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Developing trade in services: a framework

Towards a framework

Developing trade in services is a complicated process and many countries do not have an explicit policy for this area or a detailed, overall plan to develop trade in services. Trade in services, a catalyst to promote economic diversification away from traditional sectors, involves a fundamental shift in mindset throughout the whole economy along with different types of actions. Here small countries might be at an advantage, because in theory they are more flexible to introduce new economic policies (though this will also depend on political systems).

The constraints to trade in services are complex and go beyond traditional trade constraints. A policy-relevant approach is to distinguish among three sets of constraints (te Velde, 2006). These include:

- supply-side or domestic capacity constraints;
- the domestic regulatory and institutional framework; and
- external constraints (for example, international trade in services agreements).

This approach is useful for several reasons. First, it provides an analytical lens and can be used to identify the myriad of constraints to trade in services. Second, it delineates clear responsibilities for different stakeholders involved. Co-ordination between the public and private sectors is required to ensure that the constraints identified are properly tackled. Finally, unlike in the case of trade in goods, domestic regulatory frameworks can be a key. Thus, the approach points to what types of interventions are appropriate. In Section 6, the authors examine the performance of exports of services in a number of sectors in Botswana, Mauritius, St Lucia, Singapore, the United Arab Emirates and Vanuatu in the context of these three sets of constraints.

(i) Supply-side constraints

Supply-side constraints on the export capacity include:

- **Size**: The limited size of the domestic market raises the need to increase market access to reap the economies of scale. Some services have a minimum efficient scale, which is greater than the size of the domestic market in many small states.

- **Information:** A majority of exporters of services in small states are small-scale producers (Chaitoo, 2007). These exporters operate on a small scale and face a lack of information on markets and regulations. In addition, they are unable to market their products, which may lead to a lack of information on the consumer's side as well. Services products are often 'experience' goods, where sales depend on a track record of international credibility and profile. It can take time to build up international repute and credibility, especially because the fixed costs of establishing credibility are relatively costly for small services providers.
- **Technology**: Exporters in small states have limited access to (new) technology, which reduces their competitive edge.
- **Financial resources**: Service providers, especially those operating at a small scale, face constraints to access financial resources.
- **Human resources**: Some services, such as professional business, financial and educational services, are skill intensive and require appropriately trained staff. However, most small states have a poor tertiary education record and/or high rates of emigration, which severely limits the availability of human resources.
- **Infrastructure**: Small states are typically characterised by a weak physical infrastructure (such as unpaved roads, underdeveloped ports, poor connections by air etc.) and poor information and communications technology (ICT). Poor infrastructural facilities restrict domestic as well as foreign investment in the economy.

(ii) Domestic regulatory framework

The regulatory framework in small states is generally out of date and in some cases – for instance, when new sectors such as offshore schools or recreational activities emerge – an appropriate regulatory framework might be entirely absent. Standard operational matters are tedious for businesses with heavy reporting and administrative requirements. It is often difficult and time consuming to register a new company and in many cases regulations do not permit certain types of business operations.

Various government departments are involved in regulating and developing services for exports, and need to co-ordinate their activities. In order to achieve a welcoming investment climate, co-ordination is required not only among government agencies but also between the public and private sectors on regulatory issues relevant for export of services.

(iii) External constraints (trade barriers)

Following Hoekman and Braga (1997), trade barriers can be grouped into the following[1]:

- Quotas (for example, the number of flights on a route may be restricted);
- Local content and prohibitions (for example, production activities and supplies may be restricted to nationals only);

- Price-based instruments (for example, visa fees and entry/exit taxes or subsidies), which tend to hit small traders more than large scale traders;
- Standards and accreditation requirements (for example, non-recognition of degrees/certificates/diplomas obtained in foreign countries);
- Licensing and procurement requirements;
- Discriminatory access to distribution networks; and
- No commitment on mode 4 of supply of services (modes of supply are explained below).

Promising services sectors

Services can be grouped into various categories. The General Agreement on Trade in Services (GATS) defines around 160 service sub-sectors and groups them into four broad categories:

i) Infrastructure services (for example, communications, financial, transport and energy);

ii) Social services (for example, education and health);

iii) Business-type services (for example, distribution, professional, tourism, construction, engineering and environmental services); and

iv) Other services (for example, recreational and cultural).

Services can be delivered to other countries in four ways, known as modes of supply. These are:

- **Mode 1: Cross-border supply**. Cross-border supply occurs when a service crosses a national border. An example is the online purchase of insurance or software by a consumer from a producer abroad. This is included in the Balance of Payments (BoP) of a country. World trade in this mode amounted to US$1,000 billion in 2000 according to WTO estimates.
- **Mode 2: Consumption abroad**. Consumption abroad occurs when a consumer travels abroad to consume from the service supplier as with tourism, education or health services. This is also included in the national BoP statistics. World trade in this mode amounted to US$500 billion in 2000.
- **Mode 3: Commercial presence**. Commercial presence refers to the services sold by a foreign-owned company in the host economy (for example, services provided by the branches of foreign banks). These services are not included in BoP data, but are sometimes added to the foreign affiliate trade in services (FATS) statistics. World trade in this mode was estimated to be US$2,000 billion in 2000.
- **Mode 4: Temporary movement of natural persons**. Temporary movement of natural persons occurs when independent service providers or employees of a

multinational firm temporarily move to another country to provide services. This is not captured by trade data, but is often proxied by compensation of employees and remittances in the BoP statistics. World trade in this mode was estimated to be US$500 million in 2000.

Not all service categories are suitable for exporting and some services need large markets to operate. Some examples of existing successful service exporters are listed in Table 5.1, which also includes small states in certain sectors, for example, Mauritius in tourism and finance, and the Caribbean in tourism, offshore medical schools and health-related services.

Key services differ across countries according to their comparative advantage. There are several ways to identify such services in small countries, and the following indicators are important:

Table 5.1 Examples of successful developing country service exporters

		Examples in developing countries
1)	Business services	India is the main Business Processing Outsourcing (BPO) centre, but the exports of various African countries such as Mauritius, Ghana and South Africa have also increased
2)	Communication services	Only few examples of successful international expansion in the telecommunications sector in Africa, mainly from large developing economies that are able to exploit large domestic markets (for example, South Africa and Egypt)
3)	Construction and engineering services	South Africa in the US
4)	Distributional services	South Africa in rest of Africa
5)	Educational services	South Africa and Brazil as regional hubs for tertiary education, and the Caribbean islands for offshore medical schools
6)	Financial services	Financial services exports from Mauritius and the Caribbean
8)	Health and social services	South Africa, India, Thailand and the Caribbean are important competitors at the international level
9)	Travel-related services	Several successful examples in developing countries, where tourism is one of the main export sectors (for example, the Caribbean countries, Mauritius, Tanzania and Kenya)
10)	Recreational, cultural and sporting services	South Africa as a sports event organiser
11)	Transport services	Air cargo hub developed by Kenya and South Africa

- **Current or potential capacity to export**. This depends on, among others:
  - the local and export market size and the growth potential;
  - land, labour and other resource availability and cost;
  - capacity of production expansion; and
  - transportation costs and availability.
- **Competitiveness vis-à-vis other exporters of services.** For instance, India and South Africa have had strong growth in IT-enabled services, and small states need to compete with them. Similarly, Philippines, South Africa, India and others are actively training nurses to work overseas.
- **Sectoral developments in the import markets**. For example, moves towards offshoring services or concentration in tour operators.

Based on these indicators, a number of services could be identified as important for small states. For example, research in the context of the Caribbean (for example, te Velde, 2005b) shows the significance of:

Tourism: The World Tourism and Travel Council (WTTC) finds that tourism contributes 15 per cent to GDP and 16 per cent to employment in the Caribbean region. It is the main foreign exchange earner in many Caribbean countries, which export different types of tourism, ranging from mass tourism (for example, in Barbados) and cruise ships (several islands and Belize) to eco-tourism (for example, Suriname and Belize) and cultural tourism.

Financial services: The offshore financial sector has contributed significantly to the exports and GDP of the Caribbean region. For example, in the early 1990s, the sector contributed about 24 per cent to services exports and 2 per cent to GDP.

Education services: There are more than 100 partnerships between Caribbean and UK/US institutes. There are many medical offshore schools in the region (Brandon, 2003). Education services are also supplied through (temporary) movement of people – for example, Caribbean countries were responsible for 10 per cent of non-European Union (EU) work permits for teachers in the UK during 2001-2003.

Health services: The importance of health tourism (for example, surgery) is well known for the Caribbean region.

Business IT services: The market for offshore services such as IT and other back-office operations is increasing rapidly worldwide. The Caribbean has made inroads in the sector, exporting mainly to the US. Jamaica's export processing zones (EPZs) include about 15 companies, which employ over 5,000 workers in areas such as helpdesks, travel reservations and software development. A few Jamaican companies also specialise in data processing, servicing customers in New York, Toronto and London. Trinidad and Tobago has also entered the market for offshore services. It has a number of call centres employing around 1,000 workers. St Lucia has a major call centre (employing more than 200 workers) with plans for expansion.

Cultural services: Three types of cultural services are emerging in the Caribbean:

i. Music: The music industry in the Eastern Caribbean based on festival tourism is worth US$ 20 million, of which the St Lucia Jazz Festival contributes about US$ 14 million. Jamaican Reggae was estimated to be worth US$ 1.2 billion in 1995 and the music industry in Barbados, which has grown with the success of soca artists, is estimated to be worth US$ 15 million.

ii. Street festivals: Street festivals are a frequent event in the Caribbean. In recent years, they have also increased in foreign countries, for example, London hosts an annual Notting Hill Carnival.

iii. Film and video production: Film shooting by overseas production companies for entertainment purposes has also increased in the Caribbean. The government encourages and invites foreign companies to shoot films in the region.

Links between services sectors and other sectors

Growth strategies in small states have in the past been based on agriculture and to some extent manufacturing, although to be sure, services have for a long time been a component of growth in many small states anyway. A growth strategy based on services, where appropriate, would often imply a shift in thinking – as the authors argue in the conclusions. However, this does not mean that other sectors will be or should be neglected, either implicitly or explicitly. Explicitly, because a growth strategy based primarily on developing services could be complemented by strategies to also improve the contribution of agriculture to growth, e.g. by promoting eco-friendly bananas in St Lucia or nutmeg in Granada. And implicitly, because the promotion of services may also help other sectors such as agriculture through direct and indirect linkages.

The authors outline below the direct and indirect linkages between tourism and the rest of the economy, notably agriculture below, but one can also envisage linkages between other services sectors and the rest of the economy.

There are quite a lot of examples of direct linkages between tourism and agriculture. Hotels and restaurants, whose revenues are a key source of (foreign) income for many small states, make large food and drinks expenditures. Although it is well known that some types of food and drinks are imported, there is also considerable scope for local suppliers to sell their goods to hotels and restaurants. This includes locally-supplied food, but also fruit and fruit juices, rum and flowers. There are case studies that show how local initiatives may boost inputs provided by local farmers (see for example, the Overseas Development Institute [ODI]-Pro-Poor Tourism [PPT], 2004). Hotels and restaurants also need electronics, furniture and other manufactured goods, some of which are niche products (tailor-made accommodation or furniture); in some cases these can become export products in their own right.

There are also indirect effects. Econometric studies (Lejaragga and Walkenhorst, 2006) capture the dynamic effects of tourism on growth and these studies suggest that growth can be tourism-led, and in some cases tourism contributes more to growth than some traditional sectors. The effects of tourism are greater the poorer the country, suggesting that tourism is a first step towards diversification; however, as countries become more developed they move increasingly into higher value-added sectors. The indirect effects of tourism on the rest of the economy work through infrastructure (for example, air travel or roads); human resource development (for example, training of the workforce); diversification; and private sector development (especially small and medium enterprise [SME] development and entrepreneurship linkages).

For instance, Subramanian and Matthijs (2007) point to the dynamic effects of tourism. Increased air travel for tourism reduces the cost of airfreight from African countries to Europe and provided new transport opportunities for small quantities of fresh products. Tourism also increases local demand for high quality fruit and vegetables and provides an outlet for produce not meeting export standards. More generally, they argue that by positioning itself as a relatively close and attractive holiday destination, the gain for sub-Saharan Africa could not just be direct (in terms of tourism services, hotels, restaurants etc.) but also indirect: the fact that more and more direct flights arrive in African airports makes transport cheaper and export markets more readily accessible for African goods. This argument is very important for small countries, which would face greater isolation from world markets without flights for tourists.

The management, entrepreneurial and other skills that the tourism sector, and especially hotels with links to foreign business, provides constitute important long-run effects of tourism. Within the hotel industry, there is a trend towards greater investment in staff training, with up to 1 per cent of revenue being earmarked for this purpose. Some of this training is general and helps to build skills relevant for other sectors if and when workers move across sectors.

What all of this suggests is that the development of services can help other sectors, and in many cases already does, and in other cases linkages might be improved by supportive interventions.

Next steps: country case studies

In the next part of the book, the authors review how some small states have developed their knowledge-based and service industries in the context of the framework discussed in this section. Hence, they analyse the experience of Botswana, Mauritius, St Lucia, Singapore, the United Arab Emirates and Vanuatu – small countries that have successfully developed one or more services sectors – and examine their performance in the following five promising service sectors:

- Financial services;
- Education services;
- Tourism services;
- IT-enabled services; and
- Professional business services.

For example, Botswana and Mauritius are working towards making their countries the regional hub for financial services. Singapore has been immensely successful in attracting foreign business schools and developing a strong educational services sector and also becoming an international hub for other services such as finance, IT-related services, transport and tourism. St Lucia is actively promoting tourism, especially event tourism, and also hosts an IT call centre. The UAE is an emerging success story that is in the process of diversifying its economy to rely heavily on knowledge-based services. Vanuatu is an important example for other Pacific countries that face numerous economic and environmental challenges due to their small size and remote geographic location. The case studies illustrate the key public policies and economic conditions that have successfully helped to remove constraints to the development of service industries in these countries, distinguishing among domestic capacity constraints, domestic regulatory constraints and external constraints. They also discuss the challenges that still remain.

Note

1. Non-trade related external constraints also exist such as the level of competition abroad.

PART II

Country Case Studies on Developing Trade in Services in Small States