

## University of Groningen

### Developing Countries and GATS

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## Developing Countries and GATS

Edited by:  
Catrinus Jepma and  
Elise Kamphuis

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# Developing Countries and GATS

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Catrinus Jepma and Elise Kamphuis

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Groningen, June, 2003

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## Preface

In January 2000, WTO Members started a new round of negotiations to promote the progressive liberalisation of trade in services. Trying to liberalise international trade in services through multilateral negotiations is relatively new. However, trade in services is gradually increasing not only because various countries' policies concerning services sectors are increasingly market oriented these days, but also because services are increasingly being traded electronically between countries.<sup>1</sup>

Many developing countries have demonstrated little interest in the GATS negotiations. Furthermore, little impact assessment of international trade in services and developing countries economies has been made thus far. Various developing countries, however, fear that through liberalising services sectors developed countries may try to dominate their domestic markets, or that they may lose sovereignty.

Against that background, at the request of the Netherlands' Ministry of Foreign Affairs, the Science Shop of Economics, Management & Organization of the University of Groningen started a masters thesis project concerning the GATS and developing countries in September 2002. The Science Shop selected a group of 7 students of economics, business administration and law that were willing and capable to write a masters thesis in the framework of the project. These students, Arjan Douma, Alice Stegeman, Bibian Willemsen, Friso de Jong, Gertin Bies, Klaas Markvoort and Sigrid Weitenberg, analysed the possible impact of the GATS-negotiations, mainly through case studies for different developing countries and different services sectors. The main results of their studies are presented in this report.<sup>2</sup>

During the project the students were advised and supported by: dr J. Wiers, Netherlands' Ministry of Foreign Affairs, F.D. van Loon, ING bank, M.J. Braeken, Ministry of Foreign Affairs, and W.L.E. Quaadvlieg, VNO-NCW. We would like to thank them for their time and advice. We would also like to thank the (other) supervisors of the students: H.G. Krijnen, dr H.C. van der Blonk, dr C.L.M. Hermes, dr M.A.G. van Offenbeek, prof. dr. B.W. Lensink, and prof. dr H.H. Van Ark for coaching the students.

Catrinus Jepma and Elise Kamphuis

Groningen, May 2003.

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<sup>1</sup> WTO (2001), Guide to the GATS, An Overview of Issues for Further Liberalisation of Trade in Services.

<sup>2</sup> The complete studies/master theses can be ordered by sending an email to the Science Shop of Economics, Management and Organization, emailaddress: wewi@eco.rug.nl, at the price of 35 per thesis.



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## Summary and conclusions

The interest in the GATS-negotiations and their potential impact on developing countries (DCs) seems to increase as the present negotiations Round progresses. In that spirit, this report typically focuses on the DCs' potential interest in those negotiations, and on what basis to negotiate in particular. Clearly GATS has not specifically been set up for DCs: just as GATT/WTO, also GATS has been designed for all Parties, although some specific DC provisions have been recognised. Moreover, unlike the non-services sector share is the services share in the formal economies of DCs on average significantly smaller than in most industrialized countries; this is even more true for the DC share in international trade in services.

This is not to say, however, that the DCs' potential stake in the present GATS negotiations' outcome would be equally modest. As many services are relatively labour intensive and as various services' productivity is less easy to increase than that of non-services production, the developing world can generally be expected, as time progresses, to be able to (further) develop comparative advantages in generating services. Some clear cases are the booming software sector in India, the rapidly growing market of outsourcing administrative work to China, tourism in South-East Asia, or healthcare services rapidly developing in South-Africa and Latin America, to mention just of a few clear examples. Liberalising such markets may strongly benefit DCs.

This equally applies insofar as DCs succeed in taking advantage of the technological knowledge base that exists in the industrialised world by reaping its positive externalities either via incoming foreign direct investment, or via the international mobility of their inhabitants that succeed in enhancing their knowledge and schooling by (temporarily) moving abroad and introducing that knowledge back into their home countries.

So, the potential interests of DCs in further liberalisation of the services sector under GATS seems clear enough. This, however, is not to say that there are no significant dilemmas at the same time. In the following we will shortly go through them from the DCs' perspective based on the 4 modes distinguished under GATS.

1. Under the first mode basically liberalisation would imply that services generated in DCs can be exploited better and more readily as the object of outsourcing services sought by companies in the industrialised world. In fact, as far as this mode is concerned, the DCs' role is mostly rather passive as far as the GATS negotiations is concerned, as in the end the market incentives will determine if and to what extent foreign companies decide to get involved in outsourcing in DCs. Once they decide to do so, however, it is up to DC producers to enter (and increase market share at) that market. 'Offers and requests' can basically be exchanged between private partners, so that explicitly introducing this at the official level in the GATS negotiations seems on average less key to DCs.

2. Under the second mode liberalisation would mean that access to consume local services in DCs would improve. Tourism and health care in DCs are clear examples of this, and here again market decisions will determine if and how much foreign consumers will prefer (or are allowed) to spend their holidays or undergo surgery in DCs. Yet, the degree to which DCs open up their territory for offering such services to foreigners is not completely undisputed. As soon as luxury facilities emerge in DCs to satisfy the requirements and demands of well-to-do foreign clients, risks of crowding out similar facilities for the local population may start to emerge as well. Health care may pose an example insofar as, for instance, the best doctors and surgeons would be absorbed by the foreign clients-based clinics, preventing them from working for the probably less-well-equipped facilities designed for the local population. Especially if highly skilled professionals in the sector are scarce – which they often are in DCs – the risk of crowding out is real. This may pose a dilemma for the local government since the advantages of providing such services to foreigners, such as generating foreign exchange and potential spill-overs and income, have to be weighted against the potential adverse welfare implications due to the crowding out effect mentioned. Still the issue is more a general DC policy issue than a typical DC GATS issue, because – once such services are offered – market forces will basically determine their use.
3. Things do significantly change, however, when turning to mode 3, which focuses on foreign direct investment (FDI) entry. Here DCs and non-DCs have a clear negotiations issue, because for many services' sectors the non-DCs have a clear interest in trying to get a foothold in the often rapidly growing DC market, whereas DC governments – while often recognising the potential advantages of incoming FDIs – at the same time are well aware of the main risks associated with them, *i.e.* that local competing firms are outcompeted and swept off the market; that foreign multinationals through their size will develop monopoly positions at the local market and subsequently channel their monopoly rents out of the country; and that the local government increasingly loses control over production. Basically the key question for many DC governments is if they can – through their negotiations position – reconcile the advantages of FDI inflows with the potential disadvantages for their economies, by effectively setting up and implementing monitoring and control mechanisms.
4. Mode 4, finally, is probably the most contentious one under GATS, as it covers the international mobility of persons albeit on a temporary basis. Here, again, DC governments face an important dilemma. If DC inhabitants get more opportunities to stay abroad for learning and working, this not only may generate foreign exchange via their remittances, but also enhances the DCs-production capacity as the repatriates' human capital value may well have increased significantly by their stay abroad. So, via DC emigration and remigration based on GATS significant labour externalities can be reaped from other countries. The drawback, however, is that labour while staying abroad may slowdown domestic growth, especially if such labour would decide not at all, or later than envisaged, to return to the home country, and/or if migrants would finalise their

remittances. In those cases, the eventual brain drain may in the end seriously deteriorate the DC balance of payments, and on the long run undermine the capacity of the home country to develop vital new production and innovation, which – even worse - may undermine a DC's long-term growth perspective. Then migration under mode 4 may turn out to create a net loss for the DC welfare as a whole. This dilemma is all the more complex as the migration may be clearly advantageous for the migrants themselves - otherwise they probably would not at all try to emigrate - whereas the same activity could well be disadvantageous from a national welfare perspective.

The various dilemmas thus sketched have all in common that they require a case-specific assessment in order to appreciate what the optimal negotiations position should be from a particular DC's national welfare perspective. While opening up the telecom or banking or insurance market for foreign multinationals may work out just fine in one situation, a similar policy may have catastrophic results in other instances. Much will depend on the governments' ability to take the necessary accompanying measures to steer and control the processes, as well as on: the local market situation, supply and demand elasticities, local institutions, and so on. The same need to differentiate applies to the international migration or outsourcing initiatives: what works here does not necessarily work there. Success stories can be held against dramatic disruptions.

Thus, since generalisations may act as pitfalls, there seems to be a need for case-specific evidence to get some feeling for what the best negotiations position in GATS for specific cases may be given the case-specific circumstances. Therefore in the following a variety of case-studies has been elaborated that may provide a hopefully somewhat representative picture of the various aspects of the above mentioned dilemmas. We will notably focus on typical mode 3 backbone and mode 4 mobility cases, such as the telecommunication case in Mexico, the software case in India, the health care case of the Philippines, the health sector case in Cuba, the water supply case of South Africa, the banking case in Latin America, and the financial markets case in Chile.

The analysis generally suffers somewhat from the fact that little thorough empirical assessment of services market liberalisation in DCs has been made so far (UNCTAD, 2002). In fact, the little evidence there is on the relationship between competitive market structures and wider international access to services is mixed. In some cases, a positive relationship has been observed in services sectors, such as basic telecommunications, especially in countries where initial conditions are feeble (*e.g.* low teledensity or service rationing). However, other evidence would suggest, for instance with regard to financial service liberalisation, that such liberalisation in some countries had an adverse effect on access to credit for rural areas and the poor. A complexity in some of the analyses is that many services are highly regulated and/or based on state monopolies. Indeed, domestic regulation is

the most significant constraint on market access for foreign services suppliers, which adds to the complexity of identifying and quantifying the liberalisation impact. Finally, a complexity – except for the usual data problems – is linked with the welfare criterion that is used to assess the liberalisation impact, because such criterion contains various indicators such as growth, but also distributional impact, security of supply, and so on.

## **The case studies**

### **The telecomsector in Mexico**

In 1990, Mexico privatised its public telecommunications operator, Telmex, and started liberalising its telecommunications market. Significant improvements since then have been made within telecommunications: the sector grew 5.6 times faster than the overall economy; main-line density has increased significantly; mobile-line density has grown almost exponentially; costs have been taken down; quality of service has improved; and the fixed network has been totally digitalised. Furthermore, the number of pay phones has tripled during the 1990s and Internet penetration reached 3.6% in 2001. When compared with OECD countries and Latin American countries, however, improvements are not very significant. Several developments are responsible for this.

First, regulation must be stable and predictable to attract FDI, which it is not under the current law the Federal Telecommunications Law enacted in 1995. This severely affects credibility and consequently investments. In addition the required revision of the law is uncertain.

Second, development between different regions of the country is uneven. Universal service has not been complied with and expanding the benefits of telecommunications to everyone against low costs is an objective hard to reach. Not only is Mexico confronted with a ‘digital divide’ when compared with OECD countries; an internal digital divide is also manifest, because investments served large corporate users while neglecting individual users and the geographic expansion of the network.

Third, new entrants to the market do not have sufficient resources to compete with Telmex. Foreign investment is needed but is severely hampered by the restriction on FDI of 49%. Besides, necessary growth of the industry is uncertain, since debt and capital markets are practically closed to telephone companies. Telecom carriers in general are highly indebted and access to capital across Latin America has dropped over the past year. By leaving Telmex with high market power and establishing governing institutions long after reform, industry restructuring resulted in relatively high telephone tariffs and carried on an under-supply of basic telecommunications services. The institutional setting is thus responsible for creating a climate that substantially differs from Mexico’s commitments in the GATS. Because of this, the digital divide is expected to become more apparent in the next years in line with the widening poverty gap. Universal service will not be complied with, without actively pursuing social services objectives. The sector right now faces the unfavourable prospect of being stuck in the middle by lacking government intervention when it comes to reaching social services objectives, and continuous interference, obstructing competition.

### **Financial liberalization in Latin America**

Should a country open up its frontiers in the GATS framework to welcome foreign banks to its domestic banking market? A lot of arguments against and in favour of foreign banks entry have been mentioned in the literature. Some of these arguments depend on the level of development of a country. This case investigates empirically the impact of foreign bank entry on the efficiency of the domestic banking sector in ten Latin American DCs: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela. It also analyses the difference in performance between foreign and domestic banks. Latin America is important as a case area because it is one of the DC regions with the highest foreign bank participation: foreign bank control rose from 7.5% in 1994 to 25% in 1999. This process has provided empirical information on the behaviour of foreign banks in these countries.

The results of this study supported the hypothesis that foreign bank entry is associated with lower overhead expenses and domestic bank profitability, but that this is typically valid for countries at lower levels of economic development (Peru, Colombia, Ecuador and Bolivia in the case study). So, there is evidence that opening up domestic banking markets to foreign bank penetration will improve the efficiency of the domestic banking system in countries at lower levels of economic development, and this improves their welfare.

The study also showed that in Latin America foreign banks showed less profits and overhead expenses than domestic banks. A possible explanation for the profit-variable is that foreign banks suffer from an information disadvantage. The result for the overhead expenses-variable may reflect foreign banks having more efficient management and banking techniques, because of their technological advantage. The case also shows that foreign bank penetration may have a positive impact on the credit stability of the domestic banking system. The latter may provide an important consideration for countries that still have to decide whether or not to open up their markets to foreign bank subsidiaries in the framework of the GATS.

### **The financial sector in Chile**

As we learned from the above case study, liberalisation of financial services can have benefits for all countries, but also downsides. The question arises what sort of legal solutions or guarantees could be brought into the GATS proposals for negotiation,<sup>3</sup> so that the negative effects are limited or controlled. In this case it is analysed how Chile for the upcoming GATS negotiations should

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<sup>3</sup> The first negotiations on financial services in the GATS framework took place in 1997; the Annex on Financial Services came into force in 1999. In January 2000 a new round of negotiations was started in Seattle. Unfortunately, these negotiations failed completely. Article VI (Annex on Financial Services) states that negotiations on qualifications and technical standards, licensing and procedures have to take place, so that they will not create unnecessary barriers to trade. In the field of accountancy services, some progress has been made, but the negotiating process on this is still underway. Similar agreements on banking and insurance are foreseen, although negotiations on this are quite difficult, because most banking and insurance rules have been set by private organisations, so that governmental authorities find it hard to accede to these systems. In the spring of 2003, on these issues new negotiations are planned.



formulate its proposals for the liberalisation of its financial services sector in a legally correct way, and what legal demands these proposals have to meet. Financial services make out 13,6% of the BBP of Chile. The banking system now consists of Chilean and foreign banks. In 2000 there were 17 foreign owned banks, of which the Banco Santander is one of the largest. Because Chilean banks were not allowed to do business outside of Chile until 1998, foreign banks have the advantage of being able to use their large international network. The Chilean financial system nowadays is highly competitive and well integrated with the outside world. Cross-border trade is still not allowed in financial services. This is because Chile demands that a certain amount of capital has to be brought into the country to make sure a company has adequate assets.

Because Chile has already liberalised its financial services market much more than it has committed itself to, it can offer a lot into the negotiations without in fact giving up too much. Transparency would improve, if Chile makes commitments in line with the real situation. Chile already adapted its legislation to the rules of the Basel Committee on Banking Supervision. Chile's main problem is the diversified rules due to the number of trade arrangements it has concluded. Cross-border trade still is an area in which Chile could make some progress. To support small firms in the liberalisation process, it is important that a policy is formulated to secure access to financial services. Chile could work far more efficiently than it does now by mere acknowledgement of licences and supervision of the home country. Because Chile emphasised that its export interests are mostly in other areas, there could be a nice trade-off, for instance to open up cross-border trade in financial services into Chile against opening up other markets for professional services on the basis of acknowledgement of diplomas.

### **The health sector in the Philippines**

An orderly and proper migration program can increase the positive impact of migration and remittances on the economic growth of a country. This is why mode 4 can be important for DCs. Health services have long been considered as non-tradable (and provided by public institutions), but there is a change in this perception. In fact, trade in health services is growing in many areas, also in DCs. For many DCs, the current services negotiations, which began in 2000, offer opportunities to acquire health services unavailable domestically, or to export health services and human resources to a larger world market. Depending on appropriate regulatory conditions, trade liberalisation of the health sector can contribute to enhancing quality and efficiency of supplies and/or increasing foreign exchange earnings. This case focused on the (temporary) movement of health service providers of the Philippines, a country known as the number one export country of nurses. In assessing the migration impact, it should be realised that medical migration itself directly implies both private and public effects, while remittances typically have private effects. Public effects of remittances are only generated indirectly. This should be taken into account in all cost-benefit analyses of migration of service providers. The study concluded that although the migrants were relatively rich and highly educated, migration still seemed to be a flight out of poverty. The Philippines has a surplus of nurses

and medical doctors, although in practice there is a shortage of medical doctors from a domestic health point of view. It turned out that medical doctors tend to migrate permanently. Therefore, it seems not desirable to stimulate the migration of doctors any further. The encouragement of migration under nurses, however, seemed recommendable. There will be fewer disadvantages when the GATS contributes to stimulate *temporary* migration of medical doctors.

### **The software sector in India**

The software sector in India developed successfully for a number of reasons. Firstly, the Indian government stimulated the sector through tax benefits, less restrictions on imports and exports, and looser FDI rules. Secondly, India has a cheap, relative highly educated English speaking labour force. Third, India has the benefit of existing linkages between domestic firms and overseas subsidiaries. However, the same success met constraint, due to: the insufficiently developed infrastructure, both a lagging quality and a lagging productivity in comparison with the increasing wages, a general lack of education capacities, and the heavy migration of professionals. The Indian government specifically supported the tendency of professionals moving abroad by claiming better access via mode 4 in the WTO. India considers mode 4 to offer opportunities for improving export rates of the software sector by increasing the possibilities for Indian firms to send their software specialists abroad to provide the asked services. The case analyses the dilemma this policy created. On the one hand India loses employees, at least temporarily, through mode 4, thus creating a positive balance-of-payment effect: migrating Indians will send money back to India (remittances). On the other hand, this leads to exports of software services forgone. The dilemma is that such flows are a trade-off also as far as their bop-impact is concerned. Moreover, at one point in time emigration based on mode 4 may leave the Indian software sector with a shortage of professionals, and India's economy with bop-problems insofar as diminishing export benefits outweigh the increase in remittances.

### **Health sector in Cuba**

The health services sector has traditionally been subject to serious impediments for international trade. In many countries, government involvement has always been high within the sector and health services are offered significantly below costs. Finally, technical constraints always have hindered trade in health services between countries. However, due to the recent developments concerning trade in services, governments also have begun to reconsider their role in the provision of health services. Cuba is a member of the WTO since 1948. Although Cuba has not made any GATS commitments concerning the health sector so far, it trades health services via two modes of supply identified by the GATS: 'consumption abroad' and 'presence of natural persons abroad'. 'Consumption abroad' in Cuba takes place via special hospitals for foreign patients. These hospitals provide high quality health services at competitive prices to foreigners only. 'Presence of natural persons abroad' occurs via sending health personnel abroad on short-term remunerated contracts to foreign countries, under

government supervision<sup>4</sup>. Although offered under governmental authority, these health services are supplied on a commercial basis and are therefore covered by the GATS. Cuba provides therefore an interesting case to analyse the consequences of liberalising the health sector under mode 2 and 4 and to assess to what extent this liberalisation can contribute to solving the shortage of all kinds of medical goods in Cuba.

### **Water in South Africa**

Privatisation in the services sector is becoming more and more common because governments find themselves inappropriate to supply services on an optimal price-performance proportion. Trade expansion is another indirect reason for DCs to hand over public services to private foreign multinationals. Revenues increased by foreign trade can be used to pay-off foreign debt. This raises the question if a DC should open its borders for privatisation of public services like water. This case study focused on the experiences of privatisation of drinking water in three towns in South Africa. The investors were large foreign multinationals striving to profit maximisation. They signed a concession contract with the three municipalities. The case concluded that privatisation did not provide better conditions to the municipalities, than before. The old patterns of unequal infrastructure in the towns continued and followed the same racial geography. The privatisation did not raise black per capita water consumption above levels before apartheid. The principle of cost-recovery led to a process of disconnections and reduction of services for people who were not able to meet their obligations. Privatisation led also to problems around monitoring, transaction costs, contract compliance and corruption.

While the experiences of South Africa showed dramatic consequences of water privatisation in three towns, South Africa as a whole performed quite well. Within a country like South Africa, there exist huge political, social and economical differences, causing water privatisation effects to vary from place to place. Therefore, each strategy on privatisation should be seen within the unique context of the political, social and economical characteristics of an individual location.

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<sup>4</sup> Chanda, 2001.

## Chapter 1 Introduction

This study analyses what services' market liberalisation may mean for developing countries (DC)s,<sup>5</sup> and how such liberalisation can be evaluated from the perspective of their welfare. First, this chapter focusses on the rules and the negotiation process of the General Agreement on Trade in Services (GATS), and on the position of DCs in particular. Second, in the chapters 2-8, a number of case studies will be discussed in order to illustrate the typical interests of developing countries in concrete cases, as well as the complexity of the assessment of the pros and cons both at the short and long run of services market liberalisation for the people living in DCs.

### § 1.1 The GATS

The process of liberalisation of international trade in goods under the General Agreement on Trade and Tariffs (GATT) started as early as 1948 upon the ratification of the Agreement. By contrast, it lasted until 1995 before a start was made with an international agreement to liberalise international trade in services: in January of that year, GATS came into effect. GATS provides a legal framework, to foster (liberal) trade and enhance international competition in services (some of the main aspect of its structure and principles have been spelled out in Box 1). The main goal of the GATS is to remove, based on a multilateral negotiations process, protectionistic regulation and to provide more transparency about various national rules and regulations, in order to promote liberalisation of services' markets with increasing participation of DCs. To be able to understand the Agreement, it is necessary to understand the structure and wording of the legal text as is explained in Box 1.

#### **Box 1 The structure and principles of GATS**

##### **The structure of GATS**

The GATS text consists of two main parts (except from part I that discusses scope and definitions, part IV on progressive liberalisation, part V on institutional provisions, and part VI on final provisions). Part II states the general principles, the most important ones being the Most-Favoured-Nation Treatment principle and the principle of Transparency. The philosophy of GATS is that such principles will be accepted unless specifically indicated otherwise, *i.e.* governments have to apply these principles unconditionally across all services sectors. Part III contains the principles of market access and national treatment that only apply if Member States specifically commit themselves to admit foreign suppliers of services to their markets, and (thus far) additionally only with regard to a number of sectors that were scheduled during the Uruguay

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<sup>5</sup> GATT defining 'developing countries' also for GATS refers to those contracting parties "the economies of which can only support low standards of living and are in the early stages of development". The descriptions used most are those of the UN General Assembly, and the World Bank classifying the developing countries into the poorest or low-income countries (GNP per capita below \$ 800, - per annum), and middle-income countries (GNP per capita of less than \$ 1000, - per annum); together they are usually referred to as "developing countries".

Round. These principles apply only to sectors that governments explicitly agree to cover. The commitments specify what part of their markets member states are prepared to open up (market access), and how they plan to do so. This part also specifies what exemptions can be made on such commitments (R. Adlung, 2001: 259).<sup>6</sup>

GATS distinguishes four modes of supply of services (Art. I):<sup>6</sup>

1 'Cross-border supply'. In this case the service is supplied from one member state directly to a receiver in another member state.

2 'Consumption abroad'. This applies for example if a consumer travels to the country where the supplier is situated (for example a tourist).

3 'Commercial presence'. This is the term for services sold in the territory of a member state by foreign entities that have established a commercial presence.

4 'Presence of natural persons'. This is the provision of services that require the movement of natural persons from one member state to another. The Annex on Movement of Natural Persons specifies that Members remain free to operate measures regarding citizenship, residence or access to the employment market on a permanent basis.

In the schedules of specific commitments of members it is stated what modes of supply they are prepared to liberalise for what specific markets (and what restrictions they want to introduce).

### GATS' general principles

GATS is based on a number of principles. First, the *Most Favoured Nation principle* (MFN), as stated in Art. II. This basic principle means that each government is required to "accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable treatment than that it accords to like services and service suppliers of any other country". MFN applies to any type of service. However, a typical characteristic of the GATS treaty is that any member state is free to make exemptions as long as they are based on arguments compatible with the Agreement.<sup>7</sup> Such exemptions need to be indicated in the schedules of the 'specific commitments' (Art. II.2, also Annex on Art. II exemptions). Moreover, GATS, just like GATT, respects regional integration as an exception to the MFN principle; in addition it allows measures that prevent member states from enjoying the benefits from trade with direct neighbours or of locally produced products (Article II.3).

A second principle, that of *transparency*, indicates that all member states have to make public their national rules, and keep that information available for other member states, so that they can know what standards they have to live up to, and whether these measures still match the

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<sup>6</sup> Excluded are services provided to the public in the exercise of governmental authority, and air traffic and related rights, which are the subject of bilateral agreements.

<sup>7</sup> For the MFN-principle goes that exemptions can be made for a maximum of ten years. The exemptions are also subject of discussion in following rounds of negotiations.

agreement (Art. III, GATS). This article also makes sure that enquiry points are created, so that other members can get information about market access.

A third principle is that of *proportionality*. This shows up in a lot of articles. Art. VI, for instance, on domestic regulations, stipulates that requirements a service supplier has to live up to are not more burdensome than necessary to ensure the quality of that service. In Art. XVI (market access) a number of quantitative measures that restrict market access are banned in principle. Member states cannot maintain these measures unless mentioned in the schedule of specific commitments, but if they do, they can maintain them for only ten years. Art. XIV provides member states with the general exceptions. It covers a broad range of exceptions that should be based on legitimate reasons. In practice the concept 'legitimate reason' can cover a broad array of arguments to limit the liberalisation of services.<sup>8</sup>

*National Treatment* is another general principle, mentioned in Art. XVII. When a foreign supplier of services enters the market, he should not have to live up to other or higher demands than his domestic competitors on that market. This is a specific commitment; it applies in a sector if a commitment to that effect is made and if no limitations or exceptions are listed in a member's schedule (R. Adlung, 2001:260).

Finally, there is the principle of *Market Access* (Art. XVI) that implies that in principle all Members should be able to get access to other members' markets, although – just as with regard to national treatment – there has to be a specific commitment in the schedules to make this rule effective.

### § 1.1.1 THE PROCESS

In January 2000, WTO Member governments started a new round of negotiations to promote the progressive liberalisation of trade in services. The purpose of these negotiations is to remove unnecessary regulations. This should make it easier for domestic and foreign companies to do business, and would therefore encourage economic growth in all countries.<sup>9</sup>

The present negotiations round is the follow-up of the coming into being of the GATS that entered into force in January 1995, and its first version was meant to be valid until 1997.<sup>10</sup> The deadline of the round is January 1, 2005.

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<sup>8</sup> For instance, restrictions to protect public moral or to maintain public order, measures to protect human, animal or plant life or health, and measures to secure compliance with laws or regulations, including the prevention of fraud, the protection of privacy and safety in general are allowed.

<sup>9</sup> The liberalisation of services is criticised by several NGOs, such as the World Development Movement and Alliance for Democracy. The WTO reacted by a brochure aimed at debunking the myths and falsehoods surrounding the GATS and its new negotiations.

(see [http://www.wto.org/english/tratop\\_e/serv\\_e/gats\\_factfiction\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/gats_factfiction_e.htm)).

<sup>10</sup> At present, because no new agreement has been reached consensus upon, business is still done on the basis of this agreement.

GATS was agreed upon under the Uruguay Round of multilateral trade negotiations. It sets out a framework of legally binding rules governing the conduct of world trade in services. It is supported by a number of specific commitments undertaken by individual Members of the World Trade Organisation (WTO) in specified services sectors or across a particular mode of supply.<sup>11</sup>

Entries in the schedules of commitments fall into one of the three categories. First, 'none or no limitations', refers to the case that a country is committing itself to ensuring that there are no restrictions which are inconsistent with GATS rules covering participation in the market by foreign service suppliers. In the market access column, 'none' means that foreign service suppliers are free to enter the market, while in the national treatment column, none means that the foreign service supplier is guaranteed the same level of fair treatment as domestic counterparts. Second, 'unbound' means that a country has not bound its actions for a particular sector and mode of supply; in effect it is making no commitment either to open-up its market or to keep it as open as it was at the time of accession to the WTO. Exclusion from the commitment of the measures pertaining to a particular mode of supply may be due to technical unfeasibility of the provision of the service through the mode of supply in question. All other entries describe in detail the measures otherwise inconsistent with market access or national treatment which the government reserves the right to apply. Finally, a country can bind its commitments. These commitments – once being accepted as binding - are intended to prevent Members from unilaterally changing their domestic law or other regulation in order to reintroduce new barriers to entry into these specified markets or modes. This is why GATS-rules discourages Members to withdraw their commitments<sup>12</sup>. However, many DCs are probably not capable to pay the costs involved with changing commitments (Altinger, L. and A. Enders, 1996:311).

The basic target of GATS, as was already argued, is to provide a framework for a progressive liberalisation of the international trade in services and international services market. One of the key aspects of GATS therefore is to let countries increasingly accept specific binding commitments towards *Market Access* (Art. XVI), *i.e.* that in principle all Member States should get access to other Members' services markets.

Unlike the GATT treaty that contains various provisions to deal with the specific circumstances of DCs, GATS on the whole is less strong on that issue, one of the main reasons being that, since no commitments really exist until listed in the schedules of specific commitments, it is much harder for DCs to make their claims effective than under the GATT scheme.<sup>13</sup>

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<sup>11</sup> 'Members' are defined as those countries that joined the WTO up till now. About 100 of the WTO's over 140 members are DCs.

<sup>12</sup> After three years it is possible to withdraw a commitment, so long as a Member is prepared to compensate other Members whose service suppliers are allegedly adversely affected.

<sup>13</sup> GATS Fact and fiction, brochure of the WTO secretariat 2001, p.2.

Also the GATS negotiations differ from the GATT negotiations. It is, for instance, not possible for Members to just exchange commitments between them. According to Art. 10 of the guidelines and procedures of the GATS “the starting point of the negotiations for specific commitments shall be the current schedules, without prejudice to the content of the requests.” Negotiations normally proceed on the basis of requests and offers; that is, countries request from each other to consider liberalising particular sectors, and respond with offers.<sup>14</sup> Agreement to liberalise is, however, not reached until all participating Members – including DCs – are satisfied with the total package being offered. In practice, the negotiations occur on a one on one basis, which is very time consuming. It might be a good idea to make offers to groups of countries, to work more efficiently.<sup>15</sup>

The services GATS commitments apply to are mainly: banking, insurance, accountancy services, tourism, telecommunication, and transport services.<sup>16</sup> Services such as education and healthcare are only included insofar as they constitute commercial activities.<sup>17</sup> In principle, the GATS covers services in any sector except services supplied in the exercise of governmental authority. Services “which are supplied neither on a commercial basis, nor in competition with one or more service suppliers” are explicitly excluded from the GATS. This seems to imply that only private services are covered by the GATS. (DFID, September 2001:5). However, “where a government acts on a commercial basis and/or as competitor with other suppliers, its activities are treated like those of any private supplier.” (OECD, *op. cit.*, p. 7, 1994). In most WTO countries public services like health and education consist of a complex, continually shifting mix of governmental and private funding and contain a mixing of governmental, private, not-for-profit and private for-profit delivery (Sinclair and Gieshaber-Otto, 2002). It is not completely clear to what extent GATS commitments apply to these kinds of services.

### § 1.1.2 THE ROLE OF SERVICES

The trade and services’ market impact of the GATS negotiations process has so far remained modest, but if considerable progress is made in the ongoing international negotiations as time passes by, the potential economic effects of international services liberalisation are considerable. One of the reasons is that the role of services in the world economy is expanding, as incomes grow. Between 1990 and 2000 the annual percentage change in world exports of commercial services was 6,5, just like the annual percentage change in the world exports of commercial merchandise. In 2001, the value of

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<sup>14</sup>This takes the form of so-called positive listings, i.e. Members individually choose with regard to which sectors and modes of supply they want to make binding commitments and in which they do not. Countries can also determine their extent of liberalisation. This is called a ‘positive listing’ or a ‘bottom-up’ approach. Requests for market access in the present negotiation round had to be submitted by 30 June 2002, and initial offers of market access by 31 March 2003.

<sup>15</sup> Art. 11 Guidelines and Procedures: Liberalisation shall be advanced through bilateral, plurilateral or multilateral negotiations, and the main method will be the request-offer approach.

<sup>16</sup> The air transport sector is excluded in principle, because this sector has its own organisation and rules.

<sup>17</sup> Those sectors are traditionally considered as governmental, non-commercial services sectors.



world exports of commercial services was \$1,458 billion and of merchandise \$5,984 billion. So, the value of the international trade in services is equivalent to about one-quarter of the international trade in goods. However, these figures may underestimate the true economic role of services, because a very large proportion of international trade in services does not cross national frontiers, because it is the service supplier (such as a branch of an insurance company) or the service consumer (patient receiving medical treatment in a foreign country) who does so instead (WTO Secretariat, Oct. 1999).

The growing importance of services for developed countries and DCs justifies the potential importance of the GATS-agreement. However, the services sector in most of the DCs is highly developed, while it is underdeveloped in most of the DCs. Therefore DCs fear that under free entry of foreign services or of foreign direct investment leading to foreign services production, developed country firms would directly or indirectly dominate their markets before domestic industries could even mature. In some cases they are even afraid that liberalising services imports may involve losing their sovereignty. This is one of the reasons that the interest in the GATS-negotiations and their potential impact on DCs seems to increase as the present negotiations Round progresses.

In that spirit, this report typically focuses on the DCs' potential interest in those negotiations, and in on what basis and how to negotiate in particular. Clearly GATS has not specifically been set up for DCs, but rather has been designed to be beneficial for all Parties. Nevertheless, some specific DC provisions have been recognized (see also §1.2). Moreover, the services' share in the formal economies of DCs is on average significantly smaller than in most developed countries; which is even more true for their share in the international trade in services that is dominated by the US, the EU and Asia (see figure 1.1).

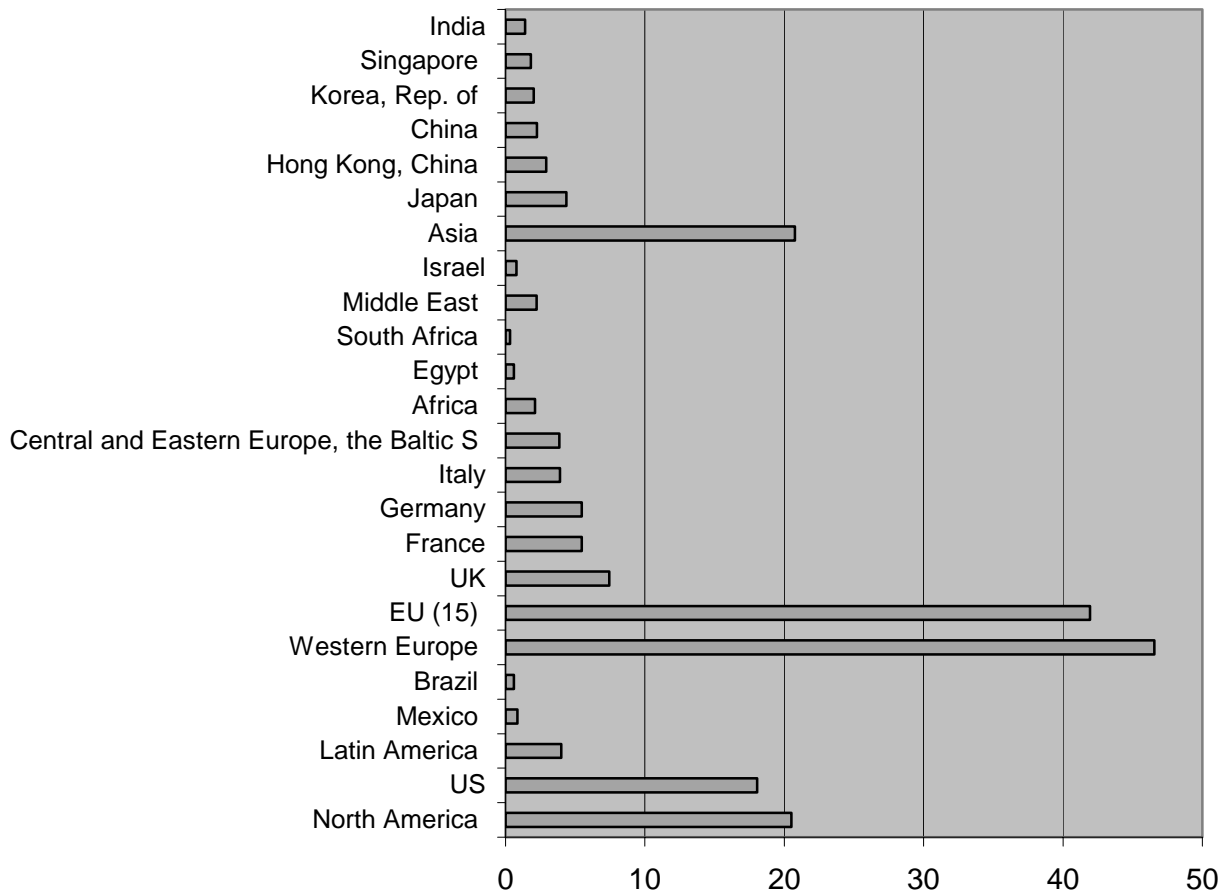


Figure 1.1 World exports of commercial services by region (2001, %)

Source: WTO data.

In addition, figure 1.2 shows that during 1990-2001, the share of DCs in world commercial services' trade has gradually increased. Nevertheless that share still amounts to no more than one quarter.

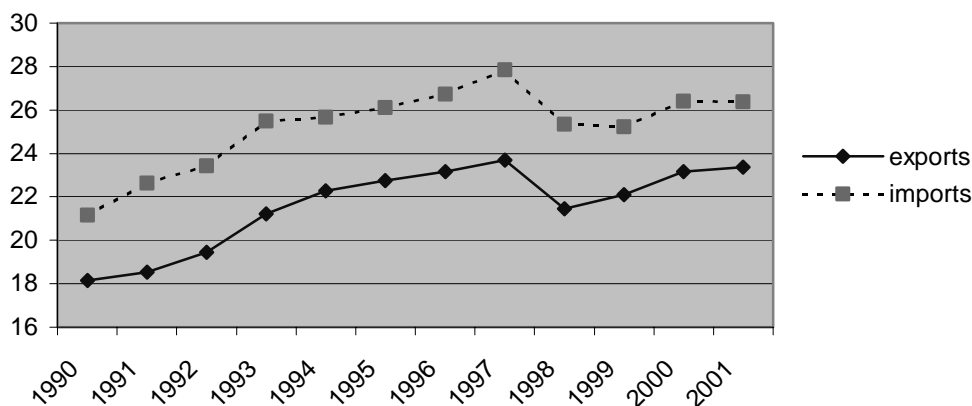


Figure 1.2 Share of DCs in world commercial services trade (1990-2001, %)

Source: WTO data.

This is not to say, however, that DCs' potential stake in the present GATS negotiations' outcome would be equally modest. As many services are relatively labour-intensive and as various services' productivity is less easy to increase than that of non-services' production, the developing world can generally be expected, as time progresses, to be able to (further) develop comparative advantages in generating services. According to the World Bank liberalization of services in DCs could provide as much as \$6 trillion additional income in this region by 2015 (World Bank, *Global Economic Prospects for Developing Countries* 2001). McGuire estimated that by removing restrictions on all modes of services supply, DCs are projected to be better off by \$130 billion (McGuire, 2002:10).

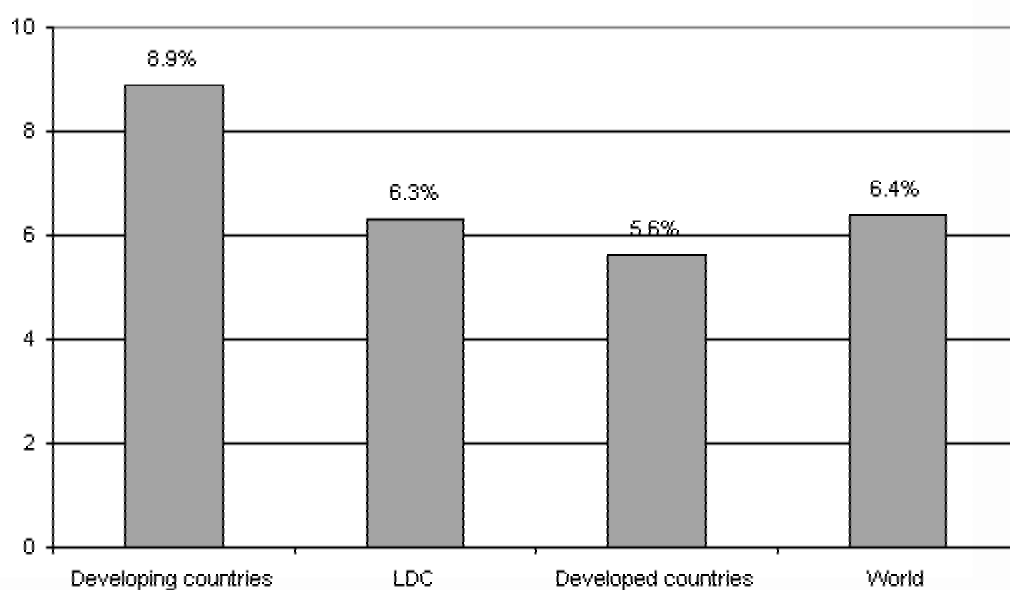


Figure 1.3 Growth of commercial services' exports of developed, developing and least developed countries (1990 – 2000, %)

Source: WTO statistics.

Figure 1.3 shows that between 1990 and 2000, the growth of exports of commercial services for DCs as well as for the least developed countries (LDCs) exceeded that of developed countries. Some clear cases of successful DC services sectors are: the booming software sector in India, the rapidly growing market of outsourcing administrative work to China, tourism in South-East Asia, or healthcare services rapidly developing in South-Africa and Latin America, to mention just of few clear examples. Liberalising such markets may strongly benefit DCs.

## § 1.2 GATS and the Developing Countries

According to a leading expert on GATS, Additya Mattoo from the World Bank, the GATS has created a more secure environment for trade in services, but has not generated the negotiating momentum to

reduce protection, nor the rules to ensure that protection takes a desirable form. In dealing with the trade-impeding impact of domestic regulations, according to the same experts, it has achieved even less.<sup>18</sup> Moreover, the different interests of DCs and developed countries complicate the negotiation process. A typical example of an issue pushed by DCs' interest is a general safeguard mechanism for services setting out the conditions under which governments can differentiate between foreign- and domestically-owned enterprises operating in their territories.

The difference in interest in services' market liberalisation between developing and developed countries is reflected in sometimes conflicting proposals submitted thus far in the GATS framework. It is also reflected by the comparatively small number of commitments on services activities that has thus far been made by DCs (covering some 16% of most of their services activities) as compared to the much larger corresponding share of developed countries' commitments, namely some 64% (see table 1.1). Activities where commitments have been made during the Uruguay Round by most DCs include the tourism-related services of 'hotels and restaurants' (69 of 77 DCs), reflecting the current importance of this sector in foreign exchange earnings of many DCs. Insurance services have been subject of commitments by one-half of DCs; banking and other non-insurance financial services by one-third; computer and related services and construction services by one-quarter; and value-added telecom services by one-fifth. In addition, several DCs made commitments on basic telecom services and maritime transport, on an autonomous basis, since these sectors were generally considered to be excluded from the scope of final commitments. Among these belong as well, audio-visual, postal, courier and transportation services, which form part of the agenda of the WTO.

Table 1.1 Commitments on services activities by country group

	Percentage of 149 services activities	Percentage of 149 activities, excl. audiovisual, postal, courier and basic telecom, and transportation
Developed economies	64	82
Transition economies	52	66
Developing economies	16	19

*Source:* Altinger and Enders, 1996, p. 316.

Remarkable was the frequent exclusion of cross-border supply from commitments by DCs, not covered in almost one-half of commitments compared to 25% in developed countries (Altinger and Enders, 1996: 319). Since cross-border supply is considered to be a substitute for the supply of services through commercial presence in many service activities, the frequent exclusion of this mode

<sup>18</sup> For some suggestions on improvements in the rules of the Agreement, see Mattoo, 2001.

of supply underlines the emphasis placed by DCs on attracting investment commitments. At the same time, however, even for commercial presence, limitations on access are more frequent in DCs than in developed countries (75% of commitments compared to 60%).

In general, however, DCs seem to have difficulties in identifying their negotiating objectives for GATS, and also face a lack of capacity to effectively deal with the negotiations and their preparation. However, according to UNCTAD's 1999 Assessment, DCs have made commitments under GATS with respect to a number of services of industries, often binding recently adopted legislation or pre-committing future policies even without having much experience in implementing those, and also have undertaken a relatively high share of full bindings under the cross-border and commercial presence modes of supply. By contrast, they do not seem to have received concessions of any meaningful economic value under the movement of natural persons mode of supply (UNCTAD, 1999).

#### § 1.2.1 MODE 4

Another clear example of typical DCs' interests is the inclusion of *labour movements* (mode 4) in GATS.<sup>19</sup> This issue was indeed successfully pressed for by the DCs' negotiators to be included in the GATS as a separate mode. In this way the influx of temporary migrants in countries, which require their services, is allowed. For many DCs it is a challenge to take advantage of the opportunities offered by this global trend.<sup>20</sup> Developed countries on the contrary are more cautious in their approach towards mode 4 and preserve all kind of barriers and have very few commitments with respect to such labour movements. As far as these commitments are made they focused on highly skilled labour and expertise increasing the opportunities of brain drain and on intra-company transferees for which investments are needed to establish commercial presence.<sup>21</sup> In fact, the current commitments under mode 4 are just an extension of the commitments in mode 3 and thus provide little opportunities for DCs (Francisco, 2002, 5:10-11).

In addition, barriers can be found in horizontal and sector-specific limitation on market access. The US, for example, limits in its commitment the entry and temporary stay of fashion models and specialty occupations to 65,000 persons annually on a worldwide basis, so that the potential share of a single DC will be small, and even smaller for specific service providers (United Nations and WHO, 1998:233). Another example is the pre-employment requirement in which countries require persons to be employed by a firm a year immediately preceding the transfer. Finally, the application of domestic

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<sup>19</sup> Mode 4 of the GATS does not apply to measures concerning employment, citizenship or residence on a permanent basis.

<sup>20</sup> Many developing countries are labour surplus economies.

<sup>21</sup> The GATS classifies four major groups of service providers: intra-company transferees, individual service providers and specialists on specific assignments, short-term or business visitors, and diplomatic and international personnel. 135 of the 240 commitments entries are explicitly related to intra-company transferees.

minimum wage legislation, *i.e.* wages paid to temporary migrants should be equal to the wages paid to nationals in that same profession, eliminates the comparative advantage of DCs in cheap service providers (United Nations and WHO, 1998:233-4). Wage requirements are often coupled with restrictions regarding work conditions, working hours and social security benefits (Francisco, 2002:13). For example, foreigners in the US are treated in the same manner as US citizens and thus have to pay taxes. But most of the time temporary migrants are also subject to taxation in their home country, thus leading to double taxation. It has been argued that special arrangements in the GATS-agreement should try to prevent this possibility (United Nations and WHO, 1998:234).

An extra barrier for migrants is formed by licensing and qualification systems. Due to the public interest many service sub-sectors use entry-conditions with regard to education, experience or training. These regulations can be relatively restrictive, especially for people who migrate for a short term. The variation in the educational system of member-countries creates a further restriction. On top of this, testing, certification and licensing requirements (especially for professionals and specialized skills) varies across and among countries. For instance, employers should have taken timely and noteworthy steps to hire and retain domestic workers in the concerned profession (testing requirement). The consequences of all these impediments are that the entry of temporary service providers becomes limited and, when service providers manage to enter a country, they are often given lower positions, salary or benefits, even if their qualifications and skills are comparable to those of domestic workers, (Francisco, 2002:13-14).

Another barrier is the use of vague terminologies and definitions in the current schedule of commitments leaving room for a variety of interpretations. For example the schedule of commitments does not have an approved definition of what represents 'temporary' in the host country. Further, the predictability of the actual entry conditions should be improved. This holds particularly for economic needs and labour market tests (Francisco, 2002:14). The criteria for such tests should be agreed on and clearly specified in the schedule of commitments. This openness and transparency contributes to the knowledge of foreign service providers about their chances of entry and thus adds to the liberalisation of the temporary movement of service providers.

### § 1.2.2 THE SPECIFIC POSITION OF DEVELOPING COUNTRIES

Just as in GATT, GATS also contains some provisions that give preferential treatment to DCs. These provisions are based on principles introduced in 1974 in the UNGA resolutions 3201(S-VI) and 3281(XXIX) of the New International Economic Order (NIEO): the protection of the economic interests of developing countries, the fundamental concept of legal inequality or positive discrimination and that of non-reciprocity. These principles from then on were the basis of negotiations within the UN and later in the WTO provided their prerogatives and preferential

treatment within GATT. Based on these principles DCs could postpone liberalisation or the reduction of trade tariffs longer than their developed partners. For instance Art. XVIII (GATT), the so-called escape clause, which allows developing members to maintain trade barriers under specific circumstances, was adjusted 1979 in order to help DCs protect their infant industries – under specified circumstances and conditions such as notification of the other members. This meant the introduction of the right of DCs to protect their economies. The developed members were restricted in their right to take reprisals, which implies non-reciprocity (Verwey, 1990:123-7).

The GATS provisions that give preferential treatment to DCs have been laid down in various articles. An article that typically deals with encouraging the increased participation of DCs in international services trade through specific negotiated commitments is Art. IV.1 on:

- access to technology on a commercial basis;
- improved access to distribution channels and information networks;
- the liberalisation of market access in sectors of export interest to developing countries.

Another specific DC-related provision is Art. IV.2 that says that developed member countries shall within two years from the date of entry into force of the WTO agreement, establish contact points for the purpose of facilitating the access of DC members' service suppliers to information related to their respective markets, concerning: a) commercial and technical aspects of the supply of services; b) registration recognition and obtaining of professional qualification; and c) the availability of services technology.

Art. XIX.2 provides that liberalisation takes place with due respect for national policy objectives and development levels, both with regard to overall coverage and to individual sectors. There shall be appropriate flexibility for individual developing country Members (especially LDCs) for opening fewer sectors, liberalising fewer types of transactions, progressively extending market access in line with their development situation and, when making access to their markets available to foreign service suppliers, attaching to such access specific conditions aimed at achieving the objectives referred to in Art. IV. As the descriptions used here are rather vague, its value can not be estimated precisely. Furthermore, on the basis of mutually agreed criteria there shall be taken account of autonomous liberalisation by Members since previous negotiations, and credits will be given accordingly.

Art. XIX.3 mentions that before each negotiation round, negotiation guidelines and procedures should be established, and that for this purpose “the Council for Trade in Services shall carry out an assessment of trade in services in overall terms and on a sectoral basis with reference to the objectives of this Agreement, including those set out in Art. IV.1.” India, Cuba, Dominic Republic, Haiti, Kenya, Pakistan, Peru, Uganda, Venezuela and Zimbabwe complained in a request at the WTO that an

assessment as mentioned in Art. XIX.3 has never been made.<sup>22</sup> One has made little effort to start such an assessment despite some earlier actions from Members.

In the Guidelines and Procedures for the Negotiations on Trade in Services Art. 1 stipulates that the negotiations shall be conducted on the basis of progressive liberalisation as a means of promoting the economic growth of all trading partners and the development of developing countries.<sup>23</sup> In Art. 2 the wording is: “there shall be appropriate flexibility for individual developing country members, as provided for in Art. XIX:2”. Although this seems to be a hard commitment, there is no definition for appropriate flexibility. Similar phrases can be found in Art. 3 and 6: “due consideration should be given to the needs of small and medium-sized service-suppliers, particularly those of developing countries.” The wording that is used “due consideration” is very imprecise and “should” is used here instead of “shall”. This means that no real subjective right can be derived from this article, although at first sight it looks very promising. Art. 6, says: “MFN Exemptions shall be subject to negotiation according to paragraph 6 of the Annex on Article II (MFN) Exemptions. In such negotiations, appropriate flexibility shall be accorded to individual developing country Members”, and Art. 5, “There shall be no a priori exclusion of any service sector or mode of supply. Special attention shall be given to sectors and modes of supply of export interest to developing countries.” This makes it very important for DCs to clarify their export interests before the negotiations start.

The next article – Art. 14 – is very important for DCs: “the Council for Trade in Services in Special Sessions will carry out assessments of trade in services, and the negotiations shall be adjusted to the outcome of these assessments”. When the DCs make sure the Council actually does this, the pressure to hold on to the good intentions is much greater than without continuous monitoring. Art. 15, finally, says: “To ensure the effective implementation of Art. IV and XIX.2, the Council monitors the extent to which Art. IV is implemented in the negotiations, and will make suggestions.”

#### *Interpretation of articles IV and XIX of GATS:*

DCs have joined to make a proposal regarding the interpretation of Art. IV and XIX, in which they emphasise the importance of these articles.<sup>24</sup> They argue that there are two operational elements in facilitating the increased participation of DCs. First, the facilitation of exports, that is enhanced and non-reciprocal access for DCs’ exports to developed country markets. And second, flexibility and policy discretion to DCs with respect to their own markets, *i.e.* the right to regulate in order to pursue developmental objectives, the right to maintain some trade barriers, and the right to provide

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<sup>22</sup> Request in communication from these countries to the Council for Trade in Services, S/CSS/W/114.

<sup>23</sup> Guidelines and procedures for the negotiations on trade in services WTO 29-03-2001(s/1/93) art I.

<sup>24</sup> Communication from Cuba, Pakistan, Senegal, Sri Lanka, Tanzania, Uganda, Zambia and Zimbabwe, Increasing Participation of Developing Countries in International Trade in Services: effective Implementation of art IV of GATS, Council for Trade in Services, 06-12-2001.



appropriate support to their domestic services suppliers. So, the most important elements for them are increased access to developed markets and protection of developing markets, including restricted and conditional access to their own markets. Moreover, to gain access to developed markets they want improved access to distribution channels and information networks. Furthermore, they point out that Art. XIX specifically mentions the possibility for DCs to open up individual sectors, and parts of sectors of their markets, all in line with their level of development.

In their proposal the DCs asked for specific actions to be taken by the Council for Trade in Services, and by the developed member states. Their wording is very specific and interpretable in one way only. For instance in Art 1: “the Council for trade in services shall carry out an assessment of trade in services”, followed by what specific items have to be assessed. Also in Art. 3 they demand that the actions to facilitate access of DCs are mapped out, so that on the basis of that “best practices and concrete actions can be outlined that Members must take to discharge their obligations under Art IV” (of GATS).

If such phrases were used throughout the negotiations and in all concluding documents, DCs would probably have had more confidence in the results and would have been more prone to ‘join the action’. They might have even had liberalised greater parts of their services markets.

### **§ 1.3 Dilemmas**

The above has made clear that the potential interests of DCs in further liberalisation of the services sector under GATS seems clear enough. This, however, is not to say that there are no significant dilemmas at the same time. In the following these dilemmas will be shortly discussed from the DCs’ perspective based on the 4 modes of services supply distinguished under GATS.

Under the first mode liberalisation would basically imply that services generated in DCs can be related to the promising market of outsourcing services provided by DCs. In fact, as far as this mode is concerned, the DCs’ role is at the most rather passive as far as the GATS negotiations is concerned, as in the end the market decisions will determine if and to what extent foreign companies decide to get involved in outsourcing in DCs. Once they decide to do so, however, it is up to DC producers to enter that market. ‘Offers and requests’ can basically be exchanged between private partners, so that explicitly introducing this in the GATS negotiations seems on average less key to DCs.

Under the second mode liberalisation would mean that access to consume local services in DCs would improve. Tourism and health care in DCs are clear examples hereof, and here again market decisions will determine if and how much foreign consumers will prefer to spend their holidays or undergo surgery in DCs. Yet, the degree to which DCs open up their territory for offering such services to foreigners is not completely undisputed. As soon as luxury facilities emerge in DCs to satisfy the requirements and demands of well-to-do foreign clients, risks of crowding out similar facilities for the local population may start to emerge as well. Health care may pose an example insofar as, for

instance, the best doctors and surgeons would be absorbed by the foreign clients-based clinics, preventing them from working for the probably less-well-equipped local population. Especially if highly skilled professionals in the sector are scarce – which is often the case in DCs – the risk of crowding out is real (see also the case study on the Cuban health sector next). This may pose a dilemma for the local government, since the advantages of providing such services to foreigners, such as generating foreign exchange and potential spill-overs and income, have to be weighted against the potential adverse welfare implications due to the crowding out effect mentioned. Still the issue is more a general DC policy issue than a typical DC GATS issue, because – once such services are offered – market forces will basically determine their use.

Things do significantly change, however, when turning to mode 3, which focuses on foreign direct investment (FDI) entry. Here DCs and non-DCs have a clear negotiations issues, because for many services' sectors the non-DCs have a clear interest in trying to get a foothold in the often rapidly growing DC market, whereas DC governments – while often recognizing the potential advantages of incoming FDI – at the same time are well aware of the main risks associated with them, *i.e.* that local competing firms are outcompeted and swept off the market; that foreign multinationals through their size will develop monopoly positions at the local market and subsequently channel their monopoly rents out of the country; and that the local government increasingly loses control over production. Basically the key question for many DC governments is if they can – through their negotiations position – reconcile the advantages of FDI inflows on the one hand, while effectively setting up and implementing monitoring and control mechanisms on the other hand to make sure that their conditions to redress potential disadvantages for their economies are actually satisfactory. This dilemma typically shows up in sectors such as utilities and telecom; a case study of each of these sectors has been included in this study, notably a case study on the Mexican Telecom services industry and one on the South African water sector. In addition a somewhat more general study will be presented on how foreign banking interferes with domestic banking in a number of Latin American countries, with a separate and particular focus on Chile.

mode 4, finally, is probably the most contentious one, as it covers the international mobility of persons, in practice mostly on a temporary basis. Here, again, DC governments face an important dilemma. If DC inhabitants get more opportunities to stay abroad for learning and working, this may not only generate foreign exchange via their remittances, but also enhances the DCs' production capacity as the repatriates' human capital value may well have increased significantly by their stay abroad, or via the DC emigration based on GATS significant labour externalities can be reaped from other countries. The drawback, however, is that labour while staying abroad may slowdown domestic growth, especially if such labour would decide not at all, or later than envisaged, to return to the home country and/or if migrants would finalise their remittances. In the latter case, the eventual brain drain

may in the end seriously deteriorate the DC balance-of-payments, and on the long run undermine the capacity of the home country to develop vital new production and innovation, which may undermine a DC's long-term growth perspective. Then migration under mode 4 may turn out to be negative for the DC welfare as a whole. This dilemma is all the more complex as the incentives for the migrants themselves may be clearly advantageous - otherwise they probably would not at all try to emigrate - whereas the same activity would be disadvantageous from a national welfare perspective. Two case studies that try to illustrate this dilemma discussed next are dealing with the Indian software sector and the Philippine medical sector and their workers, respectively.

## Chapter 2 The Mexican telecom services industry (by Friso de Jong)

The importance of the telecom services industry as a ‘backbone-industry’ is evident: advanced telecom services are considered to be a precondition for the development of any competitive economy, and crucial to the efficient functioning and competitiveness of the public as well as the private sector, enabling them to elaborate, transmit and receive information on a local, national and international level (Snow, 1988:172 in: Van der Krogt, 1996:9). So, it is also important for the development of other sectors (Mattoo, Rathindran and Subramanian, 2001; Saunders, Warford and Wellenius, 1994). In most DCs telecom services fall short of needs, thus constraining development (Saunders, Warford and Wellenius, 1994:3). The Agreement on Basic Telecommunications (ABT) seeks to expand the benefits of telecommunications throughout the world by liberalising it. Governments representing about 82% of world revenue in telecommunications committed to ensure competition with the coming into effect of the agreement as of January 1998. However, most of these economies already privatised and liberalised their markets before the coming into effect of the ABT.

The particular interest for the GATS negotiations relates to mode 3 on commercial presence. In the analysis the focus is on the consequences of the liberalisation for the Mexican economy in general, both economically and socially. Since regulation is considered to be of the utmost importance in changing the rules of the game, special attention will be focused on the regulatory climate (as part of the institutional setting).

Mexico has been chosen as a case because of Mexico’s relevance to the world economy in general being the second-largest economy of Latin America (after Brazil) and having a population of more than 100 million inhabitants. Furthermore, Mexico was an early reformer of market conditions since the 1980s,<sup>25</sup> when import-substitution was no longer thought of as an alternative to world trade.<sup>26</sup> Moreover, Mexico was one of the early reformers of telecommunications markets in Latin America by opening its basic telecom service to competition and foreign ownership prior to the January 1998 ‘start date’ of the WTO convention. Finally, since Mexico privatised Teléfonos de México (Telmex) in 1990, and liberalisation was introduced gradually to the market from this very same date, consequences of this reform can be analysed 13 years from then, as is done in this case study.<sup>27</sup>

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<sup>25</sup> Mexico joined the GATT in 1986 and the NAFTA and the OECD in 1994, which shows its willingness to be part of trade and co-operation agreements (NAFTA was a Mexican initiative).

<sup>26</sup> The fraction of imports subject to licenses fell from more than 90% to less than 25%; the maximum tariff was cut by 75%, and even the average tariff fell by 50%.

<sup>27</sup> This study has tremendously benefited from a three months study period in Mexico. Without the support and dedication of several persons, this research would not have been possible. My gratitude goes especially to Nanno Mulder and Jorge Máttar

## § 2.1 Liberalisation of the Telecom services industry

### § 2.1.1 TELECOMMUNICATION DEFINITIONS IN THE GATS

‘Telecommunications’ is defined as the transmission and reception of signals by any electromagnetic means. Specification is, however, needed. The GATS Services Sector Classification List breaks down telecommunications into 14 sub-sectors and an ‘other’ category, which is to be found in table 2.1.

Table 2.1 Telecommunications defined

<u>Basic telecom services</u>	<u>Value added services</u>
a. Voice telephone services	h. Electronic mail
b. Packet-switched data transmission services	i. Voice mail
c. Circuit-switched data transmission services	j. On-line information and data base retrieval
d. Telex services	k. Electronic data interchange (EDI)
e. Telegraph services	l. Enhanced/value-added facsimile services, incl. store and forward, store and retrieve
f. Facsimile services	m. Code and protocol conversion
g. Private leased circuit services	n. On-line information and/or data processing (incl. transaction processing)
	o. Other

A division is made between ‘basic telecommunications’ (a-g) and ‘value added services’ (h-n). Basic telecommunications implies the relay of voice or data from sender to receiver. Value-added telecommunication services are telecommunications for which suppliers ‘add value’ to the customer's information by enhancing its form or content or by providing for its storage and retrieval. The starting point in this case study to classify telecom services is the kind of services consumers buy from telecom carriers. Therefore, basic telecommunications is divided in local/long distance/international, wire or radio-based, public or non-public, resale or facilities-based and mobile/fixed services.

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for respectively arranging and providing me with an inspiring place to work at the United Nations Economic Commission for Latin America and the Caribbean (ELCAC), Mexico City. Furthermore I would like to thank Albert Oosterhoff, Katja Schoenmaker and the economic department at the Netherlands’ Embassy in Mexico City, Natalia Volkow and all industry representatives who were willing to exchange thoughts with me.

### § 2.1.2 LIBERALISATION OF TELECOMMUNICATION<sup>28</sup>

In the middle of the eighties, Mexico already launched a privatisation program, which dismantled government operations in 49 different industries. It has been one of the most extensive in the world in terms of both size and number of companies privatised (La Porta and Lopez-de-Silanes, 1997). In that spirit the formerly State-Owned-Enterprise (SOE), and national telecom company, Telmex, had been privatised in 1990.<sup>29</sup> The objectives pursued by the government were to (Mariscal, 2002:75):

- Guarantee the State's control of the telecommunications sector;
- Radically upgrade telephone service;
- Guarantee the rights of workers;
- Conduct research and development in order to strengthen the sovereignty of the country; and
- Maintain telecommunications under control of a Mexican majority.

The original ownership structure of Telmex changed in 1990 as can be seen in table 2.2.

Table 2.2 Ownership structure of Telmex

Original structure	Modified structure
51% share of series AA	20.4% of shares series AA
49% share series A	19.6% of shares series A
	60% of shares series L (limited voting rights)

*Source:* Annual report Telmex 1990 in: Escobar de Medécigo, 1999, p. 12.

In December 1990 the control of Telmex was transferred to a consortium including: Grupo Carso (a Mexican conglomerate owned by Carlos Slim), Southwestern Bell Corporation (SBC) and France Telecom. This consortium bought 20.4% of the social capital of the firm representing type 'AA' shares, of which 51% voting shares were included. Since Carso Global Telecom bought 12% of the social capital, it became the most important shareholder in terms of its ownership of voting shares. The other 49% voting shares were held by SBC. The remaining government shares in the company

<sup>28</sup> Liberalisation should not be confused with mere deregulation. One may have a deregulated monopoly or a tightly regulated multi-carrier system. The replacement of a century-old monopoly has proven to be very difficult by means of deregulation. Instead of fewer regulations, governments have recognised that a strong regulation is needed for the restructuring of the telecom market (Van Marrewijk, 1999:78). Liberalisation thus comprehends both deregulation as well as regulation (or re-regulation as Van der Krogt likes to call it). Deregulation is defined as a policy that allows the forces of supply and demand to operate free of government interference (Mariscal, 2002).

Privatisation is the selling of a state-owned enterprise at the stock market or to private consortia by the national government. Operationally, privatisation is conceived of as part of liberalisation; in fact the Mexican government intended privatisation to be followed by liberalisation. The privatisation of Telmex in 1990 is therefore considered as the start of the process of liberalisation, which actually was introduced formally from 1990 onwards as well.

<sup>29</sup> Telmex was officially established on December 23, 1947, by the merger of the two telephone systems.

were sold through public offerings and private sales, which raised more than \$6 billion according to the World Bank and Public-Private Infrastructure Advisory Facility (PPIAF, 2002:17). The decision to maintain a vertically integrated firm within telecommunications was mainly based on short-term needs, impatience in selling the public telecommunications operator (PTO), and the establishment of new alliances between the government and the private sector, as well as the labour union (Mariscal, 2002:26).

The concession title granted by the Ministry of Transport and Communication (Secretaría de Comunicaciones y Transportes, SCT) obliged Telmex to modernise (digitalise) the network (as a necessary prerequisite to provide interconnection), expand lines by 12% per year until 1994, reduce the waiting period for repairs, improve the quality of service, and improve services in rural areas: at least one telephone to each town with 500 inhabitants or more by 1994. In turn, Telmex would preserve its monopoly on long-distance (LD) telephony until 1996. This six-year monopoly was accounted for to allow Telmex to rebalance the tariffs between LD and local services. Local services were generally subsidised by revenues generated from highly profitable LD services and in order for competition to take place, transparent prices had to be established. Another reason for this six-year period was to make Telmex an attractive opportunity to invest in.

#### *The institutional setting*

No institutional setting was available until 1993, when the Federal Competition Commission (Comisión Federal de Competencia, CFC) was established. In 1995, the Federal Telecommunications Law (Ley Federal de Telecomunicaciones, LFT) was enacted, followed by the institutionalisation of a regulator for the telecom services industry in 1996: the Federal Telecommunications Commission (Comisión Federal de Telecomunicaciones, COFETEL).

The LFT opens to competition all segments of the market. Concessions are required to operate public telecommunications networks and the use for radio spectrum and satellite orbital slots are awarded through competitive bidding. Value-added service providers only need to be registered. The law confirms SCT authority to manage the use of spectrum auctions, to issue new concessions, to solve issues of interconnection, and also envisions the founding of an independent regulatory authority (Mariscal, 2002:77-78). However, the LFT has been subject to some controversies (Mariscal, 2002:78). One of these is the requirement of facilities-based competition. In order to promote network expansion, the law obligated new providers to build new infrastructure. In some instances, this requirement forces operators to build more infrastructure than originally planned and thus discourages competition and may limit the overall level of investment. Additionally, the LFT did not provide sufficient independence of the regulator from the government. Moreover, the actual implementation of the law has been subject to uncertainties. The main obstacles in the implementation of the LFT have been the vast numbers of litigations that have been filed by all the firms in the industry. The

Mexican judicial system provides a legal recourse, amparo, that allows a plaintiff to demand a temporary suspension of regulatory actions when she or he considers regulatory resolutions to have violated their constitutional rights. Most regulated companies have used this procedure and, given that the court system operates slowly, amparos have remained in place for two to three years. The result has been a temporary suspension of most regulatory decisions. When competition on long-distance started in 1997, the entrance of mostly American carriers changed the climate in which issues were solved completely. It was not until 2000 that telecom carriers settled, after four years of fighting, issues among themselves. The American competitors definitely were not paying attention to Mexico's guiding business culture and suffered losses (both financially, as well as immaterially) by litigating on a scale unprecedented.

#### *The regulatory authority*

The institutionalisation of a regulatory authority has been arranged by several transitory articles attached to the law. Although the law has excellent guiding principles and succeeded in attracting (especially American) competitors to the market for long distance telephony, the regulatory environment lacks a clear mandate for the regulator to base operations on. Cofetel is responsible for, among other things: enacting regulations and technical standards; ensuring that holders comply with the terms of their concessions and permits; suspending operators without concessions; resolving interconnection disputes between competitors; and maintaining a registry of applicable rates. Cofetel is an (semi-) autonomous entity of the SCT. The latter is the telecommunications policy-maker, and retains the authority to grant all concessions and permits. Cofetel recommends the SCT on major issues, such as amending existing telecommunications laws and regulations, allocating spectrum, granting, transferring, renewing or revoking concessions and applying penalties for concession violations. However, the SCT has the final decision-making power on these issues. Once a final decision is made, Cofetel implements the related regulations (Briceño, 2000:6). However, the relation between Cofetel and the SCT is difficult and time consuming (*e.g.* in the case of applying for a license). Furthermore, some activities are duplicated and responsibilities and authorisation are in unbalance. Cofetel's number one responsibility is to further competition, but no proper means are reserved for Cofetel to reach this objective. This leaves Cofetel to operate in a vacuum.

With regard to granting concessions Cofetel is required to review an entrant's detailed business plan and its technical and financial competence to provide the service described in the plan. However, when a market is competitive and where customers decide whether to patronise a new entrant, a concession process is unnecessary, and forces Cofetel to use its (already very limited) resources in unproductive ways (World Bank, 2002:21).

In practice decisions taken by Cofetel can be challenged in court. Then, the final resolution is drawn by the judicial body. The law should inhibit clear objectives for the regulator to abide but lacks clear



guidelines or procedures and responsibilities for the regulatory authority to follow in regulating the market. This has obstructed Cofetel in taking decisions and implementing resolutions since these were challenged by carriers in court. A good example hereof is the resolution drawn by the CFC in 1998, stating the dominance of Telmex in five markets: local service, interconnection, retail domestic long-distance, wholesale domestic long distance, and international long-distance. It took Cofetel over two years to draw up the appropriate new regulation in March 2000. Telmex litigated against it in court and only recently won. The resolution drafted was turned down on the basis of legal technicalities, which made the resolution legally non-existent.

In addition, litigation is different in being a private party or serving the law as a public entity. As a public servant one must abide the law, while as a private party one can go as far as one likes, as long as the law is not trespassed. Decisions that do not have a foothold in the law can be challenged on a personal level on the basis of the abuse of position, which is subject to criminal law. Therefore, operating as a public entity poses the constant threat of being charged with abuse of position. This causes the recent situation in which decisions are reluctantly taken, or even not taken at all.

Cofetel, established by Presidential Decree, has not been able to enforce regulation since the LFT does not contain the procedures to do so. Furthermore, the LFT of 1995 is the means to regulate the market, which does not contain the concept of universal service and is for this reason incomplete since one of the objectives of Cofetel is to make sure that the benefits of telecommunications are to be expanded throughout the country. This, together with its place in the organisational structure under the Ministry of Transportation and Communication gives it an extreme weak mandate to rule independently. The Ministry is the final one to draw or in some cases, the judicial body. Telmex but competitors alike have been successful in litigating against Cofetel resolutions in court.

The organisational structure in which it is the Ministry that has final decision making power is very liable to politics. It is said that the Vice-president of the SCT (who is entrusted with telecommunications) is not that in favour of competition at all. At the same time, however, he is the 'boss' of Cofetel which was established to promote competition. The immense value of Telmex on the stock market (about 16%) could be a reason not to hinder Telmex in its operations, since this is an (emotional) indicator which is narrowly followed by potential foreign investors. This has actually been an argument not to deal with Telmex. Decrease of the value of Telmex on the stock market would therefore not be for the benefit for the country as a whole. Thereby extensive lobbying by Telmex during the past 4 years with Mexico's three main parties, must have had its influence as well.

#### *Interconnection policy*

Article 42 of the LFT establishes that all carriers have to interconnect each other and reach an agreement hereon. It furthermore provided a generic obligation that Telmex's interconnection charges must be non-discriminatory, cost-based, and publicly available (based on a Resolution on

Interconnection published by the SCT in 1994). Interconnection rates are to be negotiated on a bilateral basis by the carriers themselves under Cofetel supervision, but they do not have to be approved by Cofetel in order to be valid. The concessionaires have a period of 60 days from the date one party requests interconnection to the other party to reach an interconnection agreement. Cofetel is entitled to intervene if the parties do not reach an agreement after 60 calendar days to take a decision regarding those issues on which the parties have failed to reach agreement (OECD, 2001:40).<sup>30</sup> However, such interventions were frequently followed by (successful) litigations against Cofetel, due to the shortcomings –pointed at earlier - in the LFT. This eventually culminated in the U.S. taking a complaint to the WTO with respect to measures affecting telecommunications services in Mexico.<sup>31</sup> Interconnection tariffs must be registered and become part of the Public Telecommunications Registry for which Cofetel is responsible (OECD, 2001:40). As Briceño rightly notices, the mandatory creation of a public Registry is a positive step towards the achievement of the principles - transparency of the interconnection agreements and non-discrimination of interconnection conditions among operators - subscribed by Mexico in the WTO. It is not clear, however, who can have access to the information contained in the Registry, which information of the interconnection contracts is disclosed, and which is considered confidential (Briceño, 2000:10).

Calling prices are strongly influenced by access charges that must be paid to Telmex for the local component of a call. These charges are supposed to differentiate between recovering the cost of physically interconnecting separate networks (interconnection) and the contribution of various competitive services to recovering the cost of the local network (access). The tariff (at \$0.03 per minute in 2000) is still substantially above estimates of the actual cost of interconnection, including the cost of terminating or originating a call, which are \$0.01 per minute at most (World Bank and PPIAF, 2002:23). Since the competing local carrier must pay more to Telmex for interconnection when a call exceeds five minutes, in addition to Telmex' \$0.14 per call charge for local calling, competitors have a strong incentive not to compete for customers who are likely to have long connect times with Telmex customers, such as those who use the Internet. For calls from wire-line to mobile telephones, \$0.063 per minute must be paid to Telmex for billing and interconnection, producing a price of \$0.40 for the first minute and \$0.26 per minute thereafter. Because this interconnection charge is so high, it strongly discourages the use of mobile telephones (World Bank and PPIAF, 2002:25).

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<sup>30</sup> The law was drawn without the existence of a regulatory authority, leaving the SCT to be responsible for attending meetings between carriers to reach an agreement. The SCT transferred this responsibility to the regulatory authority when it was institutionalised.

<sup>31</sup> Mexico – Measures affecting telecommunications services (WT/DS/204). First written submission of the United States of America, October 3, 2002. Mexico's answer is to be found in: México – Medidas que afectan los servicios de telecomunicaciones (WT/DS/204). Primera comunicación escrita Estados Unidos Mexicanos.

The process of establishing interconnection agreements was severely obstructed by Telmex, refusing to provide information on costs. Cofetel thus needed to establish interconnection rates based on assumptions. Initially, the goal was to reach cost-based rates and it was established below the lowest to be accounted for in Latin America, which was Argentina at that specific period. This decision on interconnection rates has been subject to litigation based on the fact that the regulatory authority is not supposed to create the method, and the model therefore lacked a legal basis. The cause is again to be found in a lack of missing procedures in the LFT. The interconnection rates were finally set at competitive standards in November 2000. Settlement rates were established according to international standards, and because of continuing inflation rates in constant terms were indexed to inflation for this two year period. Appreciation of the exchange rates had not been accounted for, however, which caused the high interconnection rates when compared internationally. In real terms, interconnection rates, however, were stable and reached \$0.015 once the period finished.

Telecommunications services in general are regulated by a price cap, which is imposed on the sector every four years, by Cofetel. It therefore provides specific services (*e.g.* local, public) with a weighted average, which gives Telmex the opportunity to raise prices in sectors where it (practically) does not have to deal with competition (*e.g.* local) and cut back prices in sectors where competition is more fierce (*e.g.* long-distance).

## § 2.2 Developments after privatisation

To get an impression of the impact of liberalisation of the telecom services industry, quality of service, coverage, and investments within the industry will be analysed.

### *Quality of service*

Since 2001 the network is for 100% digitalised and other remarkable results are to be reported as well. As of September 2002 only 1.7 failures per 100 lines is registered, compared with 13.5 in 1990. 72.8% has been repaired the same day as of September 2001, whereas this percentage was 50.1 in 1990. Customers would have to wait 23.9 months in 1990 to get a connection, whereas only 1.1 month is to be accounted for as of 2000 (Cofetel).

### § 2.2.1 COVERAGE

Coverage is measured by penetration, *i.e.* the number of lines or subscribers per 100 inhabitants of fixed line telecommunications or mobile telephone services. Figure 2.1 shows that main line density has improved, although not significantly when compared with OECD countries or even other Latin American countries (see figures 2.2 and 2.3). Because Telmex's concession title inhibited the obligation to increase lines at a rate of 12% until 1994, main line density grew rapidly until 1994. The

peso crisis caused lots of uncertainties, which is often referred to as well being the reason for stagnation in investments in main line density after 1994.

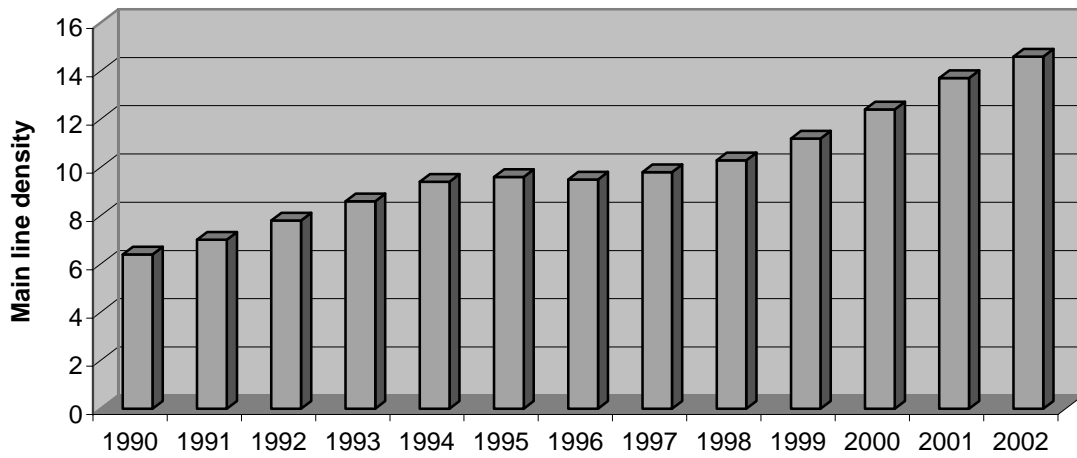


Figure 2.1 Main line density 1990-2002

Source: Cofotel.

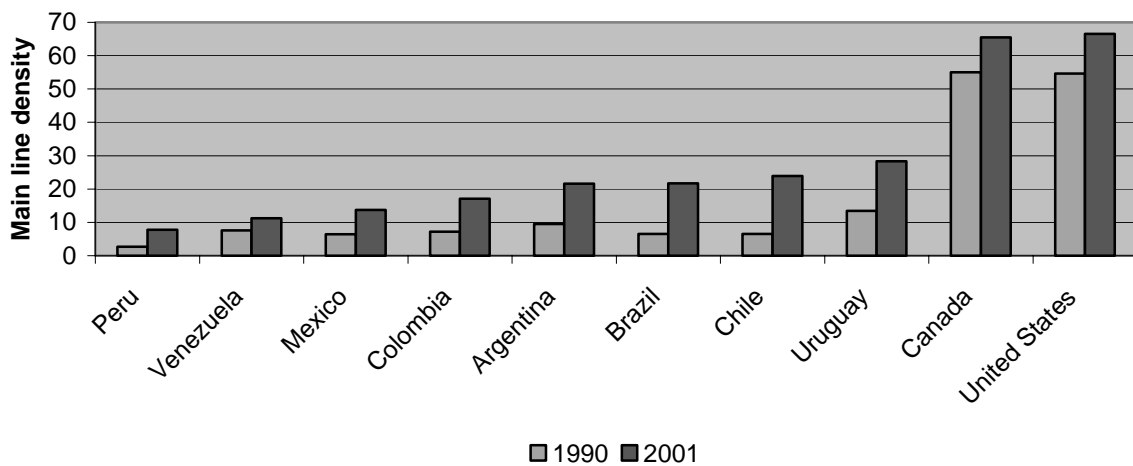


Figure 2.2 Comparison with American countries on main line density

Source: Cofotel.

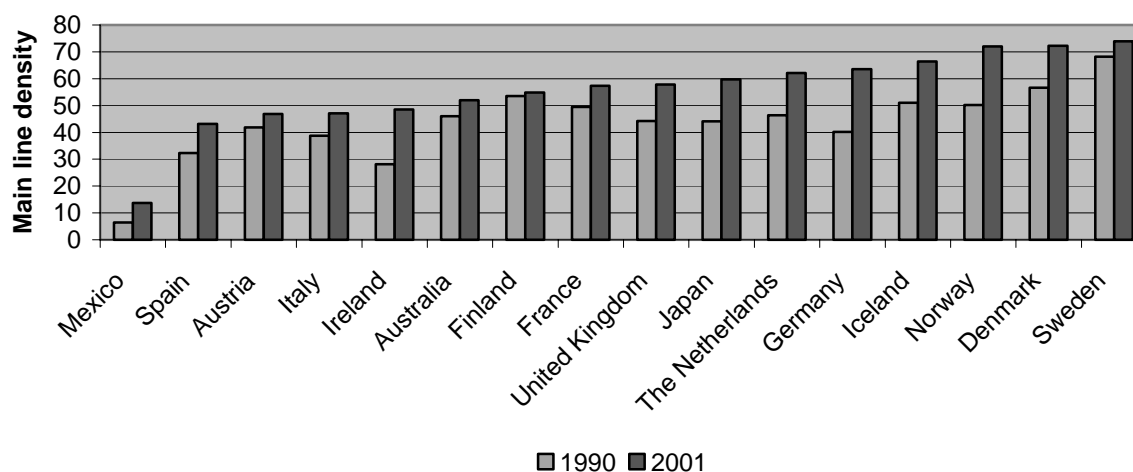


Figure 2.3 International comparison on main line density

Source: Cofetel.

#### Fixed line telephone services

Fixed line telephone services consist of local telephone services, long-distance services, public telephone services (pay phones) and Internet. These will be addressed below.

Table 2.3 Local providers

Telmex	Avantel <sup>32</sup>	Alestra <sup>33</sup>	Maxcom <sup>34</sup>	Megacable	Telnor <sup>35</sup>	Axtel
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Source: Cofetel.

The market for *local telephone* services was opened up to competition, together with the privatisation of Telmex, in 1990. For years to come, no one entered the market, (partly) due to the fact that competition rules were not published until October 1997. It was not until 1999 that the first local service customers were signed up by competitors. The market share in that very same year of competitive new entrants was 0.45% (OECD, 2001:32). There was not much to win on this market, however, since prices of Telmex were under pressure. Furthermore, negotiations on interconnection fees among companies, until last year, were always unsuccessful. This prompted many providers to construct their own infrastructure right next to Telmex' communication infrastructure. Excess (redundant) capacity was the result and no one actually benefited from this type of competition, since

<sup>32</sup> Avantel has been established on October 1994 with participation of Grupo Financiero Banamex-Accival and MCI WorldCom.

<sup>33</sup> Alestra has been established on November 1994 by a strategic alliance formed by AT&T (49%) and Onexa (51%). The latter is a company created by the co-operation of Alfa and BBVA Bancomer.

<sup>34</sup> Maxcom covers the states of Tamaulipas, San Luís Potosí, Veracruz, Puebla, Distrito Federal, Estado de México, Tabasco, Campeche, Yucatán, Quintana Roo, Chiapas, Oaxaca and Morelos.

<sup>35</sup> Telnor, a subsidiary of Telmex, covers the state of Baja California and in the north-western section of the state of Sonora.

the decrease in costs by switching from one telephone operator to another did not outweigh the absence of number portability.

Table 2.3 provides an overview of local telephone providers. Apart from Telmex, basically all these carriers provide services to business. Telmex holds more than 95% of all fixed-line subscribers in the country (Sinclair, 2002:26).

Probably the tensest situation is to be found within *long-distance* services because of disputes on interconnection since the liberalisation in 1997. Initially, 11 concession titles were issued (Escobar de Medécigo, 1999:31). Eventually, 22 concessionaires were issued of which only 11 providing a service (see table 2.4 for an overview of long-distance providers). The other half have been unable to put their licenses into operation, primarily because they could not compete with Telmex or pay the high interconnection fees that Telmex charged them (Calvo, 2002:4-5). This actually caused the recent situation in which three key long-distance operators can be distinguished: Telmex, Avantel and Alestra.

Prices were lowered significantly, but only marginally when compared with cost price or with prices in other Latin American countries. A rather positive development was the uniform price setting for phone calls inside Mexico. A phone call that starts in a foreign country on the other hand, has to be finished with the infrastructure of Telmex, of which both Avantel and Alestra rent capacity. Telmex solely negotiates with these foreign telecom operators on interconnection and represents Avantel and Alestra as well. Besides the fact that these operators are each other's competitors, there exists a high level of dependency on Telmex, when it comes to these negotiations.

With the opening up of the long-distance market for competition, other long-distance service providers were able to gain an almost 30% share on both the national long-distance market as well as on the international long-distance market. Telmex nevertheless was able to regain part of this market and now controls about 75% of Mexico's long-distance business (both national and international).

Table 2.4 Local providers

Alestra	Atsi	Avantel	Axtel	Bestel
Iusatel <sup>36</sup>	Marcatel	Maxcom	Miditel	Protel
RSL Com Net	Telereunión	Telmex	Telnor	Unefón

Source: Cofetel.

<sup>36</sup> Iusatel is the long-distance carrier of Iusacell. It is under the management and operating control of Verizon Communications Inc., which holds 39.4% of Iusacell. Vodafone Group Plc (NYSE: VOD), holds a 34.5% interest in Iusacell and the remaining 26.1% is controlled by the public.

Since 1996 *the public telephone services* (pay telephones) market has been opened to competition. Twelve companies entered the market since then. The number of pay telephones has tripled during the 1990s, making Mexico one of the Latin American countries with the highest pay-phone penetration at 3.28 per 1,000 inhabitants. However, the number of pay phones is still small, and the annual growth in pay lines is a small proportion of total line growth. Pay-phone penetration is also well below the OECD average of 4.9 per 1,000 inhabitants (World Bank and PPIAF, 2002:21-2).

In 1999 Telmex introduced a new program supported by the SCT to expand *Internet* usage by providing customers a low-end personal computer and access to the Internet as a bundled service and by using funds from an affiliated foundation to pay part of the initial cost and monthly fee for a computer and Internet access for schools (World Bank and PPIAF, 2002:22). Mexico has 6.9 personal computers per 100 inhabitants with internet penetration of 3.6% (as of 2002). Especially the latter is low when compared with both other Latin American countries or with OECD countries.

One can therefore speak of a ‘digital divide’ between Mexico and other OECD countries. It refers to the gap that exists between geographic areas or individuals at different socio-economic levels in respect to their opportunities to access information and communication technologies needed to access the Internet and engage in electronic commerce (OECD, 2001:265).

#### *Wireless telephone services*

Mobile telephony was introduced on the Mexican market in 1987. In 1990 it was decided to establish duopolies in every distinguished region. It therefore distributed two concession titles for every region in Mexico of which Telcel (a subsidiary of América Movil which was then still under operating control of Telmex) got one in each. Prepaid mobile programs, introduced in 1995, and ‘calling party pays’ (CPP) programs, introduced in 1999, have – as table 2.5 shows - resulted in skyrocketing penetration rates.

Table 2.5 Mobile telephone density

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Density <sup>37</sup>	0.1	0.2	0.4	0.4	0.6	0.8	1.1	1.8	3.5	8.0	14.2	21.6	25.4

Source: Cofetel.

In 2000 mobile penetration rates trespassed main-line penetration as can be seen in figure 2.4. In 2002, more than 25 million Mexicans were mobile subscribers. Of these more than 90% are estimated

<sup>37</sup> Number of cellular mobile telephone subscribers per 100 inhabitants. Defined as: users of portable telephones subscribing to an automatic public mobile telephone service which provides access to the Public Switched Telephone Network (PSTN) using cellular technology (ITU, Yearbook of Statistics, Telecommunication Services, Geneva, annual).

to use prepaid programs. Sinclair argues that both programs have released the demand for communication services in low teledensity market segments (2002:27). The amount of subscribers, especially in remote areas, is expected to rise substantially after total CPP is installed. At the moment only local CPP is in place, which means that a received long-distance call has to be paid for by the mobile receiver.

Mexico relies primarily on two technologies: cellular telephones and Personal Communications Service (PCS), which is similar to cellular but can accommodate a broader range of telecommunications services, including text and video. At the moment mobile telecom operators like Telcel and Teléfonos are investing heavily in gsm-technology.

Only a year ago, Mexico had nine competitors in the mobile arena. Due to consolidation, less than half remain at present. Recently, Teléfonos acquired Pegaso, becoming the second biggest player on the market, though with respectable distance from Telcel, which controls over 77% of the market. This left Mexico with four mobile operators.

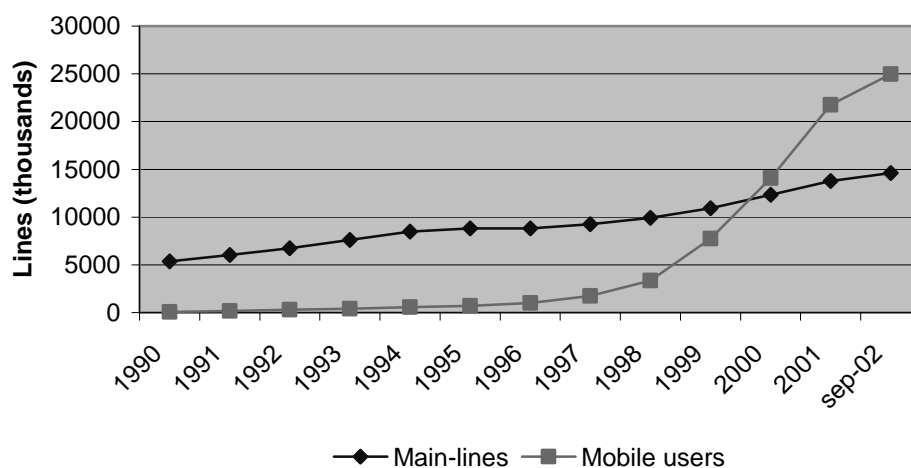


Figure 2.4 Main lines and mobile users

Source: Based on Cofetel.

### § 2.2.2 INVESTMENTS

Main line density is unevenly developed between different regions of Mexico. Table 2.6 shows the uneven development between different regions of the country. Population is centred in Mexico's biggest cities, like for example Mexico City, Guadalajara and Monterrey and competition is focused on highly dense populated areas like these cities.



Table 2.6 Main line density per district (year 2000)

District	Telephone lines		Main line density
	Residential	Non Residential	
Chiapas	101,605	37,589	3.6
Oaxaca	102,393	36,070	4.1
Tabasco	76,494	29,155	5.4
Hidalgo	109,401	31,380	6.1
Zacatecas	65,550	21,038	6.5
Campeche	35,303	13,176	6.6
Tlaxcala	52,860	13,200	6.7
Guerrero	171,850	49,150	7.0
Veracruz	374,829	121,648	7.0
San Luis Potosí	133,669	47,292	7.8
Michoacán	256,788	70,341	8.1
Puebla	312,376	93,869	8.1
Nayarit	65,606	19,754	9.1
Guanajuato	311,624	110,871	9.1
Durango	105,812	31,796	9.5
Yucatán	117,872	45,248	9.5
Sinaloa	193,879	74,780	10.4
Querétaro	108,668	49,171	11.1
Quintana Roo	63,879	43,469	11.4
México	1,290,926	245,798	11.4
Aguascalientes	85,375	31,545	11.9
Morelos	166,681	39,811	12.5
Chihuahua	315,812	100,064	13.6
Sonora	222,142	91,462	13.7
Tamaulipas	272,756	103,849	13.9
Coahuila	235,808	83,515	13.9
Colima	56,029	20,614	14.5
Jalisco	791,853	274,759	16.6
Baja California Sur	47,728	22,930	16.6
Baja California	339,153	120,150	18.1
Nuevo León	598,155	248,222	21.8
Distrito Federal	1,851,178	975,906	33.4
<b>Total</b>	<b>9,034,054</b>	<b>3,297,622</b>	<b>12.5</b>

Source: Cofetel.

In areas - rural, lower income areas - where no 'critical mass' is available, communities are deprived from basic telecommunication infrastructure.

Table 2.7 Localities with rural telecommunications services

Year	Communication via the SCT <sup>38</sup>	Communications via Telmex	Total	Annual difference (%)
1990	334	4,350	4,684	-
1991	614	7,071	7,685	64.1
1992	904	10,017	10,921	42.1
1993	943	12,536	13,479	23.4
1994	1,416	16,542	17,958	33.2
1995	1,416	16,735	18,151	1.1
1996	2,450	16,738	19,188	5.7
1997	11,000	16,738	27,738	44.6
1998	17,673	16,738	34,411	24.1
1999	22,953	16,738	39,691	15.3
2000	30,382	16,738	47,120	18.7

*Source:* Dirección de Telefonía Rural and Cofetel.

The objectives of Cofetel on the one hand and telecom operators on the other, are thus in conflict. 'How to expand the benefits of telecommunications to all' or more specifically 'how to expand the network in order to improve coverage' is Cofetel's main concern, whereas telecom operators (like any other commercial business) want to generate profits which are not to be yielded in these areas. At the moment, a company has to establish operations in three provinces in order to qualify for a concession title. As can be seen in table 2.7 Telmex is actually the only one providing rural telecommunications services according to its concession title.

<sup>38</sup> The rural telecommunication program by the SCT only serves those communities with 100 up to 499 inhabitants.

Figure 2.5 illustrates the increasing accessibility of these communities by telecommunications services.

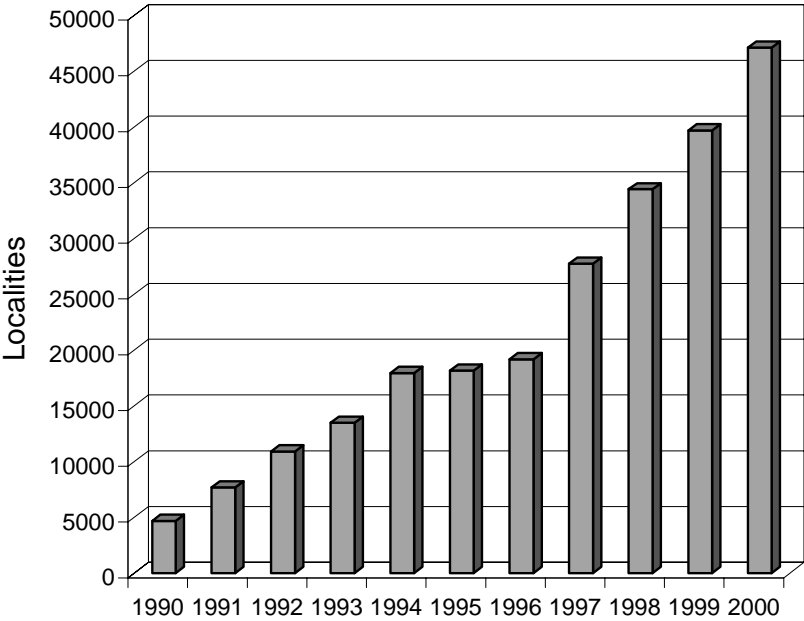


Figure 2.5 Localities with rural telecommunications

Source: Dirección de Telefonía Rural and Cofetel.

So, Mexico has not only to cope with an external ‘digital divide’, but also with - even more alarming for the consumers - an internal ‘digital divide’. Especially when it is taken into consideration that Telmex polarised its services, in order to serve the large corporate users while neglecting individual users and the geographic expansion of the network, resulting in slashing down the rates of international long-distance telephony (relatively) and making domestic-long-distance and local service tariffs more expensive (Barrera, 1995:58). This means that the investments of nearly \$22 billion during the 1990s to 1999 (see table 2.8) in network expansion and modernisation of the telecommunication industry were mostly for the benefit of business. Part of these investments have been allocated inefficiently and created redundant capacity.

Table 2.8 Investments in the telecom services industry (millions of \$)

1995	1996	1997	1998	1999	2000	2001	2002 <sup>e</sup>
1,488	1,596	1,964	3,162	4,027	5,165	5,736	4,021

e: estimated

Source: Cofetel.

Although investments in telecom increased from about \$1,500 in 1997 to about \$5,700 in 2001, the companies in general, with some exceptions, do not have the resources to carry out their investment plans. Access to capital across Latin America has dropped over 2002 and the recent economic situation makes the situation even more difficult. This is illustrated by falling levels of investment over the past few years. Calvo estimates that \$4 billion has been invested in 2002 of which 85% went into fixed and cellular phone services. The latter are therefore believed to have the highest growth potential for years to come (Calvo, 2002:4).

The telecommunication sector grew from 1.53% GDP in 1990 to 2.29% GDP in 1999 (OECD, 2001:57). It grew 5.6 times faster than the overall economy, which has seriously been troubled by the crisis of 1994. Sinclair establishes a reverse relation between growth in fixed-line telephony products and economic development. He argues that with the preference of the mass market for prepaid products (90% of mobile telephony) these lower income echelons simply are not consumers of fixed-line telephony products (2002:26). This leads to the conclusion that growth in fixed-line penetration is more a result of, rather than a motor for, economic development. This corresponds to the correlation that exists between GDP per capita and telephone traffic.

## **§ 2.3 Telecommunication and GATS**

Negotiations on the liberalisation of the telecom services industry evolved from the Uruguay Round in 1994. Hereafter, negotiations were extended under auspices of the Negotiating Group on Basic Telecommunications (NGBT). By April 1994, the talks had resulted in offers from 48 governments (contained in 34 offers), but some saw the package as not yet sufficient to successfully complete the talks. At the meeting in April 1996, participants accepted the suggestion of WTO Director-General Ruggiero to attach the results achieved so far in the negotiations to a Protocol, in a decision adopted on 30 April 1996 by the Council for Trade in Services. The Decision affirmed the opportunity to negotiate further to try to secure improvements. After April 1996, the Group on Basic Telecommunications (GBT) was responsible for implementing the further extension of negotiations. Finally, 55 schedules, covering 69 governments, of legally binding commitments to open some or all of the participating countries' basic telecommunications market to foreign competition was reached consensus upon. After final consensus the Protocol entered into force on February 5, 1998. On that date, the schedules on basic telecommunication services of the signatories became an integral part of the GATS schedules of services commitments.

### § 2.3.1 MEXICO'S COMMITMENTS AND EXEMPTIONS<sup>39</sup>

Mexico commits to the Reference Paper on regulatory principles for the redesign of national regulatory rules and institutions to ensure compatibility with trade disciplines.<sup>40</sup> It provides a framework on which to assess Mexico's commitment. The six key principles in the Reference Paper are:

- *Competitive safeguards.* Governments are required to ensure that major suppliers, especially the national PTOs, do not engage in anticompetitive cross-subsidisation, use information gathered from competitors with trade-restricting results, or fail to make available, on a timely basis, the technical information about their facilities and operations needed by competitors to enter the market.
- *Interconnection.* PTOs are to provide market entrants with interconnection at any technically feasible point in the network. Interconnection is to be provided at non-discriminatory terms, conditions, and rates, and should be of a quality no less favourable than the provider gives its own services. Moreover, interconnection rates are to be cost oriented, transparent, and, where economically feasible, unbundled. A dispute mechanism administered by an independent body is called for to handle disputes over interconnection terms and other issues.
- *Universal service.* Such obligations are to be administered in a transparent, non-discriminatory, and competitively neutral manner that are not more burdensome than required to meet the policy objectives.
- *Public availability of licensing criteria.* Where licenses are needed, information and decision-making procedures are to be transparent.
- *Independent regulators.* Regulatory bodies are to be separated from service providers and not accountable to them.
- *Allocation and use of scarce resources.* Procedures for allocating and using frequencies, numbers, and rights-of-way are to be carried out in an objective, timely, transparent, and non-discriminatory manner.

Excluded from the agreement are radiobroadcasting, cable television, satellite transmissions, DTH and DBS services and of audiodigital services. With regard to cross-border supply (mode 1) it is stated that 'international traffic must be routed through the facilities of an enterprise that has a license granted by the Ministry of Transport and Communication' (Secretaría de Comunicaciones y

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<sup>39</sup> The enumeration in this section is by no means exhaustive. For a complete overview of commitments and exemptions on telecommunications services, please review the referred schedules. The commitments and exemptions provided serve as an impression of Mexico's commitments and exemptions.

<sup>40</sup> The Reference Paper lays out key principles for the redesign of national regulatory rules and institutions to ensure compatibility with trade disciplines. Participants succeeded in elaborating a set of principles covering matters such as competition safeguards, interconnection guarantees, transparent licensing processes, and the independence of regulators. They also agreed that each would use the text as a tool in deciding what regulatory disciplines to undertake as additional commitments.

Transportes, SCT). With regard to commercial presence (mode 3) 'a concession from the SCT is required'. Furthermore, an important improvement, when comparing these commitments and exemptions with an earlier version, includes the raising of the foreign equity limitation from 40 to 49%. Excluded from this exemption are cellular telephony services where permission is required from the Commission of Foreign Investment for a greater level of foreign participation. Telecommunicationes de México (Telecomm) has exclusive rights to links with Intelsat and Immarsat. Services other than international long-distance services which require use of satellites must use Mexican satellite infrastructure until the year 2002.

However, Mexico's schedules of commitments are not ratified by congress and are therefore not considered law, according to the Mexican policy system. Moreover, the process of granting of concession titles for new services or new entrants to the market is highly obstructed by the bureaucratic mole. This is partly due to the division of work between the SCT and Cofetel, as explained above. But even if a firm has survived the bureaucracy and fulfilled all the prerequisites for a concession title, granting by the SCT is still not certain. Thus, the situation based on the commitments scheduled within the GATS seems more liberal than the factual situation.

On the basis of a 1999 International Telecommunication Union survey (ITU), McGuire concluded that Mexico is moderately restricted. Its restrictions on access to leased lines and networks are similar to those of the most restricted economies. A comparison of the classification on trade restrictiveness with Gross Domestic Product (GDP) per capita suggests that economies with less restricted service sectors tend to have higher GDP per capita (McGuire, 2002: 20). Removing restrictions on FDI could mean a reduction in the price of foreign telecommunications by 14.43% and of domestic telecommunications by 6.24% (McGuire, 2002: 24). Restrictions on FDI are estimated to increase the price of services of telecommunications in DCs by up to 5%. The government objective to grow strong domestic telecom carriers (infancy industry argument), able to compete with Telmex is not believed to outweigh the benefits for its citizens by paying lower prices. This has a direct impact on the economy, notwithstanding the increase of the customer base (when prices drop, more people will simply be able to afford telecommunication services).<sup>41</sup>

### § 2.3.2 THE AGREEMENT ON BASIC TELECOMMUNICATIONS

Previous assessment of the Agreement raised three main shortcomings: the limited scope of liberalisation created by the Agreement, the lack of precision of the regulatory principles of the Reference Paper, and the weaknesses of the sectoral approach in comparison with a more horizontal approach to competition policy and domestic regulation (Blouin, 2000).

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<sup>41</sup> As a rule of thumb, 5% of people's income can be spend on telecommunications.

Skeptics would stress that most of the commitments taken as a result of the negotiations on basic telecommunications are standstill commitments, *i.e.* they consist in binding liberalising measures that have already been adopted at the national or regional level (Noam, 1997). This is especially true for developed countries like Canada, the US and the EU. One could therefore argue that WTO commitments in services, in general, are only binding liberalisation initiatives which were already in place at the national or regional level. To take it a step further, one could even point out that international agreements generally lag behind domestic policy.

On the other hand, if one adopts a more optimistic view of the ABT, one has to stress that a binding commitment to keep a sector open to foreign competition provides investors with the certainty and predictability that domestic liberalisation alone cannot give. The ‘insurance policy’ aspect of this agreement should not be neglected. Moreover, as the parties to the agreement took binding commitments regarding telecommunications services, the sector is now subject to a multilateral dispute settlement process, the WTO’s Dispute Settlement Understanding (DSU) (Blouin, 2000).

The agreement acknowledges the importance of ‘internal measures’ as potential barriers to trade, and regulatory policies in particular have been subjected to greater scrutiny. Regulatory measures can impede market access in many ways, even if regulation is applied in a nondiscriminatory manner to domestic and foreign firms.

In contradiction to others, Blouin sees the Reference Paper and the way it is formulated (the document does not oblige the signatories to adopt one single set of regulations regarding telecommunications services) as a strength rather than as a weakness (Blouin, 2000). In practice, the Reference Paper will make regulatory requirements and governmental policies of different jurisdictions more similar and will result in a certain amount of policy convergence. Nevertheless, it remains that the only objective is to provide guidelines.

The approach adopted by the Reference Paper aims at striking a balance between two objectives: international market openness and national sovereignty.

Blouin continues by addressing the desirability of a horizontal approach. Such an approach would allow a more coherent perspective on how competition policy and regulatory policy relate to trade policy. Nevertheless, the sectoral approach adopted for telecommunications presents some clear benefits. It allows Members to craft agreements which deal with the issues that are unique to that sector. Lawyers raised one weakness about the regulatory principles in the ABT: it lacks precision. They argue that many of the concepts used in the text are vague. For example, the fact that the central notion of “major supplier” is defined in very general terms in the Reference paper casts some doubts

over the capacity of the document to create enforceable safeguards against anti-competitive behaviours (Bronkers and Larouche, 1997). Moreover the Reference Paper identifies cross-subsidisation as an anti-competitive practice. Bronkers and Larouche emphasize that it is difficult to monitor this cross-subsidisation, as it demands the implementation of strict accounting, reporting, auditing and disclosure systems, which are not included in the Reference Paper. Telmex stopping providing information on costs from 1997 as referred to before, does not help in overseeing its practices.

The question of the lack of precision can be considered from a legal perspective: it is difficult to enforce vague rules. On the other hand, one could praise the degree of regulatory flexibility granted by such broad definitions. Trade agreements have to accommodate differences in domestic regulation in order to respect sovereign states' right to create national rules while attempting to limit the range of divergence, to limit the negative consequences for international trade. Moreover, it leaves scope for a much-needed flexibility to experiment and identify the regulations, which can best manage the transition from monopolised to competitive telecommunications markets. Finally, this flexibility is needed to be guiding in a sector in which changes, especially in technology, are rapidly following each other.

Multilateral liberalisation is a necessary complement of unilateral liberalisation. Unilateral liberalisation, whereby Governments liberalise trade regardless of the efforts of other economies, plays an important role in reforming service sectors. Reform often takes place as governments realise the benefits of promoting competition and establishing an efficient supply of services. Many of the respondents referred to the GATS agreement and to the WTO in general as a framework, which highly contributed to awareness in the telecom industry at large with regard to the direction to be taken. Involvement in these, and other free trade agreements secured or locked in, long-term economic dedication to open up the economy. Sorsa complements this view by stating that multilateral liberalisation under the GATS complements the efforts of governments to liberalise unilaterally (Sorsa, 1997 in: McGuire, 2002:31). GATS commitments and ongoing negotiations can advance services liberalisation in a non-discriminatory manner within internationally enforceable rules. The multilateral system can help to lock in unilateral reforms to limit possible backsliding by governments in the future. However, the effectiveness of the GATS in meeting these objectives, at least in the short run, will depend in large part on the extent to which WTO Members have bound their existing policies, or preferably committed themselves to new liberalisation (McGuire, 2002:31).

It is generally believed that despite liberalisation, it remains relatively hard for new entrants to gain significant market share, particularly in relation to access to the final customer and the provision of fixed local service generally. Through, amongst others, mergers and acquisitions, large access providers could gain a market position permitting them to dictate terms, conditions and prices of



access by smaller providers. Finally, as more telecom providers become global companies, it is increasingly likely that some of their activities may fall outside the jurisdiction of any single national competition body or other relevant government authority. In such situations, enhanced bilateral and multilateral cooperation on competition policy may have an important role to play (WTO, 2001:543, 544). Continuing efforts in assessing and improving performance of multilateral trade agreements should therefore be at the forefront of the agenda, the coming years to secure commitments made and to provide businesses with the certainty of clear guidelines with regard to doing business on a world-wide scale.

Although the WTO agreement on basic telecommunications is to be considered as a major milestone in the liberalisation of services, the question is whether its impact is substantial. Noam argues that many countries as signatories to the WTO agreement - like the US, the EU and Japan already liberalised their markets (partly) (Hufbauer and Wada, 1997:54). Mexico already considered everything proposed during the subsequent negotiation rounds with the instigation of NAFTA, and committed itself to liberalisation from 1990.

## **§ 2.4 Conclusions and recommendations**

Mexico's telecom services industry showed significant improvements over the past 13 years: the sector grew 5.6 times faster than the overall economy; main-line density has doubled; mobile-line density has grown almost exponentially; costs have been taken down; quality of service has improved; and the fixed network has been totally digitalised. However, Mexico failed in delivering services according to - one of - the stated objective(s) of its liberalisation: 'making it possible for everyone to communicate through low prices'. It turned out that investments served large corporate users while neglecting individual users and rural areas; competition did not rise sufficiently so that Telmex kept its dominant position.

The main reason for the negative developments of liberalisation is the institutionalisation of governing institutions, long after reform. First, the law did not provide Cofetel the authorisation needed to enforce regulation and thus to further competition. Second, it did not secure the independence of the regulator from the Ministry of Transport and Communication. Third, it did not comprehend sufficient guidelines and procedures in case of disputes. Fourth, the Ministry of Transport and Communication determined the pace at which presidents at Cofetel were fired and appointed. Political influence was thus evident. As a consequence, decisions by Cofetel were reluctantly taken, or not taken at all and, with the entrance of (mostly) American carriers, its decisions and resolutions were litigated. Finally, foreign investment was needed but was severely hampered by the restriction on FDI of 49%.

The conclusion seems justified that most investments into the industry were for the better of business and did not add substantially to residential coverage. The digital divide is expected to become more apparent in the next years in line with the widening gap in poverty.

There are two sides to the story. On the one hand, investing in remote areas will, with the actual state of technology, not be profitable. On the other, income, needed to afford telecommunications is absent as well. Universal service will not be complied with, without actively pursuing social services objectives. Although successful programs are available like in Chile (reverse auction) and these have been mentioned and designed within Mexico as well (E-Mexico initiative), the implementation falls short of needs. The sector right now faces the unfavourable prospect of being stuck in the middle by lacking government intervention when it comes to reaching social services objectives, and continuous interference, obstructing competition on the market. Initiatives like the revision of the Telecommunication Law started, but are obstructed by political unwillingness and disagreement in congress.

This provides another perspective by which the privatisation of Telmex as a vertically integrated company can be valued. On the basis of the government's objectives, privatisation has been successful, though by giving a firm high market power in the telecom sector and establishing governing institutions long after reform, industry restructuring also resulted in high telephone tariffs and carried on an under-supply of basic telecommunications services (Mariscal, 2002: 68). The sector as a whole and the economy in general, thus suffered from the privatisation strategy of the government.

#### § 2.4.1 RECOMMENDATIONS

In changing the rules of the game, *i.e.* liberalising the market and/or privatising the public telecommunications operator, it is of the utmost importance to:

- Establish a truly independent regulatory authority with balanced authorities and responsibilities.
- Adapt the Telecommunication Law to the new situation, *i.e.* provide the regulator with strong foothold in the law and equip the regulator with sufficient procedures to regulate the sector. This will reduce the scope of litigating against decisions taken and resolutions drawn by the regulator and thereby diminish uncertainty and instability.
- Serve low dense populated areas, which are not served by telecommunications, by universal service under auspices of the government. A system called 'inverse auction' has proved to be successful in reaching universal service objectives. In the end, technology transfer, technology evolution and diffusion will make it profitable to invest in these areas as well by telecom carriers in general.
- Introduce total calling party pays in mobile telephony. This could highly add to communicate everyone against low costs.

- Review any law, but especially law concerning considerable infrastructure like telecommunications, quickly, so that uncertainty about the direction of the industry among carriers will be reduced and investment decisions will not be put on hold because of law review.
- Prevent cross-subsidisation practices in the case of privatising the public telecommunications operator as a vertically integrated company. This could be realised by a price setting policy consisting of a price cap on a basket of services and a price floor per specific service.
- Minimise possible obstacles in providing for the entry of new players to the market, since consumers decide whether or not a company is going to succeed. Therefore, the process of granting licenses or permits is preferred when compared with the granting of concession titles, which constitute a very thorough and time consuming process.

In order for the GATS to become meaningful and operationally applicable within telecommunications, it is of the utmost importance to:

- Operationalise provisions as elaborated on in the Reference Paper, *i.e.* define when one can speak of a 'dominant carrier'.
- Aim for the total independence of regulators instead of mere separation from service providers. This will stimulate individual countries to again consider the principles as laid out in the Reference Paper, and act accordingly.

## Chapter 3 Financial liberalisation in Latin America (by Gertin Bies)

Should a country open up its frontiers via the GATS framework to welcome foreign banks to its domestic banking market? As will be shown there are a lot of arguments both against and in favour of the entry of foreign banks, some of which could well depend on the development level of a country. This case study therefore, investigates the effects of foreign bank entry on the efficiency of the domestic banking sector in ten DCs in Latin America: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela. It also analyses differences in performance of foreign and domestic banks. Latin America is an interesting case area for a number of reasons. First, it has one of the highest foreign bank participation. Second, while for the region as a whole foreign bank lending has increased in recent years, there are still large differences in the extent to which various countries within the region are depending on this source of funds. Finally, the region has experienced considerable shocks (both positive and negative) in the last few years. In the second half of the 1990s, foreign banks significantly increased their ownership shares of emerging market banking systems because local banks sought to re-capitalize in the wake of various financial crises, and also due to the broader industry trend of consolidation, privatisation, and liberalisation (Crystal, J, *et al.*, 2002:1-6). Foreign bank control in the region rose from 7.5% in 1994 to 25% in 1999 (IMF, 2000:153). This process has contributed to the availability of valuable empirical information on the behaviour of foreign banks in these countries.

### § 3.1 Foreign banking and the host country

It is not so easy for a country to decide whether it should open its borders to foreign banks. On reviewing recent literature, many arguments in favour as well against the entry of foreign banks come up.

#### *Arguments in favour of foreign banks entry*

- Foreign bank entry is associated with a reduction in: domestic bank profitability, non-interest income and overhead expenses, and an increase in efficiency and diversity of financial services. (Lensink and Hermes, 2002, Claessens, *et al.*, 2001; Bol *et al.*, 2002).
- Foreign bank entry may lead to positive spill-over effects, such as the introduction of new financial services, the introduction of modern and more efficient banking techniques, the improvement of management of domestic banks, the improvement of bank regulation and supervision, and the reduction of influence of the government on the domestic financial sector (Lensink and Hermes, 2002).
- Foreign banks may increase the quality of human capital in the domestic banking system (Lensink and Hermes, 2002).
- Foreign banks may also attract (other) foreign direct investments (FDI).

- Foreign banks may enhance a country's access to international capital (Levine, 1996).
- Well-capitalised foreign banks may be able and willing to keep lending to domestic firms during adverse economic conditions, as opposed to domestic banks, which will possibly lower the credit supply of the latter (De Haas and Van Lelyveld, 2002).
- Increased foreign bank presence is associated with better lending terms (lower interest rates, lower fees, longer maturities) for all, but especially larger firms (Clarke *et al.*, 2001).
- Foreign bank entry stimulates gross domestic investment in the host economies (Lensink and Murinde, 2002).

*Arguments against foreign banking entry*

- Foreign bank entry may weaken the position of the (less-sophisticated) domestic banking system. Domestic banks are not able to cope with the increased competition and may leave the market. This may cause some disruptions (unemployment) and some political concerns, such as increased foreign control (De Haas and Van Lelyveld, 2002).
- Foreign banks get higher interest margins, overhead expenses and profitability than domestic banks in DCs, because in DCs a foreign bank's technological advantage is strong enough to overcome any informational disadvantage. The opposite is true in developed countries. This suggests that the reasons for foreign entry, as well as the competitive and regulatory conditions found abroad, differ significantly between developed and developing countries as the destination (Demirgüç-Kunt and Huizinga, 1998, Claessens *et al.*, 2001).
- Foreign banks will not provide additional (or possibly less) credit during an economic downturn in the host country. Also changes in economic conditions in the foreign bank's home country may have a negative effect on bank activity in the local market (De Haas and Van Lelyveld, 2002);
- Domestic supervisory and monetary authorities often fear that their influence on banks' behaviour may diminish (De Haas and Van Lelyveld, 2002).
- Foreign banks and large banks tend to lend less to small firms (Berger, Klapper and Udell, 2001, Kraft, 2002).
- Foreign banks entry in the corporate loan market does not decrease the margins and profits in the personal loan market (Gruben *et al.*, 1998).
- At lower levels of economic development foreign bank entry is associated with increasing costs and margins, because at lower levels of economic development, banking markets are less developed and competitive. Implementing such spill-over effects may raise costs of local banks, at least in the short term. However, due to a lack of competition domestic banks usually finance the implementation costs by raising their margins (Lensink and Hermes, 2002).

## § 3.2 Data

For this study bank-level accounting data and macroeconomic data of 2001 were used. The sample of bank-level accounting data is from the BankScope database provided by Bureau van Dijk (version December 2002). A bank is defined as foreign when at least 50% of its shares are foreign owned, *i.e.*, when there is foreign control of a bank's operations. Coverage by BankScope is comprehensive, with banks included roughly accounting for 90% of the assets of banks in each country. However, BankScope does not capture foreign branches, which may lead to an underestimation of the level of foreign participation (Mathieson and Roldos, 2001). The extended Bankscope data contain all commercial banks, saving banks, cooperative banks, real estate & mortgage banks, medium- & long-term credit banks and investment banks & securities houses in the 10 Latin American countries.

### § 3.2.1 DATA OF FOREIGN BANKS IN LATIN AMERICA

#### *Degree of foreign bank penetration*

Table 3.1 shows two measures of foreign bank presence in the national banking markets of 10 Latin American countries in 2001: the share of banks that are foreign-owned, and the share of foreign bank assets in total bank assets.

Table 3.1 Foreign banks in 10 Latin American economies (2001)

	Number of foreign banks <sup>42</sup>	Number of total banks	Number of foreign banks as a % of total number of banks	Value of foreign bank assets as % of total bank assets
Argentina	23	77	30	25
Bolivia	6	12	50	68
Brazil	30	117	26	16
Chile	6	26	19	14
Colombia	7	32	22	23
Ecuador	2	28	7	39
Mexico	9	33	27	34
Peru	4	14	29	49
Uruguay	9	22	41	30
Venezuela	7	62	11	37
Total	103	423	24	23

The table shows for 2001 that foreign banks accounted on average for 24% the total number of banks and that foreign banks held 23% of total bank assets in the 10 Latin American economies. This illustrates the amount of credit supplied by foreign banks and to what extent foreign banks are involved in financial intermediation.

For three-fifths of the countries the asset presence measure exceeds foreign presence measure (this is the case for Bolivia, Colombia, Ecuador, Mexico, Peru and Venezuela). This reflects that foreign

<sup>42</sup> A foreign bank is defined as having at least 50% foreign ownership.

banks tend to be larger than domestic banks. However, in the two largest economies in Latin America, Argentina and Brazil, foreign banks tend to be smaller than domestic banks.

By focusing on the share of banks assets owned by foreign banks one may either underestimate or overestimate foreign influence. Underestimation may be due to the fact that banks from outside the country may have a minority share (Bol *et al.*, 2002); Overestimation can be due to the 50% rule. Therefore this study also empirically estimates how (increased) foreign bank presence, affects the operations of the banking system. Table 3.2 shows foreign bank penetration measured by the exact percentage foreign ownership. From the table the conclusion can be drawn that the 50% rule results in an overestimation of foreign bank penetration. This is also due to the fact that a lot of ownership was not known in BankScope.

Table 3.2 Foreign bank penetration measured by the exact % foreign ownership

	<i>Foreign bank assets*</i>	<i>Total bank assets</i>	<i>Value of foreign assets in relation to total bank assets (%)</i>
Argentina	21.178.918	96.260.395	22
Bolivia	2.027.900	4.605.044	44
Brazil	54.525.819	370.961.860	15
Chile	9.248.279	67.753.718	14
Colombia	3.340.610	32.364.198	10
Ecuador	326.868	5.737.400	6
Mexico	13.790.668	168.260.294	8
Peru	8.004.533	16.298.824	49
Uruguay	2.496.221	12.899.693	19
Venezuela	3.763.703	32.077.792	12
<b>Total</b>	<b>118.703.519</b>	<b>807.219.216</b>	<b>15</b>

\*Foreign bank assets are the exact % foreign ownership multiplied by total bank assets.

Table 3.3 shows that on average foreign banks tend to be smaller than domestic banks in Latin America. A striking fact is that the banks in Mexico are on average much larger than in the rest of Latin America. The average size reflects the average size of the total assets of the banks and illustrates the amount of credit supplied by the banks.

Table 3.3 Average size domestic versus foreign banks

	Average size domestic banks (in 1000 \$)	Average size foreign banks (in 1000 \$)
Argentina	1331	1060
Bolivia	243	524
Brazil	3568	2018
Chile	2787	1844
Colombia	997	1062
Ecuador	134	1127
Mexico	4655	6283
Peru	828	2005
Uruguay	697	427
Venezuela	369	1682
<b>Average</b>	<b>1932</b>	<b>1835</b>

*Link between foreign bank presence and national income*

The question arises as to whether there is a systematic link between foreign bank presence on the one hand and national income on the other hand. In table 3.4, the 10 countries have been ranked by national income and foreign bank weight.

Table 3.4 Foreign banks and national income

	Value of foreign bank assets in relation to total bank assets (%)	GDP/cap (\$)
Argentina	25	7168
Mexico	34	6215
Uruguay	30	5412
Venezuela	37	5077
Chile	14	4123
Brazil	16	2911
Peru	49	2069
Colombia	23	1940
Ecuador	39	1395
Bolivia	68	941



It shows that there is not a significant relation between foreign bank presence and national income. The Spearman Rank Correlation coefficient found was  $-0,38$ , suggesting a negative association. In fact, the countries with the lowest foreign bank presence, Chile and Brazil, are middle-income countries.<sup>43</sup>

Table 3.5 Bank variables: Domestic versus Foreign<sup>44</sup> (2001)

Country	Own <sup>45</sup>	Net margin/ta (%) <sup>46</sup>	Non-int. income/ta <sup>47</sup>	Over- head/ta <sup>48</sup>	Before tax profits/ta <sup>49</sup>	Loan loss prov./ta <sup>50</sup>
			(%)	(%)	(%)	(%)
Argentina	D	3.6	4.5	5.7	0.3	2.0
	F	4.1	5.7	6.4	0.3	3.1
Bolivia	D	4.8	1.1	4.9	-1.7	2.7
	F	5.7	1.2	3.8	0.7	2.4
Brazil	D	5.8	3.6	6.3	2.0	1.1
	F	5.6	-2.1	6.3	-3.4	0.6
Chile	D	3.7	0.9	2.7	1.4	0.6
	F	4.6	1.4	3.6	1.4	1.0
Colombia	D	3.6	6.6	7.7	1.1	1.4
	F	5.1	5.6	9.1	0.3	1.2
Ecuador	D	2.5	4.4	5.5	-2.2	3.6
	F	3.2	4.3	5.9	0.8	0.8
Mexico	D	4.7	3.0	5.0	1.9	0.8
	F	5.3	1.5	4.3	0.6	1.8
Peru	D	4.5	1.4	5.2	0.1	0.6
	F	5.2	3.0	5.2	1.0	2.0
Uruguay	D	4.9	5.1	7.7	0.8	1.5
	F	3.1	2.0	3.2	1.1	0.7
Venezuela	D	10.3	2.5	9.2	2.3	1.4
	F	9.8	3.0	8.8	2.9	1.0

Source: Data from Bank-Scope data base of Bureau Van Dijk.

<sup>43</sup> Consistent with Claessens' (1999) findings.

<sup>44</sup> Ratios are calculated for the total of foreign banks and the total of domestic banks in each country separately.

<sup>45</sup> Ownership denotes if a bank is a foreign bank (F) or domestic (D). A foreign bank is defined to have at least 50% foreign ownership.

<sup>46</sup> Net margin/ta is defined as net interest income over total assets.

<sup>47</sup> Non-interest income/ta is net non-interest income over total assets.

<sup>48</sup> Overhead/ta is overhead divided by total assets.

<sup>49</sup> Before- tax profits/ta is before-tax profits divided by total assets.

<sup>50</sup> Loan loss provisions/ta is loan loss provisions over total assets.

Table 3.5 provides information on the net interest margins and other accounting variables for all domestic and foreign banks in each of the 10 countries in 2001 separately. An analysis of the data based on the methodology of Demirgüç-Kunt and Huizinga (1998) shows that in seven of the ten Latin American countries foreign banks reported significantly higher net interest margins than domestic banks.<sup>51</sup>

How can these results be explained? It has been argued that foreign banks may be able to realise high interest margins in DCs, because of three reasons. First, foreign banks are frequently exempted from credit allocation regulations and other restrictions, which are a net burden on margins. Secondly, in countries where state banks dominate a large share of the banking system, non-commercial criteria may be frequently used to allocate credit, resulting in downward pressure on margins. Finally, market inefficiencies and outmoded banking practices in DCs may also allow foreign banks to reap higher net interest margins than domestic banks, outweighing the information disadvantages they may face.

Another result is that in four of the ten Latin American countries (Argentina, Chile, Colombia and Ecuador) foreign banks have higher overhead costs than domestic banks. Claessens *et al.* have argued that this might be due to the fact that foreign banks have to overcome large informational disadvantages. In the six other countries foreign banks have lower overhead expenses than domestic banks, probably because the foreign banks mostly engage in wholesale transactions.

Next, the loan loss provisioning turns out to differ between domestic and foreign banks. First, differences may reflect a difference in customer mix (with foreign banks concentrating on large corporations (more risky) rather than mortgage or consumer loans). Alternatively, different provisioning ratios may reflect differences in foreign and domestic banks' ability to screen bad credit risks and willingness to take provisions for bad risks. In only four of the ten countries foreign banks have higher provisioning ratios.

Finally, table 3.6 provides information on differences in before-tax profits over assets between domestic and foreign banks. This variable is affected by each of the other variables in the table. Only in three of the ten countries did foreign banks have lower before-tax profits than domestic banks in 2001. This is in line with what others found for DCs.

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<sup>51</sup> This is in line with what Claessens *et al.* found for many developing countries.

### § 3.3 Impact of foreign bank entry on the operation of domestic banks

Next, it was analysed empirically with the help of the same 2001 cross-country data set, how foreign bank entry affects the operations of domestic banks and if foreign banks differ from domestic banks in terms of interest margins, non-interest income, overhead expenses, loan loss provisions, and profitability.

The estimation results indicate that foreign bank entry is significantly associated with a reduction in domestic bank profitability, suggesting that foreign bank entry promotes the efficiency of the domestic banking system. This relationship seems, however, to be only valid for countries at lower levels of economic development.<sup>52</sup> The reason could be that at lower levels of economic development foreign bank entry has a strong competitive impact on domestic banks and lead to less income and lower costs for domestic banks. At higher levels of economic development, however, competitive pressure of foreign banks is less strong since the gap between domestic and foreign banks is smaller. It was calculated that only in countries with a GDP per capita of less than some \$2,500 (Peru, Colombia, Ecuador and Bolivia in the case study) foreign bank entry significantly reduces domestic bank profitability.

Foreign bank entry also turned out to significantly reduce non-interest income and overhead expenses of domestic banks, although these results are less significant and only valid for countries at lower levels of economic development. Foreign bank entry also raises domestic lending, probably because foreign banks concentrate more on large corporations (with higher risks) than on consumers, or because they have an informational disadvantage in identifying good credit risks. There was no significant association of net interest margins with foreign bank entry.

Some other estimates using an alternative definition of the foreign bank share suggested that it is the size rather than the number of foreign banks that is associated with competitive conditions in national banking markets.<sup>53</sup> One possible explanation is that domestic banks in Latin America do not change their competitive behavior until foreign banks have gained their long-run market share.

Finally, it was tested whether or not foreign ownership is correlated with changes in any of the key variables characterizing the banking system. The estimation results indicated that foreign ownership is significantly associated with lower before-tax profits and lower overhead expenses. There seems also to be support for the idea that foreign banks are less profitable than domestic banks. One possible explanation is that foreign banks have an information disadvantage. The results for the overhead expenses-variable may reflect more efficient management and more efficient banking techniques, because of technological advantages.<sup>54</sup>

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<sup>52</sup> This is the opposite of what Lensink and Hermes (2002) found.

<sup>53</sup> This is the opposite of what Claessens *et al.* found.

<sup>54</sup> These results are the opposite of what Claessens *et al.* found.

### **§ 3.4 Conclusions**

The study results on the impact of foreign banks on Latin America support the hypothesis that foreign bank entry is associated with lower overhead expenses and domestic bank profitability, although this is only valid for countries at lower levels of economic development (Peru, Colombia, Ecuador and Bolivia in the case study). Therefore, one can conclude that opening up domestic banking markets to foreign bank penetration likely improves the efficiency of the domestic banking system in countries at lower levels of economic development, which is welfare improving.

In Latin America foreign banks tend to have lower profits and lower overhead expenses than domestic banks. A possible explanation is that foreign banks have an information disadvantage. The result for the overhead expenses-variable may reflect more efficient management and more efficient banking techniques, because of technological advantage.

The evidence in Latin America also shows that foreign bank penetration into host country banking systems can have positive effects for the credit stability of these domestic banking systems. This may be an important consideration for countries that still have to decide whether or not to open up their markets to foreign bank subsidiaries in the framework of the GATS. However, countries at lower levels of economic development might consider first to consolidate and strengthen the domestic banking system so that banks are competitive enough and operate at international levels of efficiency before the sector is fully opened to foreign bank entry.



## Chapter 4 Liberalisation of the financial services sector in Chile (by Bibian Willemsen)

As we learned from the former case study, liberalisation of financial services can have benefits, but also downsides. The question arises what sort of legal solutions or guarantees could be brought into the GATS proposals for negotiation,<sup>55</sup> so that the negative effects are limited or controlled. To answer this question this chapter focuses on Chile. Despite Chile's relatively high level of development as a developing country,<sup>56</sup> it is still allowed to make more exceptions than the developed members, has a fairly open economy, and partly liberalised its financial services sector. This makes Chile an interesting case to analyse.

### § 4.1 CHILE

#### § 4.1.1 FINANCIAL LIBERALISATION PROGRAM

In 1975 the Chile government changed its policy from import substitution to a free market policy, that is best described as open regionalism. But it did not introduce measures of prudential financial regulation (Hermes, N. 1995:180). This led to a situation where the military Junta in 1975 introduced a model of 'free banking', *i.e.* a situation without an authority to monitor banking behaviour, so that commercial banks did not invest in screening and monitoring their clients and were only interested in investments with high risks and high returns. Because this liberalisation was very swift, bank managers did not have time to adjust to the new market conditions and the monetary authorities did not have time or the resources to build up a qualified staff to effectively regulate financial markets under free market conditions. Another consequence was an increase in the power of Grupos, very large conglomerates composed of different enterprises, as they bought the privatised state-owned companies.<sup>57</sup> The Grupos owned about 80% of the financial services suppliers in the country and were very much in debt. At the time of the liberalisation, the financials entered in very risky investments within their Grupo. The liberalisation process resulted in the financial crisis of 1982.

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<sup>55</sup> The first negotiations on financial services in the GATS framework took place in 1997; the Annex on Financial Services came into force in 1999. In January 2000 a new round of negotiations was started in Seattle. Unfortunately, these negotiations failed completely. Article VI (Annex on Financial Services) states that negotiations on qualifications and technical standards, licensing and procedures have to take place, so that they will not create unnecessary barriers to trade. In the field of accountancy services, some progress has been made, but the negotiating process on this is still underway. Similar agreements on banking and insurance are foreseen, although negotiations on this are quite difficult, because most banking and insurance rules have been set by private organisations, so that governmental authorities find it hard to accede to these systems. In the spring of 2003, on these issues new negotiations are planned.

<sup>56</sup> Chile is allowed to make more exceptions in its commitments than the developed members.

<sup>57</sup> The structure of the Grupos consisted of financial enterprises at the heart of the conglomerate, which financed the other enterprises and were led by closely related managers.

#### § 4.1.2 CURRENT SITUATION

Chile's government aimed at reaching a per capita income of \$9,500 within 15 years. During the period 1992-1996 the number of persons living below the poverty line fell from 4,351,579 to 3,345,176, thanks to sustained economic growth and target-oriented social policies. However, income distribution figures show that growth has not benefited all population groups to the same degree.

Although the Chilean government has the legal right to repossess foreign property, it has not used this right since 25 years. It has concluded investment protection agreements with over 20 countries, but most of them still have to be ratified by the Chilean parliament. The general policy of the Chilean Government is to give its corporations a more secure environment. This is shown by implementation of low interest rates, and its attention to the smaller firms. The economy highly depends on the exploitation of natural resources such as mining (copper) and fishery, and the infrastructure and social regime are not very well developed. In the economic recession of 1998/'99 the vulnerability of the dependence on natural resources became very clear. This is why the government now stimulates small companies in different economic sectors (Ministry of Economic Affairs, 2001). Chile stimulates and diversifies its economy by eliminating trade and investment measures; its average import tariff is 6% only since January 2003, and Chile concluded bilateral trade agreements with Canada, Mexico, Colombia, Ecuador and Venezuela. Besides, Chile is an associate member of MERCOSUR<sup>1</sup>, is participating in the Asian Pacific Economic Cooperation forum (APEC), and is currently negotiating an agreement with the European Union. These regional agreements, according to the Trade Policy Review Body, have resulted in differential treatment between Chile's trading partners because tariffs are phased out over varying periods for different goods and services and over different time periods.<sup>58</sup>

#### *The financial sector and the GATS<sup>59</sup>*

The Banco Central de Chile (BCC) is the highest monetary authority and independent from the government in the areas of monetary policy and monetary exchange regime. In 1999 Chile still registered the so-called 'encaje' in GATS. From May 2000, the Central Bank has taken the following measures to liberalise the capital markets. First, the 'encaje' was lifted, so that capital that flowed into Chile no longer had to stay there for 2 years. Moreover, banks and third parties were authorised to carry out transactions with foreign parties in Chilean currency. Since 2001, the capital exchange market was fully liberalised: importers and exporters can handle their transactions on the basis of free exchange rates. For financial transactions without international merit there still is an official government exchange.

Since 1995, Chile liberalised mode 3 'commercial presence' under a number of conditions. For banking (in the sense of accepting deposits and lending) and insurance (in the sense of life and non-

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<sup>58</sup> Chile's trade regime contributes to strong economic growth, but increasing emphasis on regional agreements, Trade Policy Review Body, WTO <http://docsonline.wto.org/>, 10 September 1997.

<sup>59</sup> Financial services make out 13.6 % of the BBP.

life insurance) commercial presence is welcomed, but the legal form is restricted; when a foreign supplier of financial services wishes to open a branch or start a new company in Chile, it is subject to an economic needs test from the Banking and Financial Institutions Supervision Department<sup>60</sup> and to discretionary licensing (Quan, 2000:21). In most sections in the schedules of commitments national treatment is unbound for Chile, but it is mainly required that all foreign parties get incorporated in Chile so that they will have to comply with Chilean law, and also gain rights under these laws.

In practice Chile welcomes foreign investment in its services sector. According to the Trade Policy Review Body, treatment of foreign nationals has gone beyond the commitments made under the GATS. The recently ratified free-trade agreement with Canada includes services, and services will also be included in the framework agreement negotiated with the European Union. Foreign presence is especially important in the financial services sector because of the related transfer of technology. To increase foreign access to the Chilean financial market banking laws were modified and Chile drafted a new competition law and updated its legislation on intellectual property. The banking system now consists of Chilean and foreign banks. In 2000 there were 17 foreign owned banks, of which the Banco Santander-Chile is the largest. Because Chilean banks were not allowed to do business outside of Chile until 1998, foreign banks have an advantage over them because they can use an international network. The Chilean financial system nowadays is highly competitive and well integrated with the outside world. Due to the capital market reforms, institutional investors such as pension funds, insurance companies and mutual funds got access to new financial instruments while appropriate safeguards were maintained.

Cross border trade in financial services is still not allowed in financial services. This is because Chile demands that a certain amount of capital has to be brought into the country to make sure a company has adequate assets. The usefulness of such a deposit insurance system is very controversial, because it forces intermediaries to turn to higher risk investments to maintain the same level of returns (Hermes, 1995:73).

## **§ 4.2 Chile and the upcoming Financial Services negotiations**

### **§ 4.2.1 CONDITIONS TO LIBERALISE**

According to Hermes, before liberalising financial markets it is very important that an institutional framework is in place to ensure market functioning and a sound legal system, for instance to secure

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<sup>60</sup> WTO services database, new financial services commitments, CHILE, <http://gats-info-eu.int/>



property rights and the guaranteeing of contracts (Hermes, 1995:57). In addition, the ability to gain and process information is very important for development, especially in financial markets.

A legal framework is necessary, because it reduces the need for expensive information gathering. So, prudential regulation or supervision rules have to be in place. These rules may include: risk-based capital requirements, liquidity requirements, rules that encourage diversification of portfolios, and restrictions with respect to the new entry of financial intermediaries. This can even force corporations to make public certain sensitive information, such as the performance of financial intermediaries (Hermes, 1995:72). The Annex on Financial Services, Article 2, on Domestic Regulation of the GATS, states that national authorities are allowed to take such prudential measures. However, because all countries develop such rules individually, these rules can diverge. As a result, it is sometimes very complex for individual companies that operate in several different countries to comply with them. This constitutes a barrier to trade. The only way out is mentioned in the second part of Article 2, stating: "Where such measures do not concur with the provisions of the Agreement (GATS), they shall not be used as a means of avoiding a member's commitments or obligations under this Agreement." Although this seems to be a solid clause, the problem is that individual service-suppliers that have the feeling that this rule is abused to their disadvantage have to prove this abuse themselves.

A solution to this problem would be to adopt a general system of prudential measures, *e.g.* controlled by the IMF. During the last couple of years Chile indeed introduced a new set of regulations governing conflicts of interests and insider information to ensure the transparent functioning of the market. In addition, a reform is underway aimed at acquiring new business, facilitating the internationalisation of operations of banks in Chile, bringing capital adequacy regulations into line with the suggestions of the Basle Committee, and basing the granting of licences on standardised criteria is underway

Another way to go might be to acknowledge the financial status and license a company has in its own country, so that foreign companies do not have to set aside liquidities twice (once in their home country and again in the host country). Modern money transfer systems provide the certainty that claims can be settled within a few days, so there is no practical need for the stalling of capital in the host country.

To deal with the possible situation that large players control the market, competition policy should be introduced. Chile introduced new legislation that strengthens the National Economic Prosecutor's Office by granting it increased resources with which to carry out its task of controlling, preventing and punishing anti-competitive practices as rapidly and as efficiently as possible.

So domestic authorities need to make sure the infrastructure and legal system come into place. They can achieve this through demands in the GATS negotiations on the basis of transfer of knowledge.

#### § 4.2.2 CHILEAN GOALS

This section is based on the Chilean proposal on all services,<sup>61</sup> but focuses on financial services. According to its Communication to the Council for Trade in Services in 2001, Chile considers that “the services negotiations should improve market access significantly for developed and developing countries, and to do so, that the negotiations should achieve: higher levels of liberalisation in all services sector...; simplification of schedules and greater transparency in commitments; limitation of the scope and number of MFN exemptions; and the development of binding rules on domestic regulation.”

Chile emphasises the importance in these negotiations of eliminating the lack of symmetry in the commitments undertaken by members in respect of the different modes of supply recognised by GATS. Chile takes the view that the multilateral trade system can only be efficient and continue to grow and acquire strength, if it is based on legal regulations. This requires an added effort to eliminate from the system all traces of arbitrary discrimination, such as the possibility of applying selective safeguards, anti-dumping duties without proper disciplines, and exceptions to MFN treatment in the GATS. Similarly, recourse to unilateral and extraterritorial measures provided for in certain domestic legislations undermines the protection, certainty and stability provided by the rules of international law

In the field of professional services, Chile proposes that an area of interest could be ‘a standardised minimum commitment to not apply trade-restrictive nationality or permanent residency requirements as a condition for meeting qualifications and licensing requirements for service providers, except in exceptional cases’.<sup>62</sup> Chile regrets the failure to implement Art. VII of GATS on ‘recognition’. This article stipulates that for the sake of transparency, it is important to have agreements between professional groups in Member Countries that could benefit other Members in accordance with the provisions of Art. VII, paragraph 2 of GATS. Many of these agreements are concluded between private associations, so that it becomes very difficult in practice to afford adequate opportunity for other interested members to negotiate their accession to such an agreement or arrangement, or to negotiate comparable ones with it.

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<sup>61</sup> Communication from Chile, The Negotiations on Trade in Services, Council for Trade in Services, 14-05-2001 Art.1.

<sup>62</sup> Communication from Chile, The Negotiations on Trade in Services, Council for Trade in Services, 14-05-2001 Art.6.

### § 4.2.3 WHAT THE EUROPEAN UNION AND UNITED STATES WANT FROM CHILE

The European Union in its general request asks Chile to make commitments in accordance with the classification in the Annex on Financial Services (European Commission, July 2002:5). It requests that Chile removes the possibility of requiring a one-year statutory deposit on a percentage base of foreign currency remittances (in modes 1,2 and 3), and it would like to see the prior authorisation of transferring dividends abroad (in mode 3) eliminated from the schedules. Next to that it wants the rule (relating to mode 3) that paid-in capital has to stay in the country for 2 years to be eliminated (the practice in Chile currently is 1 year).

The European Union would like to see that limitations on the numbers of service suppliers, or caps on foreign shareholding in subsidiaries abroad to be removed from Chile's schedule, and also that cross-border trade is liberalised in reinsurance, (which Chile has already done under conditions) and in processing information. It would also like regulatory frameworks to underpin market access commitments already made (European Commission, July 2002:5).<sup>63</sup> In general – so also for other services and modes of supply – it asks for the elimination of measures such as restrictions on the type of legal entity and compulsory joint-venture constructions.

The EC enumerates services auxiliary to insurance, such as consultancy, actuarial risk assessment and claim settlement services, and also advisory, intermediation and other auxiliary financial services, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy. For all these services the EC requests Chile to make full commitments in modes 1 and 2 (thus to schedule “none”), and commitments for natural persons employed in this service sector and seeking temporary entry as contractual service suppliers as in mode 4. Such natural persons can be required to have a university degree or technical qualifications, plus the appropriate professional qualifications where this is required by domestic law. The length of the stay may be limited to the length of the contract.

In Chile direct branching (mode 3) is not allowed in insurance and pension funds, and the EC asks Chile to commit these subjects. The EC further asks Chile to specify the market access criteria of approval when a foreign investor wants to acquire more than 10% of the banks capital.

Market access is often hindered by cumbersome regulations, so domestic regulation that is not only consistent with GATS, but also supports market liberalisation is what, according to the EU, is needed the most, because that is the backbone of development (European Commission, July 2002:2).

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<sup>63</sup> Trade in Services, Summary of the EC's initial requests to third countries in negotiations, Brussels 1-7-2002: p.5.

The US in general wants full liberalisation in the financial services sector, but specifically it wants to remove restrictions on the ability of the supplier to choose the form in which he wants to establish himself in the host country, whether it is as a subsidiary, a branch or a joint-venture; and also the level of equity participation in a joint-venture.<sup>64</sup> In addition, the US proposes to remove restrictions on certain forms of cross-border trade (mode 2) for all sectors and mode 1 for: financial information and advisory services, reinsurance and retrocession, MAT (Marine, Aviation, and Transport)-insurance, insurance intermediation and related services such as consultancy, actuarial, risk assessment and claim settlement services. It wants quantitative restrictions in the form of numerical quotas, monopolies or exclusive providers, economic needs tests and also mandatory cession requirements out of the way.

By taking these examples, the wishes of the developed countries become very clear; they would like an over-all liberalisation, and they aim at getting access to developing markets. The DCs, and in this case Chile, have to assess beforehand what they want to get out of the financial services negotiations, and how they can turn these proposals into an outcome profitable for them.

## **§ 4.3 Conclusions**

### **§ 4.3.1 CHILEAN POSITION IN GATS NEGOTIATIONS ON FINANCIAL SERVICES**

Because Chile has already liberalised its financial services market a lot more than it has committed itself to, it can offer much in the negotiations without in fact giving up a lot. It would be helpful to make the commitments in their schedule in line with what they have already done. This for the sake of transparency, that the Chilean delegation already indicated it wants of the other participants.

Chile mainly has a problem with diversified rules due to the amount of free trade arrangements it has concluded. This could be solved by flattening those out on the basis of MFN treatment in the financial services negotiations. Chile already asked this of other countries, specifically in the field of professional services. So it would not be unreasonable for Chile to offer this in the financial services field. For the same reason it is a good idea to make proposals for groups of countries. Chile adapted its legislation to the rules of the Basel Committee. It seems to be a good idea to ask other countries to do the same, before Chile liberalises its financial services sector more. Cross-border trade still is an area in which Chile could make some progress. In insurance it has made some commitments, but other products in financial services are also very easily imported and exported, because of modern technologies. A possible offer could be to allow cross-border trade and consumption abroad for some

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<sup>64</sup> Communication from the United States, financial services; Council for Trade in Services, 18-12-2000 paragraph II.

banking and direct insurance products, provided that the service provider has enough assets in the home country, and is legally instituted and supervised over there.

Chile can secure the access to financial institutions of small firms and rural areas by demanding financial institutions to have commercial presence to safeguard such access. In addition, Chile could make an offer in which it acknowledges the licences and supervision of the home country of direct writers that supply financial services, through, for instance, the Internet or by mail. For smaller firms and rural areas this can be advantageous due to the low overhead costs. This offer could, for example, be made to all countries that have integrated the rules of the Basel Committee in their legal systems. Because Chile emphasised its export interests are mostly in other areas, there could be a nice trade-off, for instance to open up cross-border trade in financial services in Chile against opening up other markets for professional services, on the basis of acknowledgement of diplomas.

#### § 4.3.2 A PROPOSAL

According to the demands formulated in the previous paragraph, this paragraph formulates a proposal that Chile can make.

##### *General requests*

Chile calls upon the Council for Trade in Services to guarantee that the assessments it promised, (to view the negotiations in the light of Art IV and XIX) are carried out. That means that non-reciprocity and market access for developing members have to be taken into account. Actions that have to be taken by developed members have to be spelled out. Special attention shall be given to the possibilities to apply the General Exceptions, noting that the Council for Trade in Services shall review the proportionality of all exceptions made.

The principle of proportionality, which means that there should not be any more restrictions on trade than strictly necessary to secure public order and safety, shall be applied throughout all negotiations and in the specific commitments of the Developed Members.

The international banking, securities and insurance rules as constituted by the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions, and the International Association of Insurance Supervisors, can function as an overall set of rules to prevent disruption of domestic economies and losing control over capital markets. These regulations shall be the basis for binding rules on domestic regulation. The legal form in which the service supplier wants to establish himself in the host country can under conditions be free. The main condition is that it is clear who is liable in case of damages or financial mishap. Next to that the financial basis and legal supervision have to be guaranteed by the Authorities in the home country.

*Offers and requests*

To enhance transparency, Chile offers to bring into the specific commitments the liberalisations it already has in place. Chile asks the developed members to do the same before the end of this negotiating round, so that Chilean service suppliers know their possibilities to provide services in Member countries. Next to that Chile demands full publication of the conditions for market entrance, at the info-points, in English Spanish and French, so that Chilean service suppliers are informed about the rules they have to live up to. To make entrance conditions non-discriminatory, Chile proposes to eliminate the lack of symmetry in the schedules of specific commitments in the different modes of supply. This can be achieved through applying liberalisation to modes of supply across all sectors within a limited timeframe. The basis always has to be MFN Treatment; conditions are that the developing countries that gain access to developed countries' markets through this arrangement will open up their markets for our service suppliers within a year.

Chile offers cross-border trade for banking and direct insurance products, provided that service providers come from a country that has integrated the regulations as formulated by the Basel Committee on banking supervision in its legal system, and that they are legally instituted, licensed and supervised in their home country. Chile requests access to the markets of the other participants for professional services, construction and transport on the same basis. This means on the basis of MFN treatment, consisting of at least acknowledgement of diplomas, and licensing and supervision in the home country. All developed members have to make their conditions, rules and regulations on market access in these fields directly available for developing members through the info-points. This means publication on the Internet in French, English and Spanish, and also through traditional channels such as telephone, fax or mail, on the basis of costing price to make sure the information is available to all service-suppliers.

Chile requests technical assistance, education and transfer of knowledge from the developed member states to close existing gaps in the infrastructure and legal system, which is necessary for the development of its financial services sector. In the field of direct insurance and banking services this has to relate to payment and clearinghouse systems, supervision on trade through modern channels such as the Internet, aimed at strengthening the domestic services capacity. In the field of professional services, construction and transport, it has to lead to increased knowledge, quality and technological levels with the goal of facilitating access to the markets of Developed Members.



## Chapter 5 The Philippines and mode 4 (by Alice Stegeman)

Health services have long been considered as non-tradable (and provided by public institutions), but there is a change in this perception. In fact, trade in health services is growing in many areas, also in DCs. The health care sector has a labour-intensive character; in almost every country labour-associated expenditures comprise 50% to 75% of the sector's recurrent budget (Brito *et al.*, 2000:1). For many DCs, the current services negotiations, which began in 2000, offer opportunities to acquire health services unavailable domestically, or to export health services and human resources to a larger world market. Depending on appropriate regulatory conditions, trade liberalisation of the health sector can contribute to enhancing quality and efficiency of supplies and/or increasing foreign exchange earnings.

This case focuses on cost and benefits of the (temporary) movement, mode 4 of health service providers of the Philippines, a country, which is known as the number one export country of nurses. An orderly and proper migration program can yield remittances (foreign exchange earnings) for the Philippines and reduce unemployment under certain groups of service providers. But it can also lead to brain drain and/or an increasing income gap between poor and rich (due to an uneven distribution of remittances over different income groups) in the Philippines.

### § 5.1 Introduction

The results and conclusions presented in this chapter are based on analyses of existing statistics and on a survey under Philippine health workers abroad.

#### § 5.1.1 THE SURVEY

The sample survey consisted of 140 valid e-mail addresses of Philippine medical personnel who were working abroad or who had worked abroad.<sup>65</sup> They were sent a questionnaire that consisted of 21 questions, which dealt with subjects related to medical migration from the Philippines. The survey was conducted in November and December of 2002. The response was 15%.<sup>66</sup> Of the 21 respondents 11 were males and 10 females. Most of the respondents were between 31-40 years old (61.9%), while 28.6% of the respondents were between 41-60 years old. Most of the respondents were physician (18 persons), while the remaining were nurses (all females).<sup>67</sup>

<sup>65</sup> Source of emailaddresses was [http://www.uerm.edu/directory/medalumni\\*.html](http://www.uerm.edu/directory/medalumni*.html) (\* = 1, 2 and 3) and <http://www.doktorko.com>.

<sup>66</sup> One should realize that the survey results are not representative of the migrating Filipino health service providers' population. For that purpose, the survey was too small. But it is possible to deduce some (general) indications from the survey.

<sup>67</sup> The reason can be that physicians are more often registered than nurses, while they have a more 'important' profession



## § 5.2 The health sector

### § 5.2.1 CURRENT SITUATION

In 2000, the total number of people working in the Philippine health sector amounted to 1,478,562, which is less than 2% of the population.<sup>68</sup> The Philippines had in that year 95,016 physicians, 41,484 dentists, 337,939 nurses, 129,532 midwives and 44,316 pharmacists. In 2001, there was one doctor per 20,000 citizens.<sup>69</sup> There is a surplus of nurses in the Philippines, so that many nurses migrate, whether temporarily or not. Nowadays there is a trend that physicians are also studying nursing, so that they have a better chance of being exported.<sup>70</sup> Health workers are underpaid and they have to deal with workloads beyond their capacities. Often they have to work without benefits and job security.<sup>71</sup> This resulted in a shortage of good and qualified medical doctors, not because there are too few people who follow a medical education, but because too many doctors migrate.<sup>72</sup>

In addition, the growing private health sector in the Philippines attracts a lot of health professionals from government hospitals. The remuneration and working conditions are much better in the private sector. Because government hospitals are supposed to deliver inexpensive care mainly for the poorer segment of the population, losing good doctors to the private sector has a negative impact on the availability of good health care for the poorer Filipinos (United Nations and WHO, 1998:220). The Philippines do not attract foreign doctors, since the working conditions and salaries are not competitive.

Public hospitals have to deal with harsh budget cuts and many of the hospitals were privatised, meaning that profit making becomes a priority. Hospitals had to become more efficient, which is often believed to be attainable by means of retrenchments. This leads to discharges under health personnel. Even more discharges could become reality when private hospitals do not earn enough income. So, it can be stated that there is (high) unemployment under health service providers and this unemployment will probably rise even further when the privatisation and devolution processes continue.

The present health system does not meet the needs of the Philippine population; the service delivery system is inappropriate. The deteriorating health status of the Philippines is largely a consequence of a defective budget allocation and the scarce attention given to the health sector by the government. In the Philippines, there is a surplus of nurses and physicians, although the latter is created by

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than nurses.

<sup>68</sup> Department of Health Philippines, website: <http://www.doh.gov.ph>.

<sup>69</sup> Council for Health and Development, Inc., Health Care Without the IMF-World Bank, 2002:1.

<sup>70</sup> Council for Health and Development, Inc., Coalition for Health Budget Increase, 2002:1.

<sup>71</sup> Council for Health and Development, Inc., Health for Sale... But Who Can Pay?, 2001: 8.

<sup>72</sup> Kathmandu Post, Ensure Public Health, 2000.

privatisation and retrenchment, and does not comply with the demand for physicians. These surpluses on the labour market of health personnel could be a reason to stimulate migration of the last category of medical personnel.

The ‘out-of-pocket-payments’ of the Philippines are enormous; they amount to over 50% of the total spending. With its current policy (Health Sector Reform Agenda), the government denies her social responsibility and health services will become inaccessible for many people. The Philippine government sees health as ‘big business’ and is trying to create opportunities for local and foreign investors in the health sector. While the commercialisation of the health sector continues, the quality of the health care services is decreasing. The provision of health care is left largely in the hands of the private sector, which has profit making as priority. The results of this are more poverty, hunger, disease and death for the Filipinos. It is very clear that in this way, ‘health for all’ will never be achieved in the Philippines.

#### § 5.2.2 MIGRATION POLICY

The ‘export’ policy of the Philippine government is based on the assumption that migrants send remittances to their home country. These remittances play a vital role in the Philippine economy. That is the principal reason why the Philippine government stimulates migration. Another important reason is the high unemployment in the Philippines. Migration can be seen as a short-term solution to alleviate this. In the early 1970s, when the Philippine economy suffered from high unemployment and a tight balance of payments, migration was first seen as a partial solution for the problems in the Philippines. Migration could help preventing a further deterioration of the economy. Nowadays, migration is an indispensable part of the Philippine national development policy and serves to relieve the burdens of steep unemployment levels and to underpin the foreign currency reserves (ERCOF, 2000:1).

Table 5.1 shows for fourteen selected medical professions the number, covered by the GATS, of Filipino workers abroad.<sup>73</sup> The number of migrants in the table includes permanent medical migrants as well as temporary migrants. It shows that it is realistic to expect an increasing pattern with regard to the total number of Philippine medical migrants. This pattern can be further strengthened under the GATS when the agreement manages to reduce the barriers and other problems and insecurities health service providers encounter with (temporary) migration. The increase in Filipino nurses working abroad during 1998 – 2001 is remarkable. The number more than doubled in this short period.

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<sup>73</sup> Medical migration relates to the migration of physicians, nurses, dentists, midwives, and other medical personnel.

Table 5.1 Overseas Filipino Health Workers by Skill

Year	1998	1999	2001
Bacteriologists pharmacologists and related scientists	2	3	1
Dental assistants	172	193	601
Dentists	32	56	58
Dietitians and public health nutritionists	98	66	64
Doctors medical	55	59	61
Medical assistants	7	3	57
Midwifery personnel	57	49	81
Midwives professional	149	66	190
Nurses professional	4,591	5,413	13,536
Nursing personnel	808	559	285
Optometrists and opticians	68	96	83
Pharmaceutical assistants	37	51	169
Pharmacists	47	55	64
Physiotherapists and occupational therapists	317	147	334
<b>Total</b>	<b>6,440</b>	<b>6,816</b>	<b>15,584</b>

*Source:* Philippine Overseas Employment Administration (POEA).<sup>74</sup>

In 1999, 219,724 Filipinos migrated (POEA).<sup>75</sup> This means that the health service providers accounted for 2.9% of the total number of Philippine migrants in 1999. In 2001, 269,751 Filipinos migrated, so that in that year, the Philippine health workers accounted for 5.8% of the total number of migrants. This is partly due to the increase in migration of Filipino nurses. The figures indicate that health service providers as a group do not account for a (relatively) big share in the total number of Philippine migrants, but this does not automatically imply that the influence of medical migration on the Philippine economy and health sector is also restricted.

Although the above-mentioned official figures are useful in that it allows one to get a general picture of medical migration trends from the Philippines, the figures should be viewed with caution. Often the problem with official data is that it understates the true extent of migration. There is always some illegal and undocumented migrant labour.

<sup>74</sup> The Philippine Overseas Employment Administration (POEA) records for every year Filipinos who migrate, per skill. Economic Resource Center for Overseas Filipinos, *The Development Potential of Migration*, 2000:1.

<sup>75</sup> The real number will probably be higher, because not all Filipinos working abroad are registered.

### § 5.2.3 COUNTRY OF DESTINATION

For service providers in general, the Middle East continues to be a major destination. Asian countries are also very attractive for Filipino migrants. But while Filipino service providers are spread around the world, it seems that their skills and professions determine their country of destination. According to Josephine Francisco, the main destinations of Philippine nurses are Saudi Arabia, the United Kingdom, Libya and Singapore. Statistical data delivered by the POEA (Philippine Overseas Employment Administration) indicate that the destination countries of Filipino (professional) nurses vary a lot. In 2001, Ireland absorbed 1,529 Filipino nurses, the United Kingdom 5,383, whereas The Netherlands absorbed only 34 Filipino nurses. Saudi Arabia also admitted a lot of Filipino nurses, namely 5,045 in 2001. The figure for the US is in some way disappointing, 304 Filipino nurses only, even if the US has the reputation of being a popular destination country for Filipino nurses and many American hospitals have engaged Filipino nurses. It seems that not all Filipino nurses working abroad (especially in the United States), are registered (POEA). Table 5.2 shows that Saudi Arabia and the United States are popular as a destination country for Filipino medical doctors.

Table 5.2 Destination countries of Filipino physicians

Year	Saudi Arabia	United States	Total
1998	36	2	<b>55</b>
1999	36	4	<b>59</b>
2000	14	2	<b>27</b>
2001	49	9	<b>61</b>
2002	70	31	<b>129</b>

*Source:* POEA.

In the survey 20 respondents (95.2%) migrated to the United States. This supports the impression that the United States is a favourite destination country for Filipinos.

## § 5.3 Costs and benefits of migration

### § 5.3.1 MODE 4 BARRIERS

Of the respondents in the survey 57.1% encountered immigration related regulations concerning entry and stay of health service providers, for example with reference to visas, work permits and so on. Often the immigration related regulations are not very clear and transparent, which caused problems. Another barrier, which was encountered by six respondents (28.6%), had to do with regulations concerning the recognition of qualifications, work experience and training (for example residency and nationality requirements, difficulty of passing licensing examinations). Often qualifications and work experience of Filipino health workers were not recognised in the US. It is generally known that

medical migrants in the US have to pass licensing examinations before they are qualified to work there. Several migrants allege that they had experienced difficulties with passing these examinations. The GATS can contribute to the alleviation of these two barriers; mutual recognition schemes and agreement on its interpretation should be contributable to achieve greater and freer cross-border flows of service providers. Other barriers experienced by Filipino health service providers were: language problems (23.8%), differential treatment of domestic and foreign health personnel - for example with advancement possibilities - (33.3%), and discrimination by domestic health personnel (19%). There is not much what the GATS can do to alleviate these barriers, especially because the last two barriers are so-called 'invisible' barriers.

### § 5.3.2 REMITTANCES FROM PHILIPPINE HEALTH SERVICE PROVIDERS

Remittances are said to play a vital role in the Philippine economy. That is the principal reason why the Philippine government stimulates migration. According to Ashwani Saith, remittances are often a main source of income for Filipino families. In 1991, 16.6% of all Filipino families, *i.e.* 1.99 million families, were recipients (Saith, 1997:21). The central bank of the Philippines (Bangko Sentral ng Pilipinas) records the total yearly amount of remittances sent by all migrants. To assess the amount of remittances sent by Filipino health workers, the assumption is made that when health workers account for x% of the total migrants, then they will send roughly x% of the total remittances. This so-called upper bound reflects the maximum amount of remittances from medical workers, while the lower bound reflects the minimum amount of remittances sent by medical workers. The lower bound estimation assumes that only half of the medical migrants will send remittances.<sup>76</sup> The real amount of remittances sent by Philippine health workers most probably lies somewhere in between. The results of the estimation procedure are shown in table 5.3.

Table 5.3 Amount of remittances sent by Philippine health workers

year	% of total migrants	total remittances <sup>77</sup> (in 1000 \$)	upper bound of remittances (\$) from medical workers <sup>78</sup>	lower bound of remittances (\$) from medical workers <sup>79</sup>
1998	2.9	7,367,989	213,671,681	71,416,981
1999	2.9	6,794,550	197,041,950	98,520,975
2001	5.8	6,031,271	349,813,718	174,906,859

<sup>76</sup> This assumption is based on the result of the survey.

<sup>77</sup> Source: Bangko Sentral ng Pilipinas.

<sup>78</sup> This column is obtained by multiplying column 2 with column 3.

<sup>79</sup> This column is obtained by first multiplying column 2 with ½ and then the outcome has to be multiplied with column 3.

According to the survey kept under Philippine health service providers (mostly physicians) abroad, just over half of the respondents (12 respondents) sent remittances home.<sup>80</sup> This can be explained by the fact that when physicians migrate, they often take their family with them. In that case they have less reason to send remittances to the Philippines. The survey pointed also out that sending of remittances is not gender dependent, meaning both men and women send remittances. It also turned out that migrants who sent remittances are not more committed to the Philippines than migrants who do not. Thus, the fact that a migrant sends remittances does not imply he/she is a temporary migrant. Five of the 12 respondents used the remittances for saving and three to set up business ventures in the Philippines. Other spending of remittances was on consumer and durable goods, medical expenses, education, improvement of housing or new housing and community projects.

The remittances have been instrumental in helping the Philippine economy counterbalance foreign exchange outflows especially as a saving grace during periods of negative GDP growth, thus maintaining a positive GDP. During the last decade, remittances as a percentage of GNP increased substantially, from 2.67% in 1990 to 8.42% in 1999 (Francisco, 2002:3). Table 5.4 shows that the impact of remittances on the Philippine GDP is much smaller as literature suggested when a correction is made for purchasing power.

Table 5.4 Remittances expressed as a percentage of Philippine GDP (PPP corrected)

Year	Percentage	Year	Percentage
1984	0.90	1992	1.06
1985	0.76	1993	1.01
1986	0.73	1994	1.13
1987	0.77	1995	1.65
1988	0.70	1996	1.29
1989	0.72	1997	1.52
1990	0.77	1998	1.85
1991	0.80	1999	1.48

<sup>80</sup> A NSO (National Statistics Office) Special Survey found that only 80% of Philippine migrants (in general) were remitting in 1991. Because of this the benefits of migration could be smaller than expected.

## § 5.3.3 MIGRATION AND POVERTY IN THE PHILIPPINES

The well-known story is that poverty must have driven the migrants out, and, consequently remittances would make the recipient families better off. However, according to Ashwani Saith, Philippine migrants come disproportionately from a few regions, most of them on the richer end of scale. The Family Income and Expenditure Survey of 1991 also indicates that the incidence of migration is much more pronounced in four regions, viz. the Metro Manila (National Capital Region), Ilocos, Southern Tagalog and Central Luzon. The survey kept under Philippine medical migrants endorses this view. Of the respondents, 12 came from Metro Manila, the national capital region and the richest region of the Philippines, one from Southern Tagalog and one from Central Luzon. Table 5.5 indicates that the higher the class of income, the more remittances families receive. This result does also stand up for medical migrants: the family of 15 medical migrants in the survey lived in urban areas, indicating that it is not the poorest that migrate. Table 5.6 shows that people in urban areas receive more remittances than people in rural areas, although the share of receiving families in rural areas is growing. Moreover, remittances account for a larger share of income in urban areas.

Table 5.5 Families in the Philippines with 'Income from abroad' as main source of income, by size class of income (1991,%)

All families	under 15,000	15,000- 19,999	20,000- 29,999	30,000- 39,999	40,000- 59,999	60,000- 99,999	100,000- 249,999	250,000 and over
6.47	1.49	1.16	2.30	2.76	6.17	10.12	16.41	15.77

Source: Saith, 1997, table 9, p. 26.

Table 5.6 % of families receiving income from abroad and % of income received from abroad (1985, 1988, 1991 )

Year	URBAN		RURAL		TOTAL	
	families	income	families	income	families	income
1985	22.5 (n.a.)	10.0	9.0 (n.a.)	6.4	14.1 (...)	8.4
1988	21.6 (8.4)	9.1	10.5 (4.2)	5.5	14.7 (5.8)	7.5
1991	22.0 (n.a.)	9.4	11.2 (n.a.)	6.2	16.6 (6.5)	8.4

Source: Saith, 1997, table 11, p. 28.

The impression that mostly rich(er) people benefit from medical migration was confirmed by the high percentage of respondents that described the financial situation of their family as 'modal', while none

of them described it as 'poor' and 19% as 'rich'. All in all, there is overwhelming evidence for the conclusion that (medical) emigration is mainly from the richer sections of Filipino households, which accounts for the relative higher migration statistics from the richer urban areas. As a consequence, it is these groups who typically reap the benefits (remittances) of overseas (medical) migration (Saith, 1997: 24-7).

Nevertheless, 71.4% of the respondents mention the higher salary and income abroad as the key-motive to leave the Philippines, whether temporarily or permanently, whereas for 52.4% the bad economic situation in the Philippines was a reason to migrate. Almost one out of four respondents mentioned the need to earn money to assist the family in the Philippines financially as the motive for the migration. Thus, although those that migrate do not belong to the poorest people in the Philippines, it seems that medical migration is often a flight out of poverty.

#### § 5.3.4 BRAIN DRAIN

When the migration is permanent, DCs lose (often) valuable human resources, particularly highly qualified professionals. This is commonly referred to as a brain drain. Brain drain can thus be defined as any loss of skills needed for economic growth and development in any given country (Todaro, 2000:130). This means that medical brain drain can be described as the migration of health service providers, who DCs can least afford to lose.

Experienced medical migrants often worked in the private sector, so that supply gaps due to emigration will mainly arise in the this sector. Such gaps are assumed to often be filled up with personnel from the public sector, so called 'scream skinning'.<sup>81</sup> As a consequence the public sector (on which the poor rely) may lose its most prepared and experienced health professionals. In other words shifts of health personnel adversely affect the supply of health services in general. This process is further reinforced because the best health service providers are leaving the country, *i.e.* only those pass qualification tests abroad.

A government can require private hospitals to reserve a minimum number or percentage of beds for free treatment to the needy, to offer some basic medical services in remote rural areas, or to train more health personnel than required for their own purposes. In this manner any reduction in health service capacity for the poor can be limited (WHO and WTO, 2002:119-20).

During the survey, the main part of the respondents (18 resp.) was working abroad and 3 respondents had returned to the Philippines and worked in the health sector. The majority of the respondents appeared to be permanent migrants; 8 respondents had plans to return to the Philippines or already

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<sup>81</sup> This is a reasonable assumption. Health professionals who migrate often mention a better salary as one of the motives for migration, even if they already worked in the best-paid jobs in their home country.



returned. Their motives were: reunion with the family; obligations felt towards the home country; the wish to contribute to the improvement of the Philippine health sector, the environment or the culture. This applied especially to physicians and men. The majority of the respondents thought that their experience abroad would lead to improved skills, and that they could better contribute to the health sector in the Philippines by returning (18 resp.). All respondents followed a university education. This would suggest that medical migration from the Philippines is associated with brain drain, when they do not return.

Motives of the permanent medical migrants to stay abroad were: better economic conditions (12 resp.); better working conditions abroad (10 resp.); better career opportunities (11 resp.); a more stable political situation abroad (6 resp.); better living conditions abroad (10 resp.); to support their family financially (4 resp.); to have build up a life abroad (7 resp.); and educational opportunities for their children (5 resp.).

#### § 5.3.5 THE HEALTH LABOUR MARKET

At least part of the respondents from the survey, who followed their medical education in the Philippines, had (severe) difficulties in finding an appropriate job (matching their capabilities). For 8 respondents this was a reason to migrate. Moreover, 61.9% of the surveyed medical migrants called the existence of better-equipped hospitals and research centres abroad a reason to migrate. All in all it currently does not seem very attractive and satisfactory for Filipino health service providers to work in their own national health sector.

The opening up of the health services sector for trade is likely to affect the availability of health personnel in the Philippines and it may contribute to better quality of services. The (temporary) migration of nurses does not have a negative impact on the supply of health services in the Philippines, due to the surplus of nurses. However, because of the shortage of physicians encouragement of their migration would reduce both the quantity and the quality of medical supply. Temporary migration of doctors could contribute to the reduction of the artificially created unemployment under doctors. At the same time skills can be improved due to temporary migration, especially if experience abroad is aimed at preventive health care instead of curative care.<sup>82</sup> But it needs to be assured that it comprises *temporary* migration and not permanent migration.

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<sup>82</sup> DCs have special interest in preventive health care, whereas developed countries are mainly interested in curative care.

## § 5.4 Conclusions and Recommendations

### § 5.4.1 CONCLUSIONS

Although the medical sector migrants from the Philippines were relatively rich and highly educated, migration still seemed to be a flight out of poverty. The argument that migration flows will mainly benefit relatively poor people does not hold.

Temporary migration of Philippine health service providers can:

- Enhance the level of remittances, supporting economic growth. If corrected for purchasing power, the level of remittances less than generally perceived.
- Lead to the adoption of (new) knowledge, which can contribute to the Philippine health sector, especially if aimed at preventive care.
- Help to reduce the unemployment under health service providers in the Philippines, especially amongst nurses.

But it can also:

- Lead to brain drain if doctors are involved, *i.e.* a loss of valuable human capital. The migrants were on average highly educated and most of them were permanent migrants.
- Undermine the health care activities in the Philippines, especially in public hospitals and in remote areas, because migration of health service providers in the private sector are usually replaced by health workers from the public national health sector where wages are generally lower.
- So migration may indeed adversely affect economic growth in the Philippines, insofar as the disadvantages for the overall economy surpass the advantages. This seems to typically apply to the migration of doctors and much less so (or not at all) to the migration of nurses.

### § 5.4.2 RECOMMENDATIONS

The Philippines' government could request other WTO-members to open up their markets for Philippine nurses, so that their surplus will be reduced.<sup>83</sup> This would improve the quantity and quality of health care services in other countries, whereas the Philippines will not experience clear negative effects with regard to domestic health care supply. The consequences for the quality of Philippine health care supply are less obvious. With reference to the migration of physicians the Philippines may request other WTO-members to open up their markets for Philippine physicians, provided that certain conditions are satisfied, such as *temporary* migration only. The Philippines experiences a shortage of medical doctors by medical standards, but experiences also unemployment under medical doctors due

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<sup>83</sup> Nowadays, there is an enormous demand for medical services in the international market. This is particularly true for developed countries, which demand especially nursing services, as they have to deal with an aging population.

to privatisation and cutbacks of the government. This is why only temporary migration should be stimulated. So, the Philippines could request the Members with respect to mode 4 to open their markets for Philippine professionals - nurses and physicians - but to limit the duration of their stay to a certain period. In addition it could request for a 'technology transfer clause', *i.e.* a requirement to train the Philippine nurses and medical doctors.

Mutual recognition schemes in the areas of testing certification and licensing as to education, experience and skills qualifications can contribute to an improvement of market access for service providers. Regulations concerning entry and stay of health service providers (with reference to visas, work permits, *etc.*) could also be addressed in the upcoming negotiations.

## Chapter 6 India and mode 4 (by Klaas Markvoort)

The tremendous growth in the software sector inspired various DCs to try to take part in it. Although the main focus of this sector still is in the G7 countries, non-OECD countries become increasingly interesting as outsourcing areas for large computer services of multinational corporations, because of their relatively low wages given their levels of education. Projections of future growth rates in the software and computer sector illustrate the evolving importance of this sector for DCs. It is estimated that the average growth rate of this sector is worldwide around 10%; Japan's and Western Europe's estimated growth rates are some 3% and 6%, respectively, whereas the estimated growth for the United States is slightly above 10%. However, the rate of growth for the non-OECD countries, mainly the Asian ones, is estimated over 18%.<sup>84</sup>

GATS becomes increasingly important for India as the Indian share in world exports of services doubled in the last twenty years from 0.55% in 1980 to 1.4% in 2001. One of the fastest growing sectors in India is the computer and related services sector.<sup>85</sup> It is a key area for generating employment and exports. The sector has unique characteristics in that it requires skilled manpower and few materials, and is environment-friendly. This also explains why India has grown so important in the software sector. India can provide highly educated people, who have a good command of the English language, and who accept relatively modest wages. Especially the software sector can be seen as the success story in India's latest history. With growth rates of around 6% and an increasing part of India's GDP, the software sector can no longer be overlooked.

In this process more and more software professionals from India are hired by developed countries to replace the more expensive alternative of offshore service provision. This creates the following dilemma for India with regard to GATS mode 4. On the one hand India loses employees, at least temporarily, through mode 4. A positive balance-of-payment (bop) effect of this is that migrating Indians send money back to India: remittances. On the other hand, this leads to exports of software services forgone. The dilemma is that such flows are a trade-off also as far as their bop-impact is concerned. Moreover, at one point in time emigration based on mode 4 may leave the Indian software sector with a shortage of professionals, and India's economy with bop-problems insofar as diminishing export benefits outweigh the increase in remittances.

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<sup>84</sup> World Trade Organization, Guide to the GATS, 2001.

<sup>85</sup> World Trade Organization, S/CSS/W/141, 22-03-2002.

## § 6.1 Introduction to the Indian software sector

Software consists of both ‘packaged’ (or standardized) and customized products and computer services, defined as computer-related consultancy services.<sup>86</sup> In this case study packaged and unpackaged software and services related to software are all considered to be included in the software definition; we, therefore, chose to use a rather broad definition.<sup>87</sup>

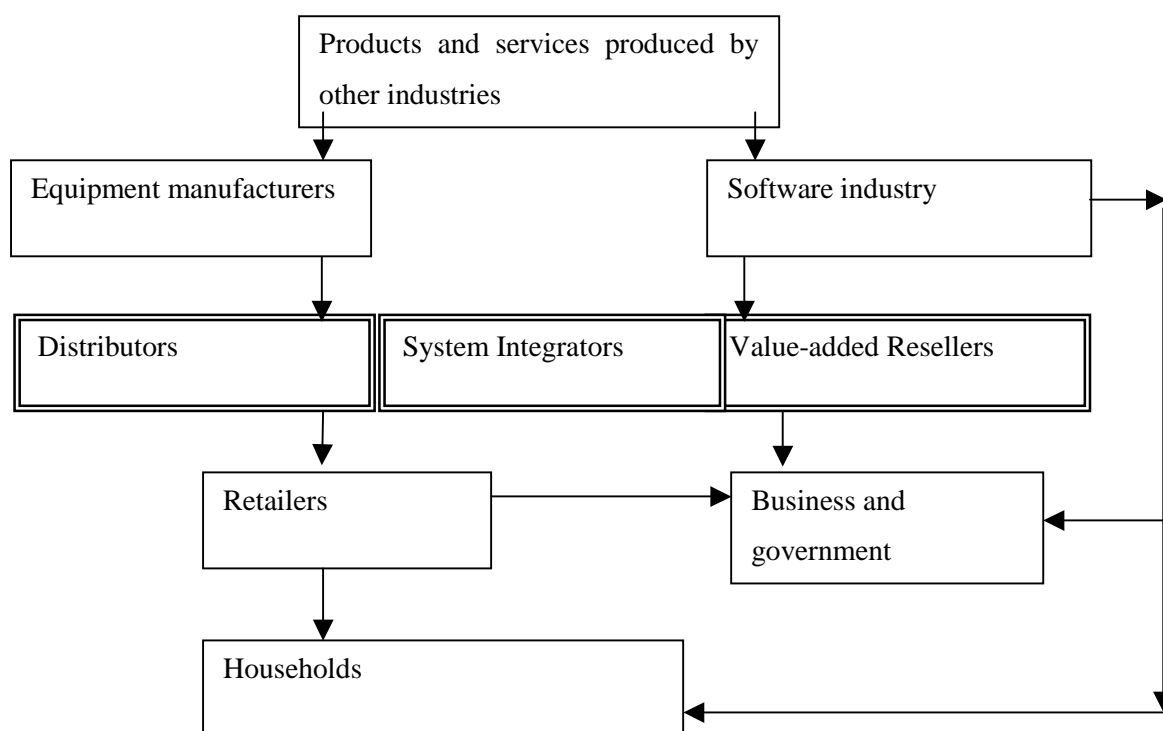


Figure 6.1 Structure of software industry

Source: World Trade Organization, Guide to the GATS, 2001.

India has become so important in the software sector, a.o. because it can provide highly educated people, who have a good understanding of the English language and accept reasonably low wages. For instance, the average cost per line of code in Switzerland (with about the highest wage level) exceeds by more than five times that of India (the cheapest country); average salaries are more than eleven times higher in Switzerland (Mattoo, 2000). However, in Purchasing Power Parity (PPP) terms the figures look somewhat different (see table 6.1).

<sup>86</sup> World Trade Organization, Guide to the GATS, 2001. Software implementation services can be found as sub-category in the GATS Services Sector List document MTN.GNS/W/120 under sub sector 1B, business and professional services. However, computer software is in this classification scheme only referred to as ‘consultancy’ services related to ‘development and implementation’ of software.

<sup>87</sup> Over last decade the attention has shifted from customised software to packaged software and system-integrated services. Additionally, firms who are reorganising their IT environment frequently use consultancy services to develop and implement them or they might even outsource their IT needs.

Table 6.1 PPP Adjustment for software services in India

Employee group	Charge rates for a C++ programmer of identical quality		PPP correction factor
	US\$ / hour		
US employees in the US	75		1
Indian employees in the US in Indian companies	60		1.25
Indian employees in India working for export market	20		3.75
Indian employees in India working for domestic market	12.5		6

*Source:* McKinsey Global Institute, 2001.

### § 6.1.1 SOME NUMBERS<sup>88</sup>

India is a country with a per capita income of \$400. Total output of the flourishing software sector is about \$10 billion per year, and over the last seven years the average growth number has been around 40%. There seems to be some confusion about the number of people employed in the software sector. According to NASSCOM (National Association of Software and Service Companies) the number lies at around 120,000 programmers. However, other estimates mention no less than around 1.4 million programmers. The real number lies probably somewhere in the middle. According to a recent survey performed by McKinsey<sup>89</sup> the number is 510,000, of which two-thirds work in the domestic market and only one-third would be employed in the export market. Although this sector activities are spread around the country, they are mainly located in Bombay, Bangalore and Delhi (80%). There are 3,000 exporting companies (75% of the exports are professional services and consultancy), 4,000 companies typically producing for the domestic market, and every year there are hundreds of start-ups. The structure of ownership of all these companies is illustrated in figure 6.2. The main services areas of the software companies are insurance, financial service (including banking) and certain segments of manufacturing. The sectors share in the global market has increased from 11.9% in 1991 to 18.5% in

<sup>88</sup> This part draws heavily on V.N. Balasubramanyam and A. Balasubramanyam, 2001.

<sup>89</sup> McKinsey Global Institute, 2001.

1998. India's largest software export partner is the United States (65% of total) followed - far behind - by Europe (10%), the UK (10%), and Japan (5%).<sup>90</sup>

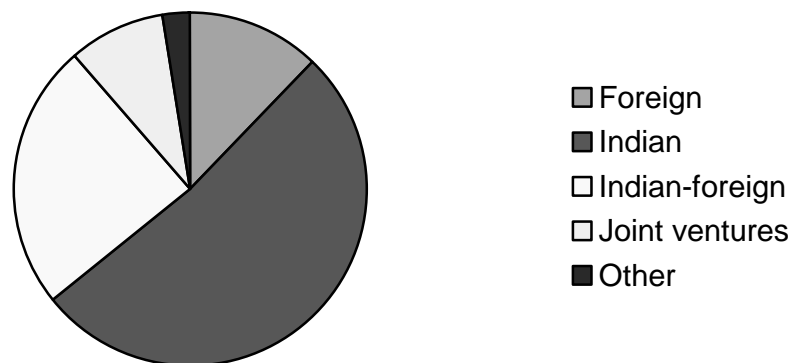


Figure 6.2 Structure of ownership

Source: Balasubramanyam and Balasubramanyam, 2001.

## § 6.2 The needs of the software sector

In the past the software sector has proven itself to be able to cope with difficult circumstances such as a lack of proper infrastructure. The Indian government has acknowledged this problem. Other issues that increasingly get the attention of Indian policy makers nowadays are the rapidly raising wages in the sector, the potential competition from other DCs, and issues regarding to education and training. Competition is a rather 'hot' issue at the moment. China, as non-OECD country is one of the largest software sector competitors.<sup>91</sup>

### § 6.2.1 INFRASTRUCTURE

For the production of software the availability of power and the quality of the telecommunications infrastructure (bandwidth and, increasingly, limited telephone penetration) is very important. In 1996, India had 15 main telephone lines per 1000 persons, compared with 395 per 1000 for Ireland and 446 per 1000 for Israel. Illustrative is also the penetration rate of PCs: 1.5 computers per 1000 persons in India versus 145 for Ireland and 117.6 for Israel (A. Ashora and S. Athreye, 2002). For software firms, after wages, costs for power are the second highest expenditure. So, many software firms generate their own power. Low bandwidths can also pose a problem. While current bandwidths are adequate for simple tasks, they could become an obstacle to more complex, higher value-added projects being awarded to the same firms. For the newly emerging area of e-commerce, the lack of telephone penetration poses an important problem. So, infrastructure problems are a serious threat

<sup>90</sup> Dataquest, 1998.

<sup>91</sup> However, only recently the Chinese Premier Zhu Rongji visited India and approved within 15 minutes a request of the Indian software company Infosys to open a branch office in China.

especially for the software (and related) companies. Improving that situation could attract more foreign investors to the Indian software sector, which are now hesitating to enter the market because they fear that the communication between their home and foreign operation will not be optimal. Moreover, potential investors are afraid that due to the constraints of the infrastructure Indian companies cannot perform the required complicated task. Without dramatic improvements in the efficiency of service delivery, infrastructure constraints are likely to remain a significant constraint on achieving improvements in growth and further progress in global integration (World Bank, 1996).

Secondly, due to the low number of telephone lines and computers available in the domestic market, the software companies lack a proper home market. However, the Indian government or its inhabitants do not have sufficient financial resources to fund the required investments in infrastructure at short notice: at the current efficiency level, in order to keep growing at a 4% per annum, an estimated investment amount is needed of around \$750 billion (World Bank, 1996)!

#### § 6.2.2 WAGES, PRODUCTIVITY AND QUALITY

Although the main obstacle to productivity growth in the Indian software services industry is probably related to the low wage level, the same level is also the single most favourable factor for growth in output. The low wages give employees an incentive to move around quickly when an opportunity for a higher wage arises. This leads to high attrition rates in the software sector, which on its turn reduces productivity and efficiency levels. Driven by the ever-higher wages being offered for the best programmers, best practice Indian companies continue to improve their productivity levels and to charge higher rates.

However, due to the low cost of labour at the entry level, companies tend to continue to enter the low end of the value ladder. As a consequence the average Indian productivity remains almost constant at its current low level. Due to the low wage rates, India is well positioned to provide outsourced software services to the world market. However, as more and more foreign companies are actually outsourcing their software needs to India, this will undoubtedly raise the software sector wage levels in India. In fact, now already wages at the professional level are increasing very rapidly at a rate of up to 25%.

Thus, the sector has entered a new stage; it can no longer only rely on the low wage effect to attract customers, because the customers also desire a qualitative proper product, and more and more other countries such as China, Mexico, Ireland and the Philippines are focusing on the 'low wage'-segment of the market. The quality of Indian Software Solution (ISS) has increased, but it is still not at a level sufficient for the sector to survive the increasing competition in the software industry on the long run. The same accounts for productivity. A large survey held under large American firms about the perception of Indian corporations showed that the bulk of these firms did not expect that Indian firms



would be able to fulfill their future needs in terms of productivity and quality. The survey also showed that only a small percentage would opt for the Indian option when considering outsourcing software solutions abroad (T. Abraham, *et al.*, 1998). What the sector therefore needs to do is to set up standards (such as ISO 9000) and try to stick to them.

### § 6.2.3 EDUCATION

The Indian software sector now already faces a shortage of highly-trained professionals. A survey by McKinsey suggests that till 2010 the number of professionals needed will grow with an annual rate of approximately 23% to a level of 2,100,000. At the moment the number of sufficiently skilled graduates entering the Indian labour market is about 95,000 per year, of which 35,000 start to work in the Indian software sector (McKinsey Global Institute, 2001). This number poses a serious threat to software sector growth in the nearby future. One of the reasons why entrance to the software sector remains modest is that many graduates prefer to work in other sectors or abroad. In that regard, the US market seems particularly attractive to them, because for highly trained professionals the prospects seem better. This explains why about 30% of the Indian graduates are attracted by the mainly American firms and start working there. Not only is, for instance, the education level and the working and living environment considered to be better, a.o. because of the lack of proper teaching talent in India. But also American firms tend to actively attract Indian graduates because they are relatively cheap compared to others in the US.

## § 6.3 Mode 4

With regard to the software sector India did not put limitations on its commitments for Modes 1 (cross-border trade) and 2 (consumption abroad). For mode 3 the only limitation regards market access where foreign corporations are only permitted to have a 51% maximum interest in Indian corporations. India has requested other members of the WTO to make sector-specific commitments concerning mode 4. India itself poses, a.o. a maximum of three months to five years depending on the reason for stay in India. For instance, business visitors are only allowed to stay for 90 days and cannot receive remuneration from within India, while intra-corporate transferees, such as managers, executives and specialists, are allowed to stay for a maximum period of five years. India has made no further commitments or restraints regarding the software sector (including MFN exemptions).

India sees mode 4 as an opportunity to improve the export rates of the software sector by increasing the possibilities for Indian firms to send their software specialists abroad to provide the services asked for. It therefore requests other Member States to allow access for its software professionals to move freely abroad during periods up to 1 to 3 years maximum. However, in practice if one has acceded a foreign country and worked there for several years, one usually can apply for a permanent residence. To counteract that 'abuse', India requests more and faster issuing of short-time visas. In the following

the impact of migration of Indian software specialists on the Indian balance of payments will be assessed.

### § 6.3.1 BALANCE OF PAYMENTS (BOP)

India's bop shows a deficit for quite some time. However, the balance on services – that is to a significant extent determined by the services from software companies - <sup>92</sup> has been positive for a couple of years. If software professionals would increasingly start to move abroad, this could, however, negatively affect the bop, *ceteris paribus*.

If the Indian requests with regard to GATS mode 4 will be accepted, this could lead to much larger migration numbers of software specialists. Such a development could on the one hand positively affect the Indian bop due to increasing remittances. On the other hand the bop could be affected negatively because in India itself such shortages of these professionals could arise that production in and therefore export from India would slow down. The question therefore arises as to what the net bop effects could be of migration policy adjustment under GATS.

## § 6.4 The model

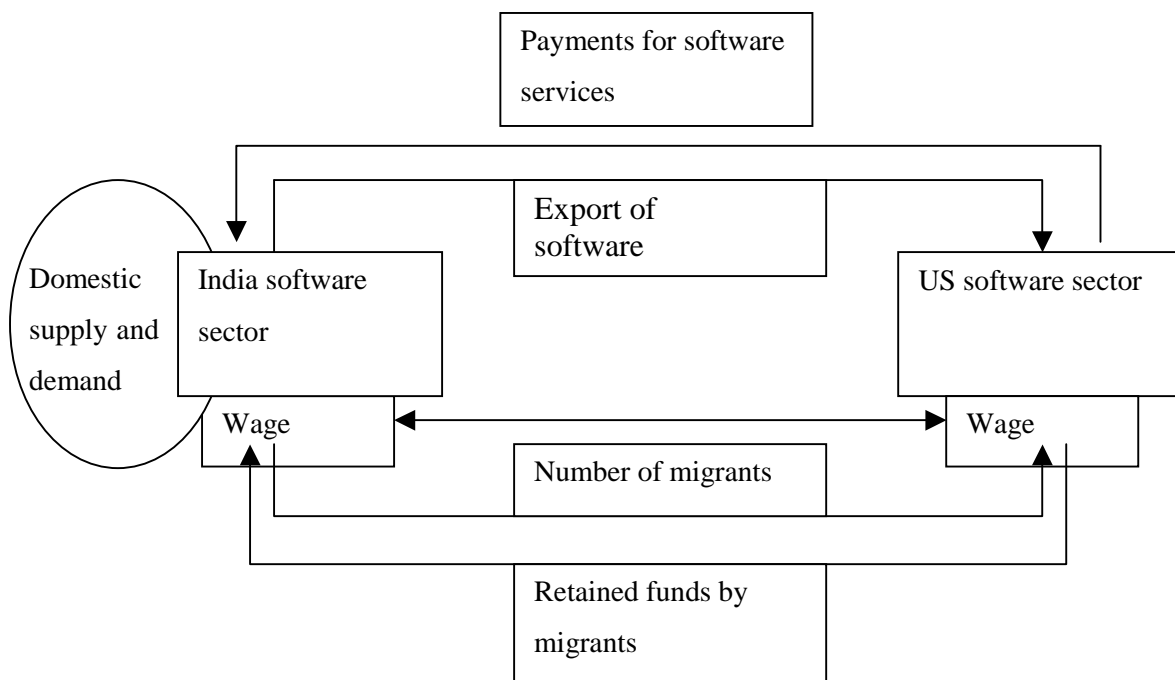


Figure 6.3 Flow model

<sup>92</sup> This exports amounted to some INR 35 billion in 2001; these flows are growing by approximately 30% per annum.

To assess the various bop effects, first of all, the number of migrants is important, which is assumed to depend on the ratio of wages in India and in the western part of the world. The western wage levels are also expected to affect the size of remittances. The wages in India are expected to depend on demand and supply on the domestic market. Furthermore, the number of Indian professionals available to work will depend on the number of graduates, which - as mentioned - seems to be too low to fully satisfy demand. The bop-related flows have been represented in figure 6.3.

In the upper level of the figure wage differences explain the number of migrants, in this case Indian software professionals moving to the West. Remittances flow in the opposite direction. At the lower level one finds the exports of software and the payments in return. All possible failures of deliveries or transport costs are disregarded. A last element in this model is the domestic market. Although it comprises about 25% of total output of software, this market is further disregarded. The assumption is made that if export falls, the domestic market turnover will fall in proportion.

#### § 6.4.1 THE RESULTS

In figure 6.4 the number of migrants from India to the US has been correlated with the wage differential between these countries. This shows that an increasing wage differential stimulates migration.

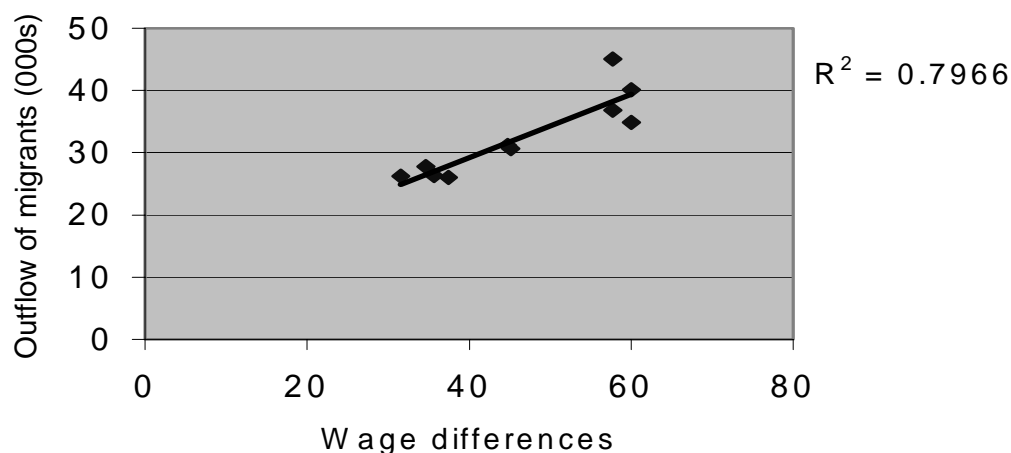


Figure 6.4 Wage differences (%) vs. outflow of migrants

*Source:* Compiled from 1985-1992 data of OECD, Migration Statistics.

Figure 6.5 subsequently shows how the outflow of migrants affects total remittances (in INR m.) to India.

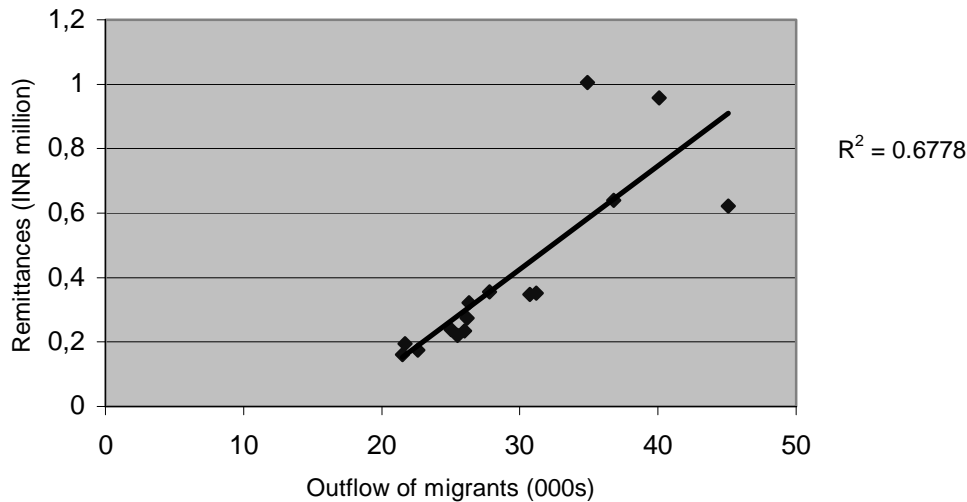


Figure 6.5 Outflow of migrants vs. remittances

*Source:* See figure 6.4.

Next, it will be tried to determine the net effects on the Indian bop of liberalisation through mode 4 by extrapolating the remittances and export figures into the future.<sup>93</sup> In order to calculate these effects data were used from McKinsey Global Institute and NASSCOM. First, it was necessary to determine the amount of personnel needed and available to produce software exports. Every year one third of all college graduates migrates to the US or elsewhere for advanced studies, and another one-third starts working in other industries. The remaining graduates are employed in the domestic software sector where they are assumed to become the future managers. (So let's say, that the graduates from 2000 have become professionals by 2005 and may become manager by 2010.) However, once they are at the managerial level, a large part of the Indian professionals migrates to the west. McKinsey-NASSCOM estimated this to be some 35,000 professionals per annum on average without the mode 4 facilities. It is assumed that further liberalization under mode 4 will raise this annual volume to some 50,000. The questions that now arise are: how many (potential) managers remain available for guiding and training new specialists in the field in India; how many specialists will enter the market; and how much value could they produce for exports? In that regard total output per professional was assumed to increase significantly due to scale effects and increasing efficiency levels (for some data, see the following box).

<sup>93</sup> In fact, the current visa rules could already cause bop problems by 2012.

## Box 2 McKinsey Global Institute about shortage of personnel and possible scenarios

“... we expect the shortage of experienced software professionals to be the biggest external barrier to the continued strong growth of the industry. At current growth rates, India will require around 2 million entry-level programmers and 200,000 high quality senior resources by 2010. We expect the Indian industry to grow at nearly 30% a year to reach \$46 billion by 2010. ... Consequently, employment will grow at 23% a year leading to a requirement of over 2 million entry-level programmers by 2010.

However, at the current levels of output of computer science and engineering graduates, we estimate a shortfall of almost 35% in meeting the demand for senior resources. Of the 95,000 new, high quality professionals that graduate annually from Indian colleges, only 35,000 are likely to be available to software companies each year. The addition of these 35,000 new graduates each year to the current stock of around 100,000 programmers will be insufficient to meet the demand for 200,000 project leaders in 2010 as a large percentage are likely to emigrate to other countries. Even the government’s current plans for education will yield only modest increases and are unlikely to meet the expected demand. The situation is further aggravated by the fact that companies from developed markets (particularly the US) have started luring away large sections of this pool for their home markets. The rapid rise in wages of senior resources is an indication of their increasing scarcity. For instance, while average software wages grew by 25% in 2000, the wages of senior resources increased by more than 60%.”

“...assuming that the availability of software professionals does not become a constraint, Indian companies can expect a total export potential of \$25 billion from both legacy and

*Source:* McKinsey Global Institute, 2001.

Next, future remittances and revenues generated by software exports have been summed up to calculate aggregate income. Figure 6.6 represents four scenarios on this. The top line shows a scenario in which the assumption is made that the supply of software professionals can always satisfy domestic demand in India, so that the total value can be maximised. The next three lines take into account the economic impact of migration of professionals. The second line assumes that 30,000 migrants per year leave India. From 2002-2011, the aggregated income will be higher compared to scenario 1, and from 2012-2015 the total income is still increasing, albeit less than in scenario 1. By 2012 the negative impact of migration on total income counteracts the positive effects of remittances. This total income ‘break-even-point’ shows up earlier if, instead, as in the last two scenarios, 50,000 or 70,000

professionals will move abroad every year. Although, in the first years the total income is slightly higher compared to scenario 1, this will change later on, after about 2008, whereby less restriction on migration shows larger long-term negative income effects for India. So, from this bop model it can be concluded that up to about 2008 significant mode 4 commitments are not likely to have a serious negative effect on the bop. Thereafter, however, the software sector in India is expected to be unable to handle demand because of a lack of managing personnel.

As a final remark it should be mentioned that even if mode 4 liberalisation may have adverse long-term implications for the Indian economy as a whole, this is not to say, however, that the same migration may not have strong positive implications for those directly engaged: the software specialist and their families may obviously benefit from having access to the opportunities offered abroad.

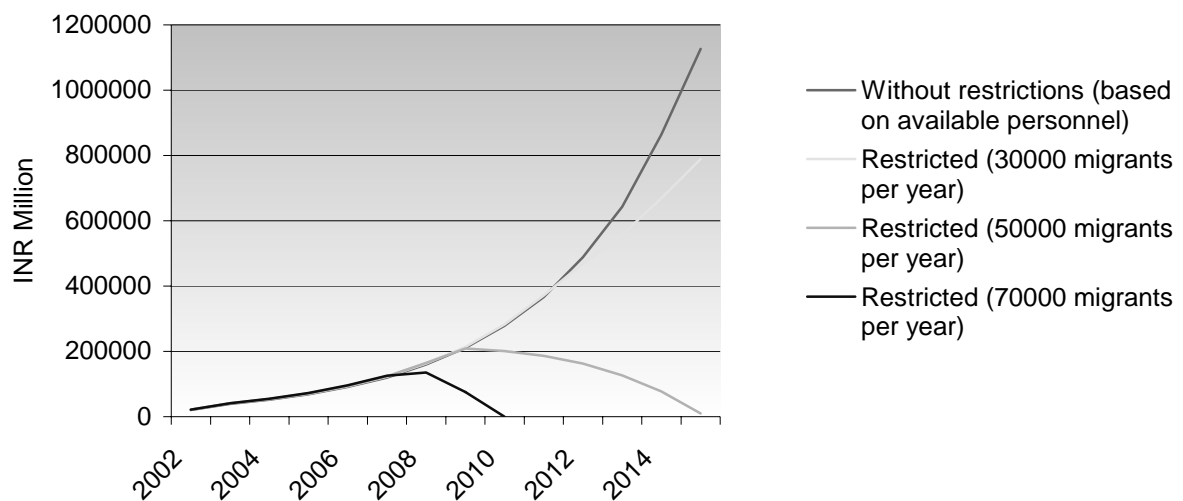


Figure 6.6 Total income (export revenues plus remittances)

## § 6.5 Conclusions and recommendations

The software sector in India developed successfully, supported by: tax benefits, less restrictions on imports and exports, more liberal FDI rules, the presence of a cheap, relatively highly educated English-speaking labour force, and the linkages between software firms both nationally and internationally. However, the current success may come to end due to an insufficient infrastructure, because quality and productivity lag behind the rapidly increasing wages, due to a lack of education and training capacities, and especially because the professionals' strong incentives to move abroad.

The latter may be supported by the request India has made to the other Members of the WTO concerning mode 4. India sees mode 4 as an opportunity to improve the export rates of the software sector by increasing the possibilities for Indian firms to send their software specialists abroad to

provide the asked services. If the Indian requests with regard to GATS mode 4 will be accepted, this could lead to much large migration numbers of software specialist.

Such a development could on the one hand positively affect the Indian bop due to increasing remittances. On the other hand the bop could be affected negatively because in India itself there could turn out to be shortages of such professionals that would slowdown production in and therefore exports from India. The question therefore arises as to what the net bop effects could be of migration policy adjustment under GATS if Members would accept this request, which demands that software professionals can move 'freely' abroad for periods up to 1 - 3 years. In this regard one has to keep in mind that in practice, if one has acceded a foreign country and worked there for several years, one usually can apply for a permanent residence. To counteract that 'abuse' India requests more and faster issuing of short-time visas.

Increasing migration opportunities while generating more remittances, may clearly endanger the export capacity of the Indian software sector itself. The overall impact can be to deteriorate India's bop, which already shows an ongoing high trade deficit. In this case-study the impact of migration of Indian software specialists on the Indian bop has been assessed by summing up projected future remittances and revenues generated by software exports to calculate aggregate income. The case showed that for the first couple of years, 2002-2008, no serious bop problems will result from liberalising migration under GATS mode 4, and that the total income resulting from the net impact of remittances and export revenues will increase. However, according to the simulations, depending on the number of software professionals migrating the sector will eventually not be able to comply with its export demand due to a shortage of managing staff, so that the outflow will increasingly have negative repercussions on the Indian bop. In the best scenario of 30,000 migrants yearly leaving India the overall negative bop impact will occur in about 2012, but this turning point will be reached earlier as migration numbers would increase (in a scenario with 70,000 annual software migrants from India this will be in 2008).

This long-term adverse impact on the Indian economy of migration is partly related to the fact that Indians, once abroad, apply for a permanent stay. To counteract this likely effect of a GATS 4 liberalisation, it seems important that Members in their sector-specific commitments oblige India's request for more and faster issuing of *short-time* visas.

## Chapter 7 The health sector in Cuba (by Sigrid Weitenberg)

Traditionally, especially the health services sector has been subject to serious impediments for trade between countries. In many countries, government involvement has always been high within the sector, quite often by way of a government monopoly offering health services free or significantly below costs. Finally, technical constraints have hindered trade in health services between countries. Therefore, to date, less than 40% of WTO countries have made GATS schedules of commitments for the health sector. However, due to the recent developments concerning trade in services, governments have begun to reconsider their role in the provision of health services. Although less rapidly than on, for example, financial and telecommunication services, more and more Members of the WTO are beginning to undertake some form of commitment on health services.

Cuba is a member of the WTO since 1948. Although Cuba has not made any GATS commitments concerning the health sector so far, it trades health services via two modes of supply identified by the GATS: 'consumption abroad' and 'presence of natural persons'. 'Consumption abroad' in Cuba takes place via special hospitals for foreign patients. These hospitals provide high quality health services at competitive prices to foreigners only. 'Presence of natural persons' occurs via sending health personnel abroad under government supervision on short-term remunerated contracts to foreign countries (Chanda, 2001). Although offered under governmental authority, these health services are supplied on a commercial basis and are therefore covered by the GATS. Cuba provides an interesting case to analyse the consequences of liberalising the health sector under mode 2 and 4 and to assess to what extent this liberalisation can contribute to solving the shortage of all kinds of medical goods in Cuba.

Furthermore, in 1996, more than 25,000 foreign patients came to Cuba for all kinds of treatment. The country mainly attracts foreign patients from Latin America, Europe and Russia. Special hospitals and clinics in Cuba provide high-quality health services for relative low prices (Chanda, 2001).

### § 7.1 Introduction

#### § 7.1.1 THE RESEARCH

To gain more insight in the consequences of trade in health services via treating foreign patients and sending medical doctors abroad, part of the research was carried out in Cuba during December 2002 and January 2003. The research in Cuba was hampered by the lack of a professional visa for the researcher. Due to this the Ministry of Public Health in Cuba was not allowed to provide all information concerning the health system. In addition it was very difficult to get permission to enter a building or to speak with a certain person, even in case of an official permission. Despite the



difficulties in the city of Havana, primary data were collected through semi-structured interviews with doctors from the Cuban Ministry of Public Health, doctors working in hospitals in the city of Havana and a director from the company Cubanacan Tourism and Health. Eventually, six Cuban professionals working in the country's health sector (some of them twice) were interviewed. In addition data was gathered through several informal conversations with Cuban people. Finally, several health institutions in the city of Havana were observed. The office of a family doctor, a hospital and a polyclinic were visited, together with a medical student of the University of Havana. However, it was not possible to gather a lot of quantitative data, such as the exact amount of money generated through the offering of healthcare to foreign patients.

### § 7.1.2 COUNTRY PROFILE

In 1920, US companies owned more than two-thirds of Cuba's farmland and most of its mines. Moreover, in 1958, when president Batista was in power after his second military coup, more than half of Cuba's land, industry, and essential services were in foreign hands. After Batista's second coup, a revolutionary circle formed in Havana, including Fidel Castro. Although a first attempt of the revolutionaries to seize power failed, in 1959 they succeeded and Batista fled to the Dominican Republic. On January 1, 1959 a new period had begun for Cuba. Fidel Castro and his companions turned Cuba into a socialist country. All major Cuban-owned firms and small private businesses were nationalised. Furthermore, self-employment and private trading were banned. Because a lot of US companies were harmed through the privatisation of the Cuban government, the US government imposed a partial embargo on Cuba in 1961.

Much later, in the 1990s, after the disruption of the trade with the East bloc and the tightening of the US embargo, the Cuban government had to take some significant reforms. Due to the shortage of hard currency, in 1993, the government made it legal for the Cuban population to use US dollars. Furthermore, although highly restricted, it permitted self-employment by individual Cubans and allowed the creation of free farmers' markets in 1994. Finally, the government encouraged foreign investment, especially in tourism. However, foreign companies are not allowed to employ Cuban employees directly but have to pay the wages to the Cuban government. The government will then pay the salaries in pesos to the workers, keeping the main part of the hard currency for itself. Due to these limited economic reforms Cuba succeeded in increasing its access to a part of the hard currency required to keep the economy functioning, however, at a low level.

Nowadays, Cuba still is a socialist state controlled by President Fidel Castro. The country has 11 million inhabitants of which 2 million live in the capital Havana. Due to the fact that Castro is Chief

of State, First Secretary of the Communist Party and commander in chief of the armed forces, Castro exercises control over all parts of Cuban life.<sup>94</sup> Moreover, as the Cuban economy is based on Marxist – Leninist precepts, his government owns and runs most means of its production. Finally, about 75 % of the labour force is directly employed by the Cuban State. Main sectors of Cuban economy are tourism, nickel mining, and agriculture, especially sugar and tobacco. Since the late 1990s, tourism became the main source of foreign exchange. In addition, remittances from Cuban people living abroad are important sources of income for many families. The value of total remittances is estimated at \$500 – \$800 million annually.

## § 7.2 History of the health sector in Cuba

### § 7.1 BEFORE 1959

Before the Cuban Revolution in 1959, the quality of health care in Cuba was low. Diseases, which could have been cured, caused the death of thousands of people a year, especially children. Life expectancy was low and campaigns about hygiene or healthy food did not exist. The government spent only a small amount of money on the public health sector. Due to corrupt politicians and government employees part of this budget was not even used for the health sector (T.H. MacDonald, 1999:101). The absence of real government health care caused this sector to be almost entirely private. The private clinics focused on treating wealthy Cuban people and foreigners, mostly Americans. Those clinics provided health services at much lower prices than those offered in the US. Furthermore, the American Medical Association (AMA) did not restrict the use of medical care in Cuba, because the AMA rules concerning ethical and safety issues did not apply to health services in Cuba. Therefore, medical care provided in Cuba could be more innovative. For example, radical cosmetic surgeries, which were not allowed in the US, could be obtained in Cuba for a relatively low price.

### § 7.2 1959-1989

After the revolution, the health sector in Cuba changed from a privatised into a socialised system. In 1960, the Cuban Health System, coordinated by the Ministry of Public Health, was created. According to the law pursued by the Ministry of Public Health, every Cuban citizen had the right to obtain free health services. Furthermore, the quality of health services in Cuba should be improved radically. The main principles of the Ministry, based on socialist public health, were focused on:

- Providing medical care and prevention to the entire population of Cuba
- Developing activities aimed at the protection of the social environment

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<sup>94</sup> URL: <http://lib.lmu.edu/ref/ejournalc5.htm>.

- Giving attention to the elderly and physically and mentally disabled people
- Providing medical information to health workers in order to sustain and improve their knowledge
- Realising biomedical research and improving scientific activities
- Importing, producing and distributing drugs and medical equipment
- Keeping up with statistical information concerning the health sector
- Appropriate planning of all health activities.<sup>95</sup>

The health sector became more internationalised with foreign medical staff travelling to Cuba for education, Cuban staff travelling to other countries to provide health services, and tourists having access to Cuban health services in special clinics. The health sector in Cuba had a quality level comparable to the health systems in developed countries in Europe and in North America.

### § 7.3 1989 - NOW

The US embargo introduced by the government of president Eisenhower in 1960 clearly had a negative impact on the economy of Cuba. The embargo included a ban on US exports to Cuba and also a ban on Cuban imports into the US (American Association for World health, 1997:9). Until the late 1980s this adverse impact was counterbalanced by the relationship with the Soviet bloc. However, as the socialist bloc crumbled in 1989, the US-embargo became suddenly extremely effective. Cuba no longer had access to the East bloc medical market. Furthermore, it became harder to purchase medical products from Western Europe, due to a lack of hard currency. To make things even worse for the health sector in Cuba, the embargo was tightened in 1992. In the same period several third-country medical companies were taken over by US firms, including companies that used to be prime suppliers to the health sector in Cuba. However, now being third-country for US-subidiaries, they became subject to the embargo, and therefore, were no longer allowed to deliver drugs or medical equipment to Cuba. Due to these developments, Cuba suddenly had to deal with cut-offs of key medicines, medical equipment, medical texts, inputs for diagnostics, vaccinations and pharmaceutical and biotechnology research and development (American Association for World health, 1997:11). As a result, the health sector severely weakened.

## § 7.3 The contemporary health sector in Cuba

### *Recent and current reforms in the health sector*

Since the revolution, the main principles of the Ministry of Public Health have not changed. Moreover, the right of every Cuban citizen to obtain free health services is still the most important

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<sup>95</sup> MINSAP, Manual de Enfermeria General I y II, 1990.

principle of the health sector. In 1991, the Ministry drafted a document, 'Objectives, Aims, and Guidelines for Improving the Health of the Cuban Population 1992-2000'. Despite the economic crisis, the Ministry of Public Health decided to focus at maintaining the sustainability of the sector in financial terms and increasing the quality and effectiveness of health services (Pan American Health Organization, 1999:5).

The contents of the reforms of the health sector were recorded in the Methodological File. Its objectives were:

- To improve the efficiency and quality of the National Health System, while respecting the basic strategies and principles
- To achieve greater decentralisation and intersectoral action within the health system
- To achieve greater efficiency of and participation by the international community
- To promote other basic areas of specialised care (Pan American Health Organization, 1999:11).

After the design of the Methodological File by several experts from the Ministry of Public Health, a plan of action was developed to implement the File. Primary care was at the core of the strategies pursued by the Ministry of Public Health. In order to achieve the goal of efficiency, the need for more expensive hospital care had to be reduced. Therefore, the Ministry focused at increasing the utilisation of primary care provided by Family Doctors and Polyclinics. Patients could obtain all regular health services at this level. Only in case of emergencies, or when specialised services were required, they went to a hospital to receive the more expensive secondary care. Furthermore, costs would be saved by the emphasis on prevention, health promotion, early diagnosis and early intervention, so that the utilisation of expensive secondary health care in hospitals would be reduced (UN, 2000).

#### *Current quality of health care*

Due to the reforms the government succeeded, despite the embargo and the disappearance of trade with the East bloc, in maintaining the high standard of the health sector in Cuba. From table 7.1 it can be concluded that the standard of the Cuban health sector is comparable to the standard of an industrialised nation like the UK. However, although the health care situation is better than a few years ago, Cuba still faces a shortage of all kinds of medical goods, which may endanger the quality of the health sector in the (near) future. For example, the repair of equipment has slowed down through the lack of spare parts (American Association for World Health, 1997:13). Therefore, a lot of medical equipment is out of commission. According to a medical student, only three of the eight operating rooms in the hospital 'Docente Comandante Manuel Fajardo' in Havana were being used, as the other five were broken. Moreover, the Ministry of Public Health reports that 13% of Cuba's X-ray machines did not function anymore.

Today, only 889 of the 1,297 medicines that were available in Cuba in 1991 can be obtained. Some 60% of drugs are produced by Cuban research institutes throughout the country. However, the more

sophisticated drugs have to be bought in Europe, which is very expensive and hard to get for the Cubans because of a lack of hard currency.<sup>96</sup>

Table 7.1 Comparative health indicators (UNDP, 2002)

	Cuba	UK	Chile	Haiti	Guatemala
Life expectancy (years; 2000)	76	78	75	53	65
Infant mortality (per 1,000; 2000)	7	6	10	81	44
Maternal mortality (per 100,000; 1985-1999)	33	7	23	520	190
Doctors (per 100,000; 1990-1999)	530	164	110	8	93

#### *Administrative system*

The Cuban Health System provides health services at the national, the provincial and the municipal level (Pan American Health Organization, 1999:3). The central organ on the national level is the Ministry of Public Health. The Ministry controls, coordinates and directs all the health services and activities within the country. Directly under the Ministry, university centres, specialised medical research and care institutions, the Union of the Medical-Pharmaceutical Industry and several firms, which distribute, import and/or export drugs and medical equipment also operate on the national level. On the provincial level, the provincial assemblies have direct financial and administrative control over the provincial public health offices. These offices are, for example, provincial hospitals, intermunicipal hospitals, education centres, blood banks and health and epidemiology centres.

Finally, the municipal level contains several municipal public health offices, which form different so-called 'areas of health'. Municipal assemblies control the offices both financially and administratively. Examples of municipal public health offices are polyclinics, municipal hospitals, oral health clinics, maternity homes and old people's homes. Furthermore, the 'areas of health' (municipal public health offices) consist of 'sectors of health', also coordinated by the municipal assemblies. 'Sectors of health' are formed by the offices of Family Doctors, pharmacies and other medical posts. Within the Municipal assemblies, the People's Councils are the nuclei at the municipal level. The Councils act as an organ for co-ordination, thus expressing the administrative decentralisation within the health system of Cuba (Pan American Health Organization, 1999:3).

Finally, as a result of the new strategy of the government, nowadays, the assemblies on each level are made up of representatives of the various social sectors and civil organisations and are headed by a government representative. This has increased the intersectoral collaboration and, therefore, also the

<sup>96</sup> According to an interview with a doctor from the Cuban Ministry of Public Health.

social participation in the identification and the solution of problems concerning the health sector (Pan American Health Organisation, 1998:214).

#### *The financial system*

The National Health System in Cuba is completely financed by state resources and highly decentralised, as more than 90% is financed from municipal budgets.<sup>97</sup> The total amount of money spent by the entire health sector despite the economic crisis in 1989 was 1,016 million pesos and increased with 77%, to 1,796 million pesos in 2001. In percentage of the entire state budget, the budget for the health sector rose from 6.6% in 1990 to 11.4% in 2001.<sup>98</sup> Since 1993, all imports of supplies by the Ministry of Public Health must be financed out of the foreign currency budget that the State allocates for this purpose.<sup>99</sup> In 1989 the amount of money spent on imports of medicines, equipment and instruments was \$237 million, dropped to \$90 million in 1994 and increased to \$138 million in 1998, which was not enough to cover all necessities. The severe reduction in foreign currency financing seriously affected supply. For example, the availability of medical supplies used in health units decreased and the production of drugs by the domestic industry dropped by more than one-third between 1990 and 1993.

Cuba identified and developed various means to acquire foreign currency in order to decrease the shortage: by exporting medicines to other countries (\$47 million in 1997), offering health services to foreigners, sending Cuban medical professionals abroad (an estimated amount of \$6 million a year), educating foreign students, exporting of software with medical applications to other countries and by receiving donations of several NGO's and of employees working in the Cuban tourism sector (they gave 20% of all tips to a special cancer project in 1996; this generated more than \$1 million).

#### *Professionals*

In 2001, Cuba had 67,128 physicians, 80,719 nurses, 10,150 dentists, and 67,128 technical professionals.<sup>100</sup> In addition to this, 134,538 workers were employed in other areas of the health sector. Nowadays, an adequate number of physicians have been reached. However, there still is a shortage in the number of nurses. Therefore, people are encouraged to participate in the education for both mid- and high-level nursing personnel.

Cuba also has agreements with other countries about health professionals working abroad. With each requesting country an agreement is made. Most of the services provided by Cuban health workers in foreign countries are for free. However, some countries do pay the government of Cuba a certain amount of money for every health worker they 'receive'. For example, a few years ago, the

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<sup>97</sup> URL:<http://www.paho.org/English/HIA1998/Cuba.pdf>.

<sup>98</sup> Oficina Nacional de Estadísticas (ONE, 2002), Anuario Estadístico 2001.

<sup>99</sup> URL:<http://www.paho.org/English/HIA1998/Cuba.pdf>.

<sup>100</sup> According to an interview with a doctor from the Ministry of Public Health, December 2002.

government of South Africa hired 600 Cuban physicians from the Cuban government, in order to deal with its shortage of health workers.<sup>101</sup> In 2001, there were 3,418 Cuban medical professionals working in 57 foreign countries.<sup>102</sup>

## § 7.4 The Health sector and GATS

The GATS covers ‘any service in any sector except services supplied in the exercise of governmental authority’. This definition excludes health services, which are not provided for profit and do not compete with other supplied health services. However, the GATS does cover private health services or health services supplied for profit. Within the GATS, the health sector is defined together with social services. The classification list contains the following services:

*Professional services:* Medical and dental services, Veterinary services, Services provided by midwives, physiotherapists, *etcetera*.

*Health related and social services:* Hospital services, Other human health services, Social services.

In principle trade in health services can occur via the 4 modes of supply (Chanda, 2001):

- Cross-border supply of health services refers to cross-border trade in laboratory samples, diagnosis, clinical consultations and second opinions via traditional and electronic mail.
- Consumption abroad includes the movement of consumers to the country providing the health services. Furthermore, this mode of supply deals with (para-)medical education and health tourism offered to foreigners.
- Commercial presence refers to the establishment of foreign owned hospitals, clinics, nursing homes, and diagnostic and treatment centres within countries.
- Presence of natural persons refers to trade in health services through temporary and permanent movement of health personnel, including physicians, technicians, consultants, trainers, health management personnel, and other professionals. Health personnel move from the territory of one member into the territory of another member in order to supply services.

Within schedules of commitment concerning the health sector, several members did not make any commitments for mode 1. Part of these members, as mentioned in their schedules, felt that cross-border supply was not possible due to technical constraints. However, when this is based on incorrect judgement or when the technology changes, the schedules will be more restrictive than they were intended to be. This might indicate that if members would feel that cross-border supply was possible, they would probably undertake commitments for this mode (WTO, Guide to the GATS, 2001:388).

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<sup>101</sup> Volkskrant, September 30, 2002.

<sup>102</sup> Juventud Rebelde, 3-4-2001 (Cuban newspaper).

In general, Members tend to make most GATS commitments for mode 2. This is because in many cases, governments of developing and developed countries decide that it is not useful to influence demand patterns when consumers already have left the concerning countries. Moreover, mode 2 tends to be more liberal because this mode can be seen as a substitute for mode 3 and mode 4. Foreign investment and the movement of physicians into a foreign country can be (partly) replaced by attracting foreign patients for health treatment. Important to note here is that, as DCs are often competitive health suppliers in the area of hospital services and consumption abroad, it is especially interesting for them knowing that most developed countries have made commitments without limitations for this sub sector and mode of supply.

Like most sector-specific schedules of commitment made by members, schedules concerning the health sector include most limitations for mode 4. This is the case for both developing and developed countries.

#### § 7.4.1 MODE 2, PATIENTS GOING ABROAD

Patients seek health care abroad, for example: to take advantage of highly qualified and specialised health care unavailable in their home country, to avoid the long waiting lists or to benefit from natural endowments such as hot springs and spas. Other patients may go abroad in order to obtain lower priced health services of equal quality, for example, when cosmetic surgery is not covered by the health care insurance and people go abroad for a more affordable one (Adams & Kinnon, 1998). The treatment of foreign patients can have an impact on the equity, quality and efficiency of the receiving health system:

- The equity of the health sector can be negatively affected when foreign patients compete with domestic ones to receive health care. Especially when the capacity of the health sector is limited, foreign patients can limit the access for domestic patients as has happened, for example, in the Kenyan health sector. In Kenya the foreign patients that came to Kenya to receive medical care caused a decrease in care available for (poorer) Kenyan people.<sup>103</sup> Moreover, the use of public funds for health care provided to foreigners may reduce the amount of funds available for medical care aimed at the domestic population and may lower the access of domestic patients to medical care. On the other hand, when incomes generated by this mode are invested - for example in new medical facilities or medical personal - in the entire health sector, equity can increase.
- The quality of the health sector can be positively affected when the quality has to be upgraded and maintained to the standard required to attract foreign patients. Due to the necessary improvement and maintenance of health services, the quality of services provided to domestic patients will also increase. This positive spillover effects may not occur when health professionals in separate

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<sup>103</sup> Stichting Onderzoek Multinationale Ondernemingen (SOMO), Challenges for the South in the WTO Negotiations on Services.



facilities treat foreign patients. In addition, when incomes generated by this mode are used for the entire health system, its quality may also increase.<sup>104</sup>

- When the incomes generated through liberalising mode 2 are used for upgrading the quality or improving the access of the entire health sector the efficiency of the health sector may increase because the sector's output improves (*e.g.* equity and quality) while its costs stay the same. However, when these costs are financed by public funds at the costs of resources for the rest of the health system the output of the public health sector decreases and as a consequence also the efficiency of the health sector.

### *Health care insurance*

It can be concluded that the main advantage of liberalisation of the health sector concerns the incomes generated via mode 2. An important trade barrier that has a major impact on the number of patients going abroad for medical care is the non-portability of public and private health care insurances: public hospitals may be required not to accept insurance cover from foreign-based companies or a regulated domestic insurer may be prevented from reimbursing the cost of treatment abroad. When public and private health insurances services would be liberalised, patients who otherwise would not have the opportunity to pay for treatment abroad may decide to acquire foreign health care when it is covered by the insurance (UNCTAD Secretariat, 1998). For example, elderly people are being deterred from retiring abroad due to the non-portability of health insurances. Here, the impact of the trade barrier is being indicated by the fact that, according to a joint study from the UN and the WHO, when just 3% of all elderly people would retire in DCs, they would bring with them possible medical expenditures of \$10 to \$15 billion (United Nations and WHO, 1998).

Some WTO Members (*e.g.* the US and Bulgaria) explicitly have included the non-portability of public health insurances in their schedules of commitments for the health sector.<sup>105</sup> An important reason for both governments and individual health insurers to refuse reimbursement of treatment abroad refers to the assumption that these health services are of lower quality against higher prices than those offered domestically.

The liberalisation of health insurance services and the resulting increase of patients going abroad to countries with lower wage levels, could decrease waiting lists and costs of health care in the home country of patients. The receiving countries, however, have to pay attention to the possible discrimination of patients. The aforementioned case study of the Kenyan health sector showed that liberalisation of the health insurance services led to 'cream skimming' in Kenya. The public health sector had to insure low-income and/or high-risk patients (*e.g.* patients suffering from HIV/aids),

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<sup>104</sup> Adams & Kinnon (1998), *op. cit.*

<sup>105</sup> The US schedule of commitment for the health sector states concerning Mode of supply 2 that 'federal or state government reimbursement of medical expenses is limited to licensed, certified facilities in the US or in a specific US state'.

because private foreign suppliers of health insurance services refused these patients. Another consequence was that the medical care system became too expensive for a lot of Kenyans, so that they were not insured at all, and, therefore, did not have access to the health system (Kinuthia, 2002).

Several provisions of the GATS may deal with negative effects of liberalising health insurance suppliers. Although, WTO members are required not to discriminate between foreign firms and domestic ones (Art. XVI and XVII), Members are allowed to take domestic measures, *e.g.* that all (foreign and domestic) private insurance companies have to reserve a minimum percentage of their insurances for poor and high-risk patients. These measures may decrease or even prevent the effect of ‘cream skimming’ and increase the insurance coverage of the entire population. However, when only foreign private insurance companies need to be subject to such domestic regulation, action may be stimulated based on the fact that Members are allowed to enter in their schedule of commitment concerning national treatment ‘any limitations in the treatment of foreign service suppliers which puts them in a less favourable position than their domestic counterparts’.<sup>106</sup> GATS seems not to provide direct opportunities to deal with the ‘crowding out’ effect, which has a negative effect on equity. However, since the Agreement does not impose any limitations on the conditions under which a host country has to treat foreign patients, domestic regulation can be formulated in order to avoid or diminish the risk of ‘crowding out’. For example, a country may subject health services provided to foreigners to special taxes.

#### § 7.4.2 MODE 4, HEALTH PROFESSIONALS GOING ABROAD

The main reason for health professionals to move abroad is to seek improved living and working conditions. Moreover, they also may wish to acquire higher professional qualifications or to expose themselves to new techniques not available in their home country. Finally, health professionals may want to provide health care abroad because of idealism or because they are searching for a challenge. The employers in the host countries are looking for health professionals abroad because the necessary skills are in short of supply domestically (UNCTAD Secretariat, 1998). When the labour market is in equilibrium the question arises whether the movement of health professionals encourages residents, who may otherwise have worked as health professional, to seek more lucrative employment in other sectors and/or professions. Or do the immigrants add to the supply of health professionals thus depressing wages and encouraging over-extensive use of the relevant services (WTO, 2001:626)? For the home country the migration of health professional can have an impact on the equity, quality and efficiency of the health system:

- When the migration of health professionals produces shortages it has a negative impact on the equity of the health sector. Especially, in countries with a very low number of highly qualified

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<sup>106</sup> [URL:http://gats-info.eu.int/gats-info/gatscomm.pl?MENU=hhh](http://gats-info.eu.int/gats-info/gatscomm.pl?MENU=hhh).

and specialised health personnel, the migration of even a few people already can have a major impact. In these cases, an entire service could become inoperative. However, when the moving health professionals are those of which the home country has a surplus, migration will influence the efficiency of the health sector more than the equity (Adams & Kinnon, 1998). In this case, the output (*e.g.* quality and equity) of the health sector will stay the same although its costs decrease due to the flow of health workers abroad.

- When the migration of health professionals is permanent, this can have a negative impact on the quality because they take valuable knowledge, capabilities and human capital with them, *i.e.* ‘brain-drain’.<sup>107</sup> Many countries experience both an outflow and inflow of health professionals. For example, Jamaica ‘exports’ nurses to the US and receives nurses from Nigeria to compensate shortages in the health sector. However, DCs may not always have the resources to replace migrated health professionals, so that they are most affected by the effect of ‘brain drain’. Of all migrating health professionals, DCs are estimated to supply 56% and receive 11%. The South African Medical Association (SAMA), for example, estimated that, in the last few years, at least 5,000 doctors have left the country to western countries. One of the worst cases of ‘brain drain’ refers to Zambia, where some years ago, 1,600 doctors worked in the country’s health sector, while now only 400 are left.<sup>108</sup>
- When the migration of health professionals is temporary this can have a positive impact on the quality, when they acquire knowledge and skills that can be applied in their home country when they return, *i.e.* brain gain.
- The migration of health professionals influences the efficiency negatively, when the education of health workers is highly subsidised by public funding and requires significant investments. The efficiency will further decrease when measures have to be taken to compensate for the shortage of health workers. For example, South Africa has made agreements with Cuba to obtain medical professionals in order to replace the South Africans who have left the country. Although these costs can be partly offset by the remittances sent by the health professionals abroad, the health sector itself is not directly compensated (Adams & Kinnon, 1998).

Restrictions to movement of health professionals may arise from economic needs tests (ENT) requirements, discriminatory licensing, difficulties with accreditation or recognition of foreign professional qualifications, nationality and residency requirements, state and provincial requirements, immigration requirements, access to examinations for completion of qualifications, foreign exchange controls affecting the repatriation of earnings, or discriminatory regulation of fees and expenses. An opportunity of the GATS is to (partly) remove these trade barriers in order to stimulate and facilitate

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<sup>107</sup>By definition ‘brain drain’ is the permanent emigration of qualified and skilled persons ([URL:http://migration.ucdavis.edu/cmpr/sdreport/thomas1/thomas.html](http://migration.ucdavis.edu/cmpr/sdreport/thomas1/thomas.html)).

<sup>108</sup>[URL:http://www.djh.dk/global](http://www.djh.dk/global).

temporarily movement of health professionals abroad. For example, host countries can grant special temporary visas to foreign health workers who occupy positions in the health system for a limited period of time (the US grant special temporary visas to foreign nurses). Moreover, when a host country recognises foreign diplomas and other qualifications it also becomes easier and more attractive for health professionals to move and work abroad. Another example is the efforts of Central, South and Eastern Africa towards creating common standards and qualifications for nurses. Finally, within commitments time limits may be specified which refer to the duration of health professionals in the host country.

GATS commitments of WTO Members that include regulations that deal with the mentioned trade barriers may increase the temporary flow of health professionals from home to host country. However, because it is difficult to identify what national regulation concerning limitations on market access and national treatment should be included in the schedule of commitment, part of these rules is not being scheduled by WTO members. Thus, although GATS commitments are made, it is possible that host countries developed domestic regulation with adverse effects on trade in health services via Mode of supply 4. Here, WTO Members may gain from one of the key principles of the GATS, which refers to transparency. In order to make sure that the stay of the professionals is temporary, the home and host country should formulate domestic regulation.

The question arises whether the limitations concerning market access, which host countries may include in their schedules of commitment, may influence the effect of 'brain drain'. One of the limitations refers to the total number of natural persons that may be employed in a particular services sector of the host country (GATS, Art. XVI). For example, a WTO member could request other members to open up their health sector for a maximum total number of health professionals. When host countries follow that request, this may lead to a decrease in the total number of health professionals moving to these countries. However, no conclusions can be drawn about how this may affect the 'brain drain' of individual countries. Since WTO members are not allowed to discriminate (due to the MFN rule), they are not allowed to limit the number of health professionals coming from one specific country only.

## § 7.5 Trade in health services in Cuba

### § 7.5.1 MODE 2, CUBANACAN TOURISM AND HEALTH

Cubanacan Tourism and Health, formerly known as Serivmed, is the company from the Cubanacan Group specialised in offering medical services to foreigners. The company is part of the corporate 'Grupo Turístico Cubanacán S.A'.<sup>109</sup> Cuba's most important tourism organisation. The Cuban State owns this organisation and, therefore, also the company Cubanacan Tourism and Health. The main goal of Cubanacan Tourism and Health is "to furnish the clients with the achievements, the expertise, the know-how, and the professionalism of the Cuban medical sector, and to understand the legal and the ethical responsibility that this represents" (Cubanacan Tourism and Health, 2002). The company's strategy includes the provision of highly qualified health care at competitive prices due to low labour costs. Moreover, through offering certain unique treatments (Cuban health professionals are able to treat skin diseases which are seen as incurable in the rest of the world), the country also makes its health services competitive in the world market. Finally, part of its strategy refers to the offering of exclusive medical treatment and programs in luxury beach resorts.

Cubanacan Tourism and Health established a number of international clinics in every principal tourist's area in the country and medical offices and dispensaries at hotels (and other places to stay) to provide tourist primary medical care when necessary. Moreover, a network of optical stores and international drugstores has been built. Finally, Cuba has a whole net of international drugstores that holds the exclusive right to commercialise Cuban drugs for specialised medical treatments and it also sells drugs from international pharmaceutical firms.

Cubanacan Tourism and Health uses the infrastructure of the Ministry of Public Health to provide the necessary care. Some of their hospitals (*e.g.* the hospitals 'Docente Comandante Manuel Fajardo' and the 'Hermanos Almejeiras' in Havana) have one floor for treatment and hospitalisation of foreign patients to which Cuban citizens do not have access. Besides (primary medical) care provided in international clinics, Cubanacan Tourism and Health also offers several medical programs for treatment against drug and alcohol addiction, neurosurgical treatment, treatment of skin diseases like vitiligo and psoriasis, clinical and surgical programs, oncology programs and aesthetic surgery programs. These programs are assisted by several medical and scientific institutions.

Finally, Cubanacan Tourism and Health offers 'quality of life programs' aimed at delaying the aging process, preventing disease occurrence and eliminating stress. They include thermal bath, stress management and aesthetic and beauty treatments such as special massages, cosmetology and facial aesthetic. Some 'quality of life' programs are situated in luxury tourist resorts, others in the

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<sup>109</sup> Tour Group Cubanacan S.A.

International Clinics. A summary of all international clinics and institutions of Cubanacan Tourism and Health by province of Cuba is presented in table 7.2.

Table 7.2 International clinics and institutions by Cuban province (Cubanacan Tourism and Health (2002)).

Province of Cuba	<i>International Clinics</i>	<i>Medical offices in hotels/lodges</i>	<i>International Drugstores</i>	<i>Optical Stores</i>	<i>'Quality of life' programs</i>
Pinar del Rio	-	8	-	1	1
City of Havana	3	37	12	4	1
Havana	-	2	2	-	-
Matanzas	1	17	6	2	4
Cienfuegos	1	5	3	1	-
Villa Clara	-	2	1	-	-
Sancti Spiritus	1	7	2a	-	-
Ciego de Avila	1	7	1	1	1
Holguín	1	8	2	-	2
Camagüey	1	6	4	-	4
Santiago de Cuba	1	10		1	1
Bayamo	-	2	6	-	4
Granma	-	-	1	-	-
<b>Total</b>	<b>10</b>	<b>110</b>	<b>40</b>	<b>10</b>	<b>18</b>

Cubanacan Tourism and Health also has opened commercial representations in markets like Argentine, Brazil, Chile and Mexico and it established in association with Brazilian investors a hospital in the treatment of skin disorders in Brazil.

The medical staff of Cubanacan Tourism and Health receives the same salary as health professionals in the public health sector. However, working conditions seemed to be better in the clinics of Cubanacan Tourism and Health.<sup>110</sup> The main differences concern the quality of buildings, equipment and materials. For example, while in a hospital in Havana most beds on the wards for Cuban patients were old, dirty or even broken, the beds on the top floor of this hospital destined for foreign patients obviously were in much better state. Moreover, the separate rooms on this floor offered more privacy to patients than the floors for local people. Furthermore, the quality of the hospital buildings for foreigners differs significantly from the ones for domestic patients in that hospitals for foreign

<sup>110</sup> Based on visits in the city of Havana.

patients are maintained very well, while several hospitals for Cuban patients were damaged and needed to be renovated. These differences influence the working conditions for health professionals and the quality of medical care which patients receive. The difference in quality in health care for foreign and domestic patients is justified by the fact that foreign patients pay for the health care they receive, and therefore 'deserve' health care of higher quality. In addition, there were no obvious signs of the effect of 'crowding out' (yet) in the Cuban health sector. This does not mean that Cuba does not have to take into account the possible negative impact of 'crowding out' in the future. When trade in health services via mode of supply 2 will be continued, domestic regulations should be formulated in order to decrease or even avoid the possible occurrence of this phenomenon.

Cubanacan Tourism and Health's attracts mainly patients from Latin America, Europe and Russia (Chanda, 2001), generating an income about \$25 million in 2002. According to a doctor working at the International Relations Department of the Ministry of Public Health in Cuba, the revenues are channelled to the Cubanacan Tourism and Health and to the Ministry of Public Health. Therefore, it seems plausible that the revenues will be at least partly allocated to the public health sector and therefore can improve the quality and equity for the Cuban patients. The opportunities for more revenues depend on a.o. things the possibilities to increase the portability of the health insurances of Cuba's foreign patients. At the moment it seems that the treatments that Russian patients receive in Cuba are not covered by their public or private insurance. Because Russia is not a Member of the WTO it cannot make any GATS commitments for (parts of) services sectors, including the market for suppliers of private health care insurances.<sup>111</sup> The public health care insurance of citizens of the EU is limited to the coverage of emergency medical care which they may need when staying in other EU countries or in countries with which bilateral agreements are made (WTO, 2001). The EU has not made GATS commitments concerning the liberalisation of the market for suppliers of private health care insurances or bilateral agreements with Cuba. Thus, also European patients have to pay by themselves for treatment in Cuba.<sup>112</sup>

However, Latin America makes efforts to gradually open its health insurance markets (WTO, 2001). For example, Panama, Jamaica and Mexico have included health insurance services in their schedules of commitment for financial services. Although subject to limitations,<sup>113</sup> this implies a more liberalised health insurance market in this region, which (tend to) cover treatment abroad.

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<sup>111</sup> [URL:http:// www.wto.org](http://www.wto.org).

<sup>112</sup> [URL:http://www.cvz.nl/](http://www.cvz.nl/).

<sup>113</sup> For example, in Mexico, foreign investors may hold, in aggregate, up to 30% of capital stock. Moreover, effective control of the enterprise by the Mexican shareholders is required.

### § 7.5.2 MIGRATION OF HEALTH PROFESSIONALS IN CUBA

In 2001, 3,418 Cuban professionals worked in 57 different foreign countries for a period of two or three years.<sup>114</sup> They are all supervised by the Cuban government and considered as representatives of Cuba. Therefore, the Ministry emphasises a strict selection.

Because free health services for everybody is the basic idea within the Cuban society, Cuba claimed that most of his or her medical services provided abroad are also for free. Cuba makes an agreement with each requesting and paying country. These agreements are being revised every year, so that all three parties, the Cuban state, the government of the foreign country and the health worker, have the opportunity to terminate the agreement. In the agreement the Cuban state and the receiving government arrange also the amount of money paid by the latter. In most cases, Cuba and the recipient country agree that the latter take care of the basic needs of the Cuban health professionals abroad, while the Cuban state takes care of the family in Cuba. The amounts and division of the money differ per contract and per country. For example, sometimes the state and the health worker get the same amount of money (50-50) or sometimes the division is 70-30, which means that the health worker gets 70% and the state 30% of the money.<sup>115</sup> The amount of money the Cuban health workers receive is often less than the salary of local health professionals in the host country.

However, according to a doctor from the Ministry of Public Health, countries, which can afford, do pay the Cuban government for every health worker they 'receive'. For example, the doctor claimed that Tanzania and Brazil pay for the Cuban health professionals they receive in their health sector. It is estimated that Cuba receives about \$6 billion a year for doctors working abroad.

Cuba invested the revenues generated through the bilateral agreements in the public health sector. In addition, the health professionals who return to Cuba cause a small 'brain gain' in the health sector, because they learn sometimes about diseases and treatments, which cannot be found in Cuba. Because most of the Cuban health workers return to Cuba, according to a doctor from the Ministry of Public Health the negative effect of brain drain is rather small.<sup>116</sup> One can conclude therefore that the revenues of the health professionals working abroad compensate the brain drain and the temporary pressure on the health capacity, so that the overall impact on the health sector in Cuba is positive.

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<sup>114</sup> Juventud Rebelde (Cuban newspaper, April 2001).

<sup>115</sup> According to an interview with a doctor from the Ministry of Public Health.

<sup>116</sup> The reason for this can be that Cuban health professionals going abroad leave their families behind.



## § 7.6 Conclusions and recommendations

### § 7.6.1 OPPORTUNITIES AND THREATS

#### *Opportunities*

The U.S. embargo threatens the efficiency of the Cuban health sector, since the main medical supplies have to be bought in relatively expensive markets. In addition, the equity and quality are being endangered due to the shortages in medical goods. Liberalising the health service via mode of supply 2 and 4 under the GATS could deal with these problems due to an increase in foreign exchanges for Cuba. When, more countries allow their citizens to receive health care in foreign countries, more patients might decide to go abroad and to Cuba to obtain medical care. This may lead to an increase in incomes generated by the company Cubanacan Tourism and Health and for the public health sector. The revenues could be used to buy more medicines, other medical goods human and to upgrade physical resources. Thus, the equity and quality of the Cuban health sector might improve and therefore, its efficiency also might increase. The rise in the number of foreign patients could further be stimulated when WTO Members decided to liberalise their health insurance market. Liberalisation of the international health insurance market should go along with an international institution to monitor and control the quality and price of health services.

Since the EU requested Cuba to liberalise particular services sectors,<sup>117</sup> Cuba can in return request the EU to consider liberalisation of the health insurance market to stimulate the ‘portability’ of insurances. After bargaining, the parties may come to an agreement when the EU offers (partly) liberalisation of the health insurance market and Cuba offers liberalisation of one or more of the specific services sectors desired by the EU.

#### *Threats*

An increase in foreign patients in Cuba increases the chance of ‘crowding out’, which may further endanger the equity of the health sector.

When Cuban health professionals working abroad are being covered by the GATS, the ‘national treatment’ rule of the Agreement may also refer to them, thus the receiving WTO Members have to treat the Cuban professionals in the same way as they treat other local or foreign health workers. This could involve an increase of the wage level of the Cuban health professional working abroad (the average wage in Cuba is \$10 a month). Therefore, despite the control of the Cuban State, more

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<sup>117</sup> The requests of the European Union to Cuba cover the following services sectors: professional services, business services, telecommunication services, construction and related engineering services, distribution services, environmental services, financial services, tourism and travel services, news agency services and transport services.

professionals may decide not return to Cuba, which would lead to ‘brain drain’. ‘Brain drain’ may further aggravate the threatening of the equity, quality and efficiency of the Cuban health sector since there not only will be shortages in medical goods but also in personnel.

Reviewing the main cultural values concerning health in Cuba it is likely that Cuban government concludes that the Agreement’s purpose does not comply with the main values of its health sector. The main value of the Cuban health sector refers to the right of every Cuban citizen to obtain free health services. Moreover, Cuba also values the provision of health care to poor foreign countries highly. Cuban values concerning health are clearly expressed in a speech of Fidel Castro, presented in a Cuban newspaper (*Juventud Rebelde*, 2002: nr. 27). Castro states here that: “these days, health care in Cuba is probably the most secure and universal and entirely free for all citizens.” Besides this, according to Castro: “health care would dehumanise enormously if it would be commercialised from the production of medicines till the offering of services”. Doctors from the Ministry of Public Health and people in the street also shared this vision. Finally, the values concerning health care in Cuba are being expressed in the fact that (foreign) private investment in the health sector is not allowed.

#### § 7.6.2 RECOMMENDATIONS

Cuba should only join GATS negotiations for both modes of supply in the future when the country is able to create domestic regulations based on which the opportunities of liberalisation via modes of supply 2 and 4 under the GATS will exceed the threats. It is recommended that Cuba should make in future GATS negotiations with respect to mode 2 and 4, the following request and formulate domestic regulation to realise the opportunities and control the threats of liberalising mode 2 and 4.

##### *Mode 2*

Requests concerning:

- liberalisation of health insurances directed at WTO members, which may provide more foreign patients (*e.g.* the European Union).
- concerning the liberalisation of trade in health services via mode of supply 2 directed at WTO Members, which have not made GATS commitments yet for this mode (and which may provide more foreign patients).

Domestic regulation should aim at the decrease or prevention of the effect of ‘crowding out’ in the health sector. For example, it should be examined whether it is possible for Cuba to develop national legislation concerning a maximum number of foreign patients coming to the country for health care. In addition, further research should be conducted to determine what the content of other domestic regulation should be and would officially allowed to be.

*Mode 4*

Cuba should formulate requests

- concerning the liberalisation of trade in health services via mode of supply 4. These requests should include regulations that facilitate temporarily sending of (Cuban) health professionals abroad and, at the same time, they also should contain provisions, which decrease the chance of permanent movement. For example, time limits or temporary visas and recognition of diplomas and other qualifications of health professionals may be included.
- to host countries to take measures which ensure that Cuban health professionals will only stay temporarily in their country and return to Cuba.
- Cuba should also consider the existing national regulation concerning trade in health services via mode of supply 4 of host countries. Since WTO Members are not obliged to include all rules in schedules of commitments, there may exist other regulation with a negative impact on this mode of supply. Requests to host countries to get information can be based on and justified by the Transparency principle of the GATS.

Domestic regulation should aim at the decrease or prevention of the effect of ‘brain drain’ in the health sector. For example, since the Cuba State at this moment also supervises health professionals working abroad, it could be considered to further increase the control. In addition, Cuba could examine the possibilities of deposit requirements or guarantees, which would make it unattractive for health professionals to permanently leave their home country.

However, since basic values of the Cuban health sector are in conflict with the ideas of the WTO and the GATS, it may be improbable that Cuba will join GATS negotiations concerning this sector in the future and, therefore, no requests may be made at all.

In order to deal with this, the Cuban government should be informed with the following facts:

- Cuba does not (necessarily) have to make GATS commitments concerning the health sector itself.
- Modes of supply 2 and 4 under the GATS do not refer to privatisation of the health sector, and therefore,
- GATS commitments do not imply that the main values of the Cuban health sector will be threatened.

Finally, it is important to notice is that this research has been limited to the impact of possible changes, enabled through liberalisation via modes of supply 2 and 4 under the GATS, *on the current problems* within the Cuban health sector. Thus, when considering participation in GATS negotiations, the Cuban State should also take into account the possible changes, which do not directly affect these problems.

## Chapter 8 GATS and water (by Arjan Douma)

Less than one half percent of all the water on Earth is available fresh water. The rest is seawater or polar ice. Fresh water is only renewable by rainfall, at a rate of 40-50,000 cubic KM per year. Global consumption of fresh water doubles every 20 years, more than twice the rate of human population growth. According to the United Nations, more than one billion people on Earth already lack access to clean drinking water. Some estimates even foresee an increase of people with water shortage to two-thirds of world's population in 25 years, while the Millennium Development Goal was to halve the proportion of people without access to safe drinking water by the year 2015 (UNDP). With privatisation of water services, a territorial monopoly is transferred from government to private companies. Since the 1990s, three giant global corporations steadily embedded themselves in the water supply of many developing countries. Two French corporations, Vivendi and Suez-Lyonnaise des Eaux, and the German-owned corporation Thames Water of England supplied almost 300 million people (ICIJ.org). This case study analyses the performance of Suez-Lyonnaise des Eaux in three towns in the Eastern Cape.

South Africa experienced the effects of water privatisation from an early stage and it has a history of huge inequalities in water supply. The case analysed the risks of concluding long-term contracts for the three towns and the company. The case measured the performance of privatisation by analysing the water infrastructure distribution and the fate of a unit of water as it flows through the network. The case study on the three towns is based on the findings and conclusions by Greg Ruiters, who did field research after the effects of water privatisation in South Africa. The case study is not meant to provide a universal picture of water privatisation because this is strongly dependent on specific circumstances. Each country has its own characteristics of water amounts, infrastructure and political stability. That is why a universal approach of water privatisation for the world is not possible (Whittington, 1993). South African faces a unique historical background and for that a unique racial separation of water services. It cannot be compared to any succeeding or failing process of privatisation in the world, but can set an example for the ongoing debates on worldwide water privatisation in DCs.

### § 8.1 Privatisation

In the 1990s, many DCs have undergone far-reaching market-oriented reforms leading to considerable reduction of the State's role in economic activity. This has resulted in widespread privatisation, deregulation, and internal and external financial liberalisation (World Bank, 2002). Limited technical and managerial capacities and inadequate commercial and cost recovery policies explain, in part, the poor performance and low productivity of many public companies, which is why

the public water sector welcomed privatisation with open arms. By putting water supply in private hands, it becomes an economically tradable service.

The strategy on liberalisation is based on the next basic principles. First, reduction of rules based on the restriction of competition. Second, fine-tuning of supply and demand within the market. And third, a clear separation between the market and the public sector. Van Bergeijk and Haffner (1996) define privatisation as follows: “Policy based on reducing size and tasks of the public sector”. According to them, public water supply companies are willing to hand over services within the hands of the private sector in order to:

- expand the service to non-served consumers
- improve the quality and efficiency of service, but most of all
- reduce costs of service or profit consciousness.

Privatisation in the services sector is becoming more and more common because governments find themselves inappropriate to supply services on an optimal price-performance proportion. Trade expansion is another indirect international reason for DCs to hand over public services to private foreign multinationals. Revenues increased by foreign trade can be used to pay-off foreign debt (Arthur D. Little International, 1999).

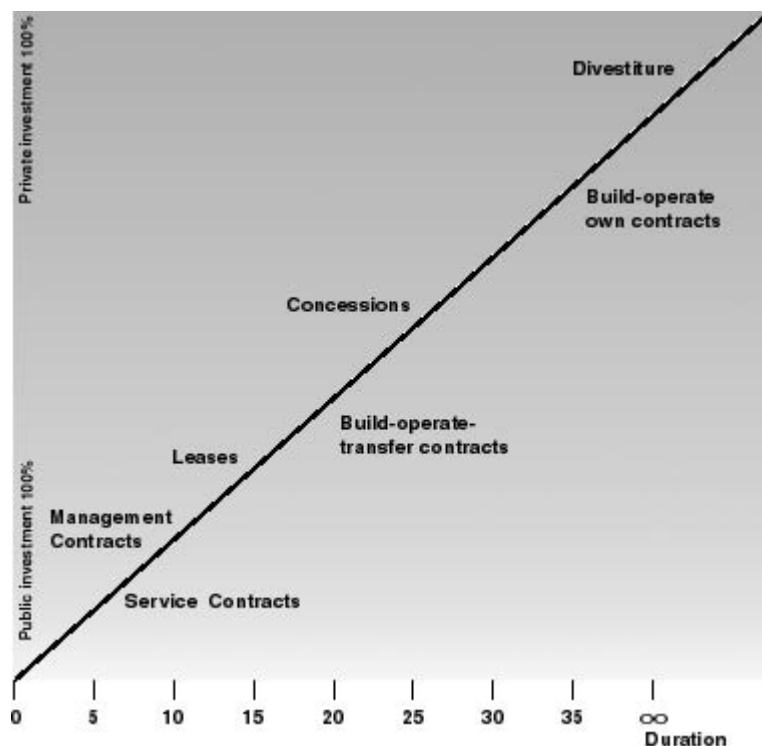
Privatisation takes many contractual service forms involving the movement from public to private hands. Naturally a service in public hands means in hands of the state, the population. With the transition into private hands, access to services is limited on one’s ability to pay. The concluding of a contract to privatise forces a shift from ideological to institutional policy, and a change in the form of capital. Water, for example, may be stripped of its image as abundant, provided by nature or as a public good and universal entitlement. It may eventually lead to a scarce economic good. Such deregulation requires a different view on the economy of water and different notions of justice. Regarding urban services, it reconstructs local democracy and power at the municipal level. The deregulation of municipal water management provides insight in new ways of constituting political and social subjects: from entitled citizens to customers (Tanyi, 1997).

Many of the privatised companies were natural monopolies under state ownership. Privatising them did not necessarily lead to greater social welfare since it simply involved replacing the public monopoly with a private one (Stiglitz, 2002). On the one hand, the water sector in public hands may be preferable to private control from a social welfare perspective. On the other hand, privatisation can be preferable as the private one can operate more efficiently. On the other hand, as Stiglitz points out: “external liberalisation cannot lead to more competition if liberalised imports and exports are limited by domestic monopolistic restrictions”. Khemani calls attention to another aspect of privatisation: foreign take-overs. Often developing and emerging market economies facing hard budget constraints

or rising deficits, are in desperate need of foreign investment and may have no choice but to capitulate to such demands (Khemani, 1999).

### § 8.1.1 DIFFERENT FORMS OF PRIVATISATION

Privatisation can take place in several directions, which are divided between public investments and private investments. Figure 7.1 ranges these options for private sector participation: at the lighter end are those in which the government has full responsibility for operations, maintenance, capital investment, financing, and commercial risk; at the other darker side, those in which the private sector takes on much of this responsibility. But even where the private sector takes on full responsibility for operations and financing, as in concessions, it does so within a framework created by the government. The idea behind this framework is to establish regulatory arrangements to protect consumers from monopolistic pricing and enforce health and environmental standards and subsidy regimes to ensure access to services for the disadvantaged ([www.WorldBank.org](http://www.WorldBank.org)).



Increasing level of delegation, risk, and irreversibility

Figure 8.1 The range of options

Source: World Bank, 2003.

These privatising options can be distinguished by allocating them by responsibility (see table 8.1). However, private sector arrangements are often mixtures of two or more options. For example, lease contracts often pass some responsibility for small-scale investments onto the private sector. Options

might also be used in combination. A build-operate-transfer (BOT) contract for bulk water supply might be combined with a management or lease contract for operating the distribution system.

Table 8.1 Allocation of key responsibilities under public-private participation options

Option	Asset ownership	Operations and maintenance	Capital investment	Commercial risk	Duration
Service contract	Public	Public and private	Public	Public	1-2 years
Management contract	Public	Private	Public	Public	3-5 years
Lease contract	Public	Private	Public	Shared	8-15 years
Concession contract	Public	Private	Private	Private	25-30 years
BOT/BOO	Private and public	Private	Private	Private	20-30 years
Divestiture	Private or private and public	Private	Private	Private	Indefinite (may be limited by license)

Source: World Bank.org, 2003.

Typical forms of Public Private Partnerships are:

**Service contract:** This most basic contract means that the government maintains ownership and control of all facilities, capital assets and properties. It rewards the contractor the right and obligation to perform specific services within well-defined specifications for a short period. Responsibility to capital investment and commercial risk stays within the authority of the government (Arthur D. Little International, 1999).

**Management contract:** This option transfers more responsibility and control to the private party. The private party is generally not expected to invest in facility improvements, but may be responsible for specified levels of routine or preventative maintenance (Owen, 1998).

**Lease contract:** The private party becomes the asset manager and operator of an existing publicly owned facility and pays a specified lease payment to the government. The operator collects the authorised tariff from the users (as well as any applicable subsidies) and may earn a profit from operating the facility. The private party is generally not expected to invest in facility improvements, but may be responsible for specified levels of routine and periodic maintenance (Arthur D. Little International, 1999).

**Concession:** The private party takes over all aspects of facility management and operation from the government, often on a long-term basis. The private party's responsibilities include maintenance and specified rehabilitation and capital investment in facility upgrades and enhancements. The private party is generally fully responsible for raising the required capital. The concession agreement specifies an agreed schedule of concession fees that must be paid by the private party to the government for the rights attending the concession. It may also require the private party to pay a portion of the profits to the government. The duration of the concession should be sufficient to provide the private party with an opportunity to recover the funds invested (Arthur D. Little International, 1999).

Particular examples include build-operate-transfer (BOT), build-operate-own (BOO) and mixtures. In a BOT, the private party undertakes the financing and construction of a given infrastructure facility, as well as its operation and maintenance for a specified period. Given the often-substantial capital investment by the private sector under such arrangements, contracts tend to be of long duration, *i.e.* >25 years (Owen, 1998). A BOO is similar, but the arrangement is infinite.

As will appear South Africa has been in favour of the concession contract.

#### § 8.1.2 STRATEGY ON WATER PRIVATISATION

One of the objectives for a corporate strategy on water is to empower people and communities to decide how to use water. Therefore the involvement and co-operation of all stakeholders in integrated management is essential. Water-privatisation can only be successful when large-scale market reforms are implemented. These reforms can be achieved from national and international investors. The country is more or less obliged to stress democratic conditions for privatisation by creating:

- **Publicity (transparency):** any investor, any employee of an enterprise being privatised, must have access to complete information about the enterprise, the mechanism of its privatisation-contract, and the investors who attempt to take part in its privatisation;
- **Competitive basis:** in a privatisation all stakeholders, local and foreign, must be able to participate on equal terms;
- **System solutions:** privatisation must take place in a package with other reforms: de-monopolisation and the development of competition and the reestablishment of a healthy financial system.

Without a systemic approach and the fulfilment of the conditions listed above, privatisation could become a strong destabilising factor of the social and political life in the country (Ruet, 2002). To achieve a water secure world, the World Water Council advised a holistic, systemic approach relying on integrated water resource management instead of the current fragmentation in managing water. But as the case study will show, there consists little coherence between goals set out by contracts and its performance. Profitability, growth and return on investment are all important and common



measures from a business point of view, but from a social point of view a more systemic view is essential.

## § 8.2 Water Policy in South Africa

South Africa is not a well-watered country. Water from costly schemes had, under the Apartheid regime, generally been supplied only to economically viable enterprises in mining, industry and agriculture and to urban communities that support them. In these circumstances of a total population of 42 million, not more than 14 million received reticulated, tapped water in 1994 (UN, 2002). Vast, mostly black, rural areas relied on streams, springs and ground water.

The water industry of South Africa incorporates a 3-tiered structure, comprising the Central Government (Department of Water Affairs & Forestry, DWAF), Water Boards and Municipalities.<sup>118</sup> DWAF, the central controlling body, monitors the use of South Africa's water resources and coordinates the cooperation between the various Water Boards who develop regional water supply services. All Water Boards are autonomous and finance their capital expenditure projects from water sales. Boards are responsible for the purification of raw water distribution, which is sold to the municipality. DWAF monitors water boards through performance contracts. Municipalities are responsible for the distribution and payments of water to local households, agriculture and industry.

The African National Congress (ANC) introduced after 1992 a new political movement, the so-called “neo-liberal” policy. This policy focused on the vast black majority of South Africans, who have been discriminated for potable water under Apartheid. Therefore, Rand Water - South Africa's largest Water Board- advocated to engage with municipalities and other users on the optimal institutional arrangements best suited to the pressing needs of the population (Randwater annual report, 2000). To this end, DWAF was also engaged in developing strong financial and technical institutions for a friendly investors climate to enable water boards to serve their present and their future customers effectively. Foreign investment in the South African water industry was promoted because:

- The increased government debt meant an increasing burden for the economy: the costs of the public debt were very high and consumed nearly 20% of the national budget. The public debt was 55% of GDP, and areas, like the health and education services, which demanded and increase in government spending, were more problematic to finance via foreign investments.
- Provision and reticulation of water were in great need of substantial investments. This included both the upgrading of older systems and the development of new systems. Such infrastructural projects were expensive.

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<sup>118</sup> In this case the municipality is often named as council, because it is the Executive of the city.

- The level of domestic savings was very low, so that substantial domestic borrowing could potentially crowd out investment.
- Foreign investment had the potential to improve local technical expertise and generate innovative ways of providing water at affordable tariffs (Rogerson, 1996).

### § 8.2.1 LIBERALISATION

The late-apartheid regime and the new ANC government aimed to ‘restructure the economy’ and introduced municipal privatisation. Fort Beaufort, Queenstown and Stutterheim, small towns in the poor Eastern Cape province, were the first targets (1992–96), followed by medium-sized towns like Nelspruit (1996–99) and the country’s largest metropolis, Johannesburg (1999).

In 1996, the government adopted a macro-economic program titled ‘Growth, Employment and Redistribution (GEAR)’, in which the private sector was recognized as ‘the engine of economic growth’ with an open, export-orientated and de-regulated economy, flexible to ‘allow South African industry to become internationally competitive’.

Municipal Service Partnerships (MSP) in South Africa preferred long-term contracts, because they involve less investment (such as extension of services to townships) and less risks for the contracted partners. These contracts were based on delegation of defined municipal functions for a 10-, 25-, or 30-year period. They included operation, rehabilitation, maintenance, customer services, and expansion of assets, which were still owned by the municipalities (DCD, 1997). The new constitution of South Africa pointed municipalities at their responsibilities for ensuring all residents to have access to basic services such as water. It guaranteed all South Africans the right of access to sufficient water, obliging the government to monitor municipalities for meeting these social goals.<sup>119</sup> ANC-policy for levels of and access to services was based on full-cost-recovery (municipality meeting contract payments) and ‘willingness to pay’, so that municipalities had to balance services in line with their revenues. Many South Africans who lacked the ability to pay were only provided with the lowest possible level of service. Because the economic base in many municipalities was limited, the non-payment for services became a major problem.<sup>120</sup> In order to provide basic services to the poor the government had to fill the gap by transfers that were supposed to cover operating costs (DCD, 1997). The money municipals received from inter-governmental grants and other sources was, however, not sufficient to provide enough capital to meet local needs. The government was not willing to transfer more money to the local government, while municipalities lacked the capability to cover the maintenance or operating costs. The solution was to provide service-levels according to community

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<sup>119</sup> Basic water supply is defined as 25 litres per person per day and access to a water source within 200 meters (DWAF, 1995).

<sup>120</sup> In 1996, only 25% of the services supplied to residents were paid (DoF, 2000).

affordability. This solution fitted the state policy of cost reducing and full cost-recovery. The private sector played a major role in financing the up-front investment and in operating and managing the services in a more efficient and effective way.

### *Water industry*

In 1997, water revenues of core municipalities in South Africa were estimated at R5.3 billion, *i.e.* 14,2% of total municipal revenues. In a large city like Johannesburg water sales accounted for over R1.6 billion per annum (DCD, 1998).<sup>121</sup> Privatised water was supplied on an effective demand, cost-recovery basis, and for that accurate metering of the ‘customer’ was vital. As a result water and monitoring companies collected huge profits on debt collections, water cut-offs and reconnections. In the new water industry, for example, a key aspect was in principle universal metering but pre-paid (self-disconnections) metering for the poor.<sup>122</sup> These self-disconnections were intended to leave the control of the water-meter and bill to the consumer, thus reducing the number of non-paying customers. Additionally, self-disconnections were cheaper and less politicised than metering and cutting-off by the council. The new policy changed the geographical and legal environment drastically and speeded up large-scale privatisation. World corporations had already made their needs clearly known in submissions to the State, and their interests were prioritised (WRC, 1995).

## **§ 8.3 Economics and contract mechanisms**

In 1992, Water and Sanitation services SA (WSSA), a subsidiary of Suez-Lyonnaise des Eaux, world’s largest private water company, signed its first concession contract with Queenstown, followed by Stutterheim in 1993 and Fort Beaufort in 1995. Suez-Lyonnaise Des Eaux signed contracts that were for most part commercial agreements. The contract promised to build a long-term relationship with the municipality to ‘provide an affordable, cost effective and optimised service, to implement effective consumer management’ and to ensure that customers are ‘willing and able to pay for services, while maximising revenue collection’ (WSSA, 1995). (PSIRU, 1999).

### **§ 8.3.1 EASTERN CAPE CONTRACTS**

WSSA concluded contracts on a long-period basis so that the impact of the investment could be spread over many kiloliters of water to be consumed by citizens of today and tomorrow. The contract contains: the full scope of services, including specification of all physical plant, services that are required and asset water infrastructure; the operation and maintenance of present and future water facilities in exclusive responsibilities (material and financial) to WSSA for the duration of the

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<sup>121</sup> These figures provide a clue to the kind of revenue that the private sector could earn.

<sup>122</sup> In Stutterheim, ‘self-disconnecting’ devices started in 2001 (DBSA, 2001).

contract; and the outsourcing as many activities as possible to the municipality. Local sources and sub-contractors will be used to restrict own capital investments (WSSA, 1995).

#### *Agreements on repairs and replacements*

From the start in 1992, 1 km of water network per year would be replaced in Queenstown. During the contract period, the water network was extended to neighbouring townships, the connections to drinking water increased from 4,500 to 14,000 households, and the company became responsible for the replacement of 2½ km a year and replacement of an additional 2 km per year of the network for a four-year period (total network length assumed at 270 km). Fort Beaufort's contract, launched in 1994, included an 8 km pipe replacement requirement over 10 years, or 11% of its existing water pipes. Stutterheim would need to replace 150 m per year, or 1,5 km of new pipe over 10 years (WSSA, 2000). Table 8.2 presents more details per town and with regard to the proportion of total network replaced (in brackets). The percentages of pipe replacements range from 3,4% to 22%.

Table 8.2 Agreements on repairs and replacements

Town	Queenstown, 1992 Mlungisi, 1995	Stutterheim, 1993	Fort Beaufort, 1994
Contract length	25 years	10 years	10 years
Water-pipe replaced	1992: 25km/130km (19%) 1995: 62.5km/270km (23%)	1.5km/44km (3,4%)	8km /71km (11%)
Water meters	1,000 ('92) and an additional 2,000 meters	Replace all meters within 7, old in 5 years	1000

*Source:* WSSA, 1995.

#### *Risks to partnership*

Table 8.3 shows that, despite the intentions of the contracts that all joining parties will share risks equally, in fact the concession contract shifts most risk onto the municipality. Although the firm formally bears operational risks, these may be redefined in various ways. The contracts tend to follow a similar pattern: for every formal risk accepted by the company there is a set of qualifying escape clauses.

Table 8.3 Grid of risks in Suez concession contracts

Risk Categories	Risk for municipality	Risk for firm
Risks of changing consumer demand	Because main part of firm's revenue is fix.	Risk is limited to loss of variable revenue.
Performance risk	No targets were set for leak reduction. The operator is responsible for overall performance of plant such that standards for quality and quantity of water are achieved.	When water quality is inferior, the authority payment on volume charges will be reduced.
Consumer non-payment	Municipality sets tariffs and bears full risk of non-payment.	Persistent non-payment undermines the contract.
Other value risk	No quantifiable expectations at the end of the contract.	Asymmetric information, because firms have the access to information.
Operating risk	Firms may raise operating fixed costs for any unforeseen event, like network expansion to low-income residents.	Low risk.
Risk of water losses	All losses at consumer's residences, including huge water losses in townships, which have no water-meters.	Infrastructure losses and losses in the production (treatment) process.
Risk shifting	Reasonable risk, because of fixed payments during contract.	No risks to firm's fixed income. Loss on volume charges.

Source: WSSA 1995, DCD, 1998, Water Research Commission, 1996.

The final risk to the firm is contract cancellation by the municipality. This is only possible after the first half of the contract-period and by notification of cancellation within two years. The municipality must pay out the operator for the remaining years, repay the operator all investments and outstanding amounts, and reemploy the entire workforce at the same operator conditions. When the firm does not comply with the contract, the municipality has the right to cancel the contract without further charges. The unequal risk sharing between municipality and firm can partly be explained by the large size of Suez compared to the small size of the individual municipalities. This also explains why Suez coordinated most administration, strategies, computerised analysis and complex problems at the regional scale, so that each town became a subpart of the WSSA Eastern Cape operations. Municipal councils face the lack of economies of scale in monitoring capacity, so they have to take the company's word when, *e.g.* meters fail, power cuts occur, or when spare parts are long in arriving. Although there are three contracts, WSSA behaves as if it is one entity when it divides labour and

resources. In the end WSSA may be able to take greater risks, and even short falling in one town, but still meeting the contracts targets by its performance in another town.

### *Regulation of contracts*

According to the World Bank the regulatory framework has to be sufficiently flexible and open-ended to attract, rather than discourage private investors. In the Eastern Cape cases, regulation by contract was frequently applied, but South African local councillors showed limited determination, in part because, as a regulator, they faced asymmetrical information. Monitoring privatisation is essential to moderate deregulation. DWAF states, that: "Public-private partnerships should be managed with a degree of caution appropriate to all privatisation processes. The Water Service authority will perform inspections of the system and monitor any impact which the supply of water services may have on the environment." However, a new form of bureaucracy combined with penalties for failing service agreements shifted deregulation to another way of regulation. The World Bank admits that contracts can be risky and that much depends on adequate definitions and contract monitoring: "Concession management contracts should produce efficiently to gain revenues large enough to balance the regulatory costs of establishing targets and monitoring of its performance. Specifying clear and indisputable targets is often difficult, especially when information about a system's current performance is limited. ... unaccounted-for-water can be a good indicator of a system's efficiency, but might hard to measure; especially if metering is inadequate. Decisions about involving private companies in the water sector can be politically costly, governments may be unwilling to shift to a management contract, especially if they have not raised tariffs to cost recovery levels."

Whereas public services may reduce the effects of uneven development and social differences, privatisation in practice does the opposite. The long-term contracts did not work out as intended. Firstly, they trapped municipalities in a web of path-dependent processes, which created inflexibility and diminished the options of using incentives that poverty-stricken and declining towns might exercise. Secondly, contracts only work out well if there is good monitoring, the municipalities, however, were not able to carry the costs for monitoring; the municipalities, however, were not able to carry the costs of monitoring. Thirdly, privatisation contributed via its imports to the local state's declining political authority, thus further contributing to the process of worsening performance.

## § 8.4 Privatisation in Fort Beaufort, Queenstown and Stutterheim

### § 8.4.1 EXPERIENCE OF FORT BEAUFORT

In 1997 Fort Beaufort consisted of: Central Town (largely white), Bhofolo (African), Hillside (African) and Newtown (Coloured). Water flowed in different racially defined ways from the treatment works into this town. For example, if the Bhofolo reservoirs were under-filled or its pumps broke down, the old white area would not be affected. Table 8.4 shows differences in infrastructures between the districts.

Table 8.4 Fort Beauforts water infrastructure by racial area

	Greater Fort Beaufort	Bhofolo (black)	Fort Beaufort (white)
Population	39 000 <sup>123</sup>	24,000	1,900
Water network	91 km	28 km	42 km
Buckets	4,420	4,000	None
Meters	1,100	Bulk-meter, fixed rates	1,100, billed

Source: WSSA, 1995, Fort Beaufort TLC, 1997.

The contract between the municipality and WSSA fell apart because: the municipality had difficulties meeting its monthly payments for the water account, collection ratios fell as tariffs in black areas increased, and the general economic decline in the town (including white departure) led to lower usage levels of the town's water infrastructure, so that contractual charges increased. In Fort Beaufort, the actual water consumption was 28% above the four-year projection, so that the council had to pay WSSA close to 28% more than had been calculated for in the initial projections, eliminating expected profits. This larger than expected volume of water sold, indicated massive network failures. These failures may, on the one hand, be caused by either to network losses, water theft, or illegal connections. On the other hand, it may be caused by the simple fact that numerous (poor) people have had informal access to water. Although total Fort Beaufort water consumption increased by 28% from 1996, the relative share of black townships (population to water consumption) declined over four years.

Table 8.5 shows that water-loss reductions have not been achieved within the five years during which the WSSA have had control over the water. In the treatment works, where WSSA had exclusivity,

<sup>123</sup> This includes illegal settlements (Source: Fort Beaufort TLC, 1997).

losses remained at the same level. The losses in town even increased to 30-40%, highlighting the need for major pipe replacements. In spite of these numbers, only 2 km pipe-line and two main roads were replaced in the 1999/2000 period.

Table 8.5 Fort Beaufort Water Losses as a Percentage of flows

	Jun 96	Jul 96	Nov 96	Aug 96	Jan 97	Mar 97	Apr 98	Mar 98	Jun 98	Jul 98	Aug 98	Sep 00
Loss WTW <sup>124</sup>	8	10	8	10	8	10	6	8	8	6	7	14
Town Loss	10	23	25	20	36	35	29	25	41	24	28	34

Source: WSSA, 2000.

### Box 3 Water losses

Every day WSSA pumped up about 3,800 kl of raw water from the river. 300 kl (8%) was lost before reaching the treatment works. Another 350 kl (9%) was lost during the treatment process. Thus remained a final water production of 3,150 kl. The final metered water-volume – by individual and bulk meters – was 2,600 kl per day, creating another loss of 550 kl caused either by leaks or illegal tapping acts. This total loss of 1,200 kl per day had to be paid by the council, as water charges were volume related. WSSA had no intention to reduce losses of raw water, as any investments to the water infrastructure – except for unmetered townships – would diminish WSSA-profits. Over the entire cycle (from river to meter), close to 32% of the initial raw water was lost. In addition, internal house pipes and yard-taps experienced losses due to leaks. According to estimates of WSSA, in some areas as much as 40% of water sold was lost. In the end only 1,950 kl (equalling only half of the original raw water pumped from the river) was actually used, and the consumer only received 60% of the water actually paid for. The most direct way to reduce the water loss would be repairing leaking taps – a very simple procedure. WSSA, however, has always refused to act on this, since such a measure would go beyond the scope of the contract and would reduce water sales drastically.

Source: WSSA/Fort Beaufort Monthly Report.

<sup>124</sup> WTW = Water Treatment Works



From 1996 to 2001 the contract costs for Fort Beaufort rose by 500%, from R 95,000 to approximately R 475,000. This increase did not conflict with the terms of the contract. No municipality had ever thought of any insurance against these contracts. By 1999, the major fallacies in the Fort Beaufort privatisation-contract became clear. The loss of financial flexibility was keenly felt and the ten-year contract with WSSA became a millstone around the neck. For Fort Beaufort it was obvious that the expected advantages of privatisation had not been realised. Due to the unreasonably high level of consumer payment in order to realise financial gains, and to the unforeseen gaps in the contract, the privatisation failed utterly.

#### § 8.4.2 EXPERIENCE OF QUEENSTOWN

In examining the rationale of contracts, it is evident that predictions for the contracted period are crucial. For Queenstown, WSSA assumed that the population growth would translate into a 5% consumption growth. However, due to the population boom from 17,000 to 117,000 (!) people – caused by Queenstown’s expansion to the black communities Mlungisi and Ezibelini – the water consumption plunged, while population and poverty increased (WSSA, 1995; Queenstown, 1999).

The 17,000 white residents of old Queenstown were supplied by 120 km of water pipe and 145 km was available for the 100,000 blacks, an inheritance from the old racially-defined regime.<sup>125</sup> The ‘white’ network by far exceeded the investment in the ‘black’ network, because it was much more extensive and the infrastructure was older, casing more bursts and leaks. Therefore, in economic terms, whites should be paying five times more per unit of water investments than blacks.

In the period 1995-1999 the white population halved from 17,000 to approximately 8,500, while the total population increased from 117,000 to 148,500, a 25% increase. In 1999, more than 90% of Queenstown was black and township-based, but it consumed only 50% of total water. The water consumption per person decreased drastically. This is not surprising since access to water became charged and the community, living in poverty, could not pay for this service. These figures do, however, show that Queenstown’s policy on full-cost-recovery and ability-to-pay had worked.

WSSA’s leak-reduction record after seven years in Queenstown appeared minimal. For each month between August 1999 and January 2000 (a six-month period) water losses in treatment plants and networks skyrocketed to an average of 107 million liters per month, *i.e.* 560 liters per person per month, not much more than the average monthly usage of black people in townships (WSSA, 2000).

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<sup>125</sup> In short, 1.45 meters per person served the black population and 7 meters per person the white population.

Repairs and maintenance varies geographically because of racial differences in investments. First, priority was given to maintenance and pipe replacement in economically more important (mostly white) areas. Second, because the black townships' infrastructure was not very sizeable and built more recently, most contractual repairs were made in white, thinly populated areas with older pipes. The rationale behind this policy was that infrastructure should follow money so that money in turn would follow better infrastructure. However, given the limited and poor status of township infrastructure no new medium or large business would be set up there. Third, the privatisation result was providing 'sustainable' or lower levels of infrastructure to ensure cost-recovery. The consequence was that as long as blacks stayed in apartheid locations, they would invariably be worse off even if it would be possible to equalise conditions (build new roads, houses, *etc.*) and upgrade townships.

#### *Fort Beaufort vs. Queenstown*

In 1993, the ratio of fixed charges relative to combined variable charges in Queenstown was 3 to 2, meaning that Queenstown's payments based on volume were relatively high showing a greater utilisation of infrastructure. In contrast, Fort Beaufort's ratio was 3 to 1. So, Fort Beaufort was paying too much on the fixed side. From this point of view Queenstown's initial 25-year contract (excluding black areas) seemed a better racist bargain.<sup>126</sup> In the worst case of the water supply running out (*i.e.* extreme droughts) and volumes dropping to zero, the council would still have to pay fixed charges.

Several general points, need to be stressed here. The more the fixed-variable ratio swings in favour of fixed charges, the less sense the contract would make for the council. In the end the council depends directly on higher volumes – based on a better-maintained network with less raw water losses (since the council pays for raw water) – to boost billing revenue. Higher volumes only make sense, though, if people pay. The Fort Beaufort trap was to have higher volumes but declining payments. The company also loses with low volume usage, but at least has a guaranteed income from fixed charges. It is in the interest of the company to promote higher volumes. The problem of under-used water networks rose with large-scale cut-offs and interruptions.

The Queenstown situation did not lead to a disturbed relationship between the company and the council, but it was not without problems either. In the first year the company squeezed its capital investment because the municipality was unable to pay its water-account. In addition, connections,

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<sup>126</sup> Fort Beaufort either had a very bad network, that required a lot of maintenance relative to Queenstown, or it was not able to gain on economies of scale and thus faced higher maintenance costs and lower volumes were spread over the network. Fort Beaufort also included meter reading in its contract. But Fort Beaufort's shorter-term contracts also attracted higher fixed fees. Instead of 25 years to get back money, the company had to get bigger returns within ten-year contracts on long-life investments like pipes and meters.

reconnections and repairs that were essential but not covered by the contract led to additional costs. Monitoring the agents became a huge concern. For example, Queenstown municipality questioned the agent's habit of claiming new-for-old pipe replacements when in fact he only fixed leaks and bursts. A good picture of maintenance activities and capital was frustrated by his approach (WSSA/Queenstown, 1993).

#### § 8.4.3 EXPERIENCE OF STUTTERHEIM

For Stutterheim the gap between costs and income declined from 1995 till 1998. This was bad news to WSSA, since they predicted increasing revenues and lower costs from privatisation. Nevertheless, it seemed to operate better than Queenstown or Fort Beaufort. Expenditures increased due to rising costs of delegated management of investments in maintenance and repairs of leaking network. On the other hand revenues declined because the proportion of water sold to the township rose a little at the cost of the water consumed by town. After all, demand management proved hostile to privatisation as the Stutterheim and Queenstown cases showed. Although Stutterheim's water-consumption over 1995-2000 increased by 20%, it was clearly not high enough to meet the level required for reaching profitability (Stutterheim TLC, 2000).

Although the volume of water flowing to the township increased by 35% over five years, this was absorbed by large population growth. So, as in Fort Beaufort and Queenstown, privatisation in Stutterheim did not lead to an increasing access to water.

#### § 8.4.4 THE CONSEQUENCES TO FORT BEAUFORT, QUEENSTOWN AND STUTTERHEIM

##### *Tariffs as strategy*

In all three municipalities tariffs on water increased after privatisation. In Fort Beaufort the rate structure changed to uniform rates for the whole town, involving for the townships a 600% rise of the fixed rate for their bundle of services per month to R60 in 1996.<sup>127</sup> In 1997, block tariffs were imposed so that households who were away or used less than 10 kl per month, would be charged a fixed rate of R27. However, black users without meters could easily be overcharged, when they used less than 10kl, and excessive use of water above 10 kl was stimulated as the block tariffs rose marginally with consumption. The fixed tariff for Queenstown was raised by 250%, from R15 per month in 1995 to a fixed rate of R38 per month after privatisation. The country's average for 30 kl was R82 (DoF, 2000). Corresponding to Bhofolo, Stutterheim's township paid a fixed rate of R22 for

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<sup>127</sup> Until privatisation (October 1995), Bhofolo residents did not possess indoor water.

unmetered basic water supply (10 kl at a yard tap or R2.20 per kl) in 1997. Those with metered supply (white areas) were charged a fixed amount of R16 (R6.00 less than the township poor) for the first 10kl and a rising block tariff of R1.80 per kl above 11 kl per month.

In a few years water bills rose more than 300% in Fort Beaufort's township, Stutterheim and Queenstown. Not been provided with the promised improvements to services, people protested against such payment. Almost 90% of the township residents lived on less than R600 (\$70) per month. Households in these townships consisted of at least six persons and at least half of them were children. With consumption already under 10 kl per month, people were not able to reduce consumption.

Due to the huge tariffs debts rose dramatically. For example, in Fort Beaufort consumers owed the municipality R13 million by February 2000. By June 2000 debts spiralled to R15 million and within a single month to R17 million (Fort Beaufort TLC, 2000). Households had to pay over 30% of their income for services. As this was beyond the capacity of most, households' debts skyrocketed. The declining number of large users – whites leaving town – caused revenue to diminish and infrastructure to worsen even more.

#### *Water cuts*

Once debt was above a certain amount, cut-off followed automatically. Already by the end of 1997, within a few years after privatisation, first water cut-offs were noticed in the three towns. Stutterheim was the first to experience water cut-offs. In the last three months of 1997, 20% of its township residents faced water cut-offs, with only 6% reconnected in the following three months. Even schools experienced water and electricity cut-offs in 2000 – even under apartheid this was hardly practised. Two other ANC run Cape Town municipalities cut water to over 16,000 households (WSSA, 2000). But these cuts have not spurred payment. WSSA warned the townships for the consequences of not paying, threatening with council bankruptcy, drop in quality of service and, in the end, a total drop out of services. To the majority of consumers who paid for their services, this policy was unfair. Consumers who were disconnected would be monitored and were fined for swindling with meters and illegal tapping from neighbours. In the three observed cities, the most bizarre development had been the almost one-year-long cut-off in 1999-2000 of the Fort Beaufort bucket-system. According to WSSA, households had a few options to prevent permanent cut-offs:

- Cables, pipes etc. replaced by a pre-paid communal water standpipe in each street.
- Very high levels of reconnection fees.
- Payment of the household debts before any services would be considered at all.
- Self-disconnection or prepaid meters.

The last option of water-cuts made billings or meter readings unnecessary. Pre-payment was seen as an alternative to municipal disconnection when customers were not able to pay for their accounts.

However, whereas municipal disconnection was a visible process, self-disconnection was invisible and masked the smooth way people obtained their water. It was obvious that specifically the black areas with high debts would be targeted for pre-paid water devices.

Some communities had been able to get councils to backtrack and charge lower fixed rates. In 2000, Fort Beaufort agreed to charge R20 per month instead of R80 for services provided. While councils were impressed by the massive resistance, WSSA was not. In the context of massive non-payments, it pronounced: “Based on our experience, we know that revenue can be gathered humanely and fairly and that the town can be put back on its feet, even though unemployment and poverty are largely present” (WSSA, 2000).

## **§ 8.5 Conclusions and recommendations**

Privatisation can lead to economic growth, job creation and financial room for the government and thus create a better overall standard of living. Early privatisation of the water sector in the Eastern Cape towns in South Africa, however, did not create the expected better conditions to the municipalities. Investors in the water sector in Fort Beaufort, Queenstown and Stutterheim were large foreign multinationals. The old patterns of unequal infrastructure in these towns remained in line with the traditional racial geography. Water privatisation did not raise black per capita consumption above the levels under apartheid. The principle of cost-recovery of the investors led to a process of disconnections and reductions of services for those unable to meet their obligations. Contracts locked municipalities into long-term rigid arrangements, raising costs in a period of steep economic decline. The asymmetry in power relations between the conglomerations and the municipalities made it hard for the latter to operate autonomously. Risk burdens in the contract were unequally spread. The long-term contracts diminished the possibilities for the poor inhabitants – mostly black people residing in townships – and the declining towns to look for alternatives. Procedures for monitoring the WSSA were missing and no possibilities for opposing legal restrictions to the WSSA were established (DBSA, 2001).

So, these small towns pilot projects may have served as a first step for Suez and others to get a foothold in bigger cities of South Africa. Perhaps, the company may not have made much money, but as a loss-leader the Eastern Cape towns may have served their purpose.

The United Nations reported that South Africa overall has been doing quite well after 1994: “In the latest seven years, South Africa has halved the number of people who lack access to safe water, far ahead of the target of 2015 for halving the proportion of people who are unable to reach or to afford safe drinking water. If the present targets are met, South Africa aims to provide everyone with clean

drinking water by 2008” (UN, 2002). This is, however, not in line with the experiences of the three towns in this case study. Within a country like South Africa, there are enormous political, social and economical differences. Water privatisation effects can therefore vary from place to place. The case studies would suggest, though, that privatisation policies are more likely to fail when towns face economic decline and poverty increase.

It is clear that, if social unrest is to be prevented, interest groups should be dealt with fairly in water-privatisation strategies. Moreover, the path to privatisation should be well prepared, and contracts should be set up in a fair and well-considered manner. Finally, monitoring activities and creating legal safeguards are essential to the success of these public-private agreements.



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