Policy brief
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Services trade policies in the East African Community and merchandise exports

In brief

- The economic performance of services sectors in East African Community (EAC) countries has a rather direct impact on the productivity of firms and their export performance in the agricultural and manufacturing sectors.
- At country average input use specifications, a 10% increase in services productivity is associated with an increase in manufacturing productivity of 0.32% in Burundi, 0.41% in Kenya, 0.34% in Rwanda, 0.67% in Tanzania, and 0.55% in Uganda.
- This relationship translates into increases in exports of 0.24% in Burundi, 0.30% in Kenya, 0.25% in Rwanda, 0.50% in Tanzania, and 0.41% in Uganda.
- Cross-country differences are related to differences in firm-level input use, which in turn may be related to applied services sector policies, including trade policies.
- If the EAC were to implement reforms that would lower the average level of services trade restrictions to that in Ghana (the African country with the fewest services trade barriers, with an index ranking of 18), exports of EAC countries could increase substantially: by 13% for Rwanda, and almost 20% for Kenya, Tanzania and Uganda

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Services play an important role as intermediate inputs that are used by other sectors in the economy. Farmers and firms in the manufacturing sector need a variety of services, ranging from finance to telecommunications, transportation and distribution. If these inputs are expensive or low quality, the competitiveness of farmers and firms located in the country will be reduced. They will find it more difficult to compete with imports and more difficult to compete in export markets.

Trade is a channel through which firms can improve their access to services, either in the form of lower prices or greater choice (more variety). Thus, policies that restrict trade in services may be one factor lowering national competitiveness. Recent research has shown that more open services trade policies are associated with better performance of manufacturing sectors, especially in industries that require higher-intensity service sector inputs to their production processes. Given that services trade restrictions in many countries and sectors are often high, liberalisation is one mechanism to foster productivity improvements and economic growth.

In a new paper prepared for the IGC Bernard Hoekman and Ben Shepherd analyse the linkages between the economic performance of services sectors in the EAC countries and the productivity and export performance of firms in agricultural and manufacturing sectors. Using available firm-level data, the authors show that services matter: a 10% improvement in services productivity is estimated to increase merchandise exports of EAC countries by 0.25% to 0.5%. They point out that these results are likely to substantially underestimate the importance of better performance of service sectors for EAC economies. This is because companies and farmers in EAC countries currently rely much less on services than their counterparts in higher-income economies, which is in part because of the limited availability of high quality, competitively-priced services.

The availability of competitively priced services is impacted by the business environment and the quality of economic governance, including policies that restrict trade and investment in services. The World Bank has developed indicators of the restrictiveness of services trade policies for over 100 countries. EAC member states are somewhat less restrictive than the average nation in sub-Saharan Africa, but four out of five EAC member countries have an average services trade restriction score that is 25 or higher. The most restrictive EAC country is Uganda (an index of 35), followed by Tanzania and Kenya (with indices averaging around 30). In their IGC paper, Hoekman and Shepherd estimate the impacts of current policies that restrict trade in services on the merchandise export performance of EAC countries. They show that if the EAC were to implement reforms that would lower the average level of services trade restrictions to that in Ghana (the African country with the fewest services trade barriers, with an index ranking of 18), exports of EAC countries could increase substantially: by 13% for Rwanda, and almost 20% for Kenya, Tanzania and Uganda.

There is a big difference in the estimated potential impacts of better services performance on merchandise exports based on firm survey data and the estimated impact of services trade reforms on merchandise trade using aggregate trade statistics. The estimates of services trade policy reforms using trade data illustrate the great potential that exists for export growth if EAC-based firms are able to improve their access to services inputs, especially 'backbone services' such as transportation, retail distribution and telecommunications. Particularly important in this regard are policies that restrict or otherwise raise the cost of foreign direct investment in these sectors.

These findings are consistent with related research by Cosimo et al, (2015) on the effects of services trade restrictions. They find that economies with better economic governance benefit more from open services trade policies. One reason for this is that many services are not storable. Foreign suppliers need to establish a local presence in the market in order to provide services. Policies that restrict establishment of a commercial presence of foreign firms will then impede trade. But removing such policies may not be enough. Foreign firms wishing to establish a commercial presence will also consider the business environment in which they must operate.

Quality of economic governance and related institutions will have significant impacts on the effect of services trade reforms. Good economic governance, as measured by variables such as control of corruption, the quality of regulation and strong rule of law, significantly increases the potential gains for an economy of services trade liberalisation.

To identify priority areas for policy reforms it is important to 'unpack' how different dimensions of the business environment and economic governance institutions interact with services trade policies and the resultant impacts on different services sectors. This calls for in-depth country-level analysis of the linkages between regulatory reform in services sectors and broader governance reforms.

Policy recommendations

- This study shows that services policies and sectorial competitiveness are important determinants of downstream productivity and exports in goods sectors. EAC countries could reap substantial merchandise trade gains by implementing additional reforms in key service sectors, in particular retail distribution and transport.
- Because many services in these sectors are not storable, policies that restrict or otherwise raise the cost of foreign direct investment in these sectors such as impediments for foreign firms to establish a local presence are of particular importance
- There is also an important private sector development agenda. Governments need to actively support the acquisition of the skills and knowledge that form the backbone of the modern services economy.
- In-depth country-level analysis of the linkages between regulatory reform in service sectors and broader governance reforms is required to understand which policies are most effective in increasing service sector productivity.
- As with any kind of trade policy, reforms to policies that affect services trade have distributional consequences. It is important to be aware of the gains and losses associated with reform, so that appropriate adjustment policies can be designed and put in place.

References

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About the International Growth Centre

The International Growth Centre (IGC) aims to promote sustainable growth in developing countries by providing demand-led policy advice based on frontier research. The IGC directs a global network of world-leading researchers and in-country teams in Africa and South Asia and works closely with partner governments to generate high quality research and policy advice on key growth challenges.
The IGC believes that long-term poverty reduction will not be achieved without sustainable economic growth. IGC research focuses on developing an effective state, fostering private sector enterprise, enabling functioning cities and promoting access to energy – with the underlying aim of driving up living standards and lifting people out of poverty. With offices in 14 countries, the IGC sponsors the work of hundreds of researchers in leading universities around the world. The IGC is based at the LSE in partnership with the University of Oxford, and led by Professor Jonathan Leape, Executive Director, and Directors Professor Robin Burgess and Professor Paul Collier. The IGC is funded by the UK Department for International Development (DFID).

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