Bringing ASEAN into the Global Services Network Revolution

Christopher Findlay

Executive Dean, Faculty of the Professions
University of Adelaide

Introduction

The services sector is already relatively large and growing in the Association of Southeast Asian Nations (ASEAN) so that its performance has significant implications for the economies of the region. Some effects are direct, through its own performance, and others are indirect, through its contribution to the performance of other sectors. There is scope for the services sector to make an even greater contribution than it has so far, including to the creation of 'real jobs' and not simply offering employment of 'last resort'. However, significant reform, which is difficult in this sector, is a condition for capturing these opportunities. There is also a risk that a stronger contribution of services may be associated with issues of lack of inclusiveness in the growth that it induces. These are the topics of this chapter.

The next section discusses some basic data about services, their scale, their types, and their nature. One question is why the share of services in the economy grows as income grows. The relative positions of different ASEAN economies with respect to services are also noted.

The third section of the chapter discusses the nature of and the opportunities arising from the services revolution under way. This includes the application of new technology to services, the emerging closer collaboration of goods and services producers, and the increasing tradability of services. The section reviews an older argument that services sector growth is bad for overall productivity growth.

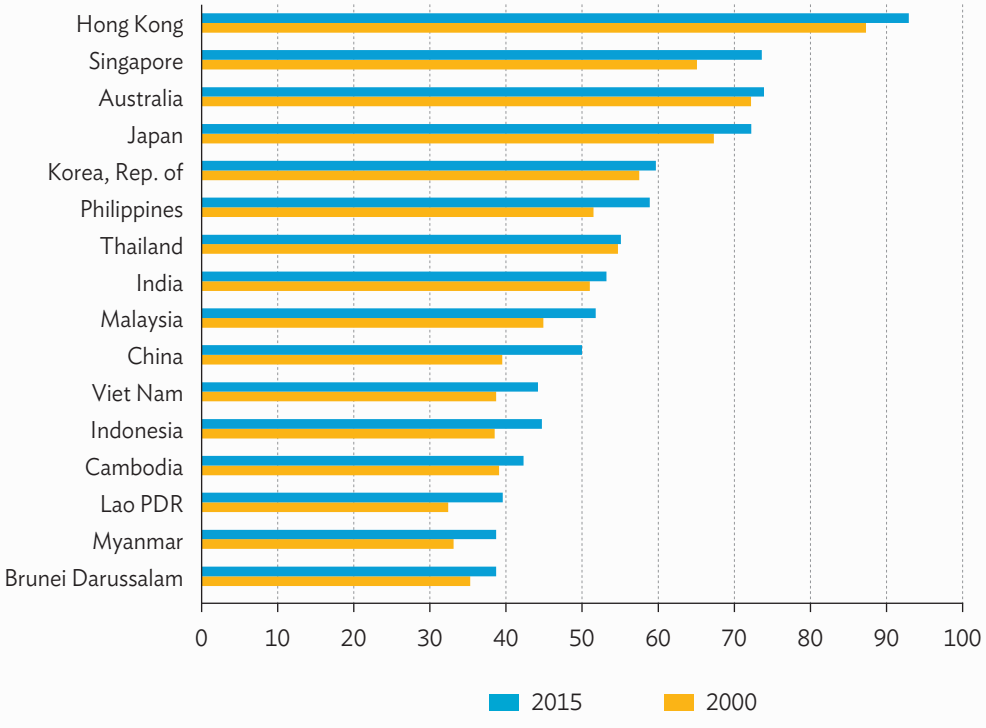
The fourth section includes discussion of ways to capture the opportunities of section 3. The earlier discussion in section 2 of the nature of services transactions provides a checklist of talking points, which include institutional factors, the policy environment, infrastructure quality, and human resources investment.

The chapter concludes with a discussion of the remaining challenges, especially related to the design of the policy reform agenda. This includes a review of the value of regional cooperation in ASEAN on services policy.

Services – What Are They?

The change in the share of services in gross domestic product (GDP) in ASEAN member economies and in the dialogue partners of China, including Hong Kong, Republic of Korea (henceforth, Korea), Japan, Australia, and India is shown in Figure 1. In all cases the services share increased. ASEAN members report of the order of at least 40% of output in services while China is at 50% according to these data in 2015: Thailand and the Philippines as well as Japan and Korea are in a group around 60%, while Singapore, Australia, and Hong Kong are at 70% and higher. Significant increases in the share have occurred in the Philippines, Malaysia, Singapore, and China since 2000.

Figure 1: Service Sector Shares of GDP, 2000 and 2015

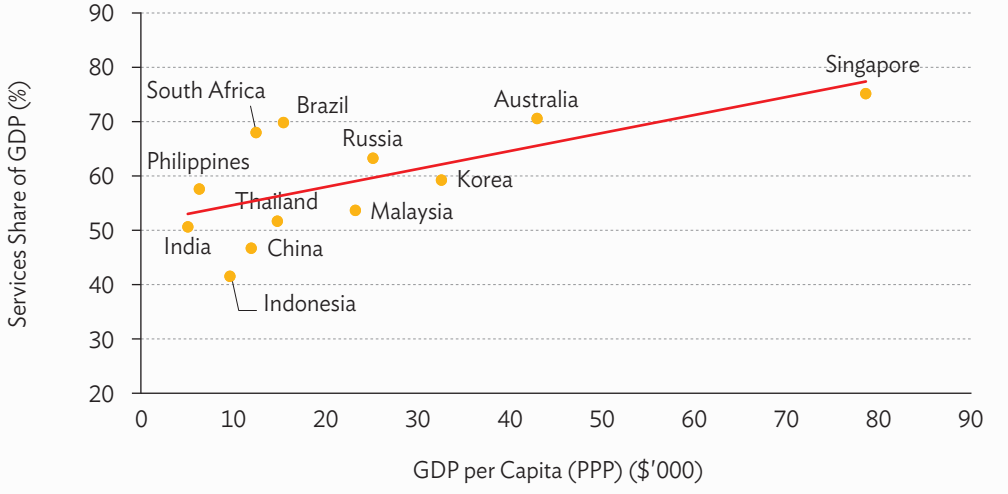


GDP = gross domestic product; Lao PDR = Lao People's Democratic Republic.
Source: ADB (2016).

Figure 1 shows rising shares of services in GDP over time. This could be due to technological change, including in the ways that business is organised, as explained below. Income per capita also rose over this period, which is another factor. Figure 2 shows a cross section of shares of services in GDP compared to income per capita. Higher incomes are associated with a higher services share of output, summarised by the positive slope of the trend line in the figure.

While the trend line in Figure 2 is linear, Eichengreen and Gupta (2011) observed a more complex relationship between the services share of output and income levels. They found that the share of services in output rises with income at lower income levels, but at a decelerating rate, and a later stage in which the services share rises at an accelerating rate as economies move from middle to high incomes. This last stage begins at US$3,800 (2000 purchasing power parity [PPP] values) in their 1950–2005 data set.

Figure 2: Services Share of GDP and GDP per Capita, 2013



GDP = gross domestic product; PPP = purchasing power parity.
Source: WDI.

Eichengreen and Gupta distinguished three groups of services to deepen their analysis of the origins of the two stages of growth in the services share of output. One group they call the traditional services such as wholesale and retail trade, and transport and storage. The second is a group of services mainly consumed by households such as education, health, hotels, restaurants, and personal services. The third is a group of 'modern' services such as finance, business services, communications, computer services, and

legal services. In their data, the share of group one services declines over time, the share of the second group grows faster from middle-income levels, and the third group performs likewise but especially at higher income levels.

A number of factors contribute to these trends, according to Eichengreen and Gupta. These include income elasticities of demand, tradability, technology, and the demand by firms for intermediate inputs. Demand for services comes from household demand, export demand, and demand from other sectors. The tradability of services affects the scope for growth through exports. Technological change of interest occurs through the application of information and communications technology (ICT), which leads to better performance and more sales of services in markets. Firms demand intermediate inputs when they are willing to contract out the provision of 'modern' service activities, rather than providing them in house.

Eichengreen and Gupta refer to low levels of the household income elasticity of demand to explain the decline in the share of those services in group 1. They also refer to lower tradability of these activities, which reduces the scope for growth through exports, and the lesser scope to apply information and communications technology in these sectors, which also impedes their growth. These features of lack of tradability and limits on the application of technology may have been evident in their sample period, but recent events challenge this assessment. Much of the revolution now in progress applies in these sectors, as discussed further below.

The same factors related to demand, tradability, and technology apply to the second and third groups of services but with reverse effects. Group 2 services are more exportable, have a higher household income elasticity of demand, and show more scope for productivity growth. These forces are even stronger, Eichengreen and Gupta argue, for the third group.

The change in demand from other sectors for services is another explanator of the growth in services sales. As firms shift to outsourcing rather than in-house provision, the consequence is growth in the services sector according to the national accounting data. But outsourcing of services has a feature that differs from the procurement of intermediates in goods production. As Hill (1977) defined it, a service transaction occurs when one firm adds value to the products owned by another (or to a person). A firm could, for example, employ labour and capital to provide transport services in-house (where it would appear as part of its value adding effort) or it could contract out the provision of that activity. However, the transport company would not take ownership of the products it was handling.

Decisions to contract out can change over time. The decision to cease production in-house leads to a transaction at arm's length, which requires a contract. Both parties must be confident that the contract can be enforced. This confidence is related to the quality of the institutions of an economy. Issues of confidence will be especially important for complex transactions, which are more likely to be associated with the so-called modern services. Rising confidence in contracting, or using the market, is therefore likely to be associated with a rising share of services in the economy, but especially modern services. The determinants of institutional quality are complex, but there is a relationship with income, though the direction of the causation is also debated. This relationship, however, helps explain the link of the surge in the services output share with higher incomes.[1] Income growth means that the economy eventually meets a threshold at which there is a widespread change in the confidence to use markets to buy services.

Eichengreen and Gupta, however, questioned the relative importance of the contracting out process as a source of services output growth. This follows their inspection of input–output coefficients (the use of services as intermediates in the value of output of other sectors) in the United States and other advanced countries as well as India. They are not convinced that outsourcing has been an important driver of services sector growth. More recently, however, Thangavelu, Nuryartono, and Findlay (2016) found a different situation where the use of services in Indonesian manufacturing has increased over time.

The expectation in this framework is that modern services will tend to grow more rapidly at higher levels of income. These are also the skill-intensive sectors. Buera and Kabowski (2012) provided data for the United States on the share of college educated employees in different service activities. Table 1 summarises the range of values of these shares for the three groups of services.

Table 1: Share of College Educated Employees by Groups of Services

Group 1: 0.03 to 0.36
Group 2: 0.07 to 0.32
Group 3: 0.27 to 0.70

Source: Calculated from data provided by Buera and Kabowski (2012).

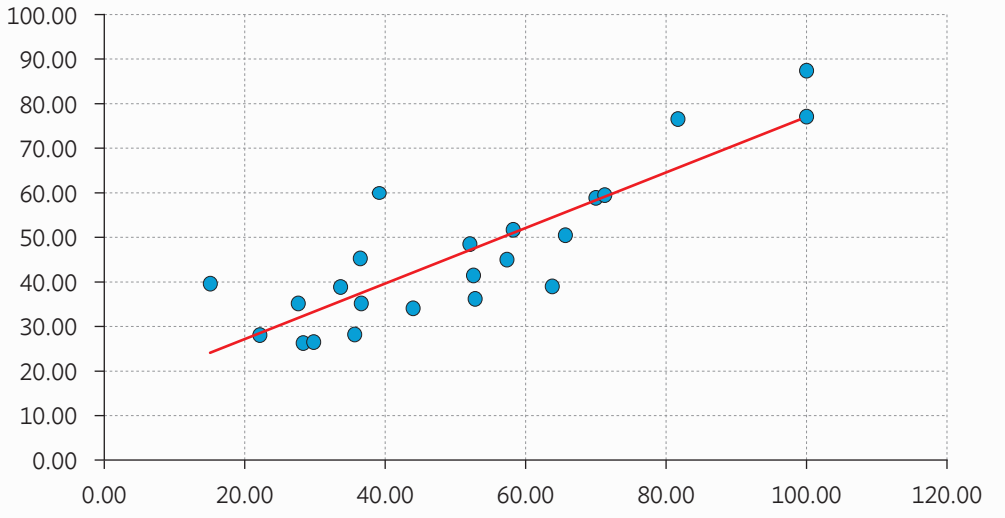
[1] The option of contracting applies to households (for example, household cleaning services or maintenance) and for personal services (such as education or health). Buera and Kabowksi (2012) provided a model of household decision-making which also leads to expectations of a threshold level of income above which the services share of output surges.

Table 1 shows some overlap in values and in fact there is little difference between the first two groups. But the range of values is significantly different for group 3. This situation highlights a risk, which is the lack of inclusive growth. In this framework, the economy reaches a point where the skill-intensive modern sector starts growing relative to the traditional sectors that are less skill-intensive. Demand for skilled labour is increasing in this scenario and the wages of skilled labour could also increase and would do so relative to the wages of unskilled labour. There remains, however, a part of the services sector that could still be called 'the employer of last resort' (Manning and Aswicahyono, 2012). This includes elements of services of categories of groups 1 and 2 (though noting the observation above that the services revolution also applies in some of these areas). Wages in the modern sector rise more rapidly, which contributes to a situation of a widening of the income distribution, in an environment where similar forces in manufacturing are already leading to a 'hollowing out' of employment in that sector. There is a risk, therefore, that events in the services sector will reinforce the changes in manufacturing, which has negative consequences for the political support for structural change, including that induced by openness and trade. Later sections include further reference to the role of investment in human capital in this context.

The discussion so far has focussed on the positive relationship of the services share of output to income per head. There is also considerable variation around the trend line in Figure 2. ASEAN economies located below the line include Thailand, Malaysia, and in particular Indonesia. One factor related to the size of the services sector is the overall structure of the economy and the demand for services as intermediate inputs by the rest of the economy. Organisation for Economic Co-operation and Development data show that some sectors are relatively light users of services as intermediates, such as the resource sectors. Economies with larger shares of outputs in those sectors may then also have smaller aggregate services sectors. The performance of the sector also matters, since that affects the willingness to contract out and buy services in markets, and the drivers of services sector performance are a theme of the discussion below.

Finally, an interesting association is that between the services share of output and the extent of urbanisation in an economy (see Figure 3). The effects could run in both directions. Urbanisation supports the growth of the services sector, by providing larger markets for specialist providers who supply the services contracted out by firms and households. At the same time, an urban area is a more attractive place to live because of the quality and range of services on offer. This linkage is receiving increasing attention in research on the performance and growth of the services sector.

Figure 3: Urbanisation Rate and Share of Services in Employment, Developing Asia, 2009 (%)



Source: ADB (2012), Figure 2.2.7.

The Opportunity of the Services Revolution

One concern has been that productivity growth in services would lag manufacturing. Growth of the services sector would then slow down overall productivity growth. In addition, services prices would have to rise to cover the costs of attracting labour from its alternative higher productivity applications. Inevitably, according to this view, the quality of urban life would diminish over time (Baumol, 1967). Productivity in services is often difficult to measure because of the nature of the transaction, which involves adding value to things belonging to others (there is no purchase and sale to capture the increase in value), and that difficulty may have led to underestimates of productivity growth. However, despite this issue there is too much productivity pessimism in relation to services.

Services can contribute to productivity growth through a number of channels. First, in the Hill framework, the nature of the services transaction is evidently productivity improving. Firms and households decide to contract out because their overall performance is better when they do so: less labour and capital, and other inputs, are used relative to final output by contracting out to specialists who are more productive than are in-house providers. This effect is even greater when services markets are competitive, which in turns adds to incentives for innovation.

Second, there is more scope for application of ICT to services than has been imaged. This applies in particular to the first group of services defined by Eichengreen and Gupta. Parham (2004) reported research that found significant growth in productivity in the wholesale and retail sectors through the application of ICTs. That technology is a driver of the recent boom in the sharing economy, which has led to significant increases in the productivity of various forms of capital through joint use by larger numbers of users. This applies not just to cars and houses but also in other services such as education where online delivery makes course materials available to millions instead of hundreds of students, e.g. through Massive Open Online Courses.

Third, the dividing line between manufacturing and services firms is blurring. More firms do both to support their competitiveness and offer consumers higher levels of quality, specificity, and variety. Manufacturing firms contract out the provision of services inputs but there is evidence they are also selling more services. As Lodefalk (2017: 75) notes:

> 'Contemporary manufacturing firms often import, use, produce and export services… Likewise, services firms export a significant amount of goods. Firms can differentiate themselves by adding services to products, bundling them with products, or offering them in connection with the sale, during the life or at the end of the life of a manufactured product.'

As 3D printing develops, the reorganisation of manufacturing will accelerate, as will the nature of international trade. This shift may happen in some sectors sooner than in others, which is a topic for further work.

Fourth, services are becoming more tradable. By the nature of the transaction (adding value to others or items belonging to others), providing services involves contact between buyers and sellers, which appears to limit tradability. However, there are different modes of trade, for example when consumers or producers move, and the application of digital technology is making it easier for these parties to interact in other ways. Trade has productivity improving effects. This includes the traditional gains from international specialisation, since services production involves value-adding activities different forms of which employ labour and capital in varying proportions. Thangavelu, Ing, and Urata (2015) found a significant positive relationship of exports on services productivity: the stock of human capital also contributes to services productivity. Other channels by which trade contributes are through the addition to competition (Park and Shin, 2013) and technology transfer. Trade in all its forms also adds capacity and variety in domestic markets. That is, all the familiar arguments for integration across borders apply in services markets.

Fifth, manufacturing goods have services contained within them. This occurs in a variety of ways, including through the contracting out process. Services also support the development of value chains in the manufacturing and agriculture sectors. The different components of these chains are connected by services links. The more efficiently those links are operated, the more extensive the chains can become. Hoekman and Shepherd (2017: 512) found that

> 'Insofar as an increasing share of global trade in manufactures is organized through supply chains, with inputs being processed and value added by specialized firms located in different countries that require access to a variety of producer services (including in particular efficient transport, distribution, and logistics services), the productivity of such services will be a determinant of the ability of companies to participate in international production'

When only cross border transactions were reported, services was thought to account for about 20% of world trade, but the new data on trade in value added, which identifies the services contained within the gross value of exports, finds that more than half of world trade involves a services component.

Sixth, services too will benefit from the evolution of their own value chains, which will in turn promote productivity growth. There is evidence of a 'trade slowdown', one explanation of which may be the exhaustion of the opportunities for breaking out of value chains in manufacturing. Mattoo (2015)[2] argued that the same conditions that prompted the value chain process in manufacturing, such as falling trade barriers and the application of digital technologies as well as falling transport costs, now apply to services.

In conclusion, the productivity pessimism associated with services has been too great and there are opportunities to capture a significant positive contribution from services to growth. The 'revolution' with respect to technology and tradability, which is underway, facilitates this contribution. The opportunities include productivity growth in services itself and its contribution to the performance of the rest of the economy, including value chains in other sectors and from the application of value chains within the sector itself. In addition, there are opportunities from the application of digital technology and from capturing the gains from trade and investment in services.

[2] Presentation to APEC meetings in CEBU in 2015.

Capturing the Opportunity

The question is how to capture the opportunities identified in the previous section. A number of points apply.

First, access to ICT is valuable. Access is not the same as the local production of those technologies or goods and services that embody them. In this context, a commitment to free trade in technology related products is valuable as well as the infrastructure that supports the application of digital technology. An instrument for the former purpose is the Information Technology Agreement. Services policy itself is relevant to the second element.

Second, the scope for contracting out is critical to the opportunity to procure services in competitive markets from specialist providers. The willingness to contract out depends on the confidence in contracting, which as noted above is related to institutional quality.

Third, promoting the tradability of services is important – it includes both exports and imports. In a value chain world the phrase that applies to goods producers applies also to services, that is, 'exporters are importers'. As already noted, trade and investment in services is productivity promoting. Removing barriers to trade and investment in services is important.

Fourth, services will make a better contribution when they are provided in competitive markets. Users of services are more likely to contract out the provision of services, and capture the benefits of doing so, when those markets are competitive so that prices are lower, innovation is greater, and variety is wider. There is scope for a virtuous circle in which competitive markets beget a greater willingness to contract out, which also adds to the scale of markets and the scope for competition amongst providers.

The third and fourth points involve removing restrictions on the services sector and by implication impediments to its performance. Recent research has developed measures of 'restrictiveness' that apply to services, with respect to both competition and to trade. Both the Organisation for Economic Co-operation and Development and the World Bank have undertaken this work. The methodology involves identifying policies relevant to particular sectors, scoring the actual application of policy by its degree of restrictiveness, and then producing an overall indicator or index of restrictiveness.

There is evidence that higher degrees of restrictiveness are associated with poorer performance in services. He and Findlay (2012) examined the determinants of the share of services in the gross value of exports. A smaller share is interpreted as evidence of a

poorer performance by the services sector. Explanatory variables include the Services Trade Restrictiveness Index (STRI) and the costs of contracting out, and control variables such as GDP/capita and the composition of exports. They found that STRI values explain more of the variation in the services share in exports compared with other variables. Export composition was the next most significant variable followed by the costs of contracting out. Hoekman and Shepherd (2017) also assessed the impact of variations in STRI values. They found that a higher STRI value is negatively correlated with manufactured exports and the main channel of effect is via the impact of policy on foreign direct investment in services. As expected from earlier comments, decreasing services trade restrictiveness would also have a positive indirect impact on the manufacturing sectors that use services as intermediate inputs in production. This result was also found by Beverelli, Fiorini, and Hoekman (2017) who reported that countries with high institutional capacity (and therefore the ability to contract out) benefit the most from services trade policy reforms in terms of increased productivity in downstream industries. This result reinforces the value of a focus on institutional quality in the design of strategies for the services sector.

The indices provide a useful method for any economy to benchmark its policy settings and to identify the scope for gains from reform. As yet, these indices are not available for all ASEAN economies and there is value in widening their coverage.

Fifth, access to skilled labour is important for the emergence of specialist services providers, who generate these benefits. The significance of skills was evident in the discussion above of the origins of the surge in the services share of output at higher income levels. Access to skilled labour also supports the ability of local firms to respond to competition in more open markets and a greater confidence in being able to compete is one factor that reduces the resistance to reform and to opening up services markets.

Sixth, infrastructure quality is a contributor to the performance of the services sector. The Asian Development Bank (ADB, 2012) stressed its contribution to productivity growth in services, alongside the features of the policy settings ('a good regulatory environment') and access to human capital. Nasir and Kalirajan (2016) offered a test of the relative importance of these factors. They observed that ASEAN countries that are performing well in manufacturing are less efficient in terms of realisation of their export potential in modern services such as computer and information services, business and professional services, and telecommunications services. They say that

> 'Improvements in the business environment, regulatory reforms and provision of modern infrastructure can reduce 'behind the border' constraints … modern services do not depend heavily on physical infrastructure such as

> port facilities (but) the poor quality of infrastructure, such as power shortages and chaotic urban transportation, hamper the growth of these services.' (Nasir and Kalirajan, 2016: 24)

With respect to human capital they observe that

> 'Appropriate training and improved standards of graduates in IT and related disciplines are also important for the growth ... of modern services exports from developing countries...An increase in the stock of graduates and the adoption of ICT technologies (has) a significant and positive impact.' (Nasir and Kalirajan, 2016: 24)

This assessment is consistent with the earlier presentation on the stages of services growth, the importance of group three services in the later stages, and the skill mix of employment in that sector, which is evident in Table 1.

These last two contributors are elements of the services sector themselves and the earlier points about removing impediments to trade and investment, and to competition, are part of the mechanism to generate the contribution by infrastructure and human capital.

Conclusion

There are opportunities for services to contribute to growth, including through improvements in productivity. Those opportunities can be captured by reducing barriers to access to modern ICT, building institutions that support the procurement of services through market transactions, removing barriers to trade and investment, reducing restrictions on competition in domestic markets, and providing access to human capital and to relevant infrastructure.

This is a useful checklist for services sector strategy, but challenges remain. One is the risk already identified that the trends in the development of the services sector reinforce the hollowing out of the labour market that is evident in manufacturing. The response to this issue is a topic for further work amongst the ASEAN members and is related to the strategy for human capital investment and labour market integration in the region. Another is that policy reform, which is key to capturing the benefits that services offer especially in the context of the revolution underway, is difficult. The remainder of this conclusion is focused on this issue.

There are real risks of market failures in the services sector, which are related to the nature of the transaction. These include problems of lack of information and of competition. Services consumption and production occurs at the same time, so consumers may find out too late their provider is not actually qualified or not providing the service they thought they were buying. Nor are services produced and stocked and stored: service producers create and hold the capacity to offer services instead, since the production and consumption have to be simultaneous. This characteristic of the sunk investment in a lump of capacity means a big benefit to first movers in some services markets, leading to barriers to entry by new competitors. There is in other words risk of market failures because of lack of information and issues around competition. The policy responses to these situations are complex and often difficult to assess. For example, many options are available for responding and the best is choice is made where there is no alternative measure that resolves the market failure issue but with lesser effects on trade and competition. Application of this criterion, however, is difficult, since it requires a lot of data and analysis and requires constant review since the answer can change over time as technology changes. This is a demanding situation for policymakers.

Other factors that make reform difficult include the following (Findlay and Pangestu, 2016):

- The benefits of reform for the competitiveness of other sectors are not sufficiently appreciated, including the scope to participate in global value chains. Empirical research such as that reported above in relation to the impact of STRI values on services performance indicators is valuable.
- There are sensitivities and resistances due to the consequences of adjustment by incumbents including professionals, who are articulate and politically well-organised through their accrediting bodies. Opening up sectors dominated by state-owned enterprises such as transport, banking, infrastructure related services, and fixed-line telecommunications is especially difficult. Confidence in the ability of local firms to compete with foreign providers is also a talking point in many economies, responses to which include the focus on reform in the infrastructure sector and which involves investment in human capital.
- Institutional quality also matters. The link to the willingness to contract out was noted above. There is also a link from institutional quality to the capacity to manage reform: Van der Marel (2017) reports for a sample of OECD countries that those with higher regulatory barriers in services also have less capability to manage reform. In addition, complex coordination is usually required across agencies, which is costly to organise. Trade ministries, for example, have to take on new roles of coordinating the expert input of other agencies, which is challenging.

In this context, international cooperation offers support for reform, through the benefits of joint efforts, through peer pressure, and through capacity building. ASEAN has had formal agreements on trade in services since 1995. In the context of the 2006 AEC Blueprint, the goals include faster progress in some priority sectors and in some modes of support (where consumers move and in cross border transactions) plus the relaxation of limits on foreign equity participation. Assessments are that performance can be improved.

- The ASEAN Framework Agreement on Services (AFAS) has made improvements in the number of sectors included (called the extensive margin) and within sectors (called the intensive margin). However, commitments lag actual policy (Dee, 2015).
- AFAS has made significant progress towards meeting its commitments but its ambitions are modest (and it falls short of the liberalisation provided by many trade agreements). To make progress on liberalisation, attention will have to be given to regulatory barriers to trade and investment (Ahsan et al., 2015).
- Two areas in which services integration in ASEAN has been noticeable are air transport and the development of mutual recognition agreements for professional services (Ahsan et al., 2015). Mutual recognition agreements have been completed in engineering, nursing, architectural services, medical and dental services, accountancy, and hospitality. Standards have been agreed on, and all these subsectors are establishing certification frameworks. The movement of professionals has yet to be tested, however, because domestic rules and regulations on permission to work still apply.

Some barriers to trade and investment are the result of deliberate decisions to discriminate, such as limits on licenses available to foreign providers. Others are the response of independent decision-making which, for historical reasons and in the context of the complexity of policymaking in this sector just outlined, leads to incompatible systems of regulation designed to deal with the information or competition issues outlined above. The APEC Economic Committee (2016) argued that attention to regulatory barriers will require a new approach to cooperation. In some cases, policy may not even exist and the lack of a policy can be an impediment to new providers entering a market. These are not matters for the incremental exchange of degrees of market access. They are about the recognition and coordination of the processes of regulation employed in different economies. That will also involve sharing of experience and capacity building to be successful. In this situation ASEAN has an important contribution to make.

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