificities and technical complexities. Thus, while some regulations are applied across all services sectors, others may be sector-specific. Again, ensuring coherence between general and sector-specific regulation, as well as the intersection with other regulatory fields, such as competition and investment policy, can pose a significant challenge for rule-making. Moreover, the ever-changing nature of markets and technologies, which is a key feature of several services sectors, can easily render the regulatory regime outdated, and demand continuous and systematic fine-tuning of the regulatory framework.²⁴

2.16. On regulatory practices, there has been significant work on the importance of transparent rules and streamlined processes for improving the business environment. The World Bank "Doing Business" reports have been tracking such reforms and regulatory practices, of which transparency is a key factor, around the world for the last 10 years.²⁵ The indicators measure the procedures, time and cost required to complete a transaction in accordance with relevant regulations. The surveys have found that the economies which rank highest on the ease of doing business are not those where there is no regulation—but those where governments have managed to create rules that facilitate interactions in the marketplace without needlessly hindering the development of the private sector. One of the key findings being that economies which rank high tend to combine efficient regulatory processes with strong legal institutions that protect property and investor rights. An effective regulatory environment has in turn been found to boost trade performance.

2.17. While these surveys capture more than services sector enterprises they help provide a general indicator of the cost and complexity of regulatory processes on businesses in a particular economy. In this regard, the latest "Doing Business" report for 2013 has found that business-related regulatory practices have been slowly converging as economies with initially poor performance narrow the gap with better performers. Among the 50 economies with the biggest improvements since 2005, the largest share—a third—are in Sub-Saharan Africa. For these and many other developing countries, it nevertheless remains a significant development challenge to

²² See, Mamdouh, H (2010), op.cit.

²³ Majluf, L and Zarrilli, S (2007), "Challenging Conventional Wisdom: Development implications of trade in services liberalization", UNCTAD Trade, Poverty and Cross-Cutting Development Issues Study Series No.2; and UNCTAD (2010), op.cit.

²⁴ WTO (2012c) "Background Note for the Workshop on Aid for Trade and Services", Note by the Secretariat WT/COMTD/AFT/W/34, 29 June 2012.

²⁵ See the website <http://www.doingbusiness.org>

continually ensure that regulations and procedures evolve in accordance with market and technological developments.

2.18. Box 1 below provides an example of how some of these challenges are being addressed in projects supported by "Aid for Trade". Although, such initiatives are part of a wider programme of regulatory reform aimed at improving the overall business and investment climate, service suppliers stand to benefit given the prevalence of licensing and qualification requirements in their sectors.

Box 1 Aid for Trade Case Study: Kenya Business Regulatory Reform Unit (BRRU)

One of the key priorities of the Kenyan Government is to transform Kenya into a competitive investment destination. Excessive, inaccessible and burdensome licensing practices have been identified as major and tangible impediments in the achievement of this goal and broader economic development. In response to this challenge, the Government of Kenya launched a review and reform of business licences and permits starting from 2005, with recognized positive results and increased interest in regulatory reforms.

A Business Regulatory Reform Unit was established to permanently keep track of all regulatory regimes and licensing in Kenya and ensure that new regulations, licenses, fees and charges do not create unnecessary burdens on business and meet international best practices. The Unit is also expected to liaise with Regulators to ensure that all future regulations with respect to licensing conform to international best practice. 1,325 separate business licenses, fees and user charges were identified in Kenya. Since then, action has been taken to simplify or eliminate most of these licenses. In total, 379 licenses have so far been simplified, while 315 licenses were eliminated.

Among the key activities are establishing a Business Regulation Law, currently the Business Regulation Bill, that will legally establish a high profile Regulatory Reform Committee that will spearhead the reform process, with the assistance of the Business Regulatory Reform Unit (BRRU); and the supervision and screening of the quality of new licensing regulations through a Regulatory Impact Assessment (RIA) system.

Source: Aid for Trade website, <http://www.oecd.org/countries/kenya/46982094.pdf>

2.19. There are currently very few "Aid for Trade" projects which specifically addresses services related-domestic regulatory challenges. It is thus difficult to draw generalized lessons from their experiences.²⁶ That being said, the Kenyan regulatory reform project described in Box 1 highlighted the following challenges as affecting the pace of reform. These include: conflicting interests between government departments and regulators in-charge of various critical aspects of licensing; fear of reforms and change in administrative processes, which poses a threat to lax institutions that would not want to move away from their comfort zones; delays in passing regulations through the Parliamentary process; the cost of carrying out the various activities is expensive and requires extensive planning and budgeting; and resources may fall short in some periods and thus delay the process.²⁷

2.2 The institutional framework

2.20. Not only do developing countries face the challenge of formulating appropriate rules and streamlining regulatory procedures, there is the key issue of the accompanying institutional framework. As the shift towards private or public-private provision of services has come later to developing countries, there is often less experience with the role and function of a regulator as

²⁶ WTO (2012c) op. cit. The "Background Note for the Workshop on Aid for Trade and Services" lists a total of 276 case stories. Of these only a few can be said to indirectly have a services-related regulatory component, for example: Comoros business services and regulatory environment (including for tourism); Malawi Business Environment Strengthening; Costa Rica FDI Attraction and Participation in Global Value Chains; Maldives EIF support to streamline business support services; and Tanzania Business Sector Support Programme.

²⁷ See description of problems encountered in the Kenyan Business Regulatory Reform Unit, <http://www.oecd.org/countries/kenya/46982094.pdf>

distinct from that of a government ministry. In some cases, certain sectors might be operating in a regulatory vacuum. Often mandates of existing agencies had to be reviewed, sometimes completely changed, to reflect the new policy direction, for example from a government-controlled to a competitive market sector. The starting point is thus the mandate of a regulatory institution, which must be carefully drawn to reflect its objectives, functions and *modus operandi*, and its relationship to the government.

2.21. In this regard, one of the most used regulatory model, particularly in infrastructure services, for ensuring a separation of functions has been the establishment of independent regulatory agencies. The purpose of independence is to ensure that the regulator is free from commercial or political influence. In other words, the independent regulator is expected to pursue its stated mandate in an impartial manner without the risk of falling captive to vested interests. While independent, the institutional structure usually provides for an effective interface between various governmental institutions dealing with different regulatory frameworks of mutual relevance. The interface with private-sector institutions, think-tanks and civil-society organizations are usually also encouraged and facilitated. This model cannot however be said to exist in all sectors. It should be noted that in some professional services, self-regulation is a more common model and regulatory powers are granted to professional bodies.²⁸ In such a situation, it is not uncommon for a practicing professional to also assume a decision making position in the body.²⁹ Thus, the stress might be more on the impartiality of decision making and transparent processes.

2.22. Independence of the regulator does not mean the absence of an accountability framework. Rather, in virtually all models of independent regulation, a regulatory body would be accountable to the legislature, the government and the public. However, the terms for such accountability are usually drawn in such a way so as not to compromise its independence of action. Whilst not all developing countries have fully independent regulators, it is a model which has been propagated extensively, particularly with respect to infrastructure services. For instance, the African Forum of Utility Regulators recommends that the following key principles form part of an initial framework of for utility regulation in Africa:

"Minimum regulation necessary to achieve policy and sector objectives;

Adherence to transparent decision-making and due process requirements;

Independent or autonomous regulation where possible [emphasis added];

Accountability towards government, investors and end-users;

Promotion of competition by limiting anti-competitive behaviour".....³⁰

2.23. Establishing an independent regulator, should that be considered to be the appropriate model for the sector, is not without challenges. There are issues of capacity and human resources. A recurring challenge raised in DTIS studies is the limited technical and institutional capacity within government and the private sector to implement a regulatory reform process. The efficacy of all regulatory frameworks requires specialist skills and relevant experience, and good access to data and a thorough understanding of regulatory fundamentals and the operations of market actors. Building that professional capacity in newly established regulators is a considerable developmental challenge particularly in view of the dynamic and innovative nature of competitive markets. Economies with a small population and a limited pool of professionals with the necessary skills to draw upon, may also experience a particular difficulty in ensuring that the same individual does not assume more than one role in the sector.

2.24. In the field of utility regulation, global surveys have found that the most frequently reported institutional constraint was the lack of specialized skills: 30% of respondents cited insufficient training as a significant constraint and 61% stated that training received to date was deficient in

²⁸ See discussion on professional services regulation in UNCTAD (2004), Trade and Development Aspects of Professional Services and Regulatory Frameworks, Note by the UNCTAD Secretariat, TD/B/COM.1/EM.25/2, 25 November 2004.

²⁹ See for instance, the description of legal services in the Note by the Secretariat, "Regulatory Issues in Sectors and Modes of Supply", S/WPDR/W/48, 13 June 2012.

³⁰ "Framework for Utility Regulation in Africa" as quoted by Eberhard, A (2007), op. cit., p.13.

that it generally lacked continuity and was poorly targeted.³¹ Interestingly, the same survey also noted that capacity constraints may be alleviated by initially limiting regulatory discretion and adopting a gradual approach to modifying or expanding the scope of the regulator's responsibilities as capacity is built up for a more fully fledged agency. In other words, "second best" solutions may have to be adopted where local situations do not allow the implementation of "first best" practices.

2.25. Other challenges that have been cited in various studies on regulation and development deal with issues of good governance such as political interference, corruption, and a lack of transparency and participation.³² These are, of course, generic challenges faced by any regulatory agency and not specific to developing countries. "Good practices" to minimize or avoid such problems, typically suggests that regulations need to take into account a number of variables. These include: the extent that they are supported by an effective legal infrastructure to reduce uncertainty and scope for discretion; whether there is a separation of administrative and political roles with decisions delegated to an independent agency rather than taken by the government; the degree of transparency and accountability of rules that specify the procedural framework; whether there are appropriate financial and professional resources to ensure that regulatory agencies can work effectively; and the strength of oversight judicial review mechanisms.³³ Research conducted under the auspices of the United Nations Department of Economic and Social Affairs has found that openness of an economy by itself may not be associated with higher income growth unless it is supported by an efficient regulatory framework conducive to private sector activities.³⁴ The UNCTAD World Investment Report 2012 has also noted that without an adequate regulatory framework, a country will not be attractive for investors, because they seek clarity, stability and predictability.³⁵ The Report also highlighted that regulations must be adequately enforced by impartial, competent and efficient institutions.³⁶

2.26. At the same time, other research on regulatory governance has also noted that in transferring conditions, which have usually been distilled from developed country experiences, it is necessary to modify and to fit them to the many and varied political and institutional contexts of developing countries.³⁷ For instance, there might be a greater degree of government intervention to support an overarching development agenda and in certain cases a political decision might be made to place the needs of the poor above the requirements of economic efficiency.³⁸ This might be because direct market intervention such as price controls and quotas might be the only feasible option as they are easier to administer rather than fully fledged regulatory frameworks and standards. That being said there is much existing institutional regulatory reform activity in developing countries, which recognizes that development needs might be better served through more appropriate market regulation and efficient regulatory mechanisms.³⁹ The specific challenge faced by many developing countries is to create "win-win" situations by building regulatory institutions with the capacity to provide an environment conducive to stimulating inward investment and trade, while addressing the structural characteristics and developmental needs of the economy.⁴⁰

³¹ Tremolet, S and Shah, N (2005), "Wanted! Good Regulators for Good Regulation: An evaluation of human and financial resource constraints for utility regulation", as quoted by Eberhard, A (2007), op.cit.

³² Lafont, Jean-Jacques (2005), op.cit.; Eberhard, A (2007), op. cit.; Cook, et.al (2004), op.cit; Amann, E (2006), "Regulating Development: Evidence from Africa and Latin America", Edward Elgar, Cheltenham.

³³ These "good practice" conditions are adapted from Minogue, M and Cariño, L, (2006), "Introduction: regulatory governance in developing countries", and Minogue, M (2006), "Apples and oranges: comparing international experiences in regulatory reform", pp. 73-74 in Minogue, M and Cariño, L, (eds) (2006), *Regulatory Governance in Developing Countries*, Edward Elgar, Cheltenham.

³⁴ Hafeez, S (2003), "The Efficacy of Regulation in Developing Countries", ST/ESA/2003/DP/31, UN Economic and Social Affairs, January 2003.

³⁵ UNCTAD (2012), World Investment Report 2012: Towards a new generation of investment policies, Geneva, p.109.

³⁶ Ibid, p.118.

³⁷ Minogue, M (2006), op.cit.

³⁸ See cases studies on institutional reform in developing countries, in Minogue, M and Cariño, L, (eds) (2006), op.cit., pp.183-299.

³⁹ See, for instance, Hafeez, S (2003), op.cit.

⁴⁰ Jalilian, H, et.al (2006), "Creating the condition for international business expansion: the impact of regulation on economic growth in developing countries - a cross-country analysis", in Amann, E (ed) (2006), op.cit.

3 TRADE AND DEVELOPMENT ASPECTS OF THE REGULATORY CHALLENGE

3.1. The economic gains from services liberalization mainly result from its effect on increasing competition between service suppliers in the domestic economy. Thus, what matters are improvements in overall market contestability. Unless policy reform brings about competition, privatization of state monopolies may only transfer monopoly rents from public to private owners. It also raises the perennial question of which should come first, regulations or the liberalization of services markets. Given the specific characteristics of each service sector and national differences, much will depend on the objectives of the reform programme, the role that regulation is intended to play and the state of existing institutions. There is no "one size fits all" answer to this question. Nevertheless, it is possible to point to some general considerations.

3.1 Internal aspects

3.2. In practice, it is often the privatization and subsequent trade liberalization in a particular sector which drives the regulatory reform agenda, and governments have developed and evolved their regulations and institutions as part of the same process.⁴¹ In the telecommunications sector, for example, it was the decision by many developed and developing countries to liberalize the market which resulted in the introduction of new legislation that promoted consumer interests through disciplines on interconnection, transparent licensing procedures, independent regulators, non-discriminatory universal service obligations, etc. Indeed, it was the Reference Paper on telecommunications negotiated at the WTO which helped shape the regulatory environment for that sector. There can thus be strong synergies between trade and regulatory instruments.

3.3. On the other hand, "regulatory capture" (discussed in section 2 above) by special interest groups may obstruct the introduction of new regulations or institutions which seek to reduce the scope for discretionary decision making. In such a situation, institutions may have traditionally been weak and under resourced as it served certain vested interests to keep them so. This is a political economic problem that can occur even without any trade opening. Regulatory fragility, may in turn be used as arguments against liberalization to external competitors. Unless there is strong government commitment towards reform, experience has shown that it is difficult to overcome "regulatory capture" and develop policies and institutions that are free from commercial or political interference.⁴²

3.4. Regulation is crucial in many service sectors regardless of whether the sector is open to trade. Such regulation is needed to ensure that services markets work properly by addressing problems associated with information asymmetries, natural monopolies and externalities. In some service sectors, competition is unlikely without appropriate regulation. For example, in telecommunications or other infrastructure-based services, regulation is important to ensure that new entrants can interconnect on to the network, which all operators have to use, at reasonable price and conditions. This will affect both domestic and foreign telecoms providers. Unless there is regulation which prevents the owner of the network from exploiting its control of essential infrastructure, the full benefits of competitive markets will not be achieved by trade liberalization. Pro-competitive regulations and prudential regulations in the telecommunications and financial sector respectively have been found to be positively related to trade and investment.⁴³

3.5. At the same time, there are often concerns that the introduction of domestic and foreign competition may carry risks and potential costs. For instance, if prices before liberalization were kept artificially low through cross-subsidisation or governmental financial support, it can be expected that when market forces are allowed to operate, prices may actually rise in the short-term.⁴⁴ Moreover, there is a risk that private providers will "skim off" the most profitable clients and cease to serve certain groups of consumers or geographical areas that are deemed unprofitable.⁴⁵ It is also widely accepted that adequate prudential regulation and supervisory

⁴¹ See for instance the discussion in Chaitoo, R (2008), "Services liberalization and domestic regulation: Why is it important?", CUTS/FICCI Conference on Global Partnership for Development: Where do we stand and where to go?, 12-13 August 2008, New Delhi, India.

⁴² Lafont, J (2005); Eberhard, A (2007); Cook, et.al (2004), op.cit.

⁴³ Kox, H and Nordås, H (2006), op. cit.

⁴⁴ Mattoo, M, et.al (2008), "A Handbook of International Trade in Services", Oxford University Press, Oxford, see discussion on economy-wide effects, pp.10-17.

⁴⁵ Cali, M, et.al (2008), "The contribution of services to development and the role of trade liberalization and regulation", Overseas Development Institute Working Papers, no. 298.

control has to accompany financial sector liberalization.⁴⁶ In short, regulatory reform entails adjustment costs and may require flanking policies to deal with adjustment costs as well as specific regulatory capacity and institution building. Each of these concerns is a major topic of research in themselves and it is beyond the scope of this Note to fully review the associated literature. Nevertheless, a general principle of economic theory is that the "first best" choice is to use instruments that are closely related to the source of the problem or distortion. For instance, non-discriminatory universal service obligations in licensing conditions for all market actors might be a better way to widen access rather than to restrict competition in order to protect an inefficient monopoly supplier. Managing services reforms, which can include trade liberalization as part of the strategy, ultimately requires a careful combination of competition-related policies and regulation.

3.2 External aspects

3.6. From a trade perspective, the problem is how to deal with two issues, namely situations where: domestic regulations rather than pursuing public policies are used as an alternate form of protectionism; and the unintended trade-restrictive consequences of national differences in regulatory requirements and procedural complexities in their implementation. Much of the work in the domestic regulation negotiations has focused on the latter, where even if there is no protectionist intent, cumbersome and/or opaque licensing and qualification procedures, excessively burdensome or complex requirements, and administrative "red tape" can still hamper trade in services. The sheer diversity of regulatory systems and standards in markets internationally, regionally, as well as national and sub-national differences, can also significantly raise the cost of compliance for the service supplier, even in situations where market access and national treatment limitations have been removed (see Box 2).

Box 2 Explaining the Underdevelopment and the Segmentation of Markets for Professional Services – Domestic Regulation

In the Ugandan DTIS study, one of the important challenges cited was how to ensure that the regulatory frameworks in place do not restrict directly or indirectly competition in service markets and slow down their expansion in spite of the extensive liberalization measures. An equally important problem was the absence of regulation, which can create a legal vacuum that actually constrains business growth and allows many opportunities for unfair competition and corruption. Furthermore, one of the problems faced by the Ugandan professional services sector was the highly segmented nature of the regional market, which did not allow economies of scale to develop.

A key challenge of services reforms relates to putting in place an adequate regulatory framework that supports the effective implementation of existing engagements. Decisions on the nature and pace of reform need to be informed by careful analysis and an understanding of good practices. A national regulatory assessment mechanism covering all professional services sectors and education services should be put in place and a roadmap for action with concrete objectives and targets needs to be developed.

In order to address market segmentation due to domestic regulation, an important regional development has been the inclusion of specific chapters in the East African Common Market Protocol aimed at inter alia improving co-operation between regulatory bodies, harmonization and mutual recognition of qualifications and standards, and facilitating registration and licensing.

Source: "Draft Uganda Trade Diagnostic Study Update", prepared for the Enhanced Integrated Framework, December 2012 and the East African Common Market Protocol.

3.7. Another aspect of regulatory weakness at home is the impact that it might have on services exports. Since regulations and institutions in many developing countries are still evolving or are not yet established, their service suppliers may not have the experience that would help them navigate through sophisticated regulatory systems that might be found in other countries. Thus, as highlighted in work undertaken by the Overseas Development Institute, weakness in the domestic regulatory framework does not just affect local market conditions but can adversely affect services

⁴⁶ *Ibid.*

exports.⁴⁷ In principle, as domestic service suppliers get used to operating within a modern standards-based regulatory framework, they will also develop the capacity that can enable them to meet requirements in foreign markets and develop potential export opportunities. Research by UNCTAD on professional services, has, for instance, noted the importance of establishing adequate regulatory frameworks for professions in developing countries in order to enhance the competitiveness of their service suppliers.⁴⁸ Some studies on the trade effects of domestic regulation have found that regulation not only hampers inward investment and the inflow of services, but also inhibits the outward orientation of local service suppliers.⁴⁹ Another finding based on the European Internal Market experience has been that reducing regulatory barriers not only results in more trade, but first and foremost it improves the productivity and competitiveness of local firms.⁵⁰

3.3 Regulatory co-operation

3.8. Increasingly, regulatory co-operation is being promoted as a way to deal with externalities generated by national differences in regulation and to enhance the capacity of developing countries. Such co-operation is often directed at improving regulators' understanding of, and confidence in, the standards, requirements and procedures with which they may not be familiar with. In some cases, the regulatory divergence between jurisdictions is a direct consequence of differences in societal values and risks tolerance. In such cases, co-operation may also be directed at finding less trade-restrictive means of achieving a particular objective or on ways to assist foreign services suppliers to meet particular standards or other requirements.

3.9. Indeed, there is a relatively long history of regulatory cooperation at the sectoral-level, such as in postal and communication, financial services, transportation, education, as well as certain professional services. Such cooperation has been necessary to deal with externalities that are generated by international interdependencies and which demand a coordinated regulatory response from different jurisdictions in order to be effective. It has also been required to allow for the compatibility and interoperability of different systems, measures or qualifications.

3.10. For example, the International Federation of Accountants (IFAC), the International Accounting Standards Committee (IASC) and the International Organization of Securities Commissions (IOSCO) set international standards for the accountancy sector. The Universal Postal Convention defines general guidelines on international postal services and regulations on the operations of letter post mail. The standards developed by the International Telecommunications Union (ITU) are fundamental to the functioning and interoperability of information, communication and technology (ICT) networks globally. In education, the UNESCO Regional Conventions on recognition of qualifications have sought to address the recognition of academic qualifications for academic purposes and sometimes play a role in recognising diplomas for professional purposes.

3.11. In the financial sector, the Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters with the objective of enhancing understanding of key supervisory issues and improving the quality of banking supervision worldwide. A Financial Stability Board (FSB), which brings together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts, has also been established. The FSB coordinates the work of national financial authorities and international standard setting bodies with the aim of developing and promoting the effective regulatory, supervisory and other financial sector policies.

3.12. Although not undertaken primarily for the purposes of trade, such cooperation has important implications for trade and development, as they can encourage greater understanding, if not harmonization, amongst regulators. From the perspective of developing countries, an important part of the regulatory challenge is also to develop the capacity as well as to have the resources to participate in these diverse fora. There are risks that international standard setting or

⁴⁷ Cali, M, et.al (2008), op.cit.

⁴⁸ See UNCTAD (2004), op.cit.

⁴⁹ Nordas, H and Kox, H (2009), "Quantifying regulatory barriers to services trade", OECD Trade Policy Working Paper, No.85

⁵⁰ Monteagudo, J, et.al (2012), "The economic impact of the Services Directive: A first assessment following implementation", European Commission, DG ECFIN, Product Market Reforms Unit.

regulation may by chance or by design, serve the interests of those that have the resources to participate and influence the process. Whilst such concerns have been very much at the forefront in goods trade, there has been less discussion and awareness of it in services trade. Some of this has to do with the fact that the regulation of services is less developed at the international level and where such instruments do exist, they tend to be sectorally focused and outside the direct purview of trade ministries.

3.13. That being said, it is interesting to note that in some of the more recent preferential trade agreements, attention has been given to some of the developing country-specific issues of appropriate regulatory frameworks, standards and procedures, as well as participation in international standard setting organizations (see Box 3). While these are but some examples drawn from outside the WTO, they help highlight how some of the challenges faced by developing countries in regulatory cooperation have been addressed in a trade context.

Box 3 CARIFORUM-EC Economic Partnership Agreement - examples of provisions addressing regulatory framework challenges faced by developing countries

CHAPTER 5

Regulatory Framework

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Section 7

Tourism Services

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Article 113

Small-and medium-sized enterprises

The EC Party and the Signatory CARIFORUM States shall endeavour to facilitate the participation of small- and medium sized enterprises in the tourism services sector.

Article 114

Mutual recognition

The Parties shall cooperate towards the mutual recognition of requirements, qualifications, licenses or other regulations in accordance with Article 85.

Article 116

Environmental and quality standards

The Parties and the Signatory CARIFORUM States shall encourage compliance with environmental and quality standards applicable to tourism services in a reasonable and objective manner, without constituting unnecessary barriers to trade, and shall endeavour to facilitate the participation of the Signatory CARIFORUM States in relevant international organisations setting environmental and quality standards applicable to tourism services.

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CHAPTER 7

Co-operation

Article 121

Cooperation

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2. Subject to the provisions of Article 7, the Parties agree to cooperate, including by providing

support for technical assistance, training and capacity building in, inter alia, the following areas:

- (a) Improving the ability of service suppliers of the Signatory CARIFORUM States to gather information on and to meet regulations and standards of the EC Party at European Community, national and sub-national levels;
- (b) Improving the export capacity of service suppliers of the Signatory CARIFORUM States, with particular attention to the marketing of tourism and cultural services, the needs of small and medium-sized enterprises, franchising and the negotiation of mutual recognition agreements;
- (c) Facilitating interaction and dialogue between service suppliers of the EC Party and of the Signatory CARIFORUM States;
- (d) Addressing quality and standards needs in those sectors where the Signatory CARIFORUM States have undertaken commitments under this Agreement and with respect to their domestic and regional markets as well as trade between the Parties, and in order to ensure participation in the development and adoption of sustainable tourism standards;
- (e) Developing and implementing regulatory regimes for specific service sectors at CARIFORUM regional level and in Signatory CARIFORUM States in those sectors where they have undertaken commitments under this Agreement;

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Source: CARIFORUM-EC Economic Partnership Agreement Legal Text

3.14. In the context of the East African Common Market, specific attention has also been given to regulatory co-operation on the harmonization and recognition of qualification and experience, as well as disciplines on regulations relating to the movement of persons, workers and capital (see Box 4). What is interesting in these initiatives is the combination of provisions which are aimed at not only disciplining, but also at promoting regulation, as well as participation in international standard setting. There also seems to be a focus on regulatory issues pertaining to sectors and modes, with emphasis given to regulatory capacity building.

Box 4 East African Common Market - examples of provisions to minimize impact of regulations on services trade

THE EAST AFRICAN COMMUNITY COMMON MARKET (RIGHT OF ESTABLISHMENT) REGULATIONS

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REGULATION 9 Registration and Licensing

1. Each Partner State shall submit to the Secretariat:

- (a) the names of the competent authorities of the Partner State;
- (b) the relevant registration, permit and licensing requirements; and
- (c) any other relevant approvals required to undertake economic activities.

2. The Secretariat shall disseminate the information submitted under paragraph 1 of this regulation to competent authorities of the other Partner States.

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REGULATION 11 Cooperation between Competent Authorities

The competent authorities of the Partner States shall co-operate in order to:

- (a) share information on priority economic activities where the right of establishment makes a valuable contribution to the economic development of the Partner States;

(b) simplify the processes and procedures involved in obtaining the relevant licenses and other relevant documents;

(c) harmonise the fees to be paid for obtaining and processing necessary documents; and

(d) share any other relevant information pertaining to the right of establishment.

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Source: East African Common Market Protocol and Annexes

4 CONCLUDING OBSERVATIONS

4.1. The purpose of this Note has been to provide background information on services-related regulatory challenges that might be faced by developing countries. Given the purpose of this document, which was requested to help Members in their discussions of the regulatory issues Note (S/WPDR/W/48), it does not seek to draw any particular conclusions. It is envisaged that, in any ensuing discussions, Members would complement the information provided in the Note with their own specific experiences, as appropriate. To assist further discussions, some general observations based on the foregoing appear pertinent:

- a. Development and strengthening of institutional and regulatory capacity to effectively remedy market failure, assess risks and safeguard public interests are critical to ensuring the smooth functioning of services markets. In some service sectors, competition is unlikely without appropriate regulation. Liberalization of services markets has thus required greater emphasis on formulating new regulation or re-regulation to ensure regulatory quality and efficiency, and transparent processes, as well as appropriately mandated regulatory bodies. It is useful to recall that the GATS, in its Preamble, recognizes "...the right of Members to regulate, and to introduce new regulations, on the supply of services within their 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 this right".
- b. Much of existing literature on addressing regulatory weakness suggest that the challenges faced are not about having more or less regulation, but more in terms of having better regulation - that is, regulation which more effectively achieves public policy objectives with the least distortion on markets. How to best tackle such challenges from the perspective of developing countries is a subject that remains at a nascent stage. That being said, two important and inter-related aspects of the regulatory challenge can be discerned, namely the effectiveness of the rules and procedures, and the regulatory institutions established to implement them.
- c. Certain research on regulatory governance has noted that in transferring conditions and practices from developed country experiences, it is necessary to modify and to fit them to the many and varied political and institutional contexts of developing countries. That being said, often the main issues faced by developing countries are on how regulation is adopted and implemented, rather than on the key principles of sound regulation, such as principles of transparency, impartiality, independence and accountability.
- d. In terms of designing and implementing regulatory frameworks, developing countries are considered to face particular knowledge, financial and human resource constraints. Overcoming these problems requires considerable resources and expertise, as well strong political commitment on the part of the government. Moreover, given the time that might be needed to develop and strengthen institutional and regulatory capacity, transition periods, and the proper sequencing of the regulatory framework and the opening of sectors to market competition are important considerations. Equally important is the avoidance of "regulatory capture" by special interest groups who may obstruct the introduction of new regulations or institutions. This is a political economic problem that can occur even without any trade opening. In practice, it is often the

liberalization of market access in a particular sector which drives the regulatory reform agenda, and governments have developed and evolved their regulations and institutions as part of the same process.

- e. Inadequate regulatory frameworks, or their complete absence, may have implications on trade and investment, as well as inhibit the competitiveness of local service suppliers. Lack of experience in meeting regulatory requirements and standards may also affect their ability to supply foreign markets. It is worth recalling that in Annex C of the Hong Kong Ministerial Declaration, it was agreed in the paragraph on technical assistance that "... such assistance should be provided on, inter alia, compiling and analysing statistical data on trade in services, assessing interests in and gains from services trade, **building regulatory capacity** [emphasis added], particularly on those services sectors where liberalization is being undertaken by developing countries". However, while these have been recognized as important supply side constraints, "Aid for Trade" seems to have been an underutilized avenue for addressing them. There are currently very few initiatives that are aimed at specifically addressing capacity constraints in the development of services-related regulatory and institutional frameworks. Similarly, there is relatively little on how service suppliers in developing countries can be facilitated to meet requirements and procedures in export markets. Finding ways to support regulatory capacity building and cooperation so as to complement services policy reform and minimize the effects of regulatory diversity across jurisdictions could do much to foster trade and development.
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