

International Trade in Offshore Business Services: Can Developing Countries Compete?¹

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Introduction

For many developing countries, diversification away from traditional primary industries to international business services has been a highly successful means of achieving economic development. Governments have pursued economic development policies for diversification into industries such as financial services, shipping, commercial services, computer services and, more recently, e-commerce, in order to build comparative advantage in these industries, which are among the fastest-growing sectors of the global economy.

Many Commonwealth countries have benefited strongly from pursuing such strategies, escaping the vicious cycle of deteriorating long-term real prices for agricultural and mineral commodities, highly volatile commodity prices and vulnerability of crops to extreme weather conditions.

Table 1. Growth Rate of Global Exports by Industry Sector, 1990–98

	Annual average growth rate in world trade value (%)
Agricultural Products	4
Mining Products	1
Commercial Services	7

Source: WTO

While globalisation has often assisted such industrial diversification strategies, since many international services are relatively mobile geographically, there are increasing concerns that global competition in such industries will be subjected to regulation by a handful of the most power-

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ful developed countries, potentially locking out developing countries from competing effectively in a number of these industries.

The recent OECD Initiative on Harmful Tax Competition, as well as other OECD initiatives such as the previous OECD initiative on the Multilateral Agreement on Investment and planned new e-commerce initiatives, are raising concerns in developing countries that a small number of advanced economies are raising new barriers to competition from developing countries in the global business services industries, where the OECD countries have had a dominant position historically. The WTO is also phasing out use of investment incentives and export incentives as a tool of economic development, which will affect many developing countries.

The Growth of International Business Services

The international business services industry has shown rapid growth in the last two decades. This reflects a number of global trends, including the deregulation of domestic financial markets in many countries, rapid growth in world trade and investment and the globalisation of many segments of the services industry. Initiatives in the GATT Uruguay Round to liberalise trade in services have underpinned the growth of the international business services industry. The process of liberalisation of trade in services is likely to continue to be an important component of future WTO discussions. At present, the OECD countries control almost all world trade in commercial services, accounting for around 80 per cent of total global service sector exports.

Table 2. Share of World Trade in Commercial Services, 2000

Region	Share (%)
OECD Countries:	
North America	22.0
Western Europe	44.4
Japan	4.8
Developing Countries:	
Africa	2.2
Latin America	4.3
Non-OECD Asia	13.0

Source: WTO

Although the OECD countries continue to dominate world trade in services, developing countries have benefited from even their small share of global services trade. Diversification into offshore IT and financial services has benefited many developing economies very substantially in a number of ways. Firstly, the offshore financial services industry has been a high growth sector globally. Therefore it has provided a dynamic growth sector for national output in comparison with the existing alternatives available to many countries. For example, many Caribbean economies were heavily reliant on traditional industries, namely subsistence farming and the export of primary commodities. Moreover, from a terms of trade perspective, the price of international services has been rising far more rapidly for decades than for secondary industries, while primary product prices have actually been declining. Indeed, a major problem faced by developing nations has been the declining terms of trade for primary commodity exporting nations. Consequently, the international services industry has provided an excellent economic development driver and a strategic growth industry which has helped to lift per capita incomes and national living standards in many developing countries.

The promotion of information and communication services represents, for the Government of Grenada, a vital part of our diversification effort, and our search for alternatives to commodity agriculture. The decline of Grenada's commodity export trade has had a devastating impact on the country's capacity to earn foreign exchange, to generate employment and to pursue agricultural and rural programmes. Moreover, the liberalizing of trade and the reduction of tariffs levels in response to global requirements have seriously weakened the government's revenue-generating capacity, in some areas.

Dr Keith Mitchell, Prime Minister of Grenada, June 2001

For some jurisdictions, the offshore business services industry has transformed their economies. Barbados is a good example of how a strategy of diversification away from traditional agricultural industries to international business services has been a highly successful means of achieving economic development. In the 1950s, the economy was heavily reliant on sugar cane production, with sugar accounting for 30 per cent of GDP, a third of export earnings and 25 per cent of total employment. Moreover, the economy was subject to large volatility in global sugar prices, which given the high dependency on this single agricultural product, caused great economic vulnerability. Barbados was also subject to deteriorating terms of trade in the long term, as the price of manufactures and services imports was rising far more rapidly than export prices for its agricultural exports.

With the development of the international business services industry over the last two decades, the domestic economy has been transformed, with Barbados now having a strong economic base consisting of a wide range of international financial and other business service exports. Indeed, these new international service industries account for 30 per cent of GDP, while sugar's share has fallen to just 3 per cent of GDP. The strategy of diversifying away from sugar has been extremely judicious, as the viability of the sugar industry is increasingly uncertain, due to uneconomical field operations, ageing factories and declining world sugar prices. Barbados is now classified as an upper-middle-income country, with its workforce having employment opportunities in a wide range of highly skilled professions in many service industries, compared with the limited opportunities in agricultural employment just a generation ago.

As an industry sector requiring a skilled workforce, the financial sector has also provided a means for bringing about workforce skilling and employment opportunities for tertiary-trained local employees who may have had far more limited opportunities in the absence of such an export-driven financial sector. Graduates in areas such as management, law, accountancy, finance and social sciences have far greater scope for employment through the development of such a sector. Moreover, the relatively high incomes and associated investment in this sector generate considerable multiplier effects through corporate and household expenditure into construction, retailing, business and government services. Generally such multiplier effects could result in two or three jobs created in other sectors for every job created in the offshore financial sector directly.

Table 3. Contribution of International Financial Services Industry to GDP in Selected Commonwealth Jurisdictions

	Estimates of international financial service sector as share of GDP (%)
The Bahamas	15
Barbados	30
Bermuda	20
British Virgin Islands	36
The Cayman Islands	21
The Cook Islands	7
Grenada	5
Isle of Man	42
Guernsey	64

The financial services industry, while an important component of international business services, is only one of many industries being developed. Other important sectors include shipping services, distribution services, service centres and company headquartering. The most dynamic new growth sector is e-commerce, software and electronic data processing services.

Financial Services

The offshore financial services industry has evolved substantially during the last 30 years, in response to the globalisation of the world economy and financial markets. The size of the offshore industry is estimated at \$5–6 trillion, with around 70 offshore financial centres worldwide. Offshore financial services includes the provision of financial services to overseas clients, so that major international financial centres with a high share of such business, such as the City of London, are also considered to be offshore centres. Indeed, recent IMF estimates of global offshore financial services activity indicate that around 60 per cent of total global offshore centres activity is in London, the USA and the Japanese offshore market.

After taking into account the substantial offshore centres in other OECD countries, the non-OECD share of the total offshore financial services industry is estimated to account for less than 20 per cent. With major international financial centres such as Hong Kong and Singapore included in this 20 per cent figure, there are a large number of small offshore centres which are involved in the provision of a relatively small share of the total market.

While the City of London has hundreds of years of history as an international centre for the provision of international banking, insurance and other financial services, many of the other offshore centres have emerged relatively recently. A large number of these are Commonwealth jurisdictions; the recent IMF list of offshore centres includes 29 Commonwealth countries. Of the 29, ten are British-administered, reflecting the historic role of British financial institutions in international finance. Indeed, these close linkages with Britain have been an important factor in assisting their competitiveness due to the use of well-established Commonwealth legal systems, stable government and defence security.

The evolution of many of these OFCs reflects initiatives for economic diversification into more sustainable, highly-skilled industries, so as to boost economic development and living standards in small states. For example, in many Caribbean countries, economic strategies to diversify

away from agricultural dependency were encouraged by the international development community, resulting in strong efforts to move into sectors such as financial services and tourism. In many cases, colonial administrations initiated the establishment of these offshore financial centres, in order to try to create sustainable industries that would allow economies to develop and generate employment, as well as to reduce dependence on fiscal support from their European masters.

In parallel, the deregulation of global business services allowed greater geographic mobility of capital, while the value of world trade and international corporate activity has risen sharply. This has created demand for the international provision of a range of business services, including global banking, insurance, reinsurance, funds management, leasing, factoring, shipping, distribution centres and a wide range of other business services.

Table 4. Commonwealth Countries and Territories with Offshore Financial Centres

Europe	Caribbean (<i>continued</i>)
Cyprus	Belize
Isle of Man (UKDT)	Cayman Islands (UKOT)
Jersey (UKDT)	Dominica
Gibraltar (UKDT)	Grenada
Guernsey/Sark/Alderney (UKDT)	Montserrat (UKOT)
Malta	St Kitts and Nevis
UK (City of London)	St Lucia
	St Vincent and the Grenadines
	Turks and Caicos Islands (UKOT)
Africa	
Mauritius	
Seychelles	Asia/Pacific
	Australia
Caribbean	Cook Islands
Antigua	Labuan (Malaysia)
Anguilla (UKOT)	Nauru
Bahamas	Niue
Barbados	Samoa
British Virgin Islands (UKOT)	Singapore
Bermuda (UKOT)	Vanuatu

Source: IMF

Many of the largest financial centres have substantial hosting of global institutional investment funds. These include mutual funds, investment trusts, pension funds and hedge funds. This component of international

financial services has been growing at a rapid pace as international investors or managers seek to provide for privately-funded retirement, long-term savings and international portfolio investment. Generally these funds are collected and taxed in the country of the investor's residence, but are pooled for investment purposes into a common fund. It is more advantageous to locate such investment funds in a jurisdiction where they will be taxed minimally, since generally the investment distributions are already taxed in the jurisdictions where the investments were originally generated and distributed.

Some offshore centres have specialised in certain areas. Bermuda, for example, is a major international insurance centre. This has resulted in the establishment of highly skilled expertise in Bermuda for insurance-related services, giving the jurisdiction global competitive advantage in this particular sector due to the congregation of large numbers of insurance firms and industry professionals on the island. Barbados is a major centre for foreign sales corporations, with an estimated 2,300 registered in 1997. The Bahamas offshore services industry includes the world's third largest international shipping registry, with around 1,500 ships registered. A number of Caribbean offshore centres are also major centres for highly specialised commercial products, such as specialisation in aircraft leasing for international airlines, for which Cayman Islands and British Virgin Islands are major specialist global centres with high quality professional expertise in these sophisticated products. Indeed, the vast majority (on a dollar-weighted basis) of Caymans' business is institutional business, i.e. Special Purpose Vehicles used in international trade and debt structuring, etc. Cayman Islands has also become a major centre for specialist captive insurance products, with strong professional expertise in how to structure such complex insurance products. Much of the business of offshore centres is also sourced from activities of blue-chip multinationals which comply with the highest international accounting standards.

A large part of private investments in non-OECD international financial centres relates to blue-chip investment funds which are fully transparent and fully taxed at point of distribution, with around 6,000 such funds located in OFCs. For example, the Cayman Islands has an estimated 3,200 mutual funds, with over US\$200 billion in funds managed in Cayman, but the bulk of these funds are institutional funds, such as large global fund managers or the many large US tax-exempt institutions such as US university endowment programmes.

The OFCs are also playing an increasingly important role in financing multinational corporate investments in developing countries. For example, Hong Kong plays a predominant role as funding hub for business in North

Asia, particularly for the global Foreign Direct Investment (FDI) flows in and out of China. The Caribbean financial centres are also playing an important role in regional foreign direct investment flows with North Asia, with more than half of Hong Kong's FDI going to the British Virgin Islands, the Cayman Islands and Bermuda (UNCTAD World Investment Report, 2001). This investment is mainly into corporate investment vehicles, with the bulk reinvested in China or Hong Kong as FDI or equity flows. For example, a major recent deal was a cross-border mergers and acquisitions deal by China Mobile (Hong Kong) Ltd, which acquired seven mobile networks in China in 2000 in a US\$33 billion deal. The deal was part financed by capital raised through new shares issued to its parent company in the British Virgin Islands, resulting in FDI inflows of US\$23 billion into China Mobile (Hong Kong), or around one-third of Hong Kong's FDI inflows in 2000. India has had a similar relationship with Mauritius, which has served as a major financial centre for foreign corporate investment vehicles into India.

Banking in offshore centres constitutes an important part of the global international banking industry. Based on reporting by a number of major offshore centres to the BIS on offshore deposits, the size of international banking provided by centres such as Cayman Islands and the Bahamas is comparable to the offshore banking sectors of some of the small OECD countries, though just a fraction of major offshore banking centres such as London. However, even this comparison overstates the role of centres like Cayman Islands in global international banking, with over 80 per cent of Cayman bank deposits estimated to be held by large global financial institutions, such as large US and European banks, which sweep overnight funds in and out of wholesale overnight money accounts with their Cayman subsidiaries. Such overnight institutional deposits are fully transparent and regulated in the USA and other onshore centres by their own banking regulatory authorities, as well as by the Cayman Islands Monetary Authority, which has very strict legislation and enforcement mechanisms in place to comply with FATF guidelines. Therefore, the role of the Cayman Islands in the provision of non-institutional banking services is relatively small in comparison with the large scale of institutional banking activity, which is related to the attractiveness of the Cayman Islands as a tax neutral platform for global institutional banking and fund management.

India and China are also providing financial services to their diaspora, due to the very large emigrant communities established abroad. It has to be recognised that diaspora from countries in East Asia and India, as well as other developing countries like South Africa, do have substantial potential to become an important source of capital inflows for many

developing countries, and these developing countries need to provide offshore financial services centres if they wish to tap this market. For example, India has provided a wide range of banking and other financial services products for its non-residents globally, with special preferential taxation exemptions. This has helped to generate very large foreign exchange deposits in the Indian economy, providing a key source of capital inflows for the current account. Total non-resident bank deposits in Indian financial institutions were estimated at around US\$15 billion in 1999, and are estimated to have risen to US\$23 billion in 2000. While this is still relatively small compared to the size of offshore deposits in large offshore financial centres like Hong Kong or Luxembourg, the size of total non-resident deposits has tripled during the last decade, and more than doubled since 1997.

The Indian diaspora has also become an important new market for the international growth of Indian domestic financial institutions, assisting them to become more globally competitive in international financial markets by developing sophisticated international financial products. India has also used its overseas Indian community to raise sovereign debt, rather than the usual tapping of foreign bond markets utilised by most countries. Two such bond issues in 1998 and 2000 raised a total of around US\$10 billion from Indians abroad. There are also very large remittances from Indian workers in the OECD and in the Middle East, which have created a significant offshore financial services sector in India. Consequently the offshore financial services sector is playing a key role in financing Indian economic development and providing critical foreign exchange inflows for India's current account position.

The Indian example may provide a useful model for other developing countries. There is probably a strong case on economic development grounds for allowing emigrants from developing countries to be given incentives to invest in their home countries and exemptions on savings taxation on any such investments back to their home countries by rich industrial countries where they work. This could take many forms, including the Indian model of retail bond raisings, special venture capital or unit trust funds for emigrant investors, and other such long-term savings vehicles. This will provide a valuable mechanism for generating foreign exchange for development in many developing countries at a time when finding sources of financing for development is one of the most pressing issues on the international development agenda. It is also one of the potential measures that developed countries can take to compensate developing countries for attracting their scarce skilled personnel, although other measures, such as aid funding for boosting training capacity, are also necessary.

E-Commerce and IT Services

E-commerce and other IT services have become a key strategic focus for many developing countries in their export diversification and industrial development strategies. Many Commonwealth developing countries are now focusing policy initiatives on building competitiveness in exporting IT services and e-commerce. This includes software services, e-commerce and data-processing services. Many Commonwealth countries, including India, Malaysia, Singapore, Malta, Mauritius and South Africa have been encouraging the development of these new growth sectors, in order to strengthen their competitiveness in the leading growth industries for the twenty-first century.

For example, Forrester Research has projected that B2B e-commerce will reach US\$2.7 trillion in 2004, with 17 per cent of all business trade transacted through the internet. Jupiter Research has predicted that by 2005, the largest online B2B markets would be in computer and telecommunications, food and beverages, autos and parts, industrial equipment and supplies and real estate. Developing countries that are seeking to be at the forefront of global competitiveness are trying to develop industry strategies that position them to compete effectively worldwide in these fast-growing industry sectors for the digital age.

For example, India is benefiting from a major transformation occurring in the economy due to its offshore IT industry. This is resulting in strong positive effects on the current account balance, as IT exports are growing at a 50 per cent pace year after year. Software exports are now making a substantial contribution to overall exports, accounting for around 10 per cent of total exports. Software exports are forecast to rise by a further 60 per cent in 2000–01, to an estimated US\$6.3 billion, with the very rapid growth of this sector resulting in a fundamental transformation of both the growth rate and overall composition of India's exports. Domestic sales from the industry are estimated at US\$2.3 billion, giving total industry output of US\$8.6 billion. The US is the dominant export market for India, taking around 65 per cent of India's software exports in 1999–2000, while the EU accounted for a further 25 per cent. However, the EU market is rapidly growing, with Indian software exports to the EU estimated at US\$842 million in 1999–2000, but rising by a projected 35 per cent in 2001.

A large share of Indian software companies domestic revenue is attributable to offshore services, which is work done by a software company in India for an offshore client.

Table 5. India's Offshore IT Services, 2000

	Offshore services revenue as share of total (%)
Infosys	67
Wipro	52
Satyam	58
Mastek	33
Sonata	47
HCL Tech	63
Polaris	49
Silverline	36
Visualsoft	49

Source: Economic Times of India

Indian software and related services are expected to grow by a further 50 per cent in 2001–02, with export revenue rising to US\$9.5 billion and total output of US\$13 billion. This rapid pace of expansion in India's technology exports offers new scope for optimism about the medium-term external trade outlook, as well as generating new foreign direct investment flows and equity capital flows into India. McKinsey & Co has estimated that India's IT exports could rise to US\$50 billion by 2008. The Indian National Association of Software and Services Companies has projected industry revenues rising to US\$87 billion by 2008, and accounting for 7.5 per cent of national GDP.

In India, there are already tax exemptions for exports from Export Processing Zones, Free Trade Zones and Software Technology Parks. Tax holidays are also provided to export oriented units set up anywhere in India. The 2001–2 Budget extended special tax exemptions to profits from on site exports of services provided from software technology parks. Of India's total software exports of US\$6 billion in 2000–1, an estimated 74 per cent was from its Software Technology Parks.

Developing countries are also working together to build their leading edge IT export industries. In Mauritius, the government has launched a new strategy to make Mauritius a free trade zone for the IT industry and promote the island as a leading regional e-commerce hub. IBM has recently decided to establish its regional headquarters in Mauritius. The Indian Institute of Technology in Chennai has plans to open a hi-tech hardware centre in Mauritius, with a feasibility study underway for the hardware centre, which would be set up under a US\$100m line of credit facility being offered by India to the Government of Mauritius for import

of Indian IT-related products for a proposed Cyber City and IT education projects. India's ISRO is also planning to establish a space research centre in Mauritius.

Table 6. Software Exports from Software Technology Parks of India
(Crore Rupees)

Centre	1999–2000	2000–01
Bangalore	4321	7475
Bhubaneswar	89	200
Calcutta	150	250
Chennai	1890	2956
Gandhinagar	27	102
Hyderabad	1059	1990
Jaipur	15	30
Noida	2450	4350
Mohali	15	40
Pune	572	960
Navi Mumbai	962	1610
Thiruvananthapuram	57	88
Total	11607	20051

Source: STPI in *Economic Times of India*

The EU proposed VAT rules in June 2000 that could have impacted seriously on developing country e-businesses. In terms of the current provisions no VAT is payable by a developing country e-business on sales of digital products and services to the EU. To protect European e-businesses, the EU proposed legislation that would have forced overseas online sellers from around the world to collect VAT on sales of digital products and services to non-business customers in Europe. E-businesses with more than 100 000 Euro in sales in the 15 EU member states would have been forced to register in one of the EU countries and file EU VAT returns. The EU's attempt to charge extraterritorial VAT was seen as overreaching and the proposals encountered many comments and complaints. According to estimates, the scope of these sales was merely 2 per cent of e-trade. International principles for taxing e-commerce were also discussed at the OECD Ministerial Conference in Ottawa in 1998. It was agreed that, for consumption taxes, the rules should result in taxation in the jurisdiction where consumption takes place.

Given the number of markets they operate in, the potential tax compliance burden this could create for multinationals is enormous.

PriceWaterhouseCoopers' E-business Tax Consulting Leader, Christina Rich

Furthermore, a developing country e-business that supplies digital products to private consumers in the EU would have been deemed to have a permanent establishment in the EU. This could have resulted in e-businesses being liable for direct taxes in EU member countries as well. In May 2001, the UK vetoed a revised proposal by the Swedish Presidency of the EU to apply VAT on e-commerce. The UK has suggested a moratorium on the taxation of e-commerce between internet suppliers and EU consumers, although all the other 14 EU members supported it, indicating that continued EU pressure on the UK to concede on this matter is likely to continue.

The OECD also agreed that an e-business that carries out an essential or material portion of its business through a website on a server that the business owns or hires in an OECD member country, will have a taxable presence wherever the server is situated, even if there are no staff where the server is situated. Further consensus was reached by the OECD member countries that internet service providers who have servers in other countries in order to provide services such as the hosting of web sites, have a taxable presence in the place where the servers are situated.

Free Trade Zones and Other Investment Incentives

The OECD Initiative extends not just to financial services, but to all geographically mobile services, including, but not limited to, shipping, distribution services, service industries and company headquartering. The OECD is already taking steps to extend its work to e-commerce and its 1998 Report flagged that manufacturing industries in developing countries would also have to be addressed later.

... it is recognised that the distinction between regimes directed at financial and other services on the one hand, and at manufacturing and similar activities on the other hand, is not always easy to apply. The Committee intends to explore this issue in the future.

OECD 1998 Report on Harmful Tax Competition, p. 8, para. 6

The OECD requirements for reforms in developing country jurisdictions which have agreed to make advance commitments to comply with the OECD requirements under its Harmful Tax Competition Initiative include the requirement that 'foreign-owned entities must be able to do business in the domestic economy'.

The implications of this requirement as part of the OECD programme of eliminating harmful tax competition are very significant for many developing countries. Many developing countries, including major economies

such as India and South Africa, do not allow equal access to foreign-owned entities in their domestic economies.

Foreign ownership is strictly limited in many industry sectors throughout the Commonwealth, and many developing countries do not allow automatic access to foreign companies to do business in their domestic economies in all sectors. In many industries, developing countries require a phased approach to liberalisation in order to give domestic firms time to develop efficient and competitive industry sectors before being forced to compete on equal terms with international market leaders.

In relation to the OECD principles of removal of harmful tax competition in geographically mobile services, there are also implications for the tax and investment practices in place in many Commonwealth countries other than those that are listed by the OECD. Specifically, the OECD requires that 'Any preferential tax rates available to offshore regimes must also be available to domestic business of the same type'.

Many developing countries offer preferential tax regimes to foreign investors or export-related investment, which are not available to domestic companies which operate in the domestic market, or even to domestic company business sales to the domestic market. Many developing countries also utilise special export processing zones, free trade zones and other incentive regimes to encourage investment in export processing industries.

Many of the East Asian economies have had considerable success, through use of competitive taxation packages, in attracting foreign investment into infant industries. Countries like Mauritius, India and Dubai have used free trade zones and other low-tax regimes for export development very successfully.

Indeed, the Indian Budget for 2001–2 has introduced ten-year tax holidays for developers of special economic zones, with income from long-term investment for the development of special economic zones being exempt from tax. There are already tax exemptions for exports from export processing zones, free trade zones and software technology parks. Tax holidays are also provided to export-oriented units set up anywhere in India. The Budget extended special tax exemptions to profits from on site exports of services provided from software technology parks. Similar fiscal regimes are in place in many of the other developing countries in Africa and Asia, in order to encourage foreign investment.

Two of the most successful economies to attract regional headquarters are Hong Kong and Singapore ... Singapore began to attract regional headquarters actively when it introduced, in 1996, various incentives under an International

Business Hub Programme. By end-2000, some 200 foreign affiliates there had regional headquarters status ...

UNCTAD, World Investment Report, 2001

The importance of subsidies for economic development has been recognised by the WTO. Even though the WTO's Agreement on Subsidies and Countervailing Measures which came into effect in January 1995 requires the phasing out of most export subsidies by developed countries by 2000 and by developing countries by 2002, there are exemptions. In particular, the WTO SCM Agreement recognised the important role that subsidies can play in economic development of developing countries and exempted countries with a per capita GDP income of less than US\$1,000 per year from any SCM rules on prohibited export subsidies. A key concern is the impact of having such a low level of cutoff for GDP per capita, since many relatively poor developing countries could face a large-scale shift in foreign investment in export processing industries to developing countries with GDP per capita below this cutoff level for no particularly compelling economic rationale.

The basic idea behind an export platform (such as a free trade zone) is to create an enclave in which the problems of poor trade policies, weak infrastructure, and inconsistent rule of law that plague the rest of the economy are at least partially eliminated.

Perhaps the most compelling piece of evidence in support of export platforms is that the vast majority of manufactured exports in the successful economies utilised at least one of these facilities. In Taiwan and Korea, for example, essentially all manufactured exports were either produced in a zone or a bonded warehouse. The vast majority of China's manufactured exports come through the special economic zones. Over 95 per cent of Mauritius's manufactured exports are produced in EPZs. Exports from Mexico's maquiladoras account for over 50 per cent of total manufactured exports.

Steven Radelet, Harvard Institute for International Development,
CAER Discussion Paper 43, November 1999

Strong arguments in favour of tax competition, including use of incentives, include the design of taxation on capital. In many countries, there is multiple taxation of capital, first through corporate taxes on the income stream from the investment, and then as taxes on individual income from the dividend streams and capital gains from the same capital (Mattey and Spiegel, 1996). Many have argued that this creates a tax bias against business investment, and therefore tax competition and incentives provides one means of partially offsetting this bias. Mattey and Spiegel also discuss a range of other efficiency effects from tax competition.

One of the potential consequences of tax competition is a reduction in government revenues, which could constrain government services to suboptimal levels. However, formal demonstrations of this result have relied on models where the local governments are limited to a single tax instrument. Allowing other revenue sources can overturn this result. Indeed, the limited empirical evidence suggests that revenue losses from competition over state and local corporate income and property tax receipts are at least partly offset by increased taxes from other sources, such as individual income taxes or sales taxes.

There are a number of other salient arguments that state and local government tax competition can enhance efficiency. One is that properly managed tax competition can create positive 'spillover effects' within a community by attracting or retaining firms with high levels of these external benefits. Localities can use tax incentives to help nurture 'industry clusters' which exploit 'agglomeration economies,' the increases in efficiency of production from the geographic concentration of related activities.

Joe Matthey, Senior Economist and Mark Spiegel, Senior Economist, Federal Reserve Bank of San Francisco, 'On the efficiency effects of tax competition for firms', The Region, Federal Reserve Bank of Minneapolis, June 1996

New Challenges to Developing Countries

Developing countries that are exporting international business services are currently facing considerable pressures for change from a number of initiatives coming from the OECD countries, including from its Harmful Tax Competition and E-commerce Initiatives. The Harmful Competition Initiative is focused on eliminating what the OECD determines to be 'harmful' practices in all geographically mobile services provided by all countries worldwide. This extends not just to financial services, but all geographically mobile services, including, but not limited to, shipping, distribution services, service industries, and company headquartering. The OECD is already taking steps to extend its work to e-commerce in developing countries, and its 1998 Report flagged that manufacturing industries in developing countries would be likely to have to be addressed later. Hence the OECD moves to eliminate harmful tax competition in financial services in non-OECD countries is part of a broader initiative to remove 'harmful' competition in a wide range of industry sectors, including e-commerce and manufacturing.

Tax Harmonisation

For the EU countries, these initiatives are part of a broader strategic objective to harmonise taxes within the EU. This is also an integral part

of plans for an EU-wide tax that will give greater taxing powers to the EU bureaucracy in Brussels. However, harmonisation within the EU will not be sustainable if other major competitors are not also harmonising to EU rates, as there will be large-scale relocation of private investment to other countries and out of the EU. This therefore creates considerable pressure for the EU to ensure that other lower-taxing countries harmonise to its tax rates. The importance of low corporate tax rates for corporate investment inflows is demonstrated by the case of Ireland which has managed to achieve rapid economic growth for over a decade, assisted by a very low-tax environment for foreign corporations, now to be extended to all corporations, combined with a strong fiscal surplus.

Combating 'tax dumping' is one immediate priority; it is not acceptable for certain member States to practice unfair tax competition in order to attract international investment and offshore headquarters of European groups. Ultimately, the corporate tax system as a whole will have to be harmonised.

Mr Lionel Jospin, Prime Minister of France, Address on 'The Future of an Enlarged Europe', 28 May 2001, Paris

This raises concerns from an economic development policy perspective. At the OECD Forum on Harmful Tax Competition in June 2000, attended by 30 developing countries, a number of developing countries felt that action should also be taken against low-tax OECD regimes to prevent them 'poaching' developing country companies away from their home bases.

The WTO has observed that 'protectionism is not the first best choice to deal with fiscal challenges arising from trade liberalisation and globalisation'. In fact, governments are already responding to these challenges in more appropriate ways. High marginal income tax rates and corporate tax rates are coming down while consumption taxes rise. The WTO's 1998 Annual Report observed that tax harmonisation was being discussed in the EU and the OECD to deal with harmful tax competition, but noted:

This option, however, should be treated with considerable caution, as the fight against a 'race to the bottom' in tax rates may be used as a pretext for introducing a tax cartel.

The danger with the OECD Initiative is that the new global model will be a 'race to the top' for corporate tax rates, as countries harmonise to the highest common denominator and pressurise low-taxing countries to increase their tax rates.

A major concern is that the continental European welfare states face significant demographic problems over the next two decades due to ageing populations but, unlike the UK, have failed to develop adequate private

pension provision. This creates a further risk of a global 'race to the top', driven by rising fiscal burdens in socialist Europe.

International Tax Competition

Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them. Both lead to variety and innovation; to improvement in the quality of the goods and services and a reduction in their cost. A governmental cartel is no less damaging than a private cartel.

The principle of subsidiarity – that government services be provided, and paid for, so far as possible at the level of government closest to the citizen – would be violated by any attempt to impose from the center a uniform tax regime.

Milton Friedman, Hoover Institution, Stanford University, Emeritus Professor, University of Chicago and Nobel Laureate, May 2001

By lowering fiscal burdens and government intervention, countries grow quicker, resulting in stronger total tax revenues and government expenditures than in high-taxing countries. In sum, lowering the fiscal burden gives government a smaller percentage share of the economy, but of a much larger total pie. Moreover, it reduces the moral hazard that government bureaucracies create a culture of dependency on the state, particularly through political pork-barrelling by targeted handouts to various segments of the electorate. The continental European welfare state is an example of how such moral hazard results in economic rigidities such as inflexible labour markets and structural budget deficits, which impede economic progress.

For the Commonwealth, this is a key area for policy focus as developing countries search for more rapid economic growth and the path to economic success. While many forms of external assistance are possible, in the end a critical determinant of economic success lies in domestic economic management. Singapore and Ireland are among the leading fiscal models that other countries need to emulate if they are seeking to develop their industries and employment. Ireland has transformed its economy into one of the most successful in the world through a range of policy initiatives, of which low-tax regimes were a very important component.

India's 2001–2 Budget indicates how some major developing countries are beginning to recognise the importance of creating a favourable taxation regime that encourages entrepreneurship and the development of new industries. The Indian Budget cut the top rate of corporate and personal tax to 36 and 30 per cent respectively, both important steps towards cre-

ating a more dynamic economy. Savings incentives are also assisting in creating a fast-growing Indian mutual funds industry, creating a significant pool of domestic savings for equity and venture capital investments, including remittances from millions of non-resident Indians working in OECD and other countries.

However, the shift towards reducing the role of government is still budding in many developing countries after decades of socialist and communist economic philosophy which have resulted in economic stagnation and decline for many nations. Such shifts can easily be undone in a global tide towards a high-tax model, given the demonstrated inclination for governments to try to increase revenues in order to fund their expenditure programmes, rather than lowering spending in order to reduce tax burdens.

... the likelihood of maintaining a still satisfactory overall budget position over the longer run is greater, I believe, if surpluses are used to lower tax rates rather than to embark on new spending programs. History illustrates the difficulties of keeping spending in check, especially in programs that are open-ended commitments, which too often have led to larger outlays than initially envisioned. Decisions to reduce taxes, however, are more likely to be contained by the need to maintain an adequate revenue base to finance necessary government services. Moreover, especially if designed to lower marginal rates, tax reductions can offer favourable incentives for economic performance.

Alan Greenspan, *Federal Reserve's Semi-annual Report on the Economy and Monetary Policy*, Committee on Banking and Financial Services, US House of Representatives, 17 February 2000

The average tax burden in OECD countries has risen from 35 per cent in 1988 to an all-time high of 37 per cent of GDP in 1998, despite buoyant tax revenues, reflecting the tax and spend policies of many European countries.

... tax competition can even be helpful, not harmful, because it keeps governments in check. Tax competition can be a good spur for governments to keep to their core functions; to create a competitive business environment and not proliferate activities; to look for efficiencies and productivity gains, and to keep costs down.

Intervention by Singapore at Commonwealth Senior Finance Officials Meeting, September 2000

The WTO Annual Report for 1998 stated:

The empirical evidence does not provide convincing support for the claim that globalisation undermines governments' abilities to pursue their core functions.

Revenue has increased strongly in industrialised countries in recent decades. Only the structure of revenue collection is changing.

WTO Annual Report, 1998

According to Professor Devereux of Warwick University, average OECD corporate tax revenue as a share of total tax revenues has remained constant over the last 20–30 years. Indeed, the OECD's 1998 *Report on Harmful Tax Competition* states that 'the available data do not permit a detailed comparative analysis of the economic and revenue effects involving low tax jurisdictions' and 'preferential tax regimes'.

At least so far as taxes on corporate income are concerned, fears of an imminent collapse in government revenues may be overstated. In fact, for the EU as a whole, revenues from taxes on corporate income have increased over the last 20 years, both as a share of GDP and as a share of total tax revenue. Whilst there has been a downward trend in corporate tax rates, this has been accompanied by both a broadening of corporate tax bases and an improvement in underlying company profitability.

Institute for Fiscal Studies, *Corporate Tax Harmonisation in Europe*,
November 2000

International Rule-making and Global Standards

There are a wide range of initiatives by various international organisations, other than the OECD initiative discussed above, to develop global standards which allow nation states to be bound voluntarily by entering into bilateral or multilateral treaties. However, there is growing concern among developing countries about the trend towards development of new international standards in international organisations where developing countries have little or no voice. Perhaps the most extreme example of exclusion of developing countries in international rule-making is the OECD, which is a club of 30 rich countries, comprising predominantly European nations bound by a commitment to the EU. Developing countries have no vote in the development of standards through this organisation.

Even in the IMF and World Bank, developing countries have only a small voice, with the majority of the voting rights being controlled by the OECD countries. For example, the 44 sub-Saharan African countries have just 4.5 per cent of the voting rights and only two Executive Directors at the IMF. The problem is accentuated by several unusual constituencies of large groups of developing countries headed by an OECD country in the Executive Directorship.

Developing countries need a greater voice in providing strategic direction to the Bretton Woods institutions to ensure greater effectiveness and credibility. ... We must ensure that we [developing countries] can exercise ownership in a manner far beyond outdated formulae which currently govern quota distribution.

Trevor Manuel, South African Finance Minister, IMF/World Bank Annual Meetings, Prague, 2000

The fear is that international standards developed by a handful of the richest nations can be used as new forms of protectionism, to block competition from developing countries in the fastest growing segments of international services trade where OECD countries have concentrated their own strategic economic focus.

In e-commerce, ICANN, the international organisation which manages internet space, has negligible developing country representation in an industry that is so critical to the future potential of developing countries to make a transition to a more rapid growth path.

So far, developing countries are only observers of the process. They do not participate on the boards of key organisations such as ICANN, which allow a minority to make decisions affecting their Internet space. A lack of economical resources as much as awareness of the understanding of these strategic issues are the main reasons for non-participation.

'The Role of Domain Names', Rosa Delgado, Director, Société Internationale de Télécommunications Aéronautique (SITA), E-COMM 3, June 2001

These OECD initiatives in areas such as the Multilateral Agreement on Investment, the Harmful Tax Competition Initiative and the latest e-commerce initiatives are examples of how rule-making by the most powerful nations can erode the sovereign powers of developing countries. A key issue for small and developing countries is to ensure that they have an effective voice in the development of any international rules and standards.

If it is to reflect international realities, a globalised world requires more comprehensive institutions than the G-7 and a United Nations Security Council which comprises the victors of a war now more than half a century behind us. It requires active engagement with the two most populous countries in the world, China and India, rather than attempts to side-line or marginalise them. And it obliges us to develop international trade and financial organisations that reflect more fully the role of the developing world in the international economy and that take its interests into account. There has been talk about opening up the IMF and the World Bank, but it hasn't gone far enough.

Paul Keating, former Australian Prime Minister, 'Australia in a Globalised World', Melbourne, 14 July 1999

Creating A Shared Vision

A key challenge for Commonwealth nations is to work together to build a greater global consensus on how all nations can benefit from the opportunities arising in the fast-growing international business services industries. Important issues include how international standards should be set and how international organisations can facilitate this process. The need to achieve high standards of international prudential regulation and transparency are also critical objectives for Commonwealth countries.

Global Inclusiveness

It is essential that developing countries are fully included in any process of setting of international standards, whether for tax, environment, trade, labour standards or any other process of international standard-setting.

There are many positive ways in which developed and developing countries can work together to develop standards in many areas of international business services. The properly constituted international bodies that represent all regions already exist, in the form of the UN, the IMF and World Bank, as well as the WTO.

For example, in the area of e-commerce, a model law on e-commerce has already been developed by the UN. The Model Law on Electronic Commerce (MLEC), was adopted in 1996 by the UN Commission on International Trade Law (UNCITRAL). This provides a means by which all countries can rapidly address gaps in their legislation regarding e-commerce. Twelve countries had already adopted the MLEC by the end of 2000, with many others considering its adoption.

Similarly, the World Intellectual Property Organisation (WIPO), an intergovernmental organisation comprising 175 member nations, has developed two internet treaties. These are the WIPO Copyright Treaty, and the WIPO Performances and Phonograms Treaty.

These forms of globally inclusive and co-operative approaches to developing best practice have generated considerable enthusiasm from developing countries, which feel they are consulted and included in the development and management of these global standards. Many developing countries are then able to push for their adoption within their own legislative systems, since they have had inclusive participation in the development of these standards.

High Financial Standards

Strengthening regulation of the financial services industry worldwide is one of the key priorities for creating a more stable, dynamic global economy. The need for better regulation, strengthening of capital adequacy of financial institutions, development of high quality prudential regulation and implementing high levels of transparency and international best practice accounting standards are critical issues for all nations in the decade ahead. Many international business services centres already have very high standards of regulation and supervision, both within the OECD and in non-OECD jurisdictions. However, there needs to be a wider approach to improving transparency and regulatory standards than just focusing on the international business services segment of the business services industry.

All countries and territories in the Commonwealth can benefit by ensuring that they implement the highest standards of prudential supervision and regulation, as well as developing transparent accounting and management practices that meet international best practice and global standards. Financial disclosure and transparent practices are essential components of achieving high quality financial systems, combined with adoption of advanced risk management techniques. However, such initiatives cannot be ring-fenced to international financial services centres alone – they must encompass the full range of domestic financial institutions in all Commonwealth jurisdictions, as well as financial systems in all developed and developing countries. The recent domestic financial sector crises in three of the OECD countries – Japan, Korea and Turkey – which according to some estimates will cost over US\$600 billion of taxpayers funds, highlight the critical importance of establishing well-regulated, properly supervised financial systems that are transparent, meet international accounting best practice and international capital adequacy standards.

While the OECD is pursuing small states with offshore financial centres to increase transparency of their banks, some OECD countries lack even the barest transparency in their own domestic sectors. For example, Turkey, an OECD member country, is currently experiencing a major macroeconomic and financial markets crisis stemming from the bad debts hidden within its state-owned banks, which control 40 per cent of the nation's banking assets. These banks have long been protected by Turkish laws that remove requirements for disclosure or investigation of bank balance sheets and exposure of non-performing loans, let alone compliance with international accounting standards.

Three of the Turkish state banks alone have accumulated estimated bad debts of US\$20 billion, equivalent to 20 per cent of Turkish GDP.

*'Turkey's state-owned banks present a litany of problems',
Wall Street Journal, 30 April 2001.*

In the case of Korea, Standard & Poors stated in February 2001:

Three years after the start of Korea's financial crisis, and notwithstanding over Won 140 trillion of capital infusions, credit quality of Korean banks remains alarmingly weak ...

... the disclosure standards at Korean companies, however, are often substandard. Last year a string of foreign suitors broke off planned tie-ups with Korean companies after starting their due diligence, presumably after uncovering severe discrepancies between the expected and actual financial health of the target. The message for investors is that transparency continues to be insufficient at Korean companies, even after three years of reform.

Standard and Poors, 'Korean reversal on reform buoys short term credit',
13 February 2001

In France, the bailout of then state-owned Credit Lyonnais was estimated to cost taxpayers US\$15 billion, with a government inquiry started in 1996. Further problems have surfaced in recent months.

... the bank is at the epicenter of a scandal that won't go away, the legacy of a fateful purchase of California's failed Executive Life Insurance Co. in the early 1990s. Claiming Crédit Lyonnais fraudulently gained control of Executive Life, California and the state's powerful Insurance Dept. have launched a civil suit against the bank. And in Washington, the Justice Dept. is winding up a grand jury investigation that could result in the bank's criminal indictment. The U.S. Federal Reserve could also levy fines or even lift Crédit Lyonnais' U.S. banking license.

*'The sword over Lyonnais – can the French state rescue the bank?',
Business Week, July 30 2001*

Mexico, another OECD member, has only recently begun to recover from a massive banking sector crisis in the mid-1990s. According to *The Banker*, the estimated cost of the bank rescue operations resulting from the Tequila Crisis in 1994–95 was estimated at 18 per cent of GDP and even as late as January 2000 it was announced that one of the banks would cost an extra \$1 billion to clean up.

One of the worst cases of poor banking regulation is Japan, whose huge banking sector has enormous bad debts by global standards, posing a potential systemic risk to the world financial system. As Brink Lindsay, Director of the Cato Institute said before the US House Sub-committee

on Trade of the House Committee on Ways and Means, the extent of Japan's banking sector crisis is enormous.

Putting the matter bluntly, Japan's economy is in a mess. The 1990s has been a lost decade, with growth since 1992 averaging 1 percent a year. A recession, and perhaps a serious one, is now under way. Unemployment is at record highs. A black hole of bad debt has sucked the life out of the banking sector.

Brink Lindsay, Director, Cato Institute, July 1998

Do something. Anything. That has been the plea of global investors to Japan's rulers and financial mandarins for years, as the country's banking industry turned into one of the great black holes in the history of money.

Business Week, 15 October 2001

A decade after the Japanese asset bubble burst, banks are still estimated to have bad debts equivalent to 20 per cent of Japanese GDP. Furthermore, an estimated US\$700 billion are on the watch list, and the Japanese Financial Services Authority has projected that another US\$50 billion will go bad each year up to 2004. Japan also appears to have insufficient numbers of regulators; 10,000 US government employees worked on the US savings and loans crisis, compared with just 1,000 Japanese officials employed by the Japanese Resolution & Collection Corporation to date.

Japan's bureaucratically guided capitalism also demonstrates an increasing propensity to corruption. While the collusiveness of the political economy may be conducive to efficiency under certain circumstances, the private benefits increasingly outweigh the public, and the mire of mutual corruption deepens. There should be no need to spell out the details of the many scandals of recent years, indeed of twenty years since the Lockheed and Grumman scandals of the 1970s. They have involved top figures in the key central government agencies, provincial governors and city mayors, top corporate executives, bankers and securities company heads. The Ministry of Finance, which is the majordomo of the Japanese government, is now enmeshed in a series of scandals involving the combination of collusion and loose or inadequate supervision, as in the Jūsen or Housing Loan scandal which involved trillions of yen of mostly small investors' funds or the Daiwa bank affair, in which that bank's New York branch somehow 'lost' \$US1.1 billion, but at a deeper level this Ministry bears much of the responsibility for deliberate inflation of the bubble of the 1980s, through its cheap money and inflated land and stock price policies, and for the diversion – and in the long run almost certainly the destruction – of much of the country's savings by funneling it into the construction sector. The Ministry of Finance provided the lungs that blew out the bubble, its favoured beneficiaries fattened, while the rest of the country was left spattered with debris when the bubble burst.

Where once it would have been said that in the Asian region only Japan was modern, efficient, and not-corrupt, now it might be said that the corruption is nowhere more deeply entrenched than in Japan. In the single month of November, four major financial institutions, including the regional Hokkaido Takushoku Bank and Yamaichi Securities, the country's Number Four securities firm, collapsed. Confidence in the institutions supervised by the Ministry of Finance, including the banks, plummeted, the withdrawal of deposits and their transfer to foreign banks and securities companies began to gather pace. Manufacturers of steel safes reported unprecedented demand, which presumably meant that individuals were shifting their money out of the banking system altogether. When people begin to feel it wiser to lock their money in vaults and safes rather than entrust it to banks, something is seriously wrong. From being the wonder of the world in the 1980s when Vogel's book [Japan As Number One, Harvard University Press, 1979] appeared, top Japanese bureaucratic and financial institutions have become a sort of laughing stock, even, in a sense, worse than 'nothing'.

'From Number One to Number Nothing: Japan's Fin de Siècle Blues',
Professor Gavan McCormack, Department of Pacific and Asian History,
ANU, Canberra

Whether the Bretton Woods institutions are contributing to improved global financial standards is also questioned by some observers. Gerald O'Driscoll and Brett Schaefer of the Heritage Foundation have argued that the IMF has exported poor banking practice in many countries.

The IMF exports poor banking sector practice by example. It damages the international financial system when it continues to lend to countries like Russia, a financial black hole.

'The IMF Promotes Poor Banking Practices', O'Driscoll and Schaeffer,
Heritage Foundation, April 1999

There have also been significant concerns about the moral hazard issues related to bail outs.

... One of the reasons we have Asia [the East Asian Crisis] is that we bailed out Mexico. We signaled to creditors around the world that you could feel free to lend in Asia, and the U.S. Treasury and the IMF would bail you out if you got in trouble. Now if we bail this one out, we'll have established a second precedent, and the next time, it will be bigger and arguably something we can contain less easily.

Lawrence Lindsay, American Enterprise Institute and former Federal Reserve Governor, *Washington Post*, 22 December 1997

Therefore, although the OECD has been focusing its efforts on offshore financial centres, the largest global problems in financial regulation and systemic risk to the global financial system appear to be in onshore

centres, particularly in a number of OECD countries, such as Japan, Korea and Turkey. The scale of bad debts estimated for these three countries exceeds US\$600 billion, even after hundreds of billions of bad debt write-offs in recent years, and may be far greater, with new bad debts forecast to grow by US\$50 billion per year in Japan alone, according to Japanese government estimates. This dwarfs any concerns expressed by the OECD about how well-regulated offshore centres are, with many of the best run offshore financial centres having very high quality regulatory standards compared with Japan, Korea and Turkey. Indeed, the Channel Islands has consistently refused to allow Japanese banks permission to open offices in their jurisdictions as they do not meet the high prudential standards required for the Channel Islands.

There are no Japanese banks here. Japan's central bank, some say, doesn't regulate vigorously enough. Japanese banks get into trouble more quickly and they can't get support. Many banks in Japan have applied to set up in the Channel Islands but all have been refused. The Channel Islands policy requires a large capital base and strong regulation.

Ben Bendelow, Group Executive, Basle Trust Corp and Past President of the Offshore Institute, Jersey, 2001

High standards of corporate governance and accounting practices, therefore, including a high degree of transparency, are critical for all companies and financial institutions, not just for offshore financial centres. Such standards are also critical for an efficiently operating domestic financial system, which underpins a dynamic economy. Well-managed offshore financial centres such as the Channel Islands and the Isle of Man might be justifiably sceptical of criticisms of their financial regulation coming from the OECD, whose member countries include some of the worst global examples of financial sector regulation and banking sector bad debts, such as Japan, Korea and Turkey.

Summary

As with other major global industries, international business services will remain subject to a high level of global competition, not only in the marketplace but in the global arena of international law, trade and investment regulation and global standards, as countries vie with each other to obtain the greatest competitive advantage for their own financial services sectors.

All Commonwealth countries need to give urgent attention to ensuring that their financial systems meet the highest international standards to ensure the future success and competitiveness of their own economies. At the same time, globalisation is about international competition and

developing competitive advantage. The benefits of globalisation accrue to the most competitive and efficient segments of industry – international business services are no exception.

International business services is a rapidly growing, high value adding market segment globally, and a sector that many countries wish to strategically position themselves in in order to establish or maintain a global market leader position. At a time when many countries are suffering from high dependency on commodity exports with declining terms of trade, and when even manufacturing is suffering from intense price competition and overcapacity globally, traded services is the new frontier that is a key focus for national competitiveness strategies.

Developing countries must strengthen their capacity for effective representation in international negotiations on traded services, in order to protect their right to compete in this key global export industry. Traded services has the potential to play a leading role in the economic development of many developing countries, as well as in bridging the digital divide and transforming these nations into knowledge economies.