

UNCTAD Multi-year Expert Meeting on  
**TRADE, SERVICES AND DEVELOPMENT**  
Geneva, 18-20 July 2017

**Support Economic Transformation:  
Services and Economic Transformation**

by

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## Services trade and economic transformation<sup>1</sup>

### Summary

The services sector used to be regarded as a laggard sector not being able to drive economic transformation which involves increases in productivity. This view has become more nuanced over time, in part through the emergence of new empirical evidence. The evidence suggests that developing countries can and should use services in their quest for economic transformation. This does not mean a passive approach. Instead, if a country really wants to use the services sector this needs active support to avoid services becoming delinked from the other sectors or services absorbing only low labour productivity labour emanating from premature deindustrialisation.

### 1. Introduction

While much of the debate on economic transformation centres on transforming agriculture and moving into manufacturing, services are often an unexplored component of such strategies. A proper understanding of the trade dimension of services lies at the frontier of new analytical work on economic transformation. It is also important for policy-makers in low-income countries, many of whom may not regard services, let alone trade in services, as a prime focus of action on economic transformation. By contrast, we argue that policy (including policy directly affecting trade in services) can have a major impact in terms of raising the contribution of services for economic transformation.

A sceptical view often exists that services follow rather than lead transformation. However, we argue it is important for economies to follow a balanced growth path because of the explicit and implicit linkages between the various sectors. We suggest policy-makers need to update their evidence base on the linkages between sectors and consider more carefully what specific actions deserve priority. Even when promoting manufacturing exports is the top priority, the answer can often be found in trade in services policy.

The observation that an increase in incomes goes together with an increasing share of services in economic activity dates back to at least the 1940s (Clark, 1967; Fuchs, 1980; Kuznets, 1957). The earlier theoretical contributions suggested a linear path of transformation in which resources, such as labour and capital, shift from the agriculture sector to the manufacturing sector (Chenery, 1960; Chenery et al., 1986; Kaldor, 1967; Kuznets, 1966). The dual sector model by Lewis (1954) emphasises this concept of transformation in terms of shifts in labour shares between sectors. Such transformation is perceived to be positive, as the manufacturing sector embeds larger benefits than more traditional sectors (e.g. agriculture). These benefits, some of which apply also to the services sector, include increasing returns to scale and a larger income elasticity of demand, in addition to the effects of employment absorption, productivity increases and spillovers. As economies develop further and move beyond manufacturing production, an increasing share of resources flows to the services sector (Bhagwati, 1989a).

More recent evidence suggests that the growth of the service sector does not happen in a linear way. Eichengreen and Gupta (2013) suggest that the increasing share of services in the economy occurs in two

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<sup>1</sup> Note prepared for presentation at an UNCTAD services experts meeting 18-20 July in Geneva. This note summarises the analysis of services and economic transformation in Neil, B., Hoekman, B., Martin, H., Mendez-Parra, M., Papadavid, P, Primack, D., te Velde, D W (2016) 'Trade in Services and Economic Transformation', SET report, November. London: SET. We are grateful to the UK Department for Development for supporting this research, however, only the authors are responsible for the views expressed (or any errors).

waves: during the first wave, traditional services emerge at low levels of income; at higher levels of income the share of services increases further and in particular includes modern services, including communication, finance, computer and business services. Rodrik (2015a) argues that developing countries reach their manufacturing peak (measured as real value added as a percent of GDP) earlier in what he calls premature deindustrialisation, with an increasing share of activity and employment taking place in the services sector, albeit at low-productivity levels.

Balchin et al (2016) explored the literature and the available data to understand the links between trade in services and economic transformation. This note summarises that report and examines the following issues relating to services and economic transformation. It first describes three different models on the role of services, then presents selected new evidence, and finally concludes with some implications.

## 2. Models of services and economic transformation

Broadly speaking, there are three different concepts of a services-led economic transformation strategy. First, a strategy for **services at the service of the economy as a whole**, including manufacturing and agriculture, means tackling many problems in low-income countries. Access to services is low in Africa generally (e.g. electrification rates), and where there is access the costs of services are high. For example, road freight, water and electricity services in African countries are twice as expensive as in other developing countries. High trade costs will hamper the development of (manufacturing and agriculture) value chains and economic transformation. Moreover, the interest rate spread (between deposit and lending rates) is currently 2 percentage points higher in SSA than in other developing countries (both low income and middle income countries) (ERD, 2015) – an inefficient intermediation function will hinder transformation and diversification. Growth diagnostics and value chain analyses often find that specific service sectors are binding constraints to growth and development. Several studies find a positive link between the productivity of services and that of manufacturing (Hoekman and Shepherd, 2015) and between the productivity of services and that of agriculture (Doresh et al., 2010).

The second services strategy is to **maximise service export revenues and capital inflows, and see specific service sectors as contributing to growth in the scale of the economy (or as growth 'escalators')** (Ghani and O'Connell, 2014) – but sometimes this is done without sufficiently considering the links to the rest of the domestic economy. In this situation, the links to the wider economy and transformation are more complex. On the positive side, increased export revenues from, for example, information and communication technology (ICT) or financial services are welcome. However, this will also attract more short-term capital, which could be risky and inflationary. Indeed, it would increase the real effective exchange rate and draw in resources such as skills, which would hamper the competitiveness of manufacturing and agriculture. Manufacturing is traditionally the main sector responsible for the diffusion of innovation and productivity change, but it has lost competitiveness and performed poorly in much of Africa. Kenya is often suggested as a country where services have grown much faster than manufacturing (Khanna et al., 2016). Mozambique's exports of services on the other hand are not very dynamic, and constitute only 17% of total goods and services. Tourism is sometimes considered as an enclave industry with few linkages, but it can also be a major source of GDP, employment and foreign exchange as in Tanzania. There is also potential to develop backward linkages from tourism to the rest of the economy, particularly to the food and beverages processing industry, agriculture and fisheries, and services sectors (Jones, 2010). However, value chain and backward linkages from tourism to other sectors remain underdeveloped (Spenceley and Batey, 2011).

Some authors have pointed to a third services-led transformation concept, **the agglomeration of low-skill informal services around urban areas**. As people move out of agriculture, and migrate from rural to urban areas, the current type of industrialisation, especially in many African countries, creates insufficient numbers of jobs to absorb new labour market entrants (Rodrik's 'premature deindustrialisation'). These people end up in low-productivity services or are engaged in services activities with few productivity increases. We see that many African counties have urbanised without urban jobs, whereas any Asia countries urbanised with jobs. It is important that African countries experience a different type of urbanisation in the future, with high-productive industrial and services jobs.

A key overall discussion is how to move into high-productivity services or how to improve the productivity of services that feed into other sectors. Diao et al. (2017) discuss 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 in Africa) and through productivity improvements within the services sector (primarily in Latin America) and sometimes through both channels (primarily in 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.

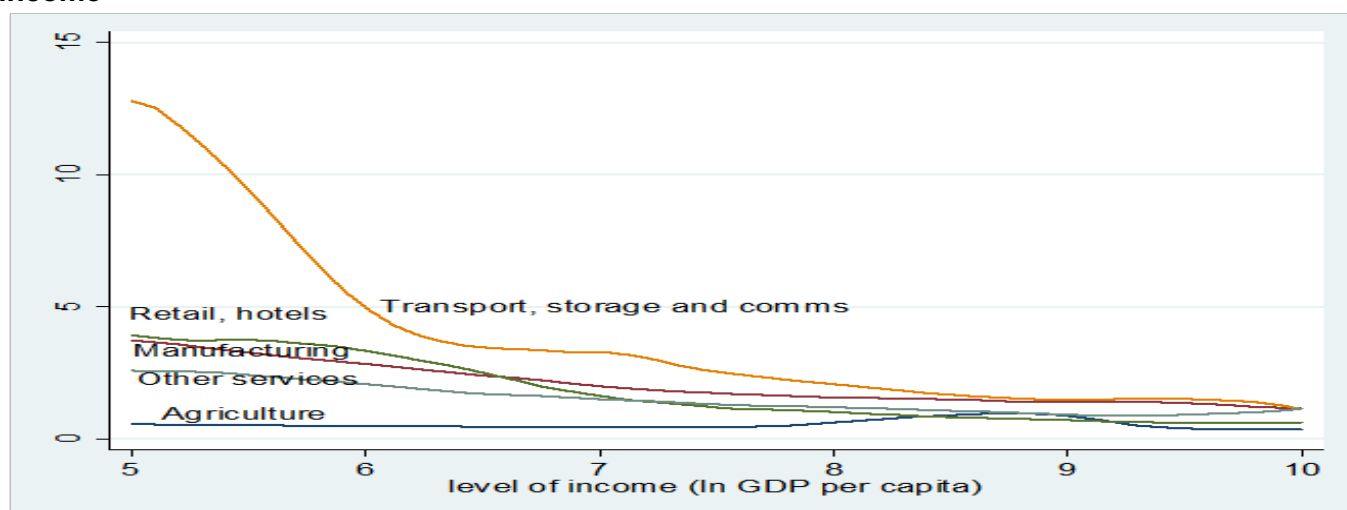
### 3. What does the evidence tell us?

The evidence tells us that there is great potential for the services sector to drive economic transformation, that there are already important direct effects from services on trade, productivity and employment but mixed linkages with other sectors and global value chains. Here we present selected evidence.

We first examine the potential for services to drive economic transformation in the poorest economies. The **existence of large productivity gaps between sectors, and service sectors included, at low levels of income suggests there are significant opportunities for structural change** (movements across sectors) to raise productivity. This means that at lower levels of income, countries can increase productivity by moving across sectors and away from agriculture; whereas at higher levels of income, the increase in productivity may be associated more with improvements within sectors. This might include functional and process upgrading in value chains. The productivity differentials between sectors decrease as levels of income increase (see Figure 1).

**Productivity differentials also exist amongst services firm within a services sector.** This is already well documented in the goods sector, but the same applies to the service sector. Low and high productivity services firms often co-exist in uncompetitive settings. The report (Balchin et al, 2016) finds large differences in labour productivity across firms within sectors in low income countries (LICs). As exporting services firms in LICs have a 46% higher labour productivity than non-exporting services firms and labour productivity of exporting services firms is significantly higher than in exporting non-services firms (and the differential is highest in LICs), -, trade plays a key role in stimulating within sector productivity change, especially for services in LICs.

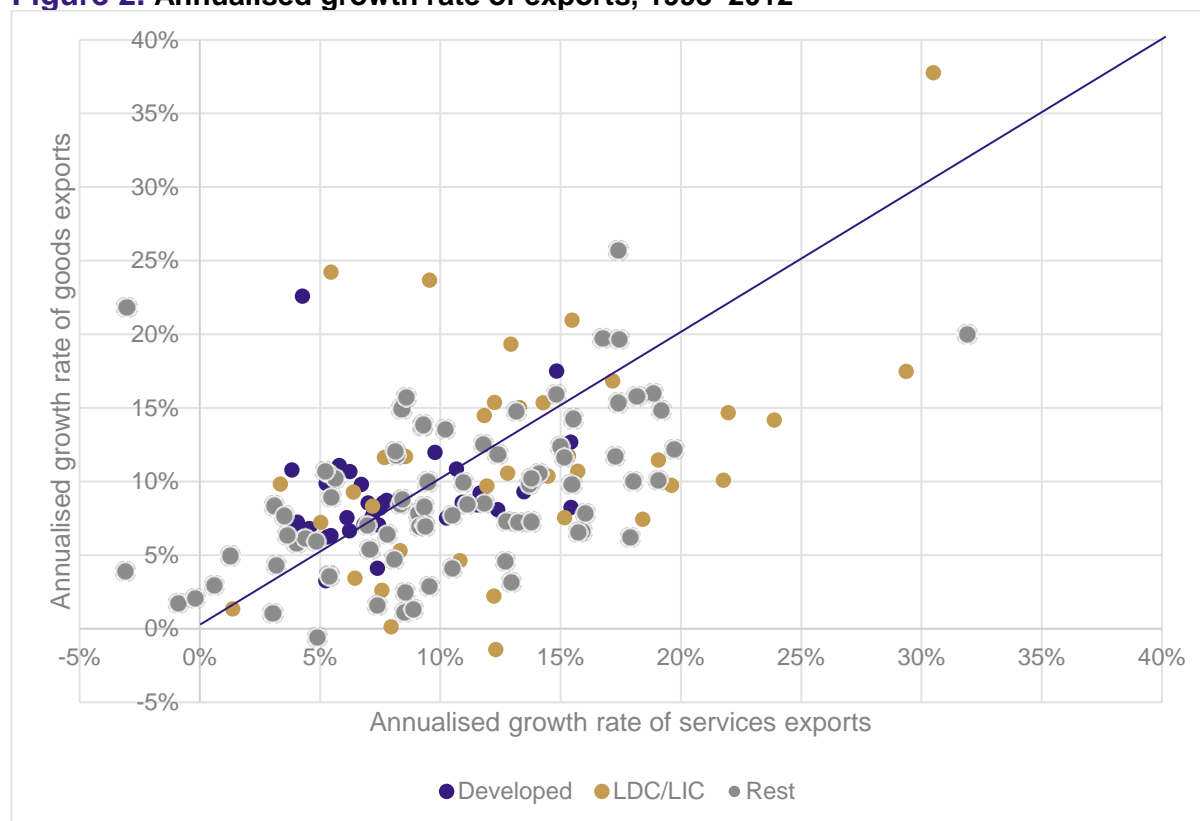
**Figure 1. Relative labour productivity levels for different sectors converge at higher levels of income**



Source: UN and ILO database, data available from <http://set.odj.org/>

**Trade in services has expanded at a faster rate than trade in goods** since 1991 in more than half of the low income countries examined. LICs services are increasingly traded as intermediates into other countries' production and increasingly as part of value chains of goods and services. Trade in services has grown markedly in LICs over the past 15 years. **Error! Reference source not found.** compares growth in the export of goods and in exports of services, obtained from Balance of Payments statistics. In many countries, especially in LICs, services exports grew faster than exports of goods.

**Figure 2. Annualised growth rate of exports, 1998–2012**

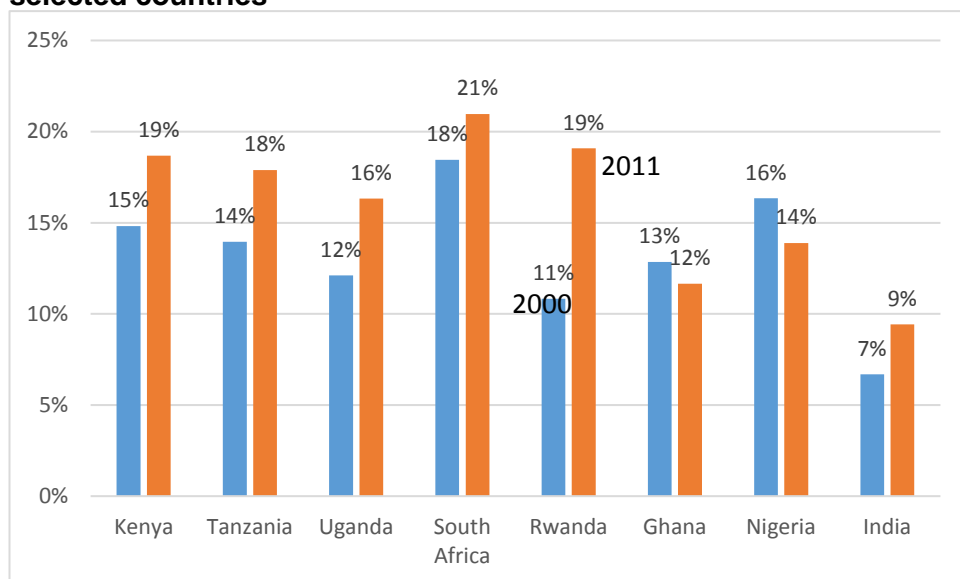


Source: Own elaboration based on services data from UNCTAD

New ODI research shows that the **share of services value added in goods exports from LICs has grown from 16% in 1992 to 22% in 2012**. Thus services are increasingly “traded” through trade in goods. Figure 3 shows the contribution of the services sector to value addition in exports for a number of African countries as well as India. It uses input–output data to calculate the amount of services needed to export agriculture and manufacturing, as well as the services value addition in services exports. The data show that the services share in value added in exports increased in all countries listed apart from Ghana and Nigeria, where increased commodity prices increased the share of the primary sector. After South Africa, Kenya holds joint second position with Rwanda, but increases have been much faster in Rwanda. This could be a sign that developing country services sectors are increasingly linked to exports, which could be good news – but at the same time it could be bad news if the costs of services have increased while services productivity has not increased (Baumol, 2012).<sup>2</sup>

<sup>2</sup> When we compare services value addition embedded in exports with total services exports, we find that the indirect contribution of services to exports via other sectors is very low in Kenya (and higher in other countries) compared with direct services exports.

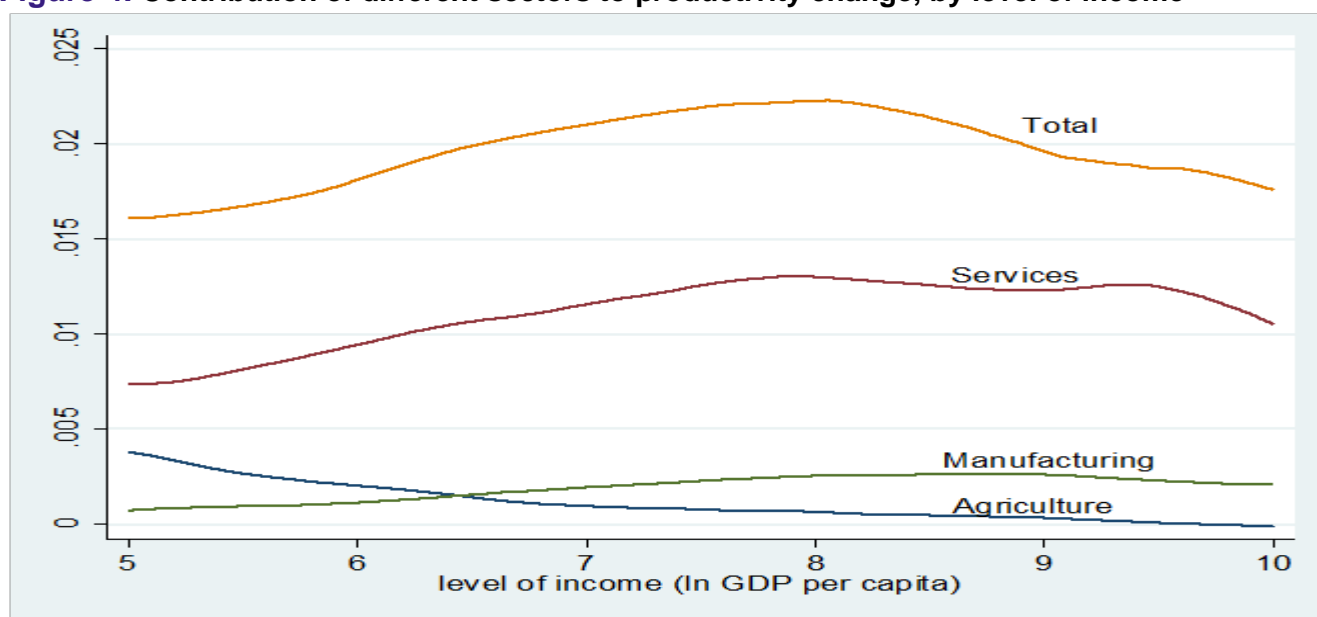
**Figure 3. Contribution of the service sectors to value addition in exports (2000 and 2011), selected countries**



Source: Own calculations using EORA database. Services include financial and business, hotels and restaurants, post and telecommunications and transport.

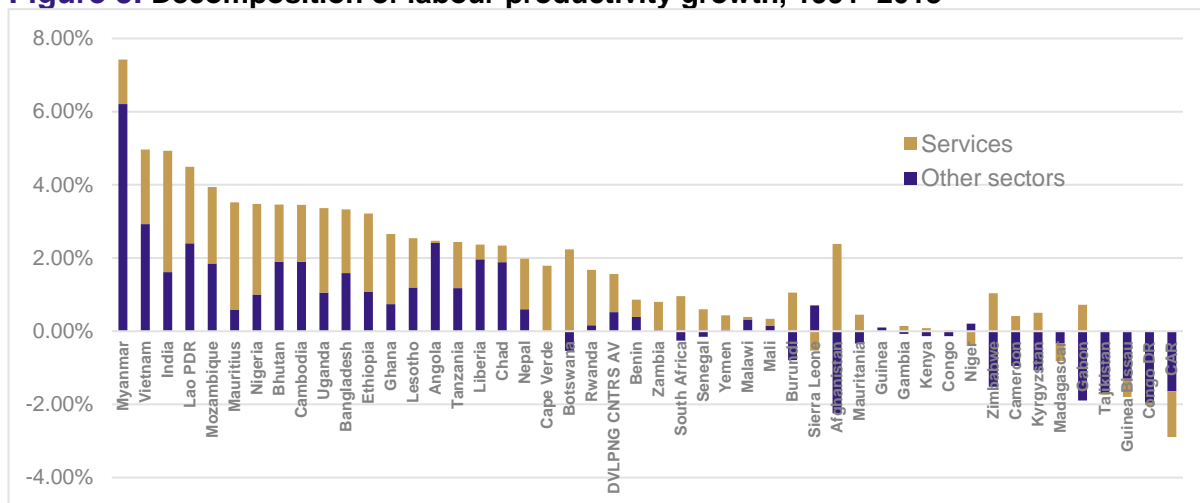
Services has also been the dominant sector in aggregate productivity change. Taking total labour productivity change and considering individual developing countries, empirical evidence suggests the growth in productivity in the services sector explains much of the total productivity change. **Error! Reference source not found.** indicates that the services sector accounts for the majority of the labour productivity change in many developing countries between 1991 and 2013. Even in countries that have experienced major expansion of the manufacturing sector, such as Bangladesh and Vietnam, the services sector is responsible for a substantial part of aggregate labour productivity change. When we take the average of productivity growth across developing countries, the services sector is responsible for two thirds of total productivity growth. This suggests that, in addition to becoming a major employer in many developing countries, services are also responsible for most of the increase in productivity observed in the past 25 years.

**Figure 4. Contribution of different sectors to productivity change, by level of income**



Source: UN and ILO database, data available from <http://set.odi.org/> Data pooled for all developing countries over 1991-2013

**Figure 5. Decomposition of labour productivity growth, 1991–2013**



Source: Own calculations based on WDI

Our work suggests there are **three broad types of effects of services** (IFC, 2014; Jouanjean et al., 2015, Balchin et al. 2016): (i) direct impact (employment, exports, GDP: a direct service); (ii) indirect impacts through input–output analysis (jobs and output in supplier industries); and (iii) second-order effects, for example productivity effects and forward linkages. Balchin et al (2016) explores the link between services and economic transformation in a range of developing country cases in five services sectors: financial services in Kenya and Nigeria; hydropower transmission services in Lesotho and Nepal; information and communication technology (ICT) services in India, Mauritius and Senegal; tourism services in Mauritius and Tanzania and trade in air transport services in Ethiopia and Kenya (comparing the performance of Ethiopian and Kenyan airlines).

The sectors illustrate the wide variety of impacts of trade in services on economic transformation, but each example is successful in its own way (see Table 1). Financial services lead to export revenues and inward FDI and employs often skilled workers, but its role as an intermediary between savings and investment opportunities drives the extent to which transformation effects are felt throughout the economy. We look at two African countries that have managed to develop a relatively large financial sector: Kenya and Nigeria. Hydropower generation and transmission services can drive economic transformation if their export revenues are used effectively and if they supply local industry with quality and sufficient electricity. We examine two small countries at different stages of use of large-scale hydropower investments: Lesotho and Nepal. ICT services have become important for many developing countries, in terms of generating export revenues and jobs but also in driving transformation through the rest of the economy. India is the frontrunner, but, in Africa, Mauritius is also an established player. Other countries are starting to explore the sector, including Senegal. Tourism services is a starter service, easy to access for poor countries, with job generation potential, but the impact of transformation depends on the cross-sector linkages. We examine Mauritius and Tanzania. Finally, we cover trade in air transport services, which is another backbone service with potential knock-on transformative effects. Here, we examine air transport services in Ethiopia and Kenya, both of which have major national airlines.

**Table 1. Summary of case study findings on transformation impacts in selected services export sectors**

Financial services <i>Kenya and Nigeria</i>	Hydropower transmission services <i>Lesotho and Nepal</i>	ICT services <i>India, Mauritius and Senegal</i>	Tourism services <i>Mauritius and Tanzania</i>	Air transport services <i>Ethiopia and Kenya</i>
<p>Generator of high-skill, high-wage employment in Kenya (also lower-skill, lower-wage jobs in financial processing hubs); but in Nigeria the growth of the sector has not been job intensive (the sector accounts for just 0.4% of total employment) or transformative.</p> <p>Rapid growth in Kenya's financial service exports, which now account for 4.6% of total services exports (although revenues are still small in value terms relative to Asian hubs), but governance in the sector in Kenya is weak there have been recent crises in the commercial banking sector (collapse of privately owned commercial banks).</p> <p>Domestic bank consolidation and injection of funds from oil exports has supported exports of Nigeria's banking services (particularly to SSA).</p>	<p>Through hydropower, Lesotho is close to reaching self-sufficiency in energy production, but Nepal still faces large domestic energy shortfalls.</p> <p>Lesotho generates large revenues through water exports to South Africa, but only limited revenue from electricity exports.</p> <p>Both countries currently only harness a small share of commercially feasible hydropower, hence there is great potential to upscale hydropower exports to emerging market neighbours and their respective regions if they are able to boost generation capacity and expand/improve interconnection infrastructure to increase transmission services.</p> <p>Concerns in Nepal that future investment inflows into hydropower generation and transmission may undermine competitiveness in other export sectors (Dutch disease).</p> <p>Potential in both countries for productivity spillovers in agriculture from hydropower generation (time savings in processing activities, rural electrification, irrigation).</p>	<p>Massive export revenues for India, but Mauritius has recorded faster revenue growth. Also good growth in export revenues from Senegal's nascent sector.</p> <p>India's offshoring IT services have had a transformative effect on employment creation (especially for women and in tier 2 or 3 cities, thereby bridging economic and social inequalities). Less substantial effects in Mauritius and Tanzania, although the ICT sector are still important employers.</p> <p>In India, multinational ICT corporations have generated positive knowledge spillovers and subcontracting R&amp;D arrangements for domestic IT firms. Also some evidence in Senegal of positive spillover effects from IT and BPO services on productivity in other sectors (e.g. through automated customs clearance, mobile phone-based services).</p>	<p>Tourism contributes significantly to GDP and employment in both countries. The direct contribution of tourism to national GDP is 7.2% in Mauritius and 3.4% in Tanzania.</p> <p>But absolute growth in tourism export revenues has been higher in Tanzania, albeit off a much smaller base.</p> <p>Direct employment in tourism contributes around 11% to total employment in Mauritius and 3.4% in Tanzania.</p> <p>Mauritius has made more progress in diversifying into other types of tourism services (medical tourism, conference and business tourism), thereby boosting linkages with other sectors. While both countries would benefit from more extensive linkages, the need is particularly urgent in Tanzania.</p>	<p>Both national airlines have successfully generated linkages with the local economy. Ethiopia Airlines' (EA) has a diversified services model (domestic, regional, international passenger markets, cargo, maintenance, repair and overhaul (MRO) services), whereas Kenya Airlines (KQ) has looked to improve linkages between the aviation and business tourism industries.</p> <p>High cargo capacity enables exports to be shipped quickly and cheaply, benefiting, for example, the cut flowers industries in both countries, but EA has greater cargo capacity. EA is well positioned to further expand provision of logistical services to the cut flowers industry (e.g. new cargo terminal, European cargo hub at Liege).</p> <p>Both carriers are significant revenue generators (larger for EA in 2015). Moreover, whereas EA registered a large profit in 2015 FY, KQ recorded a substantial loss. KQ also has higher operating costs, meaning that it has struggled to engage in competitive pricing.</p> <p>Both airlines are significant job creators, but EA employs more than twice number the number of workers than KQ.</p>

#### 4. Implications

Policy makers need to update their evidence base on the role of services in economic transformation. The day of simple, linear progression from agriculture to manufacturing, followed by services are long gone. Over the past 25 years, the services sector has become more important in terms of direct trade as well as embodied in goods trade. The services sector is the dominant sector in aggregate productivity change. The main challenge is how countries can promote the services sector in a way that support exports and jobs in the services sector (as escalator sector), whilst supporting other sectors in the economy (at the service in the economy) and not ending up as a sink of low-skill workers with few prospects (associated with premature deindustrialisation). Balchin et al (2016) discuss a range of policies to facilitate this.