

# Domestic Preparedness for Services Trade Liberalisation

*Are South Asian Countries Prepared  
For Further Liberalisation?*

*Edited by*  
**Selim Raihan**

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# Table of Content

<b>Foreword .....</b>	<b>i</b>
<b>Preface .....</b>	<b>v</b>
<b>Acknowledgements .....</b>	<b>vii</b>
<b>Note on the Contributors .....</b>	<b>ix</b>
<b>List of Acronyms .....</b>	<b>xi</b>
<b>Overview Chapter .....</b>	<b>1</b>
<i>Selim Raihan</i>	
<i>Chapter 1 .....</i>	<i>23</i>
<b>Domestic Preparedness for Services Trade Liberalisation in Bangladesh</b>	
<i>Selim Raihan and Mansur Ahmed</i>	
<i>Chapter 2 .....</i>	<i>55</i>
<b>Domestic Preparedness of India in Trade in Services</b>	
<i>Pranav Kumar and Archana Jatkar</i>	
<i>Chapter 3 .....</i>	<i>87</i>
<b>Nepal's Preparedness for Services Sector Liberalisation</b>	
<i>Navin Dahal</i>	
<i>Chapter 4 .....</i>	<i>117</i>
<b>Domestic Preparedness for Services Trade Liberalisation:</b>	
<i>A Case Study of Pakistan</i>	
<i>Mehnaz Ajmal Paracha and Sobia N. Ahmad</i>	
<i>Chapter 5 .....</i>	<i>149</i>
<b>Domestic Preparedness of Sri Lanka with respect to Services Trade Liberalisation: A Case Study of the Telecom Sector</b>	
<i>Deshal de Mel and Janaka Wijayasiri</i>	



## *Foreword*

Services – comprising of a disparate and diverse set of activities - remain vital in enhancing overall economic growth and efficiency of every country. Economic contributions of services may be traced, *inter alia*, as providers of production inputs (i.e. intermediate services for downstream industries), conduit of trade (e.g. transport and communications), as vehicle of income transfer (e.g. workers' remittances) and direct provision of socially relevant services (viz. health and education).

Indeed, one observes strengthening prominence of these activities in the output, employment and trade structures – both at the national and global level. According to latest available estimates, share of services in global GDP increased from 61 percent to 69 percent between 1990 and 2005. Even for the low income countries, the matching shares had been 41 percent and 50 percent (World Development Indicators 2007, World Bank). In fact, for the low income countries, growth of the service sector during this period (1990-2005) had been faster than that of the corresponding GDP – an expression of the sector's revealed potential. The service sector has also surpassed agriculture as the most prevalent source of employment in the world. In 2007, it provided almost 43 percent of the world's job, compared to agriculture which provided approximately 35 percent.

On the other hand, world exports of commercial services in 2006 amounted to US\$2710bn, i.e. about 19 percent of global trade. The recent global figures on exports of commercial services, however, have been stunted by price boom of fuels and other mining products as well as foodgrains and other agricultural commodities. Whatsoever, one can readily notice from the figures presented above, the subdued role of the service sector in global trade when compared to its contribution in individual national economy. In fact, such mismatch is most pronounced in the low income economies. From a dynamic perspective, it implies that service sector will increasingly emerge as the dominant source of expansion of the world trade and, consequently, global economic growth in the coming years.

So as to benefit from the predicted transformation of global trade, the obvious policy challenge would be to strategically prepare the low income countries to be globally competitive service providers. Ability to meet this challenge will greatly influence growth, investment and employment prospect, and, by implication, poverty alleviation trend in their respective economies (On various conceivable links between services liberalization and poverty reduction, see R. Adlung, The Contribution of Services Liberalisation to Poverty Reduction: What Role for GATS, WTO Working Paper, Geneva, 2007. One may, however, not fully subscribe to the author's view that the most promising option for interested government is the unilateral opening up core infrastructural services).

This proposition remains particularly true for the South Asian economies as they are poised to secure an important position in global service market.

However, in order to effectively position as a global service provider, each of the South Asian countries will have to articulate a national strategy entailing a series of measures affecting their incentive and institutional structures. One of the major components of such a national strategy would be articulating the approach towards various channels of integration in the global market of services.

While a number of South Asian countries have already hesitantly moved towards unilaterally opening up a select set of their service sector activities, the WTO – anchored multilateral process remains, arguably, the optimal way for securing liberal trade and investment conditions which is calibrated to the varying circumstances of the developing countries.

Regulatory reforms in many countries to improve contestability of service markets coupled with attempts to consider rules for trade in services began in early 1980s (see Chapter 7 in B. Hoekman and M. Kostecki, *The Political Economy of the World Trading System*, Oxford University Press, Oxford, 2007). The first attempt to put services on the GATT agenda was made during 1982 GATT Ministerial meeting. Although developing countries vigorously resisted the move, it ended up establishing a GATT Work Programme focused on undertaking national studies on service sectors with a view to assessing the potential implications of applying GATT-type rules to trade in services.

Consequently, the final outcomes of the Uruguay Round (1995) extended the coverage of multilateral trading system through the creation of a General Agreement on Trade in Services (GATS). The complexity of trade in services (in comparison to trade in goods), compelled the negotiators to demonstrate creativity and sophistication by way of conceptualizing the modes of supply, conditions and limitations on market access, conditions and qualifications on national treatment along with commitment type (i.e. horizontal or specific).

The current phase of multilateral liberalization of the global services markets has been underwritten by the state of implementation of the Doha Development Agenda (DDA) of 2001. In the more recent past, the mandate provided in the Annex C of the Hong Kong Ministerial (2005) Declaration defined the scope and timelines of the negotiations. Although it has been often stated that services is an essential part of the DDA and the same level of ambition and political will, as reflected in agriculture and non-agriculture modalities, is required for services (See for example: *Elements Required for the Completion of the Services Negotiations. Report by the Chairman. WTO Job (08)/5, dated 13.02.2008*), services negotiations have stalled till date for reasons of sequencing (among others).

It is in this context, I greatly appreciate publication of the present volume captioned, *Domestic Preparedness for Services Trade Liberalisation: Are South Asian Countries Prepared for Further Liberalisation?* The study is a testimony of the sustained efforts of CUTS to infuse civil society perspectives in the ongoing debates on Doha Round of

the WTO. In doing so CUTS has been particularly successful in catalysing a South Asian view (notwithstanding the diversity of the regional countries) by way of mobilizing leading trade policy researchers and trade policy activists in the region. I am fortunate to know personally most of the authors of the monograph and have greatly benefited from their professional works.

The present publication has addressed one of the most critical dimensions of negotiations in services at the WTO, *viz.* the adequacy of domestic regulatory and institutional frameworks. According to the mandate under Article VI:4 of GATS and as per paragraph 5 of Annex C of the Hong Kong Declaration, WTO members are required to develop disciplines on domestic regulations for service sector.

The major focus of the negotiations is on disciplines relating to licensing requirements and procedures, qualification requirements and procedures, and technical standards affecting trade in services in sectors where specific commitments are undertaken. Transparency requirements are an important issue in this regard. Development provisions, including special and differential treatment to developing countries and full exemption to LDCs also constitute part of the envisaged discipline in domestic regulations for service sector (See for example: Disciplines on Domestic Regulations Pursuant to GATS Article VI:4 (Revised Draft), Informal note by the Chair. WTO Room Document 474.08 dated 22.01.2008).

Although the developing countries, including the LDCs, enjoy a significant amount of flexibility in the area of domestic regulations for service trade, it would be counterproductive on the part of these countries to squander away this breathing space by ignoring the need to strengthen the legal provisions, rules and standards, and institutional structures governing the service sector. These are necessary not only to ensure a transparent and competitive environment as a host economy, but are also imperative for building globally competitive services supply capacity. Judicious use of technical co-operation is a relevant issue in this connection.

May I also mention that this piece of useful policy-oriented research comes out at a time when the WTO talks, following the collapse of the “Green Room” Ministerial of July 2008 remains in a suspended animation. However, it is now almost universally accepted among the WTO membership that, while remaining engaged in locating the fine balance between concessions on agricultural and industrial goods, we need to have greater clarity and moves in other areas of negotiation, particularly in services, given that final outcome will be a “single undertaking”.

One may recall in this context, the proceedings of the “Services Signalling Conference”, which was held on 26 July 2008 at WTO to gauge progress in the request/offer negotiations. The plurilateral engagement at ministerial level did transmit some “signals” regarding expanding respective offer coverage (mostly in infrastructural services and, in some cases, professional services). Members did also often express willingness to close gap between their applied and commitment regimes. Need to clarify, reduce or remove economic needs tests was also strongly emphasised. Urgency was voiced about an early endorsement of a waiver to give effect to the LDC mechanism which would allow

opening up of sectors of LDCs' export interest (particularly in Mode 4) on a priority basis.

Interestingly, the participants of the Signalling Conference also underscored the need for creation of effective disciplines on domestic regulation for optimising the benefits of opening up of the services sector (See for example: Services Signalling Conference, Report by the Chairman of the TNC, WTO Job (08)/93, dated 30.08.2008, Geneva). Thus, I can observe a broad resonance of the most recent developments at the WTO in this new research product from CUTS on the relevance of domestic preparedness for further services trade liberalisation in South Asia.

I trust that the monograph will greatly contribute to enhance awareness and knowledge of the dedicated professionals as well as the concerned citizens interested about the subject. I would also like to strongly recommend the publication to the South Asian policy makers.

My sincere compliments to the authors, CUTS and all those associated with this good work.

**Dr. Debapriya Bhattacharya**

Ambassador and Permanent Representative of Bangladesh to the WTO,  
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## *Preface*

International trade in services is not a new phenomenon. It has existed from ancient times in the form of travel and tourism, movement of workers across borders etc. However, due to technological advancement the nature of this trade has changed hugely and today trade in services takes place predominantly through organisational and institutional channels. Indeed the range of services traded between countries in today's world is remarkable. The service sector today dominates economic activity at virtually every stage of development of a country, making service trade liberalisation a necessity for its integration with the global economy. This is so because it enables countries to better enjoy the benefits of globalisation and improves economic efficiency just as freer trade in goods does. Moreover, it contributes to job creation, higher incomes, more consumer choice, downward pressure on inflation – in short, a better quality of life.

South Asian countries are immensely affected by this phenomenon of liberalisation of trade in services. This sector constitutes a significant share of gross domestic product in all South Asian countries, and that share is increasing over time. The growing trade and investment flows in services driven by liberalisation and deregulation of economies and technological advances present these countries with opportunities to diversify their economies, their export baskets and markets, to tap emerging segments that leverage their inherent and acquired sources of comparative advantage, and to address domestic concerns of quality of services and their accessibility.

The last few decades have witnessed considerable growth in this regard, with services overtaking agriculture and manufacturing as the largest contributors to a country's national income. For instance, with the exception of Nepal, the share of the services in the national income of Bangladesh, India, Pakistan and Sri Lanka is more than 50 percent. Further liberalisation in this sector could enhance the overall efficiency of these economies, provided it is carried out by considering specific domestic conditions in mind.

These countries have liberalised this sector both as a result of their commitments under the General Agreement on Trade in Services agreed to at the Uruguay Round of the General Agreement on Tariffs and Trade (the predecessor of the World Trade Organisation) as well as through unilateral measures on their own.

As part of the Doha Round of negotiations by the WTO Members, these countries are making both requests and offers for further liberalisation of services. Most of these countries have liberalised many of their services sectors but are yet to make any firm commitment at the WTO to bind such liberalisation measures.

A major reason for not binding such commitments is that the domestic regulatory framework of services is still at a very nascent stage in most of these countries. Hence, an analysis of domestic preparedness for further liberalisation becomes an imperative to assist these countries to take informed positions at the WTO negotiations.

This publication is an attempt to address these issues. It provides an overview of the services sector of a country, underlines the reasons for its growth and identifies its contribution to the various South Asian economies in terms of output, employment, trade and investment flows. It also contains experiences of these countries regarding their multilateral commitments and requests and offers at the Doha Round of negotiations, and most importantly, discussions of issues and concerns of domestic preparedness for further opening up of the services sector.

It is a well-researched effort by a group of civil society organisations in South Asia to come out with a timely and vital publication. In the process of weaving together this publication, we have provided a high degree of autonomy to respective authors coupled with a process of external evaluation.

CUTS International has been implementing this project, "WTO Doha Round & South Asia: Linking Civil Society with Trade Negotiations", with support from Oxfam Novib of the Netherlands. It was launched on the premise that the outcomes of the Doha Round will have significant implications for international trade and national development, especially for developing countries. Under the first phase of this project, research on five key issues of the July 2004 Framework Agreement by the WTO Members was undertaken. A book, *South Asian Position in the WTO Doha Round: In Search of a True Development Agenda*, was published and released at the Hong Kong Ministerial Conference of the WTO Members in December 2005.

The Hong Kong Ministerial Conference delivered some more pertinent issues for future research and advocacy. Based on the Hong Kong Ministerial Declaration, five cross-cutting issues were selected for further research work under the second phase of this project. Another book, *South Asian Position in the WTO Doha Round: In Search of a True Development Agenda-Volume II*, was published in 2007. I thank Oxfam Novib for its continuous support.

In introducing this publication, let me thank all those who are and have been associated with this project in various capacities. I thank Selim Raihan who has edited this publication and written the overview chapter as well as the contributors of country papers and my colleagues at the CUTS Centre for International Trade, Economics & Environment (CUTS CITEE).

**September 2008**  
**Jaipur, India**

**Bipul Chatterjee**  
**Deputy Executive Director**

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## *List of Acronyms*

ADB	Asian Development Bank/Agricultural Development Bank
AICTE	All India Council for Technical Education
ATM	Automated Teller Machine
BAFIO	Bank and Financial Institutions Ordinance
BCBS	Basel Committees on Banking Supervision
BCI	Bar Council of India
BIMST-EC	Bangladesh India Myanmar Sri Lanka Thailand Economic Cooperation
BoI	Board of Investment
BPO	Business Process Outsourcing
CBR	Central Board of Revenue
CDA	Capital Development Authority
CEO	Chief Executive Officer
CEPA	Comprehensive Economic Partnership Agreement
CGE	Computable General Equilibrium
CPP	Calling Party Pays
CROs	Company Registration Offices
DFU	Deregulation Facilitate Unit
DGT	Director General of Telecommunications
DoI	Department of Industry
DoT	Department of Telecommunications
EGOs	External Gateway Operators
ENTs	Economic Needs Tests
EPF	Employees Provident Fund
ESMs	Emergency Safeguard Measures
FCB	Foreign Commercial Banks
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FSS	Financial Services Sector
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GoP	Government of Pakistan

GMPCS	Global Mobile Personal Communications by Satellite
GTAP	Global Trade Analysis Project
HLC	High Level Committee
ICAI	Institute of Chartered Accountant of India
ICAP	Institute of Chartered Accountants of Pakistan
IFRS	International Financing Reporting Standards
IPO	Initial Public Offering
ISPs	Internet Service Providers
IT	Information Technology
ITES	IT Enabled Services
ITU	International Telecommunication Union
LDCs	Least Developed Countries
LMTs	Labour Market Tests
MFN	Most Favoured Nation
MoIT	Ministry of IT
MoU	Memorandum of Understanding
NAAC	National Assessment and Accreditation Council
NAB	National Board of Accreditation
NAMA	Non-agricultural Market Access
NBL	Nepal Bank Limited
NCB	Nationalised Commercial Banks
NDCL	Nepal Doorsanchar Company Limited
NEPRA	National Electric Power Regulatory Authority
NGOs	Non-governmental Organisations
NIDC	Nepal Industrial Development Corporation
NQP&P	National Quality Policy and Plan
NRB	Nepal Rastra Bank
NTA	Nepal Telecommunications Authority
NTT	Nippon Telegraph and Telephone
ODGT	Office of the Director General of Telecommunications
OECD	Organisation for Economic Cooperation and Development
OGRA	Oil and Gas Regulatory Authority
PBC	Pakistan Bar Council
PCATP	Pakistan Council of Architects and Town Planners
PCB	Private Commercial Banks
PEPA	Pakistan Environmental Protection Act
PSEB	Pakistan Software Export Board
QCR	Quality Control Review
RBB	Rastriya Banijya Bank

RCA	Revealed Comparative Advantage
RFPDC	Radio Frequency Policy Determination Committee
RTAs	Regional Trade Agreement
SAARC	South Asian Association for Regional Cooperation
SAFTA	South Asia Free Trade Area
SBP	State Bank of Pakistan
SC	Schedule Caste
S&DT	Special and Differential Treatment
SECP	Security and Exchange Commission of Pakistan
SLT	Sri Lanka Telecommunication Corporation
SMEs	Small and Medium Size Enterprises
ST	Schedule Tribes
TBT	Technical Barriers to Trade
TMNP	Temporary Movement of Natural Persons
TRCSL	Telecommunications Regulatory Commission of Sri Lanka
UGC	University Grants Commission
UNCTAD	United Nations Conference on Trade and Development
UTL	United Telecommunications Limited
VAT	Value Added Tax
WLL	Wireless in Local Loop
WTO	World Trade Organisation



# **Overview Chapter**

**Selim Raihan**



## **I. Introduction**

The services sector is the fastest growing segment of the global economy and accounts for two thirds of global output, 30 percent of global employment and 20 percent of global trade. Between 1990 and 2002, the growth in world services trade was 155 percent while those for manufacturing and agriculture were 97 percent and 40 percent respectively (Kumar, 2005). Services activity in low- and middle-income countries has been growing faster than the (gross domestic product (GDP) in the last two decades. In fact, overall economic growth is increasingly being determined by the services sector (Sorsa, 1997).

Even though the services sector is the major contributor to GDP in most of the countries, trade in services is a relatively new phenomenon and has a negligible share in the total world trade. The ‘intangibility’ and ‘unstorability’ factors were considered the main impediments to services trade. The services sector was not included in the multilateral trading system till the inception of the Uruguay Round of General Agreement on Tariffs and Trade. Following the conclusion of the Uruguay Round, the General Agreement on Trade in Services (GATS) was the first initiative that aimed at the progressive liberalisation of trade in services. Since January 1995, the World Trade Organisation (WTO) has been administering this agreement and finally, services trade is getting the necessary importance in the multilateral trading system.

In the last three decades, the services sector has boomed in the five South Asian countries studied here: namely, Bangladesh, India, Nepal, Pakistan and Sri Lanka. Alongside the growth, liberalisation of the services trade too has become a critical economic agenda for these economies. Some of their services sectors have been liberalised as part of their commitment under GATS. In fact, under the request-offer process of GATS, there have been requests from other developing and developed countries to open up their services sectors. Additionally, they have also taken steps for the unilateral liberalisation of the sector. It has been argued that opening up a number of sectors to international competition, would bring large economic benefit. However, there are growing concerns with regard to domestic preparedness. Critics also point out that weak domestic preparation prior to opening up of the economy is likely to be associated with unsatisfactory and undesirable outcomes of liberalisation.

This study presents an overview of the domestic preparedness for services trade liberalisation in five South Asian countries and analyses the associated concerns. It examines the importance of the services sector, the experiences in GATS negotiations, and domestic preparedness for further trade liberalisation. Two of these five South Asian countries, namely Bangladesh and Nepal, are categorised as Least Developed Countries (LDCs), whereas the rest are developing countries. Therefore, the choice of these countries facilitates generating useful insights by differentiating country experiences in terms of their levels of development, degree of openness in their services sectors, and institutional and regulatory capacity.

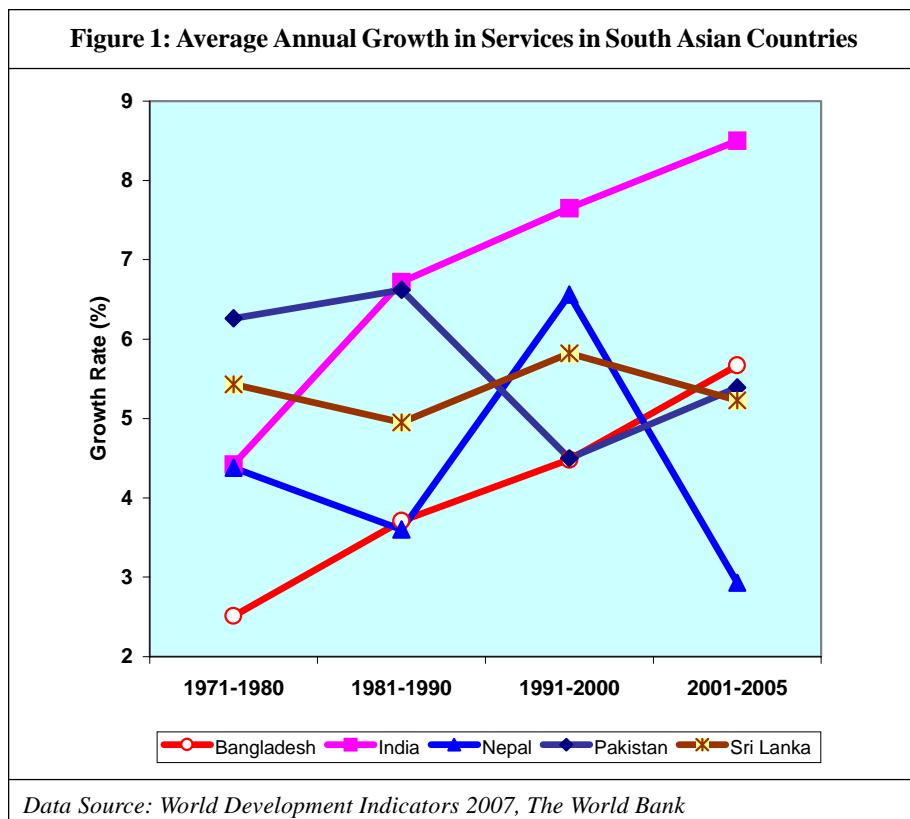
This overview chapter is divided into the following sections: Section II provides an overview of the service sector in these five countries, highlighting the growth of the sector and its contribution to the economy in terms of output, employment, trade and

investment flows. Section III deals with the experiences of these countries in terms of multilateral commitments and offers made and in this regard, the issues and concerns of domestic preparedness for further opening up of the services sector. Section IV analyses the current state of domestic preparedness in different services sub-sectors in terms of their competitiveness and the likely outcomes of liberalisation. Finally, section V concludes by summarising the major findings.

## II. Overview of the Services Sector in South Asia

### 2.1 Growth in the Services Sector

Figure 1 compares the growth rates in the services sector across five South Asian countries for different time periods. As evident, Bangladesh is experiencing a persistent rise in the growth of the services sector over the last three-and-a-half decades. In the 1970s, the average growth rate of this sector was only 2.5 percent. It jumped to 5.67 percent in 2001-05, surpassing the GDP growth rate in that period. India experienced the highest growth in the services sector among these countries. In fact, in the 1990s, it had the highest growth in services exports amongst the major economies of the world.



India's average growth rate of 4.4 percent in the 1970s almost got doubled by 2001-2005. In contrast, Nepal experienced a rather fluctuating trend in the growth of their services sector, which peaked at 6.6 percent in the 1990s and was reduced to 2.9 percent by 2001-05 (the lowest average during the entire period under consideration). Like Nepal, Pakistan also encountered fluctuations in their growth rate in 2001-05 – it was 5.4 percent; lower than the average 6.3 percent in the 1970s and 6.6 percent in the 1980s. On the other hand, Sri Lanka, experienced fluctuations but was able to maintain a growth rate of around 5.5 percent.

### **2.2 Contribution to GDP**

Over the last three decades, these South Asian countries witnessed a significant shift in the structure of their economy towards the dominance of the services sector (from the traditional sectors of agriculture and industry) in national production and employment. Table 1 suggests that with the exception of Nepal, the share of the services sector in the GDP is more than 50 percent in these countries.

<b>Countries</b>	<b>Services</b>			<b>Industry</b>			<b>Agriculture</b>		
	<b>1990</b>	<b>2000</b>	<b>2005</b>	<b>1990</b>	<b>2000</b>	<b>2005</b>	<b>1990</b>	<b>2000</b>	<b>2005</b>
Bangladesh	48	51	52.6	22	24.7	27.3	30	24.3	20.1
India	41	48.9	54.4	28	27.1	27.3	31	24	18.3
Nepal	32	—	40.8	16	—	20.9	52	—	38.2
Pakistan	49	48.9	53.3	25	24.9	25.1	26	26.2	21.6
Sri Lanka	48	52.1	57.2	26	27.3	26.1	26	20.6	16.8

*Source: World Development Indicators 2007, The World Bank*

### **2.3. Contribution to Trade**

The contribution of the services trade to the total trade of South Asian countries is increasing over time; more than doubling in actual terms, from US\$26bn to US\$51bn between 1995-2003. Considering individual country performance, as reflected in Table 2, there is an increasing contribution of the services in a country's total trade. For India, Sri Lanka and Nepal, the figures are quite impressive. Workers' remittances are gaining importance for the region, especially for the low-income countries, reflecting the significance of labour-based services exports (see Table 3). South Asia's large labour endowment, including low-skilled, semi-skilled, high skilled categories, results in a regional comparative advantage in exporting labour-based services under the Mode 4 of GATS – that is, temporary movement of workers.

<b>Table 2: Significance of Services in Total Trade (% of country's total trade)</b>							
<b>Country</b>		<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Bangladesh	Services exports	11	11	12	13	12	12
	Services imports	17	16	15	15	16	15
India	Services exports	28	28	28	28	29	-
	Services imports	26	28	28	27	25	-
Nepal	Services exports	39	36	33	35	-	30
	Services imports	11	13	14	14	-	16
Pakistan	Services exports	14	14	20	20	17	19
	Services imports	19	19	18	22	24	26
Sri Lanka	Services exports	15	22	21	22	-	20
	Services imports	20	25	22	22	-	21

*Note: Services exports do not include remittance.*  
*Source: World Development Indicators 2007, The World Bank*

<b>Table 3: Importance of Workers' Remittances (% of GDP)</b>						
<b>Country</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Bangladesh	4.2	4.5	6	6.1	6.8	7.1
India	2.6	2.3	2.7	2.9	3.0	2.9
Nepal	2.0	2.0	11.0	13.0	-	16.4
Pakistan	1.5	2.0	5.0	4.8	4.0	3.8
Sri Lanka	9.0	9.0	9.0	10.0	-	8.9

*Source: World Development Indicators 2007, The World Bank*

In the case of Bangladesh, remittance earnings appear to constitute a significant portion of the country's GDP. Going beyond the underestimated official statistics, about 3.2 million Bangladeshi people are working abroad (Blanchet et al. 2005) with major occupations being construction labour, domestic maid, engineers, health workers and nurse. Raihan and Ahmed (2008) show that very few services sectors in Bangladesh have a positive trade balance, while others have secular negative trend. Among the services sub-sectors, Bangladesh faces huge trade deficit in transportation, especially in freight, insurance services and travel, while positive balance has been found in case of government services, computer and information services, communication, and construction services.

India is also a large recipient of remittance income. The information technology (IT) boom coupled with shortage of skilled labour force in the early 1990s led to an exodus

of Indian IT professionals to the US. Gradually, there was an increased demand for Indian IT professionals in markets like Japan, Germany, Austria and Singapore. At present, there is a common trend in the professional migrants from India to developed countries, especially the US, in seeking entry to the permanent labour market. India's services trade is also much more diversified compared to any other country in the region with business services, including software exports, finance, communication, management and consultancy services growing rapidly.

Apart from Mode 4, Mode 1 (that is, cross-border supply of services) is important for India because of rapid growth in business process outsourcing (BPO) and other IT enabled services (ITES), in which the country has a great comparative advantage. Mode 2 (that is, consumption abroad) is also becoming increasingly important for India. In fact, it is an attractive place for temporary movement of people for medical treatment (health tourism) and for academic pursuit. India is considered the most competitive in providing BPO services in terms of its volume and firm level capabilities. The annual growth rate of this sector in India is 50 to 60 percent and forecasts indicate that this will continue to increase India's share of the global BPO market from 2 percent in 2003 to 4.8 percent in 2008 (Chanda, 2005).

In the last two decades, the contribution of the services sector in trade has increased significantly in the case of Nepal. In 1989-90, services (tourism, remittances and interest earnings) contributed to about 17 percent of the total foreign exchange earnings, which doubled in a decade and touched nearly 35 percent in 2003-04. In 2005, remittance income constituted more than 16 percent of the GDP in Nepal. Within services, travel and tourism constitutes the most important source of foreign exchange earnings; private remittance (the earnings of workers employed abroad) is another major source of income (Bhatt, 2005).

A large number of Pakistanis are working abroad and remittance income is an important source of foreign exchange earnings. Paracha (2008) observes that though the services sector is the fastest growing segment in Pakistan's economy, the balance of trade in services is also widening very fast.

About 1.2 million Sri Lankan workers are abroad and 70 percent of them are employed in the Middle East (CUTS, 2004). A specialty of Sri Lankan human resources export among the South Asian countries is the dominance of female migrants. In 2001, 68 percent of the 183,888 migrants were female workers (Chanda, 2005). Remittances by migrant workers continue to play a critical role in the Sri Lankan economy. Deshal and Wijayasiri (2008) report that during both 2005 and 2006, apart from 'other business services' (in which case there is a negative trade balance), in all other services sectors, Sri Lanka experienced a positive trade balance. In 2006, remittances, along with some surplus in trade in other services, have enabled Sri Lanka to mitigate large deficit in trade in goods.

#### ***2.4 Contribution to Employment***

In all the South Asian countries, though service sector employment has shown a rising trend, its contribution to total employment is much lower than its contribution to the country's GDP. In the case of Bangladesh, Raihan and Ahmed (2008) highlighted the

fact that because of liberalisation in some key services sectors, such as telecommunications and financial services, the share of services sector in total employment had increased substantially over the last few years and reached around 35 percent of the GDP by 2002-03. It, thus, appears that liberalisation has helped employment growth with the most dynamic sub-sectors exhibiting the highest rates of employment growth. However, the employment elasticity of services is lower than that of manufacturing and agriculture in Bangladesh.

In India, the services sector accounts for less than 30 percent of total employment, which is much lower than its share in the GDP. It also has much lower employment elasticity than other sectors of the economy, which indicates that service sector growth in India has primarily been driven by growth in skill-intensive services such as IT and ITES rather than employment-intensive services such as tourism (Banerjee et al. 2008).

In the case of Nepal, there is no updated data on service sector employment. However, the data for 1990-95 suggests that the share of the services sector in total employment averaged 17.12 percent during that period (WDI 2007), which was much lower than the share of services in the GDP.

In Pakistan, despite the reduction in the share of agriculture sector in job creation since 1990, agriculture remained the dominant source of employment with its share of 43.37 percent in 2005-06. The services sector, on the other hand, is contributing 36 percent employment. However, like the other South Asian countries, the employment share of the services sector is much lower than its contribution to GDP.

In Sri Lanka, the services sector accounted for 41.2 percent of employment in 2006, which was greater than the share of industry and agriculture. The fact that 41.2 percent of the total employed yielded 54.6 percent of GDP is testimony to the earning potential and economic significance of the services sector (Deshal and Wijayasiri, 2008). The major sources of employment within the services sector are tourism and personal services. Financial services and telecommunications provide less employment but generate greater earnings.

Chanda (2008), however, observes that official statistics on service sector employment in the developing countries when juxtaposed with the dynamic nature of sub-sectors such as trade and distribution services or construction services, may also suggest that part of the employment growth in services has been informal in nature. Therefore, the official estimates of the service sectors' contribution to overall employment may, to some extent, underestimate the actual contribution of this sector to total employment due to their failure to capture informal employment.

### **2.5 Services Sector and FDI**

In several South Asian countries, increased foreign direct investment (FDI) in the services sector has been associated with increased liberalisation. Raihan and Ahmed (2008) point out that in the case of Bangladesh, since 2003-04 the services sector has been able to attract large inflow of FDI and as a result, by 2005-06 the FDI inflow in the services sector accounted for 81 percent of total FDI inflows in the country. The services sub-sectors, which received the highest share of FDI in recent years, are

telecommunication, energy and financial sectors. In 2005-06, the telecommunications sector alone received 36 percent of the total FDI, followed by the banking sector (17 percent). Increased investment into such sectors is associated with deregulation of government monopoly.

The experience of India suggests a similar trend as India has experienced a large inflow of FDI in the services sector. It was higher than that in the manufacturing sector. Among the services sub-sectors, financial, IT and telecommunication services appear to be the most important recipients of FDI. During 2003-06, software services and finance, insurance, real estate, telecom, and various business services accounted for over 30 percent of India's inward FDI flows.

In 2006, major contribution of FDI to Pakistan appears to be in the telecommunication and financial services – 37 percent and 18 percent respectively. Also, the wholesale and retail sectors are growing very rapidly, especially through investment in large multinational chain stores.

In Sri Lanka, more than 50 percent of FDI went to the services and infrastructure sector in 2006. Within the services sub-sectors, telecommunication remained the most dominant.

### **III. Experiences of South Asian Countries in GATS Negotiations**

Article IV of GATS stresses that in order to increase the participation of the developing countries in global services trade, there is a need to:

- strengthen domestic service capacity of these countries and its efficiency and competitiveness, *inter alia* through access to technology on a commercial basis;
- improve these countries' access to distribution channels and information networks; and
- liberalise market access in sectors and modes of supply of export interest to them.

Such calls were re-emphasised by the WTO at the Doha Ministerial Declaration of 2001 as well as in the July 2004 Framework of the Doha Round of negotiations. In the Hong Kong Ministerial Declaration of 2005, particular attention to sectors and modes of supply of export interest to developing countries was highlighted again.

It is, however, important to note that a large number of developing countries have been facing difficulties in identifying sectors of their specific interest. Besides, registering any meaningful liberalisation commitment in the negotiations has achieved little progress. There is serious concern about the developing countries' lack of capacity to evaluate the requests received from other member countries and regarding the development of their own requests. A major challenge has been the determination of their national policy objectives and the competitiveness of each sector or sub-sector. In the case of liberalisation of Mode 4 services, in the categories and skill levels of interest to developing countries, no real progress has been achieved. Even, no progress has been achieved with respect to streamlining or increasing the efficiency of processing mechanisms for visa and work permits.

One of the most important developments at the Hong Kong Ministerial was the decision to pursue full and effective implementation of the modalities for special treatment of LDCs in trade in services. It means developing methods for effective implementation of the LDC modalities, including assisting LDCs to identify sectors and modes of supply that represent development priorities. The Hong Kong Ministerial Declaration set out a specific timeline for developing appropriate mechanisms for this, but there was no attempt to meet the July 31, 2006 deadline.

GATS also provides a general framework for negotiations on further liberalisation in services trade. The negotiations take place under the request-offer process model, whereby WTO Members submit requests to other Members to open up specific service sectors. They offer to open up their specific service sectors on a reciprocal basis. Once a country agrees, to liberalise a sector through negotiations in the WTO, it must be listed in a schedule of specific commitments. By committing to liberalise a particular service sector, a country is legally bound by GATS to provide national treatment and (most favoured nation (MFN) treatment to other WTO Members.

Negotiations under GATS are important for the South Asian countries as they are facing constraints in economic development due to poor infrastructure, institutional settings and governance deficits. Hence, the services sector is the dominant segment in these economies. Also, there is a huge growth potential of the domestic services market in these economies. These countries should adopt a strategic position in the request-offer process under GATS, as they are lucrative targets for developed countries.

Without necessary precautions and adequate readiness, these developing countries in South Asia (including two LDCs: Bangladesh and Nepal) will be lucrative targets for strong market players which might jeopardise the growth potential of the domestic services market (Raihan, 2005). Among the major supply constraints that prevent the building of a competitive services sector in the South Asian countries are the lack of: human resources and technology to ensure that professional and quality standards are met; telecommunications infrastructure; a national strategy for export of services; government support to help service firms, especially small and medium enterprises; financial capacity of firms; presence in major markets; and the ability to offer a package of services (UNCTAD, 1998).

The outcomes of ongoing GATS negotiations will have a significant implication on the national development initiative. The South Asian countries should have clearly defined negotiation strategies, based on a clear conceptual framework and understanding in order to make GATS negotiations conducive for the economic development of a country. Every strategy should have a fallback position if it becomes necessary. Most of the relevant literature emphasises on Mode 4 as these countries have comparative advantage on the movement of temporary workers. But there are other areas in services sector that also have huge growth potentials.

Bangladesh has made certain specific horizontal commitments on market access and national treatment with some limitations relating to commercial presence (Mode 3) and movement of natural persons (Mode 4) in case of communications and tourism sectors. GATS classified tourism sector into four sub-sectors and Bangladesh made commitments

in one sub-sector namely Luxury Hotels. After the inception of GATS, nine countries including the European Commission, USA, Japan and Malaysia have submitted their request to Bangladesh to liberalise a number of its services sectors.

The requests covered a wide range of sectors except education and health. Singapore requested the opening up of transport services and EC's requests include undertaking or improving commitments in business service, telecommunication, construction and related engineering services, environmental services, financial services, and transport. In terms of coverage of sectors and sub-sectors, these requests to Bangladesh covered 10 sectors out of 12, and 127 sub-sectors out of 161. They were limited to market access under Modes 1, 2, and 3, except in case of telecoms, and there were national treatment requests on all sub-sectors. Under 'Horizontal Commitment', requests were made for Mode 4 and on the removal of certain MFN exemptions in the telecom sector.

In the ongoing services trade negotiations, India is very offensive in seeking market access in developed countries, particularly under Mode 1 (cross-border trade) covering business process outsourcing and Mode 4, which deals with movement of temporary workers. Of late, India has realised its strength under other two Modes as well. India has been receiving requests from all major developed countries as well as several developing countries on a wide range of services.

Most of the requests are to enter the Indian market through commercial presence (Mode 3) with importance being given to financial and telecommunication services, though offers in the field of education and environmental services have also been made. While responding to these requests, India made an initial offer in January 2004 that was not very much different from its offer during the Uruguay Round. However, in its revised offer in August 2005, India demonstrated willingness to expand the scope of its Uruguay Round commitments by tabling several new service sectors and sub-sectors for negotiations. It further showed willingness to remove commercial presence restrictions in few important areas, on which it had already made commitments. Eleven sectors and 94 sub-sectors were covered in the revised offer contrary to seven sectors and 47 sub-sectors in the initial offer.

Nepal became the 147<sup>th</sup> member of the WTO in April, 2003. Under the WTO, Nepal has committed to liberalise 11 services sectors. In the case of financial and telecommunication services, Nepal has extended market access in Mode 2 with a restriction of providing only US\$2,000 for Nepalese citizens while going abroad. With respect to commercial presence (Mode 3), no limitation on national treatment has been placed on foreign investments and reinvestments except that both these require the approval of the Department of Industry and incentives and subsidies, if any, will be available to wholly owned Nepalese enterprises only. However, Nepal's commitment in Mode 4 is restrictive except in the categories of services sales personnel, those responsible for setting up a commercial presence, and intra-corporate transferees, that too for a limited time and not exceeding 15 percent of local employees. Nepal's commitments under the WTO will remove all limitations on the number of suppliers in the various telecommunication services by January 2009. In addition, Nepal has committed to allow foreign participation of up to 80 percent in the telecommunication sector.

Pakistan has undertaken extensive autonomous liberalisation and it stresses on balanced movement in rules and market access negotiations and progressive liberalisation accompanied by strengthening of domestic regulatory frameworks (Paracha, 2008). Pakistan has received collective requests from 19 WTO Members on services in the area of energy, environment, financial services, architectural and engineering services, integrated engineering, maritime transport, construction, telecommunication services, air transport services and logistic services. Examining the stance that Pakistan has taken in the May 2005 initial offer, it is clear that Pakistan is ready for expanding the scope of its GATS commitment. The revised offer has clearly sharpened the existing commitment by embedding safeguards within the text (Paracha, 2008).

In the case of Sri Lanka, on Modes 1 and 2 exchange controls for cross-border trade and consumption abroad were removed in 1994. FDI is allowed in almost all sectors of the economy. Sri Lanka's initial commitment in GATS was limited to tourism and travel services. This was expanded in 1997 to include financial services and telecommunications. Sri Lanka has also tabled a revised offer at the Doha Round in 2003 but no new sectors were offered other than the further liberalisation of the three sectors previously committed, particularly in Mode 3 (Deshal and Wijayasiri, 2008).

#### **IV. Domestic Preparedness for Services Trade Liberalisation in South Asian Countries: Issues and Concerns**

The role of the major services sectors such as telecommunication, banking and transport in the development of an economy involves an element of risk. There is a possibility of technical, procedural, and financial disorder in these sectors, which might have serious economic implications. A large bank collapse might have an adverse impact on the smallest producer in a remote region. Disruption of electricity, gas, telecommunication and transport can bring any economy to a standstill within a very short time. Such risks highlight the necessity of placing regulatory constraints such as capital adequacy and asset quality requirements, technical standards and the like to ensure continued availability of core technical and commercial services.

Before taking steps to liberalise the services sector, there is a need to identify the current state of potentials, weaknesses and constraints, of the domestic services sector. There is also the need to explore the linkages within various services sectors and those of services sectors under manufacturing and agricultural sectors in an economy. Prioritisation of sectors for liberalisation should be based on its link to the poor – that is, by taking into account the impact of trade liberalisation in a sector especially on poor people as producers, consumers and employees and their ability to take advantage of the opportunities from liberalisation. This will provide guidance about the critical services sector, where liberalisation may have larger potential to contribute, in terms of technology transfer, human skills development and institutional improvement.

The identification of readiness of key services sectors to face international competition after liberalisation is difficult task due to the unavailability of data. Whether a sector is prepared for international competition or not, we need to explore the competitiveness of that sector in terms of price competition, technical standard, capacity of the existing firms, etc. Given the fact that there is lack of these types of data in almost all South

<b>Table 4: Revealed Comparative Advantage of Services Sectors in South Asia</b>									
<b>Year</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Bangladesh	0.62	0.60	0.60	0.57	0.54	0.59	0.62	0.58	0.61
India	1.01	1.23	1.37	1.41	1.37	1.34	1.39		
Nepal	3.38	2.61	2.50	2.00	1.79	1.58	1.70	1.85	1.51
Pakistan	0.81	0.73	0.74	0.69	0.68	0.96	0.98	0.85	0.98
Sri Lanka	0.79	0.77	0.84	0.75	1.08	1.03	1.06	1.04	0.99

*Source: Author's calculation based on data from World Development Indicators 2007, The World Bank*

Asian countries, this study took into consideration the best available data to construct the Balassa's Index of Revealed Comparative Advantage (RCA) for the services sectors in South Asian countries.

Estimates of the RCA for overall services sector for Bangladesh, India, Nepal, Pakistan and Sri Lanka are reported in Table 4. Bangladesh has the lowest RCA index, which indicates that it is comparatively in a disadvantageous position in services trade compared to other South Asian countries. Nepal and India are in an advantageous

<b>Table 5: Revealed Comparative Advantage of Services Sub-Sectors in South Asia</b>				
	<b>Bangladesh</b>	<b>India</b>	<b>Pakistan</b>	<b>Sri Lanka</b>
Electricity	0.00	0.06	0.00	0.00
Gas Manufacture, Distribution	0.00	0.00	0.01	0.03
Water	0.00	0.08	0.02	0.19
Construction	0.04	0.07	0.04	1.07
Trade Services	0.06	1.50	0.24	0.38
Transport Services	0.19	1.17	0.23	1.14
Sea Transport	1.47	1.26	1.45	2.55
Air Transport	0.11	0.31	2.95	1.77
Communication	0.26	0.09	2.94	1.07
Financial Services	0.13	0.12	0.12	0.06
Insurance	0.09	0.80	0.24	7.11
Business Services	0.26	1.96	0.20	0.54
Recreation and Other Services	0.12	0.31	0.08	0.22
Public Administration, Defence, Health, Education	4.67	0.80	1.05	0.26

*Source: Author's calculation from GTAP database version 6.2*

position. Nepal's high RCA index can be attributed to the fact that, it has the highest share of services exports among the South Asian countries.

Using the GTAP database, it is possible to calculate the RCA for individual services sub-sectors. Table 5 reports the results of such an exercise for Bangladesh, India, Pakistan and Sri Lanka.<sup>1</sup> It indicates that for Bangladesh, the major contributor to the high RCA includes public administration, defence, health and education sub-sector and the export of defence services i.e. for peace keeping missions of the United Nations. Compared to other South Asian countries, Bangladesh is in a disadvantageous position in all services sub-sectors. In 6 out of 14 sub-sectors, India's RCA indices are higher than any other South Asian country. Whereas, Pakistan and Sri Lanka have higher RCA indices compared to other South Asian countries in 4 out of 14 sub-sectors.

#### **4.1 Experiences from Bangladesh<sup>2</sup>**

Bangladesh adopted a cautious approach in making commitments on trade in services on market access, national treatment, and MFN treatment. It was guided by a number of considerations. Like many LDCs, it found that GATS allows the developed countries greater market access in developing countries through Mode 3 while market access to unskilled or semi-skilled labour of developing countries through Mode 4 is restricted. The services sector in Bangladesh, like other LDCs and developing countries, is far less developed, and hence, under free trade in services, the country is likely to be in a disadvantageous position. Moreover, the existing legal and regulatory infrastructure should undergo minimum structural changes. A number of concerns have been raised with regard to liberalisation in different services sub-sectors.

For example, in the case of the *construction* sector, low capacity and capability of local contractors and consultants, due to weak resource base and inadequate skills and experience were considered the major concerns. Poor working environment, including low standards of safety and occupational hazards at construction sites, weak and non-facilitative policies and regulatory framework, and low productivity and quality of domestic firms due to a low technology base and limited skills and experience are the major constraints in construction services that contribute to its disadvantageous position.

Moreover, there is a lack of supporting institutional mechanisms to facilitate easier access to key inputs including access to finance and equipment. For instance, introduction of leasing arrangements for heavy construction equipment is the key to increasing the capacity of the local construction firms to undertake larger jobs. Lack of regulatory framework, intense competition among well-funded and equipped foreign operators and lack of access to finance and equipment as well as inexperienced management are issues that should be addressed to reverse this situation.

Now the question is, whether these problems could be addressed through further liberalisation or through a more restrictive regime. Citing the experience from emerging economies, analysts in this sector have been arguing that economic opening will lead to the introduction of new financing instruments that can increase the local firm's access to critical assets and will expose the labour force to skills and management experience critical for the growth and consolidation of the domestic operators. Direct

stakeholders in this sector are confident about facing foreign competition due to liberalisation.

In the *banking* sector in Bangladesh, competition has been enhanced due to the announcement of opening of markets to new entrants, and as a result, interest rates have been lowered and loan quality (i.e. the share of non-performing loans in banks' balance sheets) has improved. It appears that the activities in the banking sector, dominated by inefficient nationalised commercial banks (NCB), are being replaced by relatively more efficient and competitive private commercial banks (PCB) and foreign commercial banks (FCB). Foreign investment in this sector has brought modern technology like computerisation of banking operations, introduction of ATM services, smart card, credit/debit card, and online banking. These services have quickly been adopted by the PCBs.

According to the regulator's perspective, the deregulation and liberalisation of the banking sector has been carried out to improve financial intermediation in the economy through enhanced competition, efficiency and profitability and diversification of financial services. However, absence of prudential regulation may result in economic crisis with serious social impact as the Asian financial crisis of 1997 indicates. Hence, stakeholders consider that Bangladesh should follow cautious and slow down the process of liberalisation in the banking sector.

The regulatory agency of the *insurance* sector in Bangladesh is not equipped with adequate manpower and resources to supervise this growing industry, which limit the agency's role in the development of the sector. Insurance analysts consider that while opening this sector, apart from introducing efficiency and better regulation, the insurance companies need to be innovative in expanding their business activities in order to reach the common people.

In the *travel and transport* sector, major weaknesses in the regulatory framework include poor coordination between authorities, poor governance (corruption and poor enforcement). According to analysts, Bangladesh can liberalise this sector on Mode 4 only after setting up a proper regulatory body. Because of its unique geographical location, Bangladesh has the potential to become a 'transport hub' to serve the entire hinterland comprising Nepal, Bhutan and Northeast India.

#### **4.2 Experiences from India<sup>3</sup>**

In India, there is a strong sentiment in the *legal* services that permitting foreign law firms even in a limited manner would lead to the shrinking of the opportunities available to domestic lawyers. Kumar and Jatkar (2008) argue that it is essential to look into the immense trade potential of the Indian legal profession without compromising the interests of the legal professionals and local law firms. They further argue the need for developing an appropriate strategy for this sector. Strategy is important because while there is scope for the Indian law firms to take advantage of the expanding global business, there is also a danger that if the process is not judiciously planned and necessary structural changes not undertaken, the opening up of this sector may result in a fiasco for the domestic sector. Hence, for India the challenge lies in formulating a right strategy at the right time.

India did not schedule *education* services either in the Uruguay Round or in its revised commitments under the on going Doha Round. Although India in its revised offer included higher education, many sections such as civil societies have opposed such a move. Whatever liberalisation has occurred in this area, such as allowing 100 percent FDI on ‘automatic route’ and permitting foreign participation through twinning, collaboration, franchising and subsidiaries, has been autonomously driven. It is likely that in future GATS negotiations, India will come under increasing pressure from certain countries to multilaterally bind the liberalisation undertaken thus far. But it’s unlikely that India will agree to such demands.

In the Doha Round of negotiations, India has both offensive and defensive interest in the *accountancy* sector. In the Uruguay Round, India did not make any commitments on accounting. However, in its revised offer for accountancy services, India offered full commitments on accounting and book-keeping services under Mode 1 and Mode 2 while keeping Mode 4 subject to horizontal commitments. Supply of services under Mode 3 has been ‘unbound’. Many considered the revised offer of India as defensive as it was very little. However, this defensive position can be explained by the fact that this is a protectionist measure since its accounting firms are not globally competitive. There are also views among the stakeholders that opening up of the accountancy sector will help Indian accountants in terms of well paid jobs and enhanced employment opportunities although it can endanger some of the accounting firms.

It appears that though there are some significant potential gains from further trade liberalisation, India has adopted a cautious approach. Also, there is a need to strengthen the domestic regulatory rules in some of the service sectors and in few services sector capacity building seems to be necessary to face global competition.

#### **4.3 Experiences from Nepal<sup>4</sup>**

In Nepal, the *insurance* sector, already has three foreign companies with 100 percent equity and four joint venture companies, liberalisation under the WTO does not expose the country to a completely new scenario. However, the need for a sound regulatory system is still necessary to maintain an efficient, safe, fair and stable insurance market and promote growth and competition in the sector as insurance markets have developed at a much faster pace than the process of insurance supervision.

Over the years, the *banking* sector of Nepal has slowly transformed from a heavily state-owned sector to a vibrant one dominated by private companies. Under the Financial Sector Reform Programme, Nepal has undertaken various institutional reforms. However, Nepal Rastra Bank (the Central Bank of Nepal) needs to address gaps in its supervisory framework and enhance cross-border supervision mechanisms. In addition, before any further liberalisation of the financial sector, Nepal needs to resolve a few issues such as loan recovery from large, wilful defaulters and improve the financial condition of the two government-owned commercial banks (ADB 2007).

Nepal’s commitments under the WTO will remove all limitations on the number of suppliers in various *telecommunication* services by January 2009. In addition, Nepal has committed to allow foreign participation of up to 80 percent in the sector. These changes seek to make telecommunication services reliable and accessible throughout

the country at a reasonable cost. However, the liberalisation process has to be accompanied by the setting up of regulators to ensure that competition is fair and consumers are not exploited. In addition, as Nepal is moving from a government-owned monopolistic market into a liberalised competitive market, a major challenge is to establish an independent regulator with adequate expertise, information, authority and accountability.

#### **4.4 Experiences from Pakistan<sup>5</sup>**

The *communication* sector in Pakistan, particularly telecom, has witnessed comprehensive reforms and robust growth in recent years, contributing to a large share to the country's total GDP. As a result, it is often considered one the most successful service sectors to have gained substantial benefits from liberalisation. Regarding communications, primarily the telecom and IT (information technology) industries, Pakistan has negotiated extensively at the WTO and formulated a comprehensive schedule of commitments, further shaping Pakistan's policy framework concerning trade liberalisation in these sectors. The legislation dealing with licensing in this sector does not distinguish between domestic and foreign service providers, since Pakistan provides national treatment to all telecommunication service providers.

Another sector that has witnessed strong growth and subsequent liberalisation in recent years is the *financial* sector, particularly banking services. Pakistan's central bank, the State Bank of Pakistan, has pursued reforms aimed at liberalisation and privatisation since the beginning of the 1990s, and has achieved considerable progress. At present, there are no restrictions on the establishment or operations of foreign banks in Pakistan. In order to further strengthen and synchronise domestic legislative framework in relation to multilateral trade negotiations and commitments, the government of Pakistan has established a commission to review the country's financial sector.

There are various regulatory bodies governing the *engineering, construction and architectural* services in Pakistan. The regulations governing construction services aim to encourage joint ventures and collaboration with local service providers. Licenses are granted for projects where local firms do not have the requisite technical capacity. In effect, this works as a safeguard to local construction and engineering firms, who do not face undue competitive pressures.

The *oil and gas* sector in Pakistan is largely state-controlled although there are no restrictions on market access through commercial presence of private and/or foreign investors. The Oil and Gas Regulatory Authority (OGRA) grants licenses to companies for oil and gas distribution. The National Electric Power Regulatory Authority (NEPRA) is the principle authority dealing with the regulation of generation, transmission, and distribution of electric power in Pakistan. Both the regulatory authorities do not differentiate between the domestic and foreign service providers, and do not lay separate conditions for granting licenses. The existing regulatory framework suggests that at present there are no market access restrictions in Mode 3 (commercial presence) for private or foreign companies.

#### **4.5 Experiences from Sri Lanka<sup>6</sup>**

Despite the fact that Sri Lanka has made commitments in GATS and scheduled conditional offers at the Doha Round of negotiations, its *telecom* sector is far from perfect in terms of regulatory rigour. This is unfortunate as Sri Lanka stands to gain by locking in reforms and provide investors security for the much-needed investment in this sector. While Sri Lanka has made additional commitments to implement the Telecom Reference Paper, in practice, most of the commitments have not been met. This, in fact, could make Sri Lanka liable to international arbitration.

The level of implementation of the Reference Paper commitments is a good indication of domestic preparedness for further liberalisation. Weak implementation has resulted in many of Sri Lanka's scheduled commitments (for instance the liberalisation of the external gateway) being made redundant. The implication is that Sri Lanka should focus on tightening its domestic regulatory framework and improve the capacity of the regulatory bodies through increased financial independence. Only then would further commitments in the telecommunications sector be realistic and useful.

There is much work to be done in other sectors to improve domestic preparedness for the liberalisation of services. Many professional service associations lack regulatory and legislative capacity to effectively regulate even local service providers. This is unfortunate given the fact that Sri Lanka stands to gain if there is increased foreign participation in many service sectors. This would provide greater access to foreign expertise and technology whilst triggering competition and investment that would be beneficial to consumers in Sri Lanka. In order to enjoy these potential benefits, the regulatory environment needs to be improved.

### **V. Concluding Remarks**

It is evident from this analysis that competitiveness of the services sectors and a well-functioning regulatory system are essential for ensuring gains from services trade liberalisation in the developing countries. The South Asian countries like India, Pakistan and Sri Lanka have competitive edge in few services sub-sectors, while Bangladesh and Nepal are lagging behind compared to her South Asian counterparts in almost all categories of services trade. It can be argued that development of skill and technologies in the services sub-sectors can improve the competitiveness of these South Asian countries.

There is, however, no denying that in most instances, these countries lack established and well-functioning regulatory and institutional frameworks when it comes to services trade liberalisation. As for policy stance, a common position of these countries is the need for adequate time to frame appropriate domestic regulation policies considering the specific economic requirements and at the same time, to ensure necessary technical assistance for capacity building. There should also be considerations on ensuring adequate regulatory flexibility for these countries to promote liberalisation.

According to Article XIX of the GATS Agreement, the developing countries are allowed appropriate flexibility on an individual country basis. This implies that the South Asian countries should consider country-specific interests to take appropriate policy stance.

The GATS Agreement and the Hong Kong Ministerial Declaration has special emphasis on targeted technical assistance to enable developing countries and LDCs to participate effectively in the negotiations. The full and effective implementation of the LDC Modalities also calls for providing targeted and effective technical assistance and capacity building for LDCs. Among other directives, it has been clearly stated that targeted technical assistance should be provided through the WTO Secretariat. However, there is no such initiative from the developed country members to consider special priority sectors in relation to needs of the LDCs and developing countries.

A more careful reading reveals that the development initiatives relating to market access are either objectives for commitments or, procedural under the request-offer approach. There is a lack of developing country and LDC initiatives to prepare a good negotiating ground and it is quite reasonable that without proper technical assistance, many of the developing countries and LDCs will not be able to come out identifying areas most important to them for negotiation. In the case of evaluating or formulating requests and offers, there is a need to look into the kind of capacity available in the government (trade and other ministries, and also regulatory bodies) and needed technical assistance requirements should be formulated accordingly.

Complications relating to services negotiations call for the South Asian countries to know ways to deal with intricate matters associated with specific details of various provisions. It is also important for policymakers to be able to assess the potential implications arising out of certain provisions. Furthermore, taking effective participation in services trade requires enacting and implementing the necessary domestic regulations. All these will require technical assistance and their effective utilisation.

It is crucial to highlight that domestic regulation has its importance in protecting national policy objectives but it should not be applied as a means for undue trade restrictions. Regulation can protect consumers through ensuring quality and appropriateness of services in the midst of a wide range of providers under progressive services trade liberalisation. Regulatory measures can be applied to limit anti-competitive practices that may arise from market penetration by dominant firms.

There is a rising concern about repatriation of profits, which may result in serious balance of payments crisis for many LDCs and developing countries. Therefore, these governments can regulate this capital outflow by imposing restrictions like investment in local securities market as a measure against potential balance of payments shocks. Domestic regulation should aim at ensuring a healthy environment for capital inflows in terms of attracting FDI and also offer a friendly mechanism for ensuring better competition between domestic and foreign services providers.

Article VI.4 of GATS Agreement, relating to domestic regulation, highlights the right of the WTO Members to regulate and introduce new regulations, governing the supply of services within their territories in order to meet national policy objectives. The need of the developing countries to exercise this right has also been recognised in the preamble of GATS, given the existing asymmetries in the development of services regulations in different countries. Paragraph 7 of the Doha Ministerial Declaration reaffirms the right to introduce new regulations governing the supply of services.

At the Hong Kong Ministerial, WTO Members were asked to develop disciplines on domestic regulation as mandated under Article VI: 4 of the GATS. It can, therefore, be argued that the South Asian countries should take advantage of these provisions in GATS with a view to develop their national policy stance on domestic regulation in the services sectors, which will certainly facilitate their readiness for further trade liberalisation.

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## **Endnotes**

- 1 GTAP 6.2 database does not have disaggregated data on Nepal.
- 2 Based on Raihan and Ahmed (2008)
- 3 Based on Kumar and Jatkar (2008)
- 4 Based on SAWTEE (2008)
- 5 Based on Paracha (2008)
- 6 Based on Deshal and Wijayasiri (2008)



## Chapter 1

# **Domestic Preparedness for Services Trade Liberalisation in Bangladesh**

**Selim Raihan and Mansur Ahmed**



## **1.1. Introduction**

This study reviews the current state of regulatory framework and difficulties facing the services sector in Bangladesh with a view to examining the readiness of the services sector for further trade liberalisation. The analysis encompasses the country's strategies and policies regarding trade in services, their conformities and inconsistencies with its obligation under the GATS, the commitments made to meet the GATS obligations and their implications for the economy and will finally put forth the issues which need to be resolved to further liberalise trade in services in the future.

In the era of global economic integration, competitiveness plays a vital role in the success of international trade. In addition, the competitive environment of the domestic market facilitates higher economic growth and can help in reducing poverty. The services sector plays a fundamental role in ensuring the competitiveness of an economy. Services are used intensively in the production of all goods, making up around 10-20 percent of production costs in both manufacturing and agriculture, and sometimes more (Sauvé, 2006)<sup>1</sup>.

Although Bangladesh's specific commitments under GATS agreement is quite small, several countries have already requested the opening up certain services sectors for international competition in line with the GATS request-offer process. However, Bangladesh has been following a policy of unilateral liberalisation approach in the case of the services sector without going to the request-offer negotiation table. The country has already freed its key services sector such as financial and telecom sectors to international competition. Absence of a comprehensive study on the role of foreign participation in these services sectors in the national economy and employment generation is the main impediment to measure the outcome of liberalisation in these sectors. Bangladesh needs to frame a comprehensive national services master plan and a coherent policy framework.

This chapter has been divided into eight sections. Section 1.1 covers the motivation and objectives of the study. Section 1.2 deals with the importance of the services sector in the national economy, growth and international trade. Section 1.3 reviews the nexus between service trade liberalisation, development and poverty alleviation. Section 1.4 examines the international competitiveness of the services sector in Bangladesh. Section 1.5 analyses the existing regulatory framework. Section 1.6 focuses on Bangladesh's role in the services trade negotiation process and its potential implications. Section 1.7 deals with the technical assistance required, while Section 1.8 includes concluding remarks.

## **1.2. Overview of the Services Sector in Bangladesh**

Bangladesh remains one of the least developed countries (LDCs) with a per capita income of US\$482 (as per 2006 data). Over the past three decades, it has evolved from a controlled to a market-oriented economy through a wide range of policy reforms including reforms in trade policy, industrial policy, monetary and fiscal policy, exchange rate policy, and promotion of foreign direct investment. Trade liberalisation has been one of the major policy reforms in Bangladesh. During the course of the overall trade

<b>Table 1.1: Annual Average Growth in Services for South Asian Countries</b>				
<b>Countries</b>	<b>1971-80</b>	<b>1981-90</b>	<b>1991-00</b>	<b>2001-05</b>
Bangladesh	2.51	3.71	4.48	5.67
Nepal	4.38	3.6	6.56	2.93
India	4.42	6.72	7.65	8.5
Pakistan	6.26	6.62	4.5	5.39
Sri Lanka	5.43	4.95	5.82	5.23
Bhutan		6.57	6.72	7.23
Maldives			8.79	3.73
<i>Source: WDI (2007)</i>				

liberalisation programme, the liberalisation of the services sectors (especially telecom and financial sectors) also received much importance. The services sector is increasingly becoming a core part of the Bangladesh economy. In the context of South Asia, while in the last two and a half decades, growth rates in the services sector was fluctuating in Nepal, Pakistan, Sri Lanka and Maldives, Bangladesh and India had consistently grew (see Table 1.1).

The significant change in Bangladesh's approach towards trade and investment liberalisation in services may be attributed partly to the growing importance of the services sector in the economy and its trade and investment flows in recent years.

### **1.2.1. The Services Sector and GDP**

Economic development inevitably triggers a structural change in the composition of output in favour of services. One of the striking features of Bangladesh's growth performance in the last decade has been the strength of the services sector. During this period, the Bangladesh economy has been experiencing a significant structural change while the role of agriculture has been declining and those of industry and services have been growing. Between 1980-81 and 2006-07, the contribution of agriculture to the GDP declined from 33 percent to 21 percent, while that of industry increased from 17.3 percent to 29.8 percent. During this period, the services sector contributed to around 50 percent of Bangladesh's GDP (see Table 1.2).

Table 1.2 indicates that since 2004-05, the overall GDP of the economy has been increasing at a rate over 6 percent, which has been facilitated by high growth in industry and services sectors. In 2001-05, the services sector in Bangladesh grew, on average, at a rate of 5.67 percent per annum as against of 5.5 percent growth in overall GDP.

The rates of growth in some services sub-sectors have been higher than the growth in overall GDP. Table 1.3 presents the figures of shares of different sub-sectors in GDP as well as their contributions to the growth rate in GDP in 2006-07. It appears that in terms of the share in GDP, the major sub-sectors in the services sector include wholesale and retail trade, transport, storage and communication, real estate, renting and business activity and community, social and personal works, and their respective contributions

<b>Table 1.2: Share of Service Sectors to GDP and its Dynamics (at 1995-96 constant prices)</b>								
<b>Contribution (% share in GDP)</b>								
Sectors	1980-81	1985-86	1990-91	1995-96	2000-01	2004-05	2005-06	2006-07
Agriculture	33.07	31.15	29.23	25.68	25.03	22.27	21.84	21.11
Industry	17.31	19.13	21.04	24.87	26.20	28.31	29.03	29.77
Service	49.62	49.73	49.73	49.45	48.77	49.42	49.13	49.12
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
<b>Annual Average Growth Rate (%)</b>								
Agriculture	3.31	3.31	2.23	3.10	3.14	2.21	4.94	3.18
Industry	5.13	6.72	4.57	6.98	7.45	8.28	9.74	9.51
Service	3.55	4.10	3.28	3.96	5.53	6.36	6.40	6.74
GDP Growth	3.74	3.34	3.24	4.47	5.41	5.93	6.63	6.51

*Data Source: Bangladesh Economic Review (2007)*

to GDP in 2006-07 are 14.17 percent, 10.21 percent, 7.65 percent and 7.09 percent. Among these services sub-sectors, whole sale and retail trade, and transport, storage and communications grew at rates faster than that of the overall services sector. In 2006-07, these two sub-sectors grew by 7.44 and 8.25 percent respectively while the services sector as a whole grew by 6.74 percent.

Another sub-sector where high growth has been witnessed is the transport, storage and communication sub-sector from where a major contribution to GDP comes and which shows linkages with production and external sectors. The transport head covers roads, railways, air transport, port and shipping services; but high growth in this sector is mainly because of strong growth posted by communications that comprises telecommunication, IT and postal services. Robust growth momentums in the communication as well as the financial services have been triggered by liberalisation and reforms in these sectors. For example, deregulation policy for the telecommunication sector and market driven reforms have created a huge demand for new products, which have been instrumental in attracting new foreign investment in this sub-sector.

With the entry of five foreign cellular operators, namely, Telenor, Orascom, TM International, SingTel and Warid Telecom, competition in the cellular phone market has become tougher leading to improvement in service quality and further reduction in tariffs to the advantage of consumers. The inception of the state-owned cellular phone company, namely Teletalk, has further augmented this competitive environment. Finally, despite low contribution to GDP, education and community, social and personal services are also witnessing high sectoral growth.

Table 1.3: Sectoral Contribution to Growth rate in GDP in 2006-07				
Industrial Origin Sector	Sectoral Share of GDP at Constant Prices in 2006-07(p)	Sectoral Growth Rate of GDP at Constant Prices in 2006-07(p)	Weights	Sectoral contribution to GDP Growth rate
Agriculture and Forestry	16.38	2.95	0.16	0.48
Fishing	4.73	3.99	0.05	0.19
Mining and Carriage	1.19	10.02	0.01	0.12
Large and Medium Scale Industry	12.68	11.56	0.13	1.47
Small Scale Industry	5.11	10.28	0.05	0.53
Construction	9.16	7.05	0.09	0.65
Electricity, Gas and Water Supply	1.63	5.37	0.02	0.09
Wholesale and Retail Trade	14.17	7.44	0.14	1.05
Hotel and Restaurants	0.7	8.15	0.01	0.06
Transport, Storage and Communication	10.21	8.24	0.10	0.84
Financial Intermediations	1.73	7.54	0.02	0.13
Real Estate, Renting and Business Activities	7.65	3.77	0.08	0.29
Public Administration and Defence	2.75	8.51	0.03	0.23
Education	2.54	9.01	0.03	0.23
Health and Social Services	2.29	7.56	0.02	0.17
Community, Social and Personal Services	7.09	4.51	0.07	0.32
<b>Sub-total for Services Sectors</b>	<b>50.76</b>			<b>4.06</b>
<b>GDP at Constant Market Price</b>	<b>100</b>	<b>6.51</b>	<b>1.00</b>	<b>6.51</b>
<i>Data Source: BBS Website: <a href="http://www.bbs.gov.bd">www.bbs.gov.bd</a> (accessed on December 12, 2007)</i>				

Table 1.3 provides estimates of sectoral contribution to growth rate in GDP in 2006-07. It appears that services sectors on an average, recorded a growth of 6.74 percent, and these sectors altogether contributed more than half of the overall real GDP growth rate of Bangladesh. Among the services sub-sectors, the largest contributions are made by wholesale and retail trade and transport, storage and communication sub-sectors.

#### **1.2.2. Share of the Services Sector in Employment**

The services sector employment has also shown a rising trend but its contribution to total employment is much lower than its contribution to the country's GDP. Table 1.4 shows the sectoral composition of employment over the two decades. There was a sharp rise in employment share of the agricultural sector in the 1980s from 58.8 percent in 1982-83 to 66.4 percent in 1989-90. Since then, the Bangladesh economy has been witnessing a declining trend in the employment share of agriculture.

The share of agriculture in total employment reached to 51.7 percent in 2002-03, which signifies the increase of non-farm activities during the period. On the other hand, the share of the manufacturing sector in total employment increased from 11 percent in 1982-83 to 13 percent in 1989-90, however declined to 9.6 percent in 1995-96, which again rose to 13.7 percent in 2002-03. The employment share of the service sector has been somewhat unstable in the last two decades. It declined from 24.2 percent in 1982-83 to 16.2 percent in 1989-90. During the late 1990s and early 2000s, when liberalisation of some services sectors like telecommunication and financial intermediaries, was one of the major policy reforms, the employment share of service sector grew substantially to 34.6 percent.

<b>Table 1.4: Sectoral Composition of Employment</b>			
<b>Year</b>	<b>Sectoral Composition of Employed Workforce (%)</b>		
	<b>Agriculture</b>	<b>Manufacturing</b>	<b>Service</b>
1982-83	58.8	11	24.2
1984-85	57.7	11.5	26
1989-90	66.4	13	16.2
1995-96	63.2	9.6	25
1999-00	62.1	10.3	23.5
2002-03	51.7	13.7	34.6

*Source: WDI (2007)*

Table 1.5 reveals the employment dynamics in different services sub-sectors. Between 1995-96 and 2002-03, employment in services sector has grown by 20.32 percent. The annual average growth rate of services sector employment during the period was 2.54 percent. In terms of employment growth, hotels and restaurant was the most dynamic

<b>Table 1.5: Sub-Sectoral Dynamics of Employment</b>			
<b>Sectors</b>	<b>LFS 1995-96 Employment (in Million)</b>	<b>LFS 2002-03 Employment (in Million)</b>	<b>Annual Average Growth Rate in Employment (1995-96 to 2002-03)</b>
Electricity, Gas and Water	0.10	0.10	-2.91
Construction	1.01	1.50	6.06
Whole Sale and Retail Trade	5.70	6.10	0.88
Hotels and Restaurant	0.29	0.60	13.36
Transport, Storage and Communication	2.19	3.00	4.62
Financial and Business Services	0.21	0.30	5.36
Community and Personal Services	4.74	5.20	1.21
<b>Services</b>	<b>13.96</b>	<b>16.80</b>	<b>2.54</b>

*Source: Labour Force Survey (Various Issues).*

sub-sector, as employment in this sector grew by 13.36 percent annually during that period. Other dynamic sub-sectors were construction, financial and business services, and transport, storage and communication.

It would also be interesting to study the changes in the employment elasticity of the major sectors in Bangladesh. Palanivel (2006) calculated the employment elasticities in agriculture, industry and services sectors (see Table 1.6). It appears that in recent years, employment elasticity of the services sector is the lowest among the three broad sectors, and it has been falling overtime.

**Table 1.6: Trends in Employment Elasticities of Major Sectors and GDP for Bangladesh**

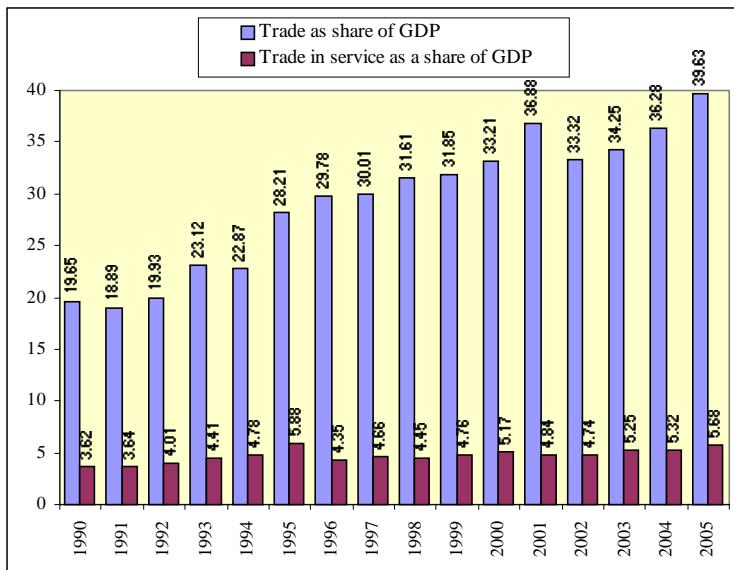
Period/Sectors	Agriculture	Industry	Services	All sectors
1980-1990	0.16	-0.16	2.89	0.36
1990-2000	0.84	0.42	0.71	0.76
2000-2004	2.02	0.82	0.56	0.82

*Source: Palanivel (2006)*

### 1.2.3. The Services Sector and Trade

Although the services sector has been consistently contributing half of the overall real GDP, its share in the country's exports is only about 12 percent. However, the corresponding figures for India, Nepal and Sri Lanka are 30.9 percent, 28.74 percent and 21.27 percent respectively (Kumar, 2005). Services trade of Bangladesh, as a share of its

**Figure 1.1: Trade Share in GDP (%)**



*Source: WDI (2007)*

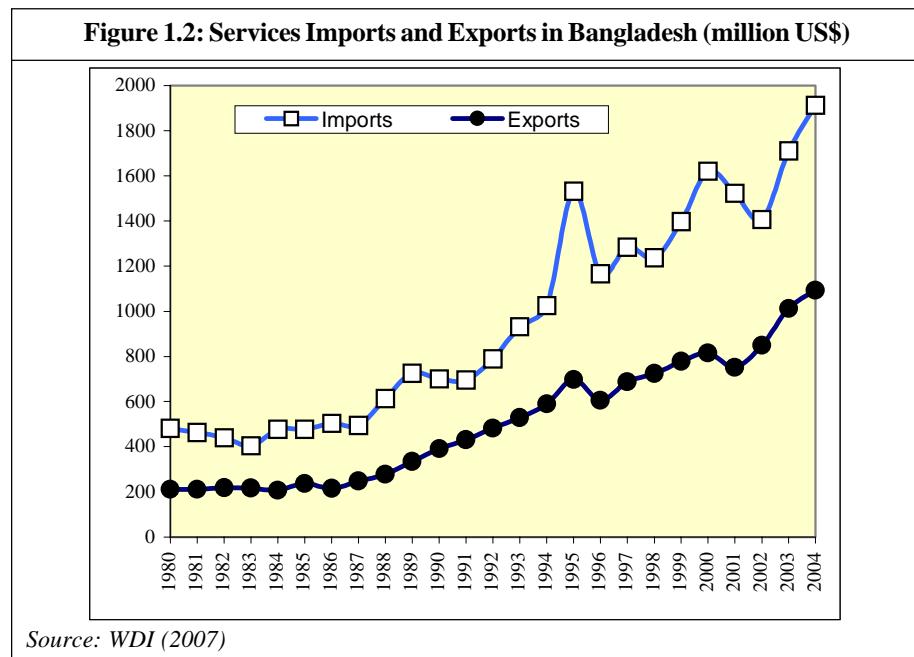
total trade, remained stagnant between 2000 and 2004. But in 2005, there was a sharp rise in the share of services trade in the total trade, which was led by growth in service imports. The stagnancy reflects the parallel growth in service and manufacture trade growth. Figure 1.1 reveals that services trade as a share of GDP has increased over the past two decades. However, increase in services trade GDP ratio is relatively insignificant compared to the increase in total trade GDP ratio (see Figure 1.1).

Though services trade is rising over time, services export as a percent of total export, over the last five years, has remained stagnant. However, service import as a percent of total import has fluctuated within 15 to 18 percent over the same time (see Table 1.7).

Years	2000	2001	2002	2003	2004	2005
Services Exports (% of Total Export)	11	11	12	13	12	12
Services Imports (% of Total Import)	17	16	15	15	16	18
Services Trade (% of Total Trade)	15	14	14	14	14	17

*Source: Handbook of Statistics, UNCTAD, 2005-06*

Services imports in Bangladesh are growing faster than the services exports. It experienced persistent and rising deficits in services trade. (see Figure 1.2)



Using the GATS classification, it is evident that very few sectors have positive trade balances, while others have secular negative balance (see Table 1.8). Among the services sub-sectors, Bangladesh faces huge trade deficit in sectors such as transportation, especially in freight, insurance services and travel, while positive balance has been found in the case of government services, computer and information services, communication, and construction services. In 2005-06, transportation imports reached US\$1633mn (see Table 1.8), while export in transportation was only US\$109mn. In 2005-06, Bangladesh nationals paid US\$163mn for insurance services, while the export was only US\$7.4mn.

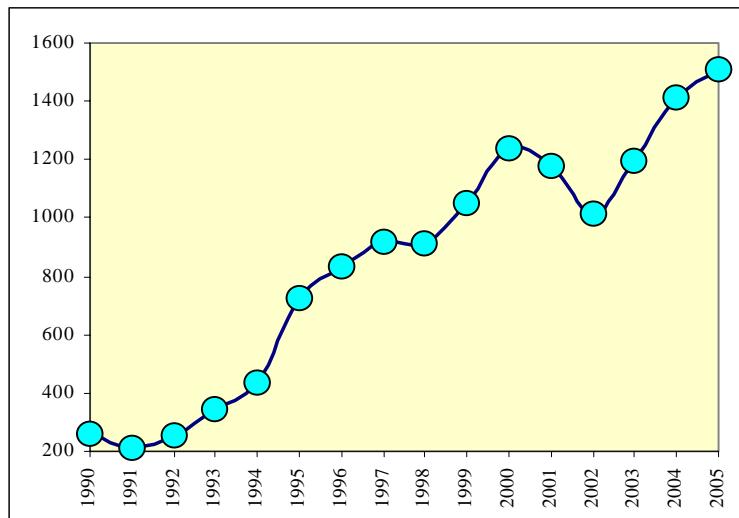
This can be explained by the high demand for insurance services in case of RMG exports. Bangladesh enjoys positive balance in the services sub-sectors such as computer and information services, communication, construction, and government services. The highest trade surplus was in the government services (US\$558.3mn) followed by the communication services (US\$36.5mn) and construction and computer and information services sector (US\$23mn). Deficit in balance of payments in the case of travel reflects the weak performance of the tourism sector in attracting foreign tourists.

<b>Table 1.8: Bangladesh's Balance of Payments in Services Sectors (2005-06) in million US\$</b>			
<b>Items</b>	<b>Credit</b>	<b>Debit</b>	<b>Net</b>
b) Services	1338.41	2329.75	-991.34
1. Transportation	108.97	1632.58	-1523.61
1.1 Passenger	3.12	224.27	-221.15
1.2 Freight	24.69	1408.01	-1383.32
1.3 Others	81.17	0.30	80.87
2. Travel	75.92	137.78	-61.85
2.1 Business	2.47	26.85	-24.37
2.2 Personal	73.45	110.93	-37.48
3. Communication Services	49.45	12.91	36.54
4. Construction Services	22.64	0.06	22.59
5. Insurance Services	7.38	163.13	-155.76
6. Financial Services	24.14	17.50	6.63
7. Computer & Information Services	27.19	4.29	22.90
8. Royalties and License fees	0.49	4.77	-4.28
9. Other Business Services	243.01	138.33	104.68
10. Entertainment, Cultural and Recreational Services	2.71	0.24	2.47
11. Government Services.i.e.	776.49	218.16	558.34

*Source: Balance of Payments, Bangladesh Bank, 2007*

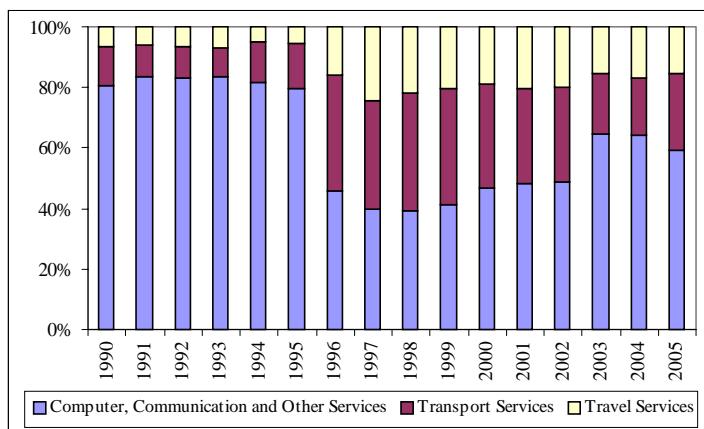
Figure 1.3 reveals a rising trend in trade deficit in commercial services for Bangladesh. The deficit in commercial services trade was US\$1511mn in 2005. Computer, communication and other services comprise the major share of the commercial services export (see Figure 1.4). Export of transport service had shown an increase in the late 1990s. On the other hand, import of transport services constitutes the major share of Bangladesh's commercial services import (see Figure 1.5). Expansion of the ready-made garment sector has played a key role in increasing the imports of transport services.

**Figure 1.3: Trade Deficit in Commercial Services Trade for Bangladesh (million US\$)**



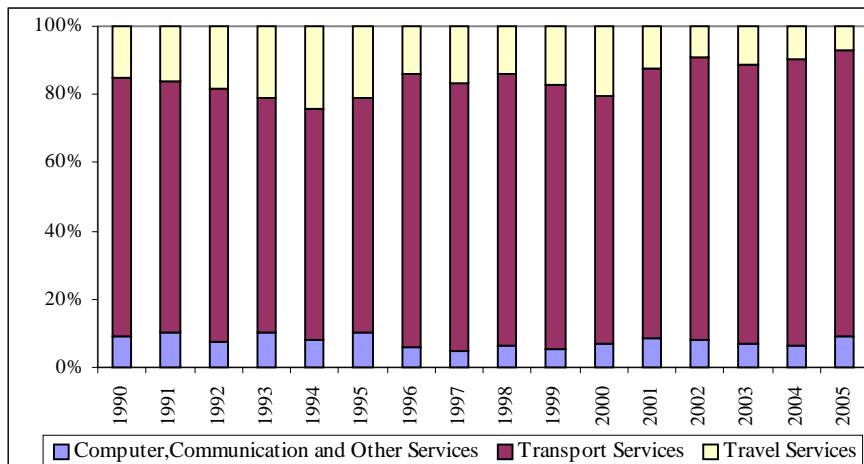
Source: WDI (2007)

**Figure 1.4: Components of Commercial Service Export from Bangladesh during 1990 and 2005**



Source: WDI (2007)

**Figure 1.5: Composition of Commercial Service Import in Bangladesh during 1990 and 2005**



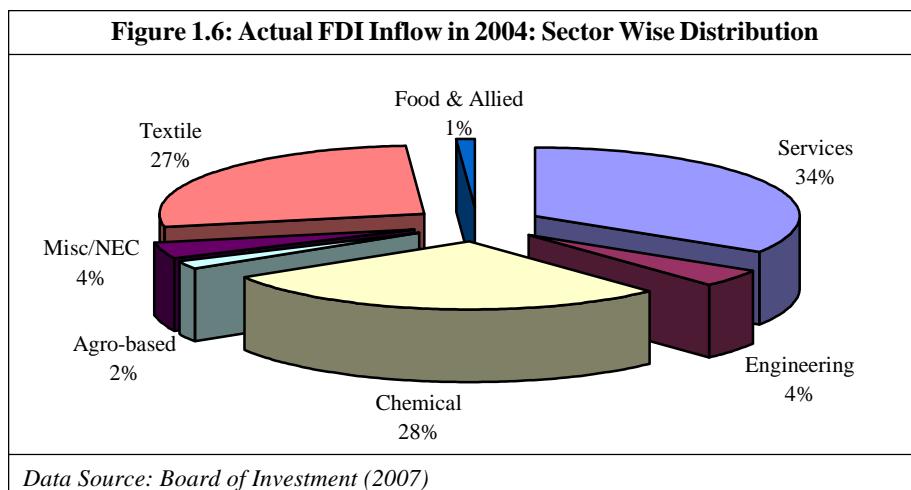
Source: WDI (2007)

#### 1.2.4. The Services Sector and FDI

Although Bangladesh has liberalised the industrial and investment policies in recent years, by reducing bureaucratic control over private investment and opening up many areas, its foreign investments did not rise in comparison to other developing countries. While the foreign investment regime was liberal, with no limitation on foreign equity participation or repatriation of profits, lack of investment in essential infrastructure clearly hampered Bangladesh's economic development. In particular, unreliable telephone connections, insufficient energy supplies, poor transportation and port services disrupted production and international trade and discouraged foreign investment.

FDI inflow stood at US\$745mn in 2005-06 while the corresponding figure was US\$804mn the previous year (Bangladesh Bank, 2007). Unavailability of FDI data in disaggregated sub-sector level makes it difficult to estimate the FDI inflows in the services sector. Moreover, there is a discrepancy between FDI statistics between the Bangladesh Bank and Board of Investment (BoI). According to the Bangladesh Bank reports, a FDI inflow from its statement of Balance of Payments (BoP) includes inflows of funds through banking channel. Meanwhile, BoI reports FDI statistics on the basis of registered investment. Its data states that the services sector attracted 34 percent of FDI followed by chemical and textile sector in 2004 (see Figure 1.6).

According to the Bangladesh Bank figures, the share of services sector in total FDI inflow fluctuated over the last few years, but the sector has been attracting the major share of FDI since 2003-04. As is reported in Table 1.9, in 2005-06, FDI in services sector reached US\$605mn which was 81 percent of total FDI inflow that year (Bangladesh Bank, 2007).



**Table 1.9: FDI in the Services Sector in Bangladesh**

Year	Total FDI (million US\$)	Services Sector (million US\$)	Services Sector Share of total FDI (%)
2002-03	376	46	12
2003-04	284	218	77
2004-05	804	450	56
2005-06	745	605	81

*Source: Statistics Department, Bangladesh Bank.*

Telecommunication, energy and financial sectors are the major services sub-sectors that have been receiving the large portions of FDI inflow in recent years. In 2005-06, the telecommunication sector received 44 percent FDI in services, which was 36 percent of total FDI (see Table 1.10). The banking sector received 20.5 percent of FDI in services and 17 percent of total FDI in 2005-06.

**Table 1.10: Distribution of Services FDI by Sub-Sector, 2005-06**

Sub-sectors	Amount (million US\$)	% of Total Services FDI	% of all FDI
Telecommunication	267.97	44.27	35.99
Gas	181.86	30.04	24.42
Banking	124.63	20.59	16.74
Power	25.01	4.13	3.36
Insurance	5.84	0.96	0.78
Total Services FDI	605.31	100.00	81.29
Manufacturing Sector	139.29	-	18.71
All FDI	744.60	-	100.00

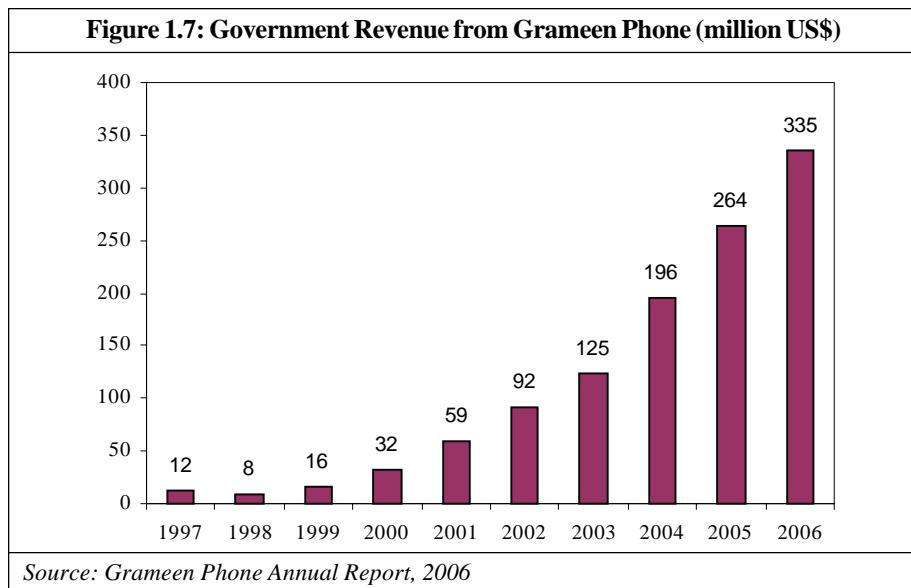
*Source: Statistics Department, Bangladesh Bank*

### 1.2.5. The Services Sector and Government Revenue

The immediate effect of liberalisation in merchandise trade is the reduction in government revenue, which might hamper government expenditure on poverty alleviation efforts. But in case of services trade liberalisation, the potential revenue loss is almost negligible. The services sector is protected by a complex set of rules and regulations in the name of national policy objectives, but such protection does not provide revenue to the government, say for instance, tariff revenue. VAT is the main source of revenue income from the services sector. In 2005-06, this sector contributed 39 percent of VAT revenue. Gas and Communication services, which include telecom sector, are the major sources of VAT income as far as the services sector is concerned (see Table 1.11).

<b>Table 1.11: Collection of VAT from Different Sub-sectors in the Services Sector (million US\$*)</b>			
<b>Sectors</b>	<b>2003-04</b>	<b>2004-05</b>	<b>2005-06</b>
1. Gas, Water Supply and Electricity Distribution	76.75	308.59	320.97
1.1. Gas	29.61	261.53	276.75
1.2. Water Supply	4.35	4.12	3.00
1.3. Electricity Distribution	42.79	42.94	41.22
2. Whole Sale and Retail Trade	0.00	0.00	0.00
3. Hotels and Restaurant	8.60	7.75	10.25
4. Transport and Storage	1.15	1.12	13.30
5. Communication Services	81.90	105.36	260.72
6. Bank Services	21.65	36.18	37.61
7. Insurance Services	1.53	13.83	13.18
8. Commercial Importers	0.00	46.85	63.51
9. Building Development Agency	0.06	0.68	0.63
10. Clinics and Hospitals	0.57	0.66	1.05
Sub-Total	214.73	521.02	721.21
Total VAT		1726.67	1848.54
Total Tax Revenue		5204.43	5393.56
<i>Source: Bhuyan (2007)</i>			
<i>* Figures were converted with the respective exchange rates.</i>			

An example of collection of government revenue is depicted in Figure 2.7, which reveals that government revenue from a private-owned cellular phone company, namely Grameen Phone, has been rising substantially over the last ten years. In 2005-06, its contribution to revenue such as VAT, corporate tax, income tax etc. stood at US\$335mn.



### 1.3. Services Trade Liberalisation, Development, and Poverty Alleviation in Bangladesh

Services trade in the global perspective is a relatively new phenomenon and has gained importance over the last decade after the inception of GATS in the Uruguay Round of International Trade talks. Even though trade in services is relatively a new phenomenon, it has immense potential in terms of further expansion of global trade. Gains from a cut of 33 percent in barriers to services trade should raise global economic welfare by US\$389.6bn, which exceeds their estimated gains from manufacture liberalisation of US\$210.7bn (Brown et al. 2001). It is now widely accepted that the gains generated from services trade liberalisation could potentially be larger than the gains stemming from the liberalisation of merchandise trade.

According to numerous economic estimates, the welfare gains from liberalisation of the global service sector could be the most substantial among the sectors that are currently under negotiation at the Doha Round—though a large proportion of the gains will flow to the developed world (Gallagher, 2005). However, carefully designed and prepared liberalisation can contribute to improve the economic performance of the developing countries through their integration in the world economy. Liberalisation of services in developing countries could provide as much as US\$6tn in additional income by 2015, four times the gains that would come from trade in goods liberalisation (World Bank, 2001).

There is no denying that efficient services contribute to improved economic performances. Availability of essential services, such as water supply, sanitation, power supply, transportation, education or health, is associated with higher productivity and earnings. Reflecting their infrastructural nature, many modern services sectors, including telecommunications, financial services and transport, not only provide final consumer

products, but basic production inputs for a wide variety of user industries. But, services in developing countries are often inaccessible, prohibitively expensive, or, even when accessible, of low quality and unsuited to the needs of consumers (World Bank, 2003). Moreover, the services sector can be particularly important in terms of employment, because many services are labour-intensive. In principle, the development of the labour-intensive sector can help reduce poverty by generating labour-intensive growth (McCulloch et al. 2001). An estimate, using a global CGE model, has shown that liberalising the movement of natural persons, i.e. by introducing a temporary visa system in developed countries permitting movement of labour, up to 3 percent of total labour force, would increase world incomes by nearly US\$160bn (Winters and Walmsley, 2002).

The potential implications of service trade liberalisation on economic growth, poverty and performance of other sectors have been studied around the world using different type of models and methodology. There is a consensus that the essential precondition for sustained poverty alleviation is rapid economic growth<sup>2</sup>. Available econometric evidence on the role of services as intermediate inputs suggests that openness in the services sector influences long-run growth performance. From a cross-country regression, Matto et al. (2001) estimated that countries with fully open telecom and financial services sectors grow up to 1.5 percentage points faster than other countries. This confirms predictions from economic theory, especially *Endogenous Growth* and *New Trade Theory*, which identify dynamic advantages stemming from increase in productivity and growth realised via technology transfers, X-efficiency, greater variety offered and improved quality of services.

An important channel of dynamic gains is the improved productivity in downstream sectors due to enhanced access to a broader variety, better quality and lower cost of input. By providing incentives for efficient allocation of resources, an open and transparent trade regime is an important precondition for broad-based and sustained growth. Thus, in the medium term, trade reform has an important role in poverty alleviation through its effects on the rate and sectoral pattern of growth. According to the Stolper-Samuelson theorem, trade liberalisation in developing countries should draw more unskilled and semi-skilled workers into employment and increase their real wages.

That's why service sector has the growing potential to be a driver of sustainable economic growth and significant poverty alleviation in Bangladesh. The growing trade in service has important implications for productivity enhancement and economic growth. The services sector is the largest sector in Bangladesh where local firms have larger participation and are better able to compete, as compared to the manufacturing sector. Demand for services is highly income-elastic, i.e. as people grow richer, their consumption of services such as tourism, education and health, expands more rapidly than their demand for manufactures and agricultural products. As a result, the issue of trade liberalisation in services raises an important concern to the government of the country: to what extent service trade liberalisation will be beneficial to achieve the national objectives such as economic growth, poverty alleviation and inequality reduction.

GATS explicitly recognises the right of the members to regulate and initiate new regulation on the supply of services within their territories in order to meet national policy objectives. Under such independence, Bangladesh has already liberalised important sub-sectors of services unilaterally, keeping the right to liberalise for request-offer process under the GATS negotiations. Unilateral service trade liberalisation has been the hallmark of Bangladesh trade policy reforms. However, unilateral service trade liberalisation will not ensure that service trade will work for persistent economic growth and poverty alleviation. Unilateral service trade liberalisation is one of the issues that has given rise to greater concern among negotiators, policymakers and civil society alike. Moreover, as service sector is the major stakeholder in the economy, decision on service trade liberalisation has greater implications for the economy. So it is wiser for Bangladesh to take a cautious approach.

The implications of service trade liberalisation to the Bangladesh economy is yet to be explored. Raihan (2005) conducted a study on service trade liberalisation and outlined negotiation strategies. The study provided an overview of the services sector and also identified the sectors with balance of payments surplus such as computer-related services, telecommunication services, distribution services, etc., which have export interests, while the sectors with balance of payments deficit such as leasing, transport, construction services, etc., which have import interests. The study optimistically concluded that liberalisation would bring an efficient, predictable environment for investment, and create new opportunities for exporting services. On the negative aspect, the study pointed out that liberalisation of all services sectors might jeopardise the macroeconomic stability of the economy affecting the SMEs in transport sectors, construction sectors and distribution services.

A recent study by Bhuyan et al. (2007) has reviewed the developments in the services sector in Bangladesh focusing on the barriers, regulations and difficulties faced by the country. It also assessed the potential of the sector, and determined the position of the country's services sector vis-à-vis the other South Asian countries. The study recommended a policy of cautious liberalisation for telecommunication and banking sector, retailing services, tourism services and health services. But the study recommended protecting insurance and transportation services in support to domestic suppliers. However, the study has used some criteria for taking decisions on liberalisation, some of them conflicting. For example, one sector may have large contribution to GDP, but not to employment.

#### **1.4. Experiences of Bangladesh in GATS Negotiations and their Implications**

The creation of GATS was one of the landmark achievements of the Uruguay Round. It was inspired by essentially the same objectives as its counterpart in merchandise trade, the General Agreement on Tariffs and Trade (GATT): creating a credible and reliable system of international trade rules; ensuring fair and equitable treatment of all participants (principle of non-discrimination); stimulating economic activity through guaranteed policy bindings; and promoting trade and development through progressive liberalisation (WTO, 2007). GATS classifies services into 12 categories and four modes of supply (Box 1.1). It allows WTO members to select the sectors, modes of supply and

#### Box 1.1: The Modes of Services Delivery under the GATS

**Mode 1: Cross-border supply** covers services flows from the territory of one Member into the territory of another Member (e.g. banking or architectural services transmitted via telecommunications or mail).

**Mode 2: Consumption abroad** refers to situations where a service consumer (e.g. tourist or patient) moves into another Member's territory to obtain a service.

**Mode 3: Commercial presence** implies that a service supplier of one Member establishes a territorial presence, including through ownership or lease of premises, in another Member's territory to provide a service (e.g. domestic subsidiaries of foreign insurance companies or hotel chains).

**Mode 4: Presence of natural persons** consists of persons of one Member entering the territory of another Member to supply a service (e.g. accountants, doctors or teachers). The Annex on Movement of Natural Persons specifies, however, that Members remain free to operate measures regarding citizenship, residence or access to the employment market on a permanent basis.

*Source: World Trade Organisation Website*

regulatory conditions in which market opening commitments can be made. Because of such flexibility, the agreement is often described as the most development friendly of all Uruguay Round agreements. Among all WTO agreements, the GATS allows its member countries to integrate the multilateral trading system at their own pace and in accordance with their national priorities and objectives.

The GATS also provides a general framework for negotiations on further liberalisation in service trade. The negotiations take place under the request-offer process, whereby WTO member countries submit requests to their trading partners to open up some specific service sectors. On the other hand, the same government offers the trading limits to the extent they are willing to open up their specific services sectors. Once a country agrees, through negotiations in the WTO, to liberalise a sector, it must be listed in a schedule of specific commitments. By committing a services sector to liberalisation, the country is legally bound by GATS to provide national and MFN treatment.

Negotiations under GATS are important for Least Developing Countries (LDCs), as they face severe constraints in economic development due to poor infrastructure, institutional settings and misgovernance. Though a dominant part of the economy, the services sector in LDCs, is in the initial stages - and there is a huge growth potential of the domestic service market. LDCs including Bangladesh should be very strategic in the request-offer process under GATS settings, as these countries are the lucrative targets for developed countries. Without necessary precautions and adequate readiness, LDCs including Bangladesh will be lucrative targets for strong market players which might jeopardise the growth potential of the domestic service market (Raihan, 2005). A

mong the major supply constraints that prevent the building of a competitive service sector in LDCs as well as in Bangladesh are the lack of the following factors: human resources and technology to ensure that professional and quality standards are met; telecommunications infrastructure; a national strategy for export of services; government support to help service firms, especially small and medium enterprises; financial capacity of firms; presence in major markets; and the ability to offer a package of services (UNCTAD, 1998).

The outcomes of ongoing GATS negotiation process will have significant implications for national development initiatives. Bangladesh should have a clearly defined negotiation strategy, based on a clear conceptual framework and understanding that might be done in order to make GATS negotiations conducive for the economic development of the country. Every strategy should have a fallback position, if it becomes necessary. Most of the relevant literature push emphasises negotiation in Mode 4 as Bangladesh has comparative advantage on the movement of natural persons. But there are other areas in services sector that have huge growth potentials.

#### ***1.4.1. Bangladesh's Role and Status in the Negotiation Process***

Under the GATS, special and differential treatment (S&DT) has been accorded particular priority to LDCs. Box 1.2 provides a summary of the mandates for accordin special priority to the LDCs. Such guidelines have been instrumental in increasing the participation of LDCs in service negotiation and addressing their requirements and objectives in line with their national priorities. Bangladesh had been active in supporting and strengthening the multilateral trading system, and its leading role among LDCs in the WTO in addressing their specific needs and concerns, was well appreciated.

It has played the role of spokesman of LDCs in the WTO negotiations twice since the completion of the Uruguay Round. Bangladesh also hosted the second LDC Ministerial Meeting in Dhaka in May, 2004 in preparation for the Cancun Ministerial Meeting. A declaration was adopted on the final day of the meeting which emphasised the temporary movement of natural persons (TMNP) and the priorities in the Dhaka Declaration was reflected in the Special Modalities for LDCs adopted by the WTO. The Special Modalities for LDCs adopted 14 out of 20 points in the Dhaka Declaration, which should be considered a great success for Bangladesh in the negotiation process. The Bangladesh mission in Geneva has been playing a proactive role in the different negotiating committees which discussed issues of interest to the country.

The development elements in GATS naturally prompted Bangladesh as well as the LDCs to effectively participate in the negotiation process. However, the Hong Kong Declaration may have serious implications for LDCs. The Hong Kong Declaration, for the first time, explicitly recognises that LDCs are not expected to undertake new commitments in services negotiations (paragraph 26). This provision is to protect LDCs from liberalising sectors where they do not wish to make commitments. However, the concern is that when LDCs are not required to undertake new commitments, they may be reluctant to take part in the discussion and negotiations, since they might consider that the terms agreed between developed and developing countries will be passed on to them on an MFN basis. From the basic trade theory suggestions, being reluctant to liberalise may result in depriving the LDCs of potential welfare gain.

#### **Box 1.2: Summary of Mandates for According Special Priority**

- **GATS Article IV:3** provides special priority for LDCs
- **Paragraph 6, LDC Modalities** requires Members to provide effective market access
- **Paragraph 7, LDC Modalities** requires Members to develop appropriate mechanisms with a view to achieving full implementation of GATS Article IV:3
- **Paragraph 47, Hong Kong Ministerial Declaration** calls on Members to implement the LDC Modalities and give priority to sectors and modes of interest to LDCs
- **Paragraph 3, Annex C, Hong Kong Declaration** calls for full and effective implementation of the LDC Modalities
- **Paragraph 9 (a), Annex C Hong Kong Declaration** requires Members to develop appropriate mechanisms for according special priority in sectors and modes of interest in accordance with Article IV:3 and paragraph 7 of the LDC modalities
- **Paragraph 9 (b), Annex C, Hong Kong Declaration** calls for undertaking commitments in sectors and modes of supply of interest to be identified by LDCs
- **Paragraph 11 (e), Annex C, Hong Kong Declaration** provides a deadline for implementation of 9(a) of 31 July 2006

*Source: South Centre (2006)*

Therefore, there is a need for LDC negotiation strategies to take into account the general interests of these countries.

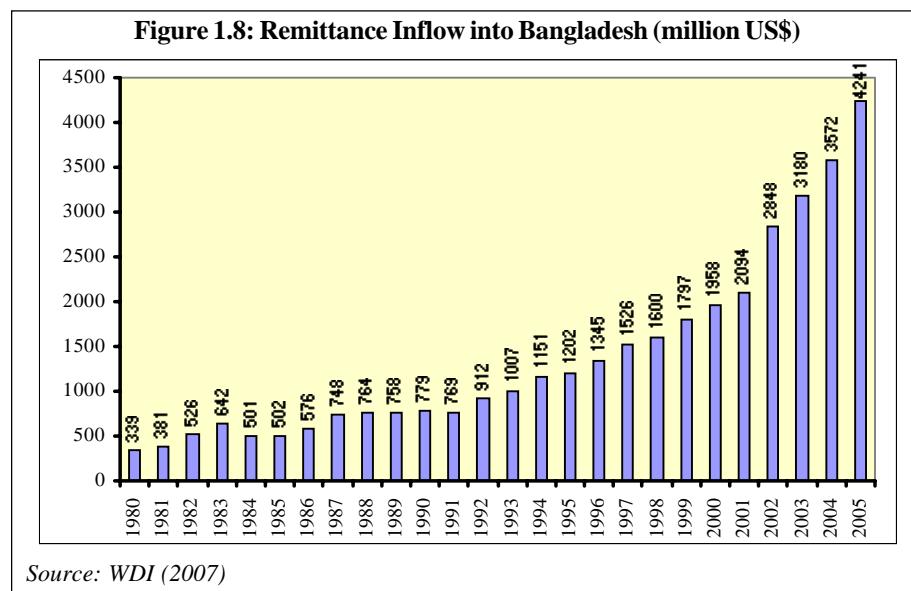
Bangladesh opened its domestic markets for specific categories like banking and financial services, but did not place these as binding commitments in GATS negotiations from the fear of not being able to control in case of serious balance of payments crisis. Commitments of Bangladesh are only for the telecommunication, travel and tourism services. Bangladesh may place requests through plurilateral negotiations. The country can make use of the domestic regulation provisions for dealing with balance of payment considerations in offering some liberalisation.

#### **2.4.2. Cases where Bangladesh has Offensive Interests**

Among different services category, Bangladesh's success lies especially on the human resource-based services export. However, there are numerous trade barriers in the developed countries regarding this sector, which, if removed, would have resulted in a huge welfare gain for Bangladesh. Bangladesh's offensive interest in the GATS negotiations is restricted primarily to one mode of service delivery: Mode 4 involving movement of natural persons. The policy stance of Bangladesh should focus on the negotiations relating to the 'non-reciprocal' Mode 4 liberalisation, separation of temporary from permanent movements of natural persons, and to go for plurilateral

negotiations with the developing countries to place the request for multiple entry GATS visa. Further, there should be request for provisions to bring uniformity in definition of service personnel and to increase coverage.

Bangladesh's strength in Mode 4-based exports is well established. In fact, remittance income from Mode 4 or temporary movement of natural persons has been the key driving force behind the improvement of the country's balance of payments in the last decade. Figure 1.8 shows the trend in the flow of remittances coming into Bangladesh, and it appears that in recent years, remittance inflow has been experiencing a steady rise. It has a comparative advantage in Mode 4-based unskilled or semi-skilled labour force export and has emerged as an important source of unskilled or semi-skilled labour service providers, mainly to the Middle East and increasingly to Southeast Asian countries. A large chunk of low or semi-skilled workers from Bangladesh are engaged in a wide range of occupations in these countries, including construction workers, production workers, transport equipment operators, domestic helps etc.



The key agendas that Bangladesh should highlight in the negotiation process will facilitate the movement of professionals (Mode 4) who have the capacity and compatibility to work in the developed countries; to request countries to do away with Economic Needs Tests (ENTs) and Labour Market Tests (LMTs), which hampers effective market access to Bangladeshi workers; and enter into discussions for a Mutual Recognition Agreement on educational qualifications and licensing requirements and procedures.

#### **1.4.3. Bangladesh's Commitments and Exemptions in GATS**

Under the GATS provision, each member is required to assume specific commitments relating to market access and national treatment in designated sectors. The relevant sectors as well as any departure from the relevant obligations of XVI and XVII are to be

specified in the country's Schedule of Commitments. Article XVI (Market Access) and XVII (National Treatment) requires Members to accord no less favourable treatment to foreign services and service suppliers than provided for in the relevant columns of their Schedule. Commitments thus guarantee minimum levels of treatment, but do not prevent Members from being more open (or less discriminatory) in practice.

The implementation of the GATS agreement is undertaken through the listing of horizontal and specific sectoral commitments in the Members' Schedule. Horizontal commitments on the four modes of service supply apply to all sectors, while specific commitments apply only to listed service sectors and sub-sectors. This listing of sectors committed for liberalisation is the *positive approach* of the GATS. In addition, countries have to list non-conforming measures present in domestic laws and regulations that affect Market Accesses and National Treatment of foreign service providers for such measures to be WTO-compatible. This is the *negative list* approach in the GATS schedule. Thus, the GATS is a combination of both positive and negative list approach.

While making commitments in trade in services on market access, national treatment, and MFN treatment, Bangladesh adopted a cautious approach. It was guided by a number of considerations. Bangladesh, like many LDCs, found that GATS allows the capital of developed countries greater market access in the developing countries through Mode 3 while market access to the unskilled or semi-skilled labour of developing countries through Mode 4 is restricted. The services sector in Bangladesh, like many other LDCs and developing countries, is far less developed compared to that of developed countries, and hence under free trade in services and hence, likely to be in a disadvantageous position. Moreover, the existing legal and regulation infrastructure should undergo minimum structural changes.

Bangladesh has made certain specific horizontal commitments on Market Access and National Treatment with some limitations relating to commercial presence (Mode 3) and movement of natural persons (Mode 4) in case of the communication and tourism sectors. GATS classified tourism sector into four sub-sectors and Bangladesh made commitments in one sub-sector namely Luxury Hotels.

#### ***1.4.4. Bangladesh and the Request-Offer Process***

In the request-offer process in the ongoing WTO market access negotiations in services, more than 160 requests and around 47 offers have been submitted by WTO members by December 2004. Several initial offers have been derestricted by the Member. The ratio of requests from developed and developing countries is almost 1:1, although only a few LDCs have issued requests. Generally speaking, developing countries seem more interested in negotiations in tourism, communications, distribution, construction, computer and related services, while the interests of developed countries are in business service, transport, financial service, energy services, environmental services, maritime transport services and education services. In Mode 4, the developed and developing countries both have shown equal interest (Werth, 2005).

After the inception of GATS, nine countries, including the European Commission, USA, Japan and Malaysia, have submitted their requests to Bangladesh to liberalise a number of services sectors (Table 1.12). The requests have covered a wide range of

sectors except education and health. Singapore requested for the opening up of transport services and the EC requests included undertaking or improving commitments in business, telecommunication, construction and related engineering services, environmental, financial, and transport services. In terms of coverage of sectors and sub-sectors, it is observed that requests to Bangladesh cover 10 sectors out of 12, and 127 sub-sectors out of 161. The requests were limited to Market Access under Modes 1, 2, and 3, except in the case of telecom, while there were National Treatment requests on all sub-sectors. Under Horizontal Commitment, requests were made for Mode 4 and on the removal of certain MFN exemptions in telecoms.

<b>Table 1.12: Sectors and the requesting countries</b>	
<b>Sectors</b>	<b>Requesting countries</b>
1. Business Services	Malaysia, USA, Korea, Sri Lanka, EC
2. Communication Services	USA, Japan, Norway, Sri Lanka, Hong Kong, EC and Korea.
3. Construction and Related Engineering Services	Japan, Korea, and EC
4. Distribution Services	Japan, USA
5. Education Services	None
6. Environmental Services	USA, Norway, and EC
7. Financial Services	USA, Japan, Korea, Sri Lanka, and EC
8. Health related and Social Services	None
9. Tourism and Travel Related Services	Sri Lanka
10. Recreational, Cultural, and Sporting Services	Korea, USA
11. Transport Services	Singapore, Japan, EC, Hong Kong, and Sri Lanka
12. Other Services	USA, Japan, Singapore, Norway, EC, and Korea
<i>Source: Bhuyan (2007)</i>	

Although Bangladesh prepared a request for special commitments during the negotiations, it has so far not submitted the initial GATS request to trading partners. Bangladesh's request includes softening the immigration policy, visa procedures, licensing requirements, exemptions from social security taxes, and mutual recognition of qualifications etc.

## 1.5. Current State of Domestic Preparedness

The methodology involved in studying the competitiveness of Bangladesh's services sectors in international trade includes the Balassa's Index of Revealed Comparative Advantage (RCA). Balassa (1965) derived an index that measures a country's

comparative advantage. It tries to identify whether a country has a “revealed” comparative advantage rather than to determine the underlying sources of comparative advantage. However, since first suggested by Balassa, the definition of RCA has been revised and modified in a manner that an excessive number of measures now exist. Estimates of the RCA for the overall services sector of Bangladesh, India, Pakistan, Sri Lanka, Nepal, Malaysia, Cambodia, Philippines, and Vietnam are reported in Table 1.13.

The RCA is calculated using the following formula:

$$RCA = (X_{ij} / X_{it}) / (X_{wj} / X_{wt})$$

Where,  $X_{ij}$  indicates country i's export of jth sector  
 $X_{it}$  indicates country i's total export  
 $X_{wj}$  indicates world's total export of jth sector  
 $X_{wt}$  indicates world's total export.

As the RCA for Bangladesh is lower than one, it indicates Bangladesh's comparative disadvantageous position in services trade. Moreover, the country is relatively in a disadvantageous position in services trade compared to other developing countries. India, Nepal, and Cambodia are in a strongly advantageous position in case of services trade in terms of RCA.

<b>Table 1.13: Revealed Comparative Advantage of Bangladesh's Services Sector vis-à-vis other Developing Countries</b>									
<b>Year</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Bangladesh	0.62	0.60	0.60	0.57	0.54	0.59	0.62	0.58	0.61
India	1.01	1.23	1.37	1.41	1.37	1.34	1.39		
Pakistan	0.81	0.73	0.74	0.69	0.68	0.96	0.98	0.85	0.98
Sri Lanka	0.79	0.77	0.84	0.75	1.08	1.03	1.06	1.04	0.99
Nepal	3.38	2.61	2.50	2.00	1.79	1.58	1.70	1.85	1.51
Cambodia	0.89	0.88	1.00	1.19	1.23	1.23	1.02	1.17	1.40
Malaysia	0.84	0.67	0.60	0.63	0.69	0.67	0.56	0.58	0.62
Philippines	1.87	0.98	0.45	0.42	0.44	0.44	0.43	0.47	0.51
Vietnam	1.08	1.06	0.86	0.80	0.77	0.73	0.69	0.63	0.58

*Source: Calculated based on data from WDI (2007)*

Using the GTAP database, it is, however, possible to calculate the RCA for individual services sub-sectors. Table 1.14 reports the results of such an exercise for Bangladesh, India and China. It appears that for some two sectors, i.e. sea transport and public administration, defence, health and education Bangladesh's RCA indices are greater than one. However, in the public administration, defence, health and education sub-sector, the export of defence services, in terms of peace keeping mission of the United Nations, is the major contributor to the high RCA in this sector. It also appears from Table 1.13 that compared to India and China, Bangladesh is in a disadvantageous position in all services sub-sectors.

<b>Table 1.14: Revealed Comparative Advantage of Bangladesh's Services Sub-Sectors</b>			
<b>Sectors</b>	<b>RCA</b>		
	<b>Bangladesh</b>	<b>India</b>	<b>China</b>
Electricity	0.00	0.06	10.96
Gas manufacture, distribution	0.00	0.00	0.00
Water	0.00	0.08	30.79
Construction	0.04	0.07	22.34
Trade Services	0.06	1.50	40.23
Transport Services	0.19	1.17	27.42
Sea Transport	1.47	1.26	8.51
Air Transport	0.11	0.31	7.90
Communication	0.26	0.09	11.04
Financial Services	0.13	0.12	10.70
Insurance	0.09	0.80	5.93
Business Services	0.26	1.96	5.58
Recreation and other Services	0.12	0.31	7.92
Public Administration, Defence, Health, Education	4.67	0.80	19.69

*Source: Calculated from GTAP database version 6.2*

However, a problem of implementing these or similar RCA indices is that real (observed) trade patterns may be distorted by government interventions, thus causing misrepresentation of underlying comparative advantage. It is thus a concern that protectionist policies of governments, to an extent, may distort RCA indices.

The international competitiveness of the services sector in Bangladesh can also be examined using the Michael's Specialisation Index. This index has been calculated based on the available data using following formula:

$$MI_{ij} = (X_{ij} / X_{ij}) - (M_{ij} / M_{ij})$$

Where,  $X_{ij}$  indicate the country j's export of ith sector.

$X_{ij}$  indicates country j's total export

$M_{ij}$  indicate the country j's import of ith sector.

$M_{ij}$  indicates country j's total import

The measure ranges between -1 and +1, with a neutral value of 0. If the value of the index is positive, the country is specialised in the specific sector, while given a negative value, the country is said to be under-specialised in the sector. The results of this exercise are presented in Table 1.15. It appears from this table that the specialisation

**Table 1.15: Michael Index for Trade Specialisation of Services Sub-sectors**

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Transportation	-0.53	-0.56	-0.55	-0.51	-0.58	-0.61	-0.63	-0.66	-0.61
Travel	-0.05	-0.05	-0.09	-0.12	-0.05	-0.01	-0.04	-0.02	0.00
Other Services	0.58	0.61	0.63	0.63	0.63	0.62	0.67	0.68	0.62
Communications	0.04	0.03	0.05	0.02	0.01	0.04	0.06	0.05	0.01
Construction	0.00	-0.01	0.00	0.00	0.00	-0.01	0.00	0.00	0.01
Computer and Information	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.01
Insurance	-0.06	-0.06	-0.06	-0.05	-0.06	-0.06	-0.06	-0.07	-0.06
Financial Services	0.00	0.00	0.01	0.00	0.00	0.01	0.02	0.01	0.01
Royalties and License Fees	-0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other Business Services	0.06	0.06	0.03	0.07	0.07	0.07	0.10	0.13	0.10
Personal, Cultural and Recreational Services	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Government Services.i.e.	0.53	0.59	0.60	0.59	0.61	0.58	0.54	0.56	0.54
Memo Item: Commercial Services	-0.53	-0.59	-0.60	-0.59	-0.61	-0.58	-0.54	-0.56	-0.54
<i>Source: Calculated based on UNCTAD Online Handbook of Statistics</i>									

indices are negative for transportation, insurance and commercial services. On the other hand, though for other services the indices are positive, for most of them the values are very low. Only in the case of other services and government services the indices are higher than 0.5.

Notably, the key role services are playing in the economy is not proportionately reflected in the share of services in the overall trade of the economy. While 49.42 percent of GDP has been generated from the services sector in 2004-05, the share of services in total trade is only 17 percent. This discrepancy is also reflected in case of sub-sectoral level. Each services sector, except government services and defence, has been contributing a very low share to the country's export basket relative to its respective share in the GDP. On the other hand, transport and travel, and insurance sector are maintaining a higher share in the country's import basket compared to its respective share in GDP.

Moreover, the role that has been played by the services sector to overall GDP is not reflected in the share of services in employment. All service sectors have lower shares in total employment relative to their respective shares in overall GDP. Among the services sectors, wholesale and retail trade, transport, community, social and personnel services and, to some extent, construction sectors are more labour intensive, absorbing 29.73 percent of total employment, while services sector as a whole has accounted for 38.28 percent of total employment (LFS 2002-03).

This study tried to identify the strength in trade competitiveness and employment generation of the major services sectors in Bangladesh in comparison to that of a liberalised services sector, namely, the telecommunication sector. First, the sectors' shares in exports, imports, and employment were normalised by dividing their respective shares in the GDP. After the normalisation, an index was calculated considering the post and telecommunication sector as the benchmark. In the case of export, all sectors under consideration have been found under-performing compared to the post and telecommunication sector (see Table 1.16). All sectors except construction, however, are more import-oriented than the telecommunication sector. However, other sectors are reasonably more labour intensive compared to the telecommunication sector.

Table 1.16: Competitiveness of Key Services Sector in Comparison to Post and Telecommunication Sector					
Sectors	Post and Telecommunication	Construction	Banks	Insurance	Transport + Travel
Export Share*	1	0.032	0.545	0.425	0.635
Import Share*	1	0.052	1.189	44.045	24.522
Employment Share*	1	3.165	1.868	4.048	6.554
Average	1	1.083	1.201	16.173	10.571

Source: Author's Calculation based on Different Data Sources  
 \*denotes the expression normalised by GDP share.

All the sectors considered in Table 1.16 have dual implications for liberalisation. These sectors are producing services that have been used as intermediate services in case of manufacturing as well as final services provided to the direct consumers. As the sectors are relatively more labour intensive, liberalising these sectors with limitation under Mode 4 might play an important role in poverty reduction through employment generation as well as bring efficiency in service provision that can enhance efficiency in the manufacturing sector.

## 1.6. Feedback from the Stakeholders on Domestic Preparedness

For the purpose of assessing the current position of the services sector with respect to services trade liberalisation and to predict the likely effects of further liberalisation in services, the study has carried out discussions with stakeholders such as policymakers, industry persons and academics based on a semi-structured questionnaire. The stakeholders hastened to add that the services sector liberalisation or reform is not possible merely through a project. Terming it a long-drawn process, they pointed out that it needs long-term commitments for reforms with consistency and properly sequenced measures. But no impact assessment of services trade liberalisation has been carried out of the large categories of service industries in order to determine which may be opened up for trade under GATS and what Bangladesh could demand in return. A comprehensive independent assessment should be made of the

developmental, environmental, employment, social and gender impacts of the liberalisation of services. Policymakers should consider the ultimate effects of service trade liberalisation on all members of society.

#### ***1.6.1. Construction***

Low capacity and capability of local contractors and consultants, due to weak resource base and inadequate skills and experience, are the major concerns for the construction sector. Poor working environment, including low standards of safety and occupational hazards on construction sites; weak and non-facilitative policies and regulatory framework; and low productivity and quality of domestic firms due to a low technology base and limited skills and experience are the major constraints in construction services that leads Bangladesh to a disadvantageous position. Moreover, there is also a lack of supporting institutional mechanisms to facilitate easier access to key inputs in the industry including finance and equipment. For instance, introduction of leasing arrangements for heavy construction equipment is the key to increasing the capacity of SMEs to undertake larger jobs.

The regulatory framework, intense competition against well funded and equipped foreign operators and lack of access to finance and equipment as well as inexperienced management are issues that should be addressed to reverse this situation. Can these problems be addressed through further liberalisation or a more restrictive regime? The analysts in the sector have been arguing that experience from emerging economies shows that economic opening will lead to the introduction of new financing instruments that can increase SME access to critical assets and will expose the labour force to skills and management experience that is critical for the growth and consolidation of the domestic operators. That is the challenge the industry stockholders must face in addressing the potential opportunities for using the services commitment schedules to address their concerns. However, direct stakeholders in this sector are confident to face foreign competition due to service trade liberalisation initiative by the government. But they have argued that as they are providing international standard services at competitive price, there is no need to liberalise this sector.

#### ***1.6.2. Banks***

According to policymakers, competition has been enhanced as a result of the opening of new markets to new entrants, and that interest spreads have been decreased and loan quality (i.e. the share of non-performing loans in banks' balance sheets) has been improved as a result of improvements in banking regulation and supervision. They argued that activities in the banking sector which was dominated by the inefficient nationalised commercial banks (NCB), a few years ago, are being replaced by the relatively more efficient and competitive private commercial banks (PCB) and foreign commercial banks (FCB). Foreign investment in the banking sector has brought modern technology like computerisation of banking operations, introduction of ATM services, smart card, credit/debit card, and online banking. These services have quickly been adopted by the PCBs. According to the bankers, the banking sector in Bangladesh has already achieved global standards in terms of efficiency and competition. So, further establishment of foreign banks will not enhance efficiency and competition but will harm the sector's stability. According to the regulator's perspective, deregulation and liberalisation of the banking sector has been carried out to improve financial

intermediation in the economy through enhanced competition, efficiency and profitability and diversification of financial services. However, absence of prudential regulation may result in economic crisis with serious social impact as the Asian financial crisis of 1997 indicates. So, stakeholders recommend that Bangladesh should follow a policy of cautious and slow liberalisation instead of wholesale liberalisation in the banking sector.

#### **1.6.3. Insurance**

The regulatory agency of the insurance industry in the country is not equipped with adequate manpower and resources to supervise this growing industry, which limit the agency's role in the development of the sector. It is, therefore, essential that the CCI recruit competent professionals who will be able to analyse the financial soundness of the companies and prepare financial reports for taking appropriate measures. The office of the Chief Controller of Insurance should also be equipped with proper logistical support, such as computer facilities, internet communication etc., which will enhance the efficiency of its day-to-day work. Insurance analysts point out that to open up this sector, apart from introducing efficiency and better regulation, insurance companies need to be innovative in expanding their business activities, which will familiarise the business to the general people.

#### **1.6.4. Travel and Transport**

According to the stakeholders, major weaknesses in the regulatory framework for the sector include poor coordination between authorities, poor governance (corruption and poor enforcement). Therefore, the challenge is to streamline the functions and increase coordination, and to link policy formulation, regulation and implementation oversight. For promoting economic cooperation among nations, particularly in the fields of tourism and trade, and for attracting foreign investment, the availability of an efficient transport network, at a relatively low cost, is an essential pre-requisite. A major expansion is required in the port infrastructure sector in order to handle sea borne traffic from increased foreign and coastal trade.

This could be achieved through private sector participation by reducing the gestation period for setting up new facilities, bringing in latest technology and improving management techniques in order to upgrade cargo handling both in terms of quality and quantity. The transport sector is labour intensive and requires less skill. It has tremendous potential for absorbing a huge number of low skilled unemployed people in the country. According to analysts, Bangladesh can liberalise the sector with limitations on Mode 4, only after setting up a proper regulatory body. They point out that because of the unique geographical location, Bangladesh has the potential for becoming the 'transport hub' to serve the entire hinterland comprising Nepal, Bhutan and Northeast India.

### **1.7. Technical Assistance required for Bangladesh**

Different country experiences suggest that trade liberalisation alone cannot act for growth and development. Especially in the case of the LDCs, lack of trade-related infrastructure facilities and deficiency of knowledge on sectoral potentiality deprive them of gaining through greater openness. The problem of lack of infrastructure facilities is acute for Bangladesh, which involves poor transportation, port and customs, and

storage facilities, along with power supply and communication system. The marketing and distribution facilities are far from satisfactory. Moreover, Bangladesh experienced problems implementing WTO commitments, in particular, concerning notifications, partly due to lack of know-how and institutional capacity. The WTO Cell under the Ministry of Commerce and Bangladesh Foreign Trade Institute have been formed to improve the institutional and human capacity in trade negotiations. Despite these efforts, Bangladesh still lacks the capacity to manage the whole negotiation process.

The complications relating to services trade negotiations call for Bangladesh and other LDCs to identify ways to deal with intricate matters associated with specific details of various provisions. It is also important for policymakers to be able to assess the potential implications arising out of certain provisions. Furthermore, taking effective participation in services trade may require enacting the necessary domestic regulations in place. All these will require technical assistance to LDCs and their effective utilisation.

Aid for trade can be an effective instrument to provide technical assistance to Bangladesh to build the supply capacity for services sectors, to strengthen domestic services capacity, efficiency and competitiveness to build institutional and human capacity, and to put up requisite infrastructure and new technologies. The scope and content of aid for trade, so far, include assisting diagnostic works, technical assistance and budget support, trade integration mechanism and integrated framework, impact and needs assessment, improving trade-related global public goods, e.g. trade database, analytical tools etc. and ensuring country ownership of trade strategy. Technical assistance through the integrated framework could be provided to Bangladesh in this regard and it will help improve the institutional capacity of the country to participate actively in GATS negotiations, and implement commitments to GATS. Moreover, technical assistance will be needed in the undertaking of appropriate regulatory reforms and translating the services regulatory framework into GATS language.

The Hong Kong Declaration emphasised on assisting LDCs to enable them to identify sectors and modes of supply that represent development priorities. The full and effective implementation of LDC modalities also calls for providing targeted and effective technical assistance and institutional capacity building for LDCs. However, there is no such initiative from the developed country members to consider the special priority sectors and LDC modes of supply. There also lacks LDC initiatives to prepare a negotiable ground for this. Bangladesh should identify areas where technical assistance is required.

## **1.8. Concluding Remarks**

This paper has highlighted some major issues related to domestic preparedness on the liberalisation of some services sectors in Bangladesh. Among these, telecommunication is the most liberalised and hence, a benchmark. This study has analysed the domestic preparedness for liberalisation in several sectors. It concludes that though there is significant potential from further trade liberalisation, a slow and cautious approach is preferred. There is a need to strengthen the domestic regulation rules and capacity in the process of services trade liberalisation.

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### Endnotes

- 1 The figure is 20-25 percent for ready-made garments in some countries (United Nations, 2005).
- 2 For instance, Ravallion (1997) has presented empirical evidence suggesting that every one-percentage point increase in per capita income can reduce headcount poverty by 1.5 to 3.5 percentage point.

## Chapter 2

# **Domestic Preparedness of India in Trade in Services**

**Pranav Kumar and Archana Jatkar**



## 2.1. Introduction

The emergence of international trade in services is not a new phenomenon. It existed in the form of trade in travel, transport and tourism services as well as in the form of movement of workers from one country to another to provide various services. With the advancement in technology, increase in internationalisation of product processes, global trade in services is estimated at around US\$2tn. Moreover, today the service attracts sumptuous investment from the world. Developing countries are becoming global players and important destinations for the services business as they open their economies to foreign investment. However, these countries are required to leverage their strengths in global service markets. Developing countries should assess the extent to which they are prepared to liberalise their service sectors and might take stock of the domestic and external constraints in realising their export interests and import requirements. Accordingly, they need to frame their domestic policies and regulatory frameworks to benefit from the gains of increased efficiency and other advantages accruing from the globalisation of services.

India, with its expanding service sector and liberalisation of many important services, is facing these concerns. In recent years, services have played a crucial role in the growth of the economy contributing nearly 55 percent of the GDP in 2006-07. The sector has come to play an increasingly dominant role in the economy accounting for 68.6 percent of the overall average growth in GDP in the last few years between 2002-03 and 2006-07.<sup>1</sup> India's export of IT services, BPO and electronic hardware are estimated to have touched US\$23.6bn in the first nine months of the current financial year.<sup>2</sup> The country has also emerged as one of the most attractive off shore destinations for service outsourcing in the world today.

There has also been an integration of India's service sector with the global economy through FDI flows. Following the strategy of liberalisation during 1990s, several public dominated services have been opened up for FDI and ceilings on foreign equity participation have been relaxed. According to UNCTAD's World Investment Report of 2004, FDI in services has been growing more rapidly than FDI in manufacturing in India. This is due to deregulation and liberalisation of important services such as banking, insurance and telecommunications. However, there remain various domestic and external impediments in realisation of India's true potential in the service sector, for example, India's export of professional services.

Certain services remain closed for FDI in India restricting competition and possible gains to accrue in terms of efficiency. It is therefore understandable that India played a proactive role in the WTO negotiations on services under the auspices of the General Agreement on Trade in Services (GATS). It is further expanding its scope in the service sector through regional and bilateral trade agreements (RTAs). The purpose is to use such agreements to negotiate the removal of various trade barriers affecting the country's service export to overseas markets and also to provide stimulus to the liberalisation process undertaken by India's service sector.

This chapter is divided into three sections. Section 2.1 deals with liberalisation of services under GATS and India's position. Section 2.2 examines the significance of

service sector in the country in terms of foreign direct investment, export enhancement, while Section 2.3 elaborates the position of some of the service sectors, domestic regulation and India's negotiating position under GATS.

## 2.2. Significance of the Services Sector in India

### 2.2.1 Overview of the Services Sector

India's emergence as one of the fastest growing economies in the world has much to do with the growth of its service sector, which has emerged as an 'engine of growth'. A striking feature of the country's growth performance is that in the four-decades from 1950 to 1990, the share of agriculture in the GDP has declined by about 25 percentage points, while industry and services have gained equally. The share of industry has stabilised since 1990 and consequently, the decline in agriculture has been picked up by the services sector (see Table 2.1). During the 1990s, the contribution of service sector to the GDP was nearly 55 percent. This high share is a unique feature of the Indian economy. As in other developing countries, decline in agricultural sector's share has been followed by growth in the share of the manufacturing sector and shift towards services sector has occurred only in the final stages of growth.

**Table 2.1: Average Sectoral Contribution (%) to India's GDP**

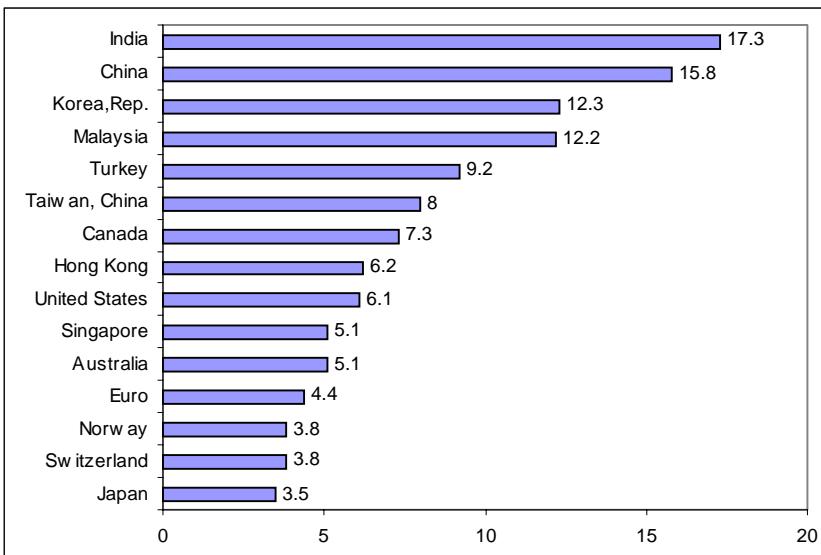
Item	1990	1995	2000	2002	2003	2004	2005	2006
Agriculture	29.3	26.5	23.4	20.09	20.09	18.8	18.3	17.5
Industry	26.9	27.8	26.2	26.4	26.1	27.5	27.6	27.9
Services	43.8	45.7	50.5	52.7	52.9	53.7	54.1	54.6

*Source Asian Development Bank: Key Indicators of Developing Asian and Pacific Countries<sup>3</sup>*

Simultaneously, India's export services registered the fastest growth the world-over, 17 percent per annum in the 1990s as compared to the world growth rate of approximately 3.7 percent during this period (see Figure 2.1). The Foreign Direct Investment (FDI) in services in India also grew significantly faster than in goods during the same time (see Figure 2.2). In 2005-06, services exports grew by 35 percent. Growth in services can largely be attributed to the information technology (IT) boom where India has emerged as a world leader. It accounted for 65 percent of the global market in offshore IT services and 46 percent of the global BPO market in 2004-05. Besides communication services, export in financial services, construction and professional services have also grown rapidly. India has now become a pool of both high skilled and low skilled service providers. The country has the largest inward remittances in the developing world.

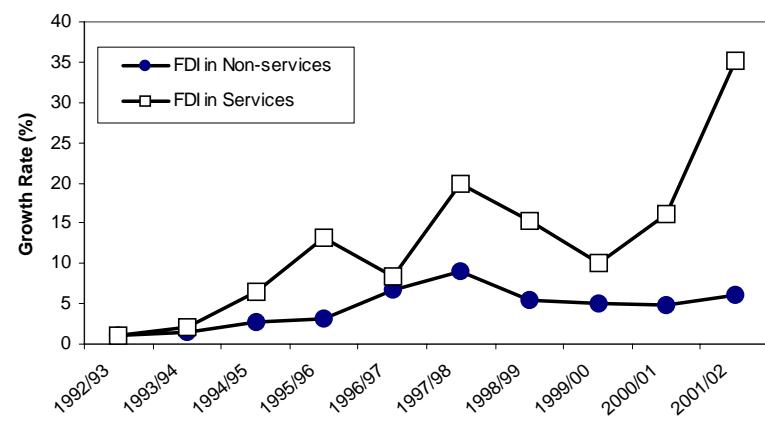
Unlike its experience in goods, India, in a very short period, has emerged as one of the most dynamic suppliers in the world. It demonstrated a strong revealed comparative advantage<sup>4</sup> (RCA) in services in comparison to goods. A simple comparison of the RCA index of services and RCA index of goods between 1996-2000 shows that the index of services increased by 74 percent while that of goods declined by 15 percent (see Figure 2.3). This increase in the RCA index of services can be attributed to a category called 'other business services', which includes software exports, finance, communication, management and consultancy services amongst others (see Figure 2.4).

**Figure 2.1: Average Growth Rate of Exports of Services during the 1990s  
(top 15 Exporters)**



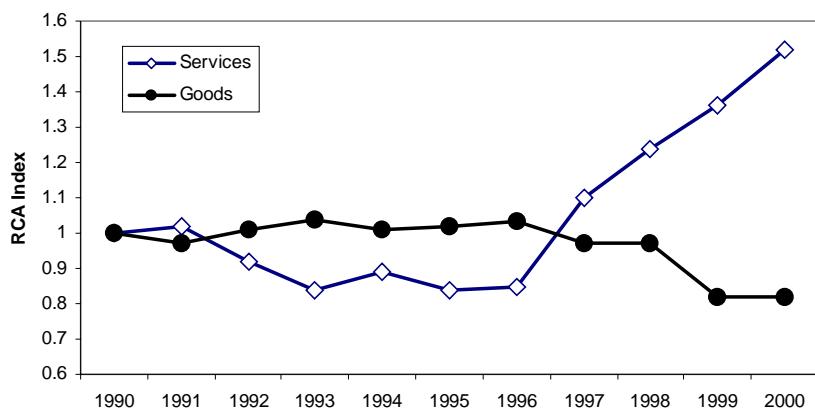
Source: *World Development Indicator, Balance of Payment Statistics Yearbook 2002*

**Figure 2.2: Growth in FDI in Services Sector and Non-Services Sectors**



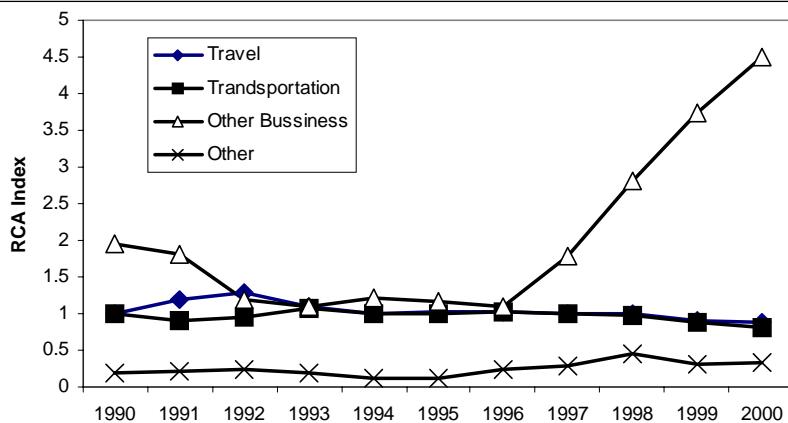
Source: *World Development Indicator, Balance of Payment Statistics Yearbook 2002*

**Figure 2.3: India's Revealed Comparative Advantage**



Source: IMF, *Balance of Payment Statistics Year Book*, 2002

**Figure 2.4: India's RCA Index for Services in Selected Categories**



Source: IMF, *Balance of Payment Statistics Year Book*, 2002

Further, the recent trend of increased specialisation of India's services export in selected sub-sectors reflects the change in composition of exports. Within software services exports, IT services grew at the rate of 35.5 percent to touch US\$18bn. IT-enabled services (ITeS) and business process outsourcing (BPO) exports also grew at an impressive rate of 33.5 percent to clock revenues of US\$8.4bn. In fact, on the back of strong export growth and buoyant domestic demand, the Indian IT-ITeS industry has recorded US\$39.6bn in revenues in 2006-07, up 30.7 percent from the previous year. According to NASSCOM, the software and service industry is well on way to achieve revenues worth US\$50bn in the current fiscal year.

On the whole, the above trends present an interesting picture. The service sector in India has been the fastest growing sector in the last decade. It has contributed the

most to the growth of GDP. The importance of services in the current scenario is further inferred from the latest Economic Survey Report of India for the period of 2006-07. It specifies that services are one of the most significant sectors of the Indian economy, contributing nearly 55 percent of the GDP in 2006-07. The service sector has come to play an increasingly dominant role in the economy accounting for 68.6 percent of the overall average growth in GDP in the last five years between 2002-03 and 2006-07.

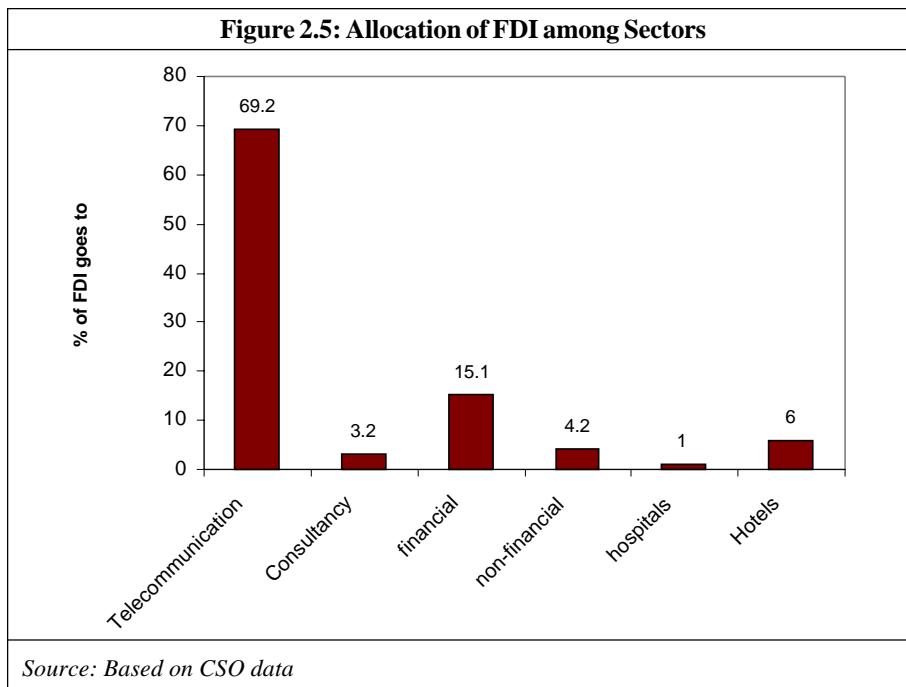
This trend is expected to continue for next year as well. Although growth in IT and ITeS has been conspicuous, there are other sectors like telecommunications, financial services, community services, hotels and restaurants that have grown faster than the GDP. For example, trade, hotels, transport and communication grew by 13 per cent against 10.4 percent the previous year. Also financial services (comprising banking, insurance, real estate and business services) grew by 11.1 percent against 10.9 per cent. And finally, community, social and personal services grew 7.8 percent against 7.7 percent. CII in its recent *State of the Economy Report* expects the growth to continue apace with services expected to grow at a rate of 11.2 percent in 2007-08.

### **2.2.2. Services Sector Share in FDI**

Along with trade, there has been a large inflow of FDI into India since the 1990s. In fact, the country has been ranked in the top ten FDI destinations in the UNCTAD World Investment Report (2004). However, this increase in FDI inflows has been accompanied by change in the structure of FDI. Following the international trend, FDI inflows into India are also shifting increasingly away from the manufacturing to the services sector. The average share of services in total FDI in the period 1990-94 increased from 10.5 percent to 28.3 percent between 1995-99 (World Investment Report, 2004).

However, the inflow of FDI in the services sector has been biased towards a few sectors (Figure 2.5). Those with the largest approvals include telecommunications and financial services. Within telecommunication, the largest recipient is cellular phone services. One of the striking features of India's FDI flows is the growing proportion of outward FDI from the services sector. The share of services in total FDI outflow increased to around 45 percent in the period 1999-2003, in which non-financial services constituted around 36 percent, trade is around 5 percent, and the rest accrued from financial and other services. It is interesting to note that the sectors which received higher FDI, i.e. telecommunications, financial and consultancy services, are also the fastest growing services sectors in the economy.

Though the above analysis of performance of different services sectors points out that trade and FDI in the services sector is also accompanied by growth in the sector, the impact of trade and FDI on the growth of services sectors has not yet been empirically examined. One of the main reasons for this is the lack of data on disaggregated services, both with respect to actual FDI and output of services. However, an important impact of FDI in services has been studied with regard to the impact on India's export of back office services (McKinsey & Co. 2003). According to NASSCOM estimates, foreign affiliates accounted for around 58 percent of exports of offshore operations in India in 2002-03.



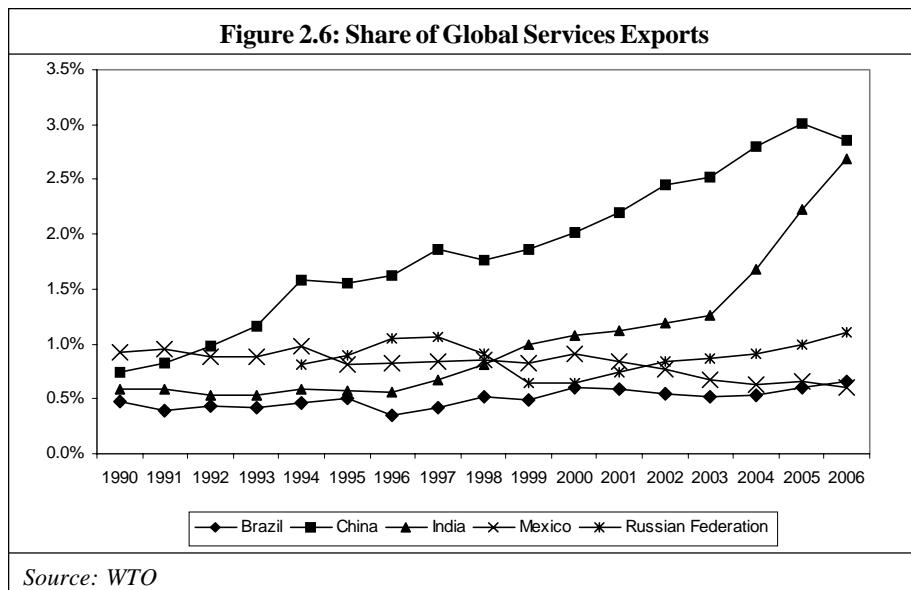
On the whole, the above pattern of growth in services brings out an interesting picture. Service sector in India has been the fastest growing sector in the last decade. Within it,, we find that the fastest growing services in the 1990s have been trade, communications, financial services, business services and community services like health and education. However, of these, only communication services have witnessed growth in their share in exports and FDI during this period.

### 2.2.3. Export of Services

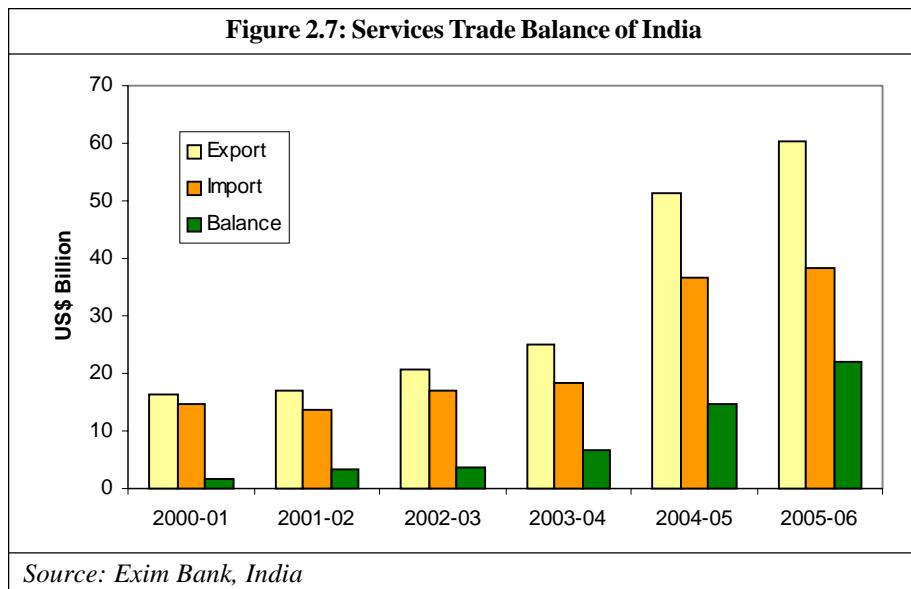
The boost in India's services sector has not only been confined to the domestic market, but also reflects in international trade. India's share in the global trade of services has increased from 2 percent in 2004 to 2.7 percent in 2006 (see Figure 2.6).

While India's share and ranking in world merchandise exports were 1 percent and 28<sup>th</sup>, respectively, its share and ranking in world commercial services exports grew to 2.7 percent and 10<sup>th</sup> . From Figure 2.6 it is clear that the country is fast emerging as one of the largest exporters of commercial services and that growth in services export is consistently increasing. India's ranking in world services export was 26<sup>th</sup> in 1998 while it stood 10<sup>th</sup> in 2006.

Further, it is noteworthy that India's trade balance is in surplus with exports rising up to US\$60bn and imports at US\$38.3bn (see Figure 2.7). The country has been recording high growth in the export of services during the last few years. Such exports have increased threefold in the last three years; in 2005-06, with a growth of 42.0 percent, it reached US\$61.4bn. Miscellaneous sectors consisting of software services, business services, financial and communication services too have registered a rapid growth.



This impressive growth in India's services exports can be attributed to the fact that in 2006-07, software and services exports grew by 33 percent to register revenues of US\$31.4bn. Also, business services grew at the rate of 82.4 percent. Furthermore, engineering services and product exports registered revenues of US\$4.9bn, up 23 percent over the previous year. Personal, cultural, recreational services grew at the rate of 96 percent, while financial services grew at the rate of 88.5 percent. Finally, travel, transport and insurance grew at the rate of 23 percent.



#### **2.2.4. Services Sector Growth and Employment Generation**

The Economic Survey for 2003-04 indicates a significant shift in the government's approach in job creation with the document acknowledging that the services sector cannot be expected to throw up as many jobs as required. It reaches the conclusion that higher growth in manufacturing is the only viable method by which surplus rural labour can be gainfully employed.

The survey points out that unlike in most countries, the share of the services sector in output has grown much faster than its share in total jobs. This is because of the nature of services — like the software business — that have witnessed a boom in India. Since these require relatively high skilled manpower, they are unlikely to solve the problem of people forced off the land by stagnating agricultural output. While growth in tourism and related businesses like hotels could help, “the service sector alone is unlikely to provide a solution to the employment problem,” the document notes. The survey's concern on joblessness stems from the fact that the rate of growth of employment has declined from about 2.7 percent per annum between 1983 and 1994 to around 1.1 percent per annum. Table 2.2 also indicates that there is stagnation in employment generation across the conventional service sectors between 1981 and 2004.

**Table 2.2 Total Employment in Select Service Sectors (Lakh Persons)**

	1981	1991	1995	1996	1997	1998	1999	2000	2001	2003	2004
Electricity, Gas and Water	7.18	9.45	9.75	9.88	9.97	9.96	10.03	9.87	9.87	9.63	9.21
Construction	11.61	12.22	12.17	12.12	11.88	11.83	11.78	11.49	11.38	9.92	9.77
Wholesale and Retail Trade	3.94	4.5	4.7	4.79	4.81	4.85	4.86	4.93	5.02	5.42	5.32
Transport, Storage & Communications	27.69	30.79	31.64	31.52	31.55	31.49	31.53	31.47	31.18	30.18	28.96
Finance, Insurance Real Estate etc	9.44	14.48	15.76	15.86	16.16	16.29	16.53	16.54	16.51	18.03	18.66
Community, Social & Personal Services	85.77	107.12	111.07	111.78	113.91	114.14	114.94	114.94	115.64	113.65	110.68

Source: Ministry of Labour and Employment (DGE&T) as given in Economic Survey 2006-07, Government of India  
Note: 1 Lakh is equivalent to 0.1 million

The performance of IT sector, which has been the major contributor to services export from India is also not very encouraging on the employment generation front. Continuing on its established track record, the overall Indian IT-BPO revenue aggregate is expected to grow by over 33 per cent and reach US\$64bn by the end of the current fiscal year (FY 2008). As a proportion of national GDP, the technology sector revenues have grown

from 1.2 per cent in FY 1998 to an estimated 5.5 percent in FY 2008. Net value added by this sector to the economy is estimated at 3.3-3.9 percent for FY 2008. However, over the same period, direct employment in the sector is expected to reach only 2 million, an increase of about 3,75,000 professionals over the previous year (NASSCOM, 2008).

### **2.3. Services Trade Liberalisation in India and GATS**

The General Agreement on Trade in Services (GATS) is the first multilateral agreement under the aegis of WTO to provide legally enforceable rights to member countries on wide range of services trade. Initially, many developing countries, including India, were not very receptive to entering into a multilateral agreement on services leading to progressive opening up of the services sector for trade. The main reason was that most of the developing countries lacked the capacity to assess the strength and weakness of domestic service sector. This would have enabled them to take decisions on which sectors to open and protect.

Secondly, GATS was the first agreement of its kind. Prior to that, services trade was not included in GATT, the predecessor of WTO. Also, many thought that services are non-tradable as it requires physical movement of either consumer or supplier. Another factor was that many of the services sectors enjoyed heavy protection during that time and governments of developing countries had exclusive monopoly over major services dealing with infrastructure such as telecommunication, energy, banking, transportation etc.

All these concerns made sure that nothing much was achieved during the Uruguay Round on services trade liberalisation. GATS remained a soft and flexible agreement. Therefore, it is often said that GATS negotiated during the Uruguay Round was less a market opening agreement than a framework, which established rules and laid the groundwork for future liberalisation. The current services negotiations under the auspices of the Doha Round are expected to accomplish the unfulfilled task of previous round by deepening trade liberalisation in services.

Like most developing countries, India too was defensive during the Uruguay Round of trade negotiation on services. However, its negotiating stance on services has undergone a paradigm shift since then. In the ongoing services trade negotiations, India has been very offensive in seeking market access in developed countries, particularly under Mode 1 (Cross-Border Trade) covering the whole issue of business process outsourcing and Mode 4, dealing with temporary movement of natural persons. Of late, India has realised its strength under two other modes as well. While it has become one of the leading destinations of medical tourism (Mode 2 – Consumption Abroad), outward investments from India are increasingly rising.

This shift in India's stance in services trade negotiations can be attributed to significant increase in services exports from India. In little over a decade, India's share in world services exports has increased from 0.53 percent in 1993 to 2.38 percent in 2005. This massive jump in export has happened because of India's huge comparative advantage in "IT enabled services" (business process outsourcing) and increase in remittances. Remittances by overseas Indians, as reflected in private transfers in the balance of

payments, have touched a new high of US\$8,145mn during the quarter ended December 2006. This is the highest-ever received by the country in any single quarter. Remittances for the entire calendar year 2006 touched US\$26.9bn.<sup>5</sup>

India's vigorous negotiations at the WTO became visible, especially, after the Doha Ministerial in 2001. The number of submissions made by India in services increased considerably after 2001. These proposals mainly focused on Mode 1 and Mode 4, where India has a comparative advantage and therefore, an audacious interest. India played the lead role in formulating and submitting communication for greater market access in the developed country markets in Mode 1 and Mode 4 in the 'Friends Group'. Furthermore, India focused on the need to enhance transparency in Mode 4 commitments and to decrease the discretionary scope in the application of restrictions such as economic needs test (ENT), lack of recognition of qualifications etc.

India along with its coalition members of Friends Group focused on Mode 1, so as to ensure the predictability of market environment. However, these negotiations yielded no additional breakthrough in market access opportunities for India. There has been no substantial improvement in commitments over the Uruguay Round made by major markets of export interest in Mode 4. Similarly, services which may provide scope for outsourcing has not been offered under Mode 1 and Mode 2 or if they are, it is with restrictive conditions, thereby mitigating the value of offers made.

Meanwhile, India has been receiving requests from all major developed countries as well as developing countries in a wide range of services. Most of the requests are to enter the Indian market through commercial presence (Mode 3) of foreign establishments with stress on financial and telecommunication services, albeit offers in the field of education and environmental services have also been made. While responding to these requests, India made an initial offer in January 2004 that was not very different from the offer at the Uruguay Round. However, in the revised offer of August 2005, India demonstrated willingness to expand the scope of its Uruguay Round commitments by tabling several new service sectors and sub-sectors for negotiations.

It further showed willingness to remove commercial presence restrictions in few important areas, which it had already committed. Eleven sectors and 94 sub-sectors were covered in the revised offer contrary to the seven sectors and forty-seven sub-sectors in the initial offer. The change in the Indian stand showed the new strategy of coming forward in services negotiations. India was hoping to receive improved revised offers on Mode 1 and Mode 4, but to no avail, the situation remained more or less unchanged.

The proactive and offensive strategy of India was also evident at the Hong Kong Ministerial in December 2005. It endorsed the plurilateral approach to negotiations alongside the US and the EU without changing the basic structure and modalities under GATS. This approach was undertaken by India to expedite the services discussion by bringing together the critical mass of countries, which are the main demandeurs and recipients of liberalisation requests. India was successful in introducing the explicit mention of the need to address the modes of export interest to developing countries and specific demands in respect of Mode 4 and appropriate flexibility to individual developing countries.

Following the initiation of plurilateral negotiations at the Hong Kong Ministerial, India received plurilateral requests in 14 sectors, which include all the major services and cross-cutting issues and involved major developed countries. India played a pivotal role in sponsoring plurilateral requests in Modes 1 and 2, Mode 4, and architecture and integrated engineering services. However, with the suspension of the Doha Round of negotiations, deadline for submitting a second round of revised offers has not been met. Given this background, it is difficult to foresee the shape of the final consolidated schedule of commitments by India as well as its main market of interests. Therefore, much will depend on what happens at the Doha Round.

## **2.4. Major Service Sectors and India's Position under GATS**

India has shown rapid growth in the service sector many of which are likely to be liberalised, given the pressure from other members in WTO. This section discusses three services, namely, education, legal and accountancy, keeping in view the demand and increased pressures on India to liberalise these sectors under GATS.

### ***2.4.1 Legal Services***

The issue of liberalising the legal services is not new. This debate began in 1999 when the Law Commission and the Bar Council of India prepared a review paper suggesting a series of radical measures, which include amendments in the Advocates Act so as to allow legal consultancy regime for foreign law firms in India. There is continuing apprehension that with the WTO commitments coming into force at a future date, the Government of India will be under obligation to liberalise legal services, thereby allowing foreign law firms to practise in India.

Further, under the WTO, with a view to achieve progressively higher levels of liberalisation, the member countries are expected to enter into successive rounds of negotiations or broaden the range of sectors for investment. Interestingly for India, legal service is one sector where the government is under tremendous pressure from developed countries to do away with most restrictions regarding the entry of foreign law firms in the country. Besides this, the burgeoning business sector dominated mainly by multinational corporations has made the country more vulnerable to the foreign legal establishment in India. Domestic interest groups including small and medium law firms, individual litigating lawyers and institutions like the Bar Council of India, have certainly considered the impact of such a move.

There are many questions, which come to mind suggesting whether India should open up its legal services. Will the available domestic legal regime protect the interest of Indian law firms? However, till date India has not included legal services under its GATS commitments schedule. Hence, the domestic regulation and restrictions in respect of legal services still remain. However, it is likely that these services may be liberalised in the near future and therefore, it is necessary to look into various aspects of these service sector.

#### **2.4.1.1. Indian Legal Services Market**

In order to make a positive assertion on whether India should liberalise the legal sector, it is necessary to understand the sector. India has the world's second largest legal

profession with more than 6,00,000 lawyers. According to available data, the Indian commercial law practice is approximately in the order of Rs 600-650 crore per annum.<sup>6</sup> The service providers are individual lawyers, small or family-based firms. However, any assessment of the legal services market in India must essentially start with a caution that statistical data on the size, composition or growth rate of the sector is non-existent. However, it is widely accepted that the legal service sector, especially corporate legal services, has grown by leaps and bounds in the last decade. Activities in the legal sector increased manifold due to increased action in project finance, intellectual property rights, competition law, corporate taxation, investment laws and infrastructure contracts.

This development occurred even before GATS came into existence and the legal market boom is indisputably attributable to liberalisation of the economy and relaxation of FDI. The domestic legal firms have shown their competency and today it is one of the burgeoning sectors in India, indicating that there is no dearth of quality domestic legal firms and the local firms are striving for dominance in the backdrop of entry of foreign legal firms. The primary reasons for overseas legal firms targeting the Indian legal sector are as follows:

- i) Liberalisation of the economy and increasing presence of multinational companies provides enhanced demand for expertise in legal matters such as corporate transactions, mergers and acquisitions;
- ii) Secondly, the availability of well-qualified English-speaking professionals at much lower rates compared to other markets. This includes the confidence of Indian legal professionals and their proven work in international arena and matters related thereto.

#### 2.4.1.2. Presence of Foreign Law Firms in India

Although India has not opened the legal sector for foreign firms, there are international firms, which have subtle presence either through their liaison offices or other informal means.

Ashurst, a well-known European legal firm, boasts of being the first legal firm with its liaison office in India since 1994. Further, their website provides that Ashurst has developed good contacts and relationships with the legal, accountancy, banking, finance and business communities and governmental and regulatory agencies in India. Accordingly, the New Delhi liaison office is able to provide their other offices with an extensive range of valuable information and knowledge on the Indian scene.<sup>7</sup> However, it is unclear whether this New Delhi office is only involved in disseminating information or is also involved in legal advisory work.

A large number of foreign legal firms have made their presence in the Indian legal market by undertaking advisory work on several projects. For instance, Linklaters is involved in advising the complex deals of Vodafone, its acquisition of Hutchison Essar, India's largest inward investment; the arrangers of facilities to part fund Tata Steel's public bid for Corus plc: India's largest outward investment; etc. On the other hand, some operate from their regional offices in Singapore, Hong Kong and Dubai and are involved in advisory services on commercial and financial transactions.

Importantly, legal outsourcing to India has now become an irreversible process with increasing number of lawyers being hired by the legal practise outsourcing firms. The demand for offshoring legal services is driven by many factors such as historical advantage as Indian law draws heavily from the British common law system, lower labour costs etc. Further, the time difference between countries saves time for legal firms in the US, Canada, UK etc.

#### 2.4.1.3. Domestic Restrictions on Indian lawyers/firms:

The Advocates Act, 1961 and the Bar Council of India Rules 1975 regulate the legal services sector in India and the Bar Council, constituted under Advocates Act, is the final regulating body. The rules aforementioned provide the following necessary conditions to practice law in India:

- Legal services can be provided only by natural persons<sup>8</sup> who are citizens of India<sup>9</sup> S/he should be at least twenty-one years of age
- S/he has to hold a degree in law from an institution/university recognised by the Bar Council of India (BCI)<sup>10</sup>
- S/he should be on the rolls of the advocates in the states where the service is being provided
- The service provider can either be a sole proprietorship or a partnership firm consisting of persons<sup>11</sup>
- In order to be eligible for enrolment as an advocate, a candidate has to be citizen of the country or a country which allows Indian nationals to practice as per the reciprocity treatment
- Indian law firms can employ foreign lawyers (only natural person) as employees or consultants only. However, these foreign lawyers cannot be appointed as partner to law firms and cannot sign any legal document or argue in the court of law.<sup>12</sup>

In addition to the above mentioned conditions, development of legal profession in India has been restricted on account of the number of impediments in the current regulatory system, which hinders Indian law firms from competing effectively against foreign firms. Some of the current restrictions, which severely limit the scope of growth in the legal profession, are:

- Partnerships are the only permitted model of practice for law firms in India
- Further modes of practice such as limited liability partnerships or limited liability corporation are not permitted
- Limitation on the number of partners is 20. This limits the growth and size of Indian law firms. Although the Partnership Act which defines and regulates partnership business in India does not provide restrictions on the number of partners., The Companies Act, 1956, provides that a partnership in India with more than 20 persons can be formed as a company.
- Bar on advertising even having entries in law directories
- Practice of law is treated as a profession and not an industry resulting in lack of finance for lawyers
- Multidisciplinary practicing firms are not allowed.

Having functioned in such a limiting framework for the past 50 years, the Indian legal profession today cannot operate on a level playing field with international lawyers,

who have grown in their practices in liberalised regimes and have vast resources at their disposal. It is further to be noted that there are only a few firms in India that have the expertise to handle commercial work for multinationals.

#### 2.4.1.4. Regulatory structure and relevant trade liberalisation under GATS

Under the GATS framework, legal service is categorised as ‘accredited’ professional services. Several requirements of lawyers and legal profession need to be considered in terms of market access and national treatment.

Typical market access limitation in terms of legal services includes restrictions on movement of professional, managerial and technical personnel and restrictions in the form of incorporation. Although lawyers engaged in advisory services are less likely to be subject to nationality requirements, general nationality requirement may still pose an obstacle. Limitations in the form of incorporation are still common.

On the National Treatment clause in reference to the legal services, there are many constraints, namely, nationality and residency requirements, restrictions on partnership with local professionals; restrictions on the hiring of local professionals; restrictions on the use of international and foreign firm names and general discrimination in the licensing process. Nationality requirements in this sector are often based on the notion that lawyers provide a “public function” requirement to partner with or hire locally licensed professionals, prevent law firms acting as foreign legal consultants from expanding into the fields of court representation and host country law.

Qualification requirements often represent a barrier to trade in legal services, especially for the practice of host country law. Legal education differs from country to country especially in India. In some instances, these differences are so significant that regulators require foreign qualified lawyers to re-qualify in order to be able to practice.

#### 2.4.1.5. India’s Interest

For exports of legal services, cross-border trade, i.e., legal process outsourcing (Mode 1) and the temporary movement of natural persons (Mode 4) are the two most important modes of supply. India has not undertaken any commitment in the legal services sector during the Uruguay Round of negotiations. It has neither offered any commitments in legal services in its Initial Offer nor in its Revised Offer submitted at the WTO in the course of the on-going services negotiations under GATS. FDI is not permitted in this sector in India and international law firms are not allowed to establish offices in the country as per the Advocates Act 1961. They are also prohibited from giving any legal advice that could constitute practicing of Indian law. Moreover, Indian law firms are not permitted to enter into profit sharing arrangements with persons other than Indian advocates.

There is a strong sentiment among various members of the profession that permitting foreign law firms even in a limited way would lead to the shrinking of opportunities available to domestic lawyers. The Bar Council of India, the apex body representing the interest of Indian advocates has on various occasions expressed its apprehensions in allowing foreign lawyers/law firms into India. It is important that we look into the

immense trade potential of the Indian legal profession, but without compromising the interests of Indian legal professionals and local law firms. At the same time, it is a reality that the Indian economy is fast integrating into the global economy.

While a number of foreign companies are investing in India, Indian companies are also acquiring foreign companies on a regular basis. This requires capacity building of Indian lawyers and law firms in areas such as international law, third country law, patents law etc. so that they can advise the foreign companies in India and also support Indian companies acquiring assets abroad. Expansion into the international market will not go unimpeded. Indian lawyers will continue to face competitive challenges from existing global players, principally the internationally focused legal practices operating from the US, Canada, UK, France, Germany and Spain.

#### 2.4.1.6 Analysing the Public Interest Argument

Issues of public interest must also be taken into consideration before liberalising the legal services in India. Following are some of the main concerns, which need to be analysed:

##### ***Increase in cost of litigation***

It is a common belief that the cost of litigation would steeply rise with the entry of foreign legal firms thereby making the litigation expenses out of reach for the common man. However, an analysis from wide sources suggests that the interest of foreign legal firms lie in the corporate legal business while civil and criminal matters, except those, which relate to companies, is still based on the client-advocate relationship. It is mostly an agreement between an individual litigation lawyer and the client. The litigation cost in general includes court plus application fee for each application filed during the case. Besides, lawyers also bill appearance charges for each appearance before the court. While the court fee and stamp fee are nominal in most civil and criminal cases, the consultancy and appearance fee varies as per the profile and standing of the lawyer. Therefore, it has no connection whatsoever with the presence or absence of foreign law firms in India. Further, the main competition therefore, would be between Indian corporate law firms, which expanded in last decade and the advocate of foreign legal firms in corporate businesses.

##### ***Quality of legal services will improve***

It is difficult to assert if there will be improvement in the quality of legal service. One thing can be ascertained here is that the sector wise expertise within the legal services will certainly be increased and hence, the presence of foreign law firms may enhance professionalism. However, any comment on the change in procedural aspects of legal practice in India cannot be made at this stage.

##### ***Job security of Indian lawyers***

Again, there is a common notion that arrival of big foreign law firms might cause Indian lawyers to lose their jobs. In fact, most overseas legal firms lack knowledge in domestic legislation and thus can increase the demand of local lawyers. Further, with the inflow of foreign investment across many sectors in the country, these firms require the knowledge and advise of Indian lawyers and therefore, the demand for local Indian lawyers will increase if overseas law firms enter. From the foreign law firm perspective,

it is economical and cost effective to employ local lawyers in their offshore offices. Besides, the strength of Indian lawyers such as common law legacy, command on English and the adversial legal procedures will have larger and wider market options for Indian lawyers.

#### ***Future of Indian legal firms***

The future of Indian legal firms will be in dilemma especially small Indian law firms. Whether the Indian law firms will close is a myth that calls for serious attention by the Government of India.

##### **2.4.1.7. Requests Made to India on Legal services at the WTO**

Many member countries viz US, EC, Australia, Singapore, Japan, China, Switzerland, New Zealand and Brazil have requested India to undertake commitments in legal services. These requests have also been reflected in the process of plurilateral negotiations, which are mostly for FLCs in corporate and international law. There is no such request to practice domestic law in Indian courts. These requests are only for their engagement in a consultative capacity. There are requests for commercial association between foreign and local lawyers and firms on India's terms and conditions.

#### ***2.4.2. Education Services***

The impact of globalisation is evident on education sector as well. This sector has been under increased 'internationalisation', and is not only creating a large pool of wealth but also employs a large number of people. Majority of jobs created in the last few years have been in the higher education sector. While higher education is increasingly important for the knowledge-based economies, globalisation leads to acquisition and enhancement of skills and competence necessary for knowledge-based economies. It further facilitates in the production of new knowledge and hence is vital.

Although education services, as defined under GATS, include education at all levels, yet the main focus is on higher education. It is an established fact that though primary and secondary educations are vital, it dwells on the quality and size of education system that differentiates a dynamic economy from a marginalised one. It is noteworthy that a variety of cross-border activities such as movement of students, teachers and programmes take place in higher education. Since GATS identifies education as part of the service sector, it has gained vital importance among other sectors.

Global trade in the education sector is large and growing in leaps and bounds. An estimate by the Organisation for Economic Cooperation and Development (OECD) shows global trade in education to be more than US\$30bn per annum in 2000. Table 2.3 shows the export and import of education services by select countries. The US is the world's largest exporter of educational services followed by UK. As regards imports, India and China top the list. According to a rough estimate, India has been incurring an annual outgo of more than US\$4bn on education.

<b>Table 2.3: Selected Countries' Export and Import of Education Services (Million \$)</b>			
<b>Country</b>	<b>Exports</b>	<b>Imports</b>	<b>Balance</b>
United States	10,280	2,150	8,130
United Kingdom	3,758	150	3,608
Australia	2,155	356	1,799
Italy	1,170	849	321
Canada	796	602	194
Greece	80	211	-131
Venezuela	60	113	-53
Mexico	29	53	-74
<i>Source: OECD (2002)</i>			

It is estimated that a significant portion of this demand in the developed and developing country are met by cross-border provision, mainly through increased mobility of students across borders. Given the export interest of developed countries, it has been pursuing the liberalisation of education services by arguing that greater trade in this sector will lead to increased economic, social and political benefits.

Under the GATS framework, education has been categorised into five sub-sectors namely, primary, secondary, higher, adult and other services. Primary and secondary are often provided by the governments of the member countries and hence not commercially tradable. This is one of the reasons why sub-sectors are not considered under the purview of GATS, considering the member countries' jurisdiction. Moreover, like other trade in services, education also takes place in four modes (see Table 2.4).

<b>Table 2.4: Modes of supply in Higher Education Services</b>		
<b>Mode of supply</b>	<b>Meaning under Education</b>	<b>Example</b>
Mode 1	Cross-border Delivery: delivery of education services via internet	Distance education, tele-education, education testing services
Mode 2	Consumption Abroad: movement of students from one country to another for higher education	Foreign students in US universities
Mode 3	Commercial Presence: establishment of local branch, campus, franchise by a foreign university in other country	Course offerings by domestic private colleges leading to degrees at foreign universities, twinning arrangements, franchising
Mode 4	Movement of natural persons	Temporary movement of teachers, lecturer and education personnel to provide education services overseas.

Although education service is considered one of the highly traded services, yet data on these services is scarce, as it is extremely difficult to gather earnings of universities and other institution from their operations abroad corresponding to Mode 3. While trade in Mode 4 is often not accounted for in trade statistics, Mode 1 is very often clubbed with miscellaneous business and professional service. Further, Mode 2, i.e. travels of students and scholars to study in foreign institution is one of the most important modes of supply in trade in education services. Thus, Mode 3 and Mode 2 are most important modes of supply.

#### 2.4.2.1. Structure of Higher Education in India

Higher education in India has undergone major change over the past two decades. Several factors are responsible for the transformation, such as increased demand of higher education due to increase in population, growth in aspiration of the layman and improvement in education sector at the school level. The change is also due to demand of skilled personnel, which can again be attributed to the change in the structure of the economy that requires more skilled persons.

The higher education system in India is very large keeping in view the large population. It is the third largest system in the world after China and the US in terms of student number. Moreover, it faces major challenges as these institutions are understaffed, non-viable, ill-equipped and so on.<sup>13</sup> The higher education system consists of around 338 universities<sup>14</sup> (229 universities, 96 deemed universities, 13 institutions of national importance) and 17,625 colleges. Growth of education sector in India has been phenomenal, taking into consideration the figures from 1950-51, wherein there were only 263,000 students in all disciplines in 750 colleges affiliated to 30 universities. In 2005, this number increased to 11 million in 17,000 degree colleges affiliated to 230 universities and non-affiliated university-level institutions.

Furthermore, there are about 10 million students in over 6,500 in vocational institutions. Student enrolment grew at an estimated rate of 7 percent between 1987 and 1993 but has now declined to 5.5 percent compound rate of growth. Today, there are 10.5 million students enrolled in all higher education institutions, with the teaching staff numbering 321,000. In spite of this phenomenal growth, the total enrolment forms only about 11 percent of the relevant age-group (17-23) population.

There are different types of institutions imparting higher education in India. These can be classified as:

- Universities under the Government
- Private Universities
- Deemed Universities (Aided)
- Deemed Universities (Unaided)
- Colleges under Government
- Private Colleges (Aided)
- Private Colleges (Unaided)
- Distance Learning
- Non-University Sector (Polytechnics and Industrial Training Institutes)
- Foreign Institutions

While India is endowed with a large and growing base of skilled professionals (21.4 million graduate workers in 2000), there are conflicting views about the quality of its endowment. According to McKinsey (2005), only 25 percent of Indian engineers, 15 percent of its finance and accounting professionals and 10 percent of Indian professionals with general degrees are suitable to work for multinational companies. The fact that many Indian professionals do not possess the global skill and quality is also evident from the fact that despite a large pool of middle managers available at home, some Indian firms are beginning to recruit them from abroad.<sup>15</sup>

Although India has a vibrant higher education system, which is marked by its largeness, yet it needs to address the following loopholes:

- Highly bureaucratised system of multiple controls and regulations exercised by central and state statutory bodies such as UGC, AICTE, university administration and local management
- Higher education sector is unable to attract and retain qualified and trained teaching staff due to its poor compensatory packages and inadequate salary structure. Further, the recruitment process for this teaching staff is too cumbersome. This results in the students, who could be potential teachers, leaving for abroad or joining some other sector.
- Another important challenge is that of poor infrastructural facilities. It ranges from poor to dismal in India. For example, the classrooms are unattractive while laboratories are poorly stocked.
- Importantly, the course structure in the universities has been outdated for years. This is one area where the other institutes of the world have gone ahead and Indian university curriculum has seriously lagged behind.

**India's import interests** in education services are as follows<sup>16</sup>:

- i) Mode 2: Indian students studying in foreign universities (US, UK, Australia)
  - Over 40,000 studying in US courses (This is more like 75,000 added per year)
  - Several thousand in Europe
- ii) Mode 3: Foreign institutions entering India through twinning and franchise arrangements
  - Indian students getting foreign degrees, doing professional courses at local branch campuses of foreign institutions in India
    - UK-based Wigan and Leigh College
    - Indian School of Business tie-up with Kellogg, Wharton, and London Business School
    - Western International University, Arizona
    - NIIT tie-up with ITT Educational Services, US
  - Tata Infotech tie-up with Hertfordshire University, UK
- iii) Mode1: Prospects for distance education and degrees from foreign academic institutions
- iv) Mode 4: Foreign faculty and scholars teaching in India.

**India's export interests** in education services are as follows:

- i) Mode 1: Prospects for tele-education in management and executive training
  - Experience with distance learning, use of new technologies (IGNOU)
  - Education process outsourcing with remote tutoring from India (along the lines of efforts by Career Launcher, Educomp Datamatics etc.)
- ii) Mode 2: Students from developing countries studying in Indian engineering and medical colleges
  - Around 5,500 students from neighbouring developing countries (2001)
  - Exchange programmes and twinning arrangements
- iii) Mode 3: Setting up of overseas campuses, franchising by Indian institutions
  - MAHE, BITS, Central Institute of English and Foreign Languages
  - Over 100 CBSE schools abroad, catering to diaspora
- iv) Mode 4: Indian teachers, lecturers teaching abroad in Middle East, Africa, researchers/scholars on visiting arrangements abroad
  - Some 10,000 secondary school teachers overseas
  - Recruitment of Indian teachers in Maths, Science, English
  - Potential as a regional hub for exporting higher education services

Lastly, trade in higher education is already taking place through the movement of students, teachers, programmes and even institutions. Global trade in higher education is large; it is estimated at more than US\$30bn per annum. The major exporters of education are the US, UK, Canada, New Zealand and Australia whereas, the major importers are China, India, the Philippines and Indonesia.

#### 2.4.2.2. Regulation of Higher Education in India

The impact of opening up of higher education services is shaped not by the WTO but by domestic factors, including domestic regulatory framework and state of the domestic education system in terms of quantity, quality, costs, infrastructure and finances. In this context, evidence suggests that some of the concerns about opening up education services may not be so misplaced.

The Constitution of India is the document, which guides the education sector amongst all other sectors. Education in general is the concurrent responsibility of the Union and States. However, coordination and determination of standards in higher and technical education, and institutions declared by the Parliament to be institutions of national importance are the responsibility of the Union. Two major legislations, which govern the higher education system in India are:

- The University Grants Commission Act, 1956
- The All India Council of Technical Education Act, 1987

Furthermore, the following two institutions have been established on national level for setting up norms and standards in the field of higher and technical education

- For universities and colleges, University Grants Commission (UGC) and National Assessment and Accreditation Council (NAAC) are the statutory body
- For technical and management education, All India Council for Technical Education (AICTE) and National Board of Accreditation (NAB)

It is worth noting here that all centrally funded institution have a unique reservation policy for students belonging to disadvantaged groups as follows:<sup>17</sup> Schedule Caste (SC), 15 percent, Schedule Tribes (ST), 7.5 percent, Disabled, 3 percent. Moreover, universities in India are established either through state legislation or the acquisition of a ‘Deemed University’ status through UGC. While a number of universities have Deemed University status; institutions offering traditional undergraduate degrees do not have this option open to them. The Supreme Court judgment in the Chhattisgarh case, decreed that each university should not only conform to the UGC norms but also be created through legislation. This makes setting up of universities not only a long and tedious process, but also an expensive one. In a similar way, AICTE used to collect a deposit per course of up to Rs. 50 lakh, which was held in a joint account for 10 years. However, such measures increase the cost of setting up institutions.

There have been some court decisions in India, which could be considered regressive. In a recent decision in the case of the State of Andhra Pradesh vs JB Education Society, the Supreme Court held that consent of the state government is necessary before starting an engineering college and AICTE cannot give such consent on its own. In fact, the judgment has gone out of the way to give quasi-monopoly power when it states that, “the state authorities can alone decide about educational facilities and the needs of the locality. If there are more colleges in a particular area, the state would not be justified in granting permission to one more college in that locality.” With this, the Supreme Court has done away with the concept of educational centres.

Many areas like Boston in the US have grown as educational centres and provide many common facilities and an academic environment conducive to higher education. Agglomeration of education institutions has been well accepted worldwide and Haryana has declared setting up of an ‘Education City’. All this will go against the spirit of the Supreme Court judgment. Karnataka, Andhra and Tamil Nadu in India are examples in this context where many private colleges have found a base in a region and are doing well.

Regulation, therefore, needs to be well structured and thoroughly researched to take full account of relevance, requirements, practical constraints and market realities. The objective of encouraging growth of educational institutions rather than restricting them should not be lost sight of. The Supreme Court has once again been restrictive in its judgment in the case of Tamil Nadu vs Adhiyaman Educational & Research Institute where it has further defused the powers of the UGC. With this judgment, it has favoured the harmonisation of education to remove disparities of standards and future occurrence of such disparities. With this judgment, the concept of distinct quality of each institution gets a blow and should not be accepted. Education is no longer a uniform harmonised affair. Higher education offers a wide variety of subjects and with continuing education it needs to be ‘demand driven’. In this context, while we need to reduce regulation at the entry point, we do not need to bring in the concept of accreditation.

#### 2.4.2.3. India’s Negotiating Position in the Education Sector

India did not schedule education services either in the Uruguay Round or in its revised commitments under the ongoing Doha Round. Although India in its revised offer

included higher education, many sections such as civil societies have opposed such a move. However, India has no multilateral obligation under the WTO to open up higher education services to foreign participation. Whatever liberalisation has occurred in this area, such as allowing 100 percent FDI on automatic route and permitting foreign participation through twinning, collaboration, franchising and subsidiaries, has been autonomously driven. Of course, it's likely that in future GATS negotiations, India will come under increasing pressure from certain countries to multilaterally bind the liberalisation undertaken thus far in this sector. But it's unlikely that India will acquiesce to such demands.

India has received requests for opening up of education services from several countries (Australia, Brazil, Japan, New Zealand, Norway, Singapore and the US), at the new GATS round of service trade negotiations in January 2000, which mostly focussed on higher education, adult education, and other education services. The US also specified training services and educational testing services and Brazil has requested primary and secondary education services, while there were no requests from the European community. All requests to India are for full market access and national treatment commitments in Modes 1, 2 and 3. India has not made any offer in education services in the GATS 2000 round due to its sensitive public good nature.

It is understandable for the US to desire opening up of training and educational testing services, it is interesting to note that Brazil has requested opening up of primary and secondary education services.

#### **2.4.3. Accountancy Services**

Demand for accountancy and audit originates from mandatory legal requirements such as financial reporting and various disclosure norms. In the market-based economy, auditors play a very vital role about informing the performance of a firm and its management. Hence, the credibility of audit and accountancy is considered to be crucial for the proper functioning of the economy, which is why it is treated as 'accredited profession'. Like all other accredited profession, there is restriction for the right to practice and is subject to various accreditations and procedures including licensing and authorisation. In such kind of services, high professional conduct and standards is a prerequisite in order to hold the welfare of its client above its own profit maximisation. Consequently, there are stringent rules and regulation operating in this area of trade in terms of local qualification and licensing requirements for individual practitioners as well as regulation for managing and owing accounting firms.

Furthermore, on a more global outlook, the accounting sector is more oligopolistic with four big firms having virtual monopoly over the sector (Table 2.5). In 2006, the four big firms<sup>18</sup> had a combined annual revenue of US\$76bn, up 9 percent from US\$70bn in 2005. The firms employ more than half –a million combined partners, client service professionals and administrative personnel. This figure climbed to 8 percent from 2005. Assuming a modest 10 percent overall employee turnover in 2005, the firms hired a total of close to 85,000 employees in 2006 or about 400 each business day of the year.

<b>Table 2.5: Annual Revenue and Employee Turnover of top four Accounting Firms</b>		
<b>Firm</b>	<b>Revenues (US\$ Billion)</b>	<b>People</b>
PricewaterhouseCoopers	25.2	146,700
Deloitte Touche Tohmatsu	23.1	150,000
Ernst & Young	18.4	114,000
KPMG	16.9	113,000

*Source: Annual reports of respective companies*

Apart from the big firms, there are several medium and small size firms operating in this sector. Another feature of this profession is that while accounting and auditing services constitute the core activities of accountancy firms, they also offer a range of other services like merger and acquisitions, insolvency services, tax advice and management consulting. Since these firms provide large number of services, the firms have expanded global reach and hence, have become the world's largest supplier of consultancy services. However, like several other sectors, it is difficult to estimate the market size of the accountancy services sector.

#### 2.4.3.1 Accounting Sector in India

In India, the concept of accounting services was first introduced with the enactment of the Companies Act in 1857 and 1866 respectively. Subsequently, after Independence, the Chartered Accountant Act of 1949 led to the formation of the Institute of Chartered Accountant of India (ICAI). While this Act of 1949 today governs the chartered accountancy practices, the Cost and Works Accountancy Act 1959 governs the cost accountancy profession.

<b>Table 2.6: Total Membership in the Institute of Chartered Accountant of India (ICAI)</b>									
FELLOWS				ASSOCIATES					
Region	In Practice			In Practice					
Western	13641	1054	2201	16896	7554	2682	20923	31159	48055
Southern	10772	811	2063	13646	3224	1278	13735	18237	31883
Eastern	5312	280	896	6488	1995	448	5386	7829	14317
Central	7767	342	773	8882	4219	529	4894	9642	18524
Northern	10153	761	1966	12880	4307	1144	8731	14182	27062
<b>TOTAL</b>	<b>47645</b>	<b>3248</b>	<b>7899</b>	<b>58792</b>	<b>21299</b>	<b>6081</b>	<b>53669</b>	<b>81049</b>	<b>13984</b>

*Source: ICAI*

India has an advantage in this sector as it produces huge number of accountants every year who have additional skills of expertise in English language apart from familiarity with international accounting standards (see Table 2.6). This demand for trained accountants has increased manifold due to the boom in mergers and acquisitions, growth in FDI in this sector and various other developments like e-commerce etc.

Further, ICAI plays an important role in the sense that it performs three vital functions

- It grants chartered accountancy qualifications
- It sets out accounting and auditing standards in India
- It acts as a watchdog for the industry in maintaining disciplines and standards among its members.<sup>19</sup>

The Indian accounting standards are developed on the basis of international accounting standards. In the last few years, there have been substantial efforts and progress in aligning the Indian standards with International Financing Reporting Standards (IFRS). This has helped the Indian accountants. With the improved quality of financial reporting and better corporate governance in the country, it is also helping the accountants in India to provide better services of international standards to its prospective clients.

#### 2.4.3.2. Domestic Regulation in the Accountancy Sector in India

There are several regulations imposed on the accountants under the relevant Act of 1949. According to the Act:

- An accountant is prohibited from soliciting customers, paying commission, brokerage or share of profits to anybody other than another accountant
- Accountants in India are not allowed to advertise their products and services
- The number of partners a firm in India can employ under the current scenario is restricted to 20 and the number of clients a firm can service is limited to 30 statutory audits per partner

Given the regulations as aforementioned, there is dearth of big accountancy firms in India and they are not widespread. Hence, it is clear that there is a lack of big players in the accountancy sector although the fragmented nature of this sector has allowed creation of significant amount of jobs at the local level. However, the proxy presence of the big four-accountancy firm is likely to change the structure of domestic accountancy sector in India in terms that they are most preferred in auditing work than the local small firms. This preference to the big four global firms over the local firm tend puts the local chartered accountants and accountancy firms at the lower end of value chain. Furthermore, on grounds of reciprocity, the ICAI does not recognise foreign qualifications. In their report, Anant and Zutshi (1999) state that reciprocity is no longer a basis under GATS, yet the ICAI should take steps to accept the Mutual Recognition Agreements with other countries. However, ICAI opines that its rules are not discriminatory.

#### 2.4.3.3. India's Negotiating Position at the WTO

In the current round of WTO, India has both offensive and defensive interest in the accountancy sector. Initially in the Uruguay round, India did not make any commitments on accounting, however in its revised offer for accountancy services, it offered full commitments in accounting and book keeping services under Mode 1 and Mode 2 but

kept Mode 4 subject to horizontal commitments. Supply in services under Mode 3 has been ‘unbound’.<sup>20</sup>

The revised offer is the result of suggestions made by the Working Group for Suggesting Negotiation Strategy in the Accountancy Sector by the Government of India. The government has accepted almost all the recommendation made by the working group and inserted them in their revised offer. Following are the salient features of the initial offer (Annexure I) made by the working group:<sup>21</sup>

- The group has proposed an initial offer in accounting and book keeping services only i.e., part CPC 862. They are of the view that auditing services be excluded from the initial offers. The group would further analyse the auditing services and give its views for offers to be made at later stages of negotiations depending upon the responses of important trading partners.
- Market Access is contemplated only for Mode 1, 2 and 4. No market access is offered under Mode 3 as of now.
- The Market Access under Mode 4 has been proposed subject to the limitations in the horizontal commitments as well as certain other limitations as indicated in the offer list in the Annexure I. It may be specially noted that market access in Mode 4 is proposed for natural persons only and not for juridical persons or employees or associates of juridical persons.
- The working group also feels that there is need for “Fair Trade Rules” for trade in services also as these are working well for trade in goods. Therefore, it is necessary to bring out provisions/rules similar to anti-dumping, subsidies and countervailing and safeguard measures for the services sector including accountancy.
- The working group also feels the necessity for the adoption of “Special and Differential (S&D) Principles” while negotiating access and national treatment in the services sector. Some of the steps proposed under this principle are in Annexure – II.
- Similarly, the working group also feels that there should be Emergency Safeguard Measures (ESMs) duly incorporating the S&D principles as a part of Fair Trade Rules. The ESMs suggested are in Annexure III.
- The problem of visa is the most significant and must be addressed as an additional commitment to be given by the other countries during the negotiations on offers.
- While our offer under Mode 4 for business visits for pre-contract stages, many countries do not permit in their offer business visits, which are otherwise considered necessary for pre-contract stages. Hence, we need to ensure reciprocity and our offer may be framed accordingly.
- Keeping the requirement insisted by many countries, the group also recommends incorporation of a pre-condition for professional indemnity insurance taken from the country of origin as a limitation under the national treatment limitations.
- Many states in India have different laws and requirements, which restrict the category of persons who can provide services. It is necessary to provide for such contingencies in the initial offer list.
- A stipulation on fulfillment of labour market tests, wherever required under the extent domestic laws has also been included in the limitations.
- The professional qualification, training and other requirements including professional standards have been used as barriers for movement of accounting

services. It is felt that there should be establishment and adoption of minimum international standards and criteria for mutual recognition of qualifications to ensure complete equity and fairness.

Meanwhile, many consider India's revised offer as defensive. This is because the country has received requests from its main trading partners in this service sector and by offering very little, India has weakened its position. However, several academics explain the complex situation by providing two main arguments: firstly, it is possible that such an offer is a negotiating move in the wake of ambiguous offers in respect of significant market access to Indian professionals by developed countries. Second, this is a protectionist measure by India since its accounting firms are not globally competitive. Further, many are of the opinion that opening up of the accountancy sector will help Indian accountants in terms of well paid jobs and enhanced employment opportunities although it can endanger some of the accounting firms as well.

To sum up, it is a complex situation for India. On one hand, there are benefits that India can harness by opening up this sector, while on the other, it can jeopardise some of the accounting and audit firms in the country. The defensive position taken by India is probably due to the lack of clarity in the offers by the developed countries. Since there is ambiguity in the language of the offers made by the developed countries, it is open to interpretation and there is an apprehension that these countries may take advantage of the vagueness in language to impose non-tariff barriers against service providers from other countries. Hence, India's revised offer can be termed as a cautious approach in the accountancy sector. Nonetheless, if we look at the dynamics of different modes of supply in this sector, it is clear that India will have to modulate its strategy in accordance with the modes of supply.

The above discussion makes it abundantly clear that Mode 1 has been playing an important role in accountancy services where as in Mode 4 India has a comparative advantage. Although in Mode 4 India faces variety of problems such as Market Access, National Treatment etc, it can bargain hard on the same by making amendments in the domestic regulation in respect to qualification and licensing requirements, so also act on removing the ENT and labour market tests. Furthermore, in Mode 3 India has vested interest although it is not yet open for this mode of supply.

It is generally argued that the domestic regulations have been mainly responsible for the uncompetitiveness of the accountancy firms in the country, the main reason for India being protective about the same. However, India's labour and cost advantage may, in the long term, provide a strong case for removing domestic regulations and opening up in Mode 3 of the accountancy services. Currently, the Doha Round of trade negotiations is at an impasse and reports indicate that the talks would remain suspended till the US presidential elections in 2009. Such a suspension provides India the time to formulate its strategy in this service sector.

## **2.5. Conclusion**

Securing the gains delivered by the services revolution in India demand domestic preparedness at home. This paper has focused on the domestic preparedness of India

in three sectors— legal, education and accountancy services. It has been stated earlier that these sectors have chosen to keep in view the growing pressure on India to liberalise the mentioned service sectors. However, much is required to be done before it opts to liberalise them. Further, it is extremely important and practical to outline the negotiation strategies.

In case of legal services, there is a need to develop an appropriate strategy. This is important because while there is scope for the Indian law firms to take advantage of the expanding global business, there's also a danger that if the process is not judiciously planned and necessary structural changes not undertaken, the opening of this sector will be converted in a fiasco for the domestic sector. Hence, for India the challenge lies in formulating the right strategy at the right time.

An analysis of India's weakness and strengths in the accountancy sector clearly points out that the dynamics of different modes of supply in this sector are different. Therefore, India may formulate its negotiating strategy accordingly. In case of education, it is observed that the regulatory environment for higher education exists in India. However, on closer look, it is found that regulatory bodies have not been successful in maintaining the standards of higher education, thereby erecting barriers for the entry of private new institutions to open up through the private enterprises route. To harness the potential of this sector, it is advocated that a more market-friendly framework may be created.

Among the services sectors, it appears that though there is significant potential for gains from further trade liberalisation, India has adopted a cautious approach. Besides, there is a need to strengthen the domestic regulation laws and capacity building in some service sectors will be necessary to face the global competition. The impasse in the conclusion of the Doha Round will provide India an opportunity to weigh the pros and cons of liberalising these services as well as provide enough time to formulate the necessary policies at the domestic level.

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- 10 A person must possess a Bachelor's degree in Law from any university within or outside the territory of India, however, it should be recognised by Bar Council of India. Further, for more on this refer Rule 3 of Res. No. 6/1997 of BCI.
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## Chapter 3

# **Nepal's Preparedness for Services Sector Liberalisation**

**Navin Dahal**



### **3.1. Introduction**

As stipulated in the Preamble, Article IV (Increasing Participation of Developing Countries) and Part IV (Progressive Liberalisation) of the General Agreement on Trade in Services (GATS), the Doha Ministerial reaffirms the Guidelines and Procedures for Negotiations (WTO, S/L/93, 29 March 2001) as the basis for negotiations to achieve the objectives of GATS. The Hong Kong Ministerial reaffirms the Doha mandate and the pre-Doha negotiating guidelines. As stated in paragraph 26 of the Ministerial Declaration, the LDCs are not required to undertake any new commitments in the services sector. However, Nepal, on a unilateral basis, brought liberalisation in a number of service sectors. Since it is emerging as one of the most dynamic sectors of the economy and its contribution to trade is increasing, services negotiations are very important for Nepal. Also, it is a growing concern with respect to the domestic preparedness of liberalisation in a number of service sectors

Available data on services trade shows that Nepal has the potential in various sectors particularly tourism-related services and Mode 4 services (Bhatt, 2005; SAWTEE, 2006). Similarly, financial, computer, information, communications and other commercial services are emerging as dynamic sectors globally and in South Asia, as well as in Nepal.

This chapter explores the concerns relating to the liberalisation of some critical service sectors in Nepal. It begins with an overview of the services sector in Nepal and goes on to analyse the domestic preparedness for liberalisation in two services sectors, namely the financial and telecommunication sector.

### **3.2. Importance of the Services Sector in Nepal**

The services sector<sup>1</sup> plays an important role in the Nepalese economy. It appears from Table 3.1 that the share of services sector in GDP has been more than 50 percent during the early 2000s. Among the services sectors, larger contributions are made by finance and real estate, and construction.

The services sector has also featured prominently in Nepal's external trade accounting for 38 percent of exports and 17 percent of imports in 2004 (see Table 3.2). However, during 1990s, there have been significant variations in these shares. Also, in the case of share of services exports and imports in GDP, large variations are observed during the same period.

In FY 1990, services (tourism, remittances and interest earnings) contributed to about 17 percent of the total foreign exchange earnings, which doubled in a decade and reached nearly 35 percent in FY 2004. Within services, travel and tourism constitutes the most important source of foreign exchange earnings, local employment, and private remittances (the earnings of workers employed abroad) are other major sources of income (Bhatt, 2005). The services sector is also important from employment perspective with the share of the services sector in total employment averaging 17.12 percent during 1990-95 (WDI 2007).

<b>Table 3.1: Contribution to GDP by Sectors (in percent)</b>					
<b>Description</b>	<b>1999/00</b>	<b>2000/01</b>	<b>2001/02</b>	<b>2002/03</b>	<b>2003/04</b>
AGRICULTURE, FISHERIES & FORESTRY	39.63	38.38	39.48	39.11	38.67
MINING & QUARRYING	0.50	0.49	0.51	0.50	0.50
MANUFACTURING	9.16	9.02	8.09	7.85	7.73
SERVICES	50.72	52.11	51.93	52.56	53.08
• Electricity, Gas, Water	1.62	1.78	2.04	2.49	2.39
• Construction	10.21	10.06	10.43	10.30	10.40
• Trade, Restaurant & Hotel	11.71	11.33	10.05	10.06	10.32
• Transport, Communication & Storage	8.01	8.46	8.54	8.75	9.21
• Finance & Real Estate	10.08	10.58	10.82	10.91	10.84
• Community & Social Service	9.09	9.91	10.05	10.05	9.91

*Source: Nepal's WTO Service Sector Commitments and its Impact on Balance of Payments Situation, Nepal Rastra Bank (2005)*

Nepal's comparative advantage and services trade potential can be identified in detail by using the method of revealed comparative advantage (RCA). The RCA calculations for Nepal and a few other countries are presented in Table 3.3. These calculations imply that in South Asia, Nepal has the most significant comparative advantage in commercial services, along with India.

The travel industry accounted for 65.9 percent of Nepal's total service exports in 2003. Table 3.4 reveals that the RCA in travel-related activities increased from 1.8 in 1990 to 2.1 in 2003. However, travel covers both goods and services acquired from an economy by travellers in that economy for their own use during visits of less than one year for business or personal purposes. So it is necessary to disaggregate travel category's total export in services and goods and then calculate the share of different categories of services that foreigners consume in Nepal (these include hotel and restaurant, travel agencies, recreational, pilgrimage, trekking, cultural, and sporting services).

Computer, information, communications and other commercial services are emerging as dynamic sectors globally, and particularly in South Asia. Though the current level of export in ICT services is not very remarkable, there are tremendous opportunities for outsourcing in geographically isolated landlocked countries like Nepal. Especially when majority of the educated people have working knowledge of English. Moreover, many ICT services are highly labour intensive like; web design, data entry, coding, computer programming (Ancel, 2001), therefore, can significantly contribute to the promotion of human development in labour abundant countries.

Table 3.2: Services Share in Trade						
Year	Services export (% of total exports)	Services imports (% of total imports)	Trade (% of GDP)	Services exports (% of GDP)	Services imports (% of GDP)	Trade in Services (% of GDP)
1990	48	20	32	6	5	10
1991	47	20	35	6	5	11
1992	42	23	42	8	7	15
1993	46	23	47	9	7	16
1994	61	20	50	14	7	22
1995	66	19	59	15	7	23
1996	66	14	58	17	5	22
1997	68	12	64	18	5	22
1998	54	14	57	12	4	16
1999	52	12	53	13	4	17
2000	39	11	56	9	4	13
2001	36	13	54	7	4	11
2002	33	14	48	6	4	10
2003	35	14	46	6	5	11
2004	38	17	48	7	6	12

Source: *World Development Indicators Online, 2007*

\*The values above have been rounded to whole numbers.

Table 3.3: Revealed Comparative Advantage (RCA) in Commercial Services	
Region/Economy	RCA, 2003
Bangladesh	0.2
Pakistan	0.5
Sri Lanka	1.1
India	1.6
Nepal	1.6
South Asia	1.4
Low and Middle Income Countries	0.7
High Income Countries	1.0

Source: *Bhatt (2005)*

**Table 3.4: Sector-wise Revealed Comparative Advantage**

Region/ Economy	Transport		Travel		Insurance & Financial		Computer Information and other Communication Services	
	1990	2003	1990	2003	1990	2003	1990	2003
Bangladesh	0.5	0.8	0.2	0.4	0.01	0.9	2.5	1.5
India	0.7	0.4	1.0	0.4	0.4	0.1	1.3	1.9
Nepal	-	0.5	1.8	2.1	-	0.02	0.9	0.5
Pakistan	2.1	2.5	0.4	0.2	0.2	0.2	0.8	0.8
Sri Lanka	1.4	1.8	0.9	1.0	0.6	0.4	0.8	0.6
South Asia	1.0	1.2	0.9	0.4	0.3	0.1	1.2	1.7
Low and Middle Income Countries	1.0	1.0	1.2	1.5	0.4	0.2	0.8	0 . 6
High Income Countries	1.0	0.9	1.0	0.8	1.07	1.1	1.0	1 . 0

*Source: Bhatt (2005)*

### **3.3. Nepal's Preparedness for Liberalisation of the Financial Services Sector**

Nepal became the 147<sup>th</sup> member of the WTO on April 23, 2003. Under the WTO, Nepal has committed to liberalise 11 of the possible 12 services sectors, financial services sector (FSS) being one of them. The General Agreement on Trade in Services (GATS) defines financial services as 'any service of a financial nature offered by a financial service supplier of a Member'. FSS under GATS covers two major sub-sectors: Insurance and insurance-related services: which includes:

- direct insurance (including co-insurance); both life and non-life;
- reinsurance and retrocession;
- insurance intermediation, such as brokerage and agency; and
- services auxiliary to insurance, such as consultancy, actuarial, risk assessment, and claim settlement services.
- Banking and other financial services (excluding insurance): which includes deposit taking; lending; payment and monetary transmission; guarantees and commitments; financial trading (money market instruments, foreign exchange, derivative products, swaps, forward rate agreements, transferable securities, and other negotiable instruments; money brokering; asset management; settlement and clearing services; provision of financial information and advisory services.

Proponents of liberalisation claim that liberalisation in the FSS will lead to higher competition and thus more efficiency in the system. FSS liberalisation is said to improve financial intermediation and investment opportunities through better resource allocation across sectors, countries and time and through better means of managing risks and

absorbing shocks. In addition, opening up of the market induces governments to improve macroeconomic management, domestic policy interventions in credit markets, and financial sector regulation and supervision (WTO 1997).

However, it should be recognised that FSS liberalisation also poses new risks. It can exacerbate pre-existing financial sector difficulties. There is a strong link between macroeconomic management, financial regulation and supervision, and the trade regime. Many developing countries have experienced banking sector problems after deregulation and liberalisation in the last 15 years. It is believed that the key cause of failure of financial sector liberalisation is unsound macroeconomic policies, inadequate government regulation and supervision, and inappropriate intervention in financial markets (WTO). Thus, it is important that liberalisation of the FSS is supported by sound macroeconomic policies and above all prudential government controls.

Under the GATS, members are allowed to take prudential measures to protect investors and ensure the integrity and stability of the financial system. Paragraph 2a of the Annex on Financial Services states that:

Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policyholders or persons to whom a fiduciary duty is owned by a financial service supplier, or to ensure the integrity and stability of the financial system.

In addition, the governments may also maintain other regulations, which are not prudential in nature, but which nevertheless can affect the conditions of operation and competition in the market such as requirements to lend to certain sectors or individuals.

In this context, this chapter will first review Nepal's commitments under the WTO in the financial services sector. It will then give a brief overview of the financial services sector and it will analyse Nepal's preparedness for liberalisation of the FSS by reviewing the existing regulatory framework and evaluating the regulators capacity in the sectors.

### ***3.3.1. Nepal's WTO Commitments in FSS***

Historically, the services sector in Nepal has been highly protected, not only against foreign investment but also in terms of participation of the private sector. However, in line with the liberal economic policies adopted after the restoration of multiparty democracy in 1991, the services sector has also witnessed gradual opening up in the last two decades. In addition to the unilateral liberalisation measures, Nepal has also made commitments at the WTO in many services sectors in all modes<sup>2</sup> of supply.

#### **3.3.1.1 Horizontal Commitments**

Nepal has extended market access in Mode 2 with a restriction of providing only US\$ 2000 to Nepalese citizens while going abroad. It has also committed that supply of services by an existing foreign supplier will not be made more restrictive than they were at the time of Nepal's accession to the WTO.

With respect to commercial presence (Mode 3), no limitation on national treatment has been placed on foreign investments and reinvestments except that both these require

the approval of the Department of Industry (DoI) and incentives and subsidies, if any, will be available to wholly-owned Nepalese enterprises only. The maximum foreign equity is also limited in most services and firms wanting to sell their services have to be incorporated.

However, the commitment of Nepal in Mode 4 (movement of natural person) is restrictive except in the categories of services sales persons, persons responsible for setting up a commercial presence, and intra-corporate transferees, that too, for a limited time and not exceeding 15 percent of local employees. In the case of *service sales person*, the entry is limited to a 90 day period, which may be renewed. In the case of *persons responsible for setting up a commercial presence*, the entry is limited to one year, which may be renewed. And finally, in the case of *intra-corporate transferees of* executives and managers and specialists, the entry is limited to a three years initial period extendable up to seven years for a total period not to exceed 10 years; limited to 15 percent of local employees. This commitment shall further liberalise after five years from the date of accession.

Also, there have been a number of additional commitments made by Nepal, which include:

- Except where an environmental impact assessment is required, decisions of the department are normally provided within 30 days of the date of application
- Approval of an investment will not normally be withheld except for failure to meet environmental standards
- A foreign investor making an investment in foreign currency shall be entitled to repatriate the following amount outside Nepal:
  - i) The amount received by the sale, in whole or part, of the investor's share of equity;
  - ii) The amount received as profit or dividend as a result of an equity investment;
  - iii) The amount received as the payment of the principal of and interest on any foreign loan; and
  - iv) The amount received under an agreement to transfer technology approved by the DoI or the Department of Cottage and Small Industries.

Nepal has also committed to liberalise the financial services in the form of operations identified below. Branches will be allowed for insurance services and wholesale banking as of January 1, 2010. Only a licensed commercial bank, a licensed specialised bank or a registered finance company may accept deposits. And only a licensed commercial bank may accept deposits, which are repayable upon demand. Besides, only financial institutions with the rating of at least 'B' by credit rating agencies like MOODI, Standard & Poor can have commercial presence in Nepal.

The total foreign shareholding in any institution providing financial services is limited to 67 percent of the issues share capital. It has, nevertheless, been bound for the existing foreign service providers as to their scope of operation and equity structure. The shares held by foreign nationals and foreign financial institutions in their locally incorporated companies are not transferable without the prior written approval of the NRB or any other competent authority as the case may be. Representative offices may not be engaged in commercial business. The member of the board of directors of a

financial service supplier will be in proportion to equity representation of the financial service supplier.

### **3.3.1.2. Sector-Specific Commitments**

#### ***Insurance and insurance-related services***

Besides the horizontal commitments, Nepal has also made sector-specific commitments in the insurance and banking services sectors. In terms of market access, there are no restrictions in Mode 1, 2 and 3 except for reinsurance and retrocession. In the reinsurance and retrocession category, Mode 1 and 2 requires mandatory re-insurance up to US\$25,000 with a domestic insurance company until December 31, 2007; while Mode 3 was unbound until December 31, 2007, after which there are no restrictions on market access. Market access in Mode 4 is unbound in all the categories. In terms of limitations on national treatments, there are no restrictions on Mode 1, 2 and 3 while Mode 4 is left unbound.

#### ***Banking and other financial services***

Sector-specific commitments in banking and other financial services suggest that in terms of limitations on market access, Modes 1 and 2 are unbound except for “provision and transfer of financial information and financial data processing and related software by suppliers of other financial services and advisory services on all the activities listed above”. In Mode 3 of supply, there is no limitation except those as indicated in the general conditions in Table 4. However, this excludes those “for derivative products under sub-sector ‘f’ and settlement of and clearing services for financial assets, including securities, derivative products, and other negotiable instruments under ‘j’ unbound until the Government of Nepal determines what type of entities can conduct these services, the related laws and regulations are established and such business is authorised by the government or other designated authority”. Furthermore, Mode 4 of supply is unbound. Similarly, in the case of limitations on national treatment, Nepal has not committed to Modes 1, 2 and 3 of supply while Mode 4 is unbound.

### ***3.3.2. Liberalisation in Insurance and Insurance-Related Services***

#### **3.3.2.1. Overview of the insurance services sector in Nepal**

A well-developed insurance sector helps enhance overall efficiency of the financial system by reducing transaction costs, creating liquidity and facilitating economies of scale in investment (IAIS). Insurance companies shift the risk and collect small-scattered capitals and invest in development activities.

Until recently, the government dominated the insurance business in Nepal. After the enactment of the Insurance Rules 1968, only two new insurance companies came into existence during the period of more than two decades, one in 1974, and another in 1987, with foreign equity of 10 percent. The insurance sector grew at a very slow pace before the initiation of the reform programmes due to inward looking and restrictive policies. With de-regulation in the form of the Insurance Act 1992 that encouraged the private sector and foreign capital, private as well as joint venture insurance companies have entered the insurance market. Today, private sector dominates the insurance market.

Out of the 21 insurance companies in the country, 14 are private companies, three are branches of foreign insurance companies, three are joint venture companies and one is predominantly government owned. Within insurance and insurance-related services, Nepal has covered areas such as: life, accident and health insurance services, non-life insurance services, reinsurance and retrocession, services auxiliary to insurance including broking and agency services (see Table 3.5).

Ownership	Nature of the Company			Total
	General	Life	Composite	
Government owned	-	-	1	1
Private sector	12	1	-	13
Foreign	2	1	-	3
Joint venture	2	2	-	4
Total	16	4	1	21

Source: Beema Samiti, [www.bsib.org.np](http://www.bsib.org.np)

The total paid up capital of insurance companies, excluding the paid up capital of branches of foreign insurance companies stood at Rs 1.2 billion in 2005. Of this, the share of domestic insurance companies was 87.1 percent. The rest was with joint venture companies.

Insurance penetration ratio (insurance premium as a ratio of gross domestic product) in Nepal is below 2 percent in 2004/05. This is extremely low compared to other developing and developed countries. In 2003, insurance penetration in India, China, South Korea, Japan, UK and USA was 3.3, 9.6, 10.8, 13.4 and 9.6 percent respectively, while that of Nepal was 1.53 percent only (Bhattarai, 2006).

### 3.3.2.2. Nepal's preparedness for insurance service liberalisation

Since there are already three foreign companies with 100 percent equity and four joint venture companies operating in Nepal, liberalisation under the WTO does not expose Nepal to a completely new scenario.

However, the need for a sound regulatory and supervisory system is still necessary to maintain an efficient, safe, fair and stable insurance market and promote growth and competition in the sector (IAIS). Insurance markers have developed and continue to develop at a much faster pace than the process of insurance supervision. Insurance supervision, while fulfilling the traditional role of protecting the policyholders, beneficiaries and third party interest, should also help to strengthen the national insurance market and promote fair competition. Insurance supervision should also make sure insurance companies remain solvent and policy holders are treated fairly (Bhattarai, 2006).

It is essential that the supervisory authority operate in a transparent and accountable manner. In addition to legal authority, the supervisory authority also needs to practice its authority and set requirements and controls in the sector. It requires the capacity and resources to ensure regulations are being implemented (Bhattarai, 2006).

The International Association of Insurance Supervisors (IAIS) has developed various principles and standards to regulate the insurance sector that include, the Insurance Core Principles, capital adequacy and solvency standards, reinsurance, disclosure and cross-border business transaction. Similarly, the OECD Insurance Committee also develops principles and standards related to the insurance market liberalisation such as the Framework for Insurance Market Liberalisation and the Twenty Insurance Guidelines for Emerging Economies that stresses the need for prudential regulation with liberalisation. These international standards and controls can be a good framework to devise regulations in the insurance sector in Nepal.

#### ***The Structure and Organisation of the Beema Samiti***

Prior to the enactment of the Insurance Act in 1968, the Act of Commerce regulated the insurance sector. However, the Act did not provide any space for government supervision in the sector. Five foreign (Indian) companies maintained regional offices in Nepal, while Nepal Insurance and Transport Company limited its business to that of a commercial bank. In 1968, with the enactment of the Insurance Act, *Rastriya Beema Sansthan* (National Insurance Corporation) was established as a government-owned insurance company. *Beema Samiti* (Insurance Board) was also established in 1968 as the regulatory authority in the sector (Bhattarai, 2006).

The Insurance Act of 1992 further established *Beema Samiti* as an autonomous body with full power. It is the governing body for the execution of the Insurance Act. The Act regulates the licensing of insurance companies, insurance agents and surveyors, which apply both to the nationals and foreigners. The purpose of the *Samiti* is to ‘systematise, regularise, develop and regulated the insurance business.’

Regulation and supervision in the insurance sector is aimed at developing a set of rules that will strike an appropriate balance between the public policy objective of ensuring strong insurance institutions and public protection, and encouraging competitiveness, entrepreneurship and efficiency (Pradhan, 2006).

The *Beema Samiti* is governed by five board of directors comprising the following individuals:

- A person nominated or designated by the Nepal government (chairman)
- Representative, Ministry of Law, Justice and Parliamentary Affairs
- Representative, Ministry of Finance
- A person nominated by the Nepal government from among persons having special knowledge in the insurance business (service provider)
- A person nominated by the Nepal government from among the insured (customer)

The following functions, duties and powers are conferred on the *Beema Samiti*:

- Provide suggestions to the Nepal government to formulate necessary policy to systematise, regulate and develop the insurance business

- Set out guidelines for insurers to invest their fund and prescribe priority sectors for such investment
- Register and renew the insurer, insurance agent, surveyor or broker and to cancel or cause to cancel such registration
- Arbitrate in disputes that arise between the insurer and the insured
- Make decisions on complaints filed by the insurer regarding the settlement of liability of the insurance
- Issue necessary directives to the insurer from time to time regarding the insurance business
- Formulate necessary basis to protect the interests of the insured, and
- Do or cause to do other necessary functions regarding the insurance business.

#### ***Regulations and Prudential Controls***

The Insurance Act 1992 and Insurance Regulations 1993 are the major regulations in the insurance sector. Some important regulations and controls under the act and regulation include:

- The regulations guarantee equal treatment to the national as well as foreign insurance companies. The Act does not restrict the pattern of ownership, location of business inside the country and the legal forms (e.g. subsidiaries vs. branches vs. joint venture).
- A license from the *Beema Samiti* is required to engage in the insurance business in Nepal.
- It's mandatory for all insurance companies to offer at least 20 percent of their shares to the general public through public issuance.
- A single company cannot indulge in both life and non-life insurance.
- There are requirements on paid up capital for service providers.
- The application for insurance license requires documents such as: memorandum and articles of association, policies and terms of conditions of the insurance business, documents displaying calculations of premium in case of life insurance, documents regarding the methods of utilising the fund etc.
- The *Beema Samiti* has the authority to cancel the registration of an insurance company if the rules and regulations are not followed.
- The total liability to be assumed should not be in excess of total assets. Foreign corporate bodies have to show evidence of adequate assets inside Nepal to bear the total liability of the insurance business.
- The government recently enacted the Insolvency Act 2006 will allow companies to declare themselves as bankrupt in case of grave financial crisis. The insolvency ordinance provides a way out when the total liabilities of an individual or enterprise exceed the total assets so that the limits of the creditors cannot be met. It discharges the debtor from burdensome debts and allows him to make a fresh start. It also provides for the speedy, efficient and equitable distribution of the debtor's non-exempt property to the creditors (Singh 2006). In the case of insurance companies, prior approval from the *Beema Samiti* is required before initiating the insolvency procedure.
- The insurer has to maintain separate insurance fund for each category of insurance business and should not utilise it to beat the liabilities relating to other categories of insurance business.

- Every insurer should maintain a reserve fund which must contain:
  - i) In case of life insurance business, an amount not less than total liability as specified by the insurance policies.
  - ii) In case of non-life insurance business an amount not less than 50 percent of the net non-life insurance premiums.
  - iii) 50 percent of the profits earned, until the amount equals the insurers paid up capital.
  - iv) An amount equal to 115 percent of outstanding claims set for the expiry of each financial year.
- The insurance companies are required to invest at least 75 percent of their total investment in government securities, treasury bills and banks fixed time deposit compulsorily. The remaining 25 percent can be invested in housing scheme, financial companies, and debenture schemes of public limited companies apart from depositing in the commercial banks.
- Onsite and offsite inspection of companies will be made by the *Beema Samiti*.
- An insurer may only assume the risk once the premium has been paid by the policyholder.
- The insurer shall have to reinsure the risk exceeding their limit in the manner specified by the *Samiti*.
- Valuation has to be made by an actuary.
- Loan, guarantee and security should not be provided to the directors.
- Onsite and offsite inspections are carried out by the *Beema Samiti*.

### ***3.3.3. Liberalisation of the Banking and Other Financial Services***

#### ***3.3.3.1. Overview of the banking sector of Nepal***

The formal banking system in Nepal commenced with the establishment of the Nepal Bank Limited (NBL) in 1937, the first commercial bank of Nepal. After nearly two decades of NBL's existence, Nepal Rastra Bank (NRB), the country's Central Bank was established in 1956. The establishment of NRB formalised the financial sector and led to the establishment of a few financial institutions in the public sector including the Nepal Industrial Development Corporation (NIDC), Agricultural Development Bank (ADB/N), Employees Provident Fund (EPF), Deposit and Credit Guarantee Corporation, Nepal Insurance Corporation and the Securities Marketing Center. In 1966, the government established the Rastriya Banijya Bank (RBB), another commercial bank. The NRB was directly involved in setting up most of these institutions with equity participation and branch expansion of commercial banks during 1970s and 1980s (NRB, 2007d).

Until the beginning of the 1980s, no other commercial bank came into existence due to stringent laws. However, the balance of payment crisis of 1983 compelled Nepal to adopt a number of structural reform measures (NRB, 2007b). In the mid-1980s, Nepal undertook significant liberalisation programmes in the financial sector. In 1984, joint venture companies were allowed to operate in the country, and immediately three joint venture banks came into operation between 1984 and 1987. The Finance Companies Act was brought into effect in 1985 to meet the demands of small borrowers. Similarly, Development Bank Act 1995 and Financial Intermediary Institutions Act 1998 were introduced to attract private sector and NGOs to establish financial institutions in rural

areas. As a consequence, a large number of development banks, financial NGOs and cooperatives came into existence (Khanal, 2007).

Table 3.6 shows the growth of financial institutions in Nepal since the 1980s, when Nepal only had two commercial banks and two development banks that were publicly owned. Since the adoption of liberalisation policies in the mid-1980s, there has been a rapid increase in the number of financial institutions in the country. Today, Nepal's financial sector is reasonably diversified, as evident from the number and variety of financial institutions. By May 2007, 20 commercial banks, 37 development banks, 73 finance companies, 11 micro-credit development banks, 17 savings and credit cooperatives and 47 non-governmental organisations (NGOs) performing limited banking activities, existed in Nepal.

Type of Financial Institutions	Number of Institutions (mid-May)							
	1980	1985	1990	1995	2000	2005	2006	2007
Commercial Banks	2	3	5	10	13	17	18	20
Development Banks	2	2	2	3	7	26	29	37
Finance Companies	-	-	-	21	45	60	70	73
Micro-Credit Development Banks	-	-	-	4	7	11	11	11
Saving and Credit Cooperatives	-	-	-	6	19	20	19	17
NGOs (Performing limited banking activities)	-	-	-	-	7	47	47	47
Total	4	5	7	44	98	181	194	205

*Source: NRB (2007d)*

In terms of ownership, the Nepalese banking system has witnessed a major change. Out of the 20 commercial banks, two are partly or fully owned by the government, six are joint venture banks while the rest are domestically owned. The government-owned commercial banks held almost 90 percent of the total assets of the commercial banks in 1990. Their share has significantly come down to 40 percent in 2006 while the share of joint venture banks and private banks has increased over the years. Joint venture banks held around 13 percent of the total assets of commercial banks in 1990, it reached 39 percent in 2006. While these banks were nonexistent in 1990, their share in total assets reached 20 percent in 2006. All these activities have led to an increase in the structure of the Nepalese financial system. Similarly, the development of the sector has led to financial deepening in the country. Financial deepening as measured by broad money to GDP ratio was 30 percent in 1990 and has increased to around 60 percent (NRB, 2007b).

Table 3.7 shows the structure of the Nepalese financial system. According to the table, as of mid-July 2006, commercial banks have the highest share in total assets (55.7 percent) followed by NRB (24.1 percent). Total assets of the financial system are almost 120 percent of gross domestic product (GDP) and if market capitalisation to GDP is included, the total assets reached 136 percent of GDP for mid-July 2006.

Table 3.7: Structure of the Nepalese Financial System (NRs in millions)												
	Mid- July 2005			Mid- July 2006								
	Total assets/ liabilities	Percentage share in total	Ratio of total assets to nominal GDP (%)	Total assets /liabilities	Percentage share in total	Ratio of total assets to nominal GDP (%)						
Financial Institutions	580498	89.3	108.8	615761.4	88.4	105.6						
Nepal Rastra Bank	142824	22.0	26.8	167606.8	24.1	28.8						
Commercial Banks	340633	52.4	63.8	387678.3	55.7	66.5						
Finance Companies	30515	4.7	5.7	38841.0	5.6	6.7						
Development Banks*	57815	8.9	10.8	10611.0	1.5	1.8						
Cooperatives	2411	0.4	0.5	2834.0	0.4	0.5						
Micro-credit Financial Institutions	6300.0	1.0	1.2	8190.4	1.2	1.4						
Contractual Savings Institutions	69210	10.7	13.0	80533.0	11.6	13.8						
Employees provident Fund	45130	6.9	8.5	51060.0	7.3	8.8						
Citizen Investment Trust	5830	0.9	1.1	6750.0	1.0	1.2						
Insurance Companies	18250	2.8	3.4	22622.0	3.3	3.9						
Total	649708	100.0	121.8	696294.4	100.0	119.4						
Ratio of Stock Market Capitalisation to GDP (in %)	11.6			16.6								
<i>*Excluding Agriculture Development Bank and Nepal Industrial Development Corporation in 2006</i>												
<i>Source: NRB, 2007d</i>												

Despite these initiatives, Nepal experienced a deepening crisis in the financial system. According to a World Bank (2002) study, the following factors led to the crisis; excessive government involvement in the banking sector; weak corporate governance and organisational culture; poor lending practices; fragmented legal framework; inadequate disclosure, accounting and auditing standards; high level of non-performing loans; and political intervention. Thus, a comprehensive Financial Sector Reform Programme was launched in 2002 to re-engineer the NRB, restructure state owned banks and build the capacity of the financial sector.

### 3.3.3.2. Nepal's preparedness for the banking sector liberalisation

The Nepal Rastra Bank (NRB) is the central bank of the country. It is the sole authority for licensing and supervising banks and financial institutions. The NRB has been

given various rights and powers including rights of granting license to banks and financial institutions, their monitoring, inspection & supervision and also taking over the management if it appears that transactions of the bank are detrimental to the interest of depositors. It has authority even to cancel license in case of material non-compliance of various prudential norms and relevant laws and regulations.

#### ***Structure and Organisation of the NRB***

The NRB is governed by seven board of directors comprising four ex-officio members: the governor, secretary, Ministry of Finance, two deputy governors; and three other directors who are appointed from amongst persons renowned in the fields of economics, monetary economics, banking, finance and commercial law. The governor, deputy governors and other directors are appointed by the Government of Nepal, Council of Ministers for a term of five years. The NRB is made up of 18 departments and the bank has seven branches and one sub-branch spread around the country (NRB).

The NRB Act 2002 enables the central bank to have *de facto* independence from the government. According to the provisions of the NRB Act, the board of directors is appointed by the Council of Ministers for five-year terms. An important provision in the 2002 Act that helps to ensure NRB's autonomy is that the governor, deputy governors, and directors can only be dismissed, after due process, in well-defined circumstances. Other provisions such as formulation of regulations and initiation of remedial steps can be taken by the NRB without referring to the Ministry of Finance or obtaining its approval. Similarly, the Ministry of Finance director will be a non-voting board member of NRB (World Bank 2002).

#### ***Banking Supervision***

To ensure stability and soundness of the banking system, the NRB seeks compliance with the Bank and Financial Institutions Ordinance (BAFIO) 2062 by banking institutions. The NRB has also crafted a number of prudential requirements to be compiled by banking institutions. These requirements are meant to limit risk taking to levels that are manageable and that do not place the individual banking institution and the banking system at risk. In addition to other prevailing laws, the main legislative framework for supervision function includes:

- Nepal Rastra Bank Act 2002
- Bank and Financial Institutions Act, 2006 (Umbrella Act)
- Company Act 2006
- Supervision By-laws 2002
- Unified Directives to commercial banks and financial institutions

The NRB has continued to review the relevant legislations and regulations to put in place up-to-date regulatory framework that meets international standards and resolves the issues of the banking industry. To improve the financial sector legislative framework, some new Acts, namely the Bank and Financial Institution Act, 2006; Insolvency Act, 2006; Secured Transaction Act, 2006; Company Act, 2006 have recently been enacted. Money laundering Control and Deposit and Credit Guarantee Acts are expected to soon materialise, all with the goal of strengthening the financial sector through its healthy development and improved stability.

The Basel Committee on Banking Supervision has developed a set of principles to promote effective banking supervision. The Basle principles propose minimum standards for licensing, ownership transfer and liquidation. They also suggest prudential rules and requirements, supervision methods and information and disclosure requirements for both domestic and cross-border activities. These principles are fully consistent with multilateral obligations and commitments. Some important Basel principles and how they are adopted in the Nepalese case are explored below:

#### ***Adequate Legal Provisions for Entry and Exit***

Licensing, transfer of ownership and bankruptcy rules are important to keep unfit companies out of the financial sector. If banks are not licensed properly or if they cannot go out of business, they create a moral hazard. If government has to bail out institutions to protect depositors, then it can encourage companies to be less vigilant in their activities.

BAFIA 2006 establishes provisions to opening up banks and financial institutions in Nepal. These include provisions related to paid up capital, promoters' qualification, sale of promoters' share and branch expansion etc. The NRB classifies an institution into A, B, C or D categories on the basis of paid-up capital.

BAFIA 2006 (Article 34 and 53) also has provisions concerning opening branches by foreign banks or financial institutions. However, the BAFIA does not elaborate on provisions regarding licensing, regulation, supervision of foreign banks and differential treatment vis-à-vis domestic banks, if any still need to be formulated. If banks or other financial institutions are in difficulties, corrective measures or, in worst case, liquidation must be regulated. Supervisors must be able to request corrective measures, which protect depositors and creditors. If internal measures and reforms do not succeed, and the institution is no longer viable, supervisors must be able to require a takeover, merger, or final closure of the institution.

The government recently enacted the Insolvency Act 2006, which will allow companies to declare themselves as bankrupt in case of grave financial crisis. The insolvency ordinance provides a way out when the total liabilities of an individual or enterprise exceed the total assets so that the limits of the creditors cannot be met. It discharges the debtor from the burdensome debts and allows him to make a fresh start. It also provides for the speedy, efficient and equitable distribution of the debtor's non-exempt property to the creditors (Singh, 2006<sup>3</sup> ). In the case of banks, prior approval from the NRB is required before initiating the insolvency procedure.

#### ***Licensing Policies***

The licensing system has to include basic assessment covering aspects of ownership, management and the operation scheme. Licensing policies should allow supervisors to reject potentially unsound market entrants. The Basle Committee supports a thorough scrutiny if shareholder suitability, financial strength, legal and operational structure, and the expertise and integrity of bank management when considering license applications. Adequate information and prior approval from the home country supervisor should be secured for applications made by foreign banks.

In order to assess the likely impact of service sector commitments, the NRB undertook a study on the legal, regulatory and supervisory provisions for foreign bank branches in Nepal. The NBR (2006) study has suggested application procedure and licensing requirements for foreign banks (Annex 2), which include the submission of the following: memorandum of association, no objection letter from the home central bank, financial statements, business plan, feasibility study, organisational chart, minimum rating requirements.

#### ***Regulations and Directives***

The development and maintenance of prudential guidance is important. This has to cover capital adequacy, loan loss provision, asset concentration, liquidity, risk management and internal control. A number of important rules and indicators have been developed to minimise and measure the exposure to risk of a financial institution. Some of these regulations and directives are discussed below:

#### ***Capital Requirement***

The Basel Committee on Banking Supervision's (BCBS) recommendations on capital accord are important guiding framework for the regulatory capital requirement for the banking industry all over the world, including Nepal. The NRB has developed and enforced capital adequacy requirement based on international practices and domestic requirements. The existing regulatory capital is largely based on the Basel Committee's 1988 recommendations, commonly known as Basle I. Basle I provided for the implementation of a credit risk measurement framework with a minimum capita standard of 8 percent. It was successfully implemented in more than 100 countries.

The International Convergence of Capital Measurements and Capital Standards, popularly known as Basel II was released on June 26, 2004. Basel II recommends major revision on the international standard of a bank's capital adequacy, which requires banks to implement risk management policies that align capital adequacy assessment with underlying credit risk, market risk and operational risk. Basel II allows each national supervisor to consider carefully the benefits of the new framework in the context of its own domestic banking system and in developing a timetable and approach to implementation. This framework only acts as a guideline for countries like Nepal and its adoption is not mandatory. However, with a view to follow the international best practices and to promote a healthy and sound financial market, the NRB is also moving towards the adoption of Basel II, albeit in a simplified form.

Adoption of Basel II is challenging both for financial institutions and the NRB. The NRB will need to revamp the supervisory procedure and methods. The bank hopes to implement the new capital adequacy framework by 2007/08. The new capital adequacy framework will be applicable to 'A' class financial institutions under the BAFIO. The proposed framework will require a minimum Tier I<sup>4</sup> capital of 6 percent of total risk weighted exposure<sup>5</sup>, and total capital (Tier I and Tier II<sup>6</sup>) of 10 percent of its total risk weighted exposure.

### ***Non-Performing Assets (NPA)***

Regulations are required for the assessment and provisioning of non-performing loans. Once non-performing loads are discovered, adequate reserves to cover them must be established.

The Nepalese Banking system is riddled with a significant amount of NPA. The total volume of NPA as on mid July 2006 was Rs 25.58 billion, which was 13.16 percent of loans and advances. The NPA are largely on account of the portfolio of public banks. The NPA ratio of the public banks in mid July 2006 was 24.93 percent while the NPA ratio of the private banks was 6.70 percent. The NPA ratio of the industry, decreased from 30.41 percent in 2001/02 to 13.16 percent in mid July 2006. Though NPA have been declining, the NPA ratio however, is still a long way from being at a satisfactory level (NRB, 2007).

Banks and financial institutions are required to create loan loss provisions on the gross value of outstanding loans, rather than on the net loans. The banks, thus, have to create provisions in accordance to the quality of their loan portfolios. Public banks with large volumes of NPA have large provisions in their balance sheets while the provisions of the private banks (except a few) are relatively lower (NRB, 2007).

### ***Single Obligator Limit***

Excessive exposure to single borrowers can also cause difficulties for financial institutions. Many countries have introduced rules limiting maximum exposure to one borrower. The limit is typically equal to or less than 25 percent of capital but it is as low as five percent in Chile. Lending to related parties like bank managers, employees is restricted as well. Nepal has also established single obligator limit for commercial banks as per international standards. However, it still needs to formulate single obligator limit for foreign banks that will be involved in wholesale banking.

In addition, Nepal also needs to specify aspects of wholesale banking such as; minimum deposit, minimum lending, minimum capital etc. Besides this, Nepal can also prioritise lending areas such as: hydropower, infrastructure etc. for foreign banks.

### ***Monitoring and Supervision***

In the host country, foreign operations should be subject to similar prudential inspection and reporting requirements as domestic institutions. Effective supervision requires among other things; availability of records and regular publication of financial statements on the basis of accepted accounting standards. The international banking scene has in recent years witnessed strong trends towards globalisation and consolidation of the financial system. Stability of the financial system has become the central challenge to bank regulators and supervisors throughout the world. Supervisory authorities all over the world are gradually moving towards adopting risk-based supervision. The NRB also plans to move towards risk-based supervision.

Currently, two departments are responsible for supervisory functions at the NRB. The bank supervision department is responsible for the inspection and supervision of all the commercial banks while Financial Institution Supervision Department oversees the inspection and supervision of all other financial institutions licensed by the NRB. The

bank also monitors and supervises other banks through on-site examination and off-site surveillance.

On-site examination is carried out at the corporate level inspection, which focuses on six components of bank safety and soundness, known as CAMELS. It is mandatory for the inspection team to carry out an inspection at the corporate level of all commercial banks at least once a year and the gap between two inspections should not exceed a period of two years. Based on CAMELS, the bank's operations are assed and the individual components are rated and a consolidated rating is calculated. The CAMELS rating ranges from one to five, lower ratings represent a well managed bank (NRB, 2005). The CAMELS rating are confidential to facilitate the flow of information between examiners and bankers.

The offsite supervision is done as a supplement to the on-site examination. The offsite supervision is designed to act as an early warning system to identify banks with potential problems so that appropriate policies and action can be determined (NRB, 2006). The offsite supervision is carried out on a quarterly basis and an annual offsite review is undertaken based on the reports and returns submitted by the banks. A separate rating has been devised for the off-site supervision, which uses the components of CAMELS except for the "M" representing management, and the rating is known as CAELS.

The current CAMELS rating, used for onsite examination, is adopted from the Federal Reserve Inspection manual. The Federal Reserve has also developed a manual for inspection of foreign branches called 'examination manual for US branches and agencies of foreign banking organisations' which needs to be studied to develop a supervision mechanism in Nepal for foreign banks.

Besides these existing regulations and supervision mechanism, to meet with the challenge, a high level committee on WTO-related matters (HLC) was established at the NRB on May 12, 2003. The HLC formed a *Task Force on Foreign Bank Branches*. The major objectives of the task force were to:

- Study the existing provision regarding foreign bank branches in Nepal
- Study the operation and policies regarding foreign bank branches in SAARC, SAECEN and other countries
- Study the role of foreign bank branches in financial intermediation and productive investment in Nepal
- Make appropriate policy recommendations regarding the opening and regulation of foreign bank branches in Nepal.

The NRB has conducted a self-assessment of its compliance with Basle Core Principles for Effective Banking Supervision. With this self-assessment, the NRB supervision department has prepared a time-bound action plan to address the identified gaps in its supervisory framework.

#### 3.3.3.3. Conclusion and recommendation

Over the years, the banking sector in Nepal has slowly transformed from a heavily state-owned sector to a vibrant sector dominated by private companies. Under the

Financial Sector Reform Programme, Nepal has undertaken various institutional reforms. The enactment of the NRM Act 2002 has strengthened the capacity of the NRB by providing it sufficient authority to fulfill its regulatory and supervisory role more effectively.

Nepal has achieved considerable success in introducing new prudential controls, solvency standards and in adopting Basel I. In addition, Nepal is in the process of implementing Basel II. The NRB has already established prudential controls in terms of domestic and joint venture banks. These include, entry and exit rules, licensing rules, supervisory and monitoring mechanisms. However, liberalisation of the banking sector will include provision of establishment of foreign bank branches in Nepal in wholesale banking. The NRB is in the process of preparing policies and regulations for the establishment of foreign bank branches in Nepal (Pradhan, 2006). Directives, rules, monitoring and supervision modalities need to be established for foreign banks. Some provisions relating to establishment of the bank as a subsidiary of foreign banks has already been incorporated in the new Bank and Financial Institution Ordinance 2005 and some new policies are being formulated by the HLC.

The NRB needs to address gaps in its supervisory framework and enhance cross-border supervision mechanisms. In addition, before further liberalisation of the financial sector, Nepal needs to resolve a few issues such as loan recovery from large, willful defaulters and improve the financial condition of the two government-owned commercial banks (ADB, 2007). Recent action taken against willful defaulters such as freezing their bank accounts, annulling their passports and placing restrictions on the sales of their assets are positive steps in this area.

### **3.4. Nepal's Preparedness for Telecommunications Services Liberalisation**

Under the WTO, Nepal has committed to liberalise 11 of the possible 12 services sectors, communication services being one of them. Telecommunication services is one of the three sub-sectors in the communication services sector. General Agreement on Trade in Services (GATS) has divided telecommunications services sub-sector into three categories:

- basic telecommunication services
- mobile telecommunication services, and
- value-added telecommunication services.

Basic telecommunications include all telecommunication services, both public and private that involve end-to-end transmission of customer supplier information i.e. local telephone services; domestic telephone services; international telephone services; telex service; domestic and international telegraph service.

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. Value-added telecommunication services include internet, e-mail; voice mail; video text; fax mail; VSAT; audio conference; pay phone;

pre-paid calling card; local, long distance and international data communication; radio paging and trunked mobile.

Nepal's commitments under the WTO will remove all limitations on the number of suppliers in all kinds of telecommunication services by January 2009. In addition, Nepal has committed to allowing foreign participation of up to 80 percent in the sector.

These changes seek to make telecommunication services reliable and accessible throughout the country at a reasonable cost. However, the liberalisation process has to be accompanied by the setting up of regulators to ensure that competition is fair and that consumers are not exploited. In addition, as Nepal is moving from a government-owned monopolistic market into a liberalised competitive market, a major challenge is to establish an independent regulator with adequate expertise, information, authority and accountability.

#### ***3.4.1. Nepal's WTO Commitments in Telecommunication Services***

Historically, the services sector in Nepal has been highly protected, not only against foreign investment, but also in terms of participation of the private sector. However, in line with the liberal economic policies adopted after the restoration of multiparty democracy in 1991, the services sector has also witnessed gradual opening up in the last two decades. In addition to the unilateral liberalisation measures, Nepal has also made commitments at the WTO in many services sectors in all modes<sup>7</sup> of supply.

##### **3.4.1.1. Horizontal commitments**

Nepal has extended market access in Mode 2 with a restriction of providing only US\$ 2,000 for Nepalese citizens while going abroad. Nepal has also committed that supply of services by an existing foreign supplier will not be made more restrictive than they exist at the time of Nepal's accession to the WTO.

With respect to commercial presence (Mode 3), no limitation on national treatment has been placed on foreign investments and reinvestments except that both of these require approval of the Department of Industry (DoI) and incentives and subsidies provided if any, would be available to wholly-owned Nepalese enterprises only. The maximum foreign equity is also limited in most services and firms wanting to sell their services have to be incorporated in Nepal.

However, commitment of Nepal in Mode 4 (movement of natural person) is restrictive except in the categories of services sales persons, persons responsible for setting up a commercial presence, and intra-corporate transferees that too for a limited time and not exceeding 15 percent of local employees. In the case of *service sales person*, the entry is limited to a 90-day period, which may be renewed. In the case of *persons responsible for setting up a commercial presence*, the entry is limited to one-year period, which may be renewed. In the case of *intra-corporate transferees*, of executives and managers and specialists the entry is limited to three years initial period that may be extended for up to seven years for a total period not to exceed 10 years; limited to 15 percent of local employees. This commitment shall further liberalise after five years from the date of accession.

Also, there have been a number of additional commitments made by Nepal, which are:

- Except where an environmental impact assessment is required, decisions of the department are normally provided within 30 days of the date of application
- Approval of an investment will not normally be withheld except for failure to meet environmental standards
- A foreign investor making an investment in foreign currency shall be entitled to repatriate the following amount outside Nepal:
  - i) The amount received by the sale, in whole or part, of the investors share of equity
  - ii) The amount received as profit or dividend as a result of an equity investment
  - iii) The amount received as the payment of the principal of and interest on any foreign loan; and
  - iv) The amount received under an agreement to transfer technology approved by the DoI or the Department of Cottage and Small Industries.

#### 3.4.1.2. Sector-specific commitments

Besides these horizontal commitments, Nepal has also committed to sector-specific commitments in the telecommunications services sector. In terms of market access in *Basic Telecommunications Services*, there are no limitations under Mode 1 and 2. In Mode 3 too, there are no limitations and from January 2009, there will be no limitation on the number of service providers. In addition, foreign participation will only be permitted through a joint venture with up to 80 percent equity participation. Mode 4 is unbound except the provision that consultants not available in Nepal may enter to work for 90 days only. While Mode 1 and 2 have no limitations on national treatment, Mode 3 also has no limitations except the majority of members of the board of directors have to be Nepali citizens. Mode 4 is unbound with respect to limitations on national treatment.

Market access in *Mobile Telecommunication Services* has no limitations in Mode 1 and 2. In Mode 3, no limitations exist except, by 2004, two mobile operators will be licensed and by January 2008, there will be no limitations on the number of service providers. Foreign participation will only be permitted through a joint venture with up to 80 percent equity participation. In addition, Nepal has committed not to prescribe mobile technology, but will leave it to the choice of the operators. In terms of national treatment, there are no limitation in Mode 1, 2 and 3; while Mode 4 is left unbound.

In terms of Market Access in *Value-Added Telecommunications*, there are no limitations in Mode 1 and 2. In Mode 3, there are no limitations except that foreign participation is permitted only through a joint venture with upto 80 percent equity participation. And Mode 4 is left ubound. In terms of National Treatment, there are no limitation in Mode 1,2 and 3; while Mode 4 is left unbound.

#### ***3.4.2. Nepal's Telecommunication Sector: An Overview***

Though a telephone line between Kathmandu and the Indian border was opened in 1913, it was not until 1962 that the first telephone exchange was established in Nepal. Nepal became a member of ITU (International Telecommunication Union) in 1957 (ITU, 2000). The growth of the sector remained slow until 1975, when the Nepal Telecommunication Corporation (NTC) was established under the Communication

Corporation Act, 1973. Under the Act, NTC had the sole authority to operate basic telephone service based on the Wireless in Local Loop (WLL) technology.

As a part of the fifth telecommunications project, a study on the structural reform of the telecommunications sector was carried out in 1994. The study recommended liberalisation of the sector, privatisation of NTC and establishment of a regulatory body. In 1996, the Telecommunication Act, 1962 was revised and in 1997 the Telecommunication Regulations were enacted. The Act and the regulation led to the establishment of Nepal Telecommunications Authority (NTA), the regulatory body in the sector.

In 2004, the Telecommunication Policy was revised to create a favorable environment for privatisation of NTC and liberalisation of the telecommunication sector. The three important strategies of the policy are as follows:

- Liberalisation of the telecommunication sector
- Commercialisation of NTC
- Application of the Open-Licensing Scheme.<sup>8</sup>

Consequently, the telecommunications sector was opened to private sector and foreign participation and the NTC, is in the process of being privatised, and is now known as Nepal Doorsanchar Company Limited (NDCL).

Since the liberalisation of the sector, 15 different value-added services have been liberalised and opened up for private participation. In addition, two licenses each have been issued for basic and mobile telephone services. Under the WTO, Nepal has committed to remove limitations on the number of service providers and allow 80 percent foreign equity through a joint venture in both basic telephone and mobile telephone services. Liberalisation of the sector to private and foreign participation has led to a transforming effect on the telecommunications sector of the country.

The following are the major players in the telecommunications services sector:

**NDCL:** In 2004, with the initiation of privatisation, it was renamed from NTC to NDCL. The government still holds 85 percent of the share. And 15 percent are in the process of being allocated to NDCL staff and the general public.

**Spice Nepal Private Limited (SPNL):** It was granted license for mobile telephone services in 2004.

**United Telecommunications Limited (UTL):** It was granted license for basic telecommunications services based on WLL technology in 2002. A joint venture between Indian and Nepali investors, 20 percent of its share is domestic, while 80 percent foreign equity of three major telecommunication service providers of India.

In terms of fixed telephone service providers, the incumbent, NDCL still accounts for 88 percent of the fixed line services, while UTL accounts for the remaining 12 percent. In terms of mobile services, SPNL has been able to increase its share to 44.75 percent of the market, while NDCL holds the remaining 55.25 percent of the market.

There are currently 32 ISPs in the market. Worldlink has 40 percent of the market share followed by NDCL at 35 percent.

#### 4.4.2.1. Preparedness for liberalisation of telecommunication services

##### **NTA: Structure and Organisation**

A regulator needs to be an independent agency with detailed public accountability, separation of the regulator's budget from the rest of the government budget, independent hiring and firing authority, and requiring that all communication between government ministries and the regulator be publicly reported. A regulator that is isolated from political discretion and where office terms do not depend on political cycles can be a way to ensure regulatory independence. Box 3.1 highlights some necessary features of a national regulatory authority.

The Nepal Telecommunication Authority (NTA), a regulatory body in the telecommunication sector, was established in 1998 in accordance with the Telecommunications Act 1997 and Telecommunications Regulation 1998. The NTA is responsible for granting licenses; prescribing, fixing and approving the standards relating to the sector; approving and regularising fees; inspecting and monitoring the activities of service providers; settling disputes between service providers; and providing suggestions to the government on policy, plan and programme for the development of the sector. (NTA)

The board of the authority consists of five members, including a chairman. The members of the board are experienced in technical and administrative, market management, account and audit or legal fields relating to the telecommunications services. NTA can also invite experts if necessary, to participate in the meeting as an observer of the authority. The chairman and members of the board can be removed by the government in case of misconduct, failure to honestly carry out the official duty, or have direct or indirect ownership or personal interest in any firm or corporate body that operates within the telecommunications sector.

The NTA is an independent body under the Ministry of Information and Communication (MoIC). Its objective is to create a favorable and competitive environment for the development, expansion and operation of telecommunication services with private sector participation (NTA). The NTA has been performing a number of functions like granting licenses, inspecting and monitoring the activities performed by private sector investors, approving and regularising fees, suggesting plan and policies to the government etc. Major functions of the NTA include:

- To make telecommunication services reliable and easily available to the public
- To make necessary arrangements to avail basic telecommunication services in all rural and urban areas throughout Nepal
- To protect the rights and interests of consumers by ensuring the provision of quality service
- To prescribe, fix and approve the standard, quality of the equipments relating to the sector
- To make arrangements for the coordination and healthy competition among those providing telecommunications services and facilities.

The NTA has a separate fund, which consists of amount received from the government, amount received as fees for issuance, renewal and transfer of license and amount received as grants. All the expenditures of the authority are borne from this fund. However, in case the fund becomes insufficient to carry out the functions of the authority, NTA may request the government for the deficit amount.

Some major issues and the regulatory framework of the telecommunications services sector are discussed below:

#### ***Licensing Procedures***

The licensing procedures for various value-added telecommunications services have been formulated and followed by the NTA. Licensing for value-added telecommunications services requires an application with details on the financial aspect (estimated capital; proposed investment; source of investment; operating cost; estimated income, expenditure and profit), the marketing aspect (estimated number of customers, estimated market share of the proposed licensee, policy regarding service quality, detailed time plan specifying the commencement of infrastructure setup and provision of service to the customers, report of financial and technical studies and work operation plan), the managerial aspect (experience, human resource involvement, copy of agreement of memorandum) and the technical aspect (details of the equipment to be used, maintenance policy, frequency to be used, location) of the licensee.

#### ***Tariff Guidelines***

In order to establish and maintain fair competition between licensed network operators and service providers, to prevent cross subsidising, promote the entry of network operators and service providers, and promote affordable telecommunications services, tariff regulation is essential. The NTA has also formulated detailed guidelines for tariff rate approval. Under the guidelines, service charges should be 'proper and reasonable' and has to be approved by the NTA. It has the authority to propose changes in any original tariff proposal. The NTA may also decide to hold public hearing on a tariff proposal where the matter is considered to be of major public concern. The tariff approval guideline also consists of a detailed timeline for the submission of tariff rate proposal, evaluation of the proposal and publication of the tariffs by the operator.

#### ***Interconnection Guidelines***

There is abundant literature on the problems of determining interconnection rates that adequately reward the incumbent for the creation and maintenance of the network while ensuring that use of the network by rivals is not foreclosed. In Nepal's case, where public ownership and control of NTCL have ended, the NTA might need to step in to ensure consumer interests and promote fair competition.

The NTA has formulated interconnecting guidelines to be applied to the inter-working of licensed network operators within the telecommunications sector in Nepal. In particular, the guidelines set out the operational guidelines and principles to govern the interconnection and access between telecommunication networks in Nepal. The license of network operators sets out the scope, terms and conditions of each franchise, and establishes a requirement for each network operator to interconnect with all other networks and provides customer access including equal access to competing services,

as well as general requirements to contribute to the development of rural telecommunications. This includes the provision of physical facilities to enable two networks to communicate with each other and transfer communications across their boundaries, and the carriage of services for an interconnecting licensee within networks, and across network boundaries.

The purpose of the interconnecting guidelines is to ensure that the dominant network operator in any particular market segment shall not abuse its market power to limit access to essential or bottleneck facilities for interconnection. Under the guidelines, all licensed network operators have the right to interconnection with each other's telecommunications network on fair and reasonable terms. The guidelines forbid the network operator seeking interconnection to make excessive demands out of proportion to its requirements, and the network operator providing interconnection from unreasonably restricting interconnection. The charges for interconnection facilities should be fair and equitable, having regard to each network operator's relative contribution to the provision of customer services.

The NTA has the authority to impose penalties in case of breach of the guidelines. Such penalty may include: pecuniary penalties commensurate with the breach, suspension of further actions on any pending and future applications for permits, licenses or authorisations of the offending network operator, compensation for the pecuniary losses suffered by a network operator as a direct result of non-compliance by the violating network operator and amendment of the license of the offending network operator (NTA).

#### ***Frequency Management***

A small section within the MoIC called the Frequency Management and Technology Analysis Division is responsible for spectrum management in Nepal. The division evaluates, reviews, redesigns and expands the required system, policy, rules and technically related national planning and programme for spectrum management based on ITU radio regulation. It also prepares the national frequency allocation table and fixes assignment and channeling plans accordingly (MoIC).

Before 1999, NTC was the sole operator in the telecommunication services and thus the sole spectrum user. As the number of users increase, there will be need for better spectrum management. Spectrum management is essential to provide quality service. Nepal may not be prepared to provide the proper prerequisites for telecommunication liberalisation in terms of spectrum management.

#### ***Spectrum Pricing Policy***

The Radio Frequency Policy Determination Committee (RFPDC) is solely responsible for spectrum pricing policy (MoIC, 2003) and the government lacks a proper spectrum pricing policy. Before the liberalisation of the telecommunication sector, it is necessary to set an appropriate spectrum pricing policy.

#### ***Dispute Settlement Mechanism***

*The Telecommunication Act provides NTA the authority to settle disputes in the sector.* Telecommunication regulations set out the specifics regarding the dispute settlement

mechanism between two licensees or a licensee and consumer. This ensures that in case of a conflict or dispute in the sector, there will be a set of rules and mechanisms to resolve the issue so that competition is fair and consumer interest are protected.

### **3.5. Conclusion**

Though Nepal has committed to allow foreign insurance companies to open branches in 2010, three foreign insurance branches and four joint venture companies already exist in the country. In addition, under the WTO, Nepal has committed to allow 67 percent foreign equity in the sector, but already allows 100 percent equity. As Nepal has already liberalised beyond WTO commitments in the insurance services sector, its commitments will not result in further liberalisation of this sector. However, the need for a sound regulatory and supervisory system is still necessary to maintain an efficient, safe, fair and stable insurance market and promote growth and competition in the sector.

To strengthen the regulatory and supervisory framework, the *Beema Samiti* is already in the process of revising the Insurance Act 1992 and Insurance Regulations 1993 (Pradhan, 2006). Reforms such as introduction of a dispute settlement mechanism need to be included in the new regulatory framework. In addition, the *Samiti* needs to strengthen the financial resilience of insurers against external shocks, enhance management capabilities particularly in the areas of strategic management and innovation, and further improve market efficiency and productivity among domestic insurance are some key areas in Nepal (Bhattarai, 2006).

*Beema Samiti* should also step up its efforts to raise consumer awareness among the general public on insurance products and services. And impart an understanding of insurance products, their benefits and the terms and conditions of the policies to effectively protect the consumers (Bhattarai, 2006).

Nepal's telecommunications services sector has undergone rapid development after the liberalisation of the sector to both private and foreign participation. Nepal's telecommunication sector will witness further liberalisation under its WTO commitments. As the country's telecommunication sector moves from being a government-owned monopoly to a competitive market, the country faces a number of challenges. One of these is the establishment of an independent regulatory body with adequate expertise, information, authority and accountability.

The NTA has already setup some guidelines for granting licenses, tariff approval and interconnection. The Telecommunication Act and Guidelines have also established mechanisms for dispute settlement. However, Nepal's telecommunication services sector faces various challenges that need to be resolved before new licenses can be granted especially in basic telecommunication and mobile telecommunication sectors. In particular, there is a need to enhance NTA's regulatory capacity in order to ensure fair competition among the incumbent and new service providers given the fact that NTDC is still a government-owned enterprise and has a huge share in the market. The other area where NTA needs to enhance its capacity is frequency management and pricing.

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## Endnotes

- 1 The focus of this section is the services sector as defined by the Government of Nepal, Central Bureau of Statistics, according to the International Industrial Classification (ISIC) and includes trade, restaurant and hotel, transport, communications and storage, finance and real estate and community and social services.
- 2 WTO GATS Agreement has defined four types of services; from the territory of one Member into the territory of any other Member (Mode 1), in the territory of one Member to the service consumer of any other Member (Mode 2), by a service supplier of one Member, through commercial presence in the territory of any other Member (Mode 3) and by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member (Mode 4).
- 3 <http://www.nepalnews.com.np/contents/2006/englishweekly/spotlight/feb/feb17/article.php> (accessed on?)
- 4 Capital that is fully paid, having no fixed servicing or dividend costs attached to it, that has high degree of permanence is Tier I capital.
- 5 Risk weighted exposure is the maximum amount of risk attached to a portfolio or a transaction or underlying assets.
- 6 Tier II capital consists of general loan loss provision, revaluation reserve, exchange equalisation reserve, investments adjustments reserves, redeemable preference share and subordinated term debt.
- 7 WTO GATS Agreement has defined four types of services; from the territory of one Member into the territory of any other Member (Mode 1), in the territory of one Member to the service consumer of any other Member (Mode 2), by a service supplier of one Member, through commercial presence in the territory of any other Member (Mode 3) and by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member (Mode 4).
- 8 Open-licensing scheme: The standard license shall be granted to any applicant possessing minimum qualification to meet the specified requirement. Telecommunication Policy 2060 B.S (2004 A.D)- Article: 5.2.2

## Chapter 4

# **Domestic Preparedness for Services Trade Liberalisation: A Case Study of Pakistan**

**Mehnaz Ajmal Paracha and Sobia N. Ahmad**



## 4.1. Introduction

As the fastest growing sector in the Pakistani economy, services account for 53.3 percent of the GDP (SBP, 2007) and employs approximately 42 percent of the labour force (Qureshi, 2007). The significance and potential of the services sector to Pakistan's development can no longer be ignored. Officials at the Ministry of Commerce in Pakistan say the services sector has 'critical importance' due to its development implications; they have been flagging and prioritising the services sector in consecutive trade policies<sup>1</sup>.

The 'economic development dimension' of a strong services sector is obvious, as it strengthens and supports further development of the agricultural and industrial sector of the economy. The economic argument for liberalising trade in services is no different than liberalising trade in goods. Efficiency in the services sector will improve through increased competition, transfer of technology, or expansion of resources (particularly human and capital resources). For Pakistan, the added advantage of liberalisation of trade in services, however, is that in many cases they serve as inputs for 'goods', and increased competitiveness in services will serve to pull down prices of final products. This aspect is especially true of infrastructural services such as banking and telecommunication. It is also important to point out that the overall effort required by the Government of Pakistan to encourage and facilitate services sector productivity incurs far less cost and promises marginally less challenges<sup>2</sup> as compared to the increase in productivity and growth in the agricultural and manufacturing sector.

Moreover, as in all cases of liberalisation, there are concerns on the negative effects of services trade liberalisation, which include displacement of local firms by foreign service providers, the loss of jobs and impact on social services such as education, health and culture. In order to mitigate this, evidence suggests that a "one size fits all" approach to liberalising a country's services sector is inappropriate, and that a cost and benefit analysis of reform should be conducted by developing countries beforehand (Zutshi, 2001). The liberalisation of trade in services can directly bring gains to the Pakistani economy if issues most important to Pakistan are addressed in GATS. For example, market access in labour-intensive services (which require temporary movement of workers) is generally more restrictive. On the other hand, Pakistan has undertaken a wide number of commitments regarding foreign participation and national treatment. It has filed MFN exemptions in banking and other financial services (Mahmood, 1999).

Under the General Agreement on Trade in Services (GATS), Pakistan has liberalised the services sector in the economy and made a schedule of commitments where horizontal, Market Access and National Treatment commitments are specified. Moreover, in the absence of a breakthrough in the Doha Round of negotiations, Pakistan's commitments are confined to the Uruguay Round. Pakistan has commitments under GATS in 47 areas, which include financial (i.e. banking and insurance), business, communications, construction/engineering, transportation, wholesale and retail trade.

This chapter aims to analyse Pakistan's domestic preparedness in the light of the GATS negotiations and subsequent commitments, and to study the current domestic consultation process that underpins the multilateral negotiating stance, as well as

focus on the ‘implementation issues’ of current commitments with a possible way forward. Section 4.2 provides an overview of the services sector, with details on linkages of services sectors with employment, trade, GDP and FDI. In particular, its place in global services trade and its profile and significance to Pakistan’s economy is highlighted. In Section 4.3, an overview of service trade liberalisation, development, and poverty alleviation in Pakistan is provided. Pakistan’s schedule of commitments, as well as sector-by-sector liberalisation efforts, is discussed in Section 4.4. In Section 4.5, the domestic regulatory environment relating to foreign service providers and the role of sectoral regulatory authorities in defining specific sectoral commitments at GATS are explained. In Section 4.6, suggestions are made to strengthen the domestic policy framework and ensure that it supports multilateral rule making and negotiation.

## 4.2. Overview of the Service Sector in Pakistan

### 4.2.1. Services Sector and GDP

The contribution of services to the GDP growth in Pakistan is evident from the trends over the last three decades. The share of services in Pakistan’s GDP has increased from 45 percent in 1970 to almost 58 percent in 2006 (Qureshi, 2007), and growth rate of services trade is 8.0 percent (PES, 2007). In the same period, commodity-producing sectors (such as agriculture and industry) contributed to one-third of the GDP growth, whereas the service sector contributed to the remaining two-thirds of real GDP growth of 6.6 percent (Qureshi, 2007). It is also pertinent to highlight the efficiency of the services sector as 42 percent of the workforce (including construction) contributes to 58 percent of the GDP. Almost three-fourths of the contribution to growth comes from services and agriculture sector, but their contribution to tax revenue is less than 20 percent.

Table 4.1 suggests that services sector growth remained at 8.0 percent during FY 2007, which was above the 7.1 percent target. The FY 2007 target had been set lower than 9.6 percent growth recorded in FY 2006 taking into account the anticipated deceleration in some of the larger sub-sectors of the services groups. However, the strong growth in services sector in FY 2006 is due to the surge in the two sub-sectors – finance and

**Table 4.1: Sector-wise Growth Rates and Shares**  
(Percent: at constant prices of 1999-2000)

	FY '06	FY '07		
	Growth Targets	Growth Rates	Growth Rates	Percent Share
Services Sector	<b>9.6</b>	<b>7.1</b>	<b>8.0</b>	<b>53.3</b>
Wholesale & Retail Trade	8.7	8.8	7.1	19.1
Transport Storage and Comm.	6.9	6.0	5.8	10.3
Finance and Insurance	33.0	12.0	18.2	5.6
Ownership of Dwellings	3.5	3.5	3.5	2.7
Public Admin and Defence	10.0	3.7	6.9	6.0
Community, Social and Personal Services	6.3	5.6	8.5	9.6

Source: PES (2007) and SBP (2007)

insurance, and social and community services. The sustained strong growth of the services sector for the last six successive years has contributed to a structural shift in the economy. The share of services sector was 53.3 percent in GDP in FY 2007 (SBP, 2007).

Besides surge in the above-mentioned two sub-sectors, the wholesale and retail trade sub-sector improved its leading position in the services sector (7.1 percent) in recent years mainly due to increasing openness of the economy and results in employment generation in urban areas<sup>3</sup>. Wholesale and retail trade sector covers the trading and value addition (contributing around one third of the value addition in services sector). The services linked with hotel and restaurants comes under this sub-sector. The finance and insurance sub-sectors flourished (growth rate 18.2 percent) by the vigorous growth and performance of banking sector, due to financial sector reforms and privatisation of large public sector institutions. Under transport and communication sub-sectors, telecommunication sector has concentrated more on attracting investment; however railway posted a healthy increase 23.8 percent in its value addition in FY 2007.

#### **4.2.2. Share of Services Sector in Employment**

Pakistan has an active labour force of 50.5 million, of which, 46.9 million are employed while 3.1 million are unemployed (PES, 2007). It is one of the most populous countries in the world, and according to the World Population Data Sheet<sup>4</sup>, the population of the country will touch the 295 million and emerge as the fifth most populous country by 2050. The share of the service sector as mentioned in the previous section is increasing with the increase in per capita income in comparison to the agriculture sector (commodity producing sector). Despite the fact that there has been reduction in the share of agriculture sector in job creation since 1990, it remained the dominant source of employment in Pakistan with a share of 43.37 percent in 2005-06. The services sector is contributing 36 percent in employed labour force, and if one includes the construction sector, the share of services sector in employment touches 42 percent (Table 4.2).

**Table 4.2: Employed Labour Force by Sectors (%)**

<b>Sectors</b>	<b>2005-06</b>		
	<b>Total</b>	<b>Rural</b>	<b>Urban</b>
<b>Commodity Producing Sector</b>	<b>63.34</b>	<b>75.11</b>	<b>36.94</b>
Agriculture (Forestry, Hunting and Fishing)	43.37	59.87	6.32
Manufacturing	13.84	9.00	24.71
Construction	6.13	6.23	5.91
<b>Services Sector</b>	<b>36.66</b>	<b>24.89</b>	<b>63.06</b>
Wholesale and Retail Trade and Restaurants and Hotels	14.67	9.30	26.71
Transport, Storage and Communication	5.74	4.64	8.22
Community, Social and Personal Services	14.35	10.06	24.00
Others	1.89	0.89	4.13
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source: Labour Force Surveys, 2005-06

It was observed that most of the employment opportunities, as a result of deregulation, privatisation and liberalisation policies, are created or increased in the urban areas. A sector-wise break up reveals that in the services sector, women are involved in the fields of teaching, medicine and domestic work while males are employed in manufacturing, trade and services.

During the last few years, some new areas have risen, through which the human capital of Pakistan is being outsourced to the rest of the world. The most important of them are telecom, auto industry, auto vending, auto service stations, showrooms, hotels and restaurants, livestock and dairy (see Table 4.3). Other sectors significant in terms of creating additional jobs include electricity and gas, trade and transport sector. In 2006, trade absorbed the largest segment (27 percent) of the urban labour force followed by manufacturing (25 percent), services (24 percent) and transport (8.2 percent), which is one of the sub-sectors under services (SBP, 2007).

**Table 4.3: Emerging Employment Scenario in Services Sectors in Pakistan**

Telecom and IT Sector	Mobile Phone, Wireless loop and LDI Companies, Public Call Offices, Internet Service Providers, Broadband Service Providers, Cable Services, Electronic Media Companies, Information Technology and Internet-Related Companies and Call Centres.
Health and Education Sector	Private and Philanthropic Hospitals and Clinics, Biomedical Sciences and Biomedical and Genetic Engineering, Private and Non-Governmental Educational Institutions, and Scientific Research and Development Organisation.
Chemical	Fertilizers, Pesticide, Seeds and Agro-Chemical Distribution.
Allies Agriculture Sectors	Dairy and Milk Processing Packaging and Marketing, Livestock, Fruits and Vegetable Industry, Fisheries and Feed Mills.
Financial Sector	Islamic Banking Services, New Private Banks including Micro Financing Institutions, Risk Managers in the Financial Sector, Leasing and Insurance.
Transport Sector	Intercity and Intra-City Coach, Bus and Transport Services, and Private Airline Companies
Construction	Construction Services particularly Plumbers, Electricians and Masons
Other Services	Advertising, Marketing, Creative Services, Accountancy and Management Consultancy, and Electronic and Print Media
Oil and Gas	Oil and Gas Exploration and Drilling, Petrol and CNG filling Station

*Source: Ministry of Labour and Manpower*

#### 4.2.3. Services Sector and Trade

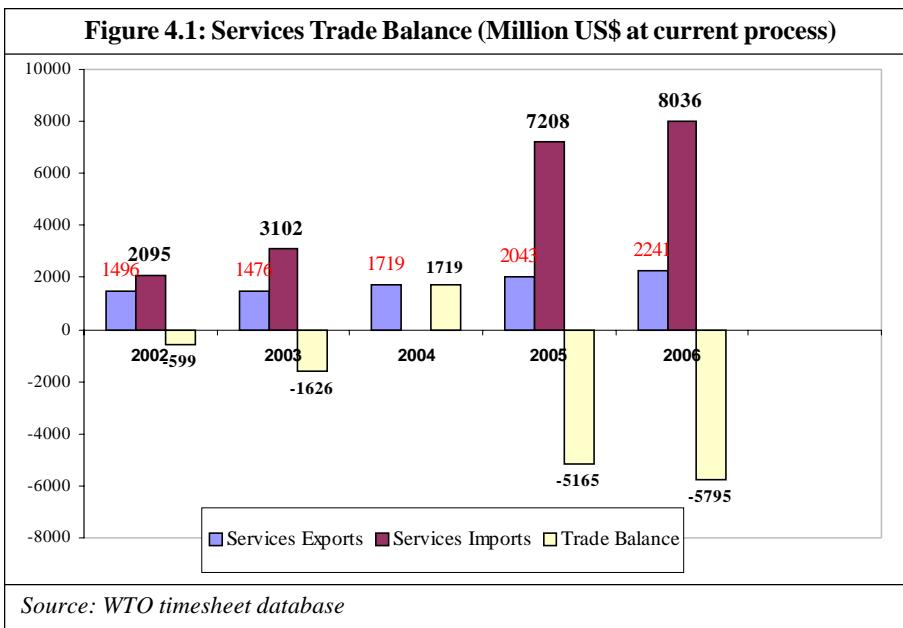
In the global context, Pakistan's share in world services trade rose from 0.23 percent in 2003 to approximately 0.38 percent in 2006. In 2006, world commercial services trade stood at US\$2.7tn while Pakistan's total commercial services trade (imports plus exports) amounted to US\$10.2bn. From Table 4.4, it is obvious that the increase in trade in services is mainly attributed to the phenomenal rise (from 2005 onwards) in the import of 'other commercial services'. Although there has been a sharp increase in imports of travel and transportation services as well, their rate of increase does not match that of other commercial services. Table 4.4 also shows that although 'other commercial services' exports are also the fastest growing exports, their growth rate is not in tandem with the growth rate of service sector imports. This information is significant because it drives the fact that even though the services sector is the fastest growing in Pakistan's economy, the service sector balance of trade is also widening extremely fast.

Table 4.4: Pakistan's Service Sector Trade Statistics in US\$ million						
		2002	2003	2004	2005	2006
Exports (US\$ million)	Transportation Services	792	836	940	1076	1111
	Travel Services	97	122	179	182	254
	Other Commercial Services	607	518	600	785	876
Imports (US\$ million)	Transportation Services	1388	1585		2616	2994
	Travel Services	255	925		1280	1536
	Other Commercial Services	452	592		3312	3505

Source: WTO statistical database ([www.wto.org](http://www.wto.org))

Moreover, service providers from developing countries such as Pakistan (most of which are SMEs) face competition from larger service-providing multinationals from developed countries (UNCTAD, 1999). In Pakistan, this is one of the main factors explaining the fact that growth in imports has been larger than growth in exports. Thus, the benefits gained from growth in service sector exports under the GATS have been more than offset by the growth in service imports.

According to Figure 4.1, the trade balance in services is steadily showing a deficit. Although the volume of services exports is considerably rising, the volume of imports is rising at a faster rate. Recently disaggregated statistics published by the government of Pakistan, however, show a different figure for the deficit in services trade. Pakistan faced a deficit of US\$4.42tn in the FY 2006, which decreased to US\$4.12tn in the FY 2007.<sup>5</sup> The deficit in services account rose from US\$1.39bn in July-September FY 2006 to US\$1.53bn in July-September FY 2007. The country received only US\$657mn in services account, but paid US\$2.19bn to foreigners in exchange for services obtained from them, which means the debit was 3.33 times higher than credit<sup>6</sup>. The difference between the WTO timesheet database and the Government of Pakistan (GoP) data may lie in the method of calculation. Nevertheless, evidence point to the fact that although exports in services are rising in Pakistan, imports in services are rising at a faster rate.



#### 4.2.4. Service Sector and FDI

Pakistan has opened its economy through privatisation and deregulation and currently has a very liberal FDI regulatory regime. The regulatory framework for foreign investment consists of three laws: Foreign Private Investment (Promotion & Protection) Act 1976; Furtherance and Protection of Economic Reforms Act 1992; and Foreign Currency Accounts (Protection) Ordinance 2001.

During the FY 2007, there was a high increase in the Net Foreign Investment (US\$8.3bn) in Pakistan, with the investment to GDP ratio rising to a record high of 23 percent, and the main reason of this was a sharp rise in the Foreign Direct Investment and surge in investment in the local market and GDRs issues. In FY '07, Pakistan has received US\$5.1bn in FDI. The Foreign Portfolio investment witnessed a substantial rise of US\$2.3bn in the FY 2007.

Table 4.5 indicates that major contribution in FDI in Pakistan was evident in Telecommunication (US\$1.89m, which was 37 percent of total the FDI) and Financial (US\$930mn which was 18.2 percent of the total FDI). The wholesale and retail trade sector is growing very rapidly, especially through investment in the large multinational chains. This not only leads to modernisation but also brings new culture, management techniques and inventory system, making the competitive market for domestic service providers improve their services. In transport, storage and communication sub-sector of the services sector, during the FY 2007, significant investment was seen, due to which the sector grew steadily and attracted around 25.3 percent of the total investment in Pakistan.

Table 4.5: Sector-Wise FDI Inflows (Million US\$)								
Sector	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08 (Jul-Feb)
Oil & Gas	80.7	268.2	186.8	202.4	193.8	312.7	545.1	400.6
Financial Business	-34.9	3.6	207.4	242.1	269.4	329.2	930.3	457.8
Trade	13.2	34.2	39.1	35.6	52.1	118	172.1	123.4
Construction	12.5	12.8	17.6	32	42.7	89.5	157.1	50.5
Power	39.9	36.4	32.8	-14.2	73.4	320.6	193.4	37.9
Transport	45.2	21.4	87.4	8.8	10.6	18.4	30.2	48
Communication	NA	12.8	24.3	221.9	517.6	1937.7	1898.7	828
Others	140.9	66.2	90.4	170.1	274	285	1092.5	504.2
Total	297.5	455.6	685.8	898.7	1433.6	3411.1	5019.4	2450.4

Source: State Bank of Pakistan

#### 4.2.5. Service Sector and Government Revenue

The sharp increase in investment in the services sector in recent years has been mostly achieved through private investment. Despite a contractionary monetary policy, credit to the private sector continued to grow strongly (12.2 percent) on the back of the improving investment climate. The Central Board of Revenue (CBR) has achieved the revenue collection target (13 percent), with 18.6 percent growth in CBR tax collection. The reason for high tax collection was supported by 26.2 percent growth in non-tax revenue. During the last five years, a significant increase was evident both in tax and non-tax revenue. As Table 4.6 suggests, the tax revenue increased from Rs 720.7 billion in 2003 to Rs 1,298 billion in 2007.

Table 4.6: Total Revenue in Billion Rupees					
	FY '03	FY '04	FY '05	FY '06	FY '07
Total Revenue	720.7	794.1	900.0	1076.6	1298
Tax Revenue	487.5	550.1	632.6	753.0	889.7
Non-Tax Revenue	233.2	244	267.4	323.6	408.3

Source: Ministry of Finance, Government of Pakistan

Sales tax is the largest component of indirect taxes, amounting to the collection of Rs 309.2 billion in FY 2007. The major contributors in the growth of sales tax collection were telecom and services. The collection of custom duty was recorded at around Rs 132.2 billion. While the Federal Excise Duty (FED) showed the lowest share with a collection of Rs 485.3 billion in services (SBP, 2007).

The major hurdles in tax revenue are narrow tax basis; unnecessary tax exemptions, tax evasions and etc. Widening the tax base by reducing exemptions, incentives and

concessions, as well as taxing all value additions including services are some of the guiding principles of tax policy. Tax reforms, especially expanding taxation gradually into the agricultural and services sectors, would result in greater yield. It will proportionately distribute the burden of taxes over all the different sectors in the economy. The CBR has taken the initiatives and the detailed budgetary measures made which can contribute to economic growth and cost of doing business for investors<sup>7</sup>.

### **4.3. Experiences of Pakistan in GATS Negotiations and its Implications**

The Uruguay Round of trade negotiations (1986-93) resulted in bringing international trade in services under common multilateral rules. The 1995 WTO General Agreement on Trade in Services (GATS) is the first set of multilaterally negotiated and legally enforceable rules that govern international trade in commercial services (i.e. excluding government services). The GATS identifies four modes of supply for trade in services.

The GATS applies to all measures by WTO members affecting trade in services. Under GATS, services include any service in any sector but excluding “services supplied in the exercise of governmental authority (WTO URL). The GATS contains three different layers of obligations. The **first layer** consists of general obligations that bind all WTO members irrespective of whether they agree to undertake market access commitments for a certain sector or not<sup>8</sup> (e.g. MFN exemptions). The **second layer** of obligations relate to specific commitments made by WTO members to grant market access and national treatment to services and service suppliers of other WTO members. These are made with respect to each of the Modes of Supply<sup>9</sup>.

The approach to making commitments is positive and highly flexible. This flexibility allows full discretion to member countries, not to make specific commitments guaranteeing specific access and treatment to foreign firms. The **third layer** of obligations relate to several **annexes** on specific sectors, exemptions, and on the movement of natural persons. These exception provisions allow WTO members to depart from their obligations or commitments under the agreement in very specific circumstances. Members are allowed to take measures for prudential reasons, including the protection of stakeholders and for preserving the stability of the financial system, as long as they are not to be used as a means of avoiding commitments/obligations under the GATS.

#### ***4.3.1. Pakistan’s Experience in GATS Negotiations and its Implications<sup>10</sup>***

Several plurilateral meetings on services sector were held after the Hong Kong Ministerial in 2007, including the bilateral meetings. Only in Article 6.4, progress was made on negotiations for disciplines in domestic regulations, where the member countries asked for transparency of regulations and balance between regulatory autonomy and needless excessive regulations that may nullify the market access recorded in member’s schedules.

While opening up its domestic service sector, Pakistan also likes to send its service providers abroad through Mode 4 of the Agreement on Services, i.e., movement of natural persons. It also wants to benefit from Mode 1, in the IT services provision with a view to removing all barriers to market entry along with the MFN exemptions.

So far, Pakistan's experience in liberalising the telecommunications, banking and franchise/distribution sector has resulted in attracting FDI, generating employment, enhancing skill development, and most importantly, improving the quality of services offered to consumers. Despite this, Pakistan's mission to the WTO has pointed out that overall developing country members have not received complete potential benefits (such as commitments under Mode 4 movement of natural persons) as according to GATS fundamental principle (laid out in the GATS Preamble) "to achieve an overall balance of rights and obligations for all WTO Members"<sup>11</sup>. Moreover, the imbalance was further perpetuated since Pakistan undertook autonomous liberalisation (and in the case of telecommunication, liberalisation was WTO plus) under structural adjustment programmes (UNCTAD, 1998).

At the macro level, the injustice is exacerbated since developing countries' share of world services exports has only increased by a small percentage (6 percent from 1995-2005), while developed countries represent the top 20 exporters of services in different sectors and overall account for three quarters of world exports of services (UNCTAD, 1999).

One of the biggest causes for concern is that the specific objectives of GATS Article IV (increasing participation of developing countries) have not yet been achieved. Developing countries continue to face barriers to their services exports, which range from price-based measures (e.g. entry and exit taxes, visa fees, tariffs on goods in which services are embodied); technical standards and licensing requirements; prohibition of access to services markets (e.g. nationality, residency or visa requirements); subsidies granted to developed countries by their governments (including the high-technology sectors); and lack of transparency in government measures.

Therefore, intended benefits from liberalisation may not be realised without appropriate preconditions and policies to enhance technological capacity and assure their diffusion to help improve access to essential services for the poor (UNCTAD, 2000; Word Bank, 2001). Without satisfactory supporting policies, the ultimate goal of services trade liberalisation (under GATS) to promote the economic growth of all trading partners may never be realised (World Bank, 2001). In this regard, domestic preparedness is one of the keys to making services sector liberalisation work for developing countries such as Pakistan.

In the post Uruguay Round period, Pakistan has liberalised its telecommunication and financial sectors with the expected benefits such as:

- The foreign services providers will be providing high quality services at lesser cost.
- It will encourage local traders and service providers to become more competitive and efficient.

This is important because at this stage of negotiations, Pakistan is in a position to organise its domestic reform agenda such that it secures commitments in areas of export interest. At the same time, securing commitments in areas of import interest

could also be regulated in a way that could help foster development of the relevant domestic sector through healthy competition, shared learnings, and partnerships. In any case, in order to gain maximum benefits from commitments made at international forums, domestic regulations should be in line and up to date with planned liberalisation of the services sector.

Pakistan has undertaken extensive autonomous liberalisation and it stresses on balanced movement in rules and market access negotiations and progressive liberalisation accompanied by strengthening of domestic regulatory frameworks. Pakistan supports “plurilateral request-offer system under services” as proposed by the Hong Kong Declaration.

Pakistan has received collective requests (from 19 WTO members) addressed to several other countries in energy services, environmental services, financial services, architectural and engineering services, integrated engineering, maritime transport, construction, telecommunication services, air transport services and logistic services. Pakistan is examining these requests.

#### ***4.3.2. Pakistan’s Commitments and Exemptions in GATS***

##### **4.3.2.1. May 2005 initial offer**

Pakistan’s initial offer was tabled on May 24, 2005. In the initial offer, equity limits have increased to 60 percent (from 51 percent) unless stated otherwise, and there are no restrictions on *foreign entities on acquisition of real estate*. Moreover, the temporary entry of business visitors has been facilitated by the categorisation of visas for service suppliers and ‘business visitors’ and ‘intra corporate transfers’. Under the initial offer, the current schedule of commitments is revised in the following way:

**Telecommunications:** Restrictions in Modes 1, 2, 3 of telecommunications sector have been removed. Moreover, new proposed commitments in way of online services and mobile telephone services have been offered.

**Financial Services:** Limits on the volume of deposits and other repayable funds mobilised by foreign banks are removed. The number of branches allowed for foreign banks (existing as well as new ones) to open up is 25, while ATMs are not to be treated as a separate branch. In case foreign nationals are to be hired for chief executive, country head and key executives, their passing the ‘Fit and Proper test<sup>12</sup>’ is imperative. The operations of foreign banks are also allowed expansion. Permissible funds (which include foreign currency) can now be transmitted through banks having authorised dealers’ license. Moreover, leasing business is allowed for foreign bank branches as well as commercial banks incorporated in Pakistan as long as it is not their core/major line of business. Portfolio management services of financial institutions can be carried out through locally incorporated subsidiaries, while financial and investment advisory services can carry on business through subsidiary companies.

**Architecture, Engineering and Integrated Engineering Sector Services<sup>13</sup>:** In the initial offer (May 2005), new commitments are proposed in Mode 2 and Mode 3, and equity limit has been raised from 40 percent to 51 percent subject to participation of local

players for architectural services, engineering services, and integrated engineering services. Moreover, joint partnership restrictions have been removed for companies registered with the Securities and Exchange Commission of Pakistan (SECP).

**Construction and Related Engineering Services:** Equity limit has been raised to 51 percent (from 40 percent) and restrictions in Mode 2 are removed.

#### **4.3.2.2. New commitments**

**Legal Services:** There are no limitations on Market Access for legal services (which is mainly in Modes 1, 3 and 4). However, for Mode 3, an Economic Needs Test (ENT) based on inquiry to gauge if direct or indirect government subsidies are provided has to be undertaken. This is to ensure a level playing field for local and foreign ventures. Moreover, non-Pakistani nationals under Mode 3 are required to attain residency under the Legal Practitioners and Bar Councils Act 1973, its rules, and any other relevant laws. Market Access under Mode 1 is unbound, and there is no restriction on Mode 2, while Mode 4 is also unbound (except as indicated in horizontal commitments).

**Accounting and Book Keeping Services (excluding Auditing Services):** Under Mode 3 commitments, in its initial offer, Pakistan proposes that foreign equity should not exceed 51 percent. The service must be supplied by a natural person who is a registered resident (as required by the Association of Chartered Certified Accountants and any other laws in force at the time). In case of a registered firm, local partners must be in majority, and for a company, 70 percent of the holdings must belong to Pakistani nationals. Also, the condition of an ENT (based on inquiry) holds.

**Architectural Services:** In terms of Market Access, limitations on architectural services are similar to those of accounting and book keeping services. However, in terms of national treatment, Mode 1 is unbound and there is no restriction in Mode 2. However, commercial presence is subject to fulfillment of all conditions applicable under foreign investor's law. Also, conditions placed under horizontal commitments apply.

**Veterinary Services:** Market Access in this sub-sector is conditional to transparent ENT to gauge whether direct or indirect subsidy is provided. Moreover, for natural persons providing services, a residency requirement is essential. Commercial presence is also subject to fulfillment of all requirements and conditions applicable to foreign investors or judicial entities.

**Services Provided by Midwives, Nurses, Paramedics and Physiotherapists:** There are no restrictions to market access for those applicable under horizontal commitments. National Treatment is subject to fulfillment of conditions for foreign entities, and practice is allowed as long as the qualifications of foreign service providers match expectations of the Pakistan Nursing Council, and legal requirements under relevant laws.

**R&D Services:** Apart from this, R&D services on social sciences and humanities, disciplinary R&D services, renting/leasing services, printing & publishing services, agricultural storage services and range land services have also been opened up for liberalisation (within the business services sector) under the May 2005 initial offer.

**Communications Services:** Under the communications sector, an initial offer for liberalisation of courier services, online information and data processes and mobile communication services has also been made, and keeping the GATS aim of ‘progressive liberalisation’ modifications have been suggested within the existing schedule of commitments.

**Distribution Services:** Another sector that has been included for liberalisation under GATS is that of distribution services, which include sub-sectors of wholesale services, retailing services and franchising. Commercial presence under all these sub-sectors is subject to ENT, the criteria for which is to include the proposed locality being covered by supplier (for wholesale trade), density of supermarkets relative to population (for retailing services), and density of establishments (for franchises). A limitation of foreign equity limit (limited to 51 percent) is also placed on retailing and wholesale trade services.

**Educational Services:** Educational services, which include higher education, adult education, and other educational services have also been unbound, and no limitations on market access or national treatment (except as indicated by horizontal commitments) exist.

**Environment Services:** Environment services that include refuse disposal services, sanitation and similar services have also been opened up under the GATS 2005 initial offer. In both these sub-sectors, the conditions on Market Access include an ENT based on inquiry to gauge if any direct or indirect government subsidy is provided and foreign equity is limited to 51 percent.

Gauging from the stance that Pakistan has taken in the May 2005 initial offer, it is clear that Pakistan is ready for expanding the scope of its GATS commitments as well as deepening it. The revised offer has clearly sharpened the existing commitments by embedding safeguards within the text. For example, in the financial sector commitment, the fit and proper test is added as essential for hiring foreign staff. This proves Pakistan’s commitment to ensuring that top management in foreign banks operating in the country are credible individuals and checks and balances are in place to assure the integrity of operations.

Moreover, inbuilt safeguards are placed in sectors such as distribution services, the concern that small businesses would be threatened is contained by subjecting market access allowances to the ENT, the criteria of which ensures that foreign service providers would operate in areas that are not already covered by existing distribution service providers. Moreover, this ensures that consumers benefit in the end, because distribution service providers are encouraged to initiate retail and wholesale operations in areas that currently don’t have them. Also, for professional services and environment services, unfair competition will not be allowed to thrive, since the ENT criteria is to investigate where direct or indirect subsidies apply to foreign service providers.

However, Pakistan’s Schedule of Commitments as well as the initial offer are extremely open and allow for wide flexibilities. As yet, market access and limitations on national treatment to most service sectors and sub-sectors are unbound, so the future negotiations leave room for ‘locking in’ on WTO obligations.

#### **4.3.3. Pakistan and the Request-Offer Process**

Pakistan has received many initial requests from certain countries for liberalisation in almost all sectors and has sent requests to countries in different sectors/sub-sector under Mode 3 and for the elimination of restrictions on Market Access and National Treatment on the basis of certain assumptions. Mostly the sectors with strong export potential are selected. Pakistan has so far made requests to countries from which it has received requests as well as to some additional countries, which are good potential markets for export of Pakistani services keeping in view the following factors<sup>14</sup>:

- Pakistan has already made some binding commitments in the services sector during the Uruguay Round followed by additional commitments in the financial and telecom sector in 1998.
- Whatever offers are made by Pakistan in response to the requests received or otherwise would automatically be available to all WTO members on most favoured national (MFN) basis.
- Decision making involves an examination as to whether on a balance, would Pakistan be better off going for maximum possible liberalisation or alternatively adopt a defensive posture and liberalise to the minimum extent in order to afford maximum protection to Pakistani service providers in the domestic context.

Pakistan has received 13 request offers in the construction and related engineering services, architectural, integrated engineering and engineering services, energy services, environmental services, telecommunications, transport, logistics, education, distribution and financial services<sup>15</sup>.

- Under construction and engineering services, Pakistan has received a combine request offer for liberalisation sponsored by Japan<sup>16</sup>, with the view to create employment and economic growth. The request asks for the removal of limitation (Market Access limitation on foreign equity, commercial presence as well as National Treatment limitation related to discriminatory registration and license) in Mode 1, 2 and 3.
- A collective offer sponsored by Canada, in collaboration with Australia, Chile, EC, Japan, Korea, Mexico, New Zealand, Norway, Switzerland and US, for the liberalisation of architectural, engineering and integrated engineering services was also received by Pakistan in Mode 4 focusing on contract services suppliers with request for the removal of limitation of ENTs and MFN.
- In energy sector, a request was placed by EC collectively with Australia, Canada, Japan, Norway, Saudi Arabia, Republic of Korea, Taiwan, Penghu, Kinmen and Matsu, Singapore and the US. The request asks for the development of energy resources in an environmentally sound manner and asked Pakistan to make improved commitments. Furthermore, the request demands substantial reduction in MA and commercial presence limitations in Mode 1, consumption abroad under Mode 2 and mode of supply under Mode 3 with the removal of foreign equity, ENTs, joint ventures and discriminatory registration and licence procedures.
- Australia, Canada, Japan, Korea, Norway, Switzerland, Taiwan, Penghu, Kinmen and the US with the sponsorship of EC has requested Pakistan for the liberalisation of environmental services under Mode 1 to schedule commitments and under Mode 2 for consumption abroad. In addition, under Mode 3, they requested for the

elimination of limitation like, foreign equity and joint venture requirements. Horizontal commitment under Mode 4 for the movement of natural persons was also requested.

**Requests Made by Pakistan:** WTO members have made 20 plurilateral collective requests<sup>17</sup>. While Pakistan co-sponsored four collective requests in computer and related services, cross-border supply, Mode 4 MFN exemptions, and maintained seven MFN exemptions, four in finance and three in telecom.

#### 4.4. Current State of Domestic Preparedness

The GATS allows member countries to enforce regulations that meet national policy objectives (and ensure consumer safety and regulate quality of service) as long as the rules and regulations are objective, impartial, and do not unfairly obstruct market access. This is so because parties recognise that effective regulatory regimes are crucial for liberalisation of services sectors. Regulatory bodies check market failures and ensure that licensing qualification and technical requirements are in line with national policy objectives and support multilateral liberalisation commitments.

Therefore, it is vital that liberalisation commitments are benchmarked with domestic preparedness, and that steps are taken to ensure that domestic regulatory reforms are dynamic and hence, in line with multilateral commitments. In order to assess how far this is currently true, Pakistan's legislative framework for each of the services sector was examined, which should form the vertebrae of rules, regulations and policies concerning trade in services.

##### 4.4.1. Communications, IT and Telecom

The communication sector in Pakistan, particularly telecom, has witnessed comprehensive reforms and robust growth in recent years, contributing to a large share of services in the country's total GDP. As a result, it is often touted as one the most successful service sectors to have gained substantial benefits from liberalisation. Regarding communications, primarily the telecom and IT industries, Pakistan has negotiated extensively at the WTO level and formulated a comprehensive schedule of commitments, further shaping Pakistan's policy framework concerning trade liberalisation in these sectors.

To assess domestic regulation, it is pertinent to examine relevant legislation that has been passed since the formulation of the Pakistan Telecommunication Authority in 1996. The Pakistan Telecommunication (Re-organisation) Act 1996, which was further amended in 2006, is a detailed apparatus dealing with the establishment of the authority, its functions and powers, its responsibilities, its policy directives, guidelines for appointing employees or members, its funding and financial obligations, tariffs, and, most importantly, its status as the exclusive power to grant licenses to telecommunication providers in Pakistan. The legislation dealing with licensing does not distinguish between domestic and foreign service providers, and this is mainly because Pakistan provides National Treatment to all telecommunication service providers. Other regulations are quite detailed and provide a strong legal backbone to the various sub-sectors within the telecom sector.

As such, there are no safeguards ‘embedded’ within the legal texts, but this is mainly included because any unfair practices by companies can be directly reported to the Monopoly Control Authority. Other than that, the Company Registration Offices (CROs) at the Securities and Exchange Commission clearly maintains rules and procedures (embedded within the Companies Ordinance 1984) for registration and operation of foreign companies in Pakistan. These companies are also provided special facilitation in order to expedite the registration process and ensure that it is not cumbersome.

Other than this, the Telecom Deregulation Policy 2003 provides a comprehensive overview of rules and regulations, fee structures and licensing conditions relating to the telecom sector for the next five years. Salient features of this policy are appended in Annex IV. According to the SECP, foreign companies operating in deregulated sectors will be subject to the provisions of their respective sectoral policies.

Similarly, the rules and regulations within the IT sector are entrenched in the registration, licensing and taxation requirements set by the SECP and Central Board of Revenue. Other than this, the Ministry of IT and Telecom and the Pakistan Software Export Board (PSEB) make policies within the sector. In order to ensure that Pakistan’s IT industry is protected in line with global outsourcing requirements, the PSEB has drafted the Electronic Data Protection Act 2005, which aims to protect electronic data and intellectual property rights. At the draft stage, the Act is under review in order to ensure that clauses reflect legal requirements of jurisdictions such as the US etc. which constitute Pakistan’s key IT export and outsourcing markets. Aside from this, the Copyright Ordinance 1962 was updated through the Copyright (Amendment) Act 1992 and the Copyright (Amendment Ordinance) 2000 whereby all copyright protection originally available to the literary and arts works was also extended to include computer software<sup>18</sup>.

All in all, as one of the services trade ‘success stories’, the IT and telecom sector is strong in terms of having a solid domestic regulatory framework and proactive regulatory authorities that provide research-based, well-thought-out negotiation strategies to the Ministry of Commerce WTO cell<sup>19</sup>.

#### **4.4.2. Finance**

Another sector that has witnessed strong growth and subsequent liberalisation in recent years is the financial sector, particularly in banking services. Pakistan’s Central bank, the State Bank of Pakistan (SBP), has pursued reforms aimed at liberalisation, competition, and privatisation since the beginning of the 1990s, and has achieved considerable progress. Concerning trade, there are presently no restrictions on the establishment or operation of foreign banks in Pakistan.<sup>20</sup>

The Banking Companies Ordinance 1962 and The Banking Companies Rules 1963 (as amended up to March 31, 1997) combine to create the principle legislative framework concerning the regulation of banking services in Pakistan. The powers vested in the SBP are applicable to all banks operating within Pakistan, whether they have been incorporated in or outside Pakistan. However, a few conditions explicitly differ in the case of banks incorporated outside Pakistan.

Section 26 of the ordinance also empowers the SBP to prohibit acceptance of deposits by banking companies incorporated outside Pakistan, allowing a time frame of six months to a year for the notification to come into effect<sup>21</sup>. However, the Central Government decreed in 1965 that the provisions of this section would be rendered non-applicable to companies incorporated outside Pakistan.

As the authority that grants licenses to banking companies in Pakistan, the SBP may require to be satisfied that the government or law of a country in which a foreign bank is incorporated provides the same facilities to banks incorporated in Pakistan, which may operate in its territory<sup>22</sup> (i.e. there is evidence of reciprocity). If a banking company fails to comply with any of the conditions of the ordinance, SBP reserves the right to cancel granted licenses. As a safeguard, the aggrieved company may apply for review to the Central Board of the SBP within 30 days of the decision.

In order to further strengthen and synchronise domestic legislative framework in relation to multilateral trade negotiations and commitments, the Government of Pakistan has established a commission to review Pakistan's financial sector loan.

For the non-Banking Financial Sector, the Security and Exchange Commission of Pakistan (SECP) is the main regulating authority. The SECP is primarily concerned with the regulation of the corporate sector and capital market; its mandate includes the supervision and regulation of insurance companies, non-banking finance companies, and private pensions, as well as the oversight of various external service providers to the corporate and financial sectors, such as chartered accountants, brokers, surveyors etc<sup>23</sup>. As the main regulating authority, the SECP also frames much of the legislative framework concerning the financial sectors mentioned above and, via the Securities and Exchange Commission of Pakistan Act 1997<sup>24</sup>, has powers to make rules and regulations.

In this way, the financial sector regulatory authorities have accomplished a comprehensive task in keeping the financial sector regulatory framework up to date with regards to formation of rules and regulations governing foreign service suppliers.

#### ***4.4.3. Engineering, Construction and Architecture***

There are various regulatory bodies governing the engineering, construction and architectural services sector in Pakistan. Those having the widest mandate include the Ministry of Housing and Works, the Pakistan Engineering Council, and the Pakistan Council of Architects and Town Planners (PCATP)<sup>25</sup>. The National Highway Authority and Pakistan Housing Authority (which is established within the Ministry of Housing and Works) have a narrower mandate of governing highway construction rules and regulations and low budget government housing scheme rules and regulations respectively. At another level, each local government byelaw is also applicable to the engineering, architecture and construction services sector. Each city district development authority has an independent regulatory body that regulates construction plans and designs applicable to their jurisdiction

Although the Ministry of Housing and Works is authorised to administer most construction and engineering-related legislation and to initiate policies on domestic

and foreign consultations, the Pakistan Engineering Council (PEC) is responsible for regulating the engineering and construction services sector in the country. The PEC and its statutory mandate includes the registration of engineers and consulting engineers, accreditation of related academic programmes, establishing standards for engineering products and services, regulating the work of professional engineering bodies, etc.

The PEC's registration criterion for professional engineers is simple: possession of a BSc. Engg/B.E degree or equivalent from an accredited/recognised programme. The PEC website clearly cites rules and relations regarding foreign service providers operating in Pakistan. It defines a foreign engineering/construction consultant as 'the enterprise partly or wholly owned by foreign nationals. Moreover, a consulting engineers firm registered outside Pakistan shall be considered as foreign firm irrespective of ownership by nationals and having a branch office in Pakistan or adopting a name similar to an expatriate firm'<sup>26</sup>. Foreign consultants must obtain a pre-registration certificate from the PEC to be able to operate in Pakistan, and in case of bidding or negotiating for any project, must register to bid for the particular project from the PEC.<sup>27</sup>

Regarding foreign constructors or foreign operators wishing to perform construction or operation of engineering works on activities that are subject to engineering byelaws, a license has to be granted by the council before any activity can be commenced. Clause 2 of Engineering Works Bye-Law 7 makes it clear that a foreign provider may be granted license "only for specific projects", which require specialised technology that is not available with a Pakistani firm. It further stipulates that the foreign constructor/operator must enter into a joint venture with the Pakistani constructor/operator, in which the share of the foreign body will be limited to the expertise and technology not available with the Pakistani firm, adding that the Pakistani firm's share must not be less than 30 percent. A foreign firm is also required to obtain a separate license for participating in bidding or negotiation for each specific project<sup>28</sup>.

Again, the regulations governing construction services aim to encourage joint ventures and collaboration with local service providers. Licenses are granted for projects where local firms do not have the requisite technical capacity. In effect, this works as a protection and safeguard to local construction and engineering firms who do not face undue competitive pressures. Despite comprehensive rules, regulation, byelaws and safeguards, the engineering, construction and architectural services sectors are bogged down by lack of coordination between federal and local governments. Regulations are currently multi-tiered, and regulatory responsibility is also scattered. As a result, implementation becomes difficult.

#### **4.4.4. Energy**

The oil and gas sector in Pakistan is largely state-controlled although there are no restrictions on Market Access through commercial presence to private or foreign investors. While some MNCs are involved in oil and gas exploration, several state-owned or partially state-owned companies, such as Pakistan State Oil or Sui Southern Gas Company dominate the sector.

The recently established Oil and Gas Regulatory Authority (OGRA) grants licenses to companies for oil and gas distribution purposes. The National Electric Power Regulatory Authority (NEPRA) is the principle authority dealing with the regulation of generation, transmission, and distribution of electric power in Pakistan. Both the regulatory authorities do not differentiate between the domestic and foreign service providers and do not lay separate conditions for granting licenses. The OGRA also grants licenses to electricity generation or distribution providers, ascertains and regulates tariffs, oversees and approves investment, prescribes standards to be followed, levies penalties, etc.

The provisions of the NEPRA Act require that a service provider must be registered as a company in Pakistan. It can be inferred that the sector is already liberalised due to the non-existence of trade-specific legislation or regulation discriminating between foreign and domestic providers, but this can also be due to lack of trade commitments relevant to the energy sector. In any case, the existing regulatory framework suggests that there are presently no Market Access restrictions in Mode 3 (Commercial Presence) for private or foreign companies. Burki and Hussain are of the opinion that there is great opportunity for better quality service provision in the sector after major infrastructural improvement through use of new technology, and that improved Market Access for generation and distribution would provide further opportunities for FDI in the sector.<sup>29</sup>

#### **4.4.5. Environment**

The existing environmental policy framework in Pakistan is quite intricate, the most important regulatory guide being the Pakistan Environmental Protection Act 1997 (PEPA). The implementation of the Act at the federal level is entrusted to the Pakistan Environmental Protection Agency (Pak-EPA), a creation of the Act itself. Concerning the possibility of foreign assistance in environmental services, Section 6 of the PEPA states:

- *(1)(h) Co-ordinate environmental policies and programmes nationally and internationally;*
- *(2)(c) Initiate with the approval of the federal government, requests for foreign assistance in support of the purposes of this Act and enter into arrangements with foreign agencies or organisations for the exchange of material or information and participate in international seminars or meetings;*<sup>30</sup>

The legislation clearly encourages collaboration between domestic management and foreign assistance and calls for policy synchronisation with international standards, but 'trade' in this sector has been sparse so far. Given Pakistan's high rate of urbanisation and an ever-increasing urban population to cater to, the severely under-resourced local government authorities or municipalities could certainly use foreign assistance for solid waste management and sewage disposal. Pakistan clearly has an import interest here.

It may also be pertinent to mention here that there are numerous firms operating in Pakistan that carry out environmental consultancy work and environmental impact assessment for industries demanding cleaner technologies, and environmentally conscious engineering projects. Further, liberalisation commitments through Mode 1

and Mode 3 would be beneficial in terms of service quality, technology transfer and cleaner environment (Burki and Hussain, 2007).

#### **4.4.6. Legal**

The Pakistan Bar Council (PBC) is the highest body of elected lawyers in the country. It came into being by an act of Parliament known as the Legal Practitioners and Bar Council Act, 1973. The PBC is responsible for the enrolment of legal practitioners and issuing them the right to practice in Pakistan.

Section 22 of the Act stipulates that ‘no person shall be entitled to practice the profession of Law unless he is an advocate<sup>31</sup>’. Individuals who are nationals of other countries must obtain a license to practice law in Pakistan from the PBC, which may be granted after the PBC’s qualification requirements have been satisfied. Section 26 of the Act clarifies that ‘a national of any other country (who has resided in Pakistan for a period of not less than one year immediately preceding the day on which he applies for admission) may be admitted as an advocate if citizens of Pakistan duly qualified are permitted to practice law in that other country<sup>32</sup>’. Section 55 of the Act further clarifies that the PBC has power to make rules about ‘the circumstances in which and the conditions subject to which nationals of any foreign country may be admitted as advocates and foreign qualifications may be recognised for purposes of their admission<sup>33</sup>’.

#### **4.4.7. Tourism**

Existing rules and regulations concerning tourist guides, hotels and restaurants, and travel agencies are elaborated in Pakistan Tourist Guide Rules, Pakistan Hotels and Restaurants Act 1976, The Travel Agencies Act 1976. These licenses stipulate that licenses must be sought from the federal government before any activity concerning tourism may commence. The legislation does not discriminate between domestic and foreign service providers, and the same conditions for the grant of a license apply to all.

Despite the degree of openness and the trade possibilities, the tourism sector in Pakistan remains under-developed mainly due to lack of fund allocation and poor infrastructure. Given Pakistan’s rich cultural heritage, diversity, and natural beauty, meaningful reforms and improvements in the sector would definitely boost the tourism industries potential and make a sizeable contribution to GDP.

#### **4.4.8. Accountancy**

The Institute of Chartered Accountants of Pakistan (ICAP) is a professional body of Chartered Accountants in Pakistan. Within the ICAP, members of the council are responsible to formulate key strategies and policies in the interest of the profession. One action of the council is the institution of the Quality Control Review (QCR) programme, which is an integral part of ICAPS regulatory framework, in order to develop and maintain professional standards for auditing firms and their functions.

Other than this, ICAP requires all foreign accountants who wish to provide accountancy services in Pakistan to pass three ICAP examinations, following which they are exempted from undergoing training. Foreign accountancy services firms can easily operate in

Pakistan as long as they comply with licensing and registration rules as regulations for establishment of a firm as imposed by the Companies Ordinance 1984 and the SECP.

#### **4.5. Feedback from the Stakeholders on Domestic Preparedness**

In order to collect primary information on domestic preparedness vis-à-vis services trade liberalisation, one on one interviews with key informants were carried out to map stakeholder perceptions in Pakistan. These interviews were conducted in 2007. The interview consisted of two sections. Section one focused on the self-assessment of the regulatory authorities and departments while the second section focused on four main aspects of trade facilitation, competition and safeguards and future outlook.

The primary role of regulatory authorities (for each service sector) is to make sound policies related to each service sector in tandem with the relevant ministries as well as overlapping bodies and associations. Within the multilateral rule-making framework, their responsibilities lie in ensuring that any commitments made at the international levels are reflected in rules and regulations proposed and drafted by them, and also that these rules provide safeguards to service providers operating within their sector, check regulations and any discouraged practices. Another key responsibility of the regulatory authorities is to liaise with the Ministry of Commerce (WTO Cell) and the relevant stakeholders in order to help prepare initial offers.

These regulatory authorities overlooking the relevant sectors play a key role as they are given the responsibility of assessing the initial request for liberalisation, and their response is taken as representative of key stakeholders within the service sectors. Therefore, theoretically it falls on them to ensure that the initial offer is comprehensive as well as reflective of national policy priorities. However, vast majority of the representatives of regulatory authorities contacted for the study were of the opinion that their engagement in the review process of offer was mainly to fulfil the responsibility, either they were not prepared to give well-informed comments, or their comments are not taken seriously and not reflected in the draft offer.

During the perception mapping on issues of domestic preparedness of the regulatory bodies to face the challenges of service trade liberalisation, 94 percent of the regulatory bodies were of the opinion that they are regulated, their administrative rules and regulations are easily understood by both foreign and domestic service providers. While six percent of the regulatory bodies disagreed with the view that one of the biggest problems affecting foreign service providers is that in Pakistan most rules and regulations are kept secret, which ultimately leads to lack of information of rules and regulations.

Around 82 percent of the regulatory bodies said that the private sector has the opportunity to comment on rules and regulations during their development, while 13 percent of the regulatory authorities said the private sector was rarely involved in development of rules and regulations by the relevant departments. Rather, the regulatory bodies only regulate while their ministries/departments play a dominant role in the development of the rules and regulations without their involvement. However, six percent of the representatives don't know about the issue.

A significant response was seen in lieu of domestic preparedness and around 82 percent of the authorities said domestic industry standard setting procedures and industry regulatory applications process are publicly available. However, 13 percent including ministries, which were of the view that Pakistan still need to strengthen its regulatory bodies as well as its position in services sector, keeping in consideration the global and regional situation, disagreed. The respondents also stressed on the need for policy coherence of the relevant ministries on the issue of services trade liberalisation. Six percent of the interviewing bodies showed lack of concern with the issue, ignoring their positive and necessary role under Mode 2, 3 and 4 of the services sector.

While asking the regulatory bodies whether government industry measures are administrated in a reasonable, objective and impartial manner and regulators inform applicants within reasonable periods of time on the status of their application, 75 percent of the regulatory bodies showed a positive response while the remaining 25 percent disagreed that neither government measures are administrated well nor regulators are receptive and approachable. .

While discussing the (second section) trade facilitation, competition and safeguards, future outlook, and policymaking, some common issues were identified and it was observed that there are some rules and laws established by the regulatory bodies, which are compulsory for every foreign services provider to fulfil before entering into the Pakistani market.

#### **4.5.1. Trade Facilitation**

A common mode of business entry in Pakistan is franchising and licensing in partnership with local entrepreneurs, or 100 percent equity through direct investment. And Pakistan offers an attractive and enabling environment for foreign investment in services sector. The investors are at liberty to choose any legal business. According to the World Bank report on Doing Business on South Asia, in terms of ranking of ease doing business, Pakistan is favourably placed with 76-index average compared to 101 in Sri Lanka and 120 in India. Likewise, on average, it takes 24 days to start a business in Pakistan compared to 31 days in Nepal and 74 days in Bangladesh. The Board of Investment, Trade Development Authority, Security Exchange Commission of Pakistan and concerned ministries provide support and facilitation services to foreign investors interested in both tangible and intangible sectors. The information on rules and regulations is generally available on the websites of the concerned ministries and organisations which can be obtained through relevant links on the Board of Investment website and electronic government website links. Business and trade investment contracts are generally dealt under corporate law. Dispute resolved out of court are generally done through the regulatory ministries.

For a foreign service provider who enters Pakistani, ordinance/laws/byelaws are passed by the organisations, which requires that foreign service providers need to apply to register either with the federal/national body or with the provincial council/department/organisation. For example, if a construction or architecture firm is going to practice in Islamabad, the firm has to be registered with the Capital Development Authority (CDA) or an architect could get the membership of the Pakistan Council of Architect and

Town Planners. There are proper procedures to scrutinise the application and determine if the foreign firm is eligible to practice in Pakistan. Licensing procedures are very easy to follow, however, there is an inbuilt mechanism in each regulatory body. For individuals to provide their services in Pakistan, they need to have degrees from accredited universities, as well as to provide an equivalence of their academic qualification in order to assess them in line with the local law students and have to be the member of the network of the specific departments i.e. Pakistan Council of Architect and Town Planners.

Some of the sectors have the requirement that foreign service providers (firms/ individuals/organisations) also need pre-registration certificate and fee, joint venture or association agreement of the parties, specifying the share of each party along with the description and scope of the project. Some of the organisations intend to apply in the bidding process (for example, the Pakistan Engineering Council). Most of the regulatory bodies have their own code of conduct/ethics, which have to be followed/ abided by the partners or service providers, violation of which leads to the penalties.

Regarding difficulties for foreign firms, they have to face language barriers, work permit for entry, environment, contacts and security problems. One of the biggest problems which affect foreign service providers is that in Pakistan, most of the rules and regulations are kept secret, which ultimately leads to lack of information on rules and regulations. As the foreign impact is different compared to the local impact, so the foreign service providers will have to face the bureaucracy. But the Government of Pakistan is in the processing of establishing such procedures to overcome the issue of bureaucracy. For example, the Higher Education Commission of Pakistan has granted authority to the Pakistan Council of Architect and Town Planners to get rid of bureaucracy by institutionalising the architectural services industry.

#### ***4.5.2. Competition and Safeguards***

There are no unfair practices carried out by domestic service providers to prevent foreign service providers from competitiveness and entering the Pakistani market. However, every domestic firm has its own market/domain. This is basically because the procedure to enter the accounting service industry has to follow very transparent rules and regulations. Domestic firms do feel concerned that multinational firms would prefer a foreign accountant because of the name and reputation that specific accounting firm represent. Being well established abroad, foreign firms have access to a larger network, which can diversify their risk and obtain further expertise whenever they need. Moreover, foreign firms are allowed to repatriate their earnings to the parent company. In case of engineering and construction services, the Pakistan Engineering Council's concerns are 100 percent valid because foreign service providers use their big name and repute and most often they use the same material and technology for construction purposes but charge a high cost by incorrectly insisting that their work quality is good. In order to deal with such issues, in 1997 the Pakistan Engineering Council took a foreign service provider to court, but the Government of Pakistan discouraged domestic service providers and did not take any action against the Pakistan Engineering Council's valid concern.

In telecommunication, the operators who have significant market power can enhance their profit by using unfair means e.g. by further decreasing their call rates. And there are no specific rules or legislation that exists to protect domestic service providers, neither are any steps taken to accommodate the local service provider's concerns except those mentioned above.

Nowadays, there is a rapid shift towards MNCs, the corporate sector more or less has monopoly practises but there are no constraints on them. Also, there are no visible checks and balances. However, there is some sort of discrimination on awarding architecture projects to certain firms by the Ministry of Housing.

On the other side, some of the respondents are of the view that domestic service providers have no reason to be concerned or threatened by foreign service providers, because most foreign firms work in collaboration with domestic firms. Even direct awards that are given to foreign firms do not threaten domestic firms because foreign firms still use domestic service providers for some barriers that they face, such as language skills, familiarity with the locality, access to cheap labour. Even though PCATP specifically states in its regulations that a private competition cannot be held, and that all competitions should be open, the Ministry of Housing and government officials sometimes pay no attention to this criteria and abuse the system. Well-established foreign firms can collaborate with well-established local firms and wipe out smaller domestic firms if they want to. It all depends on how well a service provider is connected in the Ministry of Housing and the kind of support it has from a well-reputed foreign architecture firm to get projects passed in its favour.

Disputes resolved out of court are generally done through the regulatory ministries. For any unfair practice carried out by foreign or domestic service providers, an investigation procedure has to be followed and accuser has to face penalty or retribution according to byelaws. Determination orders are issued by the Pakistan Electronic Media Regulatory Authority (PEMRA) through which tariffs are fixed for different services of e-media to halt the trend of imperfect competition. Preparation of code of conduct and other standards ensuring their enforcement check on the tendency of market power abuse.

In NEPRA, there is less local investment (only one public service provider, WAPDA, is in Pakistan) and most of the investment is international, which is entirely based on collaborations (so that the people of Pakistan would be able to know about the latest technologies). NEPRA and EDB (Engineering Development Board) have made rules to protect local service providers. For example, there is a 15 percent price preference given to local manufacturers. In the recent past, a Chinese company offered Pakistan meters for sale at 15 percent less price compare to local manufacturers, but Pakistan declined the offer to protect local manufacturers. This was because in the water and power sector, 15 percent price preference is given to local service providers.

Pakistan offers one of the most lucrative investment opportunities in services sector with none or little procedural entry barriers. There are no unspecified entry barriers, for example, foreign airlines through the Ministry of Aviation, under different freedoms of flight can/are guided for operating to and through Pakistan. It was also pointed out by

the stakeholders that there are cases where domestic service providers may initially feel threatened by foreign service providers, however, in the long-run, due to increased competition they learn new ways of doing business that result in improved quality, larger variety and competitive prices.

The local retail business, as elsewhere in the region, feels threatened as it is one of the largest employing sectors. Rules and regulations in Pakistan are equity-based and provide fair play opportunities. However, rules keep changing depending on the stage of development of local industry. There are no specific protection measures, only the policy of joint venture is considered a yardstick. For example, in telecom service sector, there are no rules/legislations to protect local service providers or accommodate their concerns.

The PNAC deals with unfair practices by domestic and foreign service providers through consultation and awareness. To accommodate the local service providers, the council has taken initiative to train, raise awareness and provide consultation to enhance competitiveness.

#### ***4.5.3. Future Outlook and Policymaking***

The most important barrier for investment is the foreign service providers' perception on Pakistan. Besides this Board of Investment (BoI), Deregulation Facilitate Unit (DFU) and Ministry of IT (MoIT) facilitate FSP fully in all operational requirements. The environment of investment in Pakistan is very conducive. Therefore, due to increase in investment there is also an increasing trend in accountancy and local firms are in better condition. The Pakistan National Accreditation Council foresees tremendous potentials for growth in the sector especially in reducing Technical Barriers to Trade (TBT) and improving quality of products and services in order to build confidence of consumers, importers & exporters so that the export base of the country should be broadened. For the preparation of Pakistan's position in trade negotiations under GATS in future, PNAC is involved in:

- Awareness-raising of stakeholders to meet the WTO requirements.
- Accreditation of various conformity assessment bodies including CB inspection and labs to meet the international requirements of testing goods.
- Handling various programmes under the National Quality Policy and Plan (NQP&P) to strengthen the national quality regulatory infrastructure. ([www.pnac.org.pk](http://www.pnac.org.pk))

The growth potential in legal services sector in Pakistan is questionable. Unfortunately, the legal sector has not been able to frame defamation suits to civilise the society. Social, cultural and religious norms weigh stronger than the legal framework. The law is very protracted, lengthy and expensive, which makes an individual seem it is not worth it.

There were major setbacks in the architecture industry in 1998 and 1999, due to the political crises and nuclear bomb testing. However, since 2002, the overall economic growth has increased steadily in Pakistan, which has resulted in a boom in the construction business, and in turn led to an increase in architectural services. And since this trend is continuing to grow, so the architecture industry is also going to grow, with domestic firms trying to collaborate with foreign firms to secure projects.

All mobile operators are expanding their networks at a much faster pace owing to the fact that most of the densely populated metropolitan cities are now covered with almost 100 percent penetration. These companies are now increasing their coverage to those uncovered areas where mobile networks have not reached. In 2003, the total investment in the telecom sector was US\$ 5 billion which increased to US\$ 30 billion in 2007. This sharp increase led to further increase in the market size and capital formation. Still, growth in telecommunication sector is positive and growth rate is 20 to 30 percent per annum.

The electronic and print media has shown tremendous growth over the past five years, ever since it has been opened for public licensing. There are over 150 FM radio licenses and more than 1,500 cable TV operators in the country. Furthermore, there are almost 50 licensed satellite TV channels—both foreign and local. In future, there is potential for wireless cable TV MMDs service in the country. DTH service is also around the corner and teleporting facility has potential for growth. Similarly, television on mobile phone is another technology which has been introduced by mobile phone service providers in the country and licensed by PEMRA. SECP expects its growth in mergers and acquisitions, in leasing and investment banking, as well as in the increased inflow of foreign firms in mutual funds sector.

Since health is not a priority in Pakistan, most of the people like to get treatment from government hospitals which provide free medicines. In the private sector, people want concessions in doctor's fees and medicines. Such conditions make it difficult for FSP to enter in this sector. But in pharmaceutical sector, it seems there will be a lot of growth, because in the span of just seven years (from 1999 to 2007), there has been an increase of 200 pharmaceutical companies because of an increase in export of Pakistan's medicines.

Secondly, many firms merged into each other and formed bigger units. Most important fact is that Pakistan is an exporter of doctors, for example the US fulfills its 25 percent requirement of doctors from the third world and Pakistani doctors who have a good reputation often go to fill in the vacancies. The potential in the health sector is very prominent; doctors from India, Sri Lanka, Bangladesh and China can come because of low salary packages in their countries as compared to Pakistan. Due to sharp hike in property prices, foreign service providers will be reluctant to open private hospitals and consequently, DSP will be protected from over influx of foreign service providers.

Pakistan is a fairly large country with a population of 150 million growing annually at 1.8 percent. The steady growth in per capita income has created affluent pockets of consumers who seek quality services that provide immense opportunities for investment in services. In tourism, there is immense potential for two and three star hotels to cater to domestic and international tourist needs particularly along the coastal belt and in northern areas.

There is a lot of potential in the transport sector as history of this sector shows a tremendous increase in profit shares, also physical barriers are very less and transit facilities are given to countries. In future, Pakistan will welcome connectivity with borders to provide trade facilitation; in this regard, the national trade corridor has been

planned. In 2004, the department has allowed Indian and Afghanistan bus services. At present, international transit process agreement with Iran, Turkey and Europe is in the pipeline.

In policymaking, the Ministry of Communication, Ministry of Commerce and trade Development Authority and the Board of Investment carefully goes through the GATS position. It was pointed out by almost all the regulatory bodies that there were several rounds of talks about future goals/strategies, but nothing was/is ever taken seriously. The representatives of the departments/sectors interact with each other and review the current goals and strategies to promote the industry, but do not publish these goals and strategies, so no one knows what the outcomes were in these meetings. Also, a large number of domestic firms have no information on the WTO Cell in Pakistan. According to 80 percent of the respondents, activities showed the growth potential as a whole in the services sector, but no future strategy has been established for the current negotiation position at GATS, neither does the MoC seek any advice from them.

With respect to GATS, no future strategies were developed, according SECP, MoC and BoI were responsible for making these types of goals. The MoC consults BoI for any update and SECP has to follow instructions given by BoI.

In order to play its part in the current negotiations at GATS, the telecommunication sector has sent a revised issue offer to the Ministry of Commerce (MoC) to be discussed at the WTO when the new round of talks come about and can take position with reference to revised issue rules and regulations.

Under the Ministry of Health, four different sectors are covered. The suggestions from all these sectors are compiled and forward to all councils, which, after incorporating their commitments and compilation, forward it to MoC. The PMDC and all other councils were involved in preparing initial offer for the WTO/MoC WTO Cell.

#### **4.6. Concluding Remarks**

It appears that although the process that underpins GATS negotiations at Geneva exists, it is somehow weak and requires strengthening. At the first instance, key informants at the Ministry of Commerce WTO wing highlighted that response to initial requests slackened due to slow response from respective ministries/sectoral regulatory bodies. There are a few cases where awareness of GATS and its commitments are not fully understood by regulatory bodies, and as a result, Pakistan cannot fully or comprehensively develop its negotiating position for that particular sector. In other instances, domestic rules and regulations are ambiguous and not clearly projected. The regulator environment is thought to be cumbersome and bureaucratic.

Although Pakistan has come a long way in terms of developing an investor-friendly environment facilitating foreign service providers, there is still room for improvement at the negotiating level as well as the national implementation level. Firstly, the consultation process between the various ministries and regulatory authorities is lengthy and as mentioned earlier, in some cases, the ministry of commerce does not

receive detailed research-based input (again, exceptions are in the case of service sectors such as finance and IT & telecom). In some ways, the process is also confusing since Pakistan's trade policy is not integrated: objectives and outcomes of multilateral agreements are often separate from Pakistan's bilateral commitments. Due to this, policymakers are often confused, and policies and rules are set ad hoc.

In a consultation meeting with Trade Related Technical Assistance<sup>34</sup> consultants, the Ministry of Commerce (WTO Wing) personnel, Board of Investment representative, Ministry of Industries representative, and a member of the Trade Development Authority Pakistan (TDAP), input was taken regarding insights in the services sector and related domestic preparedness. In this regard, the issue that came to the fore was that in Pakistan's case, the services sector has an active need to strengthen support for trade negotiating facilitation and implementation of negotiated outcomes. Policies, rules and processes are informally in place, but they are not cohesive, connected, and implemented.

The major proposal in this regard was to set up an implementation task force that would be supervised by a senior advisory group, which would comprise one member from each service sector ministry. The implementation task force would operate through resource centres (for domestic and foreign service providers) in each major city, and it would ensure that rules set at the multilateral and bilateral level are consistent with each other, and in line with national policy objectives. It would be ideal if members of each sector's regulatory authority are members of this board. The advantage of this three-tier structure is that stakeholders' input (via resource centres) would be transmitted to regulatory authorities, and also each stakeholder will have an information bank that will guide them with cross-cutting issues related to domestic and international regulations that apply to his/her service provision.

The following steps were proposed for domestic preparedness:

- Consultation on negotiations at all levels.
- Capacity enhancement of the officials indirectly linked to the regulation and policy formation e.g. Pakistan Post.
- Awareness-raising of the concerned stakeholders belonging to sectors and sub-sectors which are directly and indirectly linked to each other and strong policy coherence is imperative e.g. Ministry of Tourism and Environment, PMDC and Drug Controller Authority.
- Data compilation according to the four mode of supply (both import and export) in sector and sub-sectors.
- Protecting competitive measures/packages for domestic service providers.
- Domestic service providers (staff/stakeholders) should have the understanding of international negotiations.
- Improve the statistical coverage of services sector with disaggregated data to make clear to policymakers the value and shape of services trade.
- In response to self-assessment, there is need to remove weaknesses in the regulatory framework.
- Follow international standards both in term of import and export.
- Harmonisation of technical regulations.

- Rules and regulations made by the regulatory bodies and MoC should have a balance between protection and liberalisation.
- There is need to carry out in-depth research under each sector and sub-sector to find out export potential as well as investment opportunities for future development.

Another main issue of the services sector in Pakistan is observed in the service provision under Mode 3 (commercial presence) and Mode 4 (movement of natural persons) of Pakistani service providers in the markets of the developed countries. The developed countries most of the time put barriers especially in education qualification and the ability of the service providers for qualifying for bids. In such cases, the Government of Pakistan should take the following measures regarding liberalising its service sector:

- If the government is going to open up more sectors and sub-sectors, it should be liberalised with conditionality, i.e. joint ownership and transfer of technology.
- The relaxation of conditions in each sector and sub-sector should be subject to provision by the other party.

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## Endnotes

- 1 Humayun Akhtar Khan, Minister for Commerce. Trade Policy Speech, July 17, 2006.
- 2 This is stated with reference to the political and structural challenges.
- 3 External Trade to GDP ratio increased from 25.8 percent in FY 2000 to 32.7 percent in FY '07, after it peaked at 35.2 percent in FY '06.
- 4 2005 World Population Data Sheet, Population Reference Bureau, Washington D.C.
- 5 Trade in Services Summary, Government of Pakistan, Statistics Division, June 2007.
- 6 [http://www.dailytimes.com.pk/default.asp?page=2007%5C10%5C26%5Cstory\\_26-10-2007\\_pg5\\_1](http://www.dailytimes.com.pk/default.asp?page=2007%5C10%5C26%5Cstory_26-10-2007_pg5_1) (accessed in November 2007))
- 7 The details of the budgetary measures can be seen on CBR website. (url?)
- 8 This obligation is subject to certain exceptions such as the MFN exemption lists which WTO members were free to file at the end of the Uruguay Round; economic integration agreements; mutual recognition schemes; and general exceptions for safety and security reasons, etc.
- 9 To review the extent of national treatment obligations and the level of market access, see Pakistan's schedule of commitments at [www.wto-pakistan.org](http://www.wto-pakistan.org)
- 10 <http://www.wto-pakistan.org/?p=services> (accessed in October 2007)
- 11 Communication from Cuba, Dominican Republic, Kenya, Nigeria, Pakistan, Senegal and Zambia, TN/S/W/3, June 10, 2002.
- 12 This is to ensure the credibility, integrity, competence and honesty of the people leading the institutions, and to record that the candidate under question has not indulged in criminal and unlawful activities in the past.
- 13 Pakistan has a limited scope (Mode 1 and Mode 4) in export of architectural services, and therefore encourages joint partnership in Mode 3, which could support its export interest in Mode 1. Pakistan does have experienced professionals willing to provide their services at competitive costs as compared to developed country professionals. Any joint ventures with foreign service providers would give such professionals access to foreign markets. Pakistan also has great export interest in all modes of supply in the construction and engineering sector. This is due to the interdependency of construction and engineering services in all modes of supply coupled with the fact that Pakistan is a supply source of cheap skilled labour. Consequently, at present a small number of Pakistani engineering companies have opened offices in the Middle East and Afghanistan.
- 14 <http://www.wtopunjab.gov.pk/gats.html> (accessed in August 2008)
- 15 This section is derived from ICTSD report on Opportunities and Risks of Liberalizing Trade in Services in Pakistan.
- 16 Other members include, Australia, Canada, Taiwan, Penghu, Kinmen and Matsu, EC, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Norway, Singapore, Turkey and USA.
- 17 Computer and related, cross-border supply, telecommunications, education, audiovisual, maritime transport, air transport, postal and courier, including express delivery, distribution, logistics, Mode 4, environment, construction, architecture and engineering, legal, energy, Mode 3, MFN exemptions, financial, agriculture.
- 18 Protection to video films, periodicals and all forms of audio-visual works was also added within the amendment.
- 19 This was gauged by an interview with the Director, Ministry of IT and Telecom on August 21, 2007

20 [http://ravi.lums.edu.pk/cmer/nmpakistan/images/pak\\_paper.pdf](http://ravi.lums.edu.pk/cmer/nmpakistan/images/pak_paper.pdf)

21 [http://www.sbp.org.pk/publications/prudential/ordinance\\_62.pdf](http://www.sbp.org.pk/publications/prudential/ordinance_62.pdf) pp.35-36.

22 [http://www.sbp.org.pk/publications/prudential/ordinance\\_62.pdf](http://www.sbp.org.pk/publications/prudential/ordinance_62.pdf) pp.37-38.

23 <http://www.secp.gov.pk/aboutus.htm>

24 [http://www.secp.gov.pk/corporatelaws/dec\\_26\\_98.htm](http://www.secp.gov.pk/corporatelaws/dec_26_98.htm)

25 The Pakistan Council of Architects and Town Planners (PCATP) is the key governing body to regulate the architectural profession. The PCTAP advises the government on architecture-related issues as well as sets standards outlining the code of conduct for its own members.

26 <http://www.pec.org.pk/fo-consultants.htm>

27 [http://www.pec.org.pk/consult\\_byelaws.htm](http://www.pec.org.pk/consult_byelaws.htm)

28 [http://www.pec.org.pk/engg\\_byelaws.htm](http://www.pec.org.pk/engg_byelaws.htm)

29 [http://ravi.lums.edu.pk/cmer/nmpakistan/images/pak\\_paper.pdf](http://ravi.lums.edu.pk/cmer/nmpakistan/images/pak_paper.pdf) p. 17. (accessed in October 2007)

30 <http://www.environment.gov.pk/act-rules/envprotact1997.pdf>

31 [http://www.pbbarcouncil.com/downloads/barcouncil\\_act\\_amended\\_2005.pdf](http://www.pbbarcouncil.com/downloads/barcouncil_act_amended_2005.pdf) (accessed in July 2007)

32 [http://www.pbbarcouncil.com/downloads/barcouncil\\_act\\_amended\\_2005.pdf](http://www.pbbarcouncil.com/downloads/barcouncil_act_amended_2005.pdf) (accessed in July 2007)

33 [http://www.pbbarcouncil.com/downloads/barcouncil\\_act\\_amended\\_2005.pdf](http://www.pbbarcouncil.com/downloads/barcouncil_act_amended_2005.pdf) (accessed in July 2007)

34 Supported by the WIPO and European Commission.

## Chapter 5

# **Domestic Preparedness of Sri Lanka with respect to Services Trade Liberalisation: A Case Study of the Telecom Sector**

**Deshal de Mel and Janaka Wijayasiri**



## 5.1. Introduction

Sri Lanka has not been active in services negotiations under the Doha Round of Trade talks given that it does not have offensive interests in the export of services, at least at the multilateral level. Nevertheless, it has engaged in negotiations on a bilateral basis in Geneva largely on account of interests of other countries. So far, Sri Lanka has received requests from other countries in telecommunications, financial, educational and logistical services, which have been mostly from developed countries<sup>1</sup>. There has not been any overt pressure to open up the services sector in the country and services negotiations seem to have been sidelined by negotiations in agriculture and NAMA, which have taken the centre stage in the Doha Round. Nevertheless, when the round is finalised, it would be crucial for the country to be prepared to undertake and implement the commitments made at the multilateral level.

While Sri Lanka may not need to make any commitments in the services sector under the current round, it may need to consider how the initial offers made in 1997 could be improved as part of the larger negotiation process to secure Sri Lanka's interests in agriculture and NAMA at the round. Moreover, making commitments unilaterally in the services sector independent of requests received could bode well for the sector in question and the economy as a whole. Furthermore, trade in services has arisen in Sri Lanka's regional and bilateral trade agreements as well. The Indo-Lanka Comprehensive Economic Partnership Agreement (CEPA) is under negotiations and includes a services agreement. It is likely that SAFTA and the Sri Lanka-Pakistan FTA will also include trade in services. Therefore, it is important to take into account the issue of domestic preparedness and potential benefits of liberalisation of the service sector in Sri Lanka.

Since this chapter deals with domestic preparedness, given the great diversity of the services sector in Sri Lanka, it will focus on one case study to do justice to the required level of detail. The telecommunications sector was chosen due to the fact that it has already been committed in the GATS and is a sector where fellow GATS members have requested further liberalisation. It would not make sense to stringently assess the preparedness of a sector that has not been requested for liberalisation since the government will not liberalise a sector unless some degree of domestic preparedness is in place.

This chapter on Sri Lanka provides an overview of services sector in the country and the extent of liberalisation undertaken unilaterally, bilaterally and multilaterally. It also examines Sri Lanka's experience with commitments made under GATS negotiations in the telecom sector and assesses their implications for the industry. It further examines the current state of regulatory framework in the telecom sector and preparedness of the sector for further commitments at the multilateral level. And it finally touches on domestic preparedness of other service sectors of the economy and probable concerns associated with such liberalisation.

## 5.2. Overview of the Service Sector in Sri Lanka

The service sector has grown to become the biggest contributor to the GDP in Sri Lanka. It has also consistently been the fastest growing sector of the economy in the past decade or so. This is no less true in the performance of the service sector in 2006

**Table 5.1: Components and Growth of GDP in Sri Lanka (2006)**

<b>Sector</b>	<b>Growth (%)</b>	<b>Contribution to change in GDP (%)</b>	<b>Share of GDP (%)</b>
Agriculture	4.7	11.1	16.8
Industry	7.2	26.3	27.0
Services	8.3	62.6	56.2

*Source: CBSL Annual report 2006*

(see Table 5.1). In 2006, services made up 56.2 percent of GDP and grew at 8.3 percent. As overall GDP grew by 7.4 percent, the contribution of services to change in GDP was 62.6 percent<sup>2</sup>. Table 5.2 suggests that the major drivers of the service sector in 2006 were telecommunications (which grew at 22.7 percent), finance (10.5 percent), port activity (13.2 percent) and construction (8 percent).

**Table 5.2: Role of Services in the Economy (2006)**

<b>Item</b>	<b>Growth (%)</b>	<b>Contribution to growth in services (%)</b>
Wholesale and Retail Trade, Hotels and Restaurants	5.9	17.3
- Hotels and Restaurants	6.3	0.4
- Domestic Trade	4.5	5.4
Transport, Storage, Communication	13.1	27.2
- Transport	5.1	5.4
- Cargo Handling, Storage, Warehousing	13.2	1.7
- Telecommunications	22.7	20.1
Financial Services, Real Estate and Business Services	9.7	15.5
- Financial Services	10.5	13.5
- Real Estate, Renting and Business Services	6.2	1.9
Government Services, Personal and Social Services	2.8	2.60
Total Services	8.3	-

*Source: Central Bank of Sri Lanka: Annual Report 2006*

Services account for 41.2 percent of employment, greater than the shares of industry and agriculture. The fact that 41.2 percent of the total employed yields 54.6 percent of GDP is testimony to the earning potential and economic significance of the services sector. The major sources of employment within the services sector are tourism and personal services. Financial services and telecommunications provide less employment but generate greater earnings.

Despite the importance of the service sector in the Sri Lankan economy, trade in services has not been as dynamic. Table 5.3 shows the extent to which trade in goods exceeds trade in services.

<b>Table 5.3: Share of Services in Overall Trade (US\$ million)</b>						
<b>Item</b>	<b>2004</b>			<b>2005</b>		
	Credits	Debits	Net	Credits	Debits	Net
Goods	5757	8000	-2243	6347	8863	-2516
Services <sup>3</sup>	1527	1108	419	1540	1202	338
Total Trade (Goods and Services)	7284	9108	-1824	7887	10065	-2178

*Source: Central Bank of Sri Lanka Annual Report (2004)*

In 2006, Sri Lanka's net income from services stood at US\$256mn, down from US\$338mn in the previous year, primarily due to reduced net earnings from travel services which reduced from US\$115mn in 2005 to US\$37mn in 2006 (see Table 5.4). Net earnings from transportation services (consisting of freight charges, port-related activities and passenger fares) increased by 3.6 percent to US\$211mn in 2006<sup>4</sup>. This was led by increased port-related activity in the form of greater transhipment cargo handling, and increased passenger fare earnings due to expanded flight destinations by the national carrier.

<b>Table 5.4: Sri Lanka's Trade in Services 2004-05 (US\$ million)</b>						
<b>Item</b>	<b>2005</b>			<b>2006</b>		
	<b>Credit</b>	<b>Debit</b>	<b>Net</b>	<b>Credit</b>	<b>Debit</b>	<b>Net</b>
Transportation	673	470	204	751	540	211
Travel	429	314	115	410	373	37
Telecommunications Services	44	19	25	68	49	19
Computer and Information Services	82	0	82	98	0	98
Construction Services	29	5	24	29	6	23
Insurance Services	73	34	39	57	37	20
Other Business Services	188	322	-134	190	329	-138
Total Services	1540	1202	338	1625	1368	256
Private Remittances	1968	233	1736	2326	257	2068

*Source: Central Bank Annual Report 2006*

The role of remittances by migrant workers continues to play a critical role in the Sri Lankan economy. In 2006 net remittances increased to US\$2.06bn from US\$1.73bn in 2005. Remittances along with the slim surplus in trade in services have enabled Sri Lanka to mitigate the large deficit in trade in goods which stood at US\$ -3,370 mn in 2006. The capital account however recorded a surplus of US\$1.80bn, supported primarily by long-term government finance (net US\$491mn) and FDI (US\$451mn).

<b>Table 5.5: FDI Entering Sri Lanka by Sector 2006</b>		
<b>Sector</b>	<b>No of Projects</b>	<b>FDI (US\$ mn.)</b>
Food, Beverages & Tobacco	28	34.11
Textile, Wearing Apparel & Leather Prod.	64	103.48
Wood and Wood Products	5	4.39
Paper, Paper Products, Printing & Publishing	4	0.76
Chemical, Coal, Petroleum, Coal, Plastic	32	43.15
Non-Metallic Mineral Products	8	5.26
Fabricated Metal, Machinery & Transport Eq.	20	14.08
Other Manufactured Products	46	29.55
Agriculture	6	0.67
Services & Infrastructure	162	368.24
<b>Grand Total</b>	<b>375</b>	<b>603.69</b>

*Source: Monitoring Dept. Bo I*

In 2006, FDI entering Sri Lanka was dominated by the services sector, as more than 50 percent of the FDI went to the services sectors (see Table 5.5).

It is clear that the services sector plays a key role in all aspects of the Sri Lankan economy; GDP, economic growth, employment and FDI. However, trade in services has failed to meet expectations despite the steps taken by Sri Lanka to liberalise the sector unilaterally and bilaterally.

### **5.3. Unilateral Services Trade Liberalisation**

Sri Lanka has historically been one of the most liberal economies in South Asia, and the same applies to its services regime. In Modes 1 and 2, exchange controls for cross-border trade and consumption abroad were removed in 1994<sup>5</sup>. The most liberal service sector in Sri Lanka is Mode 3. FDI is allowed in almost all sectors of the economy. “Foreign investment is allowed with automatic approval up to 100 percent equity in all business activities other than sections such as fishing, supply of water, mass transportation, freight forwarding, professional services, travel agencies and shipping agencies”<sup>6</sup> In the following sectors foreign equity is allowed up to a limit of 40 percent of the issued capital of the company, but with approval from the Board of Investment (BoI) a greater share of equity is allowed up to the level specified by the BoI:

- Mass communication
- Education
- Freight forwarding
- Travel agencies
- Shipping agencies

In air transportation, lotteries and coastal shipping, a share of foreign equity can only be granted by permission of the government of Sri Lanka or any legal or administrative authority set up for the approval of foreign investment in such business, up to a level determined by the relevant authority.

At the same time, certain sectors are reserved entirely for Sri Lankan citizens, these include:

- Money lending
- Pawn broking
- Retail trade with a capital of less than US\$1mn

Sri Lanka has offered considerable levels of unilateral liberalisation in the key service sectors in the country. In the financial sector foreign equity limits in banking were eliminated in May 2002. There are no restrictions in foreign competition in banking, including overseas unincorporated branches. National Treatment is provided to foreign investors. Foreign investment limits in insurance were removed in 2002 and in licensed stock broking in 2000. In tourism, visa on arrival was accorded to SAARC countries in 2003, and this facility is now extended to over 70 countries. The Ceylon Tourist Board approves investment in hotels and allows up to 100 percent foreign equity. Foreign tour guides can work in the country if they pass the same exams and accreditation as required for local tour guides. In telecommunications, up to 100 percent equity is allowed in investments in telecommunication (subject to licensing) that are not classified as mass communication.

In terms of Mode 4, Sri Lanka maintains a less liberal environment than the FDI regime in services. The employment of foreign service suppliers requires the approval of the relevant ministry, for instance, Ministry of Health approval is required to hire a foreign doctor. In the case of foreign investments requiring foreign service suppliers, the BoI is the approving body.

#### **5.4. Sri Lanka's Commitments in GATS**

Sri Lanka's initial commitment in GATS was limited to tourism and travel services in 1994. This was expanded in 1997 to include financial services and telecommunications.

**Telecommunications:** Commitments were made in National Treatment (NT) and Market Access (MA) in international basic voice telecommunication services, domestic local and long distance basic telephone services, mobile cellular services, wireless local loop services, public payphone services, radio paging services, data communication services and GMPCS services provided through own gateways.

**Financial services:** Commitments were made in MA and NT in direct life insurance, non-life insurance, reinsurance and retrocession. Banking – acceptance of deposits and other repayable funds from the public, lending of all types, financial leasing, all payment and money transmission services, guarantees and commitments, trading for own account or account of customers, participating in issues of all kinds of securities, money broking, asset management, settlement and clearing services for financial

management, provision and transfer of financial services and advisory services in all of the above.

**Tourism:** Commitments were made in hotel and lodging services and travel agency and tour operators, characterised by full commitments in Mode 3 in both MA and NT.

Sri Lanka has also tabled a revised offer in the Doha Round in 2003 but no new sectors were offered other than offering to further liberalise the three sectors previously committed, particularly in Mode 3 of all three sectors. It is evident that Sri Lanka has made substantially low commitments in GATS compared to the extent of unilateral liberalisation that has been undertaken in the country. Furthermore, the level of commitment in the listed sectors is lower than the actual level of liberalisation undertaken in the sector. This has allowed for a greater deal of policy space for Sri Lanka to manoeuvre within the committed level of liberalisation and the unilaterally provided level.

Sri Lanka has submitted its request list to 18 countries in the GATS. The requests have been in the following sectors; professional services, computer-related services, communication services, health-related and social services, transport services, and services auxiliary to all modes of transport. Requests are for full commitments in all modes of service supply<sup>7</sup>.

## **5.5. Bilateral and Regional Initiatives in Liberalisation of Services**

Sri Lanka is in the process of negotiating a Comprehensive Economic Partnership Agreement (CEPA) with India, which includes the liberalisation of services. This process began in 2002, following the release of a report by the Joint Study Group to examine CEPA. The first round of technical negotiations began in February 2005. Since then progress has been staggered, and following a breakdown in services negotiations during the Vanaspathi crisis, it has resumed in January 2007. And the agreement is expected to be completed by early-2008. There are also indications that the Sri Lanka-Pakistan FTA may also be deepened into a CEPA in the near future. Other regional agreements have also been slow to acknowledge the importance of liberalising trade in services. SAFTA and BIMST-EC are two agreements where the liberalisation of services has been mooted.

## **5.6. Sri Lanka's Offensive Interests in Trade in Services**

### **5.6.1. Offensive Interests in Mode 4**

In multilateral services negotiations, Sri Lanka's main area of interest lies in the liberalisation of Mode 4. This holds true for most other South Asian countries given the region's comparative advantage in low skilled labour. The importance of Mode 4 for Sri Lanka can be gathered from the substantial flow of remittances by Sri Lankan working abroad. Currently, remittance flows to the country amounts to US\$2.4bn and exceeds both the FDI and ODA flows to the country and is the second largest source of foreign exchange to the country after the apparel sector. Increasing flows of remittances have helped the country to mitigate a weakening balance of payments position given

increasing import bills due to oil price hikes, defence expenditure and construction-related imports.

Unfortunately, in today's global trading environment, Mode 4 is the least liberal of all the modes of service delivery. Furthermore, the commitments in GATS are mainly for temporary migration of higher skilled workers such as intra-corporate transferees, speciality workers, while restrictions on lower skills workers are more stringent. This is a disadvantage to Sri Lanka and other South Asian countries since their comparative advantage lies in the export of low-skilled workers. Therefore, there is great scope for liberalisation of Mode 4 under GATS, which would be of great benefit to Sri Lanka and to the rest of South Asia. While Sri Lanka's temporary migrants are mostly low-skilled workers, particularly housemaids, it also has a potential for the export of high-skilled labour.

#### **5.6.2. Offensive Interests in Mode 1**

The business process outsourcing (BPO) sector is in its infancy in Sri Lanka. Nonetheless, it remains a sector which has tremendous potential for growth. At present, there are 25 BPOs operating in Sri Lanka and an additional 6 are awaiting BoI approval. Total employment in these firms is estimated at slightly over 4,000 with total investment over US\$13.2mn. Around 43 percent of these firms are engaged in accounting services, 19 percent operate as call centres and 14 percent as medical insurance processors (Lirneasia, 2006). A highly educated labour force (both in terms of skills and ability to communicate in the English language) combined with relatively low wages makes Sri Lanka an excellent option as an outsourcing hub.

Though telecommunications infrastructure remains a constraint, this sector is one of the fastest growing in Sri Lanka and technological improvements are occurring at a rapid rate. Specific areas where Sri Lanka can benefit include accountancy, hospital services, architectural services and computer and related services. Most of the trade that occurs under M1 is unregulated at this point in time. However, laws have been passed of late that are likely to adversely affect the free flow of services under this mode. In this context, it is important from Sri Lanka's perspective that Mode 1 is not unnecessarily over regulated any further.

#### **5.6.3. Offensive Interests in Some Specific Sectors<sup>8</sup>**

Apart from the general strength in Mode 1 and Mode 4, there are also certain sectors where Sri Lanka can benefit if there is increased Market Access available especially in South Asia. Sri Lanka would benefit a great deal if South Asian countries consider liberalising these sectors at the multilateral or unilateral levels:

**Tourism and Travel-related services:** Sri Lanka has a highly developed hotel industry and there have been substantial investments by Sri Lankan companies within the region in hotels. Furthermore, travel agency and tour operator services can be supplied by Sri Lankan firms in Mode 3 in particular.

**Maritime Services:** Sri Lanka has a well developed maritime sector and interest in exporting these services under several modes. Colombo has one of the best ports in South Asia and can offer a range of services through Mode 2 (i.e., maintenance and

repair of ships, supporting services for maritime transport, cargo handling and warehousing services). Sri Lanka also has expertise in Mode 4 for passenger and freight transport

**Retailing Services:** Sri Lanka has many competitive retailing firms along with retailing arms of production firms. This applied to both food retail and non-food retail sectors and Sri Lanka would benefit from the liberalisation in Modes 1, 3, and 4.

**Computer and Related Services:** This is an ever-expanding sector in Sri Lanka and therefore, there is much scope for benefit through liberalisation. Sri Lanka has competitive interests in all four modes in this area, particularly in Modes 1 and 4.

**Air Transport Services:** Whilst air services are out of the GATS at the moment, this is one area where Sri Lanka can provide very competitive services. As it stands, most liberalisation in this sector occurs through bilateral air services agreements. In the meanwhile, Sri Lanka has aggressively been pursuing greater market access in neighbouring countries.

## **5.7. Background to the Telecom Sector and Regulation in Sri Lanka**

Reforms in the telecom sector began in 1980 with the de-linking of posts and telecommunications services which was under Posts and Telecommunications Department in the Ministry of Posts and Telecommunications. However, the Department of Telecommunications was unable to operate commercially, raise funds or retain earnings for internal use as it was still subject to the requirements placed on it as a governmental department.

The first private operator entered the market in 1989, when Celltel, a mobile operator was licensed. But the real reforms came about with the Telecommunications Act No.25 of 1991, which transformed the operator, Department of Telecommunications (DoT) into a government-owned corporation, Sri Lanka Telecommunication Corporation (SLT) as well as created the Office of the Director General of Telecommunications (ODGT), thereby separating policy, operational and regulatory functions between the ministry, SLT and ODGT, respectively. However, the ODGT did not have the required independence, power, structure, resources or accountability to foster growth of the telecommunication sector and its performance was rather unsatisfactory.

Subsequently, the Telecommunications Act of 1991 was amended by the Sri Lanka Telecommunications Act No. 27 of 1996, which created a more independent and better-resourced body, the Telecommunications Regulatory Commission of Sri Lanka (TRCSL) to better fulfil the objectives of the Act. The commission replaced the single person authority under the ODGT with a five member commission – two ex-officio members namely secretary to the Ministry of Telecommunications serving as chairman, and director general of telecommunications (DGT) serving as the chief executive officer (CEO) of the commission and three part-time members from the fields of law, finance and management. The objectives of the commission were:

- to ensure the provision of qualitative, reliable, and efficient telecommunications service while protecting and promoting the interests of consumers;

- to maintain and promote effective competition, promote the rapid and sustained development of telecommunication facilities
- to ensure that operators carry out their obligations for providing reliable and efficient services
- to encourage the major users of telecommunication services (whose place of business is outside Sri Lanka) to establish places of business within Sri Lanka.

That year also saw the Sri Lanka Telecommunication Corporation converted into fully government-owned company named Sri Lanka Telecom Limited (SLT) in line with the market reforms taking place in the country and in the international telecommunications sector. By 1997, the government had sold 35 percent of its shares to Nippon Telegraph and Telephone (NTT) of Japan as well as handed over management control to the same company for a period of five years. At the same time, three and half percent of SLT's shares were distributed amongst the employees. In 2002, the government sold another 12 percent of its stake in SLT at an initial public offering (IPO) leaving it with only 49.5 percent.

Like many other developing countries, Sri Lanka first liberalised its domestic market before introducing competition in international telecommunication services. Competition in fixed telephony was introduced in 1996 for the first time with licensing of two wireless local loop (WLL) operators (Suntel and Lanka Bell) for a period of five years and possibly for another five years on meeting certain service requirements. They were issued licenses to operate fixed basic telephony, data transmission, payphone, voice mail and facsimile and assured of a duopoly for a period of 20 years.

In the fixed telephony sector, which includes fixed wire line, WLL and CDMA operations, the incumbent Sri Lanka Telecom currently has the largest market share of 71 percent. Since the early 1990s a number of mobile operators have been licensed and the sector is competitive with four operators: Lanka Cellular Services (now Hutch), Mobitel, Dialog GSM and Celltel (now Tigo), with Dialog dominating the market with a market share of about 57 percent. More recently in July 2007, India's Bharti Airtel was issued the fifth mobile license and is expected to commence commercial operation soon. All mobile operators have some foreign participation. In addition, several operators also provide radio paging, data communication, internet service and satellite link-ups.

Sri Lanka Telecom was not only given a monopoly in the domestic fixed wire voice telephone services and permission for tariff rebalancing for a five year period, but was also granted an exclusive license to provide international telecommunication services until August 2002 when the market was opened up with the issuing of licenses to 32 external gateway operators (EGOs). Sri Lanka's move towards opening up the international market was a massive step forward in the liberalisation process and resulted in a substantial reduction in tariffs for international calls. Although 32 EGO operators were given licenses to operate, only 10 have been able to function due to a number of reasons including the inability of the EGOs to reach interconnection agreements with existing operators. Seven of the ten EGOs in operation were existing market players while only three were new entrants.

Sri Lanka has followed a moderate approach to liberalisation of its domestic and international telecommunication market like in other developing countries. So far, it has undertaken unilateral liberalisation in Mode 1 (international telephony), Mode 3 (FDI in the sector is allowed in the country and up to 100 percent foreign equity is allowed) and in Mode 4 where firms which have invested in the country are allowed to bring in senior management and experts to work in the country. Sri Lanka scheduled the telecom sector in the GATS commitments of 1997 in an attempt to attract foreign investment to the sector. As already noted, the GATS commitments were however significantly less liberal than what was available unilaterally.

Telecom reforms, although limited, have undoubtedly had a positive impact on the industry and the economy. The sector has recorded consistent growth since the 1990s with the number of subscribers touching a figure of around 7,296,572 as of December 2006. Of these, 1,884,076 were fixed telephone subscribers and 5,412,496, mobile subscribers. Following global trends, the mobile sector in Sri Lanka overtook fixed lines in 2002 and now dominates the telecom sector, accounting for about three-quarters of the total telephone subscribers in the country. The share of mobile sector is expected to increase further in the coming years as the sector continues to grow. The compound average growth rate of the mobile sector for the past 10 years has been over 50 percent compared to 19 percent growth in the fixed line market (including WLL) over the same period. This growth has been driven by massive investments by both the fixed and mobile operators. Teledensity figures (the number of telephones per 100 persons) for both fixed and mobile have also increased to about 40 in 2007. Despite the progress made towards opening of the sector and the positive impact it had on the sector (and economy), there are a number of challenges confronting the industry. For example, there are considerable regional imbalances in terms of penetration and access to telecom facilities with most users concentrated in the western province while rural areas and conflict affected parts of the island such as the North and the East have marginal access. Internet penetration in the country is also extremely low (though the sector shows an increasing trend over the last few years).

A major concern is the lack of an up to date comprehensive telecommunications policy. Sri Lanka has not had a telecommunications policy since 1996. In September 2002, Sri Lanka came out with a Proposed Communications Policy, which is likely to have had far reaching impact on the telecommunication services if implemented. However, the proposed policy is still under review. In 2003, Interconnection Rules under Section 68 of the Telecommunications Act was promulgated and removed certain shortcomings in the Act on the issue of interconnection. Nonetheless, implementation of interconnection in the industry remains an issue.

## **5.8. Sri Lanka's Commitments in Telecom under GATS**

Like many other developing countries, Sri Lanka did not initially participate in the negotiations on telecommunications services during the Uruguay Round and was not a party to the 'Decision on Negotiations on Basic Telecommunications' (Venugopal, 2003). Subsequently, it did join the negotiations and became a signatory to the Fourth Protocol to the GATS which was concluded in February 1997. Sri Lanka submitted its set of commitments in April 1997 and fully adopted the Telecommunications Reference

Paper which sets out regulatory principles for the effective implementation of the agreement.

While there has been no pressure on Sri Lanka to improve its commitments, such pressure may arise under the Doha round or due to bilateral/plurilateral negotiations under way (Samarajiva, 2007). Bilateral negotiations with Singapore has been on hold for a while but its resumption could generate interest on the part of Singapore to open the telecom market given that SingTel and Temasek are major investors in the region and SingTel already has presence in Sri Lanka through Lanka Communications.

#### ***5.8.1. Specific Commitments***

The Sri Lanka Telecom was given a monopoly in international basic voice telecommunication services until December 31, 1999. Thereafter, the government was to issue an additional license subject to satisfactory progress in tariff rebalancing. In domestic local and long-distance basic telephone services, licenses were issued to four mobile cellular operators. The government committed to review the limitation on the number of operators in 2000. Licenses were also issued to two Wireless Local Loop (WLL) operators to provide basic telephony, data transmission, payphone, voice mail and facsimile. In addition, Sri Lanka Telecom was permitted to provide WLL services in 800 MHz Band. In public pay phone and radio paging services, the number of providers was limited to five in both services, with additional licenses provided subject to economic needs criteria. In data communication services, licenses were issued to six operators and no new licenses would be issued for facilities-based operators until 1998. For Global Mobile Personal Communications by Satellite (GMPCS), services supplied through own gateways, issuing of license is under consideration.

For all suppliers other than SLT, foreign equity participation was based on horizontal commitments – that is, foreign equity participation was permitted up to 40 percent with investments over 40 percent subject to case-by-case approval. Sri Lanka permitted foreign equity participation of up to 35 percent to a strategic partner in the government-owned operator SLT. The presence of natural persons was left unbound except as indicated in the horizontal section. Sri Lanka also submitted an MFN Exemption List to permit the government or the government-run operator to apply differential measures such as accounting rates, in bilateral agreements with other operators or countries

#### ***5.8.2. Additional Commitments under the Reference Paper***

Sri Lanka also committed to the regulatory principles outlined in the Reference Paper. The main objective was to ensure that countries adopt policies that promote competition. The six principles of the Reference Paper include:

- Competitive safeguards: Countries are required to take measures in order to prevent major suppliers from engaging in anti-competitive practices. For this purpose, the paper defines a ‘major supplier’ as a supplier that can materially affect the terms of participation in a market because of its control over essential facilities or by abusing its market position. Essential facilities include public telecommunications transport network facilities that are ‘exclusively or predominantly provided’ by one or few suppliers and for which there is no commercially or technically viable substitute.

- Interconnection: Countries are required to ensure that interconnection with a major supplier is provided:
  - at any technically feasible point in the network;
  - on non-discriminatory terms, conditions and quality;
  - in a timely fashion on transparent and reasonable terms conditions and rates;
  - on an unbundled basis so that suppliers need not pay for network components or facilities they do not need.

Under this, countries are also required to make procedures for interconnection negotiations and arrangements publicly available. The terms for interconnection must be publicly available and enforceable. A service supplier will have recourse to dispute settlement.

Universal Service: Countries are permitted to define the type of universal obligations they wish to maintain as long as these are administered in a transparent, non-discriminatory and competitively neutral manner and are not excessively burdensome than necessary<sup>9</sup>.

- Public availability of licensing criteria Independent regulators – Countries are required to ensure that the telecom is independent of any supplier. Allocation and use of scarce resources: Any procedure used for allocation of scarce resources such as frequencies, numbers and rights of way will be carried out in a objectively, timely, transparent and non-discriminatory manner.

These were included as additional commitments to the country's schedule of specific commitments on a voluntary basis.

#### **5.8.3. To What Extent have the GATS Commitments in Telecom been met?**

Specific commitments (and exceptions) in telecom under GATS were made by Sri Lanka in 1997 but they merely restated conditions, which existed at the time in the telecom sector. Sri Lanka did not make any additional commitments, which would have reduced the policy space available to the government. Since then, the sector has further opened up and exceeded the specific commitments tabled in the GATS schedule in 1997. In fact, in most cases, these commitments are obsolete now (Samarajiva, 2007). For example, commitment on International Basic Voice Telecommunication Services is obsolete given that international gateway was opened up in 2002. This is just one example of commitments that need to be revised to reflect the unilateral liberalisation that has taken since the commitments were made ten years ago. The 1997 schedule of commitments was updated in 2003 as part of Sri Lanka's Doha initial conditional offer on services. However, given the dynamic nature of the industry, the commitments drafted in 2003 became obsolete by 2007.

While Sri Lanka has met the schedule of specific commitments, it has not be able to implement additional commitments outlined in the Reference Paper which deal with regulatory disciplines (i.e., competitive safeguards, interconnection, public availability of licensing criteria, universal service, regulatory authority, allocation and use of resources) though the document has been accepted in full. This leaves Sri Lanka open to arbitration under GATS though no country has taken Sri Lanka to task<sup>10</sup>. The

following section will examine the extent to which Sri Lanka has been able to meet these additional commitments.

#### 5.8.3.1. Competitive safeguards

According to the Reference Paper, countries are required to take measures to prevent major suppliers from engaging in anti-competitive practices such as cross-subsidisation, using information obtained from competitors to stifle competition, and withholding technically/commercially relevant information from competitors that they need to provide services.

The nature of competition in Sri Lanka's telecommunications industry has changed significantly over the last decade. In the nascent stages of liberalisation, SLT's dominance in the telecommunication sector led to a number of legal disputes and accusations of anti-competitive practices. Early on, mobile operators faced particularly burdensome terms of interconnection and WLL operators have also had a number of interconnection disputes with the incumbent. Non-facilities based operators, namely Internet Service Providers (ISPs) have had great difficulty in accessing SLT's backbone and in fact, some have been driven out of business. However, as the market developed, interconnection became less of an issue between the seven major players and more of an issue between the new external gateway operators (EGOs) and established players. Whilst it could be argued that the issues between players have diminished over time due to improved regulation, it is also suggested that this is due to tacit collusion between the major players<sup>11</sup>.

The TRC has not made stringent investigations into the competitive nature of the various MoUs (memorandum of understanding) underlining the telecom market in Sri Lanka. This is particularly disconcerting given the fact that of the 32 EGOs given licenses, only three new players have been provided interconnection – fuelling suspicion that this could be due to resistance from existing players. Furthermore, SLT has now completely taken over one of the mobile players, Mobitel, creating opportunities for anti-competitive practices such as cross subsidies through fixed-mobile ownership. Until recently, other fixed operators were not allowed to own and operate mobile subsidiaries or vice versa. .

The issue of cross subsidies arises when the incumbent subsidises the costs of local calls using revenues through international telephony. This can undercut other players in the local calls market. The fact that Sri Lanka Telecom was given a monopoly in international telecommunication services till August 2002 allowed it to engage in cross subsidisation of its local calls. This undermined the competitiveness of the WLL-based operators. The potential for cross-subsidisation was reduced when SLT's monopoly in international telecommunication services ended in 2002. As a result, today cross subsidies are not an issue with regard to the international gateway, but could potentially be a problem with respect to SLT's ownership of Mobitel. In fact, in 2002 SLT provided Mobitel with an interest free loan of Rs 138mn and bore the Rs. 7.5mn cost of Mobitel's sponsorship of the England cricket tour of Sri Lanka in 2003<sup>12</sup>. Whilst TRC has found against SLT on one occasion for cross-subsidisation<sup>13</sup>, there are no formal mechanisms in the TRC to systematically examine cross-subsidisation between the two entities.

Gaps in legislation have undermined Sri Lanka's ability to deal with anti-competitive practices. Sri Lanka lacks an overarching competition policy and there are also no specific references in the Telecommunications Act to ensure competition in the industry. As a result, the TRC uses individual licence conditions to deal with anti-competitive practices. When issuing licenses the TRC adds a general clause stating that competition must be maintained in the market and that anti-competitive practices are illegal. However, there is no elaboration on what is meant by anti-competitive practices and what would constitute breach of competition. This can be illustrated by the most recent license issued to the fifth mobile operator in the country.

It is clear from Article 21 that there is only vague reference to competition—there is no elaboration as to what is entailed by “restricting competition” and “anti-competitive practices” besides the mention of cross subsidies in 21.2. Article 21 does not make specific references to the types of anti-competitive practices in the Reference Paper, thus calling into question Sri Lanka's adherence to the first requirement of the Reference Paper, both in theory and practice. It should be noted that SLT was on one occasion found guilty of violating a licence condition that had anti-competitive implications and had to pay around US\$ 1 mn to subscribers<sup>14</sup>.

The TRC examines and approves tariffs charged by operators, and would outlaw predatory pricing and other forms of pricing that it deems anti-competitive. However, the TRC lacks up-to-date data, which would enable this to be conducted effectively. For instance, the TRC does not have an up-to-date database of the costs borne by the operators, and therefore has to rely on information provided by the operators themselves. Costs faced by operators are very dynamic given the technology-driven nature of the industry; therefore the regulator needs to be very much in tune with changes in the industry.

Given the lack of a database of costs borne by operators, it is very unlikely that the TRC can make effective judgements on the competitive nature of tariffs in the industry. An unfortunate implication of this inability to effectively deal with issues of competition is that smaller players expend considerable time and resources influencing the decisions of major players and the regulator costs that are eventually passed on to consumers. It is clear that there are several doubts with regard to TRC's ability to ensure competitiveness in the market. Several factors have contributed to this including legislative imperfections, limited regulatory capacity and tacit collusion.

#### 5.8.3.2. Public availability of licensing criteria

According to the Reference Paper, countries are required to make licensing criteria, the period of time to decide license applications and the terms and conditions of individual licenses publicly available. Furthermore, an applicant is entitled to know the reasons for the denial of licence.

Sri Lanka's record in implementing this Reference Paper condition has been mixed. Whilst the terms and conditions of individual licences are publicly available on the TRC website ([www.trc.gov.lk](http://www.trc.gov.lk)), there is a lack of transparency regarding the licensing decisions—that is, the process in which decisions are made and licences are granted. For instance, with regard to the issuance of the fifth mobile licence, it is not clear why

Bharti Airtel was given the licence—there was no public availability of licensing criteria. However, in the case of issuing of licences for External Gateway Operators in March 2003, the licensing criteria were publicly available.

Other cases such as the issue of non-voice data and satellite cable broadcasting licenses were preceded by public notice. This is in accordance with the Sri Lanka Telecommunications Act of 1991, where Article 17 (3a) states that the TRC needs only give public notice with regard to licences in cases where it sees fit. “Where the Authority considers it in the public interest to do so, it may give public notice in such manner as he deems appropriate of his intention to recommend to the Minister the grant of a licence.” It is clear from the above statement that Sri Lanka’s legislation is not in line with the requirements of the Reference Paper.

Another major impediment to effective transparency of telecom licensing is the role of the Minister of Telecommunications. According to Article 17 (2) of the Telecommunications Act of 1991 (as amended in 1996), “The Minister may grant the licence referred to in subsection (1) on the recommendation of the Authority, provided he shall have the power to reject such recommendations for reasons assigned and grant a license in his own discretion.” The fact that the Minister of Telecommunications (at present the TRC falls under the President of Sri Lanka, and therefore the discretion has shifted to the President) has the ability to unilaterally reject a licence and grant one at his/her own discretion completely undermines transparency in the licensing process.

#### 5.8.3.4. Interconnection

The Reference Paper states that interconnection should be provided by a major supplier on non-discriminatory terms and quality, in a timely manner and at cost oriented rates that are transparent and sufficiently unbundled. Until recently, interconnection was not effectively addressed in the telecom legislation. Even after the amendments to the Act in 1996 interconnection was not a mandatory requirement. In the early days of liberalisation, new mobile entrants had to pay entire cost of links and switch interface, fixed termination was set at almost double the local rate, no payments were made for mobile termination of domestic or international calls and there was no discount for international calls<sup>15</sup>.

These unfair interconnection conditions were a reflection of the dominance of the incumbent SLT in a highly concentrated market with weak regulation. As the market developed and new players became increasingly competitive, the market power of SLT diminished and the regulatory environment improved. In 1999, a fixed-mobile interconnection determination was made by the TRC. This addressed to an extent the earlier problems faced by mobile players due to SLT’s dominance. Interconnection link fees were removed, fixed termination was set at lower levels that had been decided on for fixed-fixed interconnection and a 20 percent discount was given for outgoing international calls<sup>16</sup>.

With the promulgation of the Interconnection Rules in 2003, most of the interconnection lacunas between the local legislation and the reference paper were addressed. The new rules allowed the regulator to fix charges on a cost-oriented basis whenever operators failed to negotiate an interconnection agreement among them. The 2003 Rules also

included a provision to resolve interconnection disputes by the TRCSL which must make a determination within thirty days of receipt of the complaint. Whilst legislation and regulation have improved over time, implementation has been far from smooth.

Although the seven Public Switch Telecommunications Networks (PSTN) operators signed an agreement with the TRC to implement interconnection rules in 2003, in practice it is unclear whether these rules are being implemented. Knight-John and Ellepola (2003) suggest that in practice, a tacit MoU between the seven players has been agreed to. This MoU retains the Mobile Party Pays (MPP) system whereby mobile operators pay the fixed operators for calls terminated on its networks, while the fixed operators do not pay mobile operators for calls terminated on mobile networks. Thus, mobile users have to bear the cost of termination charges in terms of incoming call charges. This system is contrary to what was agreed under the 2003 Rules. Moreover, the MoU is not transparent and is in contravention to Sri Lanka's WTO commitments. The TRC has been ineffective in investigating this MoU and implementing the Calling Party Pays (CPP) system, which is the emerging international standard despite announcing that CPP would be implemented in 2004. It is clear that the current interconnection system in practice is completely contrary to the requirements of the Reference Paper. The rates and conditions of interconnection are neither non-discriminatory nor transparent.

At present the major interconnection dispute that exists is the one between the existing seven PSTN operators and the External Gateway Operators (EGOs). In August 2002, TRCSL issued thirty-two EGO licences, which ended the incumbent's monopoly over telephone services and opened up the international segment. Despite each EGO paying Rs 50 mn (approximately US\$500,000) as licence fees, only 10 EGOs have been provided with interconnection (seven of these being the existing PSTN players). The problem is two-pronged. Firstly, the incumbents (the seven established players) have resisted the provision of interconnection. This has been primarily through indirect measures such as delaying processes rather than outright refusal to provide interconnection. The TRC has not been able to effectively deal with such indirect measures that undermine competition in the industry and are contrary to the terms agreed to in the Reference Paper:

*Interconnection to be ensured in a timely fashion, on terms, conditions (including technical standards and specifications) and cost-oriented rates that are transparent, reasonable, having regard to economic feasibility, and sufficiently unbundled so that the supplier need not pay for network components or facilities that it does not require for the service to be provided*

The other major constraint in terms of market access for new EGOs is the financial requirement. Since the EGOs use the current operators' networks; if there is a failure in terms of the new suppliers, this cost will have to be borne by the current operators. As insurance for this eventuality, new EGOs are required to provide a bank guarantee which has been excessively demanding for some of the EGOs. The TRC is meant to intervene when players cannot agree on a bank guarantee price, and the persistence of problems suggests the TRC has not been effective in this role.

Perceptions among the key stakeholders whether WTO commitments on interconnection have met, widely differ (Knight-John and Ellapola, 2003). The incumbent and the telecom regulatory body point out that these commitments are in the process of being implemented while TRCSL has also highlighted the need for players in the industry to cooperate to implement them faster. On the other hand, other operators and consumer associations are of the view that these commitments are of little significance, as they have not been implemented in practice.

Failure to implement the commitments undertaken in the Reference Paper largely stems from weakness of the regulator (Knight John and Ellapola, 2003). Regardless of the TRC's ability to grant licences and the commitments made in the GATS, without effective interconnection liberalisation is pointless. The inability of EGOs to establish and provide services is a clear indication that the market for international telecommunication services is far from liberal in practice. Prior to making further GATS commitments, such regulatory shortcomings must be addressed.

#### 5.8.3.5. Independent regulator

There is a general consensus amongst the operators that the TRC is weak and lacking in regulatory clout. It lacks effective independence both from the government and indirectly from major operators. As of 2005, the TRC falls under the purview of the President of Sri Lanka. Therefore, there is limited interaction between the TRC and the Ministry of Telecommunication and Posts, which is in charge of telecommunications policy at the national level. Prior to 2005, the Ministry of Telecommunications had tremendous influence on the functioning of the TRC. The ministry not only nominated the three independent commissioners but also appointed the same individual to serve as the secretary to the ministry and chairman of the TRC. The ministry also had the authority to approve or reject TRC's licensing decisions, deeply compromising the regulator's independence.

The lack of autonomy has also had several adverse impacts on the functioning of the TRC as the regulatory commission in the past has been subject to changes when there have been changes at the ministerial level. This has resulted in a limited ability to build regulatory capacity at the highest level in the TRC. Since TRC has come under the control of the president, there has been less volatility in the administrative structure of the TRC. Nonetheless, the TRC remains under threat of political influence. While the president now appoints the regulatory commission and the director general of the TRC, he has the power to overturn licensing decisions of the TRC and the secretary to the president is now the chair of the TRC.

The Reference Paper states that regulatory body should be

*...separate from, and not accountable to, any supplier of basic telecommunications services. The decisions of and the procedures used by regulators shall be impartial with respect to all market participants.*

The TRC, by being closely aligned to the government, contravenes this requirement since the main player in the fixed line market, Sri Lanka Telecom, is partially government-owned. The problem is compounded by ex-SLT employees joining the commission,

compromising the independence of the regulatory body. In fact, a former managing director of SLT was appointed director general of TRC in 1999 and the subsequent actions that were taken were seen as favouring the incumbent (Samarajiva, 2007). A more recent example of bias in favour of SLT was the 2008 government budget decision to impose a 10 percent tax on mobile and CDMA telecommunications but not on fixed wire line services which is dominated by SLT. This is despite the fact that the latter is predominantly utilised by wealthier sections of society whilst mobile and CDMA connections have been favoured by bottom of the pyramid users.

At the same time, the finances of the TRC remain very much within the government structure and expenditure decisions require treasury approval. Despite the TRC having an independent source of income through license fees etc., the institution lacks financial independence in practice. As a result of the TRC being administered in the manner of a government institution, the commission has been unable to offer competitive remuneration required to attract high quality staff. One of the most pressing problems confronting the TRC is the current staff and their skill mix—there is an over-supply of engineers and a shortage of other technical skills (Knight-John and Ellepola, 2003). This has significantly undermined the capacity of the TRC to act as an effective regulator. Implications of this dearth in appropriate human resources have been cross cutting affecting almost all aspects of regulation referred to in this paper—capacity for adjudicating on tariffs and interconnection determinations being two examples.

Over and above political influence on the structure and function of the TRC, according to informal sources, the privately-owned major players have indirectly influenced decision-making in the TRC. It could be argued that the salary structures of the TRC make officers more vulnerable to regulatory capture. It can be concluded that while the TRC is at least on paper largely consistent with Reference Paper's principle of an independent regulator, in practice it has underperformed due to the structure and capacity of the body as well as political/regulatory capture (Knight-John and Ellepola, 2003).

#### 5.8.3.6. Allocation and use of scarce resources

The Reference Paper requires that the regulator ensure the allocation and use of scarce resources including frequencies, numbers and rights of way “will be carried out in an objective, timely, transparent and non-discriminatory manner”. However, the TRC does not match up to this requirement since allocation of frequencies takes place in an ad-hoc, first come first serve basis (Zita and Kapur, 2004). This is partly due to the nature of demand for frequencies; which has not been very regular. There have been exceptions for certain licences such as the 3G licence where a more formal tender process took place.

In 2003, a closed auction among the mobile operators was held for the sale of addition spectrum (in the 1800 MHz range). Although the TRC is to some extent constrained by the existing allocation, it appears to have responded to a large extent to requests of mobile and WLL operators for more spectrum, though there have been few instances where there was a delay, lack of transparency and discrimination in granting of licences; for example, in the issuance of CDMA licences to telecom operators<sup>17</sup>

Nonetheless, the allocation of frequencies lacks transparency other than for some improvements such as the issuance of consultation papers on spectrum policy. In 2003, the Master Frequency Register was published but it has not been properly updated. For instance, the CDMA frequency assignments of 2005 are not recorded. There was a degree of insubordination by TRC officials prior to the publication of the Master Frequency Register (Samarajiva, 2007). The reluctance to create transparency has raised concerns about previous allocations of frequencies and heightens the necessity to update the register to ensure transparency.

Unlike most international regulators the TRCSL does not have a provision to manage the frequency. According to the Telecommunications Act, the TRC can only issue the licence (1991 Act 22 (1)). As a result of this inadequacy, some of the operators hold on to chunks of frequencies, resulting in unutilised frequency. The TRC has the provision to withdraw frequencies but there is no formal, transparent and predictable guideline as to how this management should take place. This again leaves a window open for corruption and malpractice on the part of the regulator. The allocation and management of scarce resources is another example of limitations in the Sri Lankan legislature and regulatory practice which has prevented effective adherence to the GATS Telecommunications Reference Paper.

### **5.9. Implications of the GATS commitments**

Knight-John and Ellepola (2003) conducted interviews with key market players to assess the extent to which Sri Lanka has met its GATS commitments—both the commitments in the reference paper and Sri Lanka’s schedules. The opinions are mixed on the effect of Sri Lanka’s GATS commitments on the telecom industry and on the economy as a whole. Most of the views refer to the Reference Paper given the fact that the schedules themselves did not create new liberalisation, rather locking in the status quo. The incumbent SLT believes that Sri Lanka’s GATS commitments has led to an improvement in the industry by driving down prices, improving the quality and availability of services and offering innovative products which have benefited the consumers at large.

The regulator maintains that congestion has reduced with the incumbent upgrading its services and increasing its capacity. Mobile operators state that though there has been growth in the industry, an improvement in regulation could lead to higher growth. A similar view is shared by WWL operators, who also point out that foreign investment has slowed down due to inconsistent policies and regulatory weakness with consumers losing out as they receive poor quality services.

While the reforms that have been made since the 1980s have brought about a number of benefits to the industry and the whole economy, the actual impact of GATS *schedules* would have been little, if any, given that the commitments made simply reflected the status quo which existed in the industry at the time of signing of the document in 1997. Substantial liberalisation had taken place prior to GATS commitments and the commitments merely cemented them at a multilateral level. Subsequent liberalisation of the industry took place independent of the commitments made at the WTO and reflected policy decisions, which were outlined in the National Telecom Policy drawn in 1996. Nevertheless, GATS commitments in telecom helped the sector in terms of ‘locking in’

liberalisation undertaken so far (that is, reforms up to 1997) thereby preventing the possibility of the government going back on the reforms without being liable for international arbitration.

Moreover, opening up of the sector to foreign participation (subject to horizontal commitments of 40 percent foreign equity), has further strengthened the liberal investment regime in the country, which is one of the most open in the region by lending credibility to the investor-friendly policies that have been pursued by the country. More importantly, the schedules provide a positive signal to investors regarding the openness of the sector. By committing at the multilateral level such as GATS, it signals to potential investors the irreversible commitment on the part of the country to regulatory reform and provides them with a means of obtaining relief if the government goes back on its commitments. However, Sri Lanka's GATS schedules provide only a weak signal given they are out dated and do not reflect the real situation. Nonetheless, this is better than not committing the sector at all.

It is difficult to assess the impact of schedules on investment. Most of the new entrants invested in the country prior to GATS commitments (Dialog, Hutch and Mobitel in 1993-94, Suntel and Lanka Bell in 2006). The investment that has taken place has been over and above investment by these existing players. Arguably this investment was made with the security that the existing level of liberalisation (four licenses in mobile telephony, two in fixed wireless) would be maintained. Overall investment in Sri Lanka was dominated by the telecommunications sector in 2006. Malaysia (owners of Dialog Telekom) was the largest investor in Sri Lanka in 2006.

This investment has resulted in mobile subscriber growth increasing by almost eight folds since the turn of the century and increased access to telecommunications services in rural parts of the country. But it should be reiterated that this investment was primarily due to unilateral liberalisation by the government, and the GATS commitments did not provide new liberalisation, but only locked in the status quo.

A significant positive implication of Sri Lanka's GATS commitments in telecom is the additional commitments made under the Reference Paper. These have helped strengthen the regulatory framework governing the telecom sector by encouraging improvements in the Telecommunications Act. Even as of 1996, interconnection was not mandatory as per the Telecommunications Act. However, the interconnection rules promulgated in 2003 addressed this and other problems with regard to interconnection. In fact, the drafters of the interconnection rules specifically took care to ensure compliance with the Reference Paper requirements. These rules not only fulfilled Sri Lanka's GATS commitments under the Agreement on Basic Telecommunications Services, but also addressed the shortcomings, which existed in the Act.

In this context, the GATS commitments were a factor in the improvement of Sri Lanka's regulatory environment, which is critical for future investment in the sector. However, as mentioned earlier in section 5.8.3, implementation issues remain a bottleneck in this regard. It is clear from the discussion so far that most of the Reference Paper commitments have been adhered at least in paper but not in practice in part due to the inability of the TRC push forward implementation. The lesson that can be drawn from Sri Lanka's

experience of implementation of GATS commitment is that countries must ensure that domestic institutions are capable of implementing external commitments before they agree to open up the sectors in question. Nonetheless, the improvements seen in the legislature (interconnection rules) and some practices (publication of the master frequency) are steps in the right direction, possibly influenced by these external commitments.

## **5.10. Potential for Further Liberalisation and Domestic Preparedness**

Sri Lanka's GATS commitments in telecommunications are out dated and do not reflect the level of liberalisation in the industry at present. Samarajiva (2007) goes on to suggest that if these same offers were tabled today, other members would not accept them. Sri Lanka is likely to receive requests for further liberalisation in telecommunications at the multilateral (upon completion of the Doha round) or bilateral level by countries such as Singapore, a major regional investor. It is also in Sri Lanka's interest to make a more up-to-date offer that reflects the extent of liberalisation available in the country.

This can be done unilaterally without waiting for the completion of the Doha round. The present commitment provides no positive signal to potential investors, making the offers redundant from an investment attracting perspective. In this context, Sri Lanka will need to seriously consider improving its GATS commitment in telecom. However, some stumbling blocks need to be addressed first.

### ***5.10.1. Legislation***

A major factor that will hamper efforts to make further commitments in telecom at the Doha round is the lack of an updated national telecom policy. The last telecommunications policy was passed in 1996. Since then, a National Communication Policy was drafted in 2002 and contained several pro-competitive and progressive measures. However, despite being approved in principle, following a change of government in 2004, the policy was shelved and remains under revision. The main features of the Proposed Policy were:

- To transform the telecommunications market structure and regulation towards a more liberalised and technology neutral model;
- To establish an explicit Universal Access policy;
- To provide greater independence and authority to TRCSL and introduce transparency to its procedures;
- To provide TRCSL the power to regulate tariffs and reduce barriers to entry;
- Develop and enact a new Convergence Act, which would cover information and communications technology, media and telecommunication among others (Zita & Kapur, 2004).

The 1996 national telecom policy committed the government to undertake certain actions by 1999 (Samarajiva and Dokeniya, 2004) and Sri Lanka's GATS commitments, which were scheduled in 1997, more or less reproduced the national telecom commitments. Having a telecommunications policy provides focus on potential commitments and a more transparent direction to the action of regulators. It would also allow stakeholders to provide inputs to result in a participatory and effective policy and regulatory

environment. As it stands, the legislation and the Telecommunications Act (including the 2003 Interconnection Regulations), are out dated. An obstacle to the process of improving upon the telecommunications policy is the fact that the TRC now falls under the president while the telecom policy is under the Ministry of Telecommunications.

The TRC must play an active role in advising the ministry on regulatory issues that need to be addressed in policy. Technical capacity within the ministry is also inadequate to draft a cutting-edge telecommunications policy. The national policy will follow from an inclusive stakeholder-driven process, and it is essential that any future GATS commitments are reflective of such a process. Therefore, it is important that an updated telecommunications policy be in place prior to making any further commitments at the multilateral level.

As it stands, Sri Lanka has drafted a Doha conditional offer in telecom in 2003. However, this has not been formally scheduled as the Doha round remains under negotiation. It remains to be seen whether Sri Lanka will be able to schedule these offers if and when the round comes to an end given the fact that there is no national telecom policy. If a schedule is committed, it begs the question as to what policy mechanism guided the commitments in question.

#### ***5.10.2. Capacity of the TRC***

There is an urgent need to strengthen the TRC in terms of the independence of the body, transparency of its procedures and competency of its staff in order to ensure that current commitments can be adhered to and future commitments will be implemented. As mentioned earlier, the TRC functions very much as a state institution, using state salary structures and requires approval of the treasury for spending decisions. As a result, it has been difficult for the TRC to attract qualified personnel based on the salaries that they are able to offer. This has constrained the TRC's ability to function as an effective regulator due to limitations in technical capacity. This has, for instance, undermined the ability to effectively make and implement determinations on tariffs, interconnection agreements and competition requirements. In this context, it is imperative that the regulator should be made financially independent from the government—it should be taken off the control of the treasury and salaries of the employees at TRC should be brought in line those of operators in the industry which would resolve many of the problems it currently faces.

A related issue was discussed in the section on independence of regulators. It was pointed out that policymakers at the highest level of the TRC change frequently, in line with political changes at the ministerial level. This has resulted in the lack of consistency and has undermined the development of regulatory capacity at the highest levels of the TRC. While this has been resolved to some extent with the TRC being brought under the president, the efficacy of the regulator remains a key factor to consider when liberalising a service sector.

A weak regulator will be unable to create an effective regulatory environment, which could, in certain cases, make liberalisation redundant (such as the lack of interconnection with regard to Sri Lanka's EGOs). Moreover, a weak regulator will not be able manage

competition effectively and would, therefore, not necessarily be able to respond effectively to market changes resulting from liberalisation.

#### **5.10.3. Implementation Issues**

The other factor to consider before going ahead with new commitments is the extent to which present commitments have been implemented. As it was clearly detailed in section 3.2, most of the Reference Paper requirements have not been fully met in practice. Therefore, it would be prudent to focus on implementation of these fundamental requirements prior to entertaining further commitments. Interconnection is one area where a lot needs to be done to create a suitable environment to make new commitments feasible. For instance, the interconnection rates determined in 2003 were due to be updated every 6 months; however, to date, (54 months later) there has been no update in these interconnection rates.

This has hampered efforts to implement a Calling Party Pays (CPP) system which if implemented would bring down cost by several fold. Another case is that of the EGOs, the fact that 22 licenced operators have not been able to obtain interconnection is a significant deterrent to any future investors seeking opportunities in Sri Lanka's telecommunications sector. It is essential that the TRC becomes more pro-active in intervening in these interconnection disputes.

There are factors beyond the control of the TRC which also hamper efforts at regulation. Despite the 2003 interconnection rules giving the regulator more power on paper through its role in dispute settlement, operators flout this not through legally challenging rulings but by simply ignoring them. Whilst the TRC can still challenge such actions in court, the costly and time consuming nature of this process is a significant deterrent. The inadequacies of the legal system are a cross-cutting factor, affecting a multitude of activities in both domestic and international economic exchange.

The overall shortcomings in the telecom regulatory environment in Sri Lanka have undermined investment and will reduce the benefits of future liberalisation unless they are addressed. A stakeholder in Knight-John and Ellepol (2003) stated that, "Foreign investment, which depends on consistent policies, on regulatory issues and on the seriousness with which these policies are implemented, has fallen drastically due to the lack of both these factors in Sri Lanka's telecommunications industry."<sup>18</sup>

#### **5.10.4. Potential for further Liberalisation in the Doha Round**

To gauge the potential impacts of further liberalisation, it is best to consider the scheduled commitments in the Doha conditional offers. These are most likely to be adopted if and when the Doha round comes to a conclusion. The schedules were drafted in 2003 and are therefore out dated in this fast changing industry. Furthermore, they do not go beyond unilaterally extended liberalisation; therefore do not create any added pressure in terms of potential negative impacts of the commitments. The only potential concern would be if the government in the future would like to go back on commitments in an unforeseen circumstance.

However, given that the GATS schedules would be tabled following consultations with the relevant stakeholders in the industry, they should sufficiently address concerns of

the industry including adverse implications. In the meanwhile, it is important to ensure that commitments that have been already made relating to regulatory principles outlined in the Reference Paper are implemented. There is much scope for improving on these commitments before undertaking new commitments.

There are a couple of interesting observations to be made of the Doha conditional offers. Firstly, the MA and NT commitments in international basic voice telecommunications in the Doha offer (both unbound) are less liberal than those in the 1997 GATS commitments. This could possibly be explained by the fact that there was a delay in the liberalisation of the external gateway—and at the time of scheduling, this was not finalised, resulting in uncertainty and an inability to make a firm commitment. Secondly, again in international basic voice telecommunications, both MA and NT are scheduled as none in Mode 3 implying a completely liberal (subject to horizontal restrictions) environment. However, in reality, due to interconnection problems this is not the case. This is another example of how gaps in the domestic regulatory environment can make external commitments invalid.

### **5.11. Other Service Sectors in the Economy**

Given the positive list framework and the in-built safeguards under which GATS operates, governments have a great deal of freedom in deciding which sectors it wishes to liberalise under the GATS. Therefore, the government has the freedom to only schedule sectors where domestic preparedness is already strong. In this context, it is worthwhile to hypothetically assess the level of preparedness of other sectors that may or may not be liberalised in the future, either bilaterally, plurilaterally or multilaterally.

The biggest concern in Sri Lanka in terms of the liberalisation of services is the weakness in domestic regulatory frameworks—legislative weakness and capacity gaps in professional services associations. This applies to many of the professional services which has made the liberalisation of Mode 4 particularly difficult. Regulation is important to ascertain the quality of professionals entering the country. Many professional services regulatory bodies lack the legislative authority (e.g. The Sri Lanka Institute of Architects lacks the “Practice Registration” authority to regulate practitioners of architecture working in Sri Lanka) to effectively regulate service provision. Even in professional bodies that have the parliamentary authority to regulate (e.g. Sri Lanka Medical Council), capacity constraints are a problem. For instance, Sri Lanka has had bad experiences in terms of unqualified foreign medical practitioners operating in the country due to weak assessment criteria—there is no peer review system to assess qualifications of foreign doctors.

An example of regulatory problems is the case of RMPs (Apothecaries) qualified abroad receiving the same registration status by the SLMC as doctors in 2006. The SLMC lacks the capacity to monitor the functions of foreign practitioners and at present relies on complaints by consumers in order to take action. Furthermore, loopholes between the regulatory requirements of the BoI and SLMC have resulted in certain medical practitioners being able to operate in Sri Lanka with minimum assessment of capabilities.

Legislative weakness is a problem that goes beyond regulation of Mode 4. In both construction services and medical services, legislative gaps are a key constraint to liberalisation. In construction, the Construction Industry Act is scheduled to lead to the establishment of the construction authority, which would be the regulatory body for the construction industry. However, this Act has not obtained parliamentary approval for several years. Until the Act is in place, it would be impossible to make commitments in international agreements since the latter may clash with provisions in the former.

In medical services, the Private Medical Institutions Bill is again awaiting parliamentary approval. This Bill is designed to regulate domestic private hospitals given the market failures in this service due to asymmetric information between the service supplier and the patient. With an imperfect domestic regulatory structure, it is not prudent to liberalise the sector to foreign service suppliers at this stage. Furthermore, most Sri Lankan legislature (such as the Medical Ordinance) has no mention of trade through Mode 1, making it difficult to make commitments in this mode.

Given these weaknesses in domestic regulation, the liberalisation of trade in services has been challenging for Sri Lanka, despite the numerous benefits that could be obtained through liberalisation. This has applied to the country's services negotiations in the Indo-Lanka Comprehensive Economic Partnership Agreement, delaying the implementation of a services agreement between the two countries. Steps need to be taken to increase awareness of the urgency for gearing regulatory practices towards regulation of foreign service providers.

There are also benefits in sharing best practices from similar countries that have effectively improved domestic regulatory capacity. For instance, as part of the Indo-Lanka CEPA negotiations, it would be useful if Sri Lanka's professional associations learn from their Indian counterparts since India has already signed services agreements with countries like Singapore. It could also be argued that liberalisation is the trigger needed to ensure regulatory bodies get their acts together. For instance, Sri Lanka's Medical Council significantly improved their regulatory practices following the introduction of Indian investment in health services in Sri Lanka.

## 5.12. Conclusion

Considering the telecom sector, despite the fact that Sri Lanka has made commitments in GATS and has scheduled Doha conditional offers, the sector is far from perfect in terms of regulatory rigour. This is unfortunate as Sri Lanka stands to gain by locking in reforms in the telecommunications market. This would provide security for much needed investment in the industry. While Sri Lanka has made the additional commitment to implementing the telecom Reference Paper, in practice most of the commitments have not been met. This in fact could leave Sri Lanka liable to international arbitration.

The level of implementation of the Reference Paper commitments is a good indication of domestic preparedness for further liberalisation. Weak implementation has resulted in many of Sri Lanka's scheduled commitments (for instance, the liberalisation of the external gateway) being made redundant. The implication is that Sri Lanka should focus on tightening its domestic regulatory frameworks and improve the capacity of

the regulator through increased financial independence. Only then would further commitments in the telecommunications sector be realistic and useful.

There is much work to be done in other sectors to improve domestic preparedness for the liberalisation of services. Many professional service associations lack regulatory and legislative capacity to effectively regulate even local service providers. This is unfortunate given the fact that Sri Lanka stands to gain if there is increased foreign participation in many service sectors. This would provide greater access to foreign expertise and technology whilst triggering competition and investment that would be beneficial to consumers in Sri Lanka. In order to enjoy these potential benefits, however, the regulatory environment needs to be improved first and foremost.

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## Endnotes

- 1 According to the Department of Commerce of Sri Lanka, there was a low level of requests received from developing countries. These requests basically called upon the country to eliminate existing limitations and to make commitment in other areas.
- 2 Central Bank of Sri Lanka, Annual Report (2006).
- 3 This does not take into account remittances from abroad.
- 4 CBSL Annual report (2006).
- 5 Except in insurance where only travel and health insurance are allowed.
- 6 Sri Lanka Trade Policy Review 2003.
- 7 Government of Sri Lanka report to WTO secretariat as part of Trade Policy Review.
- 8 This is taken from De Mel (forthcoming).
- 9 According to discussions with stakeholders in the industry, USO was not perceived to be a major issue in regard to competition within the industry. As such, the paper would not examine this issue.
- 10 Violation of the agreement can attract financial penalties as demonstrated by the US vs. Mexico (Telmex) case on violation of the commitments it made under the Telecommunications Reference Paper of the Fourth Protocol of GATS. The WTO found against Telmex in April 2004.
- 11 Knight John and Ellapola (2004)
- 12 Notes to the Financial Statement (note 29), SLT Annual Report 2003 ([http://www.slt.lk/data/investor/pdf/annu\\_2003/html\\_verton/financial/note29.htm](http://www.slt.lk/data/investor/pdf/annu_2003/html_verton/financial/note29.htm))
- 13 One instance of cross subsidization between SLT and Mobitel was challenged by TRC and SLT was ordered by the magistrate's court to pay damages to TRC.
- 14 Samarajiva and Dockeniya (2004)
- 15 Samarajiva and Dockeniya (2004)
- 16 Ibid.
- 17 In this particular case, the incumbent SLT was the last to receive the license to operate a CDMA network despite being the first to apply for an application to operate this wireless technology. Nevertheless, it has managed to become the largest CDMA operator in the country despite a late start. It has been also reported in the local media that SLT has been deprived from offering WiMax services to the public though it has started testing facility and has made an application for WiMax license to TRC as far back as 2006. In the meanwhile, other operators like Dialog and Suntel already have rolled out their WiMax services.
- 18 Knight-John and Ellepola (2003)