



The Impact of the Internationalization of Services on Developing Countries

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Advances in information technology have vastly expanded the range of services that can be traded internationally. Developing countries stand to benefit on two fronts—they will be able to increase their exports of services and they will gain access to services not available domestically—provided they reform the regulatory environment and develop the necessary human and physical capital.

THE INTERNATIONALIZATION of services is at the very core of economic globalization. Service industries provide links between geographically dispersed economic activities and thus play a fundamental role in the growing interdependence of markets and production activities across nations. Moreover, many services considered nontradable only a few years ago are now being traded actively, as advances in information technology (IT) expand the boundaries of tradability. As technological progress further reduces communication costs, trade in services is expected to continue to expand briskly.

For developing countries, the growing internationalization of services and rapid technological change in IT present both opportunities and challenges. There are opportunities for developing new exports and attracting more services-related foreign investment.

Technological progress will allow countries to leapfrog stages of development in building their info-infrastructures, thanks to technological discontinuities (e.g., the emergence of digital networks). One challenge facing the developing countries is the design of appropriate regulatory environments for service industries. Access to efficient services matters not only because it creates the potential for new exports but also because it will be an increasingly important determinant of economic productivity and competitiveness. Other challenges include undertaking necessary investments in modern IT networks and adapting educational systems to the information age.

The services revolution

Advances in technology, especially information technology, are revolutionizing the image of services. Until recently, it was com-

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mon to view the services sector as a collection of mainly nontradable activities with a low productivity-growth potential. The expansion of this sector in industrial countries was often thought to be a side effect of deindustrialization; in developing countries, it was often attributed to the growth of the informal sector, chaotic urbanization, and a swelling public sector. Overall, the growth of services was perceived at best as a by-product of developments in the primary and secondary sectors, at worst as a drag on long-term economic growth. But, as IT transforms service industries, and as awareness grows of the importance of efficient producer services, the development of these services is coming to be regarded not as a consequence but as a precondition of economic growth.

Services comprise a wide array of economic activities. The main thrusts of the "services revolution" are the rapid expansion of knowledge-based services (for example, professional and technical services, banking and insurance, and modern health care and education) and the growing tradability of services. Knowledge-based services belie the stereotyped view of services as activities with low capital intensity—physical and human—and productivity growth. Service industries are the main investors in IT around the world. Spending on knowledge-based services, which are highly income elastic, is growing rapidly in both industrial and developing countries.

Changing boundaries of tradability. Services are often characterized as the textbook example of nontradables (e.g., a haircut). However, technological innovation has expanded the opportunities for services to be embodied in goods that are traded internationally—software on diskettes, films on videotape, and music on compact disks. But the most dynamic force behind the internationalization of services is the expansion of electronic networks (see box) and the new possibilities for trade in long-distance services associated with these networks.

Progress in IT is making it possible to unbundle the production and consumption of information-intensive service activities. These activities—e.g., research and development (R&D), computing, inventory management, quality control, accounting, personnel, secretarial, marketing, advertising, distribution, and legal services—play a fundamental role not only in service industries but also in manufacturing and primary industries. In the United States, for example, as much as 65–75 percent of employment in manufacturing may be associated with service activities. With progress in IT, outsourcing—supply by an external entity of a service previously provided in-house—has become feasible. And,

as communication costs continue to fall, the potential for international outsourcing grows.

Service activities that involve the manipulation of symbols (collection, processing, and dissemination of information) are the archetypal information-intensive activities. Data entry, analysis of income statements, and development of computer software and financial products are examples of activities in this category that are prime candidates for long-distance provision. The impact of IT on the tradability of services is not limited to the increasing feasibility of long-distance provision, however. The introduction of new products (e.g., financial derivatives) and expansion of access to market information (e.g., computer reservation systems for airlines) have also been greatly facilitated by IT.

Even services in which consumer-provider interaction has traditionally been very high (e.g., education and health services) are now amenable to unbundling and, eventually, cross-border trade. Advances in computer-mediated technology (including online access to information, two-way student-teacher communication, multimedia systems), for example, are significantly enhancing the effectiveness of long-distance education. Teleconferencing—using satellite links for contacts between medical colleges and physicians in remote areas—is

becoming a popular mechanism for continuous education. And telemedicine is becoming a reality—it is now possible to transmit ultrasound scans for evaluation by specialists in better-equipped hospitals.

Trade in commercial services has been growing much faster than global output over the last decade. Commercial services encompass transport, travel, and "other private services"—a category that comprises financial, communication, construction, information, technical, professional, and personal services. Long-distance services are typically recorded under "other private services." Service statistics have many deficiencies, but it is clear that trade in services has been growing rapidly. Average annual growth in trade in commercial services from 1980 to 1993 was 7.7 percent, compared with 4.9 percent for merchandise trade (in nominal terms). Trade in "other private services," the most dynamic component of commercial services, grew at 9.5 percent annually. The share of commercial services in global trade rose from 17 percent in 1980 to roughly 22 percent in 1993. And, to the extent that intrafirm trade in long-distance services is not properly captured by balance of payments statistics, these figures underestimate the expansion of trade in services.

Information technology: the cutting edge of the services revolution

The costs of long-distance telecommunications and the price of computational power have declined dramatically over time. The real price of microcomputers, for example, fell at an average annual rate of 28 percent between 1982 and 1988. At the same time, the quality of services delivered by IT applications has improved significantly. In the United States, for example, a voice-image hookup for a one-hour coast-to-coast teleconference cost approximately the same in 1994 as a coast-to-coast phone call of four minutes in 1915.

The convergence of computer and communication technologies is promoting the development of computer-mediated (or electronic) networks. These networks are formed by systems of computers and communication hardware, and software that allows users to communicate and transmit data and other types of information. As digital switches—computers—replace electromechanical switches, and integrated services digital networks (ISDNs) emerge, the technical feasibility of new value-added services expands rapidly. Falling prices for hardware and software generate a positive feedback effect as the demand for network services is affected not only by prices but also by the expected size of the network.

This expansion is expected to accelerate as the cost of communication bandwidth (the capacity to transmit more bits of information simultaneously) continues to fall. Moreover, the cost of communication is becoming independent of distance, and networks are becoming more international. Transnational corporations, for example, are actively building international dedicated networks to address their communication needs.

The most important development in the area of international networks is the Internet. The Internet, a network of networks, originated in the United States in the late 1960s. Access to the Internet was originally limited to the research community in universities and defense contractors but entry was opened to residential users in 1986. Since then, growth has been explosive (the number of Internet computer hosts is growing by more than 20 percent per quarter), and international links have proliferated. By early 1995, there were more than 4.8 million hosts around the globe—more than 1.5 million of these were located outside the United States. Corporations rapidly discovered the Internet. The number registered on the Net grew from less than 100 in 1990 to nearly 20,000 by mid-1994.

The internationalization of services is not limited to the modes of supply associated with international trade. Commercial presence abroad (through foreign direct investment (FDI), representative offices, or branches) remains the preferred mode of supply for many services. Trade in services tends to be complementary to FDI in general. As FDI occurs, transactions in long-distance services (such as communications services and technical advice) and movements of service providers (intracorporate transfers) expand. Since the mid-1980s, FDI flows have increased at a much faster pace than global trade and output (inflows into developing countries, for example, have increased by more than 15 percent per year), and the fastest-growing component of FDI flows has been that related to service industries.

The prospects for continuing internationalization of services through FDI are good. Demand for modern producer services is growing fast all over the world. Regulatory barriers to entry in service industries are being reduced, either through unilateral reforms or reciprocal negotiations. Developing countries increasingly are looking upon FDI in services as an especially powerful means of transferring technical and managerial know-how. Moreover, IT is increasing the appeal of transnationalization for service firms.

Opportunities

As service industries rely increasingly on IT, they tend to become more dependent on capital and human-capital inputs. This has led some analysts to suggest that developing countries cannot compete internationally in services and that policies to liberalize trade in services would be of limited interest to them. This view is mistaken. Developing countries are already carving out areas of comparative advantage in IT-based services, a process that will continue to evolve. Moreover, liberalization is not only about expanding exports; even more important is its role in helping domestic producers gain access to more efficient and diversified services in world markets.

Efficient producer services are increasingly relevant to the pursuit of an outward-oriented strategy of development. "Ship-and-forget" trade is becoming a thing of the past. To compete internationally, dynamic exporters increasingly rely on reduced product-cycle times, prompt delivery, and improved customer services. As a result, the service content of final exports is increasing. In time-sensitive industries, firms are either "quick" or "dead." Innovative service providers are enhancing

transportation and communication systems, and developing an advanced services infrastructure. Availability of such infrastructure, in turn, is becoming a major criterion in the locational decisions of exporters. The newly industrializing economies in East Asia have been particularly successful in developing a modern infrastructure for producer services.

Long-distance services. There remains much scope for expansion in developing countries' traditional service export areas (e.g., tourism). A new area of special promise is long-distance services. Data entry was one of the first service activities to be internationally outsourced. This type of activity requires only

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a low level of computer literacy and limited interaction between the customer and the supplier. The customer mails paper-based data forms or sends scanned images of data forms electronically to the foreign provider for processing. The supplier sends the computerized data back via telecommunication lines or by mailing magnetic tapes. Countries in the Caribbean have been quite active in exploring the market for offshore data entry.

Software programming is another activity that is increasingly traded across borders, with subsidiaries or partners overseas entrusted with developing software that is transmitted electronically back to the parent or partner company. For example, many leading international computer and software companies have set up R&D and production operations in Bangalore, India. The Indian software industry, which is growing rapidly, generated revenues totaling more than \$500 million in 1993-94, two-thirds of which came from exports. It is estimated that India has captured roughly 12 percent of the international market for customized software.

"Back-office" service activities are also being traded internationally. For example, several US insurance, tax-consulting, and accounting companies send claims and forms overseas for processing. In manufacturing, service activities such as product design, logistics management, R&D, and customer service are also being outsourced internationally.

There are no precise estimates of the size of the market for long-distance services that can be captured by developing countries. The fact that a significant share of these transactions takes place at the intrafirm level clouds the

picture. However, rough estimates suggest that 1-5 percent of the employment in services in industrial countries may be internationally contestable by developing countries. The potential impact of the globalization of services in terms of job displacement in industrial countries does not seem very large. But, from the perspective of developing countries, the potential impact in terms of higher exports over the long term is significant, possibly as large as their current total exports of commercial services. There are important niches in the market for long-distance services that can be successfully exploited by developing economies with a literate workforce and a modern telecommunications system.

It is important to note that markets for these services are sensitive to technological change. Long-distance services in data entry, for example, are expected to continue to expand in the near future,

reflecting the continuous fall in communication costs. Progress in optical recognition technology and the development of online services for credit card and check clearing, however, can significantly affect the need for data entry in the future. These services may lose some of their dynamism as they are displaced by innovations in software and scanner technology in the industrial world. Nonetheless, the increasing number and diversity of information-intensive jobs, the technical feasibility of new long-distance services (e.g., in remote clerical support), and the dynamism of FDI flows and of the global demand for software suggest that the overall market for long-distance services will continue to expand.

While creating possibilities for new exports, the internationalization of services is important also for developing countries as importers of services. Long-distance access to the "floating pool" of nonproprietary knowledge, for example, is being revolutionized by computer-mediated networks, such as the Internet. Electronic bulletin boards are becoming more sophisticated and increasingly effective as instruments for the transference of knowledge and for technical assistance. They can now combine text, voice, and images, and their use may significantly alter the prospects for human capital accumulation in developing countries in the next few years.

Capturing the opportunities

To capture the opportunities offered by the internationalization of services, developing countries will need to adapt their regulatory environments and develop supportive physical and human infrastructure.

Liberalization and regulatory reform. Liberalizing the import regime for services is central to achieving increased efficiency and competitiveness in the provision of services. It allows businesses to import services that are not produced domestically or that are not available at a price and quality required for competitiveness. Liberalization also fosters efficiency by increasing competitive pressures on domestic producers of services. Because of the nonstorability of many services, FDI is the major mode of international delivery of services. Lowering barriers to FDI, therefore, is crucial. Increasing recognition by developing countries of the need for such reform is reflected in the liberalization packages encompassing the services sector that many of them have unilaterally initiated in recent years. Yet most service activities continue to face a more restrictive regulatory regime than do goods.

Border policies account for only some of the impediments to internationalization. Services are regulation-prone, and the domestic regulatory environment can create additional barriers to international competition (state monopolies in service industries, legal barriers to entry in economic activities, price controls). Domestic deregulation is often a necessary complement to the opening up of the foreign trade and investment regime. Also, differences in regulatory environments for service industries across countries may restrict access on a de facto basis (for example, different standards for accreditation of professionals). Accordingly, effective liberalization may also require harmonization of regulatory practices among major trading partners (e.g., as pursued in the context of the Single Market initiative in Europe).

Alongside unilateral liberalization of services, countries are pursuing liberalization through reciprocal negotiations. An important achievement of the Uruguay Round is the adoption of the General Agreement on Trade in Services (GATS), which extends multilateral rules and disciplines to services. Several recent regional integration arrangements have also included liberalization of services.

The GATS covers four modes of international delivery of services: cross-border supply (e.g., transborder data flows, transportation services); commercial presence (e.g., provision of services abroad through FDI or representative offices and branches); consumption abroad (e.g., tourism); and movement of personnel (e.g., entry and temporary stay of foreign consultants). It broadly follows the GATT (General Agreement on Tariffs and Trade) tradition, emphasizing nondiscrimination (most-favored-nation (MFN) and national treatment) and prohibiting policy instruments that resem-

ble quantitative restrictions. It innovates, however, in covering transactions associated with commercial presence (that is, establishment trade) and introducing a concept of market access that encompasses nonborder restrictions (e.g., limitations on the type of legal organization under which foreign providers can operate are, in principle, prohibited).

Unconditional MFN is a basic obligation of signatories, but MFN exemptions are allowed. The coverage of these exemptions is still being negotiated in areas such as basic telecommunications and maritime transport. They are time-bound and should be eliminated through future negotiations. Market access and national treatment, in turn, are specific obligations under the GATS. They apply only to the service industries and activities specifically listed by the country in its schedule of commitments, at the level of each mode of supply and subject to the limitations made explicit in the offer. The GATS adopts a positive list approach with respect to sectoral coverage of service industries—that is, only the industries scheduled in the offers of the negotiating parties are subject to GATS discipline. This practice is less transparent than the negative list approach adopted, for example, in the North American Free Trade Agreement (NAFTA), in which all service industries are covered unless specifically exempted.

The complexity of the agreement (with offers made by service activity and mode of supply) renders it difficult to make a comprehensive evaluation of the economic value of the offers and their liberalizing impact. In terms of industry coverage, developing countries covered a smaller subset of service activities in their offers than industrial countries. Tourism and travel-related services were the only activities in which a substantial number of developing countries made commitments. Commitments in the area of communication services—an area of critical relevance for countries interested in pursuing outward-oriented strategies of development—were quite limited. These commitments are mostly related to value-added telecom services (e.g., data processing, electronic data interchange) but cover less than 20 percent, on average, of the service activities negotiated under this category.

The liberalization of trade in services actually achieved under the Uruguay Round seems rather limited at present. However, while the immediate liberalization may be limited, the agreement paves the way for future multilateral liberalization. The framework agreed provides for continued negotiations to be completed over a two-year period, and nothing constrains members from undertaking further unilateral liberalization, provided it is consistent with the multilateral disciplines established by the GATS.

Other supportive policies. The services revolution places a premium on the development of a competitive telecommunications system. Most developing countries are hard pressed to meet the demand for even basic telecommunication services, and investment in networks for value-added services may be considered an unaffordable luxury. However, technology now allows a country to develop a dual structure for telecommunication services: a country can invest in low-cost, dedicated networks for business needs in parallel with expanding the basic infrastructure. The private sector can play a leading role in this process, as it has in Chile, for example.

Providing access to modern, high-quality communication services is not enough. Countries can be at a competitive disadvantage in long-distance exports because of non-competitive pricing of telecommunication services. (This has been the case for some Eastern Caribbean countries.) The use of alternative means of telecommunications (e.g., low-cost satellite stations) may be inhibited by monopolistic practices of the basic telecommunications providers. Establishing a competitive framework for the provision of telecommunication services is therefore necessary.

Another important constraint faced by developing countries concerns the quality and relevance of the training of their work forces. In-house training can partially mitigate the shortcomings of the formal educational system in preparing workers to use IT in service industries. The main challenge, however, is to make the general population receptive to technological change. As economies become more service-intensive, workers must be retrained more frequently, and their performance becomes more dependent on access to IT. Accordingly, the diffusion of computer literacy should receive special attention in education strategy.

In sum, the most dynamic trade routes of the twenty-first century will be dominated by transactions in intangibles rather than goods. Service industries will be responsible for the “roads” of the global “infrastructure” and they will be the main providers of the content to be traded via electronic means. The adoption of a liberal trade and investment regime is essential for countries to maximize the benefits to be derived from the internationalization of services and to move toward the information age. This is particularly true for developing countries. F&D

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