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Coherent Services Trade Policy, Regulatory and Institutional Framework for Structural Transformation

by

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Towards A Coherent Services Trade Policy, Regulatory and Institutional Framework for Structural Economic Transformation

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Profound shifts in the trade–growth nexus have occurred in recent years. At the current time, one could say that the international trade community is contemplating a glass half full (or empty) scenario. For example, on the one hand, there is an acknowledgement that the wave of fragmentation which underpinned the GVC mechanism in recent decades has reached its limit (Hoekman, 2015). This realisation, along with other noticeable trends such as the outpacing of growth in trade in services compared to goods, has prompted a period of introspection in the international trade community.

On the other hand, since the great recession and global trade slowdown, trade in services have shown themselves to be far more resilient than trade in goods. Some have even gone as far as to say that not only are exports of services gaining momentum, but a new wave of trade globalisation (Loungani et al., 2017) - or what we have termed "future fragmentation" process - is just getting started.[1] This is because of a rapid acceleration in cross border services trade through Mode 1 of the General Agreement on Trade in Services (GATS). Digital trade now accounts for around one quarter of total world exports; of which, developing countries account for around 20 percent (*Ibid*).

There is a general recognition that the big 21st century shifts in International Trade are within the realm of services trade (Drake-Brockman, 2017). They include:

- The transformation to digitalisation (the fourth industrial revolution) and digital trade (data flows); and,
- the outsourcing of services – the services revolution.

These two major transformations should be considered alongside a more general rise in the intensity of services trade within economies (or "servicification"); the rise of intermediate goods and services within global trade; and finally, the complementarity of trade and investment. All of these developments require critical reflection on the adequacy of public policy frameworks to guide continued structural economic transformation, which is driven by technological progress, in the future.

Reflection on policy frameworks

As the rise of global trade value chains has demonstrated, trade in goods and services are deeply interconnected. It is the services which accompany trade in goods which make the greatest impact in terms of *value added*. This is the crucial aspect of trade, which drives economic growth. Since the global financial crisis when international agencies were charged with the imperative of better understanding contemporary trade, new understandings of the economic importance of trade in services have arisen. As a result, we have now moved towards the measurement of trade in the same way as GDP: moving away from the uncomfortable juxtaposition of gross numbers for trade and value-added estimates of GDP (Low, 2016). The new value-added estimates of trade have transformed our appreciation of the contribution made to total trade by services.

However, despite these advancements, data limitations for many of our members are particularly acute and similarly, capacity constraints. Generally, the realm of services trade is plagued by major data limitations across all modes included in the GATS framework. Getting data on trade flows is next

[1] This has also been referred to as the Fourth Industrial Revolution.

to impossible for African countries for Mode 1 (cross border trade, mostly digital trade) with any sectoral disaggregation, not to mention Mode 3 (commercial presence).[2]

Whilst Commonwealth members collectively have been less protectionist than others[3] - as analysis of the "Global Trade Alert", a perception based survey suggests - there is a need for more systematic evaluation and expansion of Commonwealth country coverage in globally recognised services policy review mechanisms.

In addition to these major data constraints, we have to change mind-sets. We are still operating within the context of separate regulatory frameworks for trade in goods and services. It is becoming clearer within the realm of services trade that we urgently need to catch up with rapid advancements regarding the modus operandi of conventional services delivery. Major technological advancements are on their way and these will dramatically accelerate the transformation of mechanisms of services delivery.

Are Regulatory Frameworks fit for Purpose?

Nowadays, it is recognised that a tendency to define regulatory structures for goods, services and investment in separate policy compartments interferes with the relatively seamless nature of interaction among these aspects of GVC activity (Low, 2016). Within the context of contemporary trade patterns as manifested in GVCs, rules across different modes of services supply need to be defined and applied with greater consideration of their interconnectedness, rather than being formulated in silos.

The new policy framework to maximize the gains from GVC integration is one in which a "whole of supply chain approach" must be adopted (Taglioni, et al., 2017). This reflects the fact that in a world economy where GVCs play a dominant role, imports matter as much as, if not more than, exports, and in which the flows of goods, services, people, ideas, and capital are interdependent and must be assessed jointly (*Ibid*).

As we have tried to emphasise within a recent publication titled "Future Fragmentation" within policy frameworks the assignation of policies individually to modes of supply can reduce neutrality.[4] This can serve development objectives in certain cases, but also potentially undermine them. For example, policy impediments that affect services-related participation in GVCs tend to crop up more often in relation to investment (Mode 3) and the movement of people (Mode 4), with the potential for negative effects on GVC participation and upgrading processes (Low, 2016). These restrictions may generate the incentives to supply via digital trade (Mode 1) as compared to alternative means, which could stimulate stronger linkages within domestic economies.

Although in principle, movement towards a "whole of supply chain approach" and reconciliation of regulatory structures for good and services seems relatively straightforward within country, the international community has to confront the fact that understanding company ownership structures, as well as where 'substantive activity' takes place through services trade are still not are clear cut as we would hope. Invariably, this has major implications for public policy aspects like taxation, as well as the design of a "Coherent Services Trade Policy, Regulatory and Institutional Framework for Structural Economic Transformation". The conventional profit-investment nexus has been profoundly altered through the globalisation process we have experienced in recent years. Therefore, regulatory cooperation needs to be given greater priority in intergovernmental discussions (Drake-Brockman,

[2] Based on discussions with Dr Ben Shepherd, Developing Trade Consultants.
[3] Based on analysis of the total number of implemented protectionary or discriminatory measures applied to trade (see: http://www.globaltradealert.org/).
[4] See the contribution by Low (2016).

2017). This cooperation will need to be operationalised at different levels and of course, within different fora: public and private. There will be different institutional frameworks, with implications for regulatory reform and policy formulation.

A number of our Small States are providers of high-value services to Multinational Enterprises through their role as hosts of International Financial Centres (Rutherford, 2017). Their development of comparative advantages as IFCs resulted from an economic diversification agenda which recognised the barriers to other forms of entry into manufacturing-GVCs was not economically feasible. However, although their position as IFCs was advantageous in the past, it is coming under increasing strain. Business models are changing. Many of our Small States are in the process of adapting to important regulatory shifts. This includes addressing the regulatory shortfalls which lead to the global financial crisis and the Basel regulatory reforms. This process has also affected areas such as correspondent banking for a number of our Small States - a key enabler service.

As a result, there is a need for our Small States to adapt. This includes building on existing comparative advantages and capabilities to facilitate movement into other high-value services, as they begin their fragmentation processes. Given this imperative, we have begun to explore future fragmentation processes including within the realm of services trade. This includes the likely movement of high-value services, the outsourcing of back office functions, through the services revolution.

Structural Economic Transformation

Because almost one fifth of Commonwealth countries are Least Developed Countries (LDCs) we have reviewed recent performance and results suggest the services export basket of LDCs has become more concentrated over time.[5] While travel (tourism) is the main source of services revenue and registers a net surplus, Mode 4 (presence of natural persons) is an important source of net exports but cannot be satisfactorily measured. The value of LDCs participation in royalties and licence fees remains negligible and in some cases has declined. This may be a reason for concern since many Island LDCs often rely on foreign fishing vessels.

Other "other commercial services" (e.g. communication, construction) provided by the LDCs has progressively shrunk (WTO, 2015). Overall, the LDCs services trade deficit increased by more than four times (in nominal terms) between 1995 and 2013 (*Ibid*). Other data discrepancies are also clear within the realms of transportation (are port facilities included?) and construction (e.g. Afghanistan is a major exporter?). Generally, the available evidence is suggestive of increasing specialisation within services sectors at very low levels of income. As emphasised by Rodrik (2015) the profound implications of these trends for the achievement of structural economic transformation remain under explored within the literature. And, there is no historical precedent. Although this pattern is now becoming obvious in some of the LDCs, it has been the case for some Commonwealth Small States for decades.[6]

Future Fragmentation Processes

In our recent work on future fragmentation processes, as well as taking stock of past performance, we reflect on potential dynamics and future fragmentation processes. The chapters collated in this publication provide for a more careful examination of GVCs within which our members specialise at the sectoral level: manufacturing, services and commodity trade, including within the realm of the oceans economy. Given that the overwhelming majority of the 52 Commonwealth member countries

[5] These findings are included in the LDC Monitor IV publication titled: "Achieving the Istanbul Prograame of Action by 2020" (see: http://ldc4monitor.org/).

[6] The profound implications of GVCs for the achievement of structural economic transformation continue to be explored within the literature. Structural economic transformation can be broadly defined as the reallocation of economic activity across three broad sectors (agriculture, manufacturing, and services) which accompanies the process of economic growth (Kuznets, 1966). This is no longer the case since the ascendency of GVCs.

are small states, 45 are oceans states and around one-fifth are least developed countries, understanding how dynamics are unfolding at the sectoral level is critical to encouraging more gainful GVC participation.

In view of the aforementioned trends, in order to maintain competitiveness in an increasingly automated and ICT-dominated environment, countries and companies need to be part of global production and knowledge networks, ensure regulatory certainty and take advantage of commonalities where they exist. Some of the analysis undertaken for the future fragmentation workstream suggest that improvements in ICT connectivity has the potential to boost trade in GVCs by four times the global average for our members.

As we know distance exerts a strong influence on GVC participation, due in part to the costs of co-ordination and a reduction in the exchange of tacit knowledge arising from interactions between buyers and sellers; distance can, therefore, reduce the potential for 'learning by exporting' (Sturgeon et al., 2017). Although small states may find it easier to insert themselves into GVCs through specialisation in a narrow range of tasks, overcoming some of the challenges of distance requires strong interventions designed to foster exposure to high-value activity hubs that specialise in research and development (R&D) and marketing, with targeted skill development and active linkage development.

In this regard, particular attention must be paid to information and communications technology (ICT) and connectivity. These technologies transform not only conventional business models but also how buyers and sellers interact (Keane and Bambill-Johnson, 2017). As described by Taglioni et al., (2017) cutting-edge digitally powered goods and services are likely to be outsourced based on sophisticated contractual arrangements. This means that areas such as contract enforcement and the rule of law are again important foundational areas, and important services.

Our Next Steps

There was considerable reference to both the opportunities as well as challenges of digital trade at the Commonwealth Trade Ministers Meeting (CWTMM) convened in March 2017. Other themes which arose in the discussions included GVCs, services trade more generally and innovation. We have interpreted the latter as not only conventional research and development but also greater consideration of innovation systems, e.g. specifically devised to enhance interactions between public and private actors such as structured dialogue between business associations and policy makers.

There are areas of mutual interest and where enhanced co-ordination between member states could enhance trade gains. Because the ability to transmit tacit knowledge through Commonwealth trade, finance and investment networks is inherent in the trade cost advantage shared by members - which exists without formal collaboration - it suggests the sharing of already known best practice could further enhance the gains from more concerted action. In view of the demands expressed since the CWTMM (2017) we are following up with more technical discussion this coming September. This process will then feed into the Commonwealth Heads of Government Meeting in April 2018.

We are working towards addressing the data limitations which hinder effective policy making within the realm of services trade for our members. These needs are particularly acute for our members in the Caribbean, Pacific and the LDCs. We are considering piloting alternative approaches, including working with private sector bodies such as the City of London. Innovative approaches such as "Mode 5" approaches to services liberalisation could also be pioneered within RECs. Finally, on Brexit our consultative processes continue. Whilst the UK government has recently stated that it will adopt the EU's EBA regime for LDCs, it is not clear whether the same schedule as the EU will be adopted for services (and whether there may be any preference erosion because of a more liberal schedule adopted by the UK towards third-parties).

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