EXAMINING THE COST OF SERVICES PROTECTION IN A DEVELOPING COUNTRY: THE CASE OF SOUTH AFRICA[1]

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In the lead-up to the next round of WTO talks, some commentators have argued that developing countries should liberalise their service industries for their own benefit and not just in response to industrial country demands. This paper critically explores this position for the case of South Africa. It finds that while the structure of the economy limits some of the traditional gains, a number of positive spillovers from the process ensure that there is an overall net benefit. It concludes by discussing a range of policy options that could be used to maximise the benefits and minimise the costs.

INTRODUCTION

Comprehensive negotiations on services liberalisation is a mandatory part of the next round of trade talks under the WTO. The Uruguay Round bought about little liberalisation by developing countries, but in this Round there will be considerable pressure on countries like South Africa to give greater market access to foreign providers. While many industrial countries argue that service liberalisation can only bring about net benefits for developing countries, there remains some scepticism in the developing countries themselves. This scepticism is less about the benefits of pro-competitive regulatory reform – a necessary step on the way to liberalisation and a process already started in most countries - but more about the additional benefits that will stem from granting greater market access.

This paper attempts to unpack some of the costs and benefits of reforms and the granting of further market access for South Africa in the producer services sectors. For this purpose, it draws on a number of recent sectoral studies of service liberalisation in South Africa[2]. The paper begins with an overview of how the economy may benefit from implementing pro-competitive reforms, irrespective of conceding market access. This is followed by a discussion of the additional benefits and costs that may come from granting greater market access on top of regulatory reforms. These results are tempered by an exploration of how economic environmental factors which may limit or possibly extend the benefits of reform. The paper then moves towards an analysis of the case of South Africa. It begins with a brief overview of the current state of producer services in South Africa before moving onto an assessment of how completed reform has impacted on the sectors. Finally, some comments are made on how developing countries like South Africa might proceed with liberalisation demands.

[1] This paper was written for the World Services Congress 99
[2] In particular, Butterworth and Malherbe (1999), Eisenburg (1999), Hodge (1999) and Naude (1999)

COSTS/BENEFITS FROM PRO-COMPETITIVE REGULATORY REFORM

Liberalisation of trade in service sectors characterised by network economies[3] requires that these sectors are first opened to competition through a variety of pro-competitive regulatory reforms. It is for this reason that much of the focus of trade negotiations in services has revolved around moving countries down this path and establishing clear regulatory principles for opening network industries in a non-discriminatory and competitive fashion.

The general principle behind such reforms is to separate the market for network infrastructure from the market for services provided over that network. As the network component usually retains monopolistic features, some form of licence auction combined with price-capping and non-discriminatory access requirements are used to effectively regulate this part of the industry. The service provision component is then opened to full competition without much need for regulatory oversight.

All countries have benefited from the demonstration effects of a select group of industrial countries that have pursued such reforms to date. This has served to reduce the regulatory risks of opening these markets and has shown that there are enormous benefits for the countries involved without many costs.. It is for this reason countries like South Africa have already moving down this path without significant prodding from the international trading system. Delays in implementation usually stem from the political economy difficulties faced by any reform process.

The benefits for the industry itself stem from the following sources:

- Reduction of price-cost margins - the introduction of competition limits the market power of industry players, thereby limiting the extent to which they can restrict output to raise prices and maximise profits. Regulatory reform should see a shift to marginal cost pricing and hence lower mark-ups of prices over costs and output expansion. Of course, amongst price-regulated network providers, it is the regulator and not competition which must bring about reductions in these margins.
- Static efficiency gains - the introduction of competition should see a reduction in the level of X-inefficiency in the market as firms adopt *domestic* best practice and inefficient producers are squeezed out. This contributes to further price reductions and output expansion.
- Scale efficiency gains[4] - the expansion of the market through price reductions will impact positively on scale and result in efficiency gains if scope for further scale economies exist.
- Dynamic innovation gains[5] - the introduction of competition in components of the sector should result in a higher rate of process and product innovation as firms strive to gain market share. Process innovation will reduce costs through efficiency gains while product innovation will expand market demand.
- Potential trade gains - regulatory reform will result in opportunities for domestic entrepreneurs to establish a presence in the industry and make the incumbent

[3] The sectors involved are communications, rail transport, electricity, and to a lesser extent air and maritime transport.
[4] Tybout et al (1991)
[5] Grossman and Helpman (1991)

parastatal a commercial concern. If the country develops a competitive advantage in the sector, then commercial firms are likely to pursue export or foreign investment opportunities resulting in trade gains. The incentive stems not only from the pursuit of earnings growth, but also to reap greater scale economies in production (of services and knowledge) and to stabilise earnings through market diversification. These benefit the local country along with the potential supply of investment and production inputs, and forex earnings from the repatriation of profits.

The cost of this efficiency drive is potential employment loss in the reforming sector. The loss from productivity improvements will be offset to some extent by output expansion but this is rarely sufficient in the short-run. In addition, the drive for productivity improvements will alter the structure of employment. The result will be a shift in demand towards higher skilled workers, leaving lower-skilled workers to bear the brunt of job losses[6].

A further concern for many countries is the potential social loss of reform. This may arise from low income households losing access to necessary services once cross-subsidisation is removed and commercial concerns focus on profitable segments of the market. However, subsidisation of such groups can still occur under a reformed regulatory regime but through different mechanisms - such as a non-discriminatory levy on all providers in the industry which is distributed direct to the households requiring assistance. Regulatory reform provides the additional benefit of facilitating price reductions which allows more low income households to demand such services and raises the real income of those households that are already making use of the services[7].

Within-sector analysis constitutes only a portion of the impact of reform. The downstream effects of price reductions and new product development, combined with upstream intermediate demand effects, constitute a large part of the impact of pro-competitive regulatory reform. In fact, many commentators feel that these are the real economic benefits from reform and more than offset the cost of potential employment loss[8].

These benefits include the following:

- Expansion of demand for investment goods - the reforming sector will demand greater investment goods not only to bring about improvements in efficiency, but also to expand production capacity as price reductions stimulate demand and new entrants establish a presence.
- Expansion of demand for intermediates - higher output volumes in the reforming sector will lead to an permanent increase in the level of intermediate input demand.
- Intermediate price reduction - price reductions in the reforming sector feed through to lower production costs in all other sectors of the economy, including private households. These permit price reductions and consequent output expansion in downstream industries, while increasing real income and demand in households.

[6] Bhorat and Hodge (1999)
[7] Hodge (1999)
[8] The OECD (1997) study finds that downstream employment creation offsets sectoral employment losses.

- Innovation effects - product innovation and quality improvements in the reforming sector can have a significant effect on productivity and business practices in downstream industries which make use of these products. These in turn can lead to price reductions, product innovation and output expansion in the downstream sectors.
- Trade gains - the reduction of prices and efficiency gains in downstream industries should impact positively on their trade performance, whether they are import-competing or exporters.

These effects will feed back into the system resulting in further iterations. Further, the additional payments to households in the form of wages or returns to capital that result from the process will be a source of further demand stimulation to the economy. Equally important, these downstream effects should have a significant and positive effect on employment which can offset potential losses in the reforming sector.

COSTS/BENEFITS FROM GRANTING MARKET ACCESS TO FOREIGN PROVIDERS

Once network-based service markets have undergone pro-competitive regulatory reform, they are in a position to grant market access to foreign providers along with the other service sectors without this characteristic. Market access in service industries can take four forms - cross-border supply, consumption abroad, commercial presence and presence of natural persons. The level of substitutability between these different modes of supply will be imperfect, and in fact some options may be technically infeasible for delivery of many services.

The costs and benefits of opening market access to foreign providers, regardless of mode of supply, can be drawn from the standard industrial trade literature. The benefits can be broadly summarised as follows:

- Sharpening of competition - market access to foreign providers sharpens competition in the domestic sector. This results in less market power and so lower price-cost margins, a further reduction of X-inefficiency and greater incentives for firm-level innovation.
- Transfer of technology - trading provides enhanced access to foreign technology. For domestic firms this access should accelerate learning and innovation, while also providing for the elimination of duplicative research. It will also bring about the introduction of new service products benefiting other final goods producers.
- Broadening of the market - trade broadens the market available to a service provider. This has the effect of a) allowing scope for greater exploitation of scale economies, b) increasing the returns to R&D leading to an acceleration in the innovative efforts of firms, and c) allow for greater specialisation within a service industry resulting in improvements in the quality of services.
- Resource allocation - trade leads to greater specialisation across countries resulting in more efficient allocation of domestic and world resources. This offers a once-off efficiency gain.
- Enhanced downstream benefits - the forces above will lower prices, improve quality, increase product variety and accelerate innovation. These will have a positive impact on downstream users as discussed under the section on pro-competitive reform.

- Potential trade gains - reciprocal market opening could lead to increasing exports if the country has a comparative advantage in the sector concerned. In addition, competitive pressure may force domestic firms to seek opportunities in other markets to prevent lose of scale efficiency as they lose market share in their own markets.

The potential costs to an economy from granting market access can be summarised as:

- Output and employment loss - if the economy is producing services for which it has no comparative advantage then these sectors may experience a decline, leading to a short-term structural adjustment where output and employment may be lost. This can be compensated for by opening markets in which the country holds some advantage.
- Loss of future growth opportunities[9] - specialisation along comparative advantage can lock a country out of sectors where there is scope for rapid learning and productivity improvements or for future trade growth, impacting on future growth opportunities.

However, different modes of supply and the pace of market opening will influence the extent to which each benefit and cost is realised by the liberalising economy. There are also additional costs and benefits peculiar to each mode of supply which may counter-balance some of the impacts discussed. By implication also, the experience of opening different service markets to foreign access will differ depending on whether they favour one mode of supply over another.

Commercial Presence

Opening market access through commercial presence represents one of the least risky paths that can be taken by a liberalising economy as it combines many of the benefits without much of the costs. Almost all services can be traded by commercial presence and it is the preferred option for many due to the gains from market proximity. The exceptions are those services that are by definition cross-border activities such as international air and maritime transport. Some services can only be traded by commercial presence, specifically those that require the provision or use of physical infrastructure located in the market. These include local and long-distance telephony, domestic transportation and local energy distribution.

The advantage of trade via commercial presence is that production must take place in the host country which means that there are no domestic output and employment losses from trade - only a transfer of ownership. The country still gains from technology transfer and a sharpening of competitive forces. In fact, technology transfer may well be enhanced via spillovers through local supplier use and employee turnover. Further, the demonstration effect of using new technology and management techniques could also improve their uptake amongst domestic firms.

The additional benefit of commercial presence is that it involves foreign investment, freeing local capital to pursue other opportunities in the domestic market and raising the overall level of investment in an economy. In addition, trade and domestic output gains

[9] Lucas (1988)

may be enhanced if the country establishes itself as a regional centre for supply of a particular service by multinationals.

The limitations of only opening commercial presence is that many of the potential benefits will be reduced, especially if the local market size is small. In particular, competitive forces will be lower if the market can only sustain a few entrants, and there will be lower levels of specialisation and exploitation of scale economies. This may be partially overcome through regulatory price-capping or the active promotion of greater competition either through facilitating greater competition between different modes of supply or opening other channels of domestic supply[10]. Of course, for services that can only be provided by commercial presence, these approaches are entirely necessary as opening other modes of supply are not an available cure.

Further, foreign ownership may well restrict trade from the host country that competes with subsidiaries held in other countries or which accrues to the home country office. A portion of profits and returns to capital will also leak from the host country over time. This may be handled to a extent through limitations on foreign ownership which is an approach that many developing countries have adopted.

Cross-border

Cross-border supply is becoming more viable in many service sectors due to the advancements in information/communications technology. This electronic commerce has either created the possibility of cross-border trade for some services where it was not possible before or greatly enhanced trade that was already taking place - making it more substitutable with other modes of supply. For services such as international transport, cross-border supply has always been dominant yet highly distorted by bilateral supply-sharing agreements. In this case, opening cross-border trade would involve removing such trade distortions.

Opening cross-border market access exposes the country to the potential loss of output and employment. However, it also exposes the domestic economy to greater levels of competition, a larger variety of technologies and products, and a broader market for exploiting scale economies. These benefits to downstream users could well offset any losses in the competing service sector.

The extent to which each of these costs/benefits occur depend crucially on a number of factors, namely the degree of substitutability between cross-border and other modes of supply, the relative competitiveness of the domestic sector, and the extent to which the local market size restricts competition, scale and specialisation. Of course, if market access is reciprocal then there is also the potential for trade gains if any one of the local service sectors have an established comparative advantage. Finally, countries need to be aware that restricting access to cross-border electronic commerce may prove impossible except through means such as exchange controls.

[10] For example, allowing different types of financial institutions to enter each other's markets and opening the market to outsiders like retailers.

Presence of Natural Persons

Opening market access to trade in services via the presence of natural persons concentrates on the temporary movement of persons to a country for the purpose of providing a service. In essence, such trade provides direct competition to labour services in the host country. Although this differs from commercial presence as it is the individual and not the corporation competing, the two are linked in that foreign corporations usually require the movement of key personnel for at least an initial establishment period.

The cost/benefit of such market access can be seen as a combination of the impacts experienced with cross-border and commercial presence modes of supply. Firstly, similar to cross-border, some returns to labour services are shifted to foreign labour, away from local labour. However, as production still takes place domestically, the returns to other factors and any positive spillovers remain in the domestic economy. These spillovers include a portion of income demand and the technological spillovers from interaction with the rest of the economy.

Secondly, similar to commercial presence, the temporary movement of labour provides an inflow of capital, in this case human capital. In the case where human capital is a scarce resource, trade will not only lower the cost of such services but remove any restriction that it has on growth. Further, there will be only a very small displacement effect on domestic labour services and will rather act as a complement to domestic skills. In the case where the person has little human capital, the impact is concentrated on the price of labour services and displacement of domestic labour services. In both cases, downstream benefits flow from the lowering of input prices and in the case of skilled persons, a greater range of 'products'[11]. It is for this reason that countries currently restrict the temporary movement of labour to include needed skills only.

Consumption Abroad

Consumption abroad requires the movement of the consumer to the country where the producer resides. This commonly includes tourism, education and health services. This mode of supply is mostly out of the control of any country and so has largely remained unrestricted. The main barriers include items such as exchange controls, visas, the recognition of foreign qualifications and the portability of health insurance.

In contrast to other modes of supply, opening of one's own market provides a stimulus for exports and domestic production with all the benefits associated with this such as market broadening and exchange earnings. Opening other markets provides potential domestic output loss but is countered with the benefits of offering the consumer a greater product variety and a degree of competition for similar domestic services. Variety enhances utility and competition acts as a pricing constraint on domestic services.

[11] The mix of skill and experience contained in the human capital can be seen as a new product variety and so offer similar benefits to downstream users as discussed previously.

DEVELOPING COUNTRY CHARACTERISTICS WHICH LIMIT OR ENHANCE THE BENEFITS OF REFORM

To what extent a country benefits from liberalisation and pro-competitive reform is determined to a large extent by other factors in their economy. Developing countries in particular have numerous structural deficiencies which may well limit some of the potential benefits. That said, reform of the service industries may well assist in removing some of the other constraints on growth and so have unexpected benefits for the country.

The potentially limiting factors mostly concern service sectors where commercial presence is the dominant form of production due to physical restrictions. The limitations include:

- Importers of capital goods - much of the demand created for investment goods will leak to industrial countries. Balance of payments constraints may also limit the rate of purchase and hence the pace of reform and its benefits.
- Market risk and return - higher risk and (in the case of African countries) lower returns may either see a lack of interest in establishing a commercial presence in a country or see establishment with retention of high price-cost margins. This may favour trade through other modes such as cross-border, where the potential benefits are lower. High risk premiums on interest rates will also limit domestic investment expansion in response to demand stimulus in the reforming sector.
- Regulatory and competition policy capacity - network-based services that undergo pro-competitive regulatory reform require close supervision afterwards to ensure that anti-competitive practices do not occur in the service component and that price-capping is sufficiently binding in the network component. Weak regulatory and competition policy capacity in developing countries may therefore result in higher than necessary pricing and so limited benefits from reform.
- Human capital constraint - growth stimulus from regulatory reform may be limited by the human capital constraint. Even though foreign companies may enter the market, employment is still likely to be dominated by local labour. Human capital constraints will limit both the level of investment growth but also the potential productivity improvements. In addition, the demands placed by the reforming sector may crowd-out access to human capital by other sectors while raising the costs of skilled persons.
- Low average incomes - low incomes limit market size which limits the level of potential competition and scale economies that can be achieved in a liberalised sector. This will result in lower productivity and price reduction benefits than the more industrial economies.

For cross-border supply of final demand services, a lack of confidence in the regulatory and legal systems in developing country may limit the extent of imports by industrial consumers, fearful of fraud and the lack of recourse to legal action[12]. This would result in a large trade imbalance in this mode of supply. These problems would probably not exist for intermediate demand and this may in fact favour some developing countries. This potential of unidirectional trade is probably less of a concern with opening the

[12] In the cross-border trade of financial services, final consumers may perceive the exchange risks of developing countries unmanageable and again limit trade to one direction.

presence of natural persons mode of supply even if restricted to skilled workers. This is because developing country professionals are lower priced and already export their services to a large extent.

A further concern regardless of the level of mode of supply is the level of competition in other parts of the economy. Weak competition in downstream industries will result in much of the price reductions in intermediate services being absorbed by profits and not reflected in price reductions in these sectors. This will limit the demand and employment expansion in these sectors which would usually offset the costs of employment loss in the reforming sector.

Reform has the potential to remove some of the constraints on growth. Again these are concentrated in on the commercial presence mode of supply and can be divided into the influx of foreign capital and influx of foreign technology. Foreign capital inflows provide a higher savings rate and so the potential for a higher investment rate as domestic funds can be diverted to other opportunities. Inflows of foreign capital also lower the balance of payments constraint on growth and allow lower real interest rates. This, and the boost to short-term growth rates, crowds in greater domestic investment. As foreign entrants will employ significant numbers of the local workforce, this process will result in a period of sustained development of the human capital of the local labour-force involved.

Finally, many services make use of common inputs and so a reform package that liberalises a few sectors at once, may well see the emergence of sufficient critical mass to develop an intermediate industry. Of particular interest in this case is the information technology industry which is a crucial input to all services and fundamental in bringing about productivity improvements and new product development.

A Brief Overview of The South African Producer Services Sector

South Africa has a modern economy which is reflected in a relatively sophisticated producer services sector. It is also a sector which still contains numerous government monopolies and limited international market access. However, reforms are being introduced which are gradually altering the economic landscape in the country.

The telecommunications industry has progressed considerably in the last 5 years with the licensing of two mobile telephony providers, the corporatisation and partial equity sale in the fixed line monopoly and the opening of the VANS sector. The networks are relatively modern and high growth has left SA with the largest GSM market outside of Europe and amongst the top 20 Internet users in the world. However, productivity is low, quality of service lags behind world leaders and prices are relatively high across the board. Teledensity remains low and large inequalities in access persist. To address rollout in under-serviced areas and upgrade the competitiveness of the state incumbent (Telkom), it was decided that the national monopoly in local, long-distance and international telephony would be extended until 2003. In addition, VANS service providers were restricted to using Telkom's network infrastructure. Foreign access to the market exists through minority shareholdings in all parts of the market but with holdings in the mobile and fixed line networks restricted to 30%. The sophistication of

the SA industry relative to the region has meant an outward flow of investment especially in cellular network provision. This complements South Africa's role as a regional routing hub for international calls.

The transport sector has moved more sluggishly down the road of privatisation and reform. The sector is dominated by the state-owned Transnet group, which has control of all major ports, airports and rail infrastructure. The road and domestic air transport sectors were deregulated in the mid-eighties while maritime and international air transport has always been open to numerous international carriers under bilateral agreement restrictions. More recently, airports were unbundled from the Transnet group and a minority shareholding sold, and public-private partnerships are being sought for road infrastructure development. Dominant problems in the system include a backlog of infrastructure spending, low productivity/high costs and a lack of intermodal integration. Although there is intent to introduce further pro-competitive regulatory reform, the task of unbundling the debt-ridden Transnet remains an obstacle. As South Africa is the hub of trade in the region, there is a strong trade in port and land transport services regionally.

The financial sector in South Africa is a well-regulated and sophisticated industry. The soundness of the financial system was reflected in its resilience during the Asian financial crisis. The industry's technology, infrastructure and supervision is seen to compare favourably with industrial countries. Foreign entry to the industry was once again welcomed in 1994 and has been rapid in broking, short-term insurance and investment banking. The remaining sectors are dominated by a handful of local institutions. There is generally no discrimination amongst SA-registered entities (foreign-owned or not), but foreign-registered entities are constrained in numerous ways. These include the need to be locally capitalised and the exclusion from retail banking and insurance markets. Exchange controls do persist which act as a discriminatory factor against cross-border supply but not amongst commercial presence suppliers. Despite these restrictions, many foreign financial services firms are using South Africa as a springboard into Southern Africa, following the established SA banks and insurance companies. This has led to the growth of SA as a regional financial centre.

Business services in South Africa are open and competitive. The sector offers a full range of specialised services and includes significant numbers of foreign-affiliated local partnerships in most fields. Employment in the industry is dominated by local professionals due to a large local pool of skilled labour and various restrictions on foreign entry - from some limitations on the recognition of foreign professional qualifications to a lack of transparency in the domestic regulations governing the temporary movement of persons. Overall, the sector is relatively competitive on an international level and has also began to branch out to service the region in support of domestic firms investing in these economies.

HOW HAS REFORM IMPACTED ON THE SOUTH AFRICAN ECONOMY TO DATE

Telecommunications[13]

The partial opening of the telecommunications industry has brought significant benefits for the South African economy already. The licensing of new products - specifically cellular and VANS - has added a few percentage points to GDP and created large numbers of jobs. Many of these jobs have been lower-skilled because they were created in the retail sector[14]. In fixed line telephony there has been an improvement in productivity, service quality and a re-balancing of tariffs which has reduced international calls but increased local calls. Part of this can be ascribed to increasing competition from the cellular industry as it began before an equity partner was found, and some can be ascribed to the transfer of technology from the foreign equity partners. This has had a cost in terms of employment loss but which is dwarfed relative to the expansion of jobs in cellular and VANS. Further, there has been a growing investment in human capital since foreign entry. It has also provided necessary capital for network expansion, aiming to double the teledensity of the country in 8 years. A slight macroeconomic downturn following the Asian crisis has impeded expansion slightly.

For downstream industries, much of the investment demand created by these new investments leaked from the economy as expected. These purchases of equipment and services did place some pressure on the balance of payments initially as cellular network infrastructure was rolled out. However, this has been mostly offset by capital inflows as foreign investments in telecommunications has accounted for roughly 25% of all FDI since 1994. There appears to be a sizeable impact on downstream productivity though no estimates are available. There has also been outward investment by most operators. One cellular company has established itself in 5 other markets while the other has been less ambitious to prevent competing for licence bids with its major foreign shareholder.

However, current reform has also had major limitations, mostly relating to competition and regulatory policy issues. The extension of the fixed line monopoly has prevented competition from reducing price-cost margins and accelerating productivity growth to the point where significant inroads are made into the productivity gap with leading providers internationally. Price-capping has not provided an alternative disciplining effect because it has been set at a non-binding level. While there has been some competition from the cellular market, this has focused on service rather than price. A significant reason for this is the cross-holding in one of the two providers by the fixed line monopolist. The result is that South Africa is estimated to have one of the highest cellular call rates internationally[15] and fixed line prices have not seen the dramatic drops that characterised liberalisation in other countries. This has limited any downstream effects on other industry to impacts stemming from new products and improvements in quality - no significant price effects. Finally, legal challenges to the decision by the regulator to exclude internet service provision from the monopoly has impacted on investment decisions by ISPs.

[13] See Hodge (1999) for details
[14] Retailers selling air-time, phones, computing equipment and software
[15] This is based on purchasing power parity

Financial Services[16]

There has always been some foreign participation in SA financial services but the end of apartheid and the relaxation of exchange controls has provided impetus for greater foreign entry[17]. However, the current regime prevents cross-border transactions and so market opening has been characterised by commercial presence only.

In banking, foreign entrants have secured 5% of the market but concentrated on commercial/syndicated loans, corporate finance advisory services, foreign exchange dealings, trade finance and securities trading. They have pioneered the introduction of new products which help firms manage risk and lower the cost of capital. They have improved industry regulation through strong support for initiatives from the regulatory authority[18] and provided easier access to international capital.

In the insurance industry, foreign participation has focused on individual and corporate short-term insurance, creditor insurance and reinsurance. They have secured a 38% market share in short-term insurance and 100% of the reinsurance market. Their entry has resulted in increased price competition forcing local companies to respond. New products have been introduced , such as alternative risk transfer, which have helped corporates manage risk better.

Securities trading was deregulated in a 'big bang' in 1995 and introduced negotiated commissions, corporate ownership and principal trading. This opened the market to foreign brokerages which have subsequently grabbed between 30-40% of the market. However, the market has expanded equally rapidly, ensuring little loss for local players. For instance, in the bond exchange turnover has increased three-fold and liquidity doubled. Commission rates have also come down while the quality of research has improved. Foreign entrants offer better analysis of international markets while bringing new techniques and competitive pressure to local research. They also bring new products, such as customised derivative products, which lower the costs of capital and help manage risk.

Market expansion in all financial services has expanded employment in South Africa significantly. In addition, foreign entrants across all segments of the market have played an important part in growing SA as a regional financial centre. This it has developed partly because of their use of SA as a regional base, but also because their entry has improved the competitiveness of the financial services market through cutting prices, expanding the range of products and improving service.

However, all this success has had a downside too. Dramatic market expansion has encountered a human capital constraint resulting in very large increases in salaries in the domestic industry and high turnover of staff. Where reform itself has failed is that certain markets remain protected through discriminatory legislation. In these markets, particularly retail banking and long-term insurance, there have not been the same extent of changes in prices, products and service. In fact, there has been growing dissatisfaction with what is alleged over-charging by retail banks. It is here where other

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[16] See Butterworth and Malherbe (1999) for details

[17] Roughly half of the current market participants have established since 1994.

[18] For example, more stringent money laundering regulation.

modes of competition, such as cross-border or internet banks may well pressure the markets to reform to the extent of other financial services.

Transportation[19]

Transport has not seen significant reform as yet. Deregulation of the air and road sectors has had important impacts on price and service through competition. This has impacted on other modes of supply, especially rail where competition from road transport has lowered rail's share of freight transport to 20%. In airports, the foreign equity sale has provided a much needed capital injection which has raised airport efficiency through facilities expansion. Despite protection, some parts of the transport system remain internationally competitive due to heavy investments in them to bolster specific commodity exports[20].

The deregulation that has already occurred has also not been without problems. In particular, the domestic air transport sector has seen a number of local carriers exit the market soon after establishment. The allegations are that aggressive and anti-competitive price wars by the dominant carrier are being used to force competitors out of the market. Foreign buy-ins have provided some stability to the remaining local competitors. Current reform also does not go far enough as large parts of the transport sector are inefficient and over-priced.

Business Services

Business services have always been relatively open in South Africa and political constraints rather than regulation has been a force preventing foreign entry. The main regulatory restrictions have been, and still remain, the temporary movement of natural persons and the recognition of qualifications. Since 1994 there has been a rapid expansion in the commercial presence of foreign providers, accounting for around 7 % of all FDI inflows since then. Cross-border trade has also been growing rapidly and now accounts for over 1% of exports and 1% of imports.

The entry of foreign firms shaked up the local industry, raising the quality of local business services and introducing new products. Although market share has been taken away from local firms, employment has been created locally due to the preference for commercial presence. The competition has also forced local firms to restructure and become for internationally competitive, providing scope for them to go global themselves. This has particularly been the case with the information technology services where a number of firms have grown to the status of powerful international players.

The dominant problem with reform has been the pressure on the labour market. Foreign firms entering the market were initially highly restricted by the tight market for skills locally. This gave local firms some breathing space to respond to competition, but also resulted in high staff turnover and rapidly increasing salaries. A further problem is that temporary immigration regulation is in practice obstructionist and untransparent which offers limited relief from a tight labour market in the short term.

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[19] See Naude (1999) for details
[20] The main coal and steel bulk port has one of the most efficient bulk ports in the world.

HOW SOUTH AFRICA MIGHT APPROACH FURTHER LIBERALISATION OF SERVICES

The experience from existing reform and liberalisation in South Africa has shown that although pro-competitive regulatory reform and liberalisation brings with it numerous benefits, the process needs to be managed properly such that costs are limited and benefits maximised. The lessons from theory and experience suggest that the reform process needs to be aware of the following issues:

1. Importance of pro-competitive reform - a large portion of the benefits to the economy stem from the having effective competition in a sector, regardless of whether trade in that sector is liberalised or not. It is also feasible that uncompetitive conditions remain after foreign entry, restricting the flow of benefits. Therefore countries need to tighten competition policy and even consider opening multiple modes of supply simultaneously to ensure adequate competitive pressure.
2. Importance of foreign technology access - access to foreign technology is most important when the innovation rate in a sector is high - such as telecommunications and finance. In these cases, the introduction of new products not only expands the market sufficiently to offset potential employment and market share losses, but also offers the most benefits to downstream final goods producers.
3. Regional comparative advantages - a country needs to consider its role in both the regional and international trading system. The case of South Africa shows that a country may have a regional comparative advantage which differs from its international comparative advantage. This difference allows scope for a developing country to benefit more significantly from liberalisation than expected as regional exports may offset international imports. It also, however, raises the question of whether it is better for a country to liberalise services more rapidly in the region before committing to multilateral liberalisation.
4. Human capital constraint - the human capital constraint is considerable in a developing country undergoing a rapid reform process. This can slow down investment and see a large portion of the gains accruing to skilled labour, to the detriment of downstream users. Addressing this constraint may require a more liberal stance on the temporary movement of persons or a slower pace of reform until the gradual upgrading of domestic human capital has caught up.
5. Package of reforms - the package of reforms within a single sector and between a number of sectors is important to determining the distribution of gains. The trade-offs may be over modes of supply - for instance, reform on commercial presence without a liberal position on the presence of natural persons may introduce the human capital constraint. They may be inter-sectoral - for instance opening the portability of health insurance may harm the domestic insurance industry but benefit domestic health tourism. And they may be in the extent to which liberalisation occurs - for instance foreign entry without competition in telecommunications brings few benefits.
6. Extent of market opening - it is not clear whether full liberalisation is required to reap the benefits of reform. It would seem that many of these benefits can be accrued while still retaining some limitations (such as limits on foreign holdings) which would enable development goals to be achieved too.
7. Benefits for industrial countries - there are large benefits for industrial countries from developing country liberalisation - from the returns to investment, export

growth and demand for investment goods. This affords developing countries some bargaining power to ensure that development of domestic industry and human capital occurs.

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