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# **Services Sector Development and Improving Production Network in ASEAN**

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## Services Sector Development and Improving Production Network in ASEAN

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### **Abstract**

While the importance of services sector in creating value added and employment has been recognized, the role of services as providers of major inputs to production sector are often forgotten and overlooked. This paper stresses the importance of services sector in supporting economic activities in general; the role that has become increasingly more critical in the wake of global production network. It argues that development of the services sector is crucial to supporting an economy's participation in networks of production and in promoting industrial upgrading. Within that context, this paper provides insight on the direction of services development in ASEAN countries and those countries can benefit by supporting greater services integration across the region.

Keywords: services sector, global production network, economic integration, industrial upgrading, ASEAN

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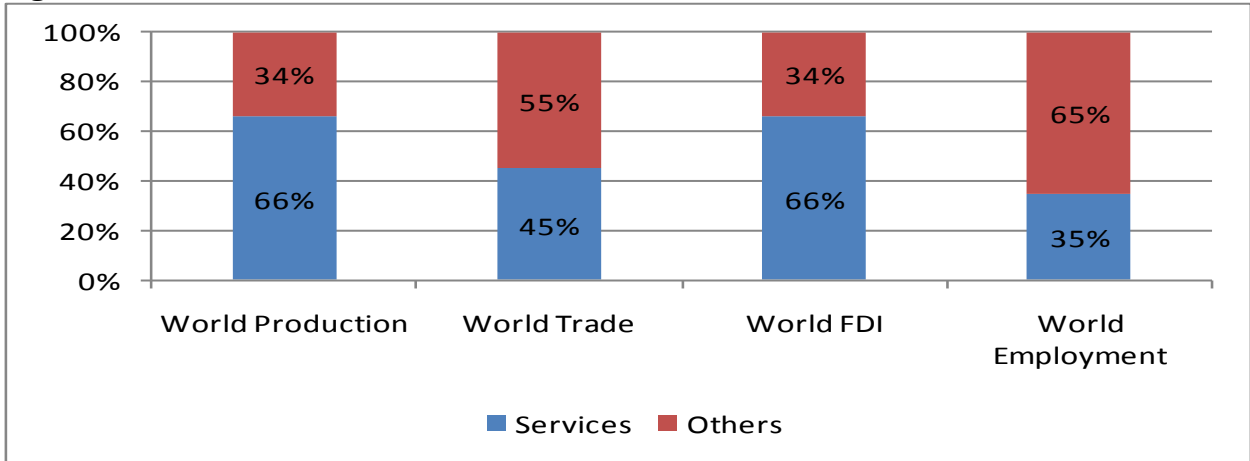
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# 1 Introduction

Services sector has long characterized as a “Cinderella sector” – a term stemming from its unrecognized importance compared to that of other economic sectors –, although the sector contributed to more than 65% of World GDP in 2011, and employed around 35% of its labor force (Figure 1). This sector is not only important in its own right, but also crucial to improving the productivity, efficiency and competitiveness of other sectors. As an input to other economic activities, such outputs of the services sector as telecommunications and logistics can determine the overall efficiency of the production process. Similarly, other services, such as distribution services, can enable consumers to readily enjoy products of economic activity, while business services, e.g. accounting and marketing, ensure that business can be managed in a proper and efficient manner.

**Figure 1. Relevance of Services Sector**



The services sector is becoming even more important given the current globalization of production. Some services play key roles in connecting fragmented production bases across separate locations, while other services have become ingrained in the production process. This paper argues that development of the services sector is crucial to supporting an economy’s participation in networks of production and in promoting industrial upgrading. Within that context, this paper provides insight on the direction of services development in ASEAN countries, and on how lessons from other parts of the world can teach the region how economic integration beyond the ASEAN Economic Community (AEC) blueprint can improve this development.

The first section of this paper examines, in more detail, the role of the services sector in contemporary production arrangements, and discusses which changes have shaped the sector’s relevance and importance towards supporting industrial upgrading. The second section looks at some implications of the development of service sector to policy formulation. Against this background, the paper examines some existing initiatives related to services reform in the context of integration in South East Asia. We also look at whether those reform will be sufficient to meet the challenges of the new global economic environment and to help these economies become more

competitive. The paper will conclude by discussing principal frameworks and strategies for services development beyond the implementation of the AEC Blueprint.

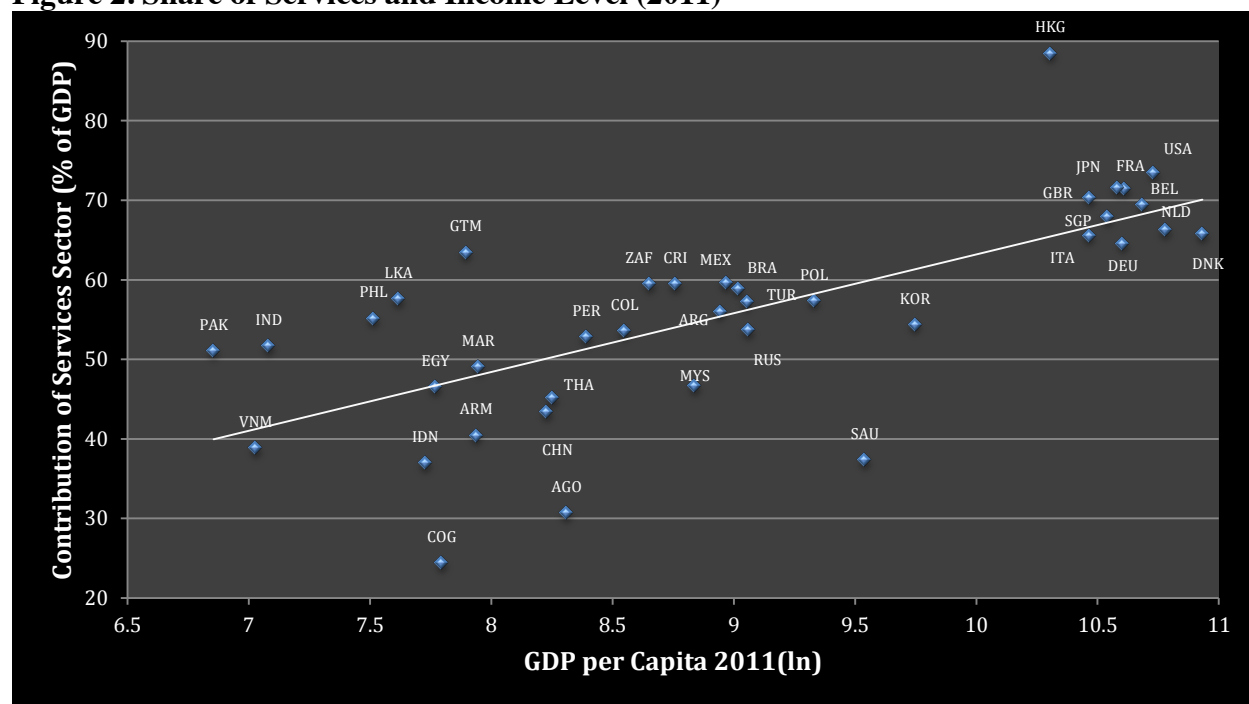
## **2 Role of Services in the Economy**

Despite its importance, the service sector has received little consideration for its contribution to economic development. Earlier observers of economic growth and development even went so far as noting that the services sector tends to yield low productivity and employ low-skilled labor. Baumol et al. (1967) even stated that the expansion of this low-productivity services sector might bring down economic growth rate given its limited improvement in productivity, the potential for savings in labor costs, as well as the nature of the sector's price-inelastic demand. Today, this notion of an unproductive services sector is known as "Baumol disease".

Similar standpoints also exist in discussions of the development policy of the services sector. Many developing countries have a misconception that, in the earlier stages of development, they need to focus on the development of the manufacturing sector, without paying much attention to the development of the services sector. Furthermore, these countries often associate the services sector with consumer services as opposed to producer services, and thus feel that domestic providers need to be protected, even if they would then have no capacity or motivation to provide better services. Developing countries therefore often chose to pursue restrictive policies in which they limit the supply of higher quality services from overseas. The notion that it is important to have efficient, high-quality services as inputs to create a competitive economy (since more than half of services output are intermediates consumed by other production sectors) seems to gain less support in policy and regulations of the sector. It is thus not surprising that services received little attention in multilateral trade negotiation under both the previous Uruguay round and current Doha Development Agenda.

Despite the common perception that services are associated with higher levels of economic development, the relationship between the sector's contribution to GDP and income per capita remains unclear. Until around a quarter-century ago, the activities of the services sector were seen as a low productivity and less-preferred source of economic development, as implied by the term "deindustrialization." Kaldor (1966), for example, considered the UK to be at a disadvantage to its continental partners due to its bigger share of services. For Britain to grow faster, his argument went, manufacturing needed to grow faster than other sectors, requiring a transfer of labor away from services to be encouraged through such initiatives as selective employment taxes.

**Figure 2. Share of Services and Income Level (2011)**



Source: World Development Indicator 2012

Other authors in the field of economic growth and development were also unsupportive of the idea of bigger share of services.<sup>1</sup> As Figure 2 illustrates, although a positive relationship can be deduced quite clearly between GDP per capita and the percentage of GDP contributed by the services sector, large deviations of data points from the best-fit line suggest that the relation might not be linear in nature. Eichengreen and Gupta (2013) investigated this notion carefully and found two waves of services sector growth. The first wave of growth occurs at a low-income level when an economy starts to grow, but at a decelerating rate, stagnating at around a US\$1800 income level. The second wave commences at an accelerating rate, after the economy reaches an income level of US\$ 4000. Due to these two waves, the share of services among higher income countries appears to be higher.

Eichengreen and Gupta (2013) also note that after 1990, the second wave of growth occurred at a lower level of income than it had before 1990. The authors suggest that, during that time, there was a big shift away from the “traditional” services that once dominated the sector, such as trade and restaurants, towards more modern services in banking, telecommunications and distribution.

These changes are the products of the emergence of a global value chains and of the growing importance of international production sharing practice over the last three decades. These changes have reinforced the importance of services as inputs in production processes at a scale that has never been seen before. The ability to place different production tasks and activities at different locations (one of the main characteristics of the existing GVCs) requires the availability of efficient services.

<sup>1</sup> Chenery and Syrquin (1975), for instance, observe no or little significant relationship between per-capita income and share of services in an economy across country.

Services are also becoming more difficult to separate from other activities, particularly in the manufacturing sector. In order to be kept up-to-date with recent changes in the business environment, such as increased competitiveness and consumer awareness, companies are shifting their focus towards more services-related activities, such as design and advertisement. Knowledge-intensive business services are becoming increasingly integrated into the production process of goods. This business trend of increasing relevance for services within manufacturing industries, known as “servitization”, or service infusion to production, can also be traced back to the emergence of a GVCs.

These recent changes have emphasized the role of services in the economy, in particular as a support for the productivity and the competitiveness of the industrial sector. Efforts to promote industrial upgrading thus need to pay more attention to the development of the services sector. Promoting the availability of high quality services may be a better alternative than promoting “picking-winner” type industrial policy. It is important to note that quality services do not need to come from locally produced services given that goods and trade can also be a reliable source of these services.

### **3 Services and Global Value Chain**

#### **3.1 Services and the Internationalization of Production**

The shift from traditional to modern services, as well as the growing of the services sector since the late 1980s, occurred at the same time as the emergence of a new business and production model for manufacturing products. In this new production model, firms optimize comparative advantages by slicing-up production at finer stages and placing them in different locations, often crossing borders, according to the intensity of tasks and the abundance of factors of production in given areas. The most competitive and the best practice firms in the current global business environment face an increasing need to source and market their product from interdependent, separate locations. This new business practice has been assigned several names, such as international production sharing practice, international production fragmentation, or GVCs and production network. Each term emphasizes some characteristic of the same phenomenon in which production is no longer about the goods themselves, but rather about the tasks performed in producing final goods.

According to Baldwin (2011), this internationalization of production is composed of two major elements: (i) doing business and production abroad and (ii) connecting international production facilities. Slicing-up the production process into several stages and placing them in different countries require firms to conduct international business activities by either establishing subsidiaries using foreign direct investments (FDIs), or by outsourcing international contracts. Either way, the dispersed production bases remain disconnected without the activities to bond them together. Organizational management and coordination, as well as the cross-border movement of people, ideas, and goods (in particular parts and components), become the link between those separated production activities, and allow for the formation of the global production network and value chains.

Services play a very important role in shaping this international production sharing practice. The first role of services is to make sure that the interconnection between dispersed production bases remains intact. Here, services act as the glue for the GVC. The second role of services takes place in the production process itself, and is embodied in the final products. The more complex the operation of the good, the higher the service component needed for it, and the greater the percentage of value added originating from services. It is no coincidence, then, that the fast growth of international production network has occurred simultaneously to a higher intensity of services in the global economy.

### **3.2 Services as the Glue of the Global Supply Chain**

Jones and Kierzkowski (2001) offered a framework for describing international production sharing practice by looking at the formation of production blocks in separate locations. Activities of those blocks could not be combined without incurring costs related to what they called “service links,” which in turn represent inputs required in addition to goods and services already used for the processes in each production block.

Not all types of services are important in linking international units of production. As opposed to many “traditional” services that tend to be non-tradable and that require users and providers to be simultaneously at the same location, services linking the global value chains (GVC) can easily move across borders to connect users in different places. Among the most important service links are infrastructure services such as transportation, logistical services, and information and telecommunication services.

Placing production in several countries becomes economical when the cost of moving all aspects of production is lower than the benefits from cheaper production. Thus the need to link producers with consumers, which in this global setting might be far away from production locations, has become increasingly apparent. As such, the timely and economical movement of goods, capital, knowledge and people has become one of the principal requirements of the 21<sup>st</sup> century trade.

There are several reasons why more efficient transportation and logistics contribute to the development of GVC. Firstly, and most obviously, transportation and logistics are important because the parts and components in production need to be transferred from location to location, oftentimes more than once, throughout the process. Unreliable logistics and transportation would thus disrupt the whole chain of production.

Another critical but perhaps less obvious function for these services comes from the ability of good logistics and transportation to reduce the needs of inventory stock, both during production and during marketing. According to the Council of Supply Chain Management, in early 1980s, carrying and holding costs related to inventory and stock represents around 48% of logistics cost in the US business system, while in 2011 the share had gone down to only around 30%. Meanwhile the share of inventory in US manufacturing production has also decreased by almost 30% during the last two decades. Since the cost of carrying and holding can reach 25% of inventory value due to depreciation and changing business environments, smaller inventory sizes allow firms to cut

their operation costs and work more efficiently. Logistics for effective inventory management is a key to new production models that involve several smaller production units distributed across a number of countries.

While splitting up production into smaller tasks allows producers to benefit from specialization, the process also forces them to incur higher coordination costs. These costs become more apparent in the cases of international production sharing where stages of production are performed in different countries and where the outsourcing of tasks becomes the norm. Nevertheless, recent advances in information and communication technology (ICT) have enabled such coordination to be done in efficiently, and with high precision.

ICT has enabled the development of GVCs in several ways. First of all, ICTs facilitate the transmission of instructions and information between units of production in the value chain. Secondly, ICTs can reduce the cost of acquiring and transmitting knowledge, which is a critical aspect in managing value chains. Third, the availability of good communication technology can substitute middle management personnel in host countries, who would normally play a key role in transmitting to and translating knowledge from headquarters (Antras et al 2008).

The development of financial services has also contributed to the emergence of value chains. These services act like a lubricant that ensures that the linkages between production blocks function properly. This is especially important for cases of arm-length transactions in the value chain, as well as for intra-firm relations. In these transactions, buyers and sellers have different interests and intentions concerning the financing of transactions. Normally, such disagreements can be solved through bargaining, in which companies starting off with a better position companies often end up with the best outcome in the negotiation. However, this outcome puts pressure on value chain arrangements, and does not provide a sustainable approach to financing working capital needs.

Better financial services thus provide various mechanisms capable of aligning the needs of all parties in the value chain. For example, they help strengthen the position of the weakest components of the chain by providing some guarantee for working capital needs. These can take the form of common trade financing or of more sophisticated reverse factoring financing - a financing solution initiated by the ordering party in order to help its suppliers. The services can also help all parties manage credit risks related to transactions in value chains, while simultaneously increasing transparency.

### **3.3 Services Embodied in Production Units**

The services sector not only provides a means with which to link production blocks across a GVC. Increasingly, services are also a part of goods production, and can be included across all activities that ensure the effective operation of production units either separately or collectively. Drake-Brockman and Stephenson (2012) categorized such services into services embodied into the production process (e.g. accounting, research and design, and computer services) and services embedded in the process (e.g. advertisement, after sales services). For the purpose of analyzing value chains for manufacturing production, the former category is more relevant than the latter.



Often, these services are labeled as business services (BS), a term used to cover a broad spectrum of intermediary services used in business-to-business transactions. Rubalcaba and Kox (2007) defined these services as NACE 71-74, corresponding to the two digit of ISIC Rev. 3 of the same classification. A more detailed taxonomy of business services and of their positions among other services is presented in Table 1. These business services represent a fast growing economic activity in both developed and developing countries.

**Table 1. Taxonomy of Producer Services**

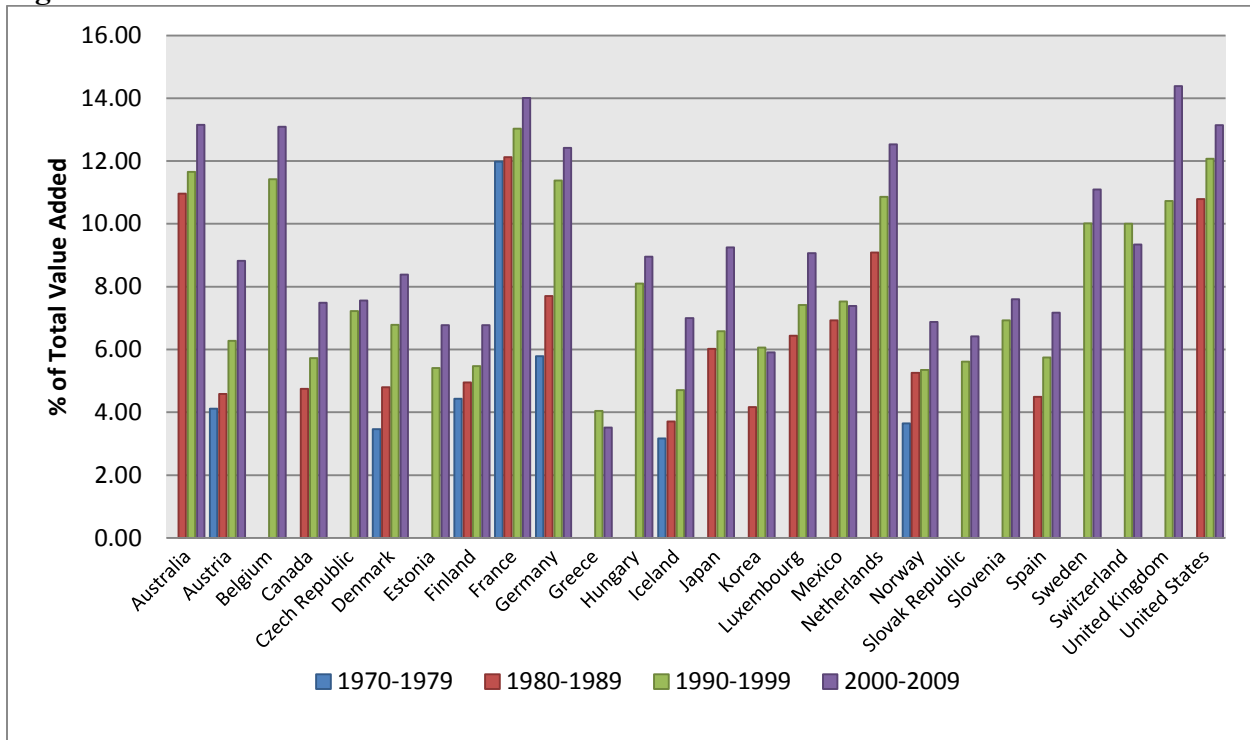
Producer Services	Business-related Services	Business Services	Knowledge Intensive Business services (KIBS)	Software and computer services	
				Business consultancy	
				Accounting, tax and legal services	
				Marketing services	
				Technical services, engineering, R&D	
			Operational Business services	Security services	
				Facility management	
				Temporary labor services	
				Administration services	
				Other operational services	
		Distribution and trade			
		Transport and logistics			
		Banking, financial sectors			
		Telecommunication, couriers			
		Energy services			
		Consumer Services partly used in production			

Source: Rubalcaba and Kox (2007)

Figure 3 describes the changes facing business services in OECD countries, and shows that the share of business services of total value added has increased quite significantly in many countries. In France, for example, the share of BS total value added has increased by more than two percentage point over the last two decades. A bigger jump can be observed in Germany, where BS accounted for more than 12.5% of total value added in 2000s, whereas two decades ago it accounted for less than 8%. While similar statistics from developing countries are difficult to compile, the trend seems to be prevalent nonetheless.<sup>2</sup>

<sup>2</sup> The only available statistics are not disaggregated enough to look at only business services performance in developing countries. Data on Real Estate, Renting and Business Services (Category K in ISIC Rev. 3) show that for India, the sector grew by the rate of 7.5% annually during the last decade, while it grew by 8.5% in China. But this classification includes real estate service that may distort the information.

**Figure 3. Business Services Performance in OECD Countries**



Source: OECD Database

This rapid development is partly due to the outsourcing of previously in-house service jobs to independent suppliers, although statistics reveal that those service tasks used to be counted as manufacturing value added. Nevertheless, this is not only a story about substitution between internal activities and outsourcing; it reflects the growing complexity and specialization of service tasks in the production process. The nature of service tasks has become too complicated and requires knowledge-intensive skills that necessitate them being done by independent providers.

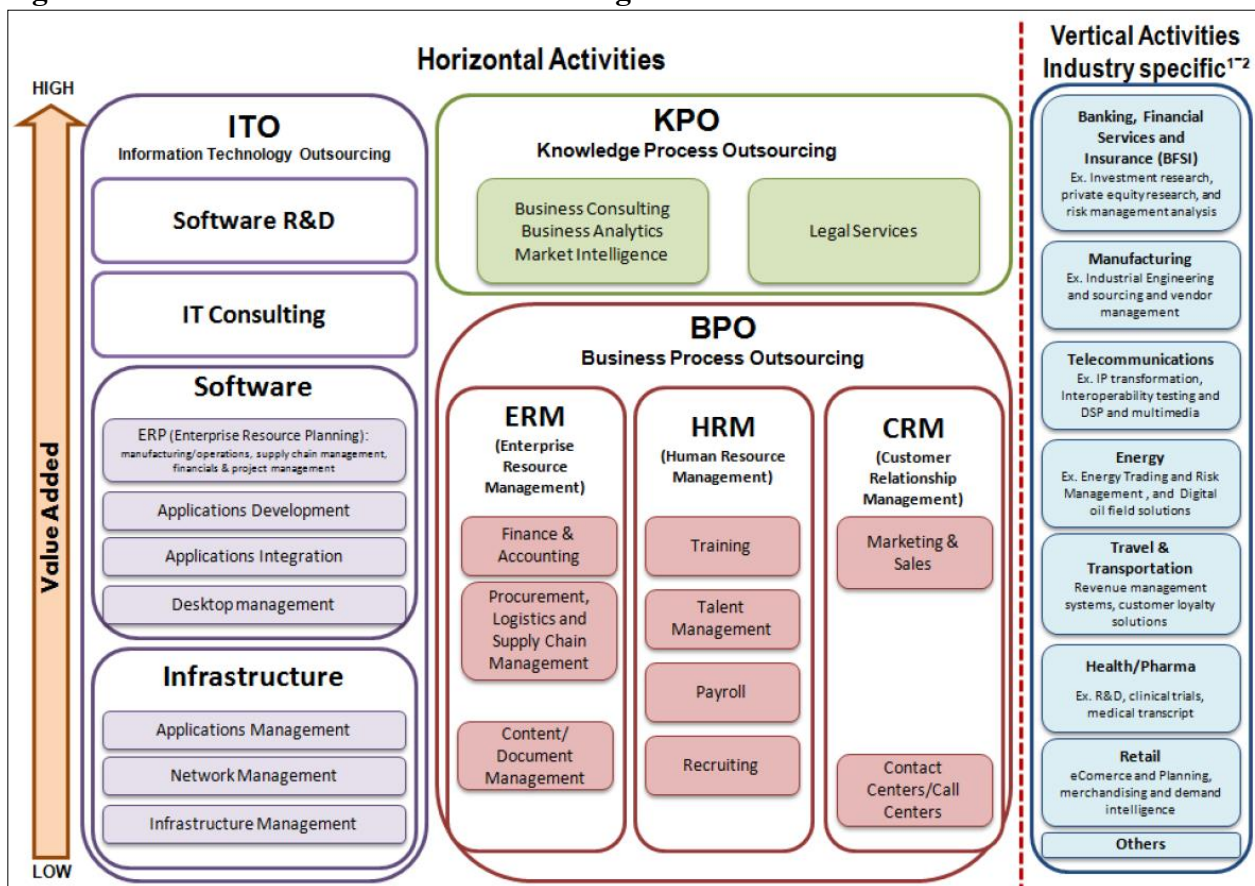
Independent providers of business services contribute significantly to the development of GVCs, as well as to the position and competitiveness of firms in the value chain. The services enable manufacturing firms to obtain higher benefits from specialization of their own operations. At the same time, economies of scale allow service providers to accumulate their knowledge by working with various clients and using that experience to invent better methods of dealing with problems. This may eventually reduce the cost of production while simultaneously supporting further development of value chain activities.

These business services have been the major sources of positive spillover. The experiences of several developed countries in the OECD have been captured in several studies about the contribution of the services to manufacturing and the overall economy. By looking at the total factor productivity during the period of 1975-2000, Nordhaus (2002) found that the development of the software industry in the US contributed up to 1.6% productivity acceleration since 1995. At a more disaggregated level, Antonelly (1999) estimated that a 1% increase of business services results in an increased value added of the client industry of up to 4.2%.

### 3.4 Services Value Chain and Offshoring

In addition to the role of services in value chain development, the “slicing-up” phenomenon also takes place in the services sector. Figure 4 provides classification of offshoring services. The first classification is related to the unbundling of activities within specific sectors (vertical), such as specific tasks in energy services. This type of offshoring services may have limited applicability in other industries and rely heavily on industry expertise. A second type of offshoring services (horizontal) takes the form of more generic business functions, such as accounting, computing or human resources, and is normally provided by specialist service providers. The services can have low to medium value added, (Business Process Outsourcing, BPO) or higher value added (Information Technology Outsourcing ITO and Knowledge Process Outsourcing KPO).

**Figure 4. Classification of Services Offshoring**



Source: Gereffi (2010)

The growing importance of offshoring horizontal services has received more attention recently since the size of the global service offshoring market is estimated to grow by around 20%, with 75% of it being BPO (Gereffi 2010). Prominent global providers of BPO, such as India and the Philippines, come from developing countries, while other developing countries also have the potential to develop these services.

### 3.5 Services and Industrial Upgrading in the Value Chain

Improving economic competitiveness has been the focus of many countries on their path to achieve better economic development levels. It is believed that the development of the manufacturing sector is the best way to ensure higher economic growth and provide employment. Some authors argue that the key in improving industrial competitiveness is by producing higher value added products. Rodrik (2006), for example, suggested that the aim of development policy should focus on the expansion of a manufacturing production base that would promote sophisticated activities. What is needed, he argues, is both a robust industrial policy targeted at new exportable goods and a supportive exchange-rate policy that promotes the production of tradeables across the board. This idea of industrial policy has now become popular among policymakers when dealing with the issue of industrial upgrading. Many supporters of the policy often use the active participation of the government and public sector to support and promote certain industries that are believed to have higher value added.

However, the massive development of GVCs requires such industrial upgrading to be put within a value chain framework. Interactions between local industrial activities and global networks of production allow for industrial upgrading while at the same time presenting risks for local industries getting locked in low value activities.

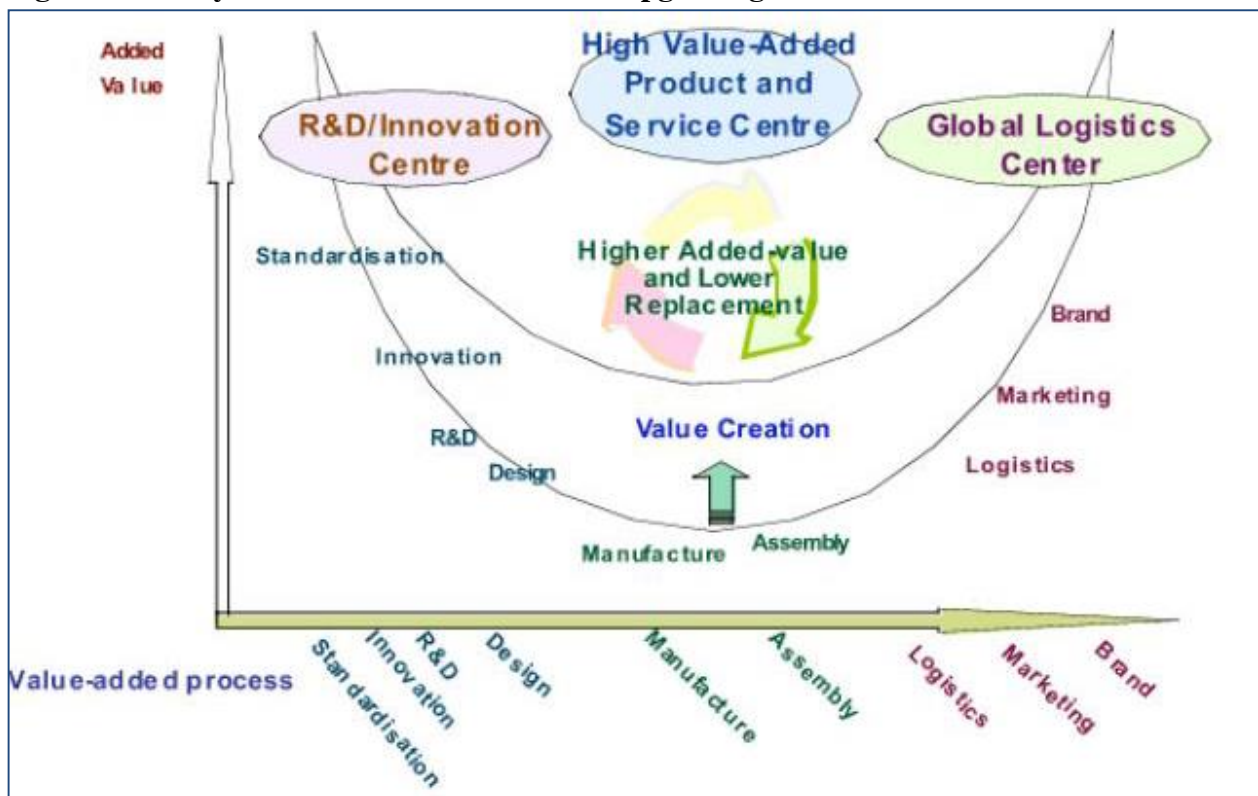
While many consider industrial upgrading a process that enables an economy to produce higher value added goods, GVCs – in which products can no longer be designated as a single country production but rather as “made in the world” – has complicated the problem. Humphrey and Smitzh (2004) offered a framework to examine industrial upgrading in the context of GVCs.

- The first way for firms to upgrade their performance in value chains is called “process upgrading.” Under this process, firms learn about their specific tasks in the chain more efficiently. This can be done through the reorganization of the production process within a single production unit, or through an improved use of linkages between the units.
- Alternatively, it can take the form of product upgrading, wherein firms or industries move to more sophisticated product lines.
- The third way is to acquire new tasks and functions in value chains to increase the overall skill content of activities. This functional upgrading may take place in the transformation of industries from assembly to original equipment manufacturing (OEM) to own-design manufacturing (ODM) or to own-brand manufacturing (OBM).
- The last upgrading alternative is inter-sectoral upgrading, in which firms move into new productive activities and take advantage of prior knowledge about the production of a first set of goods to manufacture a different set of goods with a similar function. For example, knowledge acquired in producing televisions might be used to make monitors and other computer equipment.

Against the background of our discussion in the previous section about the importance of service activities in the development of GVCs, it is then logical to see that the upgrading strategies listed above require a higher quality of services. In order to use intermediate inputs more efficiently in the production process, logistics and transportation between production units need to run effectively. Good communication supported with high quality telecommunication allows information exchange that leads to more knowledge accumulated and distributed among production units. Production units in a country that has insufficient service links will face difficulties in upgrading their production process.

The role of services is even more important in other forms of upgrading. Most notable is the role of business services embodied in the production process of each unit. Another simple but useful conceptual framework concerning value chains and upgrading comes from Stan Shih, a founder of ACER computer, who describes the relation between activities in value chains and their corresponding value added. The curve he designed, shown in Figure 5, follows a U-shaped relation and has been known as the Smiley Face curve of value chain upgrading.

**Figure 5. Smiley Face Curve of Value Chain Upgrading**



Source: Drake-Brockman and Stephenson (2011)

The bottom part of the curve represents the lowest value added activities related to manufacturing and assembly, which is a departure point of involvement for many firms and countries in GVCs. As discussed above, production units in value chains can choose several ways to increase value added and upgrade their capacities. They can continue to use the same chain activities, but move up to higher curve, as shown in Figure 5, or, alternatively, they can move along the curve to

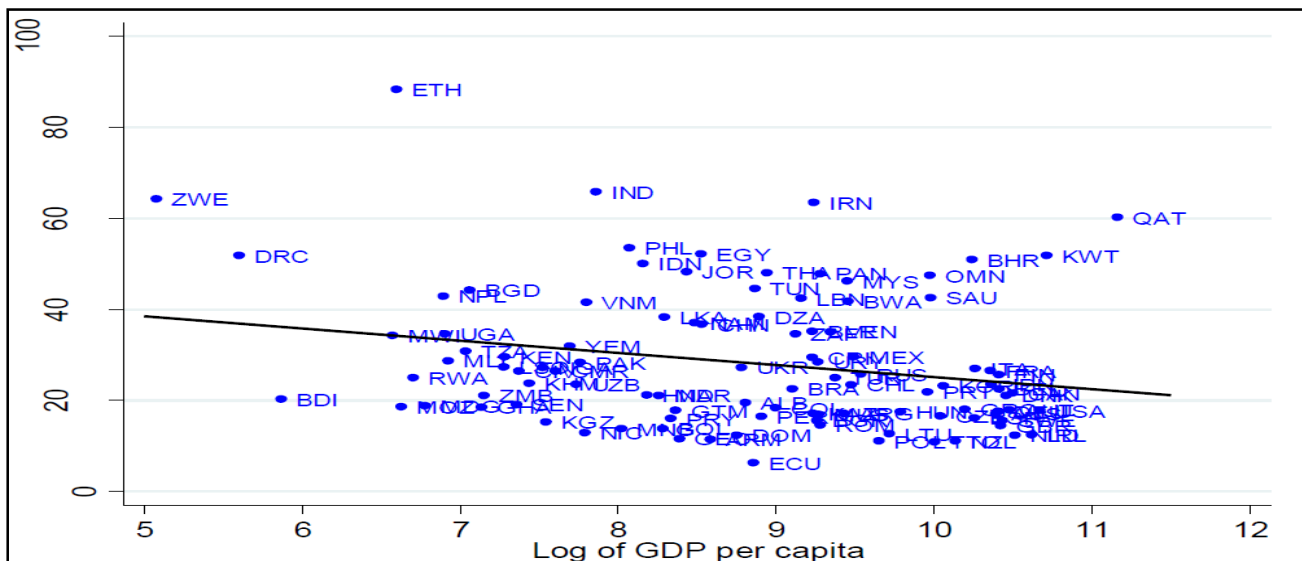
increase the value of their production process. It should be noted that most activities with higher value added tend to involve more intensive services components. This holds true for both downstream and upstream activities.

#### 4 Development of Services Sector

After discussing the importance of the services sector in supporting the development of value chains and promoting industrial upgrading, we now turn to some issues related to the development of the services sector. The key question here concerns the type of environment that enables the services sector to develop and improve economic competitiveness. One crucial issue is about competition-related policies that hamper the provision of services in many developing countries, including those in ASEAN. Empirical works on the effects of regulations on regulated sectors, such as services, shows that anti-competitive policies have non-negligible effects toward performance and growth of the sectors, as well as the economy in general.

Unfortunately, regulations of the services sector of the world remain quite restrictive, and are especially prevalent for essential services. Figure 6 shows the level of restrictions in the services sector around the world. Borchert, Gootiiz and Mattoo (2012) calculated the Service Restrictions Index (SRI) for 162 countries and five service sectors, and created a scale ranging from 0 (open without restriction) to 100 (completely closed). Currently, many developing countries have not applied restrictive regulations that would impede services development. Yet, restrictions remain high for services, like transportations and telecommunication, which impact the economy.

**Figure 6. Country Level Service Restrictions Index and GDP per capita**



Source: Borchert, Gootiiz and Mattoo (2012)

In this section, we thus examine experiences and case studies of services sector development in various countries, while simultaneously at the same time building a foundation of general principles.

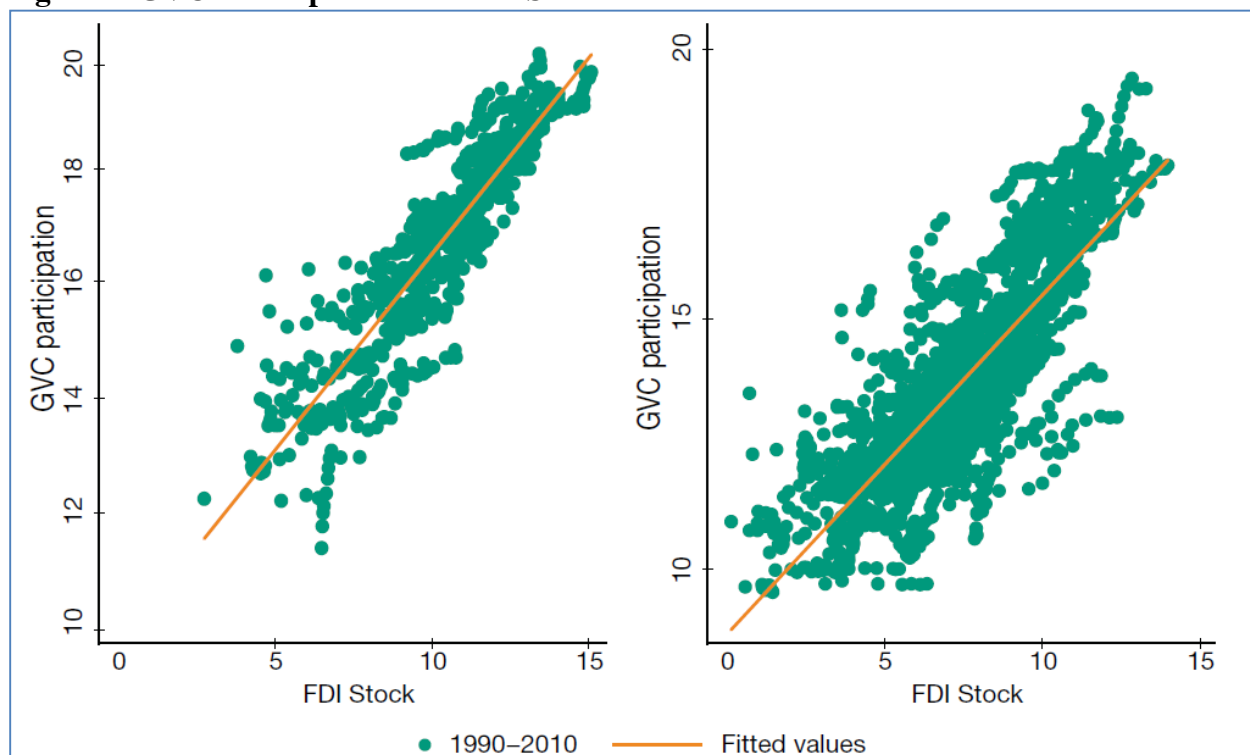


## 4.1 Services Sector Reform: Some Principles

One of the most important components about the development of the services sector is change away from several old paradigms about the role and position of the sector within the whole economy. The development of services in the current global environment should aim to provide high value added “inputs” for industrialization and modernization, rather than to see the sector as one that stands alone. It is thus necessary to recognize the sector as the key to increasing the economy’s competitiveness. It is crucial for policymakers to understand this mindset, and that they design a development strategy and policy framework for certain service sectors that do not contradict the policies of other sectors.

In order to develop a services sector, it is also important to understand that the availability of reliable and efficient services would attract more foreign direct investment. The presence of FDI is important to increasing a country’s participation in GVCs, since without it there is little chance for a country to be involved in the global production network. Recent reports from UNCTAD on world investment examine the link between FDI and GVC participation as shown in Figure 7. Looking at data for 187 countries since 1990, the regression finds strong and significant correlation between the two aspects both for developed and developing countries.

**Figure 7. GVC Participation and FDI Stock**



Source: UNCTAD (2013)

Note: Left panel shows the regression for developed countries, while the right panel presents the relation for developing countries

With this new perspective several aspects of services development should be considered.

- **First, development strategies should take into account strong linkages between different sectors of services and goods production.** Interactions that exist among sectors need to be addressed in a comprehensive way. A successful outcome for a single service sector usually depends on a package of policies that follows a cross-sectoral approach. Without having a good policy framework in telecommunication, for example, an economy would find it difficult to develop its computing sector or electronic commerce. Moreover, as we have discussed previously, the linkage between goods production and services development is becoming increasingly important.

The presence of these interactive effects suggests that the policymaking process should use a cluster approach instead of the traditional sectoral basis. A group of services sectors should be placed together in order to come up with a comprehensive development strategy. This can be achieved through improved coordination at the highest level of authorities responsible for services. It is also worth considering reorganizing government bodies based on such clustering. In many countries, distribution, warehousing and transportation are normally governed under different departments or ministries, while in reality those are all associated with logistical activities.

- **Second, countries should enhance competition among services providers.** In most cases, either a single firm or a small group of firms dominate service markets. Furthermore, in many countries these monopolistic industries are controlled by state owned enterprises (SOEs), either naturally or through regulatory design. This monopoly structure is supported for several reasons. First, people warn that market failure, notably the presence of elements of natural monopoly, would hinder private providers to operate properly. Second, it is argued that those services are related to strong public interests, and that therefore the providers need to pursue objectives that are not wholly commercial, thus making a single SOE provider appear to be the best choice for policymakers.

These monopoly practices have resulted to a lack of availability of high-quality services in many countries, as well as low productivity and inefficient operation.<sup>3</sup> In Indonesia, for instance, the government owned electricity company, PLN, has failed to satisfy the ever-growing demand of electricity in part because it operates using costly primary power sources and faulty technology, and in part because it lacks investments (Damuri, 2013). Ultimately, its inefficiencies burden state budget immensely. The same situation occurred across developed countries until service sectors undertook deregulation reforms in 1980s and 1990s.

The effects of anti-competitive behaviors damage not only the performance of the sector, but also the performance of other sectors. For example, the removal of restrictive cargo policies on shipping routes to the US resulted in an 11% reduction of transport price, but the removal

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<sup>3</sup> Industrial economists point out that regulated monopolist or oligopolists lead to many anti-competitive behaviors. Those include predatory acts and increasing barriers to entry, while at the same time governments, on behalf of the SOEs, try to increase the costs for potential rivals (Martin, 2001). There is also tendency for monopolist to strategically choose inefficient technology by selecting technology with a relatively low marginal cost at the expense of one with high fixed costs (Sappington and Sidak, 2003).



of price-fixing practices carried out by shipping companies has the potential to drive prices 38% lower (Fink, Mattoo and Naigu, 2001).

There are several approaches to introducing competition in the services sector. One common approach is to implement across-the-board competition policy. A good implementation of a competition policy may work well to prevent anti-competitive behavior from service providers. For example, sectoral regulation that simplifies the presence of new service providers and reduces the cost of setting up necessary facilities would limit the possibilities for anti-competitive activities. In the network-services case, such as electricity, telecommunication and transportation, the possibility of utilizing essential facilities is the first requirement to reducing monopoly power and introducing competition. This can be done by unbundling the services into several components, wherein essential infrastructures would be managed by entities separate from service providers. Even when pro-competitive policy does not lead to the establishment of new providers, the potential for competition it will at least keep the incumbents more efficient, and ensure that they deliver quality services.

- **Third, countries should develop strong yet reasonable regulatory frameworks.** The problem in many services sectors is not that they receive too little attention from policymakers, but rather that they tends to be too heavily regulated. As mentioned above, the presence of market failure is often cited as justification for service regulation, and for non-commercial obligations. However, many of those regulations do not target the correct problems. Take, for example, regulations that oversee the qualifications for professional services. While the presence of an inexperienced pilot can have fatal consequences, and the hiring of incompetent auditors might result to cases like Enron's, these qualification requirements should focus on the ability of existing providers rather than putting higher barriers on newcomers.

The intensity of regulatory measures affects the fixed costs of entering the market, as well as the variable costs of the operation. The presence of fewer anti-competitive regulations is associated with better performance of the services. When looking at the regulatory regimes in 23 OECD countries, Boylaud and Nicoletti (2000) find that liberalization and privatization reduce the price of telecommunication in those countries. Furthermore, the example of France when it relaxed its regulatory regime, shows that more liberal regulation for distribution services also increases job creation (Bertrand and Kramartz, 2002). Several empirical studies have looked at the effects of service regulatory reform on both other industries and the whole economy, and find that decreased regulation can increase productivity in manufacturing, and improve export performance.<sup>4</sup>

The key for a creating a better regulatory regime is in knowing the main problems and issues. Broader stakeholder consultation processes and regulatory impact assessments can shed some

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<sup>4</sup> Barone and Cigano (2011) looks at productivity improvement and growth in manufacturing sector of 17 OECD countries related to lowering regulatory regime intensity. For developing countries, Duggan, Rahardja and Varela (2013) finds that reform also increase productivity in Indonesia's manufacturing, with trade-related services – transport, communications and finance – having the greatest impact.

light on what policy should tackle. Also important is the ability to change and replace regulations and policies after a given time. Many regulations have been in place for so long that nobody remembers what the objectives to it are. Allowing “sunset clauses,” clear metrics that can be used to examine its success after a specified schedule would reduce the incentive for government to launch unnecessary and harmful regulations.

- **Fourth, countries should prioritize the development of sectors that can generate a significant multiplier impact on the economy.** Although different types of services do not necessarily impact the economy in the same way, those that contribute more include infrastructure services (such as telecommunication and energy), transportation, logistics, as and business services. Using input-output data and production functions, Antonelli (1999) estimated the contribution of several services sectors to five European economies and found that telecommunication and business services contributed the most to economic activities. Using Indonesian industrial statistics and regulatory index of services, Duggan, Rahardja and Varela (2013), also concluded that regulatory reform yielded bigger impacts on those services.

## 4.2 Role of Services Trade

Given that it is difficult to deny the important role of services in productivity improvement and industrial upgrading, the provision of high quality services is a prerequisite for sustainable economic growth. Just as countries gain access to a diversity of goods through trade, countries can also gain access to services that they might not actually be able to produce locally. Necessary services can be supplied from abroad, just like the various parts and components of a production chain are, and other intermediate inputs can be delivered from international suppliers. Furthermore, services from abroad increase competition in the market – a very important aspect that improves the performance of the industry in the long term.

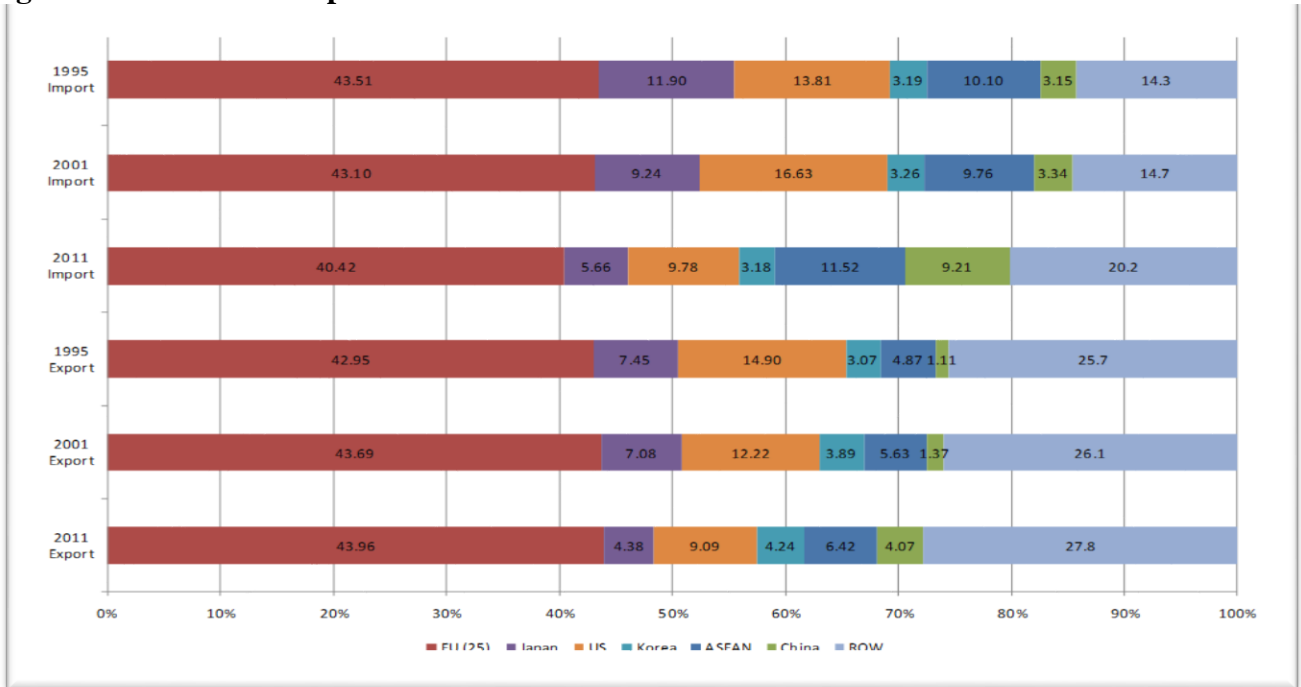
These gains are easily visible with producer services that facilitate relations between separated production blocks such as transportation and telecommunications. Shipping containers from other countries can provide cheaper and timely transportation to make sure that production bases within a country can operate competitively. In fact, trade in transportation services has increased by about 7% a year over the past 15 years due to the nature of GVCs that requires intermediate goods to be shipped across borders repeatedly over the course of the production process. Developed countries are dominant actors in the trade of transportation services, but more recently, developing countries have been catching up, both as providers and users of the services (Figure 8). As China becomes more important in international trade and GVCs, its share of imports of transport services has increased from only 3.15% in 1995 to more than 9.2% in 2011. Similar tendencies can also be observed in ASEAN countries.

Trade in transportation services allows firms to take advantage of the most efficient providers available to support their international supply chain activities. If the market for transportation services is restricted and the number of firms is limited (so that the only providers available are those originating from the same countries as the goods are from or are bound to), the cost for

transportation might increase to the point where providers from foreign countries would be equally efficient.

Access to high quality business services is also essential to support a country’s active participation in GVCs, as well as to upgrading their industrial performance. Experiences from countries that allow greater penetration of business services to support domestic production processes show that the availability of these reliable services surpasses the concerns over the inability of domestic suppliers to compete.

**Figure 8. Trade in Transportation Services**



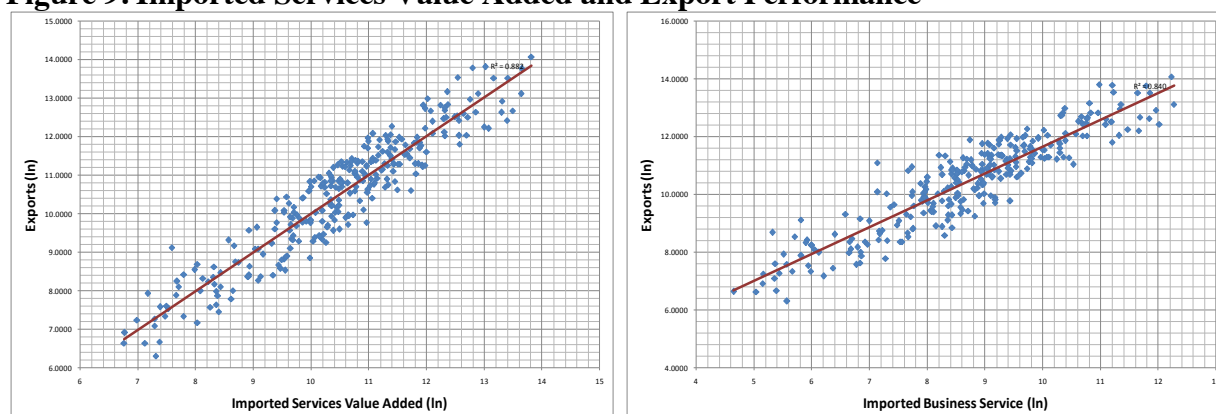
Source: WTO Statistics Trade in Merchandise and Services

For example, when Chinese businesses recognized that, in order to survive in the global market and gain access to the global financial market, they needed to adopt international standards of business governance, accounting and auditing. They thus turned to a strategy of importing necessary services from China’s closest economic allies, such as Hong Kong (Child and Tse, 2001). Business services providers in the city, with a long history of serving an international financial center, could offer Chinese business high quality services, and a reputation that could increase international market confidence in businesses from the mainland. Although opening up the market to Hong Kong had the potential to threaten domestic accountants, in the long run, these domestic accounting firms were able to and learn about international accounting standards and practices. The opening of the market was later supported by a Comprehensive Economic Partnership Agreement between China and Hong Kong, which virtually eliminated barriers to trade in services between the two economies.

Figure 9 presents the correlation between “imported” services value added and exports. In these figures, using value added data derived from an Input Output (IO) table, we examined the

correlation between the two, and a very simple regression reveals that the level of “imported” services is positively correlated with export performance. An additional regression on business services also shows similar results. It should be noted, though, that, since trade in services can take place through several means, looking only at statistics for cross-border services trade might be misleading.<sup>5</sup> In general, trade in services allows an economy to gain from cheaper and better services that might increase economic performance. It is then important for countries to pursue services reform and to keep the sector open.

**Figure 9. Imported Services Value Added and Export Performance**



Source: OECD Trade in Value Added Database (2013) and UN Comtrade Database

Note: The data comes from IO Table and trade statistics of 56 countries for five periods. Simple regressions yield strong correlation ( $R^2 = 0.88$  and  $0.84$ ).

### 4.3 Role of International Trade Agreements

There are many incentives for services sector reform and liberalization. Even though governments can initiate the reforms, international engagement usually acts as the driving force. While having a high quality and efficient services sector is in the interests of most countries, reform can be hampered by vested interests that enjoy excess profits or rents from existing protection. Commitments under international agreements can thus help countries gain strong support for reform. Furthermore, these agreements also provide credibility in international markets, which in turn attracts investments and internationally recognized service providers. Ultimately, in recognition of their rising role in international trade and of the need for further liberalization, services were included in the multilateral trade architecture of the World Trade Organization (WTO) in the form of the General Agreement on Trade in Services (GATS). Similarly, services have featured prominently in a growing numbers of bilateral and regional agreements, including ASEAN and ASEAN trade agreements.

Three main areas of commitments commonly appear in agreement on trade in services. The first one relates related to market access for services from abroad or from related foreign providers.

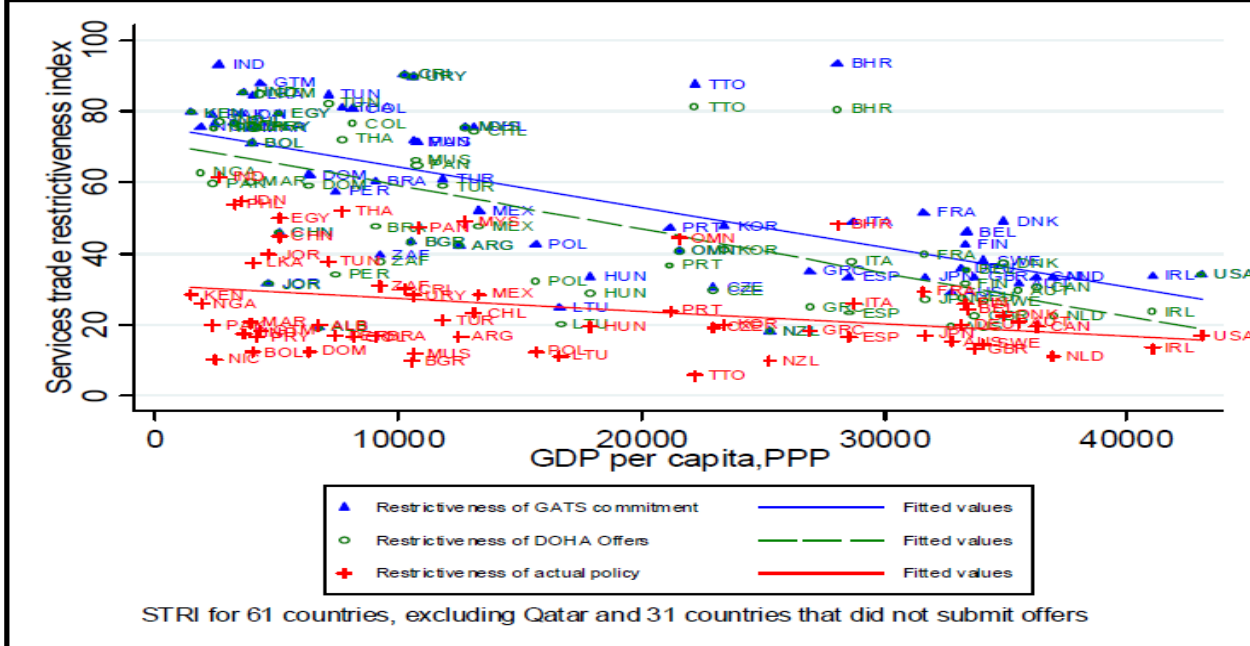
<sup>5</sup> WTO/GATS differentiates the way services can be traded into four modes of supply: (i) cross border supply of services, (ii) cross-border consumption of services, (iii) commercial presence abroad, and (iv) movement of natural person. Statistics on trade in services capture mostly mode 1 and 2, while often neglecting mode 3 and 4. For telecommunications and transport, the statistics might be quite sufficient, but they remain incomplete for other business or professional services.

These commitments regulate how countries involved in the agreement allow foreign services and providers to enter the market. These are an attempt to obtain commitments for liberalization of the services sector, and often discuss the role of foreign equity participation for commercial presence of service providers, or limitations on the entry of service workers and personnel.

While GATS set commitments on the market access of all WTO members, and the current negotiations under the Doha Development Agenda (DDA) are also pushing for greater access to the services market, many multilateral forums have a long way to go before they start providing liberalization. The best course of action for countries who have made commitments under GATS, especially concerning the commercial presence of providers, is to “lock-in” existing policies, thereby using the commitments to give assurance that the regulatory regime will not become more restrictive. Nevertheless, in many cases, commitments are even more restrictive than actual applied policy, and worries about countries losing flexibility in regulating the services sector has led to a large gap between commitment to international agreements and actual policy action at the domestic level.

Figure 10 presents the gap between the restrictiveness of service policy and that of commitments under GATS and draft offers of WTO members. The chart shows that the gap of commitments under GATS remains large, although it is still being negotiated. Very little improvement can be seen from WTO members’ request and offer of services liberalization. The gap is biggest among developing countries.

**Figure 10. Gap Between Commitments in GATS and DDA**



Source: Borchert, Gootiiz and Mattoo (2012)

Unfortunately, many preferential trade agreements (PTAs) do not offer much in addition to what was agreed to in Geneva. The ASEAN Framework Agreement on Services (AFAS) is currently negotiating commitments that offer more restrictions than actual policy, although these are better

than the commitments of ASEAN members to the WTO. Some recent preferential agreements, such as the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP), utilize a different approach than GATS framework of services commitments, which may lead to a more concrete liberalization of services sectors.

The second common form of commitment in services trade concerns national treatment, and regulates what foreign providers and services from abroad need in order to obtain the same treatment as domestic providers. Under GATS, members pledge to apply the same regulation to committed sectors for all service providers, regardless of their origin (unless restrictive measures are specified). These commitments also appear in agreements that deal specifically with the trading of services.

The third common form of commitment relates to domestic regulation. Since many regulations in the service sectors lead to increased barriers of entry to the market, negotiations about domestic regulations attempt to provide commitments that require regulations to follow reasonable, objective and impartial rules. Furthermore, these requirements, including licensing standards or technical standards, should be based on objective and transparent criteria, making their acquisition less burdensome.

However, the diversity of types of regulation of services across countries has led to other problems, since it is difficult for foreign suppliers to enter the new market when they have to adapt to regulations different from those implemented back in their home countries. Indeed, many discussions on the regulations of services focus on facilitating a regulatory harmonization across countries.

There exist three types of strategies currently being used to increase regulatory convergence. First of all, negotiators can create a set of regulations that become a guideline or standard policy core for the service sectors in a group of countries. The European Union, for example, has converged regulations for several service sectors, especially those with cross-border dimensions such as mobile telecommunication and electricity. At the multilateral level, financial services authorities supported policy harmonization given the potential for systemic risk issues in interconnected financial sectors. Interestingly, many initiatives that favored harmonization were privately-led, and originated in business services such as accounting and computing. While not aimed at addressing regulatory divergence, these private standards nevertheless influenced the practice and eventual regulations of services.

Rather than create new regulation, the second strategy to promote convergence is to provide regulatory coherence, which is used to find the elements of regulations that increase harmonization (such as the presence of domestic review mechanisms, or coordinating bodies for new regulatory measures) This strategy may also require the use of regulatory impact analyses (RIA) and other review procedures.<sup>6</sup> Such elements, together with greater market access are expected to result in

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<sup>6</sup> Most of the documents talking about regulatory coherence in those agreements are kept confidential. A leaked version of the negotiation in TPP, however, can be found at <http://www.citizenstrade.org/ctc/wp-content/uploads/2011/10/TransPacificRegulatoryCoherence.pdf>

higher harmonization of domestic regulatory regime in services. Coherence is a relatively new concept, and is used because several attempts at regulatory convergence fared poorly in the past. Several agreements on trade in services such as the TPP or Trade in Services Agreement (TISA) initiated in the WTO, have adopted this method.

The third strategy involves regulatory cooperation, wherein concerned authorities and regulators discuss how to facilitate mechanisms in order to better understand domestic regulations, instead of coming up with certain commitments. Mutual recognition agreements (MRAs) are the most common result of such negotiations, and ultimately provide mutual recognition for the qualification of service providers, especially in terms of training and accreditation. Following these negotiations, countries can also restructure their regulatory regimes while keeping in mind terms agreed upon in past MRAs

International cooperation concerning services development provides a means to achieving deeper reform in the sector. However, existing agreements remain far from satisfactory. ASEAN countries, for example, should still actively participate in and learn from initiatives conducted at multilateral and other regional level. Nevertheless, attempts to rectify existing issues have been initiated.

## **5 ASEAN Services Sector and Regional Value Chain**

After discussing many aspects of services sector development, we now turn to examining some defining features of services in ASEAN countries, looking at existing regulatory frameworks, and understanding how ASEAN members have handled problems in the region.

### **5.1 Services Development in ASEAN Members**

Table 2 presents some key characteristics of the services sector in ASEAN countries. One thing that we can see from these figures is that the services sector in ASEAN countries has a smaller role than it does in developed countries. With the exception of Singapore, services in these countries account for less than 50% of total value added compared to the 70% of total value added that appears in developed economies. This figure has not changed much since 20 years ago, although in countries such as Indonesia and Thailand, services contribution is declining. Such trends are somewhat in line with the notion of two waves of service sector development described by Eichengreen and Gupta (2009). Nevertheless, services in more developed countries, such as Malaysia are starting to improve. This is likely the product of shifts away from traditional services, such as trade, hospitality and dining, to more modern and knowledge-intensive sectors such as finance and business, whose contributions to these economies is increasing.

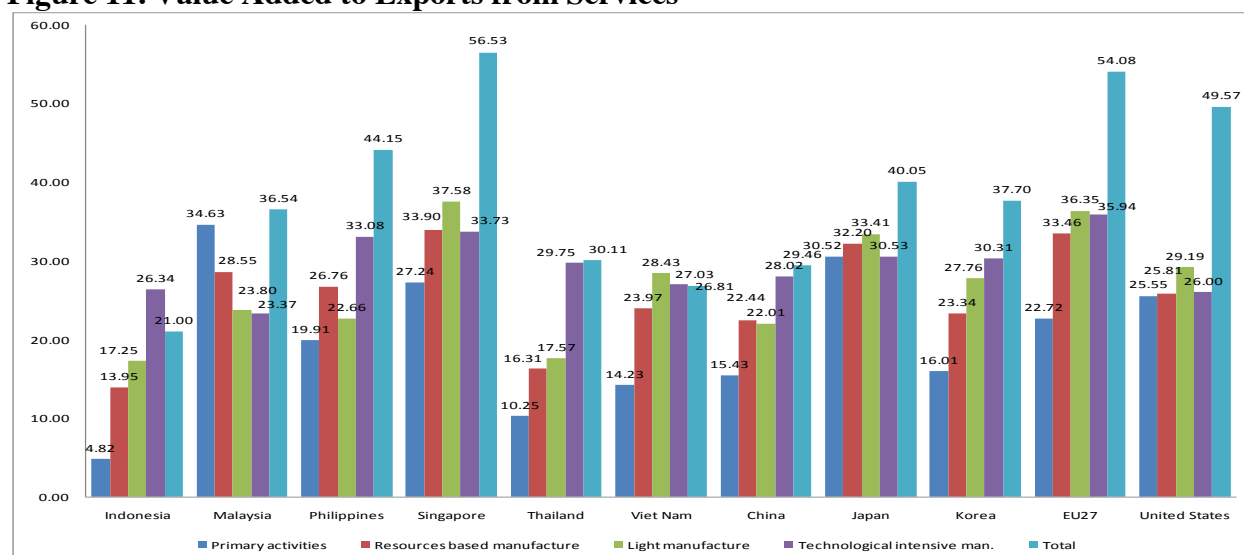
**Table 2. Services in the Economy (% of GDP)**

	Total Services		Trade		Hotels and Restaurants		Transport and Storage		Real Estate and Dwellings		Public Administration, Community, Personal, and Other Services		Communication, Finance, and Business Services	
	1990	2011	1990	2011	1990	2011	1990	2011	1990	2011	1990	2011	1990	2011
Indonesia	42.4	38.19	13.5	11.15	3.2	2.64	6.1	3.43	2.9	2.59	10.1	10.58	6.50	7.81
Malaysia	44.9	46.66	10.9	13.59	2.2	2.66	3.8	3.2	5.4	3.3	8.3	10.07	14.40	13.84
Philippines	50.8	55.93	14.7	17.47	N.A	N.A	3.2	6.46	5.8	11.39	15.7	13.57	11.5	7.05
Singapore	67.8	64.84	13.1	16.97	3.5	2.29	11.4	7.1	3.6	N.A	9.6	10.52	26.6	27.97
Thailand	50.9	43.69	17.8	12.85	5.4	4.92	4.5	6.79	2.2	2.28	9.7	12.27	11.3	4.58
Vietnam		33.91		13.06				2.79				9.89		2.30
China	31.5	43.4	6.8	9.18	1.6	N.A	3.8	4.74	2.1	N.A	7.9	N.A	9.4	N.A
India	46.1	61.34	11.8	14.06	1	1.32	6.4	5.52	5	9.32	13.3	25.07	8.8	6.05
Korea	51.5	52.3	11.80	7.98	2.40	2.02	4.70	3.33	6.50	6.28	14.80	18.09	11.2	14.59
United States	73.4	79.95	12.90	11.61	3.40	2.94	3.00	2.97	12.10	12.60	23	24.38	18.90	24.48
Japan	59.8	72.34	12.80	14.22	N.A	N.A	4.90	4.84	9.4	12.05	19.1	24	13.6	17.22
France	69.2	70.95	11.8	10	2.3	2.2	4.6	4.2	9.8	11.83	21.7	23.16	18.90	19.53

Source: CEIC Database

While these figures represent direct contribution of services to economies, the contribution of services as inputs to other economic activities, and especially exports, is even more staggering. Figure 11 shows the contributions of services to exports from ASEAN countries, taking into account the importance of value chains in the economy<sup>7</sup>. On average, ASEAN members, with the exception of Singapore, do not include many service components in their exports when compared to more developed countries. In Indonesia, services only significantly contribute to the export of technology-intensive manufacturing, although that figure remains lower than in the value gained in other countries. Elsewhere, services contribute significantly to the value of goods produced in manufacturing sectors, with these contributions making up 25-35% of the value of exported products. Again, technology-intensive manufacturing, such as that of electronics and machinery, uses more services in the production process, and is more dependent on GVCs than are other sectors of the economy.

**Figure 11. Value Added to Exports from Services**



Source: OECD Trade in Value Added Database (2013)

<sup>7</sup> Services contribution in an industry can come directly as services inputs in production process, e.g. transportation or business services used in the industry, or indirectly from services inputs of intermediate goods, e.g. transportation used in the upstream industry. The data from OECD Trade in Value Added (2013) take account both direct and indirect contribution of services in exports



Most of the contribution from services originate in domestic economies, although value added by foreign services remains relatively high. In Indonesia, less than a quarter of value added to services in exports comes from abroad. In contrast, the value added by foreign services makes up almost half of the value of exports from Thailand and Malaysia. This indicates that services play an important role in international value chains occurring in ASEAN countries. Services from one country in the region not only contribute to the production of exported goods in that country, but also to the production of exported goods in other ASEAN countries. From the OECD TIVA database we can calculate that around a third of ASEAN countries export values come from other ASEAN countries, indicating a certain level of services integration.

However, the integration is mostly done indirectly through “embedded” services of intermediate goods used in ASEAN production networks. Direct contribution of foreign services remains relatively low, in large part because of a strict regulatory framework of services.

## **5.2 ASEAN’s Initiatives on Services: A Brief Assessment**

ASEAN members have initiated negotiations concerning the services sector since 1995, when the countries decided to create a GATS-type ASEAN Framework Agreement on Services. The framework aims to provide greater market access and to promote national treatment, as well as ensure other commitments concerning services from ASEAN members. Member countries have completed eight rounds of negotiations and are currently in the midst of negotiating the ninth, with each round producing a schedule of new commitments.

The integration of services among ASEAN members is notable for several reasons. First, the process of integration is gradual, both in terms of the coverage of sectors being committed and the level of integration and commitments. Table 3 provides a summary of liberalization target of services under AFAS. By 2015, there will be 128 sub-sectors committed by ASEAN members, while in 2009 there were only 65 sectors committed. Among those subsectors, 48 are highlighted as priorities, and will be liberalized more progressively.<sup>8</sup> In having sectors commit to AFAS, countries agreed to lift restrictive measures, unless otherwise specified.

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<sup>8</sup> Those 29 priority sub-sectors come under e-ASEAN, healthcare, air travel, and tourism. Nine sub-sector of logistic are later added into priority list but with later liberalization scheduling.

**Table 3. Summary of AFAS Target**

	<b>Priority Sector (29 subsectors)</b>	<b>Logistic Sectors (9 subsectors)</b>	<b>Others</b>
Mode 1 and Mode 2	None	None	None
Mode 3: Equity Limitation	51% - 70%	49% - 70%	49% - 70%
Mode 3: MA Limitations	2009: 2 limitations 2015: No limitations	2009: 3 limitations 2015: No limitations	2011: 2 limitations 2015: No limitations
Mode 3: NT Limitations	2011: 4 limitations 2014: 2 limitations	2012-2013: 3 limitations 2015: 1 limitations	
Numbers of Committed Sectors	2009: 65	2011: 80 2014: 120	2012-2013: 100 2015: 128

Source: Compiled by author from AFAS Scheduling

The level of commitment from countries has also increased steadily. AFAS clearly targets Mode 1 and Mode 2, wherein there are no limitations or restrictions for the two modes of supply for committed sectors, while restrictions are gradually lifted for Mode 3. Given this, permissible foreign equity participation in ASEAN countries is expected to reach 70% by 2015, with priority sectors expected to reach that level even earlier. Limitations for national treatment, as well as other limitations on market access, are also expected to diminish or be eliminated by 2015.

The second notable point about ASEAN integration is that, just like in the WTO/GATS, ASEAN countries are making commitments that are more restrictive than domestic policies currently in place. Using a paradigm in which regulators use “policy space” to manage the services sector, commitments for liberalization, especially for Mode 3’s foreign equity participation, have been lower than what actual policy allows, although still higher than what member countries committed in GATS. Indonesia, for example, did not schedule retail sub-sectors in AFAS 8<sup>th</sup> commitment although the sub-sector is allowed almost 100% foreign equity participation. In maritime services, Brunei, Cambodia and Singapore allow 100% foreign investment in some sub-sectors that they have not committed to, while Malaysia and Vietnam appear to have no regulatory restrictions on entering the sectors they have not committed to (Dee, 2012).

Countries sometimes utilize this “policy space” increasing restrictions in a certain sector. In 2007, foreign ownership limitations in Indonesia’s telecommunications were reduced to 49% for fixed line services and 65% for mobiles (from 95%). This can be done since AFAS and GATS commitments are just below 49%.

However, some commitments appear to give preferential concessions by giving lower restrictions than actual policy, especially in more recent rounds of negotiations. In short, while liberalization is still limited, the targets of services integration in AFAS under the ASEAN Economic Community seem to offer concrete results.

The third notable feature of ASEAN's integration is the lack of negotiations addressing domestic regulations at the regional level. AFAS does not specify how members deal with diversity and differences in the regulatory framework of services, and efforts toward regulatory cooperation are conducted through mutual recognition agreements that focus on eight professional fields: medicine, nursing, dentistry, architecture, engineering, land surveying, accounting, and tourism. The MRAs are intended to facilitate the movement of skilled labor by allowing for the mutual recognition of qualifications of professional services suppliers from other ASEAN countries. While this facilitates the exchange of skilled labor, more time is needed for the countries to design more coherent regulations.

Line ministries and government agencies have separate venues to discuss their specific services development, such as ASEAN ministerial meeting for telecommunications or for transportation. These regional forums are intended to become the medium of greater cooperation. However, the programs of these ministerial meetings are aimed at inducing technical cooperation, as opposed to cooperation over regulation and policies. The sectoral approach of such cooperation also increases the possibility of preserving old paradigm of services development that tend to miss cross-sectoral linkages and the importance of the services sector.

Fourth, although the ASEAN services agreements work on a preferential basis, they also seem to moderately discriminate against non-members, which is important for two reasons. First, one of the benefits from liberalization is the increasing competition between service providers that leads to better quality services. Limiting market access to only a handful of trading partners by having restrictive "rules of origin" thus reduces the potential benefits of competition. Second, this discrimination also limits the incentives of foreign providers to invest in ASEAN countries.

This "trade diversion" effect of services agreements is reflected in the article "Denial of Benefits," which describes the extents of benefits to providers from outside the region. In AFAS, in order to be eligible to receive the benefits from preferential liberalization, the requirement is simply to have substantial business operations – a term which is itself up to interpretation, but which is less restrictive than such requirements as ownership – in one of the ASEAN countries (Beviglia-Zampetti and Sauv , 2006). By having such moderate requirements, AFAS remains principally preferential, although they do not disclose it to outside foreign providers.

### **5.3 Way Forward for ASEAN: Lesson Learned**

ASEAN has gone a long way towards integrating its services sectors, what with all the commitments under AFAS and the promotion of mutual recognition agreements (MRAs). However, there remain areas where ASEAN can enhance integration in the region. Below are some

ideas and policy alternatives for services development at a regional level to which the association can contribute more.

- Services development in the region needs to be based on a new perspective of GVC development, in which services are considered important both in their own right, as well as while “inputs” to other economic activities and sectors (including other services sectors, manufacturing, or agriculture). While this might appear to be common sense, the complete adoption of this philosophy would bring about a substantial change to services development strategies. The objective of services development should no longer be about how to create competitive sectors, but rather about how to provide high-quality, efficient and cheaper services. Countries can build strong domestic services to support value chain development and upgrading, but should not do so through regulations that favor inefficient providers who could jeopardize the whole supply chain.

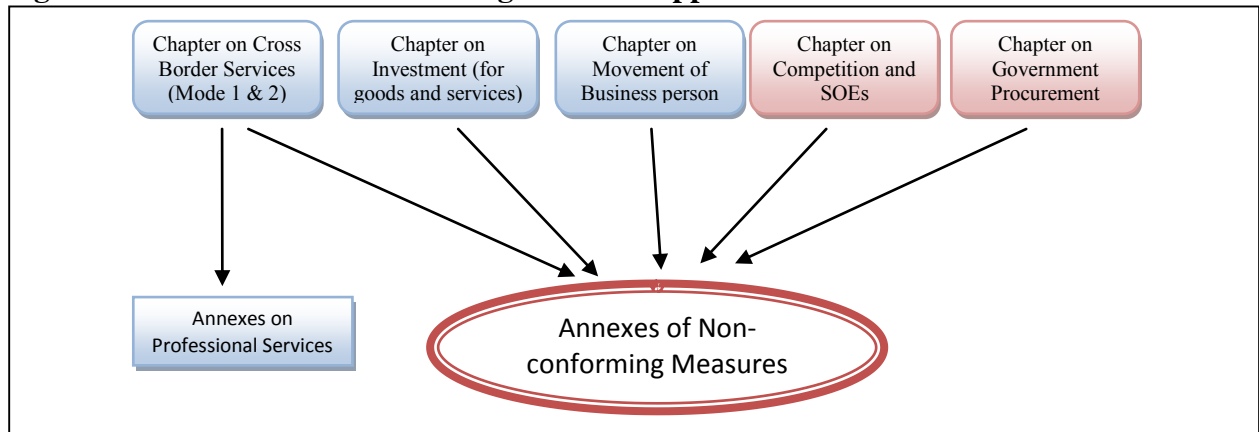
Experiences from countries that attempt to restrict certain services are abundant. Indonesia’s policy to restrict inland shipping transportation resulted in high cost of shipping and logistics within the country. Shipping goods from Jakarta to Padang costs as much as 2.7 times higher than shipping the same goods to Singapore, although the distance is almost the same (World Bank 2011). This situation is definitely not one that is favorable to value chain upgrading. Instead, regulation should be used to provide customer protection from the abuse of market power and information asymmetry. Given that, in this value chain perspective, consumers of services include other productive activities, consumer-oriented-regulations would benefit the economy as a whole. Since GVC is actually regional, putting service development strategies at the regional level would provide a strong foundation for the creation of more efficient services.

- Opening-up the services market can be an effective means to accomplishing that objective. One way liberalize would be to have ASEAN countries commit more market access to foreign services providers. AFAS should thus aim to promote a greater amount of liberalization in the context of regional integration, using the development of a regional value chain. Member countries should thus use existing negotiation frameworks to commit to greater regulation beyond that which already exists in their regimes. about it is time for ASEAN members to consider new approaches towards liberalization, including the use of a negative list approach.

Current agreements use GATS-like approach, wherein members agree to open up their services market by working with service sectors to decide what they need to liberalize, and what commitments would work best to achieve these ends. In contrast, negative list agreements start with the assumption that an economy should be principally free from restrictive measures unless an exception is specified. This principle encompasses various agreements concerning investment, cross border services, and the movement of natural people (Figure 12). In these agreements, all sectors must conform to basic disciplines unless otherwise specified in the Annexes of Non-conforming Measures, namely (i) MFN, (ii) National Treatment, (iii) Market

Access, and for cross border services principle of (iv) No Local Presence Requirement (for cross-border services), and (iv) No Performance Requirement (for investments).

**Figure 12. Common Structure of Negative List Approach in Services**



Source: Stephenson (2013)

Using a negative list approach, a higher level of services liberalization can be attained. This approach also has the benefit of bringing about a higher degree of transparency given that it requires countries to spell-out all restrictive measures already in place. This strategy valuable not only to potential services providers, but also to regulators who need to understand their own regulatory regime. The approach is not entirely new to ASEAN countries. Singapore adopted it in several of their agreements, and four ASEAN members currently negotiating the TPP are also quite familiar with it. While using a negative list approach might be easy for some ASEAN countries, others can learn a lot from it

- In addition to liberalization, cooperation over service domestic regulations needs to be taken more seriously. A certain degree of regulatory coherence should be achieved to ensure better services development and to support the regional value chain. The harmonization of regulation for road transportation services among continental South East Asian countries, for example, would help promote greater connectivity and a more reliable supply chain. Greater cooperation among telecommunication regulators and providers would reduce the costs of regional services, while the creation of a roaming fee-free region for mobile services among ASEAN countries could support regional development and people-to-people connectivity.

Regulatory coherence can be achieved through the formation of guidelines that lay down guiding principles for the regulation of specific sectors (as was done in the Telecommunication Services Reference Paper from the WTO). However, these guidelines must be subjected to review after certain periods of time in order to keep them up-to-date with new developments. The work of financial sector regulators is a good example of how to achieve greater regulatory cooperation, although such cooperation should be done under overall services agreement, as opposed to as separate discussions.

- Beyond recognizing the importance of services to GVCs, policymakers should also take note of the role of the GVC for services. Regional support for services value chain is important since offshore services value chains, such as business process outsourcing (BPO) and information technology outsourcing (ITO), have the potential to become competitive sectors for several countries in the region. This new phenomena requires supporting infrastructure services for telecommunication and energy, and countries should note that regulatory measures can support or hold back this development. Unnecessary barriers to cross-border data traffic, especially those of commercial in nature, might harm the development of offshoring services.<sup>9</sup>
- While the integration of services would bring a lot of benefits to economies across the region, non-discriminatory liberalization initiatives also offer have the potential to benefit them even more. “Rules of origin” in services commitments under AFAS are moderately receptive towards non-members, and these commitments could go even further by specifying disciplines that are more flexible.

ASEAN countries should also participate more in multilateral schemes. Since all members with the exception of Lao are members of the WTO, ASEAN should make more harmonious decisions in other multilateral trading forums. For example, ASEAN members should work together while negotiating the Trade in Services Agreement (TISA), which is an attempt to extend GATS commitments, frameworks, and scheduling modality originating. If accepted by WTO Members, this agreement will complement and strengthen the GATS, in the same way that GATT 1994 complemented & strengthened GATT 1948.

## 6 Conclusion

Industrial upgrading has become quite popular in the quest for economic development. Some observers assert that developing countries need to produce more “sophisticated” goods and move away from producing commodities. This idea, however, does not take into account the emergence of GVC, wherein countries focus on specific tasks in production chain. Due to the globalization of production, industrial upgrading does not always require the production of highly sophisticated products; instead, it can be better defined as a move from low-value to relatively high-value activities across networks.

A better way to ensure industrial upgrading is through the development of a strong services sector. Efficient and high-quality services allow countries to increase the value added to production activities, and to improve linkages with global production networks. The development of services helps developing countries avoid having “winner picking” types of industrial policies that might reduce the success of upgrading.

Similarly to goods, high-quality and efficient services do not need to be produced domestically. Services trade allows developing countries, including ASEAN members, to reap the immediate benefits of better quality services from abroad that can support activities in other economic sectors.

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<sup>9</sup> Indonesia, for example, prohibits data on financial services to be sent and processed abroad.

Trade also encourages the creation of a more favorable environment for services development by encouraging competition and collaboration among service providers. It is thus important to increase access to services market and to reduce barriers to trade.

ASEAN member countries can benefit by supporting greater services integration across the region. Current regional arrangements can be improved through such activities as better cooperation in addressing services regulatory frameworks, deeper commitments to eliminate restrictive measures, and increased active regional participation in multilateral initiatives. Ultimately, however, the most important point to understand is that a new perspective about the role of the services sector is crucial. Services should be seen as important in their own right, but also crucial to supporting the development of value chains and economic growth as a whole.

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