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Trade in Services and Economic Transformation – Report Summary

Services play a key role in stimulating economic transformation in low-income countries and policy-makers need a better understanding of the pathways

Services play a crucial role in economic transformation and opening up services to foreign competition creates further transformation opportunities, a new report by the *Supporting Economic Transformation Programme* of the Overseas Development Institute reveals.

Trade in services play a vital role in economic transformation and job creation in poor countries, but the effects are often less visible and different to those in agriculture or manufacturing.

While much of the debate on economic transformation centres on transforming agriculture and moving into manufacturing, services are an underexplored component of economic transformation strategies. There is often a sceptical view that services follow - rather than lead - transformation and that they do not create enough jobs.

However, it is important for economies to follow a balanced growth path because of the explicit and implicit linkages between the various sectors. Policy-makers need to update their evidence base on the linkages between sectors and consider more carefully what specific actions deserve priority. Logistics and business services are embodied in trade in goods through global value chains, efficiently functioning and well targeted financial and energy systems can unleash manufacturing growth. ICT is increasingly a stepping stone for transformation in small or landlocked countries, and tourism offers opportunities for export-led job creation in the poorest economies.

Appropriate policies can unlock further transformation opportunities. For example, openness can support productivity increases in services firms and support economic transformation more widely.

The report 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, trade plays a key role in stimulating within sector productivity change, especially for services in LICs.

The report uncovers a large number of empirical facts:

- **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. 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.
- Productivity differentials are large and occur across countries, across services and other sectors and between firms within services sectors, and the differentials are greater at low income levels. This suggests there are a lot of opportunities for economic transformation in the services sectors in poor countries.
- Services play a key role in aggregate productivity change. Whilst agriculture tends to contribute a significant part of labour productivity change at low income levels, the manufacturing sector takes over, up to a point, but the **services sector has contributed more than half of productivity change** over 1991-2013 in developing countries.
- Successful countries have seen productivity change in services and other sectors at the same time. This balanced growth story is unsurprising given the many links (qualitative and

quantitative) between services and other sectors. It confirms previous conceptual discussion with new empirical evidence on how services are embodied in goods trade – developing manufacturing without quality services is difficult, if not impossible.

The report also examines trade in services in 5 sectors (financial services, hydropower transmission services, ICT, tourism and air transport) in 9 countries and finds that there are different ways in which services sectors contribute to economic transformation and job creation:

- Certain services sectors are important revenue and foreign exchange earners (hydropower, tourism, ICT);
- Some services sectors have visible linkages with the rest of the economy are more prominent (e.g. suppliers in the tourism sector).
- Some services sectors are key for supporting productivity/trade in other sectors (e.g. ICT, logistics, finance). Whilst these linkages are perhaps less visible, they are very important.

What drives trade in services in developing countries?

- **Basic fundamentals** remain 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.
- But an **active services policy** can play an important role in promoting exports of services (e.g. the development of software technology parks (India) and cyber city (Mauritius) to support ICT services).
- 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 that services exports are competitive in international markets.
- **Regulation and political economy considerations** are particularly important in large services sectors. 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).

New findings in the report provide compelling evidence to take trade in services policy much more seriously as a tool for economic transformation in poor countries

- Firm-level evidence suggests that services exporters have labour productivity 46% higher than that of the non-exporters. Broadly speaking, this points to the importance of **export promotion** 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**.
- Trade policy plays a frequently crucial in **opening markets**, regionally as well as internationally (e.g. in airline or energy services). An open service sector will **increase competition** and help domestic services firms become more competitive and efficient.