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Policy dimensions of trade in services and economic transformation

by

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This note summarises the policy dimensions in Balchin et al (2016)[2]. It highlights a series of targeted policies to boost the effect on economic transformation of trade in services in low-income countries (LICs)[3]. Other policies, not target to the services sector, can be enablers for its development and maximise their effect on economic transformation. Finally, a series of cases studies in LICs illustrate some successes as well as some complications to boost the transformational effect of trade in services.

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 be found in trade in services policy.

Balchin et al (2016) and te Velde (2017)[4] explored the literature and the available data to understand the links between trade in services and economic transformation. They found that the productivity differentials are large and occur across countries, across services and other sectors and between firms within services sectors. This suggests there are a lot of opportunities for economic transformation in the services sectors. However, the debate about the determinants of these differentials is far from being settled and more detailed surveys and studies are needed.

They found also that services play a key role in aggregate productivity change and successful countries have seen productivity change in services and other sectors at the same time. This balanced growth story is not surprising given the many links (qualitative and quantitative) between services and other sectors. This confirms previous conceptual discussions with new empirical evidence on how services are embodied in goods trade – developing manufacturing without quality services is difficult if not impossible.

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[1] Note prepared for presentation at an UNCTAD services experts meeting 18-20 July in Geneva. This note summarises the policy dimensions 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).

[2] Balchin, N., 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

[3] Our definition includes all those countries classified as LICs by the World Bank plus other countries that were reclassified recently as low-middle income countries. These include Bangladesh, Pakistan, Myanmar, Kenya, Zambia and Tajikistan

[4] te Velde, D W (2017) 'Services trade and economic transformation', Note prepared for presentation at the UNCTAD services experts meeting 18-20 July in Geneva, July. London: SET

In addition, they explore the different experiences on economic transformation in the services sector and identified the ways in which services sectors contribute to economic transformation. For instance, there is heterogeneity in the impacts of different services sectors on employment. Certain services are important revenue and foreign exchange earners (hydropower, tourism, information and communication technology (ICT)); and, in some, visible linkages with the rest of the economy are more prominent (e.g. suppliers in the tourism sector). Finally, some sectors are key for supporting productivity/trade in other sectors (e.g. ICT, logistics, finance) and these linkages are perhaps less visible

As important as documenting the relevance of trade in services in transforming the economies of LICs is to highlighting the different policies that can enable and foster economic transformation. Some of these policies can be targeted to influence the actions of stakeholders trading in services in LICs, whilst others may operate horizontally, enabling the flourishing of a service sector that contributes to the economic transformation.

TRADE POLICY (DIRECTLY AFFECTING TRADE IN SERVICES) IN LICS

Firm-level evidence suggests exporting is good for productivity in services firms. This means that, as it is in the case for goods, openness (defined as the extent to which firms export) is related to transformative effects in the services sector. Broadly speaking, we have initial evidence that suggests that export promotion is also likely to be important for services producers and economic transformation more generally.

As imported services are an important part of the value added embedded in a country's goods exports, it is also necessary to remain open towards imports in services.

Openness to foreign direct investment (FDI) is also important. The effect of foreign ownership on labour productivity is large and positive, although the effects in the services sector in LICs are not as strong as elsewhere. The effect of foreign ownership is not homogenous within services and foreign ownership in some services sectors has higher labour productivity.

Trade policy plays a role and is frequently crucial in opening markets, regionally as well as internationally (e.g. in airline services).

An open service sector will increase competition and help domestic services firms become more competitive.

In the selected case studies, trade in services is mostly regional. In these contexts, it is important to liberalise trade in services within individual regions. Trade in hydropower services is a good example of this for landlocked (small) states.

OTHER POLICY IN LICS

• The presence of certain basic factors is key for success in some services sectors (e.g. natural resources/endowments and structural factors for hydropower (Lesotho, Nepal) and tourism (Mauritius, Tanzania) or a skilled workforce and telecommunications infrastructure for ICT).

• Active services policy can play an important role in promoting exports of services (e.g. the development of software technology parks (India) and a cyber city (Mauritius) to support ICT services).

• Iterative, adaptive and flexible approaches (where governments and other local actors experiment with policy interventions and adapt when needed) have proven successful in setting up mechanisms to coordinate investment in certain services sectors (e.g. hydropower in Nepal).

• An appropriate domestic regulatory framework for services is important to promote competition and improve efficiency (as, for example, the liberalisation of domestic regulations in the telecommunications sector, allowing entry of new players, has shown in Mauritius and Senegal), thereby ensuring services exports are competitive in international markets.

• Regulation and political economy considerations are particularly important in large services sectors.

• We find the productivity of services firms in LICs that supply exporters is low on average, so there is economic transformation potential by raising the productivity of these services firms, which will have knock-on effects on trade in goods and services, etc.

These suggestions on liberalisation, however, need to recognise the complicated nature of the regulations that affect trade in services. Many regulations are not border measures but are, instead, embedded in the respective domestic regulatory frameworks. These regulations may be reasonable and perfectly justifiable by addressing certain standards of quality (i.e. certification of medical practitioners). But they can constitute a formidable impediment to trade in services. Consequently, the policy space in this case may be particularly constrained and more innovative and alternative approaches may be required to overcome the constraints to liberalisation.

There are clear examples of services sectors of countries managing to overcome constraints to liberalisation. In the tourism sector, for instance, several developing countries have implemented domestic regulatory frameworks that are non-trade-distorting. For example, to support tourism services, Mauritius, South Africa and Uganda have begun to liberalise air access (although not completely) together with some broader regional initiatives, Cape Verde has implemented a liberal regime for tourism support services such as transport handlers, Tanzania has encouraged privatisation and The Gambia has been open to foreign ownership and FDI. In ICT, Mauritius and Senegal have made extensive efforts to liberalise their telecommunications sectors, allowing entry of new players and ending monopolies and exclusive rights, thereby improving efficiency and making their ICT services exports more competitive internationally.

There is also a range of mechanisms available to negotiate better access for developing countries' services exports. At the plurilateral level, large developing countries such as India and China are actively negotiating accession to the World Trade Organization General Procurement Agreement, which may boost their market access to public works and services contracts in GPA member countries. Regional negotiations are also important, particularly for facilitating mutual recognition of services sector qualifications to facilitate services trade, such as that achieved through Mutual Recognition Agreements among the Association of South East Asian Nations. Finally, bilateral services negotiations have very occasionally, with many qualifications, facilitated access for mode 4 services from developing countries (e.g. in Chile's free trade agreement (FTA) with the US or Colombia and Peru's FTA with Canada). This is particularly important for labour-intensive services sectors such as ICT, health and education where developing countries have a comparative advantage.

CASE STUDIES

FINANCIAL SERVICES IN KENYA AND NIGERIA

Regional integration has helped Kenya develop onshore and offshore financial hubs, whereas the Nigerian banking sector has depended greatly on the injection of funds from oil exports into the economy. Kenya's domestic capabilities in the financial sector are greatly helped by mobile technology, such as M-PESA, but Nigeria's trade in financial services has been hindered by economic instability and an absence of corporate governance. The financial sector in both countries has failed to link sufficiently with the domestic real economy, and regulation of the sector has been too light-touch.

Policy-led integration with EAC has boosted Kenya's trade in financial services. Nigeria has no clear strategy to promote trade in financial services, and a lack of integration has hampered the development of the sector. Export development programmes are mostly directed at goods rather than services (financial services excluded).

HYDROPOWER IN LESOTHO AND NEPAL

Both countries have abundant water resources and the necessary topography to support the generation of hydropower. But the considerable hydropower potential in these countries can be developed fully only in a regional context. The ability of Lesotho and Nepal to export electricity to their regional neighbours relies critically on the further development of a regionally interconnected grid infrastructure to facilitate transmission services. This is particularly urgent for Nepal, whereas Lesotho could exploit the existing interconnections between Southern African Development Community (SADC) member states through the Southern African Power Pool (SAPP). In addition, because we are dealing with large-scale investments in small countries, it is even more important to consider the governance and coordination arrangements around attracting investment and investing the revenues in transformative development. This requires a flexible and adaptive approach where governments and other local actors experiment with policy interventions and adapt when necessary (and there is evidence such an approach has begun to pay dividends in Nepal, where it has proven successful in setting up a mechanism to coordinate investment in the hydropower sector).

Both countries have bilateral trading arrangements with large emerging market neighbours (South Africa, India). Nepal's trade in electricity with India is facilitated through transmission interconnections at the border, but these remain limited. Hydropower exports also affected by India's restrictions on electricity imports (including import tariff, surcharge tax).

ICT IN SENEGAL, MAURITIUS AND INDIA

A number of basic factors need to be in place to take part in exports of ICT services, including a skilled workforce and telecommunications infrastructure. ICT is already an open sector, but active policy also plays a fundamental role. The government of Mauritius, for example, has proactively developed a cyber city, attracted investment and helped upgrade the sector. The Indian government has developed software technology parks (which provide access to high-quality internet and facilities to support the competitive delivery of IT and IT-enabled services and have helped attract FDI). In Senegal, the sector is markedly less developed, and much still needs to happen to develop the necessary ICT-related infrastructure and human capital required to drive its development. In the longer term, the potential of ICT to contribute to the economic transformation of the country depends on the extent to which ICT services enhance productivity and the sector's linkages with other sectors.

Liberalisation of the telecommunications sector to allow entry of new players (and reduction of tariffs on computer imports in Senegal) was important for recent ICT services development in Senegal and Mauritius. India still faces work permit issues related to mode 4 trade in IT services.

TOURISM IN MAURITIUS AND TANZANIA

Tanzania has enjoyed higher absolute growth in tourism export revenues, albeit off a much smaller base. Mauritius has made more progress in diversifying beyond sun, sea and sand tourism (beach holidays) and into other types of tourism services, principally through growing medical tourism and business tourism subsectors. Relatively good quality tourist-related infrastructure and a skilled labour force support the tourism services sector in Mauritius. In contrast, in Tanzania deficiencies in the availability and quality of tourist-related infrastructure and a shortage of relevant skills in the domestic economy adversely affect tourism services exports. In both countries, developing the sector further depends on appropriate skills development, finding new markets to further expand tourist arrivals, using open skies policy with liberalised bilateral agreements (Mauritius, for example, could do more to liberalise air transport services) and building better linkages between foreign companies and local firms.

Although positive progress has been made in liberalising the air transport sector in Mauritius, it still maintains stringent protectionist policies over its skies compared with Tanzania, resulting in relatively limited connectivity by air. Tanzania has made important progress in liberalising air travel, marking it as an easily accessible tourist destination with good air transport connectivity between domestic locations.

AIR TRANSPORT IN KENYA AND ETHIOPIA

Both Kenya Airways (KQ) and Ethiopian Airlines (EA) have been successful in attracting tourists and developing other sectors, such as flower exports, which are crucial for economic transformation. EA's diversified growth model (involving the provision of domestic, regional and international passengers transport services, cargo services and maintenance, repair and overhaul (MRO) services) facilitates strong linkages between the company and the rest of the economy, bringing greater opportunities for economic transformation. The main factors behind the success of EA's large expansion plan include its aggressive targeting of the Asian market, its numerous bilateral agreements, its successful governance structure and the unregulated labour market in Ethiopia, which have helped keep costs low relative to competitors (including strong competition from the large Middle East airlines in the African market). Recent estimates suggest EA's fares on its intra-African routes are between 10% and 21% higher thanks to restrictive bilateral agreements that exclude other competing airlines. KQ has not been as successful in capitalising on growth in air travel in the Asian market, nor has it managed to expand its regional network as successfully. Furthermore, higher operating costs mean KQ has struggled to engage in competitive pricing. This meant it was unable to bounce back from the negative shocks of the losses incurred from fuel price hedging, the reduction in international visitors following the 2014 terrorist attacks in Nairobi and the fall in regional demand following the fiscal crises in oil-exporting countries. KQ also remains heavily reliant on government funds.

Numerous bilateral agreements with other countries have helped EA price competitively. It has also been successful in expanding its regional network through strategic partnerships within Africa, thereby enhancing access to Western, Central and Southern African markets. Furthermore, partnerships with Asian airlines have helped EA expand into the Asian market. Both airlines have code-sharing agreements and partnerships with other airlines (e.g. StarAlliance for EA).