



**EGYPT'S PREREQUISITES TO ENSURE EFFECTIVE  
AND FRUITFUL REFORM OF SERVICES**

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## Abstract

This paper investigates various means to reform the service sector in Egypt with the aim of enhancing its efficiency. It discusses the different *regulatory* and *liberalization* frameworks governing the reform initiatives. Moreover, the paper investigates how regional liberalization initiatives interact with the multilateral and unilateral waves of liberalization. The main drivers for services' reform are highlighted including market failure, globalization pressures, and distributional concerns. The paper emphasizes that the stylized features for domestic regulations should be maintained in any reform process. These features include ensuring transparency, credibility and predictability and most importantly enhancing competition. The Government of Egypt should develop a services policy outlining the regulatory features and setting a strategy for liberalization. Liberalization itself, as the paper concludes, can be undertaken on a regional basis to overcome the stumbling of multilateral negotiations. However, the paper identifies that liberalization attempts should be preceded or coupled with regulatory reform to ensure the positive outcome of liberalization. Regional liberalization can serve as a better option than multilateral liberalization in some types of services (e.g., energy and transport) and if certain aspects are considered including the design of rules of origin, interest of regional partners and overcoming legal loopholes.

## ملخص

تتناول هذه الدراسة السبل المختلفة لتطوير قطاع الخدمات في مصر وذلك بغية تعزيز كفاءته. وتناقش الورقة مختلف الأطر التنظيمية وفي مجال تحرير التجارة التي تحكم مبادرات التطوير. كما تبحث في كيفية تفاعل مبادرات تحرير التجارة على المستوى الإقليمي مع موجات التحرير المختلفة، سواء متعددة الأطراف أو أحادية الجانب. فضلا عن ذلك، تلقي الورقة الضوء على الدوافع الرئيسية لتطوير الخدمات، بما في ذلك حالات فشل السوق، وضغوط العولمة، والشواغل المتعلقة بتوزيع المكاسب الناتجة عن عملية التطوير. وتؤكد الدراسة على أهمية الحفاظ على الملامح النمطية للقواعد التنظيمية المحلية في أي عملية للتطوير، ومنها ضمان الشفافية والمصادقية وإمكانية التنبؤ بالمستقبل وتعزيز المنافسة. كذلك يجب على الحكومة المصرية إعداد سياسة للخدمات تحدد الملامح التنظيمية وتضع استراتيجية للتحرير. أما التحرير في حد ذاته، كما تخلص الدراسة، فيمكن تنفيذه على أساس إقليمي لتجنب تعثر المفاوضات متعددة الأطراف. إلا أن الورقة ترى أن محاولات التحرير يجب أن يسبقها أو يصحبها تطوير للقواعد التنظيمية لضمان تحقيق النتائج الإيجابية المرجوة من التحرير. وقد يكون خيار التحرير الإقليمي أفضل من التحرير متعدد الأطراف في بعض أنواع الخدمات (مثل الطاقة والنقل)، وعند أخذ جوانب بعينها في الاعتبار، بما في ذلك تصميم قواعد المنشأ، واهتمامات الشركاء الإقليميين، والتغلب على الثغرات القانونية.

## 1. INTRODUCTION

Services efficiency<sup>1</sup> is a crucial element of the development of any economy, especially in light of the increasing share of services as a percentage of GDP in developing countries. Efficient services provide direct benefits to downstream users and shape to a large extent overall economic performance. For example, an efficient and well-regulated financial sector helps to ensure efficient transformation of savings into investment, and ensures that resources are deployed wherever they have the highest returns. Similarly, well functioning business services as accounting and legal services reduce transaction costs for businesses, which in turn help to enhance their competitiveness, whereas education and health services are necessary elements in building up the stock of human capital.

This paper investigates various means to reform the service sector in Egypt with the aim of enhancing its efficiency. It discusses the different *regulatory* and *liberalization* frameworks governing the reform initiatives. The paper deals with *general elements of services' reform* that could be applied to all sectors. It does not deal with *sector-specific* details, though it provides some anecdotal evidence for purposes of illustration. It deals mainly with regulatory and liberalization aspects of reform without addressing issues related to infrastructure or human capacity. It is worth emphasizing that some of the regulatory aspects can be viewed as institutional, which imply in our context enforcement of regulations as well as the main characteristics of good regulation including for example transparency and accountability. However, we use the term regulations instead of institutions. Moreover, the paper investigates how regional liberalization initiatives interact with the multilateral and unilateral waves of liberalization. Finally, the paper aims at identifying the prerequisites for reforming the service sector to enhance its efficiency whether related to domestic regulations or to liberalization.

The paper highlights in Section two the relative importance of services in the Egyptian economy. Section three discusses how regulatory reform can act as an effective means of enhancing service sectors' efficiency. Section four discusses the main features of trade liberalization in services and provides a short review of Egypt's attempts to liberalize services.

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<sup>1</sup> There are two types of efficiency, namely *technical efficiency* and *allocative efficiency*. Technical efficiency deals with the firm's ability to achieve maximum output given its set of inputs. Allocative efficiency has two dimensions. The first dimension deals with inputs ensuring that the firm uses the right mix of input quantities so that the ratio of input prices is equal to that of their corresponding marginal products. The second dimension deals with output ensuring that the firm selects the combination of output quantities so that the ratio of output quantities is equal to the ratio of their corresponding marginal products (World Bank Institute 2003). In this paper, the term efficiency implies both technical as well as allocative efficiency with its two dimensions.

Section five investigates the possibilities for liberalization of trade in services by adopting a regional track. Section six concludes and offers some policy recommendations.

## **2. RISING IMPORTANCE OF SERVICES IN THE EGYPTIAN ECONOMY**

Services have always been an important contributor to the Egyptian economy in terms of share of GDP, trade and employment. The importance of services in the Egyptian economy increased over time where the *percentage of services to GDP* increased from 54.6 percent in 1990/91 to 61.8 percent in 2006/07 (Table 1). Such increase in the relative importance of services in GDP was matched by an increase of services' contribution to the balance of payments. *Exports of services* played an important role in turning the current account deficit to a surplus (Figure 1). It is important to note that such contribution of services in trade is underestimated relative to the contribution of merchandise trade due to the inability to cover different modes of services supply, which is a worldwide phenomenon (Mauer and Chauvet 2002). In addition, *services' role in terms of enhancing employment* increased tremendously accounting for 54 percent of total employment in 1990/1991 and exceeding 57.5 percent by 2006/2007 as shown in Table A.1 of the Appendix (Ministry of State for Economic Development 2008, online database).<sup>2</sup>

It is important to note that the Ministry of State for Economic Development has changed its services' classification since 2001, and hence the different classifications adopted in Table 1 and in the appendix tables reflect the classification adopted by the ministry but adjusted sometimes by the author. Services were classified into three categories, namely production, public utilities, and social security and governmental services, which differ to some extent from the ministry's classification regarding the components of each category. Moreover, construction was included as a service sector, despite the fact that the Ministry of State for Economic Development up till 2001 did not consider construction as a service sector. However, since at the international level construction is classified as a service sector, and since Egypt has already undertaken commitments under the General Agreement on Trade in Services (GATS) in the construction sector, we considered it as a service sector.

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<sup>2</sup> Some studies suggest that production services have not played a highly positive role in enhancing employment, whereas social services (mainly governmental) have taken the lead in this regard (El Ehwany and El Megharbel 2008).

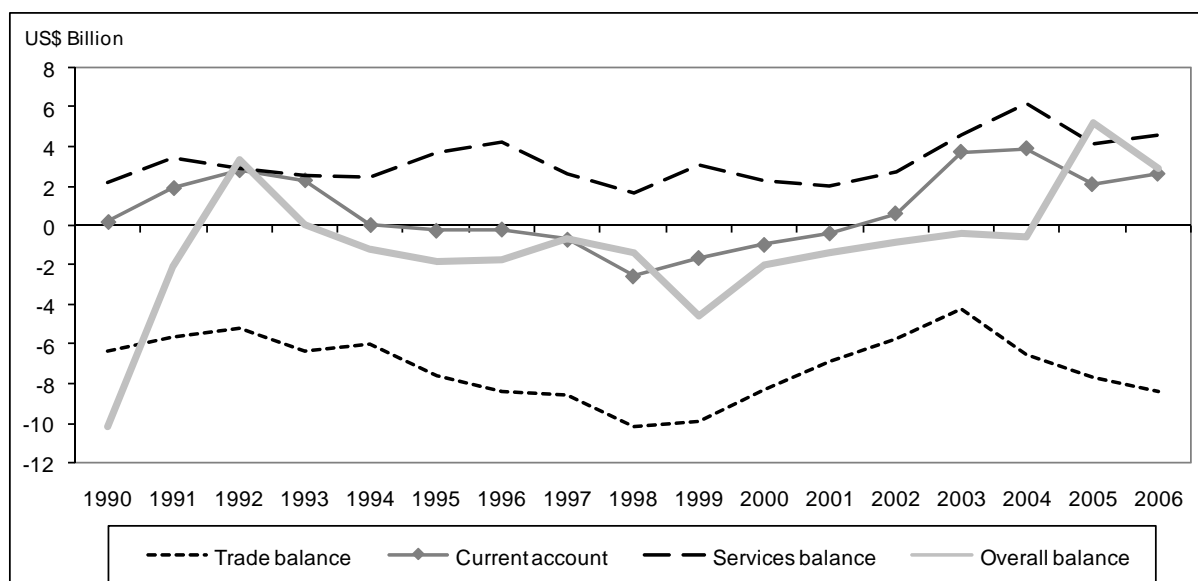
**Table 1. Services Value in Real Terms\* and Share of GDP (LE Million and Percentage) (1990/91–2006/07)**

	1990/91	% GDP	1994/95	% GDP	1997/98	% GDP	2000/01	% GDP	2003/04	% GDP	2006/07	% GDP
1) Production services	13012.5	38.1	14932.3	38.6	17873.8	40	21294.4	41.4	24351.5	42.6	30595.9	44.6
Construction	1784.5	5.2	1997.4	5.2	2543.7	5.7	2754.9	5.4	2792.6	4.9	3874.4	5.7
Transport and warehousing	1939.3	5.7	1962.1	5.1	2388.7	5.4	2655.8	5.2	2848.6	5.0	3505.2	5.1
Telecommunications	681.4	2.0	1222.8	3.2	1561.8	3.5	2177	4.2	3224.4	5.6	4440.7	6.5
Suez Canal	767.4	2.2	691.1	1.8	640.4	1.4	779.4	1.5	1004.7	1.8	1465.6	2.1
Commerce	4582.1	13.4	5289.1	13.6	6244	14.0	7213.2	14.0	7780	13.6	9254.1	13.5
Finance	1192.3	3.5	1449.8	3.7	1797.4	4.0	2212.3	4.3	2403	4.2	2823	4.1
Insurance	27.6	0.1	34.5	0.1	47.5	0.1	76	0.1	133	0.2	154.8	0.2
Hotels and restaurants	569.3	1.7	572.1	1.5	632.6	1.4	954.3	1.9	1482.5	2.6	2120.6	3.1
Housing and real estate	1468.6	4.3	1713.4	4.4	2017.7	4.5	2471.5	4.8	2682.7	4.7	2957.5	4.3
2) Public utilities	112.6	0.3	140.4	0.4	176.4	0.4	223.3	0.4	267.9	0.5	318.5	0.5
3) Social security, governmental and personal services	5551.3	16.2	6449.2	16.6	7495.8	16.8	8321.8	16.2	10038.1	17.6	11318.6	16.6
Services share of GDP		54.6		55.5		57.2		58.0		60.7		61.8

Source: Ministry of State for Economic Development (MOED) available at: <http://www.mop.gov.eg/gdp.htm>.

\*1981/1982 prices.

**Figure 1. Balance of Merchandise Trade, Balance of Services, Current Account and Overall Balance of Payments (\$ billion) (1990-2006)**

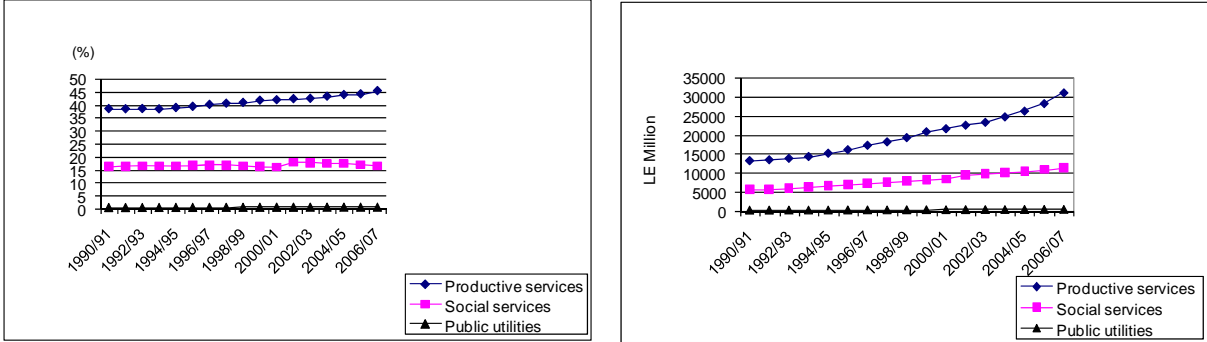


Source: International Monetary Fund (IMF), IFS database, online version, available at: <http://www.imf.org>.

The structural breakdown of services changed over time where the share of production services (as identified in Table 1), as a percentage of GDP, increased relative to that of social services and public utilities (Figure 2). Moreover, production services themselves experienced different growth paths, with sectors such as finance and telecommunications experiencing relatively higher growth rates starting the year 2000 compared to other sectors. Transport, and housing and real estate experienced an increase as well, however the rate of growth was less

steep compared to finance and telecommunications. Hotels and restaurants (including tourism) experienced a substantial increase in the year 2003/04 as reflected by their distinctly increased share of GDP.

**Figure 2. Evolution of Services, Percent of GDP and LE Million (1990/91-2006/07)**



Source: Central Bank of Egypt<sup>3</sup>(CBE), available at: <http://www.cbe.org.eg/TimeSeries/9%20Egypt's%20balance%20of%20Payments.xls>.

The role of services in enhancing the Egyptian economy has increased due to several reasons among which are globalization and technological advancements. In general, services represent an important input in the production of the majority of goods and other services (OECD 2002). In the case of Egypt and as shown in Table 2 inputs of services together with electricity represent on average 33 percent of total local inputs in the manufacturing sector. Moreover, service inputs act as important inputs for other service sectors. The importance of services as an input has increased as a result of globalization and the opening up of the Egyptian economy. For example, exporting to the major importing countries such as the European Union and the United States hinges crucially on services and their efficiency. The fact that production costs are highly similar in Egypt and its competitors has shifted the focus of competition to issues such as "lead time" and "just in time" production. Such production mechanisms depend to a large extent on the efficiency of services including transport, telecommunications and distribution services. The efficiency of such services has narrowed down the economic distance between countries (in contrast to the geographical distance which is a given fact) and thus affected significantly the competitiveness of such countries. Examples of inefficient services that can hinder the competitiveness of the Egyptian economy include lack of storage capacity, poor stock management, unreliable transportation, expensive

<sup>3</sup> The Central Bank of Egypt (CBE) was used as the main source as the Ministry of State for Economic Development database does not contain a time series. Moreover, the data for services, as indicated by the Ministry of State for Economic Development are obtained from the Central Bank of Egypt.

communications, poor product design, insufficient and costly financing, inadequate legal advice, or even outdated software products and processes. Improving the efficiency of such services is a key determinant of Egyptian firms' competitiveness and can even destroy otherwise favorable prospects for meeting domestic or export demand. The price and quality of these services (features of efficiency) are crucial in determining the cost of the majority of products in the economy, especially since services constitute a significant portion of inputs as depicted in Table 2.

**Table 2. The Importance of Services and Electricity in Different Activities in Egypt**

	Food	Spinning and weaving	Clothing and footwear	Wood and furniture	Paper and printing	Leather and products	Rubber	Chemicals	Petroleum and refining	Mineral products	Basic metals	Machinery and equipment	Transportation	Average
Total services, and electricity as a percent of local intermediates	10	28	39	43	58	36	21	32	2	48	41	35	33	33
Share of each service sector and electricity in total services inputs by industry														
Electricity	34	9	14	22	21	1	8	28	47	33	37	19	8	22
Construction and maintenance	3	2	2	5	4	1	1	8	3	10	8	2	4	4
Transportation and communications	2	3	2	9	3	6	10	4	14	9	1	17	2	6
Suez Canal	0	0	0	0	0	0	0	0	0	0	0	0	1	0
Trade	37	53	32	25	55	64	48	44	28	41	38	43	48	43
Finance	16	9	4	9	13	12	15	5	5	5	6	8	30	10
Insurance	1	0	0	1	1	0	0	1	0	0	0	0	2	1
Hotels and restaurants	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Housing	0	1	0	0	1	4	6	1	2	2	1	0	0	1
Utilities	1	0	1	1	0	0	2	2	0	0	1	0	1	1
Personal services and other services	7	22	45	27	3	12	10	7	1	1	9	9	5	12

Source: Ghoneim and Refaat (2006) based on input/output table 1998/1999.

When evaluating the potential of Egypt for exporting services, limited data availability acted as a major impediment. However, the sole source available was the *Handbook of Statistics* (UNCTAD 2008a), which enabled us to identify the service sectors where Egypt enjoys a revealed comparative advantage. Table 3 shows that Egypt enjoys a revealed comparative advantage in transport (mainly due to the Suez Canal), tourism (proxied by

travel), and communications.<sup>4</sup> Moreover, the construction sector seems to have gained comparative advantage in the last few years. On the other hand, other business services sector<sup>5</sup> seems to be losing its comparative advantage.

**Table 3. Revealed Comparative Advantage\* of Egypt's Service Sectors**

Item	1995	2000	2005	2006
Transport	1.54	1.23	1.45	1.47
Travel	0.95	1.47	1.74	1.75
Other services	0.73	0.60	0.41	0.38
Communications	1.23	1.43	1.08	1.34
Construction	0.00	0.60	1.74	1.31
Computer and information services	0.01	0.08	0.04	0.07
Insurance	0.07	0.16	0.20	0.10
Financial services	0.21	0.08	0.14	0.12
Royalties and license fees	0.11	0.11	0.18	0.17
Other business services	1.09	0.95	0.43	0.37
Personal, cultural and recreational services	0.03	0.11	0.48	0.66
Government services n.i.e.**	1.01	0.44	0.52	0.82

Source: Author's calculations based on UNCTAD (2008a).

\*The RCA index of country *i* for item *j* is often measured by the product's share in the country's exports in relation to its share in world trade:

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

where  $x_{ij}$  and  $x_{wj}$  are the values of country *i*'s exports of item *j* and world exports of item *j* and where  $X_{it}$  and  $X_{wt}$  refer to the country's total exports and world total exports. A value of less than unity implies that the country has a revealed comparative disadvantage in the product. Similarly, if the index exceeds unity, the country is said to have a revealed comparative advantage in the item.

\*\* n.i.e: not identified elsewhere.

From this brief overview of the status of services in the Egyptian economy, it is clear that the increased contribution of services in the Egyptian economy has had a positive welfare impact in terms of creating jobs, and improving the external balance. Whether such positive change is associated with the change of policies adopted by the Government of Egypt (GOE) is difficult to identify at the macro level, especially that the relative increase of the contribution of services to GDP has followed a smooth trend over the period 1990-2007. However, the relative increase in the rate of growth in some production services sectors starting the year 2000 is a reflection of the change in several variables, though it is still

<sup>4</sup> Egypt's revealed comparative advantage in communications services may be due to high settlement payments Egypt is receiving from other countries. In this case, Egypt's *comparative advantage* may actually reflect a lack of domestic liberalization (i.e., a lack of competition for international telecommunications services). Data available did not allow us to investigate this issue.

<sup>5</sup> This sector encompasses a set of rather heterogeneous activities (from bookkeeping to architecture to R&D services) and Egypt may still have a comparative advantage in certain sub-sectors, while not in others. Again data limitations did not allow us to investigate this issue thoroughly.



difficult to identify the extent of causality. For example, the introduction of the investment law (8/1997) and the technological revolution that started to affect all businesses in the late 1990s certainly have had an impact on improving certain production services sectors such as finance, telecommunications and commerce. What is evident is the increase in private sector participation in such services over time. It increased from 45.1 percent in 1990/91 to approximately 62 percent in 2006/07 as shown in Appendix Table A.2. However, the change in performance of such sectors and the role of the change in policy variables affecting such performance are difficult to measure at the aggregate level.

But we can confidently argue that the liberalization moves (on the multilateral and regional levels) did not coincide with a significant *structural* change in the performance of the service sectors at least when observing the trends of various production service sectors. None of the sectors that the GOE has liberalized by undertaking GATS commitments experienced a structural change over the period 1990-2007. The smooth positive trend experienced by the production service sectors over the period 1990-2007 was not interrupted by any structural change associated with dates of liberalization following Egypt's GATS commitments. It is worth emphasizing in this regard that GATS commitments *per se* do not necessarily reflect a domestic policy change. For example, GATS commitments could be just anchoring the status quo and do not necessarily entail a liberalization attempt. Moreover, even if GATS commitments entail a significant liberalization attempt, the time lags associated with implementation, and multiplicity and overlapping of several factors in determining effective liberalization imply that it is difficult to associate GATS commitments with domestic liberalization effects or measures undertaken. *Regulatory reforms* at the sectoral levels are likely to have affected the performance of the related sectors; however such changes cannot be easily captured at the aggregate level. Regulatory reforms are diverse in nature including de-regulation and re-regulation, and they have been spread over a long time span implying that correlating their impact at the macro level with the performance of the service sectors might not be the right approach to assess the development of the service sectors in Egypt. Moreover, the high inter-linkages between service sectors imply that the development in one sector can be highly attributed to changes in other sectors. The positive developments experienced by service sectors such as finance and commerce can be a result of the positive regulatory developments in telecommunications or other upstream service sectors, or can be a result of the increase in final demand due to a certain regulatory reform or any other reasons

associated with infrastructure and/or human capacity. For example, the flourishing of specific banking services in Egypt can be due to the regulatory reform of telecommunications (including telecommunications law 10/2003, and electronic signature law 15/2004) that secured e-banking, and/or the regulatory reform in the banking sector itself (unified banking law 88/2003) that ensured transparency, emphasized prudential regulation, and enhanced the Central Bank's independence.

The previous review identified that the service sectors have been playing a positive role in the Egyptian economy. The positive role is reflected in terms of contribution to GDP, trade, and employment. However, the diverse nature of service sectors, the overlapping of policy changes with regulatory reforms, and liberalization attempts imply that it is difficult to evaluate the service sectors' reform at the aggregate level and that a deeper investigation at the sectoral level is required to draw meaningful conclusions and effective policy implications.

Despite the need for a sector specific analysis to be able to arrive at concrete policy implications, there is a broad set of guidelines and characteristics that need to be taken into consideration at the outset when dealing with service sectors to ensure a reform process that enhances its efficiency. Translating efficiency into observed effects imply that service sectors behave in such a way as to achieve relatively low prices (lessening the abnormal profits) and adequate quantities of output with good quality. The problem that arises in assessing efficiency is the difficulty of defining the benchmark against which the performance of service sectors can be assessed. There are several benchmarks that can be used including the performance of similar firms (in terms of absolute and relative price changes as well as quantity of products provided and their quality) in other countries and the performance of most competitive firms in the economy after controlling for the size of firms. The means of implementing such broad guidelines might differ from one sector to another. Such aspects of reform are addressed in the following sections.

### 3. REGULATORY REFORM<sup>6</sup> AS A MEANS TO ENHANCE SERVICE EFFICIENCY

#### 3.1. *Why Do We Need Regulatory Reform in Service Sectors?*

Despite the fact that service sectors differ substantially among themselves, the need for economic and social regulatory intervention remains crucial. There are several reasons that explain the pressing need for regulatory reform in service sectors including market failure, globalization, and distribution of gains and losses.

##### *Market failure*

Economic and social reasons for regulatory reform arise essentially from market failure attributable to three kinds of problems, namely natural monopoly, asymmetric information, externalities and regulatory vacuum. The problem of asymmetric information<sup>7</sup> occurs in a wide range of intermediation services such as the financial sector, knowledge-based services as telecommunications, and professional services. In the case of the financial sector, for instance, it is difficult for consumers to judge the financial situation of banks or insurers. Yet, the stability of banks and insurance firms is crucial for their clients and for the economy as a whole. Hence, regulation is needed as the failure of one service provider in the market can lead to a catastrophe in the whole market (Hoekman, Matto, and Sapir 2007; Findlay and Kim 2002). The same applies to a wide array of professional services as legal and accounting where the quality of service can only be evaluated ex post by consumers (Fink and Jansen 2007). In those cases, there is a need for regulations to overcome problems associated with asymmetric information. A large number of infrastructure services share the feature of natural monopoly or oligopoly including water and wastewater, electricity, and specific transport sectors. Such services require specialized distribution networks such as roads, communications, and pipes for water supply and for energy distribution hence including as

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<sup>6</sup> "Regulation refers to the diverse set of instruments by which governments set requirements on businesses and citizens. Regulations fall into three categories: a) Economic regulations intervene directly in market decisions such as pricing, competition and market entry or exit; b) social regulations protect public interests such as health, safety, the environment, and social cohesion; and c) administrative regulations are paperwork and administrative formalities through which governments collect information and intervene in individual economic decisions.

*Regulatory reform* is not primarily a technical problem of getting regulations right. The regulatory management system—including the processes and institutions, through which regulations are developed, enforced and adjudicated—should support governance objectives in an efficient, transparent and accountable manner. Regulatory governance principles advise to: deregulate where markets work better than governments; regulate well, where markets cannot work without governments; establish systems to ensure laws are coherent and well managed; and ensure regulations are made in ways to ensure democratic principles," (OECD 2005).

<sup>7</sup> Asymmetric information implies that buyers and sellers do not have the same extent and quality of information that each of them possesses on the product (good or service) transacted among them.

well an externality dimension (Stephenson and Prieto 2002). The evident externality dimension arises from the existence of significant economies of scale and scope that cause in many cases the market to be dominated by a limited number of service producers. Regulations are needed in this case to enhance competition and prevent any abuse of dominant position, which can be exercised by the limited number of service providers in the market. Regulatory vacuum implies that there is lack of regulation needed to govern a certain sector, which is the case of several public utility sectors that have been recently privatized and lack the regulatory framework capable of handling private service providers (e.g., water and electricity sectors in different countries). Addressing all such market failures requires an efficient regulatory framework. Empirical evidence has shown that an efficient service sector depends largely on the presence of governing efficient domestic regulations as they prevent market failures (Amin and Mattoo 2006).

In the case of Egypt there has been a recent wave of attempts to control market failures through two means of regulation. The first included the enactment of specific sector laws that prevent market failure by adhering to the set of rules of the regulator of a specific sector, which in turn protects the market actors against market failure, as the case of strengthening prudential regulations of the Central Bank of Egypt (CBE) following the unified banking law (88/2003) and the financial sector reform program adopted by the Government of Egypt (2005-2008). In this case, the Central Bank set prudential rules that exceeded even the international standards as set by Basel II requirements (e.g., capital adequacy ratio), and in return guaranteed the deposits in all banks under its supervision. This action, in itself, acts as a buffer against moral hazard problems—which are likely to arise more frequently in the financial sector—as long as the monitoring of banks by CBE is undertaken seriously.<sup>8</sup> The second means of regulation was devoted to increasing the monitoring role of the Government through enactment of a competition law (Protection of Competition and the Prohibition of Monopolistic Practices, law 3/2005) and establishment of sector regulators in areas such as electricity, telecommunications, and water and sanitation.

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<sup>8</sup> In case deposits' guarantee is provided by the Central Bank without prudent regulations and strong monitoring, this can lead to several bank runs as banks will have no incentive to act responsibly toward depositors' money.

## *Globalization*

Globalization has brought several changes to the economic landscape and the functioning of economies. It includes technological innovations that have expanded the potential for competition in services especially infrastructure services, which have been historically dominated by monopolistic market structures;<sup>9</sup> introduction of new products and services that do not fit current regulatory provisions; new insights into economics of regulation, which may make it possible to design more economically efficient regulations; and the globalization of production and markets, which has increased the cost of maintaining large national differences in regulatory standards (Feketukuty 2000).

In light of such changes and the opening-up of the Egyptian economy, many of the existing regulations governing the service sector became *de facto* outdated. This implies that a large number of existing regulations is either impeding the development of service sectors in terms of production or trading, or acting as obstacles that hamper investments in service sectors. Moreover, inefficient regulatory regimes can inhibit the export of potential services. For example, in professional services low standards and disparities in domestic training and examinations can become major impediments to obtaining foreign recognition (OECD 2001). In Egypt, attention has been brought recently to such issues where efforts have been accelerated to obtain the international recognition for the Egyptian Accreditation Council (the body responsible for accrediting the standards adopted by Egyptian firms and confirming that they meet the international standards). Moreover, several initiatives have been undertaken to upgrade the levels of standards whether in production services (e.g., telecommunications), or professional services (through unions and the Ministry of Higher Education) to upgrade the

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<sup>9</sup> Modern technology has fundamentally changed the economics underlying the provision of infrastructure services. It has reduced the capital cost of infrastructure facilities in relation to variable costs, increased the opportunities for interconnecting independently provided services through computer intermediated systems, and made it possible to track, monitor and price network services supplied over a single network by different enterprises. The net result is that competition has not only become more viable but is now an essential condition for the introduction of more efficient and innovative infrastructure services.

level of service providers and encourage them to obtain international recognition.<sup>10</sup> However, in general, the focus so far in Egypt still remains on international recognition of goods whereas services receive less attention.

### *Distributional concerns*

Regulation in general needs always to strike a balance between efficiency on the economic front and equity and universal coverage on the social front (Gamberale and Mattoo 2002). The effectiveness of regulation and induced competition will determine to a large extent the size and distribution of gains from the reform process. Ineffective regulation is likely to result in a shift of profits among monopolists and rent seeking behavior. The expected potential gains such as lower prices and better quality to consumers and downstream users of the concerned service sectors are not likely to materialize in light of inefficient regulation. Moreover, ineffective regulation is likely to result in a lack of credibility, which can result in restricting entry and competition or in demands of investors for higher returns to cover regulatory risk, implying loss in production efficiency. Efficient regulation is also conducive to both fair and effective governance, improving public confidence in governmental and regulatory performance, and to economic efficiency, helping to reduce distortions that might otherwise undermine domestic policy objectives (Kieya and Nielson 2003). The balance between the benefits of regulation stemming from correcting market failures against the costs stemming from potential limitation on market entry is central to any attempt to reform services due to its significant positive efficiency and negative distributional effects (Hoekman, Mattoo, and Sapir 2007; UNCTAD 2006; OECD 2002).

Regulatory reform is key to a variety of public policy objectives, ranging from protecting consumers, enhancing competition, and developing domestic supply capacity to maintaining cultural diversity, protecting the environment, and ensuring universal access to essential services (UNCTAD 2008b). Thus, there is an urgent need for regulatory reform that accommodates the changes in the external and domestic environments while maintaining

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<sup>10</sup> Some examples for accreditation of services include the Qualicert service certification scheme, which is a recognized independent official sign of service quality ([http://www.service-excellence.sgs.com/service-excellence/qualicert\\_tm.htm](http://www.service-excellence.sgs.com/service-excellence/qualicert_tm.htm)). SGS, which is an international inspection, verification, testing and certification company, has created a new voluntary hotel classification criterion called “SGS 7 stars”. This certification service is designed to identify the extra luxurious services offered by applicant hotels ([http://www.servicexcellence.sgs.com/sgs\\_the\\_first\\_company\\_in\\_the\\_world\\_to\\_certify\\_a\\_seven\\_star\\_hotel\\_service-excellence?viewId=10020653](http://www.servicexcellence.sgs.com/sgs_the_first_company_in_the_world_to_certify_a_seven_star_hotel_service-excellence?viewId=10020653)). Educational Accreditation Association (EAA) is also a services accreditation body that provides international visibility and recognition for education institutions, to ensure their curriculum and programs meet and even exceed international and transnational requirements (<http://www.edaccredit.org/>).

certain principles that ensure an efficient outcome. There is no blueprint for regulatory reform in the field of services as it can take several forms including re-regulation and de-regulation. The kind of regulatory intervention needed depends heavily on the specificity of each sector and circumstances including the capacity to regulate and availability of information. Nevertheless, there are a number of characteristics that need to be considered when undertaking regulatory reform which are considered in the following sub-section.

In the case of Egypt, the inclusion of the *universal service* concept<sup>11</sup> started to be an integral part of laws such as telecommunications law (10/2003). The aim is to strike a balance between economic efficiency and achieving social targets. It is expected that amendments of laws governing several services will include the universal service concept.

### ***3.2. What are the Main Features of Regulatory Reform?***

Having reviewed the need for regulatory reform, the question that then follows is: what are the main characteristics of such regulatory reform to ensure effectiveness? The diversity of service sectors and the difficulty of making certain policy relevant generalizations have tended to encourage a sector specific approach when drawing and implementing reform policies. Nevertheless, there is still scope for generalizing the principles of regulatory reform, which is a crucial aspect of any service reform initiative. UNCTAD (2006) identified through a number of national assessments in a group of developing countries that regulatory reform is the major determinant in any service sector reform initiative.

Among the general principles of reform that need to be adopted are the following: transparency, credibility, objective performance-based criteria and effective competition. There is also a need to ensure a number of characteristics including fairness, predictability, enforceability and non-discrimination. Moreover, the regulatory environment should ensure sending clear signals to producers and investors, preclude rent seeking, lessen wasting economic resources, preserve consistency with the administrative capabilities of the government and other laws and regulations being kept to the minimum, and maintain social peace (Rodrik 2002; Coghlan 2000). The reform of the regulations should strike a balance between the new mode of technologies, social goals, economic efficiency and effective

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<sup>11</sup> The universal service concept ensures that service providers adhere to efficient economic standards when providing a service, but obliges them to provide services to remote areas that might not be economic from a business point of view. The covering of extra non-economic costs is provided through a special fund to service providers.

implementation of laws and regulations. Deregulation may need to be combined with re-regulation, that is, the introduction of new rules facilitating the transition to a more open system, ensuring competitive market conditions, and guaranteeing, where needed, the provision of universal services.

How to achieve such principles is a matter that should be decided by the Government of Egypt (GOE) based on the specific nature of each sector. However, the sequence of such reforms is a crucial factor in determining the outcome. The sequence of reforms differs from one sector to another depending on the sector itself and existing policies and regulations (Mattoo and Stern 2008). Hence, deciding whether to deregulate or re-regulate is a matter that depends on the status of the specific service sector under consideration.<sup>12</sup> For example, in the case of telecommunications, the decision was to use the pressure of the GATS commitments set by the GOE itself to accelerate the process of reform and liberalization together. Such method of using liberalization at the multilateral level as an anchor of reform was a unique case. In other sectors, the GOE has chosen not to use liberalization as an accelerator of reform. For example, in the case of maritime transport, GATS commitments anchored less than the status quo, whereas several domestic initiatives have been undertaken to accelerate the process of reform and liberalization, though without scheduling such initiatives in the GATS commitments. Moreover, a sector like maritime services is characterized by a great deal of non-transparency where most of its crucial regulations concerning most-favored-nation and national treatment are regulated through ministerial decrees, and not through laws. Whereas in the case of telecommunications, the law is self-explanatory to the extent that it did not include executive regulations.

*Transparency*<sup>13</sup> plays an important role in preventing the existence of unnecessary barriers to entry in different service sectors. Lack of transparency magnifies the impact of asymmetric information and hence prevents potential producers from entering the market and creates welfare loss for consumers. Moreover, lack of transparency increases the potential for corruption and rent seeking. An integral part of enhancing transparency is the existence of a due process. Due process in the administration of laws and regulations implies that firms

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<sup>12</sup> For a detailed service sector specific study of the sequence of reform and liberalization see Sidorenko and Findlay (2003).

<sup>13</sup> Article III of the GATS is mainly concerned with transparency of the domestic rules (laws and regulations) governing trade in services within the national jurisdiction of GATS members. We deal with transparency in a wider political economy context.



affected by government laws and regulations should be given the opportunity to consult the government on the interpretation and application of the regulations that affect them, to appeal regulatory decisions before appropriate administrative or judicial bodies, and to obtain a timely response to requests for regulatory decisions (Feketekuty 2000). In this regard, there should be a responsible body that defends the rights of service providers, which could be established along the lines of the Federation of Egyptian Industries or could be sector specific as the case of unions. However, the responsible body should be granted by law the right to consult with the government, when needed, in designing and amending the governing regulatory framework. The establishment of the suggested body can help enhance transparency of formulating policies and regulations, rather than depend on ad hoc initiatives for lobbying and affecting the Government's policy decisions. Transparency also requires the existence of an independent regulator, which is not the case in the existing regulators of infrastructure services and telecommunications in Egypt where the minister is the head of the board of the existing regulatory bodies. Given the fact that the GOE owns and operates an incumbent player in the aforementioned service sectors, it is difficult to ensure transparency, neutrality and fairness in the decisions of such regulatory bodies. Finally, transparency requires clearly identifying in Egypt's schedule of commitments the criteria for economic needs test to avoid different interpretations, which are likely to be subject to lobbies' pressures.

Regulatory reform programs need to be *credible*. Otherwise two sorts of problems can arise: a) if there is significant uncertainty about policy, fewer investments will be made, and service providers will demand a premium on their returns on capital; b) if it is possible to influence policy, service providers may behave strategically to manipulate policy choices in their own favor. Credibility itself has two dimensions. One is to convince agents that current reforms will not be reversed. The other is to persuade them that future reforms will be carried out. In this regard, several new GATS commitments need to be either included or at least the existing ones modified to reflect the status quo. In some sectors, as maritime, the existing GATS commitments are even so modest when compared to what domestic regulations actually permit. Such a wide gap between GATS commitments and the status quo can have a negative impact on the credibility of reforms. As argued by Mattoo (2002), "the use of the GATS as a mechanism for lending credibility to liberalization programs has been disappointing in some sectors" and "the types of conditions and limitations on market access

and national treatment in national schedules do not necessarily reflect actual practice. This possibility results in less transparency for service providers and less legal and economic certainty regarding market access."

The GOE should adopt an *objective performance-based* criterion for regulating different service sectors. A regulatory system is more likely to achieve its desired social objective and is less likely to impose a burden on economic performance if its provisions and enforcement are based on objective, measurable and performance-based criteria. This in turn helps to minimize the scope of regulation where objective and measurable criteria ensure that regulation will not be enforced on the basis of arbitrary criteria or on the whims of the regulator, but rather on a standard that is predictable, transparent and can be applied on a non-discriminatory basis to all market participants (Feketekuty 2000). For example, the benchmark for testing the impact of a certain regulation can be through its effect on trade and/or investment flows to the service sector (Findlay 2000). The existence of poor regulation can be checked through a number of indicators including among others high compliance costs, wide scope for discretion, and failure in enforcing regulation (Coghlan 2000). An objective performance-based criterion differs from one sector to another, but it should exist. In the case of Egypt, there exist many sectors where the principle is rather absent including, for example, the fields of retail trade, some subsectors of maritime related services and public transport.

*Enhancing competition* should be a major goal of regulating service sectors. A basic conclusion from the empirical literature on liberalization and/or privatization of the service sector is that larger welfare gains arise from an increase in competition than from a mere change in ownership from public to private hands (Mattoo 2002; Hoekman and Mattoo 2008). This observation is of great importance for the process of liberalization and/or privatization in the Egyptian economy, especially in light of the experience in several goods sectors where privatization attempts have resulted in anti-competitive behavior. The negative impact of the liberalization/privatization attempts arises from the lack of precautionary regulatory conditions that were needed to transform such attempts into a positive welfare impact and prevent anti-competitive behavior. Such precautionary conditions include the necessary institutional pro-competitive framework governing the market, transparent rules and regulations, and clear relationship between the government and the market players.

Finally, there is a need to minimize the costs associated with domestic regulations applied for undertaking service reform. The costs are of three types, namely administrative, compliance and distortion costs. Administrative costs are those borne directly by the government or the regulatory agency, and financed either through fees imposed on the regulated industry, or through general budget. Compliance costs refer to the overall transaction costs imposed on the regulated agents by domestic regulation, and are not limited to direct monetary costs. Compliance costs can be brought about simply by applying wrong or inefficient regulations. Finally, distortion costs are those costs that have a negative spillover effect on innovation and/or competition that might be induced when the regulation is applied due to the pressure of incumbent interest groups (Abugattas 2007; Findlay 2000; Findlay and Kim 2002).

#### **4. LIBERALIZATION OF TRADE IN SERVICES AS A MEANS TO ENHANCE SERVICE EFFICIENCY**

##### ***4.1. Nature of Liberalization of Trade in Services***

Trade liberalization in services has a number of characteristics that might be different from trade liberalization in goods including its close association with regulatory change, need at the sectoral level for prerequisites to ensure efficient liberalization, the ability to liberalize services in steps, and the need to set priorities at the sectoral level and modes of supply.

##### *Close association with regulatory change*

A major feature of trade in services is its close relationship with a variety of domestic regulations, ranging from qualification and licensing requirements and procedures in professional services, to pro-competitive regulation in telecommunications and other network services, to universal access and requirements in health and education services. Liberalization of services implies tackling non-tariff barriers (often in the form of regulations) as no tariff barriers exist. The quality of regulation may strongly influence the social and economic effects of trade and investment liberalization. It is worth emphasizing that liberalization itself under the GATS or regional trade agreements (RTAs) does not address the problem of market failure. Liberalization rather ensures that domestic regulatory measures for dealing with market failure problems do not unduly restrict trade, but liberalization itself does not ensure a pro-competitive outcome. Such trade restrictive effects can arise from a variety of technical standards, prudential regulations, and qualification requirements in professional, financial,

and numerous other services as well as from grants of monopoly rights to complement universal service obligations in such services as transport and telecommunications. In other words, unless regulatory reform is undertaken domestically, liberalization can threaten the efficient economic and social goals targeted essentially from the liberalization process (Gamberale and Mattoo 2002). This has been proven empirically in other countries, whereas for example, Konan and Van Assche (2006) have shown that in the case of Tunisia, liberalization without efficient pro-competitive regulatory framework in its telecommunications sector can result in a negative welfare effect. If liberalization is accompanied by a pro-competitive regulatory framework, welfare is likely to increase. Hence, any liberalization attempt should take into consideration the status of the regulatory framework before liberalization and how liberalization is likely to interact with such framework. In this regard, it is useful to distinguish between liberalization and deregulation. Liberalization of trade in services involves the reduction of regulatory barriers against foreigners and lessening the national discrimination against them whereas deregulation implies reducing the total amount of state regulation in a sector applied on nationals and foreigners.

Despite such differentiation between liberalization and deregulation in theory, it remains difficult in practice to disentangle them as both are highly interlinked. For example, moving to a nondiscriminatory regulatory regime can require significant changes in how some sectors, particularly public utilities, are currently regulated. This is important to specific network industries such as electricity, transport and telecommunications, which have historically been operated as public monopolies in production, and pursue universal service through cross-subsidization. The change in technology, increases in demand, and the ability to subdivide the production chain have led to a decline in the importance of natural monopoly argument in such sectors, and hence resulted in a different view on how to regulate them, and introduced the liberalization aspect into consideration bringing with it new challenges as universal service decisions and unbundling of services.

#### *Sector specific prerequisites for liberalization*

The prerequisites for a successful liberalization in the service sectors differ substantially among sectors. The institutional setup governing each service determines to a large extent its readiness for liberalization. For example, in the case of the financial sector macroeconomic

stability, main rules governing the performance of banks and implementation of effective prudential regulations remain essential for effective and successful liberalization. Such preconditions are different in the case of liberalizing the transport sector for example, which requires another type of adequate institutional framework. In other words, the preconditions for services liberalization are sector specific and are mainly related to regulations. This is a major difference between goods and services liberalization, where the institutional dimension and sector specificity might not have this paramount role in goods.

#### *Liberalization can be undertaken in steps*

The move towards liberalization can be made in stages with the enhancement of competition and lack of discrimination against foreign ownership being the two crucial variables in the liberalization process. The balance should be carefully drawn on those two aspects, where if only foreign ownership is allowed, then efficiency gains can be lost, whereas if competition only is allowed in the absence of an efficient independent regulator and the presence of the state having an equity stake in an incumbent, then efficiency gains are also likely to be lost (Hodge 2002).

#### *Choice of sectors and modes*

Another related question that the study attempts to answer is what sectors should be slated first for liberalization, aside from the existence of an effective institutional framework. Are there any priorities that should be considered, and on what basis? The study argues that the focus of liberalization attempts should be on services that either provide intermediate inputs to the rest of the economy (e.g., financial and telecommunications) or to specific sectors that the country wishes to promote (e.g., tourism, computer and professional services), or sectors in which protection has resulted in a considerable inefficiency cost to the society (e.g., insurance and transport). Liberalization of trade in services also entails identifying the choice of the modes of supply and the barriers that should be removed, which is a sector specific issue that needs to be considered carefully.

#### ***4.2. Review of Egypt's Approach in Liberalizing Services***

Egypt's experience with liberalization of trade in services is diverse and has followed different paths. Since the end of the Uruguay Round in 1994, Egypt did not conclude any multilateral or regional agreement, with the exception of undertaking commitments in the GATS in the field of communications in 2002. Egypt's GATS commitments were undertaken in five

sectors out of a total of twelve sectors according to the GATS framework. The five sectors comprised 44 sub-sectors out of a total of 160 sub-sectors identified by the GATS. The five sectors included construction and related engineering services, tourism and travel related services, financial services, international maritime services and communications. The extent of liberalization under GATS differed substantially among the different sub-sectors ranging from full liberalization with no restrictions in the case of capital market services to extremely modest liberalization in the case of maritime services. In some of the liberalized sectors, Egypt's commitments were a reflection of the status quo or even less than the existing status quo, which has been the case of the banking sector, construction and tourism. In other cases, the commitments reflected a future intent to liberalize services, which has been the case of communications and insurance. Comparing the extent of unilateral liberalization and status of national laws in 2008 for a number of sectors as tourism with Egypt's GATS commitments reflect a wide gap where the extent of existing liberalization far exceeds a number of commitments undertaken under the Uruguay Round. Meanwhile, Egypt entered into two regional agreements to liberalize services. The first regional agreement was the Egyptian-European Association Agreement, which Egypt started to implement in 2004. However, negotiations on liberalizing services on the basis of GATS-plus approach was deferred to a future date. Negotiations officially started in 2006, however, no concrete agreements have yet been reached. In 2003, Egypt with a number of Great Arab Free Trade Area (GAFTA) members agreed to enter into a regional agreement on liberalizing trade in services on the basis of GATS-plus approach. Negotiations at the regional level started in 2004, but no concrete agreements have been reached. At the unilateral level, Egypt has undertaken far-reaching liberalization steps accompanied by regulatory reforms in a wide array of service sectors. In the case of telecommunications and banking sectors, an efficient regulatory infrastructure was established following telecommunications law 10 of 2003 and banking law 88 of 2003. Such unilateral reforms, which included a strong liberal dimension did not contradict with GATS commitments, they rather emphasized them in a more coherent manner, which has been the case of the banking sector for example. Moreover, in some sectors, the GOE has modified its GATS schedule to reflect its unilateral liberalization steps and domestic reform, which has been the case, for example, of the joint venture banks that were limited to 49 percent foreign capital and has been modified afterwards by eliminating this condition. In other sectors, the GATS commitments undertaken lacked credibility,

transparency and predictability due to the inclusion of an economic needs test without definite criteria for its application that remained without modification. The inclusion of the economic needs test without specific criteria was evident in the case of tourism and insurance sectors. It is important to note that this is not only confined to Egypt, but it is an observation that has been witnessed in other countries.

This short review of Egypt's experience with service liberalization implies that there is no clear methodology to be adopted. Each sector and even sub-sector of the GATS classification followed its own particular path. In some cases, unilateral domestic liberalization existed without being included in the GATS commitments, which has been the case of educational services for example. In other cases, GATS was used as a device for undertaking regulatory reforms, which has been the case of telecommunications where opening up of the sector, which included regulatory reforms, was set in future phases signaling the shape and status of the sector over the period of implementing the GATS commitments. Sometimes GATS commitments were updated to reflect domestic regulatory reform, which has been the case of the banking sector. Some sectors have experienced a liberal domestic environment compared to what has been committed under the GATS, which has been the case of some of the tourism related sectors. Other sectors still face contradictions between GATS commitments and domestic regulatory conditions, which has been the case of construction and engineering related services, where restrictive domestic regulations impeding market access for foreigners have not been reflected in the GATS schedule.<sup>14</sup> Finally, there exist a number of sectors where initiatives for regulatory reform and liberalization remain far from the radar screen of the GOE, including mainly the case of maritime and professional services.

Notwithstanding the specificity of each sector and the need to consider the case of each sector and even sub-sector on a separate basis for regulatory reform and liberalization attempts, we argue that there is room for a coherent strategy for achieving the liberalization of services in general. For example, principles of transparency, credibility, predictability and enhancing competition should be integral elements in any liberalization attempt regardless of

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<sup>14</sup> In Egypt's schedule of GATS commitments, it was not mentioned that only construction firms classified as class A in their home countries are allowed to operate in the Egyptian market—those are rules applied by the Egyptian Federation for Construction and Building Contractors. GATS commitments stipulated that commercial presence is allowed for joint venture firms only with a maximum ceiling of 49 percent of the value of projects for the foreign partner.

the sector concerned, mode of liberalization, and liberalizing at the unilateral, regional or multilateral level. Moreover, the domestic machinery for initiating reform and liberalization should be clear and applied to all sectors in the same manner, where the involvement of relevant stakeholders including producers of the service itself, downstream users and consumers is crucial. Such machinery does not seem to exist in the Egyptian context, despite the efforts undertaken by the Ministry of Trade and Industry to establish it. Lack of awareness, absence of quantitative and precise qualitative information, weak involvement of regulators, fear from any liberalization attempts and dispersion of stakeholders are major culprits behind the absence of such national mechanism.

##### **5. CAN REGIONAL LIBERALIZATION OF SERVICES ACHIEVE THE GOAL OF ENHANCING SERVICE EFFICIENCY?**

Given the stalemate of the GATS negotiations under the WTO, the issue of liberalizing trade in services at a regional level is gaining a lot of attention. In this regard, several questions are raised including: what are the benefits of liberalizing at the regional level compared to the multilateral level? And what are the sectors or sub-sectors that are more eligible for liberalization on a regional track?

Benefits of liberalizing services on the regional track and the sectors and subsectors that are more eligible for regional liberalization include the following:

*There are a number of service sectors that are more eligible for regional liberalization than multilateral liberalization.* The specific nature of such sectors, in terms of setting their standards and the rules and regulations governing their markets, makes it more convenient to liberalize at the regional rather than the multilateral level. Among such sectors are infrastructure-type and network services (e.g., transport and energy) where regional liberalization is more suitable than multilateral liberalization for several reasons as identified below. Among the other sectors that are more eligible for regional liberalization are the construction/engineering and professional services where there exist no international standards (compared to the case of telecommunications and financial services). Such sectors are often highly restricted and subject to strict national standards. In these sectors, it is often the case that a regional approach among countries sharing the same language, degree of development, values, etc. is likely to be more fruitful and convenient in terms of negotiations where it is easier to develop a common set of criteria for the recognition of the equivalence of standards and/or the equivalence of diplomas and educational and professional training for the



granting of licenses to practice various professional services when this is carried out among a smaller sub-set of member countries (Stephenson 2002; Fink and Jansen 2007). In other cases, services can be traded on a regional basis because there is a need to be close to the consumer. This is true for transmission of electricity because the farther power is transmitted the more it is lost. Moreover, cross-border trade (Mode 1) in network services requires physical interconnection and geographic proximity in electricity, and some transport and telecommunications services, among other services (Müller-Jentsch 2004). These types of trade can only take place between neighboring countries (i.e., regionally). This is also true for some of the business and financial services where local knowledge and short travel times are important (Hodge 2002).

Moreover, commitments to liberalize trade in a regional context require striking a balance between preserving the sectoral specific nature and drawing general rules for all service sectors to ensure successful negotiations. This implies that the approach of Egypt when negotiating liberalization of services at the regional level should take such aspects into consideration. This can be done by grouping services into a number of clusters where each cluster includes services that share common characteristics. For example, Stephenson (2002) classifies services into four types, namely:

- i) infrastructure-type services: financial, telecom, energy and transport;
- ii) business-type services: distribution, professional services and other business services, tourism, construction/engineering services and environmental services;
- iii) social-type services: educational services, and health services; and
- iv) other services: recreational services and cultural services.

The breakdown of services into similar categories is likely to make it easier for negotiations, especially that the extent of regional liberalization might differ from one category to another due to certain specific features of each category ranging from high probable regional liberalization in infrastructure services to lesser degree in business-type services to even less in social-type services, and very limited in other services.

Moreover, *regional liberalization of services can help Egypt improve its infant service industries* that have a potential to compete at the global level, but not yet ready to "learn by doing" by liberalizing at the regional level. There are a number of Egyptian service

champions that have started to play a role on the global scene (e.g., in the field of telecommunications and construction). In such cases, the first leap for such sectors outside Egypt was on a regional basis and then the shift has happened to the global level. There are other potential champions that need to be promoted at the regional level to be able to compete at the global level whether in the same fields as telecommunications and construction (where Egyptian service providers have been heavily spread in a large number of Arab countries and started afterwards to extend their services out of the Arab region) but are rather of a more specific nature or in other new fields as business services. In other words, regional integration can be viewed as a step towards opening up to the whole world in the WTO context. Hence, preparing for this step—after taking the necessary regulatory precautions that prevent negative consequences of liberalization at the regional level—is needed to be able to create regional Egyptian service champions. On the imports side, it is worth emphasizing that trade diversion effects associated with preferential liberalization in services do not lead to any loss in government revenue that can lead to negative welfare effects as in the case of goods. Hence, the fears from trade diversion associated with preferential trade in goods at the regional level are not likely to materialize in the case of services (Mattoo and Fink 2002).

Regional liberalization of trade in services requires regulatory convergence among trading partners. Regulatory convergence can take several forms including adoption of trading partner's rules or compliance with global standards (Müller-Jentsch 2004). Moreover, regulatory convergence can be achieved through mutual recognition agreements (MRAs). However, to be effective such MRAs require some prior harmonization, mutual transfers of recognition powers, and credible verification procedures (Nicolaidis and Trachtman 2000; Fink and Molinuevo 2007). Without the condition of prior harmonization, the extent of success of such MRAs is highly limited (Mattoo and Sauv e 2003). Such conditions are likely to be more feasible in a bilateral or regional context than in a multilateral context. Such MRAs are of crucial importance for professional services in particular, although they extend to other services as well, including recognition of prudential measures under financial services (in order to facilitate Mode 3), recognition of educational qualifications with a view to enrolment in higher education or further training (to facilitate Mode 2 consumption of education services), and recognition of professional qualifications (to facilitate trade under Mode 4) (Fink and Jansen 2007).

Among the precautions that need to be undertaken are two major issues, namely, services with high sunk costs should maintain contestability (first movers can negatively affect the market if they are guaranteed closed markets, and hence contestability should be maintained so that late comers are able to compete with incumbents on equal footing as in the case of telecommunications and public utilities); and circumvention of rules of origin where opening up at the regional level can be the backdoor for non-regional members to enjoy the benefits that were originally designed for members only (e.g., Mode 3 in the case of tourism services where for example if the tourism sector in Egypt is opened up for Arab countries only, European firms can establish themselves in Arab countries to access the Egyptian market).

However, there are some concerns regarding regional liberalization that need to be taken into consideration including the following:

### ***5.1. Interest of Regional Partners***

The interest of regional partners in regional agreements can differ among Egypt's Arab and European partners. For example, in the case of professional services and education, Arab countries might welcome Egyptian services, which is not the case for European counterparts. On the other hand, infrastructure-related services might be of interest to both regional partners. This implies that regional liberalization in services could lead to further regional liberalization in some sectors and not others, depending on the nature of the sector and the preferences of regional partners. Such observation is of crucial importance when negotiating the liberalization of such services so that future considerations should be taken into perspective to avoid that regional liberalization (as the case of infrastructure services) blocks further liberalization initiatives (at the global or other regional levels).

### ***Rules of origin***

Rules of origin play an important role in determining the preferential treatment granted to regional partners. In the case of services, in contrast to the case of goods, rules of origin are more difficult to determine. Services can be provided by different modes, which in turn affect the rules of origin adopted. In Modes 1 and 2, rules of origin do not constitute a major problem as the service is to be provided by the trading partner. However, there is a need to agree on the broad lines for rules of origin adopted in Modes 3 and 4. There are often three

criteria that can be applied under Article V.6 of the GATS,<sup>15</sup> including: "jurisdiction to which an entity belongs," and in particular free trade areas often require that enterprises eligible for privileges be incorporated under the laws of one of the partner countries and that eligible individuals "natural persons" be citizens or residents of one of the countries; and "location of services suppliers' economic activities" and in particular enterprises may be required to have "substantial business activities" within the region, and individuals are expected to have their "center of economic interest" in the region. The criterion of "ownership and control" can be added to the other two criteria as long as RTAs involve developing countries only. The three criteria are not mutually exclusive and a mixture of the three can be applied, but there is a need for Egypt together with its regional partners to agree on which criterion is likely to be adopted (which can differ by sector) to ensure effective negotiations and avoid prolonging them similar to what happened with the negotiations on rules of origin of goods whether with Arab or European partners (Fink and Jansen 2007). To ensure that preferential agreement is granted only to regional partners and to avoid circumvention of rules of origin, Egypt together with countries joining it in RTAs can adopt additional requirements similar to those adopted in other RTAs. For example, RTAs in the western hemisphere (with the exception of MERCOSUR) go further than GATS rules of origin, defining a service supplier not only as a legal entity with a majority ownership or effective control but also as one that must conduct substantial business activities or operations in the territory of any of the member countries in order to benefit from the agreement. Moreover, given the wide ranging nature and complexity of many sectors included within the services area, various sectors can be subject either to separate protocols or annexes in RTAs. Such separate protocols or annexes should spell out with greater precision the rules and disciplines governing the sector in question, the form of acceptable regulatory intervention, or the definition of the scope of liberalization. In most of the RTAs that have adopted such separate annexes or protocols, the temporary entries for business persons, professional services and telecommunications appear most frequently (Stephenson and Prieto 2002).

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<sup>15</sup> Article V.6 of the GATS states that: "a service supplier of any other Member that is a juridical person constituted under the laws of a party to an agreement referred to in paragraph 1 shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement."

*Including a discriminatory aspect in domestic regulations and overcoming legal loopholes.* Among the main challenges that increase the costs of liberalization of services at the regional level is the need to revisit the domestic regulations to include a discriminatory aspect that favors regional partners. The inclusion of such discriminatory aspect can entail a severe cost associated with the change of domestic laws and regulations. Flexibility in designing such laws and including provisions in the regulations and/or executive decrees should be maintained to ensure the easiness of regional liberalization without extra regulatory costs.

Moreover, the challenge of tax treatment duplication or tax evasion, which is likely to arise in specific modes (mainly Mode 1) when providing a service, should be dealt with cautiously. To be more explicit, imagine for example that Egypt liberalized computer services with country Y. Firms in Egypt started to provide their services through Mode 1 to customers in country Y. What type of tax treatment should such firms receive in Egypt and country Y? Are their services free from Egyptian domestic taxes? Or will they be subject to taxes in country Y as well as Egypt's domestic taxes? And what type of means to prevent tax evasion from both governments of Egypt and country Y should be included? Those are all questions that need to be considered upfront in any regional liberalization attempt.

A final point in this regard is the need to have regulatory convergence either through harmonization or mutual recognition between Egypt and its regional partners to ensure effective regional liberalization. Empirical evidence has proved that different laws, regulations and policies in services between two countries are inversely correlated with their intra-trade in services (Kox and Lejour 2005). The reason is that diverging laws and regulations in services affect the fixed costs of services provision implying that heterogeneity of laws and regulations increases in many cases sunk entry costs for service providers when entering regional markets, which in turn reduces their intra-regional trade. Hence, to ensure effective liberalization in the regional context, convergence is needed, which can be adopted either through harmonization or mutual recognition.

## **6. CONCLUSION AND POLICY RECOMMENDATIONS**

Services have been playing an important role in the Egyptian economy. Their importance differs from one sector to another; however, overall services role cannot be undermined. This implies that the GOE should develop a strategy or a policy on how to deal with services.

Having a services policy is not less important than having an industrialization or an agricultural policy, which are more familiar to the ear than a services policy. This paper tried to pinpoint some of the major aspects that need to be considered when reforming the service sector as well as drawing broad lines for the features of reform that came out of the analysis. Reform of domestic regulations in sectors where domestic regulations exist and creation of an efficient regulatory framework in sectors that lack a regulatory framework remain the most crucial aspect of any services policy. Liberalization should be adopted conditionally after pursuing the necessary regulatory reforms, or at least they should proceed in tandem. Moreover, a regulatory framework should be created in the sectors that suffer a regulatory vacuum. And finally, regional liberalization can be adopted to enhance service reform after accounting for the risks associated with regional liberalization as explained above.

The analysis in this paper pointed out that the reform of the service sector hinges mainly on the reform of domestic regulations. The reform of domestic regulations does not have a single recipe or a *Washington Consensus* type of prescription that needs to be adopted. The reform of domestic regulations differs from one sector to another depending on the specificity of each sector, as well as the administrative capacity of the government. Nevertheless, stylized features for domestic regulations should be maintained in any reform process. The stylized features include ensuring transparency, credibility, predictability and most importantly enhancing competition. Moreover, a starting point should be revising all the regulations that govern different service sectors where a regulatory framework already exists. A clean-up process of outdated rules and regulations should be undertaken first. Most importantly, the benefits of regulations in terms of preventing market failure and the costs associated with possible limiting of market entry and compliance costs should be balanced carefully.

The analysis pointed out that liberalization of trade in services cannot be effective unless preceded or coupled with domestic reform. Any liberalization attempt is likely to be preempted if domestic reform is not undertaken beforehand. Liberalization should mainly focus on enhancing competition as well as encouraging the role of foreigners in provision of services. The encouragement of the role of foreigners is mainly attributed to their role in bringing in new practices, technology and differentiated quality of services. The sequence of undertaking domestic reform before embarking on any liberalization attempt is crucial in the majority of service sectors (Hoekman and Mattoo 2008; Mattoo 2004; UNCTAD 2006). It is

worth pinpointing in this regard that the maintenance of regulatory freedom may, in certain cases, require care when scheduling commitments to ensure enough room for policy space while maintaining at the same time transparency and credibility.

The analysis also revealed that the liberalization of trade in services per se does not entail a welfare enhancing aspect, but rather benefits of liberalization depend mainly on the presence of efficient domestic regulations. Liberalization rather helps to anchor domestic reforms or in some cases act as an accelerator for domestic reforms to be undertaken. But contrary to the goods case, liberalization cannot act as an initiator for domestic reforms unless there are political economy pressures associated with resistance to reform due to vested interests. In this case, the government might take advantage of the GATS to act as a catalyst against domestic resistance to reform. The success of this strategy depends crucially on the capacity to undertake this reform, which is very likely to be lessened if the main stakeholders are reluctant. Though such situation might be similar to the goods sector, asymmetric information due to paucity of data and information in the service sector exacerbates the problem compared to the case of goods. It is worthwhile quoting Rodrik (2002) in this regard: "Trade policy reform contributes to economic development insofar as it helps build high quality institutions along these lines. The main objective of trade policy reform should not be whether the reform will result in higher volumes of trade, render the trade regime more liberal, or increase market access abroad, but rather whether the reform will improve the quality of institutions at home."

The paper also revealed that the GOE needs to build its own strategy for reform and liberalization of services. The diversity of service sectors and the large number of domestic reforms that need to be addressed imply that a priority list should be set. The priority list should focus on services that have a large impact on the economy, have a large number of linkages with other sectors in the economy or the government wishes to promote as a result of enjoying comparative advantage for example. Such a list includes the infrastructure-related services (e.g., transport and public utilities) as well as network services (e.g., telecommunications and financial services) and tourism.

Liberalization at the regional level is relevant for Egypt to adopt given the freeze of Doha negotiations and based on the fact that some services are more eligible for regional liberalization than for multilateral liberalization. In this regard, the analysis pinpointed how

the GOE should deal with the challenges of regional liberalization including the different interests of regional partners and rules of origin. Several suggestions were provided for the sectors that can be liberalized at the regional level as well as means to avoid circumvention of rules of origin.



## APPENDIX

**Table A.1. Share of Employment in Services (1990/91-2006/07)**

	1990/91		1995/96		2000/01	
	Worker (000)	% of total employment	Worker (000)	% of total employment	Worker (000)	% of total employment
Construction	713.0	5.3	964.0	6.3	1338.0	7.7
Transport and warehousing	471.0	3.5	562.4	3.7	676.7	3.9
Telecommunications	84.0	0.6	93.6	0.6	107.8	0.6
Suez Canal	18.0	0.1	19.0	0.1	19.5	0.1
Commerce, finance and insurance	1147.0	8.6	1384.0	9.0	1627.0	9.4
Hotels and restaurants	147.0	1.1	140.0	0.9	217.0	1.3
Real estate	200.0	1.5	215.0	1.4	237.0	1.4
Personal and social services	1089.0	8.1	1272.0	8.3	1330.0	7.7
Public utilities, social insurance and governmental services	3391.0	25.4	4078.0	26.6	4516.0	26.0
Share of employment in services	7260.0	54.3	8728.0	56.9	10069.0	58.1
	2001/02		2003/04		2006/07	
	Worker (000)	% of total employment	Worker (000)	% of total employment	Worker (000)	% of total employment
Construction	1375.0	7.8	1405.0	7.8	1580.0	7.9
Transport and warehousing	691.9	3.9	712.0	3.9	811.8	4.0
Telecommunications	119.0	0.7	125.1	0.7	160.0	0.8
Suez Canal	17.1	0.1	16.8	0.1	16.2	0.1
Commerce	1526.0	8.6	1579.0	8.7	1825.0	9.1
Financial intermediation	133.4	0.8	136.6	0.8	152.0	0.8
Insurance and social insurance	54.7	0.3	56.8	0.3	70.0	0.3
Hotels and restaurants	217.0	1.2	239.0	1.3	345.0	1.7
Real estate	594.0	3.4	605.0	3.3	664.0	3.3
Government services	4457.6	25.2	4512.9	25.0	4726.0	23.5
Education, health and personal services	991.1	5.6	1035.0	5.7	1303.0	6.5
Share of employment in services	10176.8	57.6	10423.2	57.7	11653.0	57.9

Source: Ministry of State for Economic Development available at: <http://www.mop.gov.eg/work.htm>.

**Table A.2. Public and Private Contribution in Services, LE Million and Percentage of GDP (1990/91 – 2006/07)**

Sectors	1990/91				1999/2000				2004/05				2006/07			
	Public	% of total	Private	% of total	Public	% of total	Private	% of total	Public	% of total	Private	% of total	Public	% of total	Private	% of total
Construction	557.3	3.0	1,226.9	6.6	733.5	2.6	1,976.0	6.9	809.6	2.3	2,146.8	6.0	1,018.8	2.4	2,854.5	6.9
Transport	605.0	3.2	1,349.9	7.2	375.4	1.3	2,545.3	8.9	418.1	1.2	3,006.4	8.4	478.9	1.2	3,504.3	8.4
Telecommunications	676.2	3.6	5.7	0.0	1,813.6	6.4	179.7	0.6	2,098.2	5.8	1,520.6	4.2	2,294.7	5.5	2,280.9	5.5
Suez Canal	767.4	4.1	-	0.0	671.1	2.4	-	0.0	1,165.9	3.2	-	0.0	1,465.6	3.5	-	0.0
Commerce	970.4	5.2	3,600.1	19.3	538.3	1.9	6,025.2	21.2	529.7	1.5	6,813.7	19.0	595.4	1.4	7,867.8	18.9
Finance	915.9	4.9	276.4	1.5	1,467.5	5.2	579.8	2.0	1,708.3	4.8	755.7	2.1	1,923.6	4.6	855.6	2.1
Insurance	17.1	0.1	10.3	0.1	49.9	0.2	23.8	0.1	108.9	0.3	42.6	0.1	122.3	0.3	47.7	0.1
Hotels and restaurants	83.8	0.4	484.4	2.6	18.4	0.1	965.2	3.4	21.5	0.1	1,748.4	4.9	25.4	0.1	2,066.1	5.0
Real estate	102.0	0.5	1,365.1	7.3	138.7	0.5	2,157.8	7.6	150.3	0.4	2,568.3	7.1	161.6	0.4	2,775.0	6.7
Public utilities	112.6	0.6	-	0.0	206.6	0.7	-	0.0	283.6	0.8	-	0.0	318.5	0.8	-	0.0
Social insurance	41.8	0.2	-	0.0	75.0	0.3	-	0.0	1,999.8	5.6	-	0.0	2,245.3	5.4	-	0.0
Social, governmental and personal services	3,723.2	20.0	1,768.7	9.5	5,296.9	18.6	2,618.8	9.2	4,893.0	13.6	3,150.3	8.8	5,240.4	12.6	3,490.8	8.4
Total services (public and private)	18,660	45.9	21,993	54.1	28,456	40.0	42,684	60.0	35,939.7	39.5	55,046	60.5	41,633.2	38.2	66,809	61.8

Source: Ministry of State for Economic Development available at [http://www.mop.gov.eg/MOP\\_Meta/NSDP.htm](http://www.mop.gov.eg/MOP_Meta/NSDP.htm).

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