

Key Issues:

- While the presence of global value chains in goods production is well understood, those in services have attracted less attention.
- It might seem that services are more difficult to organise in a cross-border value chain format, because of the interaction expected amongst producers and consumers of services.
- On the contrary, unbundling is possible, and many examples are available. These chains also operate across borders.
- Developing value chains in services is an important driver of productivity growth. It also facilitates the adjustment of both manufacturing and services to competition in globalised markets.
- Policy impediments remain, however. A value chain perspective on developing reform packages is a valuable initiative, which would be aided by regular and transparent policy review processes.

New Frontiers for Services in Globalisation

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The building of global value chains in manufacturing is much discussed, but less attention is given to the growth of value chains in services, their drivers and their implications. In this policy brief, we discuss the nature of cross-border value chains in services production, the value of taking a value chain perspective on the design of services policy, and how to develop priorities in that respect.

How is Trade in Services Organised?

Services production involves an interaction of the producer and the consumer, in many cases one moving to be adjacent to the other. International commerce (or 'trade') in services then comprises the movement over borders of people and/or capital. For example, international tourists move to their holiday destination, or education institutions invest to set up campuses offshore to supply courses to local students. Health tourism is another example, where consumers travel offshore for access to medical care.

The provision of services such as education or tourism depends on several related activities, not just one form of interaction of consumers and producers. Health tourism for instance involves air travel, accommodation, insurance, and so on, in addition to medical practice. There is scope to procure these other elements from a variety of sources, including third-country providers. The package can therefore be unbundled. For example, a tourist from Australia takes a holiday in Japan, travelling with Singapore Airlines. In this respect, the activity involves an integrated set of value-adding activities, involving more than just the national providers of the consumer's home or host countries.

Services transactions not only involve movements of people; they also involve movements of data and information. When the service is applied to a person, or to a good (being repaired for instance), producer to consumer contact is required. In other cases, the main element of the transaction is the transfer of information and data. This can occur through the interaction of people, and sometimes depends on the nature of the information that is the best form of management of the transaction. Consumer and producer can remain separate and the data can move between them. Trade in services is observed in this case, which involves a 'cross border' transaction. A student in Indonesia, for example, may take a course online from a provider in Malaysia. This is more likely as the costs of data movement fall, and confidence in the security of data movements increases.

The value chain could involve a provider also based in a third country, via another

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cross border transaction. For example, a traveller could arrange insurance and other financial services online with a global financial institution. Travel can be planned online with platforms such as booking.com, which is reported to book 1.55 million room nights each day.¹ In this manner as well, more complex forms of value chains develop around household-level transactions.

In summary, the complexity of a trade in service transactions increases and moves towards a value chain format as third country providers become involved and as the substitution of the movement of data for people takes place.

Example of Value Chains for Household Services

Konishi (2019) identified elements of the tourism value chain in Japan. The shape of this chain is of great interest in the context of the rapid growth of tourist arrivals in Japan. She maps the chain, using results of tourist expenditure surveys, and identifies the significant 'ripple' effects of the growth of the sector. She also identified some regulatory reforms (in relation to tour guides and access to private accommodation), which has added to the supply side capacity of the sector.

Kimura, Thangavelu, Findlay, and Chen (2019) presented a picture of a health-tourism value chain. This involves the provision of a variety of services around the movement of the consumer from their home economy (accommodation, air travel, insurance, etc), as well as the provision of health services in the destination economy. These movements are facilitated by regimes related to visa, observation of relevant global standards, and the provision of financial services and legal services. Policy affecting all these activities will impede the growth of health-tourism.

Buy-in Services by Business and Servicification

The customer for a service could be, rather than a consumer-household as in the cases of education or tourism, another business such as a manufacturing firm which decides to buy in activities which previously they provided for themselves, such as transport, storage, accounting, marketing, human resources, information technology, and so on. The size of the service sector as measured by national statisticians as the extent of this sort of contracting increases.

There is often a concern about the levels and growth of productivity in the services sector and therefore people worry that a growing services sector will hold back overall productivity growth. On the contrary, the growth of the sector through these mechanisms is itself a source of productivity improvement. The 'buy-in' decision is tested in the market and will only proceed if it is worthwhile, so the firm's productivity improves as a result of making this change. These gains are made more likely by

¹ <https://bit.ly/2YL7ucC>

the emergence of competitive services markets, populated by specialist suppliers operating at an efficient scale. Confidence in the ability to make enforceable contracts with service providers is critical. Thus, as the governance regime of a country reaches higher quality levels, the services sector growth is also likely to accelerate.

Figure 1: Outsourcing Offshoring Philippines



Source: Offshoring Outsourcing Philippines (2018). <https://offshoring.com.ph/vertaccount/>

Further gains from these transactions are found when they take place in an international setting, where the parties are in different countries. This offers the gains from trade, from competition, and from access to technology. Openness to trade in goods markets, which forces a search for competitiveness, may also prompt decision-making about buying in services and the growth of the sector and of trade in services.

The offshoring of business services inputs is one example of this response. Aldaba (2019) discussed the evolution of offshoring services in the Philippines related to information technology, and its upgrading – including from business processing, which is more transactional – to higher-value added knowledge processing. Success will depend on the development of human capital and Aldaba discussed the contributions of policy via financing and quality regulation.

Graphic design is another example of a business service that can be purchased from an external provider. Platforms such as 99designs² provide an international marketplace for this service. According to Riveong and Rachmad (2018), 70% of 99designs' customers are from North America but over half of graphic designers are from Asia, the majority of whom are Indonesians and Filipinos. Many of the Indonesians are small farmers or construction workers, who use Google Translate to communicate with clients.

Increasingly, manufacturing firms are on the supply side of these transactions as well. They sell services too. These could be complements to the goods they produce, for example repairs and maintenance. Or they could be activities developed

² <https://99designs.com.au/logo-design>

in-house for which an external market has been developed. An example might be a food processing company that has developed a block-chain based method to demonstrate the provenance of its products, access to which it then sells to others worldwide. Some manufacturers convert themselves into services providers, so instead of selling a piece of machinery they sell the access to its services and retain the ownership of and responsibility for the machine.

Both the input side and the output side are examples of the phenomenon of the 'servicification' of manufacturing (Lodefalk, 2017; Mercer-Blackman and Ablaza, 2018). Kimura, Thangavelu, Findlay, and Chen (2019) showed the significance of purchased services inputs from domestic and foreign sources in East Asian manufacturing, where both are important. 'Domestic' sources of purchased services also include sales from firms located domestically but owned by foreigners. Thangavelu, Wang, and Oum (2018) demonstrated the impact of the use of both foreign and domestic inputs on labour productivity.

Value Chains in Services

The production side of services can also be disaggregated in chains of value-adding activities. Services producers themselves might buy in services. The choice depends on the transactions costs of contracting the provision of those services (specificity, quality, price, timeliness, etc.) and the advantages of the service provider. This provider might be a better option than in-house provision because, as noted, they are bigger, they benefit from scale, they are specialists, and they operate in competitive markets, and so on.

Operating from offshore, the providers also offer the gains from trade. For example, Australian airlines are 'committed' to having the maintenance of their aircraft done offshore in Hong Kong, the Philippines, Singapore, and New Zealand.³ Providers of those services could also be other airlines. Architecture firms in high-income countries may have some technical drawing completed by providers offshore. These are examples of servicification occurring in the services sector itself.

Offshore providers, however, could also be 'in-house', that is wholly owned subsidiaries, where the transactions costs involved in the arrangements may be reduced compared to arm's length contracting. For example, an office in the Philippines may provide human resource services to several regional offices of a global professional services firm.

Various shapes of an international services value chains are possible:

- One is a series of links ('snake') where value-adding activities occur one after the other. An example might be

a distribution system for goods, involving a series of steps of packaging, storage, and movement across different countries.

- Another is a network ('spider web') where a service is constructed by bringing together at one point in time several inputs. An example might be the delivery of construction services.
- A third is called a 'value shop' where a bundle of services is brought together to solve a specific problem for a client. An example might be a professional services firm called in to develop a new business model for a customer. Mirodout and Cadestin (2017) argued that the importance of value shops is generally rising.

Simangunsong, Anas, and Findlay (2019) studied the location of value-adding activities in the context of accounting services, where there has been extensive offshoring, especially of more transactional compared to analytical activities. This is organised by both professional accounting firms as well as other businesses. Offshored activities tend to agglomerate in areas with large pools of skilled labour, which offer more opportunities to match the tasks to be completed with the skills of the staff. If the firm is large enough, the transaction might be organised in house to ameliorate transactions costs.

Simangunsong, Anas, and Findlay (2019) observed that policy in both home and host country will affect the development of the accounting value chain. These relate to the movement of data, people, and commercial presence (or foreign investment). Compliance with standards and modes available for dispute settlement will also be important. As in the case of health tourism, a bundle of sectoral policies are drivers of the development of the chain, operating in the context of various regulatory practices.

Case studies reveal that the scope for offshoring has increased the competitiveness of the home business overall. Doing so also helps build the confidence of incumbent suppliers to respond to reforms that drive international competition. At the same time, offshoring has several benefits in host countries of the offshored activities. The providers involved now operate at a larger scale. They and all other local firms benefit from economies of agglomeration including a deeper labour market. They also benefit from technology transfers from their clients. All these assist the adjustment process in the markets where the offshoring is hosted when those markets are also reformed. Cooperation through services value chains creates a virtuous circle which supports reform.

An important technological shock relevant to this sector is the application of machine learning and operations. This is likely to lower the costs of undertaking transactional work at home and reduce the value of the locational advantages of the offshore provider. However, those providers appear to be responding by moving their operations closer to a value chain model, providing solutions to larger problems posed by their clients. These operations are also sources of innovation for the

³ <https://www.theaustralian.com.au/business/aviation/airlines-committed-to-offshore-maintenance/news-story/d89f5fa8488034c153e41447b0861c15>

business. However, the evolution of the models of offshoring will also shift the relative hindering effects of different policy measures. Those related to data management, storage, and transfers are likely to be increasingly important, according to Simangunsong, Anas, and Findlay (2019).

Managing Reforms

There is value in continuing to drive reform in the services sector, to capture the opportunities offered by the development to the value chains. There is, however, resistance to reform, including from incumbent suppliers but also from genuine uncertainty amongst policymakers about the impacts of policy change, given the complexity of the business environment and the number of policies involved. Findlay and Pangestu (2016) provided more examples of the challenges of policy reform in this sector. They also noted the challenges of coordinating policy changes across the number of government agencies involved.

In response to these challenges, a 'value chain way of thinking' will help define priorities for reform and coordinate their implementation. As noted already, the implementation of the value chain model will also assist in the adjustment process. This effort will be reinforced by a policymaking process which includes regular reviews of services policies. These reviews will be aided by including interaction with the business community, both services users and providers. The former includes not only firms in manufacturing but also in the services sector itself. Business participants not only provide information on the impact of policies on the shape and operation of value chains, but engaging them also helps build a constituency to support reform.

Policy Recommendations

- Services value chains are practicable and they matter. They help capture gains from trade, contribute to productivity growth, support the competitiveness of other sectors, and facilitate adjustment to international competition. It is important for policymakers to recognise these contributions.
- To capture the opportunities services value chains offer, policymakers face a significant challenge. This is because of the complexity of the business environment, the impacts of technological change, the diverse set of policies affecting services, and the difficulties of identifying their impacts. There may also be resistance to reform from incumbent services providers.

A policy review process, which adopts a value chain way of thinking and which engages the business community, is a useful device to help set and drive the implementation of reform priorities.

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