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Expanding Service Exports Background

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The Opportunity

The world, led by a number of fast-growing developing countries, is undertaking a building and construction boom of historic proportions. It is estimated that over the next 25 years, as much as $40 trillion will be spent on infrastructure of all types worldwide, more than 80 percent of which will take place outside of the United States. In addition, because of urbanization and middle class growth in population-dense countries like China, Brazil, India, Indonesia and South Africa there is an increased demand for new and better services, including health care, transportation, and entertainment. These trends in global development represent a potential surge in demand for business services, ranging from architecture, engineering and planning, to health care, logistics, finance and insurance. American companies, with their strong global reputation for expertise and high concentration of skilled workers, are competitive when it comes to delivering these services. As a result, there is a large - and largely underexploited - opportunity to expand the exporting activities of American service firms.

In particular, this opportunity is taking shape at a moment when technological innovations are easing the costs of conducting business across borders and great distances. Trade in services can be facilitated by digital platforms and technologies that ease barriers to communication, as well as the flow of ideas, capital and talent. Platforms may offer a means of connecting U.S. services with global demand, and could also streamline some of the more cumbersome requirements traditionally associated with international trade.

Currently, construction projects of unprecedented scale are taking place round the globe. A few hours from Mumbai, India, the $10 billion Lavasa project is underway: a “hill city” designed to provide the country’s emerging middle and upper classes with luxury amenities, including a nearby golf course and theme park. Roughly 40 miles west of Seoul, South Korea, the $35 billion Songdo International Business District is under development on 1,500 acres of reclaimed waterfront, and once completed will feature office buildings, schools, hospitals and cultural facilities, as well as spaces inspired by New York City’s Central Park and the waterways of Venice. The McKinsey Global Institute reports that China’s urban population will grow by 350 million people by 2025. This is likely to require an additional 5 million buildings, of which 50,000 could be skyscrapers - the equivalent of constructing New York City ten times over!

But in China, as in many other emerging market economies, potential growth is tempered by a need for more skilled labor. According to the McKinsey study: “As costs go up, it will be important to create higher-value jobs necessary for top-line growth…..The shortage of skilled labor and talent will pose a serious threat to China’s aspiration to move quickly towards higher-value-added economic activity.” The rising demand for affordable talent presents a significant opportunity for U.S. firms to export their services and thereby facilitate emerging market

growth. Trade in services presents an enormous "win-win" opportunity: continued growth in emerging markets calls for skills, talent and professional services; while in the U.S., scaling service exports presents a significant opportunity for economic growth, job creation and enhanced global engagement.

As I have documented previously (see Jensen 2011), trade in business services offers a significant, but unexploited opportunity for U.S. growth. The business service sector is large – employing about 25 percent of the labor force (more than twice the size of the manufacturing sector) – and most of the employment in business services is in tradable activities. Because business services are skill-intensive and the U.S. is still relatively skill-abundant, the U.S. has comparative advantage in tradable business services. The U.S. has globally competitive service firms and runs a persistent trade surplus in services. Yet, service firm participation in exporting significantly lags behind participation in the manufacturing sector (where the U.S. does not have comparative advantage broadly), irrespective of whether the metric is the share of export sales or the share of producers that are exporters. Hufbauer, Jensen, and Stephenson (2013) report that about 20 percent of manufacturing output is exported, but less than 5 percent of tradable business service industries output is exported. Roughly a quarter of manufacturing plants export, while less than 5 percent of service establishments in business services export. (Jensen 2011).

In contrast to the large, sophisticated business service sector in the U.S., most emerging markets have relatively small business service sectors. Jensen (2013) document the relatively small and unproductive business service sectors in a range of emerging markets and argue that – because the fast growing needs for talent in the countries are currently outstripping the ability to produce educated workers – these countries would benefit significantly from allowing greater service imports from the developed world, including the U.S.[1]

As I have discussed elsewhere, there are limitations to assessing the exact impact that increasing trade in services could have on the U.S economy and job creation. However, as a back-of the-envelope "thought experiment" (see: Hufbauer, Jensen, and Stephenson (2013)), imagine that through liberalization of barriers to trade in services it would be possible to increase the exports-to-sales ratio in tradable business services (currently less than 5 percent) to the same level as the manufacturing sector (about 20 percent). This would result in an increase of almost $800 billion in export sales, which represents a 40 percent increase in total U.S. exports. By dividing the $800 billion in additional exports by the average output per worker (about $250,000 per worker) in the tradable business service sector would represent about 3 million jobs. These calculations are very rough, with many simplifying assumptions, but they suggest enormous potential from increased trade in services.

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[1] China's recent indication of interest in joining the negotiations for the International Services Agreement (TISA) is consistent with the notion that emerging markets are now recognizing that they need to reduce their barriers to services trade.

Impediments to Exporting Services and Emerging Strategies to Overcome Existing Barriers

In spite of the large opportunity at hand, only a small share of U.S. firms engage in service trade due to a variety of impediments to exporting services; some barriers affect all firms, while others are more problematic for small and medium sized firms.

Policy Impediments

Policy impediments pose significant barriers to trade that affect all service firms. While research by the World Bank[2] suggests that the U.S. is already relatively open to trade in services, a number of large and fast-growing countries, notably China, India, Indonesia, and Russia, have relatively high barriers to trade in services. Other increasingly important economies, notably Brazil and Korea, maintain lower but still substantial barriers to service trade.

These impediments are not in the form of tariffs. Instead, a thicket of domestic regulations, policies, and industrial practices abroad make it difficult to provide business services in these countries. Some countries place requirements for and restrictions on "commercial presence." That is, if you're an architect who wants to work abroad, you need to establish an office; however, you can't establish an office until you demonstrate that a need exists for your service. This type of Catch-22 – along with economic needs tests, quotas, requirements for local joint ventures, licensing accreditation, differential tax treatments, and government procurement practices – can make it difficult, if not impossible, to export U.S. services.

One strategy is for the U.S. to aggressively push to reduce barriers to services trade. There are currently a number of venues for the U.S. to pursue service liberalization, such as the Trans-Pacific Partnership (TPP)[3], the Transatlantic Trade and Investment Partnership (TTIP)[4], and the International Services Agreement (TISA), which focuses specifically on liberalizing services trade. Service trade liberalization in the fast-growing emerging markets would allow U.S. firms with comparative advantage in service provision to start exporting, or increase exports, to these countries. The U.S. economy would benefit from increased productivity through the resulting increase in specialization, as would the economies of other developed countries, like Canada, Japan, and many EU states, all of which are similar in comparative advantage to the United States and would likely see their service exports grow as well. Countries that liberalize would also benefit from the increased productivity that comes from being able to import, as inputs to their own production, the world's best services at the best price.

Much of the spending for infrastructure in the coming boom is likely to be controlled or financed, at least in part, by governments – national, regional, and local. Those governments are sure to be subject to domestic political pressure to favor domestic producers in granting contracts for this work. This makes guaranteeing equal treatment in government procurement a crucial issue for foreign service providers. The WTO's Agreement on Government Procurement was negotiated during the Tokyo Round of GATT negotiations in the early 1980s with the

[2] This research is described in a series of papers: Gootiiz and Mattoo (2009), Borchert, Gootiiz, and Mattoo (2011), Borchert, Gootiiz, and Mattoo (2012a) and Borchert, Gootiiz, and Mattoo (2012b).

[3] See: http://www.ustr.gov/about-us/press-office/fact-sheets/2011/november/united-states-trans-pacific-partnership

[4] See Fact Sheet: Transatlantic Trade and Investment Partnership (T-TIP) http://www.ustr.gov/about-us/press-office/fact-sheets/2013/june/wh-ttip

intention of reducing preferences to domestic firms in public procurement and opening public works spending to international trade. Its coverage was extended tenfold in the subsequent Uruguay Round and now extends to government purchases totaling several hundred billion dollars annually. However, this large sum obscures the fact that, to date, only a relative handful of countries have signed the agreement, virtually all of them in the developed world. In particular, none of the large developing countries expected to account for the bulk of infrastructure spending in coming decades – Brazil, China, and India – are participants in the Government Procurement Agreement. This is another area where the U.S. could seek to improve access for U.S. service firms.

The last area for policy concerns is data flows. While it is very difficult to quantify the scope of cross-border data flows with existing data, it is readily apparent that a significant portion of U.S. exports involve data flows in some way.[5] Whether it is an internet sale (which requires the transmission of customer information cross-border), the provision of digitized information to a customer (e.g. movies, software, or architectural drawings), or the data flows associated with managing clients, risk, and human resources information in a multinational corporation (e.g. a large multinational financial services provider) – all involve cross-border data flows.

In response to security concerns, including the revelations regarding National Security Agency activities brought to light by Edward Snowden, a number of countries are considering or creating legislation to impose constraints on firms' abilities to move data across borders. These range from local data storage requirements to privacy and confidentiality requirements (e.g. requiring any information regarding a citizen to stay within the country). The policy changes all have the effect of raising costs (at a minimum) to prohibiting data flows altogether. These policy changes clearly pose a risk to international trade and are particularly threatening to U.S. exports, which are information and knowledge intensive. As a result, data flows are being taken up in a range of trade negotiations. One question is whether the Task Force should develop a strategy to push for more or different action on data flows.

Impediments of Size: "Intermediary Infrastructure"

Economic research has identified a set of strong empirical regularities regarding exporting firms; these empirical regularities have led to the development of economic theory to describe which firms enter export markets and how firms behave subsequent to entry and in the face of policy liberalization. These empirical regularities and economic theories contain important insights into thinking about broadening export participation.

The empirical regularities are (see Bernard, Jensen, Redding, and Schott 2007):

- Exporters are rare (only about a quarter of U.S. manufacturing plants export; in U.S. service industries where data exist, only about 4 percent of establishments export)
- Exporters are large (the average exporters is about twice the size of the average non-exporter)

[5] A number of organizations have tried to gauge the importance of data flows by examining some of the activities associated with data flows. For example, the Bureau of Economic Analysis estimates that about 60 percent of U.S. service exports are information-and-communication-technology-enabled (ICT-enabled) trade. The U.S. International trade Commission reports that digital products account for 57 percent of music sales, 40 percent of game sales, 30 percent of video sales and 20 percent of book sales. Last, the U.S. Census Bureau estimates that 46 percent of U.S. manufacturing sales are business-to-business e-commerce. While none of these are exactly the phenomena of interest, they indicate that this is an important activity.

- Exporters are more capital intensive, skill intensive, and pay higher wages
- The differences in size and input mix pre-date exporting (i.e. "good" firms become exporters, little evidence of exporting maker firms "better")

These empirical regularities (which have been documented across a range of countries, see for example Freund (2013)) led to the development of economic theory to explain these regularities (Melitz (2003) and Bernard, Eaton, Jensen, and Kortum (2003)). The models emphasize additional costs to export, e.g. the sunk costs to enter a new market, that lead only the most productive firms to undertake the investments needed to export. This self-selection by some, but not all, firms into exporting leads to the observed empirical regularities that exporters are rare, large, and productive. An important implication of these models is that to increase export participation requires reducing the costs associated with exporting.

Some of these costs are policy impediments, as described above, while others represent the costs associated with entering any new market, and include: conducting research to identify potential customers and how regulations and tastes match existing product characteristics, potentially modifying product characteristics to meet local preferences or regulation, identifying distribution and sales channels, and advertising. The barriers appear to affect firms of different sizes differently. More productive firms (which tend to be larger because of their higher productivity) are better able to pay the costs of exporting and are therefore more likely to export. Large firms account for the vast majority of exports and employ a larger share of workers than small firms. As a result, alleviating impediments to large firm exporting will likely have a greater impact on exporting and employment than would a focus on smaller firms. Any strategy to increases U.S. exports should recognize these features of the global economy.

Yet, some attention to small firms is warranted because of their prevalence in the service sector. Small and medium-sized enterprises (SMEs) dominate the service sector in terms of number of firms. More than 60 percent of business service firms (and more than 50 percent of personal service firms) employ 5 or fewer people. In contrast, only about 10 percent of manufacturing firms employ 5 or fewer people. (Jensen 2011). There are many small service firms that could, in principle, become exporters. Yet, to underscore the point regarding the importance of large firms described above, in both business and personal services, these smallest firms account for only about 9 percent of employment. At the other end of the distribution, the largest establishments (those with more than 1,000 employees) account for a similarly large share of employment (roughly 20 percent) in business services, personal services, and manufacturing. Thus, although the share of large-sized service producers is small, they account for a significant share of employment.

The impact of impediments, apart from policy-related barriers comes clearly into focus when comparing traditional exporters to those who take advantage of electronic marketplaces. A recent report issued by eBay Inc. presents information on the prevalence of exporting among firms that use eBay for their sales transactions. As noted above, Bernard, Jensen, Redding and Schott (2007) report only 4 percent of the 5.5 million U.S. firms export and only about 15 percent of all manufacturing firms export. By contrast, 97 percent of "commercial sellers" on eBay (those with sales of more than $10,000 in 2010) exported. The study also reports that the more than 80 percent of exporters on eBay sells to more than 5 countries, whereas Bernard, Jensen, Redding, and Schott found that most exporters export to only one country. These

statistics suggest that online market places like eBay, in conjunction with logistics services provided by firms like FedEx and UPS (who not only move the package, but also frequently manage the customs process for packages), significantly reduce the costs of international trade and enable small firms to export. In addition, electronic payment platforms, including major credit cards companies as well as services like PayPal make up an important part of intermediary infrastructure, and can facilitate and expedite cross-border transactions.

These data suggest that export facilitation firms, or "intermediaries," could work in conjunction with electronic marketplaces like eBay to support the service sector and help scale trade. For instance, owing to staffing and infrastructural limitations, small firms often lack "headquarters services," such as the means navigate legal and regulatory impediments, identify distribution channels, and develop the market research necessary for entering export markets. Intermediary platforms could then represent a potential strategy for overcoming some of the traditional barriers that stand in the way of SMEs engaging in exporting activities, although numerous questions surround whether this represents a feasible or scalable strategy.

Impediments of Size: Awareness

Another explanation for why the majority of SMEs do not engage in exporting may be a lack of awareness as to the opportunity, or, if realized, a lack of inclination to pursue it. A 2012 study by the Economist Intelligence Unit of over 300 U.S. middle market company (defined as sales between $10 million and $1 billion) senior executives reports:

- Fifty-five percent of survey respondents sell and operate solely within North America (henceforth referred to as "domestics") and about three-quarters of domestics—or 42% of the total number of respondents—are active only in the U.S.
- Domestic companies are not international firms in waiting. Seventy-three percent of domestic firms do not intend to expand beyond North America in the next three years and only 7 percent are currently engaged in such activities.
- Many domestic companies give too little thought to international opportunities. Indeed, only 3% of domestic companies review the possibility of expansion regularly and 77% do so rarely or never. For those operating entirely in the US, the figure rises to 88%.
- The leading reason given by domestic firms that intend to "stay at home" is a conviction that there is no market for their goods or services. The next most common response is a lack of knowledge about foreign markets.

These findings indicate that awareness of and commitment to export opportunities is probably an issue with a large number of U.S. service firms. A key question, therefore, is whether making firms aware of international opportunities would be result in increasing their export participation and, if so, which methods would be most effective in raising awareness.

Keys to Increasing Service Firm Export Engagement

As this paper has established, increasing service exports represents a large, but under-exploited opportunity to generate jobs and economic growth in America. Although significant barriers currently impede trade in services, several strategies could serve to help U.S. service firms either begin to export or expand their cross-border activities. These include:

Reducing policy impediments in emerging markets: Foreign policy and regulatory environments can pose significant impediments to increasing U.S service exports; these barriers may be especially pronounced in emerging market contexts, where demand for services is rapidly on the rise. Because reducing these policy impediments will benefit all service firms, lowering these barriers is a first-order priority for increasing U.S. service exports.

Identifying or developing "export intermediaries" for the service sector: Small and medium-sized service firms typically do not have the internal resources needed to successfully landscape and enter foreign export markets. Identifying or developing business models for "export intermediaries" in the service sector could be a potentially important means to increase participation by small and medium sized service firms.

Increasing awareness of export opportunities in services: Small and medium-sized service firms are far less international in their orientation than larger firms. Part of this lack of international engagement may stem from a lack of awareness, and therefore strategies to bolster awareness of opportunities may pave the way for greater exporting.