
Essay series

SET SUPPORTING ECONOMIC TRANSFORMATION

# Trade in services and economic transformation

## A new development policy priority

**Edited by Bernard Hoekman and Dirk Willem te Velde**

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# Key findings and policy suggestions

- While much of the discussion on economic transformation centres on transforming agriculture and moving into manufacturing, services are an underexplored component of economic transformation strategies.
- Services play a vital role in economic transformation and job creation in poor countries, but the effects are different from those in agriculture or manufacturing. Services affect developing countries, directly in the form of significant shares in gross domestic product, trade and foreign exchange, but also indirectly through productivity growth and enabling linkages with other sectors.
- Trade in services can support economic transformation. Notable examples of successful expansion of trade in services include the development of diversified financial services hubs in Kenya, health and business tourism in Mauritius, information and communication technology services in India, air transport in Ethiopia, and hydropower transmission services in Lesotho.
- Donors should focus more on enhancing their knowledge and understanding the relevance of a competitive services sector for the achievement of development goals, specifically through economic transformation and job creation. They can do this by supporting improvements in market intelligence, trade and regulatory data related to services; developing national export strategies in services; building a conducive policy environment in developing countries, including by setting up public-private dialogue and coalitions supporting services reform; and strengthening country capacity to collect data on services.
- The lack of quality data is a particular hindrance to policy-making in the area of services. Some data have begun to be available, including through recent support by donors, but further improvements on trade in services should focus on:
    - capturing all the modes of trade in services;
    - tracking south-south trade in services;
    - reconciling firm-level and national-level data; and
    - improving information on applied services policies.
- Trade policy is important. Openness leads to higher productivity in services firms, especially in least developed countries (LDCs), especially with appropriate domestic regulation. International negotiations in services can also support services trade in the poorest countries, including by giving preferential access to LDC exports (for example, facilitating market access by reducing the cost of visas and putting in place domestic support mechanisms to assist LDC providers to deal with administrative requirements). However, very few meaningful preferential trade measures have so far been offered in areas of comparative advantage of LDCs such as tourism, travel, construction and Mode 4.
- Aid for Trade for services is generally limited as a share of total aid. Targeting more aid to facilitate trade in services has great potential to be effective.

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In collaboration with the Department for International Development (DFID), the Supporting Economic Transformation (SET) team at the Overseas Development Institute (ODI) organised a roundtable event on trade in services, held at DFID's London offices on 11 November 2016. The aim of the roundtable was to unpack key challenges and opportunities for trade in services in developing countries and identify what DFID could do to support services. Dr Neil Balchin (ODI) produced a post-event report which summarised the key thematic issues that emerged from the discussion, based on reflections from event attendees representing ODI, DFID, TheCityUK, Commonwealth Secretariat, European University Institute, ILEAP, International Centre for Trade and Sustainable Development, International Growth Centre, International Trade Centre, Sussex University, United Nations Conference on Trade and Development, Centre for Global Development and the World Bank. For further information on the event, visit the SET website (http://set.odi.org).

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# 1. Introduction and overview

Bernard Hoekman, European University Institute and Dirk Willem te Velde, Overseas Development Institute

## Introduction

Services play a vital role in economic transformation and job creation in poor countries, but the effects are different from those in agriculture or manufacturing. While much of the discussion on economic transformation centres on transforming agriculture and moving into manufacturing, services are an underexplored component of economic transformation strategies. This publication aims to uncover the specific role of services.

There is often a sceptical view that services follow – rather than lead – transformation, and that they create the wrong type of jobs or jobs for the few. However, it is important for economies to follow a balanced growth path because of the linkages among the various sectors. Policy-makers need to update their evidence on the linkages among sectors and consider what specific actions deserve priority. This requires access to good-quality data on services and services trade. Appropriate policies related to trade in services can unlock further transformation opportunities. For example, openness can support productivity increases in services firms, in the same way as this applies to manufacturing, and support economic transformation more widely. Negotiations on trade in services can help this process. In addition to fostering commitments to liberalise access to services markets and improve domestic regulatory regimes, services preferences could help exports from the poorest countries.

This set of essays analyses the role of services, and especially trade in services, in economic transformation. The essays are divided into three parts. The first set of contributions is about understanding the role of services in economic transformation and what the donor community could do over the next few years to support increases in economy-wide productivity and employment by focusing more on services policies and the performance of services sectors. The second part discusses the need to improve data on trade in services and where the focus should be. The third and final part examines ways to support developing countries through trade agreements and preferential access to markets, and help poorer countries benefit from greater trade opportunities. What should be the priorities for promoting services trade and providing services preferences for developing countries?

## How have our contributors answered our questions about the role of services and how donors can help?

We asked the contributors what should be the role of services in economic transformation and what could the donor community do over the next few years to promote economic transformation and economy-wide productivity and employment through services? All essays in the first part note the importance of services in developing countries, directly in the form of contributing to gross domestic product (GDP), trade and foreign exchange, and the direct and indirect ways through which services promote productivity growth and foster the attainment of development objectives. Donors should update their knowledge and understand the crucial importance of a competitive services sector for the achievement of development objectives, specifically economic transformation and job creation.

The lack of quality data has long been a hindrance in updating knowledge on services necessary for effective policy-making and trade negotiations. Progress in this area has been very slow. As far as trade statistics are concerned, the essays suggest future actions to improve data on trade in services should centre around (i) better capturing services trade across the various modes through which services are provided; (ii) tracking bilateral and regional (including south-south) trade in services; (iii) reconciling firm-level and aggregated data; and (iv) tracking services policies.

Turning to priorities for promoting services trade, there is a good case for using trade negotiations to promote services trade and within this for providing services trade preferences. Services trade facilitation requires cooperation between trade and development agencies and action by immigration authorities (for example visa-related procedures). There is also scope for supporting services exports from the poorest countries including least developed countries (LDCs) by giving them preferential access and by supporting regulatory cooperation and strengthening in developing countries.

We discuss the individual contributions grouped in each of the three parts.

## Part 1: Understanding the role for services in economic transformation

The first group of essays discusses the importance of services for development. While different authors approach the topic from different backgrounds (academia, think-tanks, international organisations), they all agree on the importance of services and that the impacts on economic development vary by sector. Services are heterogeneous and it is important to recognise this.

**Xinshen Diao**, **Maggie McMillan** and **Dani Rodrik** summarise their recent research on economic transformation, which has two implications for the role of the services sector in economic growth in developing economies. Focusing on recent growth accelerations, they argue that the services sector has contributed to labour productivity growth in developing economies through structural change (primarily Africa) and through productivity improvements within the services sector (primarily Latin America) and sometimes through both channels (primarily East Asia). They also show that in many African countries, within-sector productivity growth in the services sector (and in most other sectors, with the exception of agriculture) has been weak and sometimes negative. Without more focus on within-sector productivity improvements in services (and manufacturing), it is suggested that the structural change-led growth path will peter out in Africa.

**Neil Balchin** argues that services matter for industrialisation and economic transformation. Efficient services contribute directly to growth, job creation and revenue generation, and supporting productivity growth and competitiveness in other sectors. He illustrates the ways in which different types of services contribute, using a number of examples. In Kenya, advances in mobile technology, liberalisation of the financial system, the establishment of diversified financial hubs, a favourable tax regime, and policy-led regional integration with the East African Community (EAC) have helped to facilitate financial sector deepening, boost Kenya's trade in financial services, and position the country as a regional financial hub. In Mauritius, the development of good-quality supporting infrastructure (for example, health and conference facilities) has successfully helped diversification into health and business tourism. And in Ethiopia, Ethiopian Airlines' extensive cargo capacity, coupled with the successful expansion of the national carrier's regional network, has been instrumental in enabling exports from Ethiopia to be transported overseas quickly and cheaply. Other examples include information and communication technology (ICT) services from India, which employ 3.5 million people and are responsible for some 10% of Indian GDP. Finally, in Lesotho, bilateral trade and infrastructure development agreements have helped harness abundant water resources and favourable topography to successfully supply hydropower transmission services to South Africa.

**Max Mendez-Parra** provides further evidence on the importance of services by analysing services data in the poorest countries. He argues that services not only account for an increasing share in developing country trade in goods and services, but are also becoming an increasingly important determinant of competitiveness in other sectors. Productivity in the manufacturing sector, for example, depends on the quality and price of many inputs that are increasingly generated in the services sector. He finds that despite the increase in commodity prices observed in the past 10 years, which has boosted goods export values, exports of services in many developing countries have grown faster than trade in goods. And even in countries where manufacturing has grown rapidly, such as Vietnam, or where extractives are key, as in Nigeria, no less than one third of aggregate productivity growth owes to the performance in the services sector. Services in low-income countries (LICs) are also increasingly traded as intermediates into other countries' production and hence increasingly as part of international value chains. Finally, he discusses evidence on the link between trade and productivity. Exporting services firms have higher labour productivity in low income and other developing countries. Further, among the exporting firms, those exporting services have higher labour productivity, at least in LICs. This suggests that the link between trade and productivity is particularly strong in services and LICs.

**Mohammad Razzaque** argues that industrialisation-led processes lead to better outcomes of poverty alleviation, productivity, and living standards. The manufacturing sector can generate large and productive employment opportunities with significant occupational mobility. Yet industrialisation is becoming increasingly difficult to achieve. The essay urges policy-makers and donors to explore possibilities of selected services sector interventions, particularly in the short to medium term, as a means of enhancing manufacturing competitiveness. He argues that a selective policy intervention, particularly within a relatively open trade regime, is worth considering. Various sector-specific projects supported under the Aid for Trade initiative have been encouraging. Targeted assistance to services sectors to promote competitiveness in specific industries remains quite limited, yet it is crucial for successful engagement in global value chains.

**Rajesh Aggarwal**, **Marion Jansen** and **Robert Skidmore** argue that the services sector is changing the global economic landscape. Apart from the desirable attributes of the services sector discussed by previous authors, education, healthcare, finance, ICT, transportation and logistics also play a direct role in the achievement of development goals. They list three major challenges to fully leveraging services for economic transformation in LDCs: (i) creating a whole-of-government approach to developing services exports; (ii) improving effectiveness of private sector actors in voicing their concerns to policy-makers and regulators; and (iii) improving the availability of data that makes it difficult to design and implement strategies and policies effectively. The donor community can address these challenges by improving market intelligence, trade and regulatory data related to services; developing national export strategies in services; building a conducive policy environment; setting up public-private dialogue; and strengthening country capacity to collect services data.

Despite the analytical and predictive shortcomings of case studies, they can contribute to a better understanding of the economic contributions of services. **Patrick Low** first argues that a pressing area of major neglect is the scarcity of reliable data, both on the production and use of services by firms, as well as on the quality and substance of services-related policies. He then draws a number of broad conclusions from his recent research. First, the range of services inputs is greater than previously appreciated. For example, more than 70 discrete services are needed in passenger air transport services to convey a person between two locations. Second, all service inputs are tradable, provided they are bundled with intrinsically tradable products through value chains. Third, in manufacturing, a good deal of product differentiation and market segmentation depends on the addition of service inputs into final good offerings. Finally, a general conclusion from firm interviews is that smart services policy can make a useful contribution to productivity growth.

**Ritwika Sen** and **Victor Steenbergen** examine a particularly successful case of trade in services. Tourism is an important source of growth for the EAC, increasing foreign direct investment and contributing to increased foreign exchange earnings and employment. It is one of the most important sectors for East African economies, accounting for 17% of total export earnings in Kenya and Uganda, 23% in Tanzania and 25% in Rwanda. They further demonstrate that the benefits of tourism can be extended to the wider economy through additional domestic sourcing of goods and services (provided they are efficient), access to competitively priced inputs, and measures to promote regional integration. Creation of regional infrastructure and the harmonisation of technical standards at borders will boost the competitiveness of services. The 'One Network Area' initiative, which capped mobile phone roaming costs within the EAC through the adoption of a new regional telecommunications framework led to a 200% increase in phone traffic between Kenya and Rwanda within the first 10 days of adoption. Within four months, daily minutes of roaming traffic increased by over 950%. Increased connectivity raised trade and growth.

## Part 2: Improving data on trade in services

The development of both domestic services policy and policy on trade in services is hampered by the lack of good-quality data on services, services trade and services policy. This applies to developed countries, but especially developing countries.

**Anirudh Shingal** suggests that the promotion of economic transformation and economy-wide productivity and employment effects in services requires the availability of reliable and consistent data on output, employment and trade. There are relevant data for services output and employment. There are now four international sources of services trade data: the United Nations Services Database (UNSD), transferred to UNComtrade; the WTO/UNCTAD/ITC Services Database (WTOSD); the Organisation for Economic Co-operation and Development (OECD) Trade in Services by Partner Database (TISP); and the World Bank Trade in Services Database (WBTSD). However, services trade data remain largely unavailable for bilateral trade and more disaggregated sectors, especially in the case of south-south trade, as this would be relevant for regional and bilateral negotiations. Another problem with services trade data available in international databases is their coverage of only three of the four modes by which services are traded across borders – Mode 1 (cross-border), 2 (consumption abroad) and 4 (movement of natural persons) – since balance of payments (BOP) data only cover these three modes. Mode 3 (commercial presence), which by World Trade Organization (WTO) estimates accounts for nearly two thirds of total services trade, is not captured by BOP transactions, and hence not covered in the international databases that permit comparability across countries. Some data on services sales and production values are available from foreign affiliate statistics.

**Ingo Borchert** suggests that good policy advice on how to develop services for structural transformation requires not only available data on services trade flows but information on services trade policies. The World Bank Services Trade Restrictions Database in 2012 began the collection of data on services policy. The database contains comparable information on applied services trade policies of 103 countries across a wide range of services subsectors and relevant modes of supply. This large-scale data collection effort, and associated research, funded by the Department for International Development, helped create a one-stop shop for information on services trade policies. Existing data on services trade and policy need to be kept updated and broadened to cover important areas such as cross-border data flows or e-commerce, and to distinguish among preferential, bilateral, regional and most favoured nation policies. The database is currently updated jointly by the World Bank and the WTO in collaboration with the OECD.

**Nora Dihel** and **Arti Grover Goswami** also argue that poor availability of data and huge discrepancies between official statistics and firm-level data hamper meaningful analyses of services trade in Africa. Experts and negotiators recognise Africa's export potential in traditional services such as tourism, but tend to overlook the dynamism in exports of non-traditional services, such as business services. Informal trade in services flourishes across the continent, yet data on such flows remain totally absent. The authors suggest that policy-makers should increase data generation efforts (compared to now) on services trade flows, transaction costs and outcome indicators.

A similar message emerges from the essay by **John Cooke**, but based on developed country data on trade in services. He argues that services trade and investment is of central importance for countries at all stages of development. He presents detail on types of services and data on services imports. Yet the quality of services trade and investment data lags behind that of goods data. Data on Mode 3 trade in services are the worst. Changing this would be useful to understand three issues: (i) getting the right balance between different chapters in trade and investment agreements (for example market access, investment protection and regulation); (ii) identifying and targeting barriers to business in negotiations; and (iii) shaping investment protection provisions in trade and investment agreements.

Finally, **David Primack** presents three ways in which to support economic development through services in LICs. He argues that donors should consider a three-pronged approach: (i) enhancing the availability of data and information on services production and trade (confirming the previous essays in Part 2); (ii) building capacity to trade services; and (iii) mobilising services constituencies, which also recognises the lack of interest in countries.

In summary, the authors in this part suggest that future actions to improve data on trade in services should centre around (i) better capturing Modes 3 and 4 trade in services; (ii) tracking south-south trade in services; (iii) reconciling firm-level and aggregated data; and (iv) improving information on applied services policies.

## Part 3: Aid and trade policies for developing countries

The final part discusses how developing countries can be supported, including through trade agreements that encompass services commitments; measures to give the poorest countries, including LDCs, preferential access to markets; and devoting greater policy attention and aid to improve the domestic policy environment. To date, very few meaningful preferential access measures have been put in place by donors in areas of comparative advantage of LDCs such as the tourism, travel and construction sectors and Mode 4.

**Mina Mashayekhi** notes that coherent, interlinked policies, including a comprehensive services strategy and sound regulatory and institutional frameworks, are necessary to achieve benefits from the services sector. Developing supply capacity and gaining market access through trade in services negotiations are central to this. Preferential treatment by developed and larger developing countries can be instrumental in pursuing these policy objectives. The waiver of most-favoured nation obligations allows WTO members to provide preferential treatment to services and services suppliers from LDCs. An assessment of the 23 services waiver notifications points to some preferences going beyond the WTO offers, and matching preferences in regional trade agreements. Business services receive the highest number of preferences, followed by transport services where LDCs have an advantage. This is important for LDCs also because of the potential to promote supply capacity and facilitate integration in global value chains. On the other hand, preferences in tourism, travel and construction services, where LDCs also have revealed comparative advantage, are below expectations. A modal analysis reveals that there are several preferences on Mode 4, but that the majority of those have limitations. Generally, few notifications focus on preferential regulatory treatment, support in conforming to domestic regulation and meeting quality standards in foreign markets for LDCs – a key avenue to provide meaningful and effective preferences. Moreover, regulatory requirements can *de facto* nullify market access. Some notifications include measures on capacity-building, including the construction of infrastructure for tourism and other services, but preferences in domestic regulation, such as technical standards or qualification requirements, are still missing.

**Martin Roy** discusses the role of services negotiations in Pacific countries where the services sector is the main part of the domestic economy (61% of Tonga's GDP, 63% in Vanuatu and 71% in Fiji). International agreements on trade and investment can not only offer export opportunities but also help improve the business climate and attract investment. Further binding to a much greater extent the existing – and more open – conditions of entry and operations will also be important. Development assistance has a role in supporting such outcomes. The experience of Pacific Forum Island Countries in the Pacific Agreement on Closer Economic Relations may provide useful lessons.

**Hannes Schloemann** argues that there is great scope for donors to provide more meaningful services trade preferences to firms from developing countries. He notes that services preferences differ from preferences for trade in goods in that they must aim at facilitating trade by lowering trade transactions costs, and the most straightforward way of doing so, at least initially, is to target specific areas of regulation that have a disproportionately negative impact on small and medium sized enterprises (SMEs) in developing countries. A benefit of a stronger policy focus on services trade preferences (and hence domestic reforms in developed countries) is that the issues are also likely to be important for donor country SMEs operating internationally, thus helping to identify actions that will promote donor services exports. He presents several examples of preferences, including in the following areas: (i) physical market access using visas and work permits (for example, special visa categories for service providers, admission of contractual service suppliers and independent professionals, reduced or waived visa fees); (ii) regulatory/administrative measures (for example recognise qualifications on a facilitated basis, establish a 'right to a bank account' for remittance companies from developing countries); (iii) taxation and other contributions (for example, exempt service providers from (some) withholding taxes, apply favourable social security contribution rules); and (iv) support mechanisms (for example, improve access to information, for example by establishing a 'LDC Helpdesk').

Finally, **Bernard Hoekman** discusses the experience to date with inclusion of services in reciprocal trade agreements, both among developing countries and between developed and developing countries. He argues that the limited coverage and ambition of current trade agreements when it comes to services implies a significant opportunity cost for developing countries, and suggests that one factor explaining the *status quo* relates to concerns in developing countries that services liberalisation needs to be accompanied by strengthening of regulatory regimes. Recent research supports the salience of such concerns, suggesting a greater focus is needed to accompany trade negotiations with efforts and technical/financial support to improve economic governance and regulatory institutions in developing countries.

# Part 1: Understanding the role of services in economic transformation

# 2. The recent growth boom in developing economies: the role of services

Xinshen Diao, International Food Policy Research Institute, Margaret McMillan, Tufts University and National Bureau of Economic Research and Dani Rodrik, Harvard University

## Summary

This note draws heavily on the recent paper 'The recent growth book in developing economies: a structural change perspective' by Xinshen Diao, Margaret McMillan and Dani Rodrik (2017). Although the paper is not focused on the services sector *per se*, we may draw two broad conclusions about the role of the services sector in economic growth in developing economies from this paper. We focus on country-specific growth accelerations, which started as early as 1988 and as late as 2003 and last for at least seven years. First, the services sector has contributed to labour productivity growth in developing economies through structural change (primarily Africa) and through productivity improvements within the services sector (primarily Latin America) and sometimes through both channels (primarily East Asia). Second, in many African countries, within-sector productivity growth in the services sector (and in most other sectors, with the exception of agriculture) has been weak and sometimes negative. We argue that one reason for the differences across regions relates to the characteristics of the growth boom and caution that, without within-sector productivity improvements in services and manufacturing, structural, change-led growth will peter out in Africa.

Developing countries have experienced an extraordinary period of economic development over the last couple of decades. Besides India and China, which registered record economic growth rates, countries in sub-Saharan Africa and Latin America have managed to match or exceed their performance of the 1960s and first half of the 1970s. The recent downturn in the global economy has cast a dark shadow on the future of this performance, and Latin America in particular has been badly hit by the decline in commodity prices. But growth in the low-income countries of Africa has been resilient and remains high.

Even a cursory look at the recent growth champions indicates that their experience differs greatly from the standard East Asian path. East Asian countries such as South Korea, Taiwan, and China grew through rapid export-oriented industrialisation. By contrast, none of the recent growth experiences outside East Asia show evidence of rapid industrialisation. Instead, Latin American countries have experienced premature de-industrialisation, while in Africa manufacturing industries are barely holding their own in most countries.

How do we understand this recent wave of economic growth in developing countries? What have been the main drivers and how sustainable are they? In Diao et al. (2017), we offer a structuralist perspective on this recent experience, focusing on the role of structural change in driving economy-wide labour productivity growth. In East Asian countries, the movement of labour from low-productivity agriculture and informality to modern manufacturing industries and associated activities played a critical role. We ask whether there was a similar transformation in the recent crop of growth accelerations. We also ask whether the expansion of other modern activities such as services played the role that industrialisation played in East Asian economies. And we examine the relationship between patterns of structural change and labour productivity growth within specific sectors or the 'within' component of economy-wide labour productivity growth. We focus on country-specific growth accelerations that started as early as 1988 and as late as 2003 and last for at least seven years.

Our most interesting finding is that these recent growth accelerations were based on either rapid within-sector labour productivity growth (Latin America) or growth-increasing structural change (Africa), but rarely both at the same time. We document a strong negative correlation between the two components of growth across countries, with India as the sole exception. We show that, in Latin America, within-sector labour productivity growth has been impressive, but growth-promoting structural change has been very weak. In fact, excluding agriculture, we show that structural change has made a negative contribution to overall growth, meaning labour has moved from high-productivity sectors to low-productivity activities. We also show that in Africa, the situation is the mirror image of the Latin American case. Growth-promoting structural change has been significant, especially in Ethiopia, Malawi, Senegal and Tanzania. But this has been accompanied in these countries by negative labour productivity growth within non-agricultural sectors such as manufacturing and services. This experience stands in sharp contrast to the classic East Asian growth experience (such as in South Korea and China), in which both components of labour productivity contributed strongly to overall growth. Moreover, the East Asian pattern also seems to be replicated in more recent Asian cases of growth accelerations (in Bangladesh, Cambodia, Laos, Vietnam and India, as mentioned earlier).

The Latin American pattern of weak or negative structural change was noted and discussed in McMillan and Rodrik (2011), and related to the region's commodity dependence, overvalued exchange rates, (relatively) low agricultural employment shares and de-industrialisation. But the African pattern is puzzling. Rapid growth-promoting structural change has become a feature of the African economic landscape – something that was not evident in the data in McMillan and Rodrik (2011) – which is surely good news. It is also somewhat surprising, given that industrialisation has not figured prominently in the region. But it now comes at the expense of declining labour productivity growth in the manufacturing and services sectors. How can we make sense of this anomaly?

We show that the Asian pattern of strong 'within' and 'between' components is consistent with growth being driven mainly by positive productivity shocks to the modern sectors. The African model, by contrast, is consistent with growth being driven not by the modern sector but by positive aggregate demand shocks (due to foreign transfers, for example) or by productivity growth in the traditional sector (agriculture).

These considerations suggest that positive structural change in African countries may be driven mainly from the demand side, whether due to external transfers or the induced demand effects from increased agricultural incomes. This in turn raises the issue of the sustainability of recent growth in Africa. It also highlights the importance of productivity-enhancing public investments in areas such as education, health and infrastructure.

The Department for International Development (DFID) could play an important role in funding public symposia that bring together researchers and policy-makers to share and explore further the reasons for the very low within-sector productivity growth in African countries (or the slow expansion of modern sector activities). DFID could also fund research designed to better understand the extent to which larger, more productive firms sub-contract to smaller, less productive firms. Our guess, based on casual observation and on fieldwork in Africa, is that this is not very common, but we do not know exactly why. Related to this, DFID could fund more research designed to assess the nature of productivity-enhancing technology transfer between foreign firms and domestic firms..

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# 3. Why services are important for industrialisation and economic transformation[1]

Neil Balchin, Overseas Development Institute

## Summary

Services matter for industrialisation and economic transformation. High-quality and efficient services contribute directly to growth, job creation and revenue generation, and support productivity growth and competitiveness in other sectors. Policy-makers should use trade in services policy as well as other policies to pursue a balanced growth path in which services sectors grow in conjunction with other sectors. This is key to boosting the contribution of services to economic transformation.

## Introduction

In policy debates, the focus on economic transformation is generally centred on how to transform agriculture and move into manufacturing, with less attention paid to the role services and trade in services can play in the transformation process. Efficient services sectors have an important enabling role to play in economic development and can be key contributors to economic transformation, for example as inputs into the production of other goods and services or as major contributors to global exports.

This essay explains the various channels through which services can contribute to economic transformation and highlights some examples of cases in which countries have successfully promoted the development of services sectors, and facilitated greater exports of specific services, with transformative effects.

## Linking services and economic transformation

Services are important for economic transformation by virtue of their tradability (services constitute an increasing share of global exports) and job-creating or revenue-generating potential. In addition to these *direct* effects, services also play a key role as inputs into the production of goods (and hence in the development of value chains) and in supporting productivity change, growth and competitiveness in other sectors (*indirect* effects). Information and communication technology (ICT) services, for example, help in the dissemination and diffusion of knowledge, which can boost productivity. Financial services are important for facilitating the accumulation of capital and fostering innovation (Levine, 1997). Transport and logistics services are key to moving goods or workers within and between countries. Health and education services are vital for expanding an economy's human capital.

Trade in services is also an important driver of productivity change. Balchin et al. (2016) show that services firms engaged in exporting tend to have higher productivity than their non-exporting counterparts. Mendez-Parra (2017) shows elsewhere in this volume that the services exporter productivity premium is present in both low-income countries and other countries. He also shows how services have contributed significantly to productivity growth in developing countries.

There is, however, heterogeneity in the way different types of services contribute to economic transformation (see the examples in Table 1).

## Success in developing services sectors with transformative effects

Clearly, services, and trade in services, matter for economic transformation. But getting the most out of services requires supportive policies and a conducive environment. Regional integration is also important, both to expand services trade and as a channel for boosting access to services for firms and households. Below are some examples of where developing countries have, through trade policy and other factors, successfully promoted the development of services sectors, and facilitated greater exports of specific services, with transformative effects.

- In Kenya, advances in mobile technology, liberalisation of the financial system, the establishment of diversified financial hubs, a favourable tax regime and policy-led regional integration with the East African Community have helped to facilitate financial sector deepening, boost Kenya's trade in financial services and position the country as a regional financial hub. Kenya's financial services sector is now a generator of high-skill, high-wage employment and an important contributor to total exports: the sector accounts for 2.8% of Kenya's total formal sector employment and contributes 4.6% of total services exports. However, there remain question marks over the extent to which the sector is linked to the rest of the economy.

- Bilateral trade and infrastructure development agreements have helped Lesotho to harness abundant water resources and favourable topography to successfully supply hydropower transmission services to South Africa.
- A combination of low costs, an abundant supply of relatively skilled labour, language proficiency (in English), and the development of software technology parks has helped to position India as a major global exporter of ICT services. India's ICT services sector generates sizeable export revenues: the value of ICT exports totalled $103 billion in 2014 (and the sector contributes around 9.5% to Indian gross domestic product). The sector has also had a transformative effect on employment creation (especially for women and in outlying cities). Information technology (IT) and IT-enabled services alone employ nearly 3.5 million people in India.
- Mauritius has successfully diversified into health and business tourism through the development of good-quality supporting infrastructure (for example health and conference facilities). In the case of health tourism, the number of foreign patients receiving medical treatment in Mauritius saw a 15-fold increase between 2005 and 2011, and the goal is to expand this number to 100,000 foreign patients by 2020 (USITC, 2015). Revenues through the provision of these services are expected to reach $1 billion by 2020.
- Ethiopian Airlines' extensive cargo capacity (the airline transported close to 200,000 tonnes of cargo in 2015), coupled with the successful expansion of the national carrier's regional network, has been instrumental in enabling exports from Ethiopia to be transported overseas quickly and cheaply. This has been especially beneficial for Ethiopia's export-oriented cut flowers industry, which has registered substantial growth over the past decade (the value of exports of cut flowers from Ethiopia to the rest of the world amounted to more than $662 million in 2014, up from just $12 million in 2005).
- Mauritius and Senegal have made extensive efforts to liberalise domestic regulations in the telecommunications sector to allow greater competition, thereby improving efficiency and making their ICT services exports more competitive internationally. The result has been significant growth in ICT exports. In Mauritius, for example, the value of ICT exports increased from $0.3 billion in 2005 to 1.3 billion in 2014, with the share of ICT services in total services exports increasing from 18.5% to 37% over this period.

## Concluding remarks

Services matter for economic transformation. The development of high-quality and efficient services can support productivity growth and competitiveness in other sectors, while also having important direct effects on growth, job creation and revenue generation. Policy-makers can use trade in services policy as well as other policies (for example liberalisation of domestic regulatory frameworks or the provision of supportive infrastructure) to pursue a balanced growth path in which services sectors grow in conjunction with other sectors. This is key to boosting the contribution of services sectors to economic transformation.

Table 1. Effects of different services sectors on economic transformation

| Effects on economic transformation | Services sectors |
|---|---|
| *Direct effects* | |
| Major contributors to gross domestic product | Education, finance and insurance, real estate, transport and storage, wholesale and retail trade |
| Important revenue or foreign exchange earners | Hydropower transmission services, tourism, ICT, transport, financial services |
| Significant generators of jobs | Retail trade, accommodation (for less- to medium-skilled workers)<br>Finance and insurance, professional services (for skilled workers) |
| *Indirect effects* | |
| Supporters of productivity/trade in other sectors | ICT, transport (including air transport) and logistics, finance |
| Visible linkages with the rest of the economy | Tourism (e.g. linkages to suppliers) |
| Sectors with important productivity effects | ICT, finance, transport (in the medium run) and health and education (in the long run) |

*Source: Author's own elaboration, drawing on Balchin et al. (2016) and Khanna et al. (2016).*

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# Notes

1 This essay draws on the following ODI Supporting Economic Transformation (SET) programme report prepared by the author and others: Balchin et al. (2016)..

# 4. Trade in services and economic transformation: some evidence

Max Mendez-Parra, Overseas Development Institute

## Summary

While services account for an increasing share in developing country trade in goods and services, they are also becoming an increasingly important determinant of competitiveness in other sectors. Productivity in the manufacturing sector, for example, depends on the quality and price of many inputs that are increasingly generated in the services sector. This essay discusses evidence for the importance of services in trade and production in developing countries.

## Services are becoming more important in developing country trade

The increasing share of services in world trade has already been documented.[1] However, given the importance of mineral and agricultural commodities in the export structure, the role of services in total trade tends to be underestimated in developing countries. The rise in services trade tends to be attributed primarily to developed countries. Nevertheless, despite the growth in commodity prices observed in the last 10 years, exports of services in many developing countries have grown faster than trade in goods (see Figure A7 in Balchin et al., 2016).

Growth in exports of intermediate services (i.e. services whose users are other firms) can explain this trend in most developing countries (see Figure A14 in Balchin et al., 2016). In fact, in most developing countries, exports of intermediate services account for more than 50% of total services exports. Notably, the share of intermediate services in exports has fallen in the largest economies such as India, South Africa and Kenya, but has grown in the smaller developing economies.

## More trade in intermediate services sourced regionally

Data on trade in services are very limited, especially for developing countries. Based on input-output transactions, the EORA-MRIO project (Lenzen et al., 2013) has estimated bilateral trade in services between countries using a consistent classification, distinguishing between intermediate and final use. However, it presents serious anomalies, particularly when working at disaggregated levels. Inconsistencies tend to be less when the analysis is performed using totals per country or sector.

The increase in trade in intermediate services is not limited to exports. Most developing countries are using intermediate services more intensively in their production processes (see Figure A15 in Balchin et al., 2016), increasingly explained by a process of outsourcing of activities produced within the firm (e.g. accounting) and *offshoring* of activities to more efficient foreign providers (Schwörer, 2013). Whilst in developed countries the outsourcing started in the 1970s, followed by the offshoring since 1980s, in developing countries these two processes have tended to occur simultaneously in the last 15 years. In Ethiopia, for example, intermediate services represent more than 35% of the total use of inputs in production, many of them imported. As primarily these tend to be sourced regionally (see Table A9 in Balchin et al., 2016), they contribute to increased services exports from other developing countries.

## Trade in services and productivity

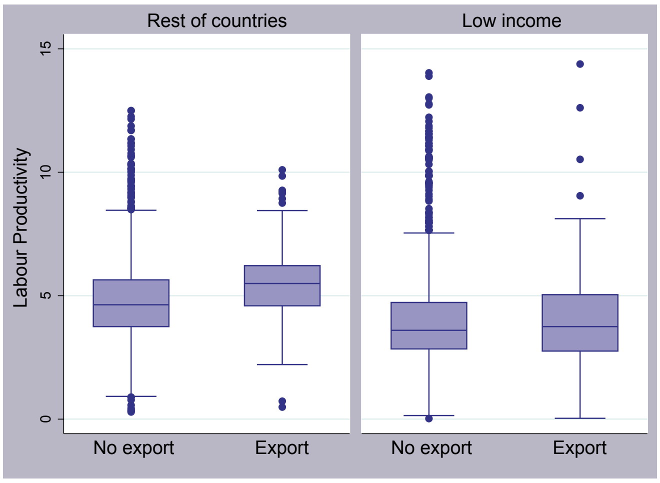
The changes in trade patterns are explained by not only changes in consumption patterns but also, increasingly, by the way value chains are organised. Services contribute to productivity growth and economic transformation in developing countries through both direct inputs and by 'embedding' value added in other industrial inputs (see Figure A11 in Balchin et al., 2016). Even in countries where manufacturing has grown rapidly, such as Vietnam, or where extractives are key, as in Nigeria, no less than one third of aggregate productivity growth is associated with performance in the service sector.

Productivity across the value chain increases through combining better-quality and cost-efficient inputs from different origins. Many studies (see Krugman, 1980; Melitz, 2003, among others) have examined the link between trade and productivity in some detail. This also applies to developing countries and, in particular, to the firms exporting services. Figure 1 shows that exporting services firms have higher labour productivity, both in LICs and in other countries. At the same time, the reverse is also true. Among the exporting firms, those exporting services present higher labour productivity, at least in LICs (Figure 2). This suggests that the link between trade and productivity is reinforced in the case of services, particularly in LICs.

## Conclusions

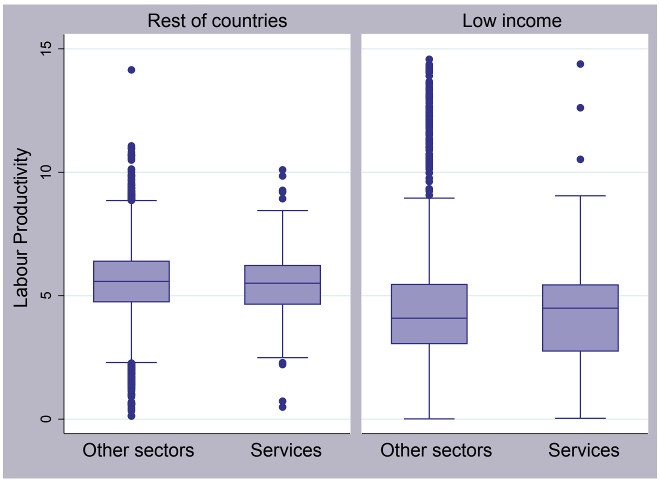
The outsourcing and offshoring of activities partly explain the rise of trade in services, especially in intermediates. This rise in the share of services coincides with a greater contribution of services to total labour productivity. Productivity in exporting services providers is higher than in other service providers.

Figure 1. Labour productivity differentials in the services sector in exporting firms by income group




Note: Labour productivity in natural logs.
Source: Own elaboration based on WBES.

Figure. 2. Labour productivity differentials in exporting firms in the services sector by income group




Note: Labour productivity in natural logs.
Source: Own elaboration based on WBES.

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# Notes

1 See, for example, UNCTAD (2015).

# 5. Using services to promote manufacturing-led structural transformation

Mohammad Razzaque, Commonwealth Secretariat

## Summary

Industrialisation for structural transformation is becoming increasingly difficult to achieve. This essay urges policy-makers and development partners to explore possibilities of selected services sector interventions, particularly in the short to medium term, as a means of enhancing manufacturing competitiveness.

While economic development generally implies progressing from primary and traditional activities to more productive manufacturing and modern services sectors, many low-income countries are finding it very difficult to embark on or consolidate such a transformation. This is partly reflected in the fact that the share of manufacturing in total sub-Saharan African value added actually declined from more than 13% in early 1990s to just about 10% in 2015.

Despite the long-established notion of and emphasis on industrialisation as the main driver for structural change in the economy, recent evidence suggests services sectors' ever-increasing role in economic transformation and development. Services currently account for more than 70% of yearly outputs in advanced economies and more than half in most developing countries. The patterns of urbanisation, reflecting one significant economic transformation, that are now being observed in developing countries seem to portray a strong divergence from the historical trends in industrialisation-led processes. Particularly natural resource exporters from Africa have been able to achieve faster rates of urbanisation, bypassing the development of the manufacturing sector (Gollin et al., 2016).

Furthermore, the 'servicification' of manufacturing phenomenon shows that when the value embodied in goods' exports is considered, services account for 40-60% of global trade (Lanz and Maurer, 2015). Along with this, the rising trends in cross-border fragmentation of production processes, termed 'global value chains', have often meant a lower share of value added for the manufacturing stage within the overall production process involving one final product. This is especially so in the primary sector and low-skill intensive manufacturing activities. Indeed, as Rodrik (2015) shows, many developing countries are facing 'premature' deindustrialisation as they become services economies before having a proper industrialisation experience unlike their advanced economies counterparts.

Does this mean low-income countries should give up the ambition for industrialisation and look only for alternative means for achieving structural transformation? Despite the above trends, the special significance of manufacturing for development is well known. It is a key source of technological improvements with important spillover effects for the rest of the economy. The sector can generate huge and productive employment opportunities with significant occupational mobility. There is evidence that better outcomes of poverty alleviation, productivity and living standards are associated with industrialisation-led processes (Gollin et al., 2016).

Of course, achieving industrialisation will be much more difficult for the reasons stated above. Nevertheless, numerous recent empirical analyses offer important insights into manufacturing competitiveness in a way that perhaps was not possible before. This new understanding is about the role of services.

As a large share of value added within goods' exports is actually associated with services, a successful industrialisation strategy, to a large extent, will rely on enhanced productivity of the associated services sector. In this regard, the traditional approach to considering sectoral development strategies based on typical trade policy instruments aimed at goods (such as tariffs and subsidies) might not have meaningful impact in creating the desired supply response. That many poor countries have failed to take advantage of trade preferences in developed countries could well be linked to the weak state of services sectors. Infrastructure services (including energy, telecommunications and transportation), financial services, health and education services (to ensure a healthy, well-trained human resource), etc., have now become important determinants of success in industrialisation. In an integrated global production network, the reduced share of manufacturing value added means efficiency and productivity gains from the services sector will be critical for linking to and moving up the value chains. It has been demonstrated that in low-income countries, the impact of services quality and policy on competitiveness is highest in low-technology industries (Nordas and Kim, 2013). That is, better services are most helpful in the type of industries commensurate with technological capacity and comparative advantage of poor countries.

Given the scope of various services and the magnitude of investments required, bringing about sustained improvements in these sectors can be feasible only over a very long period. However, policy-makers and development partners can explore the opportunities for selected interventions in the short to medium terms focusing on certain specific needs of a particular industry. It could involve skill development in one specific potential sector; prioritising power supplies in another; liberalisation of certain services to benefit selected sectors; developing bonded warehouse facilities for targeted export-oriented local firms to enable them to import duty-free intermediate inputs; and any other fiscal and financial incentives.

Sector-specific support is often considered not an ideal approach and there could be errors associated with the selection process in the first place. However, given intensifying pressure on international competitiveness, limited opportunities, and the time needed to promote efficiency of the overall services sector, a policy of selective interventions, particularly within a relatively open trade regime, is worth considering. Various sector-specific projects supported under the Aid for Trade (AfT) initiative seem to be an encouraging factor in this regard. For example, an AfT-assisted Caribbean Rum Sector Programme has been found to be extremely successful in terms of enhancing competitiveness, moving toward higher value products, introducing new brands of export products, and increasing employment, particularly of women (OECD and ODI, 2014). However, targeted assistance to services sectors to promote competitiveness in specific industries remains quite limited. In this respect, any country-specific strategy to participate in global value chains should be complemented by development of the required services. This integration is crucial, as for success in global value chains most countries will identify export-oriented manufacturing activities, the competitiveness of which can be enhanced by better services specific to the sector.

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# 6. Services for economic transformation: working with and for the private sector

Rajesh Aggarwal, Marion Jansen and Robert Skidmore, International Trade Centre

## Summary

The services sector and service trade in particular are reshaping the global economic landscape. Evidence shows the developing world has a huge amount to gain from them, but challenges remain in how to best leverage trade in services for economic transformation. This essay recommends four ways in which donors can support leaders to address these challenges, including improving market data and intelligence, developing national export strategies, supporting public-private dialogue and regulatory capacity to create a more conducive business environment and catalysing sector development in key areas such as IT and IT-enabled services and tourism.

The services sector is reshaping the global economic landscape, both in developed and developing countries. It is the bloodstream that moves capital, goods, people, and information within and across countries; the efficiency of this sector largely defines the overall productivity of the economy. Services are also central to the UN Sustainable Development Goals (SDGs). Education, healthcare, finance, information and communication technology (ICT), transportation and logistics all play a key role in the achievement of many SDGs.

Contrary to the traditional perception that developing countries have less to gain from services trade, the share of trade in services in gross domestic product (GDP) is higher for low-income countries (16%) than for high-income (14%) and middle-income countries (9%) (World Bank). Between 2005 and 2015, least developed countries' (LDCs') services exports grew almost twice as fast as their goods exports, and twice as fast those of the rest of the world (WTO, 2016).

However, challenges remain as to how best to fully leverage services for economic transformation, especially for LDCs. Three types of challenges are frequently raised by developing country stakeholders.

- Policy-makers would like to know how to create a whole-of-government approach to developing services exports or for the strengthening of a specific services sector.
- Private sector actors would like to become more effective in voicing their concerns or needs to policy-makers and regulators.
- All parties (policy-makers, private sector and regulators) suffer from a lack of data that makes it difficult, if not impossible, to design and implement strategies and policies effectively.

To address these three challenges, the donor community could direct increased efforts into the following four areas:

## (i) Improving market intelligence, trade and regulatory data related to services

Data on services trade, the productivity and competitiveness of services suppliers and services regulations (notably along the value chain) are scarce or unavailable in many countries. Better data are a pre-condition for better-informed polices and business decisions. Joint efforts by international organisations, governments and the business community in this direction should be encouraged and supported. In this context, priority should be given to strengthening country-level capacity in measuring services trade flows and conducting business surveys assessing the effects of services regulation.

## (ii) Developing national export strategies in services

Having a strategic focus on services sectors at the national policy level is often the starting point for building a conducive environment for services growth and for assistance to specific services sectors. Such strategies should ideally be based on:

- sound data;
- national dialogue involving policy-makers, regulators and private sector stakeholders;
- a good understanding of how to assess the potential for exports and expansion of a specific sector.

Increased efforts could therefore go into facilitating public-private dialogues (including through the strengthening of cross-industry bodies such as coalitions of services industries) and strengthening stakeholders' capacity to design services sector strategies, including a focus on exports.

### (iii) Build a conducive policy environment

A conducive policy environment with efficient regulation of services is crucial for economic growth and particularly for small and medium-sized enterprises (SMEs).The International Trade Centre (ITC) SME Competitiveness Outlook 2016 shows that in developing countries a 10% increase in regulatory burden reduces large firms' exports of goods by 1.6%; the effect on SME exports goes up to 3.2% (ITC, 2016). Better data on services regulations and their impacts on productivity, combined with facilitation of public-private dialogues, are crucial inputs towards a more conducive policy environment for services. Capacity-building for regulators is key to increasing their knowledge of sector developments and to gaining a better understanding of how to apply best regulatory practices to their own country's circumstances.

### (iv) Focus on sector-specific development assistance

Services sectors differ in nature. A sector-specific focus is needed when it comes to capacity-building efforts. Strengthening and expanding technical assistance of a sector-specific nature in services can therefore be very beneficial. Those sectors are most likely to include the tourism sector, the IT and IT-enabled services (ITES) sector and transport and logistics sectors.

Exports of travel from LDCs grew at an average annual rate of 11% from 1995 to 2014 (WTO, 2015). Tourism accounts world-wide for one out of eleven jobs, according to estimates of the UN Tourism Organization. While the sector accounts for 7% of LDCs' total exports, only 0.09% of total official development assistance (ODA) and 0.4% of total Aid for Trade (AfT) disbursements were allocated to the sector between 2006 and 2013 (UNWTO et al., 2016). Increased attention to tourism can have significant effects on economic growth and job creation in the developing world.

ITES is another sector where services suppliers from developing countries are increasingly gaining ground in the international market. ITES also has important impacts on productivity and growth in other sectors. The SME Competitiveness Outlook 2015 (ITC, 2015) has highlighted that in LDCs the most important determinant of competitiveness gaps between small and large firms is e-connectivity, measured by the use of e-tools such as websites and emails.

Finally, transport and logistics services are a critical determinant of a country's connectivity with global markets. It is important to implement policy and regulatory reforms that provide for a competitive transport and logistics sector (cargo handling, port services, warehousing, etc.).

### A way forward for services-related technical assistance

Given the importance of the services sector for economic development and the urgency of strengthening this crucial sector, it is advisable to follow a two-pronged approach:

- Set up public-private dialogues, potentially at subsector level (for example IT, logistics) around a well-specified objective (such as export strategy) and potentially in parallel with capacity-building. The quality of the dialogue can benefit if findings from stakeholder surveys (see above) are taken into account. Such activities can have relatively rapid effects if supported by political will at the country level.
- Strengthen country-level capacity to collect information on services trade flows at disaggregated level. Given the time such efforts take, they should be expected to have beneficial effects in the medium term but have the potential to significantly strengthen the quality of decision-making.

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# 7. What we can learn from case studies on services

Patrick Low, Asia Global Institute and Hong Kong University

## Summary

Despite the analytical and predictive shortcomings of case studies, they can contribute to a better understanding of the economic and developmental contributions that services can make. Insights reported briefly in this note result from a two-year project that developed case studies on the role of services in production, consumption and trade. Data weaknesses are severe in the sector and should be addressed. Good policy can open up significant new opportunities for development, including through upgrading in value chains and fostering innovation.

As we delve more deeply into the world of services, especially at a micro level, significant areas of neglect are becoming more apparent. Among the most pressing of these is the scarcity of reliable data, both on the production and use of services by firms, as well as on the quality and substance of services-related policies.

These are among the issues that were highlighted in a recent two-year project carried out in several Asian economies by the author and colleagues at the Hong Kong-based Fung Global Institute, partially in cooperation with Asia-Pacific Economic Cooperation's Policy Support Unit.[1] In light of a dearth of data, particularly on services entering production, the project opted for a case study approach at the firm level.

Notwithstanding the well-known analytical problems with case studies, not least of which is reliance on perception data rather than objective measurement, as well as the absence of statistical robustness, the richness of detail and insights flowing from cases render the exercise worthwhile.

Around 50 firms in both manufacturing and services were interviewed. They were largely selected on the basis of their willingness to cooperate. We did, however, seek to include both manufacturing and services firms, and a high number of firms engaged in trans-border transactions.[2]

Firms were asked to map their services inputs in detail along one of their value chains whose beginning and end were explicitly defined. We also only took account of first-tier outsourced inputs, as trying to do more would have the complicating effect of changing the identity of the lead firm.

Once we had defined the geography of each value chain and the services input structure, we asked firms questions that mostly revolved around their sourcing decisions, their product differentiation strategies where services were key elements of optional value-added, their views on the contribution of services to innovation, and their experiences with policy.

Inevitably, the data were patchy and even when we obtained hard numbers on the volume and cost of services, which some firms were willing to provide, we were asked not to use them in published output for commercial confidentiality reasons. Data issues aside, what were among the other insights or hypotheses for further work we gleaned from our project? From a Department for International Development perspective, a number of observations drawn from the case studies are suggestive of where development support efforts might focus.

First, the range of services inputs is greater than we had previously appreciated. Defined at various digital levels of the United Nations' Central Product Classification System, dozens of services were direct sources of value in firms' output. More than 70 discrete services are needed, for instance, in the production of earth-moving equipment and in passenger air transport services required to convey a person between two locations.

These services ranged across the skill spectrum. They largely fulfil supporting roles in the sense of enabling production without directly entering the actual product. Output, whether of goods or services, is a cluster or composite of intangible sources of value. This has always been so, even if not widely recognised or accounted for in the past.

Our capacity to appreciate the actual sources of value making up the cost of products has been obscured. This weakness has been greatly reduced on the trade front through the measurement of trade in value-added terms. We have seen the estimation of the services share of global exports jump from less than one-quarter to something around a half, and there are various reasons why this is still an under-estimate.[3]

Second, an important realisation made clear by value chains crossing international frontiers is that all service inputs are tradable, provided they are bundled with intrinsically tradable products. The old idea of non-tradability has much narrower relevance than previously realised and only relates to final consumption services such as hairdressing and restaurant services, where physical proximity is required for production and consumption, or the service is associated with delivery in a fixed location.

Third, firms' outsourcing decisions are driven by a range of factors that are disguised if outsourcing is captured simply as a calculus driven by cost minimisation and/or risk mitigation. Cost and risk are obviously core factors in firms' decisions about when, where and to whom to outsource. But behind these variables lurk a multitude of infrastructural, behavioural, educational and business environment factors susceptible to policy intervention. The quality and consistency of the local policy environment, coupled with the nurture of enhanced skills, are fundamental to opportunities for upgrading in local economies.

Fourth, in manufacturing, a good deal of product differentiation and market segmentation depends on the addition of service inputs into final good offerings. These types of value addition are often innovative in nature, suggesting a role for governments in fostering innovation involving services-related manufacturing.

Finally, where interviewees were critical of the policy environment, commonplace observations about the impact of policy on costs, competitiveness, location and outsourcing decisions related to relative policy neglect (compared to goods markets), bad policy design, low administrative skill levels, poor governance practices, and protectionist tendencies. Much of the protection was encountered in factor markets rather than product markets. A general conclusion is that in a world in search of productivity growth, smart services policy can make a useful contribution.

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# Notes

1 A number of the case studies under the project have been published in Low and Pasadilla (2016).

2 Manufacturing sectors covered by case studies included aircraft and auto parts, industrial equipment, computer servers, autos, white goods and consumer electronic suppliers, watches, food and beverages, pigments, furniture, textiles, packaging and pharmaceuticals. Service sectors included wastewater treatment, industrial cleaning, welding, IT services, passenger air transport and courier services. The firms interviewed were predominantly from Asia and included China, Hong Kong SAR, Taiwan, Philippines, Malaysia, Indonesia, Thailand, Singapore and Japan

3 These estimates were taken from the OECD/WTO TiVA database and refer to data from 2008 (see Escaith, 2013). The services share in global trade has probably increased in the intervening years.

# 8. Extending the growth benefits of tourism in East Africa

Ritwika Sen and Victor Steenbergen, International Growth Centre

## Summary

Tourism is an important source of growth for the East African Community (EAC), contributing to increased foreign exchange earnings, foreign direct investment and employment. The sector's strong interconnections with the wider economy in EAC countries are indicative of the potential for further enhancing its contribution to growth and development. We argue that the benefits of tourism can be extended to the wider economy through additional domestic sourcing of goods and services, access to competitively priced inputs and measures to promote regional integration.

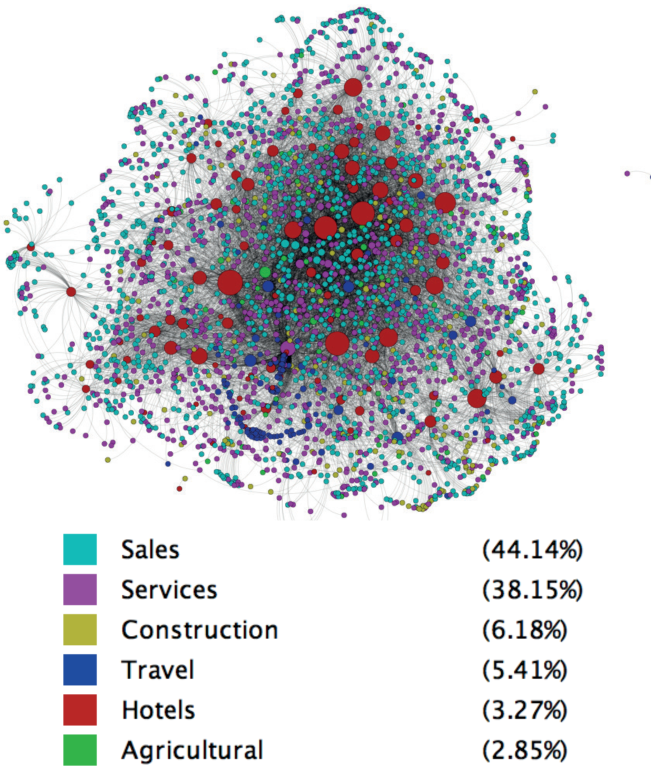
## Tourism is a critical source of growth in the EAC

Tourism is one of the most important sectors for East African economies. It accounts for 17–25% of total export earnings in Kenya and Uganda (17%), Tanzania (23%) and Rwanda (25%), and in many countries is now the largest single source of foreign exchange earnings. For example, for Rwanda, annual tourism receipts were estimated at $300 million by 2014, equal to 79% of formal services exports (English, 2016). Tourism also contributes to increased foreign direct investment (FDI) flows. In East Africa, tourism value chains employ a substantial segment of the labour force. In 2015, tourism as a share of formal employment constituted 7.3% in Rwanda, 7.8% in Uganda, 9.3% in Kenya and 10.3% in Tanzania. This includes direct employment by hotels, travel agents, airlines and other passenger transportation services (excluding commuter services). It also includes indirect employment benefits, for example from restaurant and leisure industries supported by tourists (WTTC, 2016). Given its spread across a wide geographical area, tourism's economic benefits are broadly shared across countries.

The tourism sector is also strongly connected with the wider economy in EAC countries. Spray and Agarwal (2016) mapped each buyer and supplier within the tourism sector in Rwanda, visualised in Figure 1.[1]

Each circle in the figure represents a firm, and each edge represents a financial transaction between these firms in Financial Year 2014/15. Firms that are more 'connected' with others are concentrated in the centre, whereas the periphery comprises less connected firms. Hotels (large, red circles) are by far the biggest companies in the sector. Travel companies such as tour operators (blue) provide critical linkages between hotels and the rest of the value chain. Spray and Agarwal (2016) further find that tourism depends on efficient services as critical inputs (for example transport, construction, finance, information and communication technology (ICT)); some 46% of total suppliers are services companies. The industry also depends on imports; approximately 77% of the backward supply chain is comprised of imported goods (mainly construction materials and other manufactured goods).

Figure 1. Firm buyer/supplier network in Rwanda's tourism sector




*Source: Spray and Agarwal (2016).*

## Improving the growth contribution of tourism in the EAC

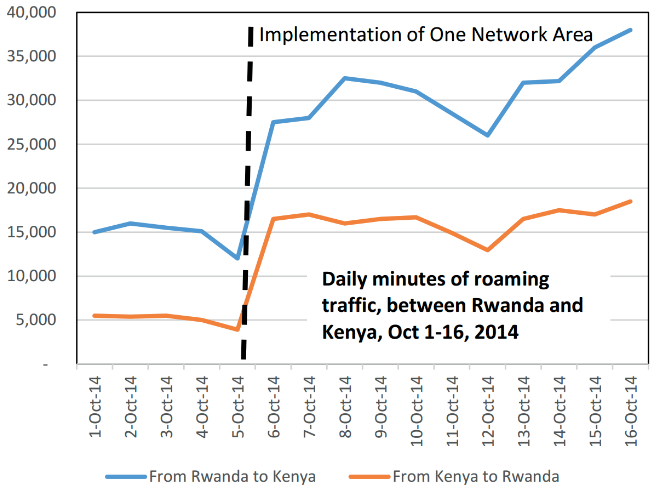
The benefits of tourism can be further extended to the wider economy through additional domestic sourcing of goods and services. For example, instead of imports, international hotels can be encouraged to buy local products including textiles, fresh and processed foods. However, many factors may limit the participation of local firms in the tourism value chains, including inadequate knowledge and information about local suppliers, skills deficits, limited access to finance, and an inability to meet required quality standards. Governments can play a proactive role to create an enabling environment for investment, and link foreign hotels and other tourist establishments with local suppliers through market enhancing mechanisms such as information provision and matchmaking. Governments can also play a central role in investing in lynchpin infrastructure, for example the Kigali Conference Centre, roads and other infrastructure to the Virunga National Park, etc. There is also a need for investment – both public and private – in skills development for prospective domestic suppliers (for example by establishing enterprise development centres).

However, the EAC remains a niche player in the global tourism industry, generating less than 0.5% of total worldwide revenues in 2014 (Daly and Guinn, 2016). One way to improve tourism's export performance is by strengthening its access to competitively priced service inputs (Hoekman and Shepherd, 2015). Tourism productivity can be improved by liberalising trade in services such as transport, finance and ICT. Increasing the number of flights is also found to be an effective way to boost tourist arrivals on a sustained basis (Acevedo et al., 2016). The liberalisation of the aviation market can help to promote tourism in the region by encouraging the development of low-cost domestic and regional carriers.

Regional integration in the sector can also help to market regional tourism products, increase market access and attract foreign direct investment. To serve this purpose, it will be critical to seek Tanzania's participation in the common EAC tourist visa, as it has the largest absolute tourism export earnings within the EAC ($2 billion in 2014) (World Bank). In addition, it will be important to engage in joint marketing campaigns, and expedite implementation of common classification certifications for service providers.

Creation of regional infrastructure and the harmonisation of technical standards at the border will also help to boost the sector's competitiveness. A powerful example is found in the recently introduced 'One Network Area' initiative, which capped mobile phone roaming costs within the EAC through adoption of a new regional telecommunications framework. An example of its impact is shown in Figure 2: within the first 10 days of adoption, phone traffic between Kenya and Rwanda increased by almost 200%. Within four months, daily minutes of roaming traffic increased by over 950%. By lowering the operational costs of regional tour companies, this initiative provides an example of strengthening regional integration of the tourism sector.

Figure 2. The impact of One Network Area on mobile phone traffic between Kenya and Rwanda




*Source: Kelly and Kemei (2016).*

In sum, the EAC has benefited greatly from tourism in recent years. To further extend its economic significance, the EAC should aim to increase tourism's local linkages, improve productivity of other service sectors and further develop a regional tourism market.

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# Notes

1 The tax dataset used by Spray and Agarwal (2016) captures international connections by accounting for foreign direct investment in hotels, restaurants and tour companies as of FY 2014/15 (the authors note that average foreign investment in Rwanda's tourism sector is $2.4 million), and import of intermediate goods such as base metals (nails, safes, iron bars, etc.) for construction. The data also capture sales to domestic firms, but are unable to account for sales to direct consumers and to international tour operators. The interpretation of Figure 1 should be subject to this caveat.

# Part 2: Improving data on trade in services

# 9. Services data priorities: trade, Aid for Trade and government procurement

Anirudh Shingal, European University Institute and World Trade Institute[1]


## Summary

The promotion of economic transformation and economy-wide productivity and employment effects in services requires the availability of reliable and consistent data on at least the macro dimensions of services – output, employment, trade – to enable successful monitoring of any aid efforts towards this end. This essay discusses current services data availability and priorities for improvement.


The availability of services output and employment data in national and international databases, including those of the World Bank, the Organisation for Economic Co-operation and Development (OECD) and the International Labour Organization (ILO), allows analysis at least for broad sectoral categories, although the coverage of disaggregated services employment data for smaller countries and concordance between output and employment data can be improved.

In contrast, measuring services trade flows and the availability of services trade data has been a long-standing challenge for meaningful economic analysis. In 2002, the OECD first published data on bilateral services trade flows for 35 exporting and 53 importing countries, largely OECD, over 1999-2002, covering four broad categories: travel services, transportation services, other commercial services and government services.

Since then, services trade data collection, compilation and reporting have witnessed major improvements, especially for the OECD countries. In 2002, the United Nations Statistical Commission (UNSC) adopted the first *Manual on Statistics of International Trade in Services* (MSITS) to provide guidelines and recommendations on how to use and develop sources to measure international trade in services. There are now four international sources of services trade data – the United Nations Services Database (UNSD), transferred to UNComtrade; the WTO/UNCTAD/ITC Services Database (WTOSD); the OECD Trade in Services by Partner Database (TISP); and the World Bank Trade in Services Database (WBTSD) – which provide for much better coverage in terms of the number of reporting countries (over 200), longer time periods (1985-2015) and availability of sectoral data (12 aggregate 3-digit sector codes according to the extended balance of payments (EBOPS) classification with further breakdowns at least for the OECD countries).

However, despite improvements in the international availability of services trade data, major challenges remain for meaningful economic analyses – particularly in the case of least developed countries (LDCs) and low-income countries (LICs). For most reporting countries, the coverage of services trade data is more complete for total or aggregate services and for trade with the world. Services trade data remain largely unavailable for bilateral trade and more disaggregated sectors, especially in the case of south-south trading partners. This implies that for most of the LDC/LIC group, we can only analyse their services trade patterns with the world. Moreover, most of south-north services trade statistics actually report services 'mirror' flows between north-south. For example, Congo's exports of commercial services to Belgium are actually Belgium's reported imports of commercial services from Congo. In the absence of 'actual' data on trade in services, it is difficult to cross-check reported statistics for inconsistencies.

Thus, the reliability of services trade data continues to be a problem. It is noticeable that there is variability in the recorded coverage of LDC/LIC services trade across years, alongside at-times significant year-on-year variation, suggesting that there might be weaknesses in the quality of data collection and transcription/coding, though other issues such as confidentiality may also play a role. Since non-investment services trade is measured via reported Balance of Payments (BOP) transactions, asymmetries in reporting BOP transactions can lead to serious discrepancies. For instance, commercial banks use different thresholds for reporting BOP transactions to the central bank or national statistical institute; significant differences in these thresholds have a bearing both on what is recorded as a services transaction and its value.

Similarly, the coverage of services value added trade in the OECD/World Trade Organization (WTO) Trade in Value Added (TiVA) and World Input Output Database (WIOD; Timmer et al., 2015) is also restricted to the OECD and large developing economies. While the Eora multi-regional input-output (MRIO) database does attempt to fill the gap for smaller countries, the reliability of these data is a concern (the IO data are reported along with their standard deviations, together with a document on the Eora homepage discussing the 'uncertainty and reliability' of these data).

Another problem with services trade data available in international databases is their coverage of only three of the four modes, in WTO parlance, by which services are transacted across borders – namely Modes 1 (cross-border), 2 (consumption abroad) and 4 (movement of natural persons) – since BOP data only cover these three modes. Mode 3 (commercial presence), which by WTO estimates accounts for nearly two-thirds of total services trade, is not captured by BOP transactions, and hence not covered in the international databases mentioned above.

One measure of services trade transacted via Mode 3 is sales or production value available from foreign affiliate statistics (FATS). However, the availability of FATS is severely limited in terms of country and time coverage. Inward FATS (production value of resident affiliates of foreign companies) are available from Eurostat for EU member states over 2003-2014 and from the WTO (sales of resident affiliates of foreign companies) for a sample of 41 OECD and non-OECD economies over 2010-2012, but not at the sectoral level.

Very recently, the European Commission (Rueda-Cantuche et al., 2016) has provided first estimates of services trade by the four modes of supply for the EU as a whole and the twelve aggregate EBOPS sectors for the year 2013, though data limitations still prevent Mode 3 estimates by EU member state. While similar efforts have been undertaken by the US, Canada and India (for its IT and IT-enabled services exports), these efforts need to be extended to span developing countries and at least the 12 aggregate EBOPS sectors.

The promotion of economic transformation and economy-wide productivity and employment in services through development assistance requires data on disbursements of Aid for Trade (AfT) across services sectors to enable an assessment of the impact of such aid. While data on official development assistance (ODA) committed and disbursed by donor countries in services sectors of recipient countries are available from the OECD Secretariat for a large sample of countries and sectors over 2002-2015, this is not the same as AfT in services. Only parts of ODA data are reported as aid going to economic infrastructure and services (including transport and storage, communications and information, and energy) and to production sectors (including banking and financial services, business and other services, and tourism), but even these are proxies at best for aid in trade-related infrastructure and productive capacity-building. Data specific to services in other categories of AfT (technical assistance for trade policy and regulations, trade-related adjustment and other trade-related needs) are completely missing.

Finally, another area where services data availability is a challenging constraint is government procurement. This accounts for 10-15% of gross domestic product in most economies, a large share of which goes towards the procurement of services. However, aggregate and disaggregated data on procurement of services by governments (mostly federal/central) from domestic and foreign suppliers are only available for the signatories of the WTO's plurilateral Agreement on Government Procurement (GPA), which does not include any LICs or LDCs. While there are notable exceptions in terms of coverage even in these publicly-available data, reliable information for non-GPA signatories is simply not available even for aggregate services procurement undertaken by governments, even at the federal level.

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# Notes

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# 10. Transforming the view: focus on services policy data

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## Summary

For evidence-based and actionable policy advice on how to harness services for structural transformation, available data on services trade flows need to be matched with granular information on services trade policies. Existing databases need to be kept updated and broadened to cover important areas such as cross-border data flows or e-commerce, and to distinguish preferential from most favoured nation policies. The growing services content of goods exports may be one way for services to promote economic transformation, on which more research is needed.

## Introduction

Following the increasing recognition of services trade in furthering economic development, a variety of efforts have been made to improve the statistical base for capturing services trade. In addition, academic research has shed light on the productivity-enhancing impact of services trade liberalisation for a range of countries (Arnold et al., 2011; Arnold et al., 2014). In spite of such progress, we are still far from having a comprehensive understanding of the role of services trade. In what ways does services trade promote economic transformation, and how could policy reform facilitate this process?

Devising policy reform to support economic transformation requires knowledge about both trade **flows** and trade **policies** in services. The fact that, thankfully, the scope and quality of services trade flow data has significantly improved over the past two decades[1] tends to obscure the fact that the evidence base on services trade policies, arguably of equal importance, is emerging only gradually. A detailed picture of applied services trade policies is indispensable for at least three reasons: (i) to inform services trade negotiations; (ii) to link policy regimes to economic outcomes such as trade, productivity or access to services; and (iii) to use trade policies to leverage services for structural change.

## The value of policy data

The publication of the World Bank Services Trade Restrictions Database (STRD) in 2012 was a bold beginning. It presents comparable information on applied services trade policies of 103 countries across a wide range of service sectors and relevant modes of supply (Borchert et al., 2014). This large-scale data collection effort, and associated research, was in part made possible by funding from the Department for International Development, whose financial support has been salient in creating a one-stop shop for information on services trade policies. This public good is currently being updated and further advanced jointly with the World Trade Organization (WTO) and in close collaboration with the Organisation for Economic Co-operation and Development (OECD), so as to provide comparable and best-in-class data for a wide range of stakeholders.

The value of bringing policy information from a vast range of countries and sectors together in one place became apparent as the STRD delivered a rich picture of numerous 'second-generation' restrictions on entry, ownership, and operations. Even in instances in which there is seemingly little explicit discrimination against foreign service suppliers, market access is often unpredictable because of opaque or discretionary licenses procedures. In addition, the STRD proved the relevance of policy data for explaining outcomes including trade and investment flows. For instance, more restrictive policy measures in the air transport, maritime transport or telecommunications sectors can be related to reduced connectivity and poorer access in those sectors, respectively (Bertho et al., 2016; Borchert et al., 2015).

## Augmenting the picture of services policies

But the data collection effort (and funding) should not stop here. To begin with, a data repository such as the STRD needs to be updated at regular intervals to maintain its relevance. Furthermore, coverage should be deepened as some areas require more granular information, and broadened to account for policy aspects that have so far not been sufficiently covered. One of the most important topics concerns the rules governing cross-border data flows. While at first glance a country's privacy policy would appear to be genuine domestic regulation, it is also true that economic integration increasingly requires the exchange of data; the use of cloud computing services is pervasive, and services sectors use (personal) data relatively intensively. Hence, rules such as local storage requirements or data transfer restrictions to certain destinations are potentially important determinants of whether and how firms in a given country can participate in (supply chain) trade.

Other aspects need to be brought comprehensively into the picture too – for instance, preferential services trade policies. It would also be useful to have better information from firm-level surveys, for example for gauging the private sector impact of policy measures or interventions. Covering these and other areas will require funding commitments from donors who are willing to invest in public goods. The payoffs from doing so will be large and multifaceted, ranging from transparency for negotiations to data for rigorous economic analyses.

## Direct and indirect services exports

Improvements in data notwithstanding, a bird never flies on one wing. A fresh analytical perspective on the role of services in structural change can yield additional, policy-relevant insights. The conventional idea of structural change sees economic activity shift from agriculture or manufacturing into services and associated export-led growth (Grover Goswami et al., 2012). Yet goods and services trade are becoming increasingly intertwined. A range of services inputs goes into the production and export of most goods, and the share is often rising. For instance, an automobile no longer consists of steel and rubber; these days 'it probably contains close to 100 million lines of software code' (Charette, 2009). The advancing fragmentation of production only amplifies the significance of embodied services inputs (Cernat and Kutlina-Dimitrova, 2014).

Hence, one aspect of structural change may be to take advantage of the opportunities afforded by regional or global value chains, whereby production of manufactures is geographically dispersed and directly or indirectly more services-intensive. An interesting observation in this regard is that distance has become less and less of a barrier to manufacturing exports **from middle-income countries** since the mid-1980s, whereas over the same period that manifestation of globalisation has largely bypassed many low-income countries (Borchert and Yotov, 2017). Part of the reason may be found in low-income countries' restrictive services trade policies that impair connectivity, as mentioned above. It could also be related to services embodied in goods trade, which suggests geographic distance is less of a barrier for such products. More research is needed to get to the bottom of this phenomenon, but services could hold the key to the successful trade and growth performance of many transition economies.

## Conclusion

In summary, we need more data and more research to sustain targeted, evidence-based and actionable policy advice on how to harness services for structural change and development. One salient aspect of this picture is sufficiently detailed and current information on policy measures affecting services trade.

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# Notes

1 See the UN Services Database (UNSD); the OECD's Trade in Services by Partner Database (TISP); or the World Bank's Trade in Services Database (WBTSD).

# 11. Africa's unexplored potential of trade in services

Nora Dihel and Arti Grover Goswami, World Bank


## Summary

Poor availability of data and huge discrepancies between official statistics and firm-level data, as well as the absence of indicators that adequately capture the impact of policy reforms, hamper meaningful analyses of services trade in Africa. Policy-makers should double data generation efforts on services trade flows, transaction costs and outcome indicators.


## Data limitations severely hamper meaningful analyses of services in Africa

Can services be the next engine of economic growth for the continent? Can African countries export enough services to each other and to the world? From informal to knowledge-intensive, services offer promising opportunities for Africa's trade diversification, growth, job creation and poverty reduction, but there are no data to answer these questions with precision.

Poor availability of data and huge discrepancies between official statistics and firm-level data make analyses of services trade and their role as intermediate inputs misleading. Informal trade in services flourishes across the continent, yet data on such flows remain totally absent. Comprehensive comparisons across sectors and regions are ambiguous or not possible. Furthermore, despite growing opportunities for African services firms to export to neighbouring countries, limited data on trade in services by partner countries and sparse information on regulatory policies and their application hamper the monitoring of progress in services liberalisation and regional integration.

As an example, the evidence on the specific exports and imports of services from Africa collected by the International Monetary Fund Balance of Payments Statistics (IMF BOPS) may not be completely accurate. For instance, IMF BOPS shows that Burundi is predominantly exporting other commercial services, which primarily comprise modern services. This in itself is difficult to imagine for a country like Burundi, which lacks the human capital required to export such services. A closer look at Kenya's other commercial services components reveals another surprising fact, namely that Kenya does not export other business services at all. So, where do we fit all the exports of business process outsourcing services from Kenya that are catching recent attention in services trade? Indeed, firm-level surveys show that over 35% of firms in Kenya export professional services, which challenges the IMF BOPS results.

In general, Africa's export potential in traditional services, such as tourism, is clearly recognised, but the incipient dynamism in exports of nontraditional services, such as business services, is often overlooked. For example, according to firm-level surveys conducted by the World Bank in professional services, more than 16% of the interviewed accounting, architectural, engineering and legal firms in the Common Market for Eastern and Southern Africa countries are already engaged in exports, mainly to neighboring countries. This contradicts official statistics, which assert that professional services exports for several countries are negligible or nonexistent. Likewise, many hospitals in sub-Saharan African countries are treating foreign patients and are using tele-medicine, yet official statistics often do not record such trade flows in medical services.

Finally, indicators that adequately capture the implementation of policy reforms and assess the impact of such reforms on trade transaction costs for ordinary traders and on services performance indicators, such as prices and quality of and access to services, remain largely absent. The available piecemeal data typically come from case studies of particular sectors in selected regions and remain insufficient to guide serious services policy reforms.

## What can policy-makers do to improve services data in Africa?

Systematic data collection efforts and comprehensive monitoring of services integration that focuses on the impact of reforms on lowering trade costs and facilitating cross-border operations should be a priority for policy-makers in Africa.

There is a pressing need to improve the recording services of trade flows to better reflect the flows of various disaggregate services and further break down the aggregate information on flows by partner countries, especially for African countries. Furthermore, traditional surveys as well as innovative data collection methods such as crowdsourcing and 'mystery shopping' can add more texture to the flows of trade in intangibles by gathering information on services trade transaction costs and outcome indicators.[1] Firm-level data on trade flows, characteristics of exporters or the cost of barriers can usefully complement existing data sources compiled by central banks, statistical offices, various ministries or other government bodies.

Policy-makers should endeavour to work with relevant data collection agencies and donors to integrate firm-level surveys and innovative methods into existing data collection frameworks, and carry out monitoring exercises that assess the impact of policy reforms on trade transaction costs and services performance indicators.

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# Notes

1 A new World Bank Group report details such data collection methods that were used to shed light on uncharted opportunities for services trade in Africa. See Dihel and Grover Goswami (2016).

# 12. Data on trade and investment in services

John Cooke, TheCityUK[1]

## Summary

Services account for an overwhelming share of overall economic activities and are increasingly delivered across borders through various modes of supply. Given the growing importance of services trade data not only for policy-makers but also for business, the availability of statistics on the international supply of services itemised by services category, mode of supply and partner country is critically important for services trade and investment policy-making. International data on trade and investment in services for economies at all stages of development need to improve if trade and development objectives are to be met.

Services trade and investment is of central importance for countries at all stages of development. Yet the quality of services trade and investment data lags behind that of goods. It needs to improve.

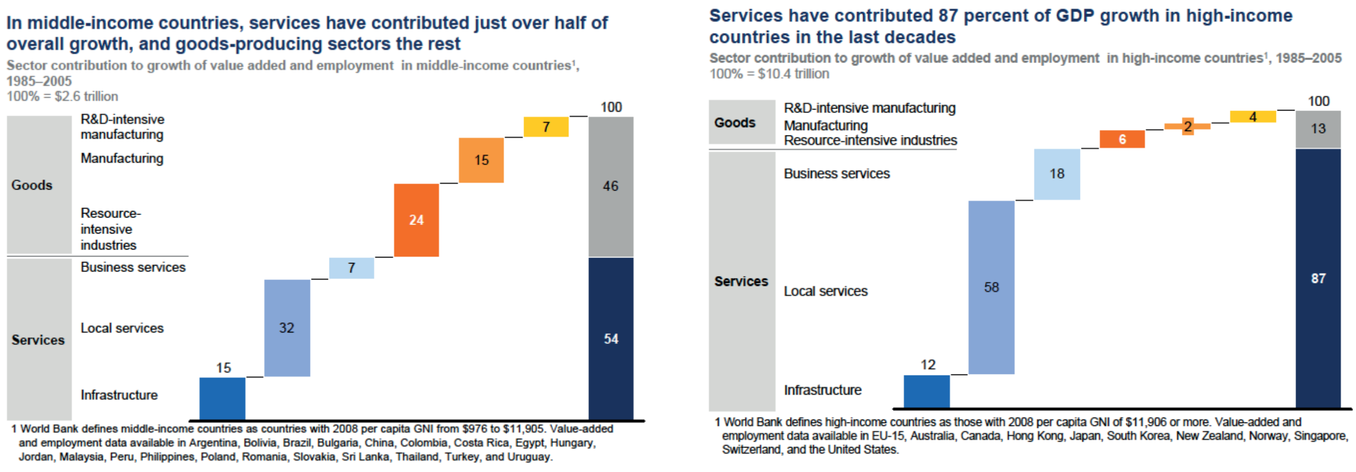
Before the conclusion of the General Agreement on Tariffs and Trade (GATT) Uruguay Round (1994), services were not, generally, trade policy subject matter. But they have grown in importance for the gross domestic product (GDP) of all high-income economies, and the same trend is reflected among emerging and developing markets (see Figure 1).

The UK is no exception. Services now lie at the heart of UK trade and investment, particularly in the high added value sectors on which the UK's future competitiveness depends. This was one of the messages in the UK Government's Green Paper 'Building our industrial strategy' (2017) and its White Paper 'The United Kingdom's exit from and new partnership with the European Union' (2017). Both laid special emphasis on trade as a proportion of UK GDP.

Figure 1. Services as part of GDP growth (middle-income and high-income countries)

*In middle-income countries, services have contributed just over half of overall growth, with goods-producing sectors accounting for the balance.*

*In high-income countries, services have contributed 87% of GDP growth in recent decades.*



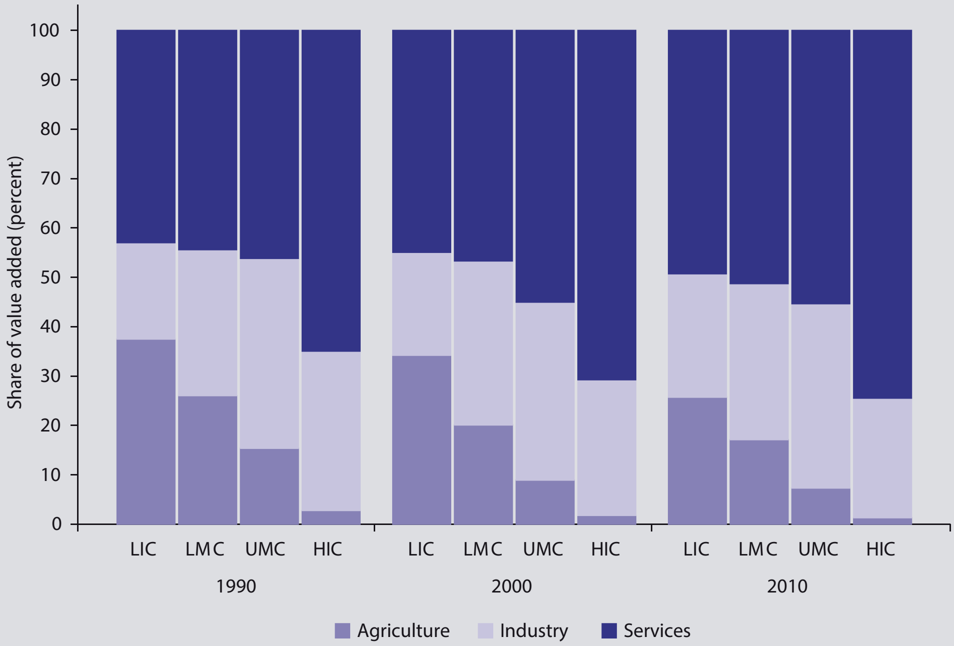

*Note: Local services = retail, hotel/restaurant, financial services, etc.*

*Source: Manyika et al. (2010).*

The robust role of services in global trade is evident from recent trends in global merchandise and commercial services trade by region and selected economies (Asia, Europe and North America) over recent decades (see Figure 2).

The growing role of services in international trade, and in the UK's export performance, is not simply a change of degree. There has also been a substantive change as the phenomenon of servicification in international business has been increasingly recognised as a feature of global trade and of the trade of advanced economies. More and more, manufacturing and agricultural businesses use a growing range of services in areas such as externally procured services inputs, in-house services production, services sold as part of a good or services sold along with goods. The reasons are often linked to the need to offer a goods/services package within a global value chain, opportunities to reduce costs and increase efficiency or factors such as longer and deeper customer relations and consumer demand. The Swedish National Board of Trade has analysed international Swedish manufactured goods businesses, in which services play a part at all stages of the production, sales and delivery chain (see Table 1).

Figure 2. Trends in global merchandise and commercial services trade




*Note: LIC = low-income country, LMC = lower-middle-income country, UMC = upper-middle-income country, HIC = high-income country. Data for 2009 instead of 2010 were used for high-income countries.*

*Source: World Development Indicators in Saez et al. (2014).*

Table 1. 'Servicification': services as a component of trade in goods

| Production | Sales | Delivery |
|---|---|---|
| Legal services | Printing, publishing | Maritime transport – freight |
| Accounting, book-keeping, etc. | Design | Inland waterways – freight |
| Taxation services | Building-cleaning services | Air transport – freight/passenger |
| Medical services | Photographic services | Road transport – freight/passenger |
| Computer services | Courier services | Cargo-handling services |
| Research and development | Logistic services | Storage and warehouse services |
| Rental/leasing | Postal services | Freight transport agency services |
| Advertising | Telecommunications | Feeder services |
| Market research | Audio-visual services | Energy services |
| Services incidental to manufacturing | Educational services | |
| Placement of personnel | Environmental services | |
| Maintenance and repair | Banking services | |
| Security services | Insurance | |
| Packaging | Health-related services | |
| | Hotels and restaurants | |
| | Travel agency services | |

*Source: National Board of Trade Sweden (2010).*

For the UK's future policy post-Brexit, this has important implications. Essentially, both the role of services in international business and the added phenomenon of servicification point to the fact that trade is a continuous flow of goods, services, capital, persons, data and skills. They also point to the need for policies hitherto framed largely by reference to trade in goods (for example the protection of intellectual property) to take account of services and servicification.

Given the importance of trade and investment in services, it is ironic that services trade and investment data are often patchy and poor. Measuring the extent, pattern and flows of different types of trade and investment will be self-evidently important for UK policy, which will be concerned with removing barriers and promoting freer trade and investment flows aligned to the comparative and competitive advantage of different trade partners. Unless these aspects are known with reasonable certainty, it will be hard to set objectives for trade and investment negotiations.

For instance, there are various ways in which overall flows in UK trade and investment in services can be represented, whether as flows of a specific kind (for example digital) or total UK exports or imports. But without details of the dynamics of change between different modes of supply (cross-border both ways, commercial presence or temporary presence of natural persons as service-suppliers – the four General Agreement on Trade in Services (**GATS**) modes) the raw data on services flows will remain difficult to deploy effectively in policy terms. This is more important for services trade than for goods as, depending on how a service is supplied, services are more subject to 'behind the border' barriers. It is also important as part of the evidence-base for maintaining an open UK services trade policy post Brexit (including the scope for importing services from emerging and developing economies and, within a heightened UK debate on migration, setting clear terms for access to global talent through temporary presence of natural persons as service-suppliers).

The data problem seems particularly marked in the area of **foreign direct investment** (**FDI**) and trade via foreign affiliates. For services trade, commercial presence (FDI or, in GATS terms, Mode 3) appears to be playing a growing role. But the precise changes are unclear. Given the changes currently underway in the global economy, it would be useful to understand them better for at least three purposes:

- getting the right balance between different chapters (for example, market access, investment protection and regulation) in trade and investment agreements;
- identifying and targeting barriers to business (for example, equity caps or other restrictions on FDI) in negotiations;
- shaping investment protection provisions in trade and investment agreements.

Services, and their role in future UK trade and investment policy, are clearly extremely important for the UK's commercial future. Yet, while large-scale patterns of services trade appear to be broadly known, their interior detail will require radically new forms of analysis if services statistics are to play their necessary part in the formation of evidence-based policy that will contribute not only to UK growth but also to global welfare

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# Notes

1 The views expressed in his essay are his own, and do not necessarily reflect those of TheCityUK.

# 13. A three-pronged approach to supporting economic transformation through services in low-income and least-developed countries

David Primack, Independent research consultant

## Summary

An agenda that prioritises the building of productive and export capacity in least developed countries (LDCs) and low-income countries (LICs) services firms, alongside the integration of services markets and reduction of cross-border regulatory differences, is essential for leveraging services and services trade for economic transformation. Going forward, the UK government (alongside other donors) should consider a three-pronged approach: (i) enhancing the availability of data and information on services production and trade; (ii) building capacity to trade services; and (iii) mobilising services constituencies.

## Introduction

In recent years, broader recognition has emerged – though not without contention[1] – that services, as tradables, have the potential to play a leading role in the growth-productivity-transformation nexus. To maximise such potential in LDCs and LICs, and to help counteract the pervasive market failures and structural constraints they face, interventions from the trade and development community should ascribe greater priority to boosting the productive capacity and export capabilities of LIC and LDC services firms. In tandem with the more traditional market integration agenda to reduce trade barrier and regulatory heterogeneity, such efforts can help to better develop more robust inter-industry linkages for these firms, and in doing so, help create new, higher-productivity services jobs.

A three-pronged approach is outlined below, with a view to (i) enhancing the availability of data and information on services production and trade; (ii) strengthening the capacity to trade services; and (iii) mobilising services constituencies.

## Enhancing the availability of data and information

Enhancing the availability of data and information on services production and trade in LICs and LDCs should be a key priority for future efforts to leverage services for economic transformation.

Primack (2016) highlights that, despite improvements in the collection of services and services trade data over the past 15 years, in most LICs and LDCs the macro- and micro-level services data needed for meaningful economic analysis do not exist. In particular, services trade statistics are often of dubious quality and lack adequate partner and product disaggregation.[2] Holmes et al. (2016) identify the use of firm-level surveys, complemented with strong measures to address firm privacy concerns, as an effective way of improving the availability and quality of such data. This has the added benefit of providing more of the data needed for exploring questions on value addition, productivity and transformation.

Case study and field-based research is also needed to better understand on-the-ground commercial realities and firm dynamics across services sectors and within resource-based value chains. Such information can help better identify the constraints (policy and otherwise) that inhibit or enable local service providers to boost their competitiveness, build productive capacity, and potentially reap the gains of integrating into, and upgrading (economically and socially) within, regional and global value chains.

## Building capacity to trade services

A broad range of capacity constraints hinder the ability of LIC and LDC services firms to produce and trade services. Supporting measures to assist firms to address these should target, *inter alia*, the availability and appropriateness of human capital (including both technical and export-related skills, as well as entrepreneurial abilities), financial capital (notably access to credit to underpin productivity-enhancing investments) and improving the availability and quality of various endowments. These include infrastructure and technological endowments (e.g. roads, electrical grids, telecommunications infrastructure) and natural and cultural endowments (for example natural resources, the arts and creative sectors, cultural links *vis-à-vis* the diaspora). Engaging LIC and LDC services firms on standards issues and supporting the development of appropriate regional standards in key services sectors is another area in need of greater attention.

## Mobilising services constituencies

Another key factor hindering traction in services reforms and services trade negotiations in LICs and LDCs is the lack of engagement of actual firms, the ostensible beneficiaries. In part, this derives from an awareness gap. Far too many firms do not identify as services producers, consumers or traders. Furthermore, the perceived prioritising of market integration concerns over more active (and for smaller firms, often more tangible) efforts to build productive and export capacity serves to further dampen their interest to engage. These dynamics are exacerbated by the fact that outside select sectors (for example finance, telecoms and transport) many services firms in LICs and LDCs are often small, fragmented and rarely organised in sector associations or advocacy groups. In the absence of diverse voices from both producers and consumers of services to help drive the agenda, vested interest can more easily take root.

Efforts to significantly raise awareness in the general public and business community on the importance of services is essential to mobilise constituencies and help better fine tune the services reform agenda to local needs. Platforms to assist small and fragmented services firms to have their voices heard can also accelerate such efforts (as well as create a mechanism for development cooperation resources to be delivered to the front line).[3]

## Conclusion

An agenda that prioritises the building of productive and export capacity in LDC and LIC services firms, alongside the integration of services markets and reduction of cross-border regulatory differences, is essential for leveraging services and services trade for economic transformation. Going forward, the UK government (alongside other donors) should consider a three-pronged approach with a view to (i) enhancing the availability of data and information on services production and trade; (ii) building capacity to trade services; and (iii) mobilising services constituencies.

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# Notes

1 See Rodrik (2014).

2 While data from advanced economies (so-called mirror data) can help fill select gaps, such techniques do little to address south-south trade, where case study efforts (e.g. ACU, 2015) indicate significant services trade is occurring.

3 For more information on such platforms in developing countries, see Hustler et al. (2012).

# Part 3: Aid and trade policies for developing countries

# 14. Supporting services trade negotiations

Bernard Hoekman, European University Institute


## Summary

Services have been neglected by low-income countries in trade negotiations. This has resulted in a significant opportunity cost, as trade liberalisation can increase access to more and better services with associated productivity and welfare gains. Regulatory concerns are one reason for neglect of services, and these should be given greater attention in the design and allocation of development assistance.


Recent compilations by the Organisation for Economic Co-operation and Development (OECD) and the World Bank have shown that barriers to trade in services are significant in many developing countries. Trade and investment restrictions in services increase the cost of transport, distribution, storage, logistics and other services that are inputs into production and exchange. Borchert et al. (2015), for example, note that many landlocked African countries restrict trade in services that are particularly important for overall trade performance; for example, on average, air transport policies are significantly more restrictive than in other countries, reducing connectivity with the rest of the world. The consequence is more concentrated market structures and less access to transport services. Liberalisation of trade in services is a potential mechanism to reduce average prices, increase quality and expand the variety of services on the market, benefiting firms that are buyers of services and households, both indirectly as consumers of goods that embody services inputs and directly as buyers of services. Given that political economy forces may constrain a government from pursuing unilateral reform to open services markets, international negotiations to lower services trade barriers on a reciprocal basis can help attain these benefits.

Most developing countries are actively involved in trade negotiations, both in the context of regional integration efforts and with OECD countries, for example, the Economic Partnership Agreements (EPAs) with the European Union. The focus of such negotiations has tended to be on trade in goods. This is unfortunate from an economic development perspective given the role that services play as determinants of productivity in agriculture, mining and manufacturing and the high barriers to trade that often prevail. For example, overall, across Africa, barriers to the cross-border movement of service suppliers often are high. Karingi and Davis (2016) note that the average African citizen needs to obtain a visa in advance of travel for 55% of the countries he or she may want to travel to. Dihel and Grover Goswami (2016) document the effects of the many barriers confronting foreign professional service providers in East and Southern Africa.

Recently, services have begun to feature more prominently on the agenda of trade negotiations. An example is the Eastern African Community (EAC) Common Market Protocol. This aims at the progressive liberalisation of trade in services, with an initial focus on business and professional services, communications, distribution, education, financial services, tourism and travel-related activities and transportation, complemented by efforts to mutually recognise professional qualifications obtained by service suppliers in EAC states. However, empirical assessments suggest that although services are beginning to figure more prominently on the agenda of trade negotiations, they have done little in terms of actual liberalisation. Moreover, the limited engagement of most developing countries in the World Trade Organization (WTO) on services, and resistance to including services in EPAs imply a substantial opportunity cost.

Why the limited focus on services? Potential reasons include lack of understanding of the importance for growth and productivity of services, human resource constraints that imply prioritising sectors deemed to be of greater importance and uncertainty as to how to go about designing trade agreements to ensure that the domestic economy will benefit from liberalisation. In particular, governments may fear being deprived of the freedom to regulate, or be concerned about the adequacy of domestic and foreign regulatory frameworks for specific services sectors (Hoekman and Mattoo, 2013). Recent research has shown that the benefits of lower barriers to trade in services depend on country-level economic governance variables (for example Beverelli et al., 2016). In part this is because many services are not storable: foreign suppliers need to establish a local presence in the market in order to provide services. Policies that restrict establishment will then impede trade. But removing such policies may not be enough. In developing countries with very weak institutions, significant gains from services trade liberalisation may be conditional on improved regulatory regimes.

These considerations suggest that there may be substantial payoffs to identify and address regulatory weaknesses and areas where international regulatory cooperation between governments is needed to facilitate cross-border trade and investment. Knowledge platforms that bring together groups with a stake in a given sector, including industries that use a given service as an input, can help identify priority areas for action and for donor support. For example, take the case of trade facilitation. This goes beyond customs clearance and operation of border crossings. It includes efficient international road corridors and transit regimes and competitive logistics services. Mechanisms that bring together the government, regulators, logistics providers, transport companies, shippers and donor agencies that all have an interest in facilitating trade can help governments better understand why specific services reforms matter and where joint action by governments is needed (Hoekman and Mattoo, 2013).

A greater focus on supporting deliberation mechanisms such as knowledge platforms may do much to increase the attention given to services in trade agreements. This includes the data agenda that has been identified by other contributions to this volume; effective deliberation requires information on prevailing policies and objective analysis of their economic effects, as well as monitoring implementation.

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# 15. Preferential treatment in services for developing countries

Mina Mashayekhi, UNCTAD[1]

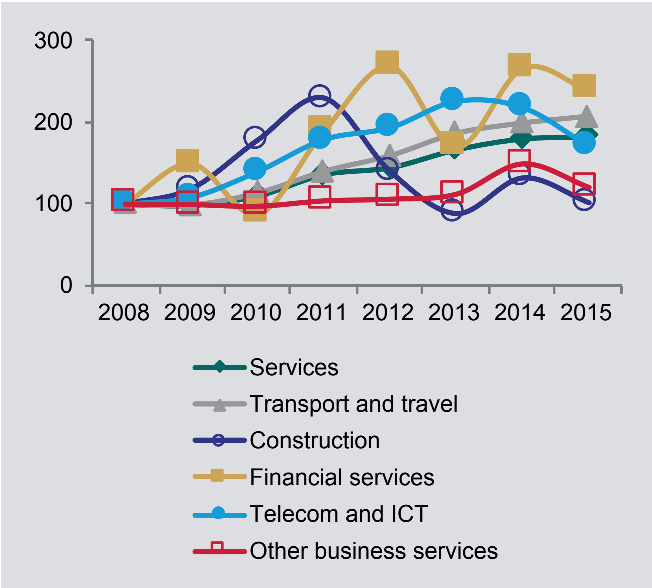
## Summary

Services are key enablers of trade and development, but many developing countries are still to fully harvest their potential. Coherent, interlinked policies, including a comprehensive services strategy and sound regulatory and institutional frameworks, are necessary to achieve benefits from the services sector. Developing supply capacity and gaining market access also remain central to this policy mix. Preferential treatment by developed countries can be instrumental in pursuing these policy objectives.

For many developing and least developed countries (LDCs), the services sector is central to their development aspirations. It accounts for more than half of output and for almost half of jobs in developing countries. The participation of services in international trade is lower, but the sector remains a key avenue for diversification as global exports of services have been more resilient than exports of goods. In LDCs, the share of services in total exports grew from 11% to 20% between 2008 and 2015. Furthermore, the importance of services for international trade is underestimated as current balance of payment data do not capture services trade through the temporary movement of natural persons or commercial presence. In addition, these statistics do not reflect the significant services value added embedded in gross exports.

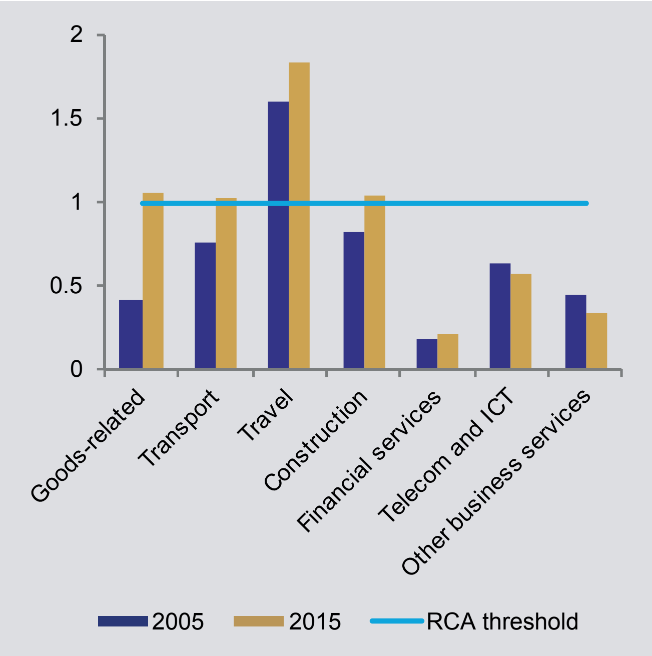
The world's largest exporters of services in 2015 continue to be major economies: the US, accounting for 14.9% of global exports in services, followed by the UK, 7.3%, China, 6% and Germany, 5.3%. Meanwhile, developing economies have increased their share in global trade in services, from 23% in 2005 to 31% in 2015. The share of LDCs in global trade in services is, however, still below 1% and has only expanded from 0.5% in 2005 to 0.8% in 2015. Transport and travel account for roughly two thirds of LDCs' services exports in 2015, while telecom and ICT and financial services have also exhibited high growth in recent years (Figure 1). This trend is important, as knowledge- and technology-based services can often add higher value added and have an intermediation role that allows specialisation, contributing to a structural transformation consistent with major development objectives. Moreover, infrastructure services are essential to the efficient functioning of productive capabilities. This significant role of services is recognised in the Sustainable Development Goals, which implicitly and explicitly rely on universal access for a set of basic and infrastructure services including financial inclusion, while encouraging knowledge and technology services. In 2015, LDCs had revealed comparative advantage (RCA) in construction, transport and travel, the latter already existent in 2005 (Figure 2). LDCs have also gained RCA in goods-related services, which can also be important as these services – and others – facilitate the participation, particularly of micro, small and medium enterprises (MSMEs) in global value chains.

Figure 1. LDCs' services exports, 2008-2015 (index 2008=100)




*Source: UNCTADstat.*

Figure 2. LDCs' revealed comparative advantages, 2005 and 2015




*Source: UNCTADstat.*

Notwithstanding, many developing countries are not fully benefiting from this potential. The United Nations Conference on Trade and Development's (UNCTAD) Services Policy Review (SPR) of Bangladesh has identified that for information and communication technology (ICT) services, lack of infrastructure – including a submarine link – and lack of supporting policies, such as education strategies, and an ICT clustering approach – including ICT parks and incubators – are impeding growth of exports in the sector. UNCTAD's SPR of Uganda has assessed that for transport services, lack of a regulatory logistics authority and of a one-stop border post is a limitation to trade. Policy and regulatory and institutional frameworks are necessary to ensure efficient markets and to achieve development gains from services. These frameworks should address externalities and coordination issues, which are determinants of services' performance and need to be aligned to build complementarities and interlinkages between services sectors and the economy at large. Trade and investment barriers should be reduced to promote competition and allow for the inflows of knowledge, technology, financing, people and other factors that can build supply capacity in services while keeping the needed policy space for development. Favouring trade openness requires a multidimensional trade policy with productive capacity-building and support to structural transformation, negotiations, trade promotion and market intelligence approaches. The SPR of Bangladesh identified that the lack of a market research unit to assess domestic and international supply needs and potential matches with Bangladeshi labour supply is a trade barrier.

Preferential treatment by developed countries and developing countries in a position to do so in services trade can contribute importantly to developing countries' and LDCs' trade policy mix. Directly, it allows for new trade opportunities, and indirectly induces the adjustment of economic agents, prices and production factors to seize new trade avenues. Thus, it facilitates a structural transformation that favours the export-oriented services sectors, as well as those with backward and forward linkages with exporters. In this context, preferences and the resulting economic adjustments are conducive to strengthened services and their enhanced contributions to productivity, competitiveness and development. The importance of preferential treatment is recognised by the General Agreement on Trade in Services (GATS), particularly by Article IV on the facilitation of the increased participation of developing countries in world trade. In this regard, the GATS envisaged the liberalisation of market access in sectors and modes of supply of export interest to developing countries. Most importantly, it also aimed at strengthening developing countries' domestic services capacity to actually benefit from access preferences, *inter alia*, through access to technology, distribution channels and information networks. The GATS further assigned special priority to LDCs in view of their special economic situation and their development, trade and financial needs.

The waiver of most-favoured nation obligations allowing World Trade Organization members to provide preferential treatment to services and services suppliers from LDCs has become an increasingly important achievement. The positive effects of this waiver are dependent on the meaningfulness of preferences, and ascertaining this potential requires evaluation of submissions and monitoring their implementation. In particular, it is important to determine if notifications have additionality in regard to already existing commitments in the GATS, in Doha Development Agenda (DDA) offers and in Regional Trade Agreements (RTAs). Furthermore, it is relevant to establish whether notifications go beyond applied regimes. It is also necessary to determine the economic value of preferences, including modal and sectoral analyses, and the viability of preferences, by taking into account possible regulatory barriers to services trade. RTAs also have an important role in providing preferential access as well as in regulatory and institutional cooperation. GATS Article V provides for RTAs with specific flexibilities for south-south RTAs. For example, the outcome of the EC-CARIFORUM Economic Partnership Agreement on services where asymmetrical commitments apply gives recognition that trade is taking place between unequal partners. Even in the context of a south-south agreement such as the ongoing Continental Free Trade Area among African Union Members, there seems to be a will to address differences in the development levels of countries, particularly for the LDCs.

A preliminary assessment of the 23 services waiver notifications points to some preferences going beyond the DDA offers, and matching preferences in RTAs. Business services receive the highest number of preferences, followed by transport services where LDCs have RCA. This is important for LDCs also because of the potential to promote supply capacity and facilitate integration in global value chains. On the other hand, preferences on tourism, travel and construction services, where LDCs have RCA, are below expectations. A modal analysis reveals that there are several preferences on Mode 4, but the majority of those have limitations. Although there are some interesting examples, such as increases in the period of stay and waiver of visa fees, there is no impressive breakthrough driving openness in Mode 4. Modes 1 and 3 are also subject to some limitations, and it is on Mode 2 that no limitations are most often found. This is not in line with the best interest of LDCs, as limitations in Mode 2 are fewer by default and because these countries would benefit from effective market access for contractual services suppliers and independent professionals, for example.

Notifications focus on market access while very few focus on preferential regulatory treatment, support in conforming with domestic regulation and meeting quality standards in foreign markets for LDCs, a key avenue to provide meaningful and effective preferences. Moreover, regulatory requirements can *de facto* nullify market access. Some notifications include measures on capacity-building, including the construction of infrastructure for tourism and other services, but preferences in domestic regulation, such as technical standards or qualification requirements, are still missing. In recognition of the importance of special and differential treatment in this regard, India's proposal of possible elements of a trade facilitation in services agreements allows for special provisions for developing countries and LDCs pertaining to the entry into force of the possible agreement. Lessons from the LDC services waiver confirm that preferential treatment approaches require careful assessment, design and implementation. The notifications need to be analysed to establish their concrete economic value. It is necessary to assist LDC suppliers to understand the exact preferential treatment and the reservations and limitations applicable, such as horizontal and sectoral EU-wide reservations. It would also be useful to support strengthening of supply capacity and build awareness with services consumers in preference-giving countries about the preferences offered to LDCs.

Thorough services assessments, such as UNCTAD's SPRs, can provide benchmarks to feed preferential treatment initiatives for developing countries. Lessons learned from UNCTAD's SPRs point to the importance of policy coherence, coordination and importance of establishing interlinkages; a multi-stakeholder approach to policy-making involving the private sector; data availability; effective regulations; institutions and governance to enhance services' competitiveness; labour skills development; and a productive technology and business environment, including for SMEs and MSMEs. Complementary international support is required to support developing countries and LDCs in taking advantage of preferences by addressing supply capacity constraints. This support should improve domestic productive capabilities in developing countries, including infrastructure, skills and technology, and should contribute to pro-development regulatory and institutional frameworks and meeting quality standards.

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# Notes

1 The views expressed are those of the author and do not necessarily reflect those of UNCTAD Secretariat.

# 16. Forum Island Countries and PACER Plus: how trade agreements can help support the services sector

Martin Roy, World Trade Organization[1]

## Summary

For small- and low-income developing countries, the vitality of the services sector is key to future growth. International agreements on trade and investment, if properly designed, can not only offer export opportunities, but also help improve the business climate and attract investment. Development assistance has a role in supporting such outcomes. The experience of Forum Island Countries in PACER Plus may provide useful lessons.

Over recent years, the 14 Forum Island Countries (FICs)[2] have made significant progress in the negotiation of a comprehensive trade agreement with Australia and New Zealand, the Pacific Agreement on Closer Economic Relations (PACER Plus). This agreement would include important obligations affecting services through chapters on trade in services, investment and the movement of natural persons.

In most of these countries, the services sector occupies the preponderant part of domestic economic production and employment. For example, services value added represents 61% of Tonga's gross domestic product (GDP), 63% in Vanuatu and 71% in Fiji. This is not surprising since most FICs, given resource constraints, have limited potential for larger-scale agriculture and manufacturing activities. In that context, further liberalisation of services sectors in FICs would bring significant benefits by enhancing contestability and increasing the efficiency of services markets, bringing higher quality and less costly services to local consumers, enterprises and exporters in all sectors.

However, the literature generally recognises that trade agreements only rarely bring about liberalisation. In that context, what opportunities might an agreement like PACER Plus present for FICs' services sector? In the case of FICs, a key benefit would arguably concern the Agreement's impact on their business climate and investment friendliness.

The World Bank's Ease of Doing Business index suggests that the business and investment climate in many FICs leaves significant room for improvement. In 2017, Vanuatu ranks 83rd, Tonga 85th, Samoa 89th, Fiji 97th, Solomon Islands at 104, Papua New Guinea at 119, Palau at 136, Marshall Islands at 143, Micronesia at 151, and Kiribati at 152.

Typical disciplines of trade agreements on investment protection (for example international standards on protection against expropriation, transfer of funds or fair and equitable treatment) have been adhered to by the large majority of countries for many years now, and constitute basic anchors of investment policies. However, this has largely not been the case for FICs, most of which are not party to any bilateral investment agreement. The inclusion of such disciplines through PACER Plus would therefore bring concrete value added and help improve the investment climate. By giving assurances that investments would not be harmed as a result of breaches of international protection standards, these disciplines help build confidence and encourage foreign investors to make longer-term economic commitments in host countries.

Another set of disciplines from trade agreements that can bring significant value added in the case of FICs concerns market access commitments on services, whereby contracting parties guarantee minimum levels of treatment in relation to non-discrimination ('national treatment') and 'market access'. These are key features of trade agreements covering services, which have proliferated in the last 15 years. However, FICs have not been part of this trend. Only six FICs are World Trade Organization Members and therefore have General Agreement on Trade in Services (GATS) commitments (Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu). While all FICs have signed the Pacific Islands Countries Trade Agreement (PICTA) Protocol on trade in services, and the four Melanesian countries have similarly concluded the extension of their trade agreement[3] to services and investment, these have yet to enter into force.

Further, since market access commitments are not general obligations and because guarantees of treatment vary by country, a closer look at the relevant GATS and PICTA schedules suggests, in most cases, a rather restrictive services regime. This is particularly the case for supply through commercial presence (Mode 3), with limited sectoral coverage and the binding of a low level of openness, often more restrictive than existing laws, including with respect to such central features as the policy regime for the admission of foreign direct investment (FDI).

In this context, PACER Plus could provide considerable value added and improve the business and investment climate by binding to a much greater extent the existing – and more open – conditions of entry and operations. This would bring much needed transparency and predictability, provide good policy anchors for governments and reference points for private operators, and would also protect against instability and future roll-backs. For those countries where existing laws contain significant restrictions (for example FDI regime or competition in telecommunications), negotiations can be used to signal interest in future reforms and in obtaining assistance to conduct them.[4]

These potential benefits also suggest some possible lessons with respect to development assistance. These might be of relevance for many small and low-income countries. Upstream, assistance for countries with limited experience that have chosen to negotiate services/investment disciplines is fundamental. Help in properly identifying the applied regimes and, where appropriate, reflecting these in market access schedules of trade agreements is fundamental for the negotiations to prosper, but also for future policy decisions outside of the negotiating context. Downstream, post-agreement assistance to incorporate best practices on investment promotion, and to assist other significant future services and investment reforms, with a view to consolidating them in credible trade agreements, is also key.

In terms of FIC exports, PACER Plus would offer guaranteed access for their goods and services across the region, including in Australia and New Zealand. Applied preferences in services trade agreements tend to be rare. What is arguably key for FICs – as it might be for other similar developing countries – is to enhance their capacity to take advantage of export opportunities. In the case of PACER Plus, the parties aim to use the Agreement as a vehicle to identify relevant domestic constraints in FICs that impede taking advantage of such opportunities, including as regards labour mobility, and to set financial targets from the two developed country partners to help address them.

Given their economic profile, outward opportunities for FICs would also go beyond Mode 4 and trade in services, and involve temporary employment of low-skilled or unskilled labour from FICs in Australia and New Zealand. PACER Plus would innovate in this regard by including a chapter on labour mobility that foresees, among other things, cooperation directed towards enhancing the operation of existing mobility schemes between the parties. Assistance linked to the Agreement would also aim to help FICs effectively take advantage of the schemes.[5]

# Notes

1 The opinions expressed in this note are those of its author. They are not intended to represent the positions or opinions of the WTO or its members and are without prejudice to members' rights and obligations under the WTO. Any errors are attributable to the author.

2 Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Nauru, Niue, Palau, Papua New Guinea, Republic of the Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu and Vanuatu. Papua New Guinea withdrew from the negotiations in 2016.

3 Fiji, Papua New Guinea, Solomon Islands and Vanuatu are signatories to the Melanesian Spearhead Group (MSG) Free Trade Agreement.

4 Such technical assistance may, for example, help move from discretionary FDI admission process – typically due to limited capacities – to a more transparent and focused one where technical criteria are clearly laid out and FDI restrictions are pre-established and well circumscribed.

5 Responding recently to a long-standing demand from FICs, Australia announced in 2016 a significant expansion of its seasonal worker programme for Pacific island states, extending it to all FICs as well as to new economic sectors and removing the cap on the number of workers. New Zealand has also taken some steps to enhance its recognised seasonal employer scheme. More recently, it increased the cap from 9,500 to 10,500.

# 17. Trade preferences for services from developing countries: why, what and how?

Hannes L. Schloemann, WTI Advisors

## Summary

Trade preferences for services and services suppliers from developing countries are a win-win tool to advance both trade and development agendas. Yet this tool is underused: many real-life barriers to trade in services remain untouched, although feasible options exist. A special focus should be on reducing regulatory and administrative challenges. In many cases, extending favourable treatment already granted to some domestic suppliers or third-country firms under trade agreements – such as access to certain professions or sectors, facilitated procedures, easier recognition, access to facilities or lower fees – is possible and should be pursued, in the process benefiting UK businesses.

Trade preferences for goods create a margin – the difference between the preferential tariff and the most favored nation (MFN) tariff – that gives beneficiary firms an advantage in a market. Critics point out that they distort incentives and may lock countries into unprofitable and un-dynamic business models. In the case of services, preferences will usually not create margins, but rather facilitate trade where a healthy potential exists but where firms cannot overcome threshold challenges.

Services preferences make a lot of sense as they stimulate activities that generate wider benefits for developing economies, while carrying virtually no costs for importing nations. Trade preferences for services are the flipside of services trade regulation, which is rather varied and complex. To simplify, one can distinguish five types of services preferences:

1. Market access: exemptions from quantitative measures, including those that bar foreigners entirely or limit the number of services providers or the volume of services trade;
2. Domestic regulation: exemptions from or facilitation of regulatory or administrative requirements relating to licensing, qualifications, standards, etc.;
3. Taxation, social security and other contributions: exemptions from taxes and other charges, facilitated processes (for example, deferred payment);
4. Financing: access to funding support mechanisms;
5. Promotion and other support: dedicated support measures or preferential participation in existing ones, for example free advice, tutoring or access to helpdesk functions.

Services preferences for least developed countries (LDCs) can be granted on a unilateral basis under the World Trade Organization's (WTO's) LDC Services Waiver,[1] for other developing nations under reciprocal trade agreements.[2]

## Why services preferences?

Services preferences can be a uniquely effective tool to use existing and stimulate future capacity. The majority of LDCs already export almost all services in nearly all modes of supply. Suppliers in low-income countries – virtually all small and medium-sized enterprises (SMEs) – are often competitive, innovative, organised, and business-savvy. But they face a great number of obstacles on their way to actual or potential foreign clients, including regulation, taxes and charges, visa and work permits and classical market access restrictions. What services providers really need and benefit from is a targeted removal or reduction of the myriad small and sometimes larger obstacles and challenges that impede their ability to effectively access and contest markets they can otherwise service perfectly well.

Many of these obstacles may seem negligible to the untrained eye, but are significant in relation to their specific circumstances, such as size, capital base, cash flow and their regulatory and educational environment at home. Many measures may also seem adequate and fair when seen from a distance (for example visa-related formalities, standardised qualification requirements and standardised fees). But a closer look will often reveal that such measures affect developing country providers disproportionately. A non-refundable visa fee of £90 may seem reasonable to a Korean telecoms executive, but to a Gambian musician it corresponds to one third or so of her country's per capita gross domestic product. If that musician, as often happens, is forced to forego an invitation to play at a music festival because she and her family cannot take the risk of a denied visa, she loses significant business and legitimate services trade is effectively blocked. Simply making visa fees (partly) reimbursable for (certain categories of) services providers from LDCs could go a long way to allow the said Gambian musician to get a foot in the door of the lucrative European music market.

## What should be the priorities?

The WTO defines some 160 services sub-sectors and four modes of supply. In conjunction with the five broad types of preferences (see above) and myriad challenges to services businesses the possibilities to do good (and do well) are almost infinite. The good news is that, thanks to the nature and role of services, almost any preference for services or services providers from developing countries will contribute to development.

The priority for successful use of preferences must be genuine openness to recognising and addressing real-life obstacles confronting developing country services exporters in accessing our market. While there remain things to be done in the area of market access, the focus should be on regulatory, administrative and tax-related measures, ideally coupled with smart support measures where feasible. Much potential lies in the systematic extension of already existing facilitation measures, including those applied within the European Economic Area and the European Union.

Below are some examples to stimulate the imagination; many more can be identified, including by talking to services providers in developing countries.[3]

- Market access:
  - o reduce residency requirements, for example allow non-resident LDC/DC auditors to conduct statutory audits (under certain circumstances or for certain clients)
  - o grant access to screen and airtime quotas for LDC/DC productions, or productions with LDC/DC content; extend or mirror benefits granted under co-production agreements.
- More specifically, physical market access – visas and work permits:
  - o employ special visa categories for services providers
  - o more widely admit contractual services suppliers and independent professionals, waiving or reducing qualification thresholds (such as holding a university degree)
  - o reduce or waive visa fees
  - o reimburse visa fees in case of refusal
  - o facilitate access to expedited visa procedures, including trusted persons programmes (waiving or reducing related fees)
  - o exercise flexibility regarding financial and other guarantee requirements
  - o facilitate documentary requirements; visa interviews via Skype in low-risk cases
  - o communicate reasons for denial.
- Regulatory/administrative measures:
  - o recognise qualifications on a facilitated basis; extend existing schemes (such as enrollment of ‘second level’ nurses)
  - o waive application fees and other charges, or defer until after first earnings
  - o establish a ‘right to a bank account’ for properly established and supervised remittance companies from developing countries.
- Taxation and other contributions:
  - o exempt services providers from (some) withholding taxes
  - o extend tax privileges for national startups to investors from developing countries
  - o apply favourable social security contribution rules (for example, treatment as independent professionals rather than employees)
  - o defer tax payments until after first profit
  - o exempt passengers on flights to or from LDCs from air passenger duty.
- Support mechanisms:
  - o improve access to information, for example, by establishing an ‘LDC helpdesk’
  - o provide support to obtain necessary certifications, for instance to gain access to exemption schemes for data processing
  - o extend tourism promotion to LDC destinations.

## Conclusion: what the UK can do pre- and post-Brexit

The UK can lead by example by being attentive to needs, creative in design and generous in approach. This may appear banal, but it isn’t. The world of services trade is severely under-understood by policy-makers, civil society and even services providers themselves. As a result, it receives much less attention than it should given its value-added share in world trade and potential for growth.

As a premier champion of services trade with close relations with many developing countries and a pronouncedly progressive development policy, the UK is ideally positioned to pursue a progressive policy on services trade preferences. This should **integrate support for (general) development of services industries; services export strategies and promotion; smart and generous preferences; and a general trade policy focus on services trade with developing countries.**

There is an important win-win proposition here. Most of the preference policy issues are relevant to UK SMEs as well. The UK is a major services exporter, and many of its services suppliers experience challenges and obstacles not dissimilar to those encountered by developing country providers around the globe. By progressively exploring services trade facilitation measures the UK will advance a global agenda of smart services liberalisation that will eventually benefit its own businesses.

In a nutshell, the UK should:

- pro-actively adopt and further develop the services trade preferences in EU trade agreements;
- push for a second round of LDC waiver preferences at the WTO, with a focus on facilitation; and
- focus on SME issues generally and with developing countries in mind.

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# Notes

1 See Schloemann (2012) for a summary.

2 A still progressive example is the 2008 EU-CARIFORUM EPA, which also includes regulatory preferences of interest. See Schloemann and Pitschas (2009).

3 The following draws on Schloemann et al. (2014a) and Schloemann et al. (2014b), which are both based on primary research. See also Uganda (on behalf of the LDC Group) (2014), the LDCs' 'Collective Request'. The list here includes aspects not reflected in the latter.

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