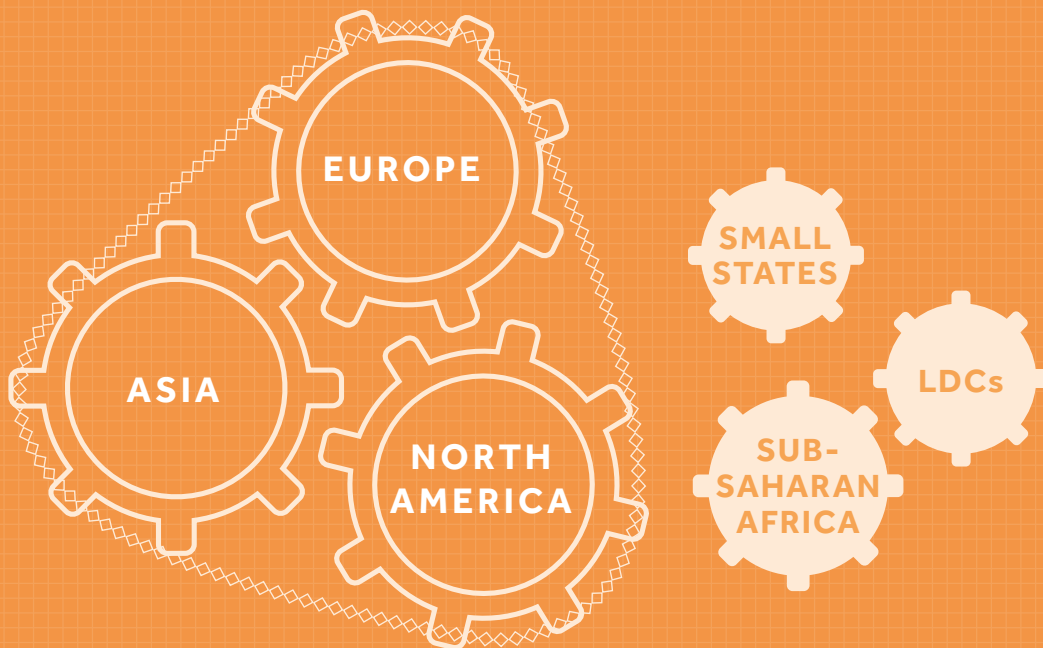


# Future Fragmentation Processes

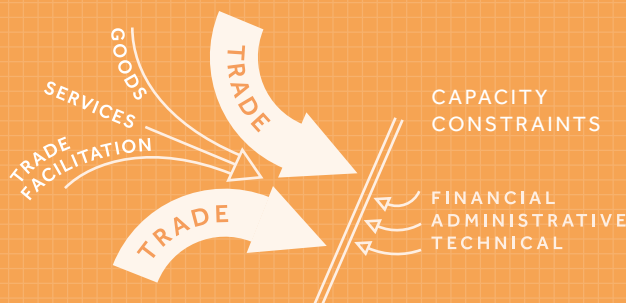
Effectively Engaging with the Ascendancy  
of Global Value Chains

## Section 2: Thematic Issues



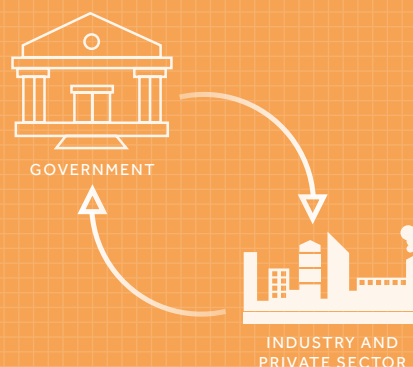
#### MANAGING TRADE POLICY AND NEGOTIATIONS

THE SCOPE OF TRADE POLICY  
MEASURES AND NEGOTIATIONS  
IS INCREASING BUT CAPACITY  
CONSTRAINTS REMAIN.



#### PROMOTING PRIVATE SECTOR DEVELOPMENT

A DYNAMIC AND VIBRANT  
PRIVATE SECTOR REQUIRES  
AN ENABLING ENVIRONMENT.



SOURCE: COMMONWEALTH TRADE REVIEW (2015)

The Commonwealth Secretariat's work on international trade includes:

- Policy and global advocacy, including on the changing dynamics arising within the global economy affecting member states, multilateral and regional trade negotiations, the trade-related implementation agenda of the Sustainable Development Goals, emerging trade issues, and trade and development implications of Brexit.
- Technical assistance to member countries for improving their trade competitiveness in global markets, especially through market access, export development strategies, enhancing the development and exports of services, and trade facilitation.
- Long-term capacity-building support to African, Caribbean and Pacific (ACP) countries through the Hubs and Spokes project, which is a joint initiative of the Commonwealth Secretariat, the European Union, the Organisation Internationale de la Francophonie and the ACP Secretariat.

## Executive Summary

### Context

Profound shifts in the trade–growth nexus have occurred in recent years, with implications for conventional trade-led growth models. Since the Great Recession, which began in 2008 after the global financial crisis (GFC), policy-makers around the world have been grappling with the profound implications of the ascendancy of global value chains (GVCs) for conventional trade policy-making. This is because the principles and models that have underpinned trade policy-making in the past are based on trade in final goods between separate firms based in sovereign states. However, it is increasingly obvious that is far from the case: new forms of trading relationships are arising as a result of profound technological advances, inducing heightened connectivity to global markets.

The unprecedented synchronised global trade shock of 2008–09 revealed the deeply interconnected nature of global trade, investment and finance. As a consequence, international institutions with a mandate for the oversight and supervision of global trade were charged by the G20 with reaching a better understanding of the mechanisms through which the crisis occurred. The result has been the construction of new quantitative databases that measure trade in value added. By identifying the contribution of imports to final goods trade, these new databases provide a more realistic picture of trade patterns. They also help to improve how we account for growth induced through trade.

However, although these new databases provide constructive insights, it is simply not possible to obtain a complete understanding of the operation of GVCs through one type of research method. Data are missing for many Commonwealth countries. Other information gaps persist, not least in view of the tightly co-ordinated nature of global trade, which has arisen as production has been fragmented and dispersed through the networks of transnational firms. All governments continue to grapple with this reality, which comes with a realisation that many of the conventional tools at their disposal to influence participation, as well as outcomes, have been profoundly altered.

Within the context of the current global trade slowdown, new leverage points and more effective dialogue mechanisms are required to more effectively realise the potential gains from trading within GVCs, which are the new trade reality. Management of the disruptive forces unleashed by new technologies,

avoidance of future financial crises and advancement of public policy objectives in view of the universally adopted Sustainable Development Goals (SDGs) requires reflection on the appropriateness of regulatory frameworks, within as well as across countries.

The potential to further leverage the 'Commonwealth Effect'<sup>1</sup> on contemporary trade and investment flows and linkages requires further reflection on the potential trajectory of future fragmentation processes. New drivers of GVCs are likely to emerge at the regional level and within sectors where firms are just beginning their internationalisation strategies.

Within this context, in **Section Two** of this publication we reflect on thematic issues with particular relevance to Commonwealth members. We begin by considering the role of international and national institutions and the regulatory frameworks within which trade takes place. These aspects now clearly feature on the 2030 Agenda, given the universal adoption of the SDGs by the international community in 2015. To avoid a global 'race to the bottom' all governments are reflecting on the institutional context within which firms' trade and interact.

We then proceed to focus specifically on the governance framework provided for trade in services, a cross-cutting issue implicitly referred to in the SDGs, but lacking an overall target. This is because policy impediments that affect services-related participation in GVCs tend to crop up more often in relation to investment and the movement of people, with the potential to limit some types of GVC participation and upgrading processes. This serves as a basis for a further exploration of trade in services and the relative position of Commonwealth small states within particular sectors. This includes their role as providers of high-value services to multinational corporations (MNCs) through hosting international financial centres (IFCs), thus facilitating tax efficiency.

The development of comparative advantages in these services has resulted from an economic diversification agenda which recognised the formidable barriers to entry in other GVC sectors such as manufacturing (due to constraints such as remoteness and small size, which raise the costs of trade). However, because IFC business models are changing, there is now a need to consider new strategies for diversifying into other high-value services.

## Highlights

### Effectively governing global value chains: the institutional interface

Since the beginning of the twenty-first century, the primacy of institutions in driving the trade–growth nexus has been at the forefront of development thinking. However, as argued by **Keane**, only recently have institutional

variables and public policy frameworks been paid greater attention within GVC analysis, as opposed to being relegated to the “background”. Although global public policy aspects, notably social and environmental, have achieved greater prominence since the adoption of the SDGs, their operationalisation of these goals across fragmented regulatory spheres continues to be subject to scrutiny and debate.

### Modes of Service Delivery and Upgrading in Global Value Chains

Because the transformation of global production through firms' internationalisation strategies has fundamentally altered the conventional profit–investment nexus, more careful consideration has to be given to the institutional context within which firms' trade and interact. These interactions – between public and private sector actors – must be contextualised as part of the processes of technological advancement and societal learning within a broader innovation system. In order to facilitate these processes, heightened governance capabilities are required.

Within this context, **Low** reflects on the role of services in enabling particular types of upgrading in GVCs. Value-added estimates of trade are transforming our understandings of the contribution made to total trade by services. A tendency to define regulatory structures that affect goods, services and investment in separate policy compartments interferes with the relatively seamless nature of interaction among these aspects of GVC activity. Within the context of contemporary trade patterns as manifested in GVCs, rules across different modes of services supply need to be defined and applied with greater consideration of their interconnectedness, rather than being formulated in silos. The assignation of policies individually to modes of supply reduces policy neutrality. This can serve development objectives in certain cases, but it can also undermine them.

### Global Value Chains, Tax and Trade: Upgrading the Position of Small States

Better understanding company ownership structures, as well as where 'substantive activity' takes place, has major implications for public policy aspects, including taxation. Given this reality, the contribution by **Rutherford** reflects on the participation of small states in GVCs. This includes their role as providers of high-value services to MNCs through hosting IFCs, thus facilitating tax efficiency. Although this position within GVC has been advantageous in the past, it is coming under increasing strain.

Business models are changing. This means consideration of new strategies for diversifying into other high-value services are required. The current

investment and regulatory regimes in many Commonwealth small states have to adapt to these regulatory shifts. This includes building on existing comparative advantages and capabilities to facilitate movement into other high-value services, as they begin their fragmentation processes.

## Note

1 See Commonwealth Trade Review (2015).

## Chapter 4

# Effectively Governing Global Value Chains: The Institutional Interface

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Jodie Keane<sup>1</sup>

### Abstract

Since the beginning of the twenty-first century, the primacy of institutions in driving the trade–growth nexus has been at the forefront of development thinking. However, only recently have institutional variables become better integrated into global value chain (GVC) analysis, as opposed to being relegated to the background. This is because of the increasing realisation that the transformation of global production through firms’ internationalisation strategies has fundamentally altered the conventional profit–investment nexus, with no area of law untouched by the implications of this type of trade. In addition to the broader framework conditions determined by governments to effectively engage with trade in GVCs, more careful consideration has to be given to the institutional context within which firms’ trade and interact; the specific mechanisms through which knowledge transfers occur. These interactions – between public and private sector actors – must be contextualised as part of the processes of technological advancement and societal learning within broader innovation systems.

### 4.1 Introduction

Since the beginning of the twenty-first century, the primacy of institutions in driving the trade–growth nexus has been at the forefront of development thinking (Acemoglu *et al.* 2001,

Rodrik 2001, Dollar and Kraay 2003). Although the debate has often been characterised by a dichotomy between types of trade policy regimes, more recently a broad consensus has emerged whereby trade reform is more proactively considered part of institutional reform. This process fundamentally alters patterns of behaviour within the public sector, as well as a government’s relationship with the private sector and the rest of the world (Rodrik *et al.* 2004).

Within this context, the relegation of institutions to the background in much of the 1990s global value chain (GVC) case-study literature is rather surprising. Although the more recent wave of the more quantitative GVC literature has attempted to incorporate the role of institutions, the approach has been limited to consideration of National institutions and their quality. For example, in the original GVC handbook developed by Kaplinsky and Morris (2001) no indicators were assigned in relation to the institutional context of GVCs. To some extent, this is because, as elaborated on by Raikes *et al.* (2000), similar institutions were simply assumed to exist within the context of a liberal trade regime, with market friendly-policies in place.<sup>2</sup>

Since then, there is recognition of a need for the incorporation of domestic regulation and public sector support within a comprehensive framework which links GVC governance, institutional frameworks and upgrading (Ponte

and Sturgeon 2014). This is precisely because GVC analysis has so far focused mainly on governance mechanisms internal to the value chain, treating the institutional framework (including state regulation) as ‘background’ (*Ibid*).

## 4.2 Reflection on regulatory frameworks

The role of international and national institutions and the regulatory frameworks within which trade takes place clearly feature on the 2030 Agenda, given the universal adoption of the SDGs by the international community in 2015. However, their operationalisation across fragmented regulatory spheres continues to be subject to scrutiny and debate.

Since the global financial crisis (GFC), and the subsequent Great Recession, there has been a much more concerted effort by researchers to focus on the nature of relations between firms and how these are shaped by external structures set by governments. The interaction between internal relations between firms and their interplay within the overarching frameworks set by governments, and the disjuncture between these, became glaringly obvious after the GFC of 2008.

The profound shifts in the trade–growth nexus that have arisen since the crisis, and the apparent reduction in the power of growth to drive trade,<sup>3</sup> have necessarily lent themselves to a period of deeper reflection on GVCs and their institutional interface. There is a need to go even further, however. Deeper reflection is required in view of the process of technological advancement induced through GVC engagement, which is by its very nature disruptive, with winners and losers. These must be identified and mediated through public policy interventions.

Although the SDGs go some way towards redressing gaps and imbalances in global

regulatory frameworks in view of public policy objectives, the scale of the challenge remains formidable. There is no one area of law that remains untouched by the implications of GVCs.<sup>4</sup> The transformation of global production through firms’ internationalisation strategies has fundamentally altered the conventional profit–investment nexus.<sup>5</sup> All governments continue to grapple with this challenge, within the context of a highly fragmented global policy landscape particularly within the realm of finance and investment.

## 4.3 New measurements of global value chains: trade in value added

The World Trade Organization launched the ‘Made in the World’ initiative in 2012, along with estimates on trade in value added (TiVA). These databases responded to some of the demands of the G20 countries for a greater understanding of the interconnected nature of global trade, in view of the synchronised slowdown that occurred in 2008. However, their contribution extends well beyond this.

For example, because of ‘double counting’ and the inclusion of imported goods in gross exports trade data, an estimated US\$5 trillion of trade flows were simply overstated (UNCTAD 2013). However, while major statistical exercises have been undertaken to understand inter-industry transactions between countries through the construction of global and regional input–output tables, obtaining accurate data on intra-firm transactions remains a challenge.

Understanding company ownership structures, as well as where ‘substantive activity’ takes place, invariably has major implications for public policy aspects, including taxation. Although some progress has been made in terms of bringing international institutions and their reporting mechanisms up to speed in view of contemporary trade and investment flows, these facts underscore some of the challenges.



Currently, the situation is one in which we estimate the value added that accrues between countries, through an analysis of trade patterns between them, rather than between firms differentiated by their ownership structures and locations of substantive activity.

Effective competition management – within increasingly oligopolistic global market structures, as indicated by recent estimates of intra-firm trade – requires judicious implementation. The ability of indigenous firms to achieve certain upgrading trajectories (including functional) without being incorporated into tiers and networks of global suppliers is becoming more and more limited. The process of functional upgrading may entail developing new contractual relations with lead firms. New ownership structures may result from the acquisition of certain technologies as well as from the creation of certain financial linkages.

Clearly, the ascendancy of GVCs has implications not only for the traditional profit–investment–growth nexus, but also for trade-induced growth trajectories. Value chains administered in various ways by transnational corporations (TNCs) now account for 80 per cent of global trade, with one-third of trade occurring within the boundaries of individual firms through intra-firm transactions. This has major implications for facilitating the process of technological upgrading and broader societal learning.

#### 4.4 Adding value

Whereas in the past value added has been calculated in terms of the difference between total revenues and total outlays on intermediate inputs (factor payments and profits), within the context of contemporary trade and investment patterns, it may be more useful to connect this summation to those variables that can be influenced by policy (Baldwin and Evenett 2015). In turn, this implies that value

added per worker may correspond not to average payments per worker but to workers' productivity, factor payments and profit margins (*Ibid*).

Because it is no longer appropriate to consider trade solely in final goods, but rather in terms of tasks (Grossman and Rossi-Hansberg 2006), this necessarily entails disaggregating the value added and skill components of trade. Therefore, obtaining information on the types of firms involved in production, the level of technological sophistication of products and the skills demanded of labourers and their remuneration becomes paramount. This requires a closer interface between GVCs and institutions to obtain, understand and respond to firms' demands in relation to the provision of education in a way that also meets public policy objectives. Greater governance capabilities are invariably required.

Some attempts have been made to better identify indicators associated with the upgrading trajectory so widely referred to in the GVC literature.<sup>6</sup> For example, moving beyond the conventional distinction between product, process, functional and inter-sectoral upgrading processes, Bernhardt and Milberg (2011) make reference to the following:

- **Economic upgrading:** increase in world export market share; increase in export unit values.
- **Social upgrading:** increase in employment; increase in real wages.

However, generally, discussion on upgrading within GVCs fails to situate this within the broader context of technological development and the acquisition of skills. Some attempts have been made to bridge this gap. For example, Pietrobelli and Rabellotti (2011) explore how the characteristics of national innovations systems (NIS) influence relations between firms and therefore their learning opportunities. However, much more empirical

research is needed to better understand these linkages within specific country contexts, as well as related policy instruments, as described in the sections below.

#### 4.5 Facilitating learning

Fundamentally, upgrading in GVCs is a multidimensional process that seeks to increase the economic competitiveness (profits, employment, skills) and/or social conditions (working conditions, low incomes, education system) of a firm, industry or group of workers.<sup>7</sup> From this perspective, upgrading involves a learning process through which firms acquire knowledge and skills – often through their relationships with other enterprises in the value chain or through supporting markets – that can be translated into innovations or improvements that increase the value of their goods or services (Frederick and Gereffi 2009).

This learning process, resulting from the acquisition of knowledge, is one of the most important public goods, and requires systematic interventions by governments (Stiglitz and Greenwald 2014). To facilitate this process a fundamental review of the structure of learning across an economy is required, within and across sectors. Stiglitz and Greenwald (2014) recommend a critical review of the following policies:

- design of educational and research institutions;
- presence of an innovation system;
- design of labour market (including rules affecting mobility of persons, within and across sectors);
- financial and capital market liberalisation (affecting the ability to learn how to allocate capital);
- intellectual property regimes;
- investment treaties;

- taxation and expenditures on infrastructure, education and technology; and
- legal frameworks for corporate governance and bankruptcy.

When upgrading within GVCs is viewed from this perspective, effective engagement expands beyond the realm of conventional trade policy formulation. Facilitating learning processes invariably relates to effective rent management; therefore, the national, as well as international, institutional context in which GVC trade takes place, matters.

#### 4.6 Influencing value chain governance

Economic upgrading within GVCs can be defined as firms, countries or regions moving to higher value activities in GVCs to increase the benefits (e.g. security, profits, value added and capabilities) of participating in global production. It requires critical analysis of the nature of interactions between stakeholders within a given system of production to transform activities from low value added to higher value. This is because value chain governance structures may need to be changed to enable certain types of upgrading to occur.

Farole and Winkler (2014) discuss some of the mediating factors that shape the nature and extent of knowledge spillovers induced through GVC engagement. These include the spillover potential of foreign investors (particularly in the context of investments within GVCs), the absorptive capacity of local agents (firms and workers), and the way in which these two factors interact within a specific host country's institutional environment. Essentially, these interactions between public and private sector actors must be contextualised as part of the processes of technological advancement and societal learning within a broader innovation system.

Given this, more careful consideration has to be given to the institutional context within which firms' trade and interact. This includes the role of organisations such as business associations, designed to facilitate these networking processes, in a systematic way. Repeated and structured interactions form part of an innovation system. In order to assess the presence of measure and assess types of innovation systems in place, the following indicators are typically referred to:<sup>8</sup>

- **interactions among enterprises** – primarily joint research activities and other technical collaborations;
- **interactions among enterprises, universities and public research institutes**, including informal linkages as well as joint research;
- **diffusion of knowledge and technology to enterprises**, including industry adoption rates for new technologies; and
- **personal mobility**, focusing on the movement of technical personnel, including within the public and private sectors.

In order to facilitate these processes, policy makers must design effective consultative mechanisms with business. There are various types of models which can be adopted (Ohno 2014). Consulting business on trade policy changes alongside civil society actors often requires delicate balancing acts. However, it is crucial to ensuring domestic impact assessments are rigorous and the appropriate flanking and sensitising measures are designed. Unfortunately, due to pressing time and resource constraints for many developing Commonwealth members, this has often not been the case, as described in the Commonwealth Trade Review 2015.

Ultimately, governments need to work more closely with their business associations and

chambers of commerce to obtain accurate and timely information. This requires greater governance capabilities, particularly in cases where the private sector, including the small-scale and informal sectors, are not yet organised.

## 4.7 Informing quantitative analyses

Some caution is urged with regard to the consideration of institutions in quantitative GVC analyses, as most studies tend to rely on a very limited number of indicators incorporated from the literature on institutional quality. The objective of the emerging literature, however, is intended to move away from the more limited consideration of institutions within trade theory: which simply focuses on differences in terms of tax and technology.

In the literature on institutional quality, export industries are associated with institutional intensity, as proxied by their association with the rule of law (and, subsequently, contract enforcement, investor protection and protection of property rights). The 'rule of law' is used as an indicator of institutional quality (Levchenko 2007). The index of rule of law developed by Kaufmann *et al.* (2005) captures the quality of contract enforcement, the security of property rights and the predictability of the judiciary. For example, the following products are identified as either high or low institutional quality:

- **High institutional quality:** aircraft parts and equipment, mineral wool, surgical appliances and supplies, packaging machinery, manufacturing industries.
- **Low institutional quality:** meatpacking plants, soybean oil mills, poultry slaughtering and processing, special product sawmills, dairy products, butter, petroleum refining, fluid milk, tire cord and fabrics, malt, setup paperboard boxes.

Subsequently, the ‘rule of law’ indicator has been taken forward in the GVC literature as an indicator of institutional capabilities. For example, a distinction is made by Pathikonda and Farole (2016) between fixed capabilities and those that are either short- or long-term policy variables that may be changed. Institutional capital is included as a long-term policy variable in their analysis. They find that proximity to markets, efficient logistics and strength of institutions are important capabilities influencing GVC participation (as indicated by trade in specific product lines).<sup>9</sup>

The fixed variables they refer to include proximity to markets (measured by GDP-weighted distance in kilometres) and natural capital (current US\$ billions). The long-term policy variables they refer to include:

- **Human capital:** measured by average years of schooling (population >15 years old).
- **Physical capital:** capital stock per person (2005 US\$ thousands).
- **Institutional capital:** ‘rule of law’ rating from –2.5 to 2.5, from the World Bank World Governance Indicators.

The short-term policy variables they refer to include:

- **Logistics/connectivity:** measured by the World Bank Logistics Performance Index.
- **Wage competitiveness:** minimum wage for an apprentice or 19-year-old worker, as measured by the World Bank Doing Business project.
- **Market access:** measured by the World Bank Overall Trade Restrictiveness Indices.
- **Access to inputs:** Overall Trade Restrictiveness Indices for individual countries.

An alternative approach to the integration of institutional indicators into GVC analysis is

adopted by Dollar *et al.* (2016). Participation in GVCs is indicated by domestic value added (forward participation), and foreign value added (backward participation) is linked to institutional quality. Using this approach, Dollar *et al.* (2016) find that countries with better institutional quality have a higher level of GVC participation in institutionally intensive sectors and experience a more rapid increase in GVC participation.<sup>10</sup> However, the positive correlation identified between GVC participation and institutions becomes less significant if the backward linkage GVC participation indicator is used. This may be because, in the research approach currently used, commodities exporters tend to exhibit higher proportions of domestic value added, defined as the backward linkage of GVCs.

To conclude, currently one major shortcoming of the inclusion of institutional indicators in GVC analyses is the sole focus on domestic regulatory indicators. The absence of discussion regarding the international dimension of institutions matters because of the fundamental asymmetries at play in relation to headquarter economies and host economies. In the past, the political economy of for example, the General Agreement on Trade and Tariffs (GATT) and its successor the World Trade Organisation (WTO), centred on a ‘prisoner’s dilemma’ tariff-setting game: to shift from high tariffs towards low tariffs, all parties had to act in concert and be punished for non-compliance (Baldwin 2012). Nowadays, the challenge for policy-makers lies in understanding the need for new policy prescriptions, and notably improvements in the disciplines for international governance of the emerging trade–investment–service nexus (*Ibid.*). Currently, it is not clear how these needs will be reconciled.

## 4.8 Concluding remarks

The emergence of GVCs has profoundly altered conventional state–business relations because the objectives of governments are no longer

as closely aligned with their domestic private sector as in the past. Improving understanding of the influence of institutional variables operating at national and international levels on contemporary trade and investment flows as manifested in GVCs remains an important research endeavour. Although the inclusion of some domestic institutional variables such as rule of law in the quantitative GVC literature is a positive development, there is currently an inability to consider their interaction with international institutions.

The interaction between institutions and technological capabilities deserves further attention. An innovation system is broadly defined in terms of a set of institutions that facilitate technological change and help to diffuse innovations. These systems facilitate interactions between private and public agents, serving to enable certain types of upgrading processes and the achievement of broader societal learning-by-doing processes. The facilitation of these processes matter because they are the only known ways to sustain growth induced through trade.

## Notes

- 1 Economic Adviser, Commonwealth Secretariat. The views expressed in this paper are the authors and do not reflect those of the Secretariat.
- 2 See IGLP Law and Global Production Working Group (2016).
- 3 There is general consensus that, where in the past a 1 per cent increase in growth led to a 2 per cent increase in trade, this has now changed to a 1:1 relationship.
- 4 Areas of interest raised in this article include competition, taxation, labour and environmental standards.
- 5 Although Milberg and Winkler (2009) makes the link between GVCs and financialisation, it is UNCTAD (2016) that draws attention to shifts in the profit nexus at the firm level, with major implications for the advancement of sustainable development objectives.
- 6 See Humphrey and Schmitz (2004).
- 7 Milberg and Winkler (2014) describe upgrading within GVCs as being synonymous with economic development.
- 8 See OECD (1997).
- 9 These products include the parts and components included in the UN Broad Economic Classification (BEC) registry and the product list of the WTO Information Technology Agreement. Using the BEC classification, the authors combined capital and consumption goods into a single 'final goods' category and isolated 'differentiated, customised, product-specific' intermediates.
- 10 Institutions using the standard empirical framework in trade-institution literature.

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## Chapter 5

# Modes of Service Delivery and Upgrading in Global Value Chains

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*Patrick Low*<sup>1</sup>

### Abstract

New understandings of the economic importance of trade in services have arisen as a result of a movement towards the measurement of trade in the same way as GDP: moving away from the uncomfortable juxtaposition of gross numbers for trade and value-added estimates of GDP. As a result, value-added estimates of trade are transforming our appreciation of the contribution made to total trade by services. In view of these developments, this paper reflects on the governance framework provided for trade in services by the General Agreement on Trade in Services. The analysis shows how the assignation of policies individually to modes of supply reduces policy neutrality. This can serve development objectives in certain cases, but it can also undermine them. Policy impediments that affect services-related participation in GVCs tend to crop up more often in relation to investment (Mode 3) and the movement of people (Mode 4), with the potential for negative effects on GVC participation and upgrading processes. A tendency to define regulatory structures that affect goods, services and investment in separate policy compartments interferes with the relatively seamless nature of interaction among these aspects of GVC activity. Within the context of contemporary trade patterns as manifested in GVCs, rules across different modes of services supply need to be defined and applied with greater consideration of their interconnectedness, rather than being formulated in silos.

### 5.1 Introduction

There is growing recognition of the vital role played by services in economic growth and development, both as separate sources of value and in conjunction with production, trade and consumption linked to manufacturing and commodities. Trade and foreign direct investment enable economies to specialise in a variety of services activities on the basis of comparative advantage.

A solid literature already exists on the GVC phenomenon, its origins, its trajectory, and its implications for development and growth in developing economies. Less is known, however, about how services fit into the picture and therefore what needs to be done on the policy front. This is important to ensure that they fulfil their potential to support the participation of developing countries in GVCs.

One key element of trade in services is the creation of opportunities to upgrade and add high-quality value in upstream and downstream segments of value chains. This paper first outlines the key features of GVCs that have increased the significance of trade in services over time. This is followed by a discussion of data challenges that are particularly acute in the services field. Because alternative modes of service delivery shape the nature of engagement of suppliers in GVCs and their scope for upgrading, this paper closely examines these aspects of participation. Finally, a number of conclusions on services-related



opportunities are outlined with a view to promoting domestic value addition and upgrading.

## 5.2 Servicification

The intensified reliance on services observed in GVCs – from the conception of production to final consumption – has increased services' contribution to GDP. The word 'servicification' has been in vogue since around 2010, following groundbreaking work on the role of services in manufacturing by the Swedish Board of Trade (Kommerskollegium 2010). This term refers to the intensified use of services that has followed the fragmentation of production, both domestically and internationally. While it was coined in relation to the greater use of services linked to manufacturing, it can also be applied to value chains that have services as their final output.

As specialisation in international production has intensified, there has been a marked tendency for less and less of the production process to be performed in house. Reliance on external suppliers has spiralled, whether they are offshore or domestic producers, and whether they are part of conglomerates or fully independent third-party suppliers. This fragmentation of production has boosted demand for services of all kinds, at all stages of production processes.

Demand for services in production and consumption-related services is a mixed bag. Some are high-tech, high-value-added activities, such as design, plant and equipment repairs, advertising, marketing and selling. Others, such as cleaning services in production facilities and packaging, add less value but can greatly expand formal employment opportunities.

The explosion of demand for services on the supply side has been accompanied by increased demand for services in the consumption

basket – a natural accompaniment to income growth. Increased service demand linked to GVC-type production and growing incomes has created new opportunities for developing countries to take part in value chains and, perhaps, upgrade their value contribution.

An important caveat here, however, is that a number of demand-side services relating to such functions as advertising, marketing and retailing may in some cases be location specific, so the opportunity to add value locally and upgrade will depend on where the market is situated. A second source of possible concern is that added value provided by local suppliers is limited to the low-skill, low-value end of production. This could happen either because local service providers are prevented from upgrading their offerings or because they are incapable of doing so. These issues are set out in the following sections.

## 5.3 The data challenge

The intangibility of services and their increasing customisation have resulted in more scarce and less reliable data on services in production and trade. This has contributed to a dearth of research and less careful policy-making, as well as a tendency to take the contribution of services for granted without enough concern for the risks of ignoring them.

The measurement of trade in the same way as GDP, for example, has only recently become feasible, moving away from the uncomfortable juxtaposition of gross numbers for trade and value-added estimates of GDP. A statistical shift, driven by advances in computing power and major data management efforts, has allowed value-added estimates of trade to transform our appreciation of the contribution made to total trade by services. It transpires that the real contribution of services is far higher when their value is identified separately from the goods in which they are embodied. We used to report services' share as less than

25 per cent of exports, while the true value is around 50 per cent – a figure much closer to what we already knew to be services' contribution to GDP.

In separating out the net import content of recorded exports, it is also possible to identify the true domestic sources of value in exports. As a result, bilateral trade balances look markedly different; the technology content of trade is revealed more accurately; and, finally, the true degree of global interdependence through trade becomes apparent.

#### 5.4 Modes of services delivery

When scholars and government officials began to think of building an international system of rules for trade in services in the 1980s, they referred to the model adopted decades earlier by the General Agreement on Tariffs and Trade (GATT). The very nature of services, however, made it necessary to build something a little different. This can be seen in the adoption of four modes of delivery under the General Agreement on Trade in Services (GATS).

A range of services can only be produced and consumed simultaneously. This implies the need for physical proximity (with a haircut being one well-known example). Other services, such as live entertainment, may not require physical proximity but still require simultaneous production and consumption. The need for physical proximity and simultaneous production and consumption have been lessened by modern digitised technologies, making services more storable and easier to produce and consume at a distance. The GATS is structured to cover these eventualities.

The GATS structure of four alternative modes of delivery also skirts the challenge of providing a definition of services by identifying them in terms of transactions.

- Mode 1 is cross-border trade in services, and is similar to the way goods are normally

traded. Most Mode 1 transactions are assumed to be digital in nature.

- Mode 2 is consumption abroad, covering such services as tourism and attendance at foreign educational or medical establishments. In terms of a trade transaction, consumption abroad means that the receiving country is the exporter and the country from which the consumer originates is the importer. Here, the importing country is agreeing not to block the displacement of its residents to consume somewhere else: in essence, a commitment to refrain from restrictions on imports.
- Mode 3 covers business establishment (in other words, investment).
- Mode 4 covers the temporary movement of people, referred to in the Agreement as 'natural persons'. These are people who move to another country to work as service suppliers.

It has been argued that the coverage of these four modes is incomplete, given that services incorporated into the export of goods are not identified separately or recorded as trade in services. A case has been made to incorporate a new Mode 5 into services agreements, to cover trade in services that would not otherwise be identified properly because it is currently embedded in goods trade (Cernat and Kutlina-Dimitrova 2014). Leaving aside the practical challenges of identifying such trade, the argument is flawed because services imports incorporated in goods or in other services are effectively Mode 1 transactions. If these are counted, the assumption that most Mode 1 transactions are digital no longer holds.

What does the GATS structure imply for vertical production arrangements spread across multiple jurisdictions, as is the case in many types of GVC? Regarding Mode 2, this becomes less important, as it is about the rights of consumers to cross frontiers. In the

case of Mode 1, when services are identified and sold separately, the terms of market access can usually be identified without much difficulty. These are often intermediate services such as telecommunications, transport and financial services. It should be borne in mind, however, that if such services can either be supplied cross-border (Mode 1) or through a commercial presence (Mode 3), the question of ‘modal neutrality’ becomes important.

In other words, governments may design policies that make access easier or less costly through one mode rather than another; this means they are not necessarily allowing a market-neutral option to suppliers. Therefore, with respect to Mode 1 services (as well as the Mode 5 notion), it is the goods regime that needs to be looked at to determine how far GVCs are affected by policies that impact on services.

Policy has the greatest impact via Modes 3 and 4. While data are not always readily available, evidence from surveys of firms suggests that service suppliers often find it harder to establish a commercial presence than enterprises supplying goods. This means that either services are supplied less competitively or conveniently via Mode 1, rather than Mode 3, or GVC operators must rely on less competitive domestic suppliers. From a long-term development perspective, a government may want to make its domestic suppliers more competitive. However, in the short term, Mode 3-type investment barriers can hamper wider opportunities to participate in GVCs.

Relatively little use has been made of the GATS as a commitment mechanism under Mode 4. There are virtually no examples of Mode 4 commitments involving unskilled workers, and only a limited number for professional personnel. Mode 4 covers only temporary presence and takes care to avoid touching on immigration policy or the right of abode.

From a developmental perspective, Mode 4 trade is useful to impart skills and as a source of foreign exchange via remittances for the country supplying the personnel. However, when a temporary presence becomes more permanent, there is a potential national trade-off between the remittances sent home and the impact of brain drain. Some developing countries have strong interests in promoting higher levels of commitment under Mode 4 among their trading partners. In terms of their own commitments, developing countries seeking enhanced GVC participation and the learning to be gained from skilled foreign personnel may find it worthwhile to facilitate foreign access for skilled labour under Mode 4.

To sum up, it is useful to consider what a neutral services regime would look like in terms of the modes of supply when exploring services trade regimes and their potential contribution to GVCs in ways that promote development and upgrading. This can provide a benchmark for consideration of the developmental implications of any departures from modal neutrality. Some departures, perhaps temporary, may enhance GVC participation and upgrading opportunities. Others that linger and that serve less development-oriented purposes may frustrate GVC participation by reducing the attractiveness of a particular location.

The GATS modes, as well as preferential trade agreements that cover services, may provide less effective support for GVC participation that enhances development when there is a gap between legal commitments and actual policies. This increases policy uncertainty and can result in lost opportunities.

## 5.5 Global value chains

The recent explosion of GVCs has altered the way we think about trade. The fragmentation of production, as well as related processes, among different countries has increased

opportunities for specialisation and growth through trade. The growth of modern industry is no longer considered a process that entails complete production processes taking place in one country. The growth of production sharing offers many more opportunities for outsourced suppliers to link to GVCs. This integration process fosters specialisation and can pave the way for greater competitiveness. Over time, outsourced suppliers can become lead firms in their own right.

The services aspect of GVC operations is arguably even more important for emerging and developing economies. This is because small and medium-sized enterprises (SMEs) are a significant part of the production base and are, in most cases, service providers. Compared with much of manufacturing, entry costs (physical capital requirements) tend to be lower for SME service providers; economies of scale are rarely part of the equation. The question is how successful SMEs service providers can be in securing their participation in GVCs.

The geographical configuration of some GVCs (and the way in which this configuration has changed over time) is influenced by the markets in which they operate. It is useful here to distinguish different kinds of GVCs. Back in the 1980s, for example, buyer-driven chains – value chains producing mass-consumption consumer goods such as textiles and clothing – tended to be controlled and owned in the West, while components and parts tended to be produced both in the West and, to some extent, the East. End-of-line assembly would take place in Eastern economies with low labour costs. Since the 1980s, however, this final stage has tended to shift to countries with lower wages as incomes have risen in countries such as China. This has opened up new opportunities for lower-income developing and least-developed countries.

These shifting patterns are less obvious in the case of GVCs built on agricultural commodities and natural resources: their starting point is

determined by the location of the resource; end markets for output are more numerous. For developing countries hosting these kinds of GVCs, the challenge is to acquire a growing share of the value added between the raw material production or extraction stage and final consumption. Here, services can be a key factor. However, in addition to the domestic challenges of creating propitious conditions to foster this process, a tendency for importing countries to structure tariffs in an escalating pattern based on the degree of value added embodied in the imports in question can greatly complicate such efforts.

For producer-driven value chains, such as those making capital goods where sunk costs cannot be recovered and the production process is complex, a large proportion of the production process is likely to be less footloose and located in higher income economies. If the output is bulky and involves high transport costs, chosen locations may be nearer end markets.

Understanding the dynamics behind decisions on the configuration, location and operation of GVCs, as well as what might influence and shape these over time, matters for the identification of new opportunities to participate in international production arrangements. A GVC-centred analytical approach emphasises the interdependency of imports and exports. It also sheds light on the opportunities to participate in internationally fractured production structures and the range of factors that influence the choice of location.

### 5.5.1 Services in global value chains

Fragmentation and international specialisation have not only raised the contribution of services to economic activity, they have also emphasised the integrated nature of goods and services in production processes. The involvement of services in GVCs is not always directly comparable to that of goods: it all depends on the function that particular services perform in GVCs.

Services merit attention because they are multifunctional. First, they play an intermediation role. They become part of the glue that holds the constituent parts of a value chain together. The services involved here include transport, communications, financial services, management, accounting, information and communication technologies, and advertising. Second, they play a co-ordination role, linked to some 'producer services' such as logistics. Third, they may be incorporated more directly into goods, such as in the case of packaging and labelling, where the services concerned change the presentation of the product but not necessarily its physical characteristics.

Another reason to focus on services is because the location where they are provided is not always a matter of free choice. The post-production downstream segments of GVCs, such as branding, marketing and distribution, are often specific to the consumption location. As the consumption destination of GVCs conforms to reconfigured sources of demand, opportunities emerge for specialisation and increased output across a whole range of services, beyond those traditionally linked to production, opening up new space for local service suppliers to link into GVCs. These opportunities may also arise over time in the upstream, pre-manufacturing segments of GVCs. For example, large markets in new locations tend to require different products to cater for local conditions and tastes, giving rise to localised R&D and other aspects of production.

Finally, linkages between trade and investment are particularly important for services provision because of the need for physical proximity for the supply of a range of services. Even when this is not a technical requirement, as it is in the case of distribution services for goods, it may reflect a preference related to business relationships between producers and consumers.

### 5.5.2 Services and outsourcing

Recent firm-based research carried out mostly in Asia by the author and colleagues on the role of services in GVCs points to a significant degree of outsourcing (Low and Pasadilla 2016). Because the research relied on case studies, rigorous statistical analysis was not possible, so the findings tend to be hypotheses that deserve further investigation, rather than firm generalisable conclusions.

The research undertaken produced 38 case studies across a variety of goods and services sectors. These were chosen on account of access to information considerations. Comparability among the case studies was further complicated by the practical need, in a joined-up world, to define the GVC under consideration in terms of where it begins and ends. These cut-offs were determined by the extent of a lead firm's involvement in the GVC concerned. For reasons of tractability, only first-tier outsourced inputs were considered – that is, only the direct services inputs contracted externally, not those used by the first-tier suppliers.

A surprising number of services were required for most of the GVCs examined. The smallest number was 26 and the largest was 80. These were defined and identified according to the UN Central Product Classification (Revision 2). These services ranged from the simplest to the most sophisticated and knowledge-intensive of tasks.

Perhaps more surprising still was the degree to which services were outsourced. Taking all 38 firms in the sample, an average of 63 per cent of all service inputs were outsourced fully or partially (38 per cent and 25 per cent respectively). This left only 37 per cent provided fully in-house. Many of the outsourced inputs were procured from local suppliers, suggesting significant opportunities to link into GVCs through services provision.



Formal models of firms' outsourcing decisions tend to attribute the choice to cost and risk factors (Costinot *et al.* 2013, Milberg and Winkler 2013). The advantage of a more granular case-study analysis is that it offers more detailed explanations of why firms do or do not outsource. This, in turn, offers more scope for understanding what policies are likely to maximise domestic opportunities for GVC involvement, as well as for upgrading.

The academic literature around the boundaries of a firm – and what gives rise to the establishment of a firm in the first place – is useful in systematising the analysis of outsourcing (Slater 2006). This literature points to a variety of factors at work. These range from considerations regarding transactions costs (arising from information and co-ordination problems) to various forms of market and bargaining power (often emanating from property rights). Finally, considerations associated with principal-agent problems, hurdles to knowledge transfer, and issues associated with monitoring and reputation can all matter. A parallel literature from business analysis focuses on what is referred to as a 'make or buy' decision. Some of the reasons for making in house include reputation and monitoring costs, co-ordination costs (timing, sequencing and technical specifications), information asymmetries, proprietary information, and liability considerations (including policy risk). Reasons for buying include economies of scale and scope, learning economies and network effects, including external economies of scale.

### 5.5.3 Upgrading and the role of policy

A growing literature has emerged in recent years on upgrading in GVCs. The term refers to the trade and developmental aspirations associated with higher value participation in GVCs (Staritz *et al.* 2011, Gereffi *et al.* 2001). The analysis of upgrading is based on the proposition that even if GVC host economies

are not as well positioned as others to influence some outcomes, they can maximise other aspects of economic empowerment. This includes consideration of policies that allow them greater scope for bargaining on aspects of value chain governance over time.

A useful and widely referred to taxonomy for upgrading activity in GVCs distinguishes among the following categories (Humphrey and Schmitz 2000):

- process upgrading (improving a production process);
- product upgrading (improving an end product);
- functional upgrading (undertaking a new activity on a value chain);
- inter-sectoral upgrading (changing the area of activity or industry); and
- channel upgrading (expanding participation to different markets – that is, expansion along the extensive margin).

The challenge is how to benefit from these different upgrading opportunities, some of which remain under-researched, even in the case-study literature. When it comes to services, one immediate question is how the different functions of the services that enter GVCs can contribute to upgrading. This is particularly important because services are an increasingly dominant source of value, are multifunctional and are capable of contributing to innovation as well as adaptation.

Effective action requires recognition of the intimate linkages across goods, services, trade and investment that enable the effective operation of GVCs. To ensure that services can make the most effective contribution possible, the policy environment should not create wedges between these different elements of production and consumption processes. It follows that some of the policy disadvantages

imposed on services industries cited in our case-study research should be addressed.

In particular, the concentration of cost-augmenting restrictions in factor markets appears to present problems. These include restrictions on foreign and (sometimes) local investors, and labour market constraints related to visas, work permits, professional qualifications, certification, practising licences and employment-contract restrictions. Interviewees also listed other avoidable policy costs, such as local content requirements (use of local suppliers with skill deficits at high cost), conformity assessment procedures for standards, overlapping regulatory jurisdictions and issues around intellectual property protection.

Another basic factor cited by virtually all interviewees related to policy stability and predictability. Frequent and often unannounced policy changes, inconsistencies among jurisdictions within the same economy and the misuse of discretionary authority were often cited as negative factors in outsourcing decisions.

Addressing some of these issues, and doing so in a way that is consistent with national development policies, could enhance opportunities for GVC-related activity in the domestic economy through a more enabling environment. Other actions that enhance domestic capabilities across the board relate to the quality of physical infrastructure, the nurturing of human capital and the quality of governance.

In short, decisions about location do not depend only on market-driven price and cost advantages. Crucially, they also rely on policies. Operating costs are influenced heavily by the regulatory environment, including, for example, whether government-administered regulation and government-supplied services are provided in ways that avoid unnecessary costs. Another part of the policy landscape

is enabling support. The quest for greater and higher value participation in GVCs can be assisted by multiple mechanisms; these range from subsidies to measures to address appropriation problems, co-ordination externalities and information deficiencies. Maintaining such a policy framework, however, requires well-honed governance capabilities, full transparency, and continuous monitoring and accountability.

## 5.6 Concluding remarks

Six main conclusions emerge from this discussion on the critical importance of services for economic growth and development.

- 1) As services have become more important in production, consumption and trade, so too have the developmental costs of the failure to factor services into economic and policy analysis.
- 2) The national and international fragmentation of production has created many new opportunities to embed services inputs in GVCs across a range of activities of varying levels of value content and technological sophistication.
- 3) Despite the challenges, the use of improved data on services – particularly in relation to services' value attributed incorrectly to goods production and trade – is essential to an understanding of services-related opportunities to add domestic value and upgrade within GVCs.
- 4) The assignment of policies individually to modes of supply reduces policy neutrality on the choices made about how to supply services. This can serve development objectives in certain cases, but it can also undermine them.
- 5) Policy impediments that affect services-related participation in GVCs tend to crop up more often in relation to investment (Mode 3) and the movement

of people (Mode 4), with the potential for negative effects on GVC participation and upgrading.

- 6) A tendency to define regulatory structures that affect goods, services and investment in separate policy compartments interferes with the relatively seamless nature of interaction among these aspects of GVC activity. Rules should be defined and applied with an eye to replicating this interconnectedness, rather than being formulated in silos.

Both the opportunities to participate in GVCs and to upgrade participation over time depend on the policy environment. Businesses rely on predictability, consistency and transparency. An environment conducive to GVC participation and upgrading opportunities depends, therefore, on approaches to policy that focus on facilitation and minimise deadweight costs. Another element of successful policy may involve the temporary use of support measures such as subsidies. Success here depends crucially on governance capabilities, including consideration of good governance as well as transparency and accountability.

## Note

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## Chapter 6

# Global Value Chains, Tax and Trade: Upgrading the Position of Small States

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### Abstract

This article considers the role that some small states that host international financial centres (IFCs) have sought to play as part of the global value chain (GVC) structures of multinational enterprises (MNEs) seeking to maximise tax efficiency. It provides some history of the challenges faced by such jurisdictions in responding to the development of norms and standards by bodies such as the Organisation for Economic Co-operation and Development, establishing context for more recent changes that, still unfolding, will affect the role that some IFCs located in small states have within MNE structures. Small states developed IFCs as a means of economic diversification, given the inherent challenges of participation in traditional GVC structures; the article concludes by reflecting on the need for IFCs, and the small states that host them, to build on the physical and professional infrastructure developed to date to identify ways that they can continue to provide high-value financial services within the GVCs of MNEs in a global tax framework in which taxation outcomes are better aligned with underlying economic activity.

### 6.1 Introduction

The fragmentation of global production that has occurred in recent years has been underpinned by revolutions not only in

technology but also in finance. A complex web of transactions has arisen between networks of firms not necessarily bound by direct ownership structures, nor ostensibly tied to the location where most substantive activity takes place. The expansion of vertically fragmented global value chains (GVCs) has been motivated by efficiency-seeking foreign direct investment (FDI), underpinned by a highly fragmented investment regime with, essentially, no globally agreed rules on finance. One aspect of the efficiency sought by multinational enterprises (MNEs) in structuring their GVCs is tax efficiency.

While there is a range of means by which an MNE can pursue tax efficiency, one method has been for MNEs to include in their GVC structures affiliated entities located in small jurisdictions that host international financial centres (IFCs). The use of entities in no- or low-tax jurisdictions in turn takes advantage, among other things, of an international tax system the development of which has been based on norms and principles that are ill suited to today's modern, globalised economy.

The onset of the global financial crisis (GFC), which saw dramatic declines in the budgetary positions of many developed countries, led to, among other things, an increased focus on the tax practices of MNEs by governments in search of revenue. These developments, unfolding alongside recent scandals such as the release of the 'Panama Papers', have led to

a period of increased scrutiny regarding the absence of globally agreed rules. Concerns have arisen regarding a global ‘race to the bottom’, with jurisdictions increasingly competing by adapting their regulatory frameworks and attracting a broad range of efficiency-seeking investments as well as finance. Alongside an increased focus on the tax practices of MNEs, major public policy concerns have arisen relating to tax evasion and the effects of illicit financial flows. The international response, led by the Organisation for Economic Co-operation and Development (OECD) and with the political impetus of the G20, led to a significant and ongoing process of reform to the international tax system that has, as one of its broad goals, a better alignment of taxation outcomes with substance – that is, the underlying economic activity.

This article reflects on these developments from the perspective of small states that host IFCs, many of which have come to play significant roles in the global investment system. Such states, often remote and isolated, and facing large trading costs and other challenges to participating in GVCs, have sought to develop IFCs as a means of diversifying their narrow economic bases towards high-value services and away from limited commodity dependency.

Current processes under way will undoubtedly affect some IFCs, although the significant diversity of small states that host IFCs means that the full implications are likely to vary significantly between countries. Yet, for many small states, identifying viable options for economic diversification and for ongoing participation in GVCs remains a very real and ongoing challenge. In adapting to the evolving international taxation and regulatory environment, building on the financial services infrastructure already in place to focus on new, value-added services may open up new opportunities.

This article is organised as follows. First, some of the terms used in the current debate on tax

and trade are defined. Some of the reasons why some small jurisdictions have sought to develop IFCs as a means of economic diversification are described. An overview of the history of regulatory and taxation landscape and issues as they have affected small states which host is provided. Finally, this article outlines some of potential implications of the current regulatory clampdown, mitigation measures, and concludes with reflections on how small states can continue to effectively engage with the future GVC fragmentation mechanism.

## 6.2 What are international financial centres?

In an area where terminology assumes a particular importance, it is unfortunate that there is so little consensus or certainty around key concepts, despite efforts to develop clear definitions (Zorome 2007). Terms such as ‘offshore financial centre’ and ‘international banking centre’ are often used interchangeably, along with the pejorative ‘tax haven’, but all have slightly different meanings depending on the context.

At the most basic level, a financial centre is simply a concentration of financial intermediaries that provide services to individuals, businesses, governments and other groups. An ‘international’ financial centre is a financial centre of international significance, providing services to entities or individuals not resident in that jurisdiction. Some of the world’s most significant IFCs include London, New York, Singapore and Hong Kong. A reference to an ‘offshore’ financial centre, as opposed to an ‘onshore’ financial centre, usually signifies services that are largely provided to non-residents. This is case for most IFCs hosted in small states, given the small size of their domestic markets.

## 6.3 Small state hosts

The Commonwealth considers a small state to be one that has a population of fewer than

### Box 6.1 Small states

The Commonwealth defines small states as sovereign countries with a population of fewer than 1.5 million people. Some larger states are also considered to be small states because they have many of the same characteristics (Commonwealth Secretariat 2016a). Similar concepts are used in different contexts. For example, the World Trade Organization (WTO) has a concept of small

and vulnerable economies (SVEs) (WTO 2016), which are jurisdictions that account for only a small fraction of world trade and are particularly vulnerable to economic uncertainties and environmental shocks. A concept of small island developing states (SIDS) is also used by a number of organisations. There are clearly overlaps between these definitions.

1.5 million, though usage also encompasses a number of larger states that have similar characteristics (Box 6.1). There are 30 small states in the Commonwealth and a number of these have established IFCs. However, there are many more territories and dependencies of Commonwealth members (notably the United Kingdom and New Zealand) that host IFCs. The network, span and global reach of IFCs can therefore vary significantly.

In terms of the services provided by IFCs hosted by small state jurisdictions, these often include a range of intermediate financial services such as international banking, insurance, the facilitation of collective investment and asset management (Lane and Milesi-Ferretti 2010). While many IFCs in small states purport to offer a full range of such intermediate financial services, many often specialise in the provision of certain services and therefore develop specific regulatory regimes for these. For example, Bermuda has emerged as a centre for insurance services, while the Cayman Islands has emerged as a centre for fund management.

The significance of IFCs hosted by various small states and jurisdictions varies greatly. Vanuatu, for example, has a relatively modest IFC that in the IMF's estimation contributes around 5 per cent to GDP, roughly 3 to 5 per

cent to government revenue and less than 2 per cent to total formal sector employment (IMF 2015a). The contribution of IFCs to the Bahamian economy is around double this (IMF 2015b). Certain small jurisdictions also host some of the most globally significant financial centres. The Cayman Islands and the British Virgin Islands, for example, rank among the top 40 global financial centres (CDI and Z/Yen 2016).

While the extent to which an IFC contributes to a small jurisdiction may vary, the type of benefits a jurisdiction may receive include direct revenue arising from corporation registrations, local employment, the transfer of skills to the local population and other ancillary benefits such as those accruing to the tourism industry. The development of IFCs has therefore been pursued as an important economic diversification strategy among many small states.

## 6.4 High-value services and export diversification strategies

Small states and jurisdictions that have sought to develop IFCs have done so in response to inherent structural characteristics that necessarily limit the application of conventional trade and development strategies

and require more heterodox policies. With small domestic markets and high trade costs as a result of long distances from export markets, many Commonwealth small states are also highly vulnerable to natural disasters such as earthquakes, volcanic eruptions, hurricanes and climate change. In response to these challenges, a number of these jurisdictions have sought to create a comparative advantage through the introduction of a regulatory regimes that accommodates niche markets (Woodward 2011).

Two of the earliest examples of small jurisdictions adopting an IFC model include the Bahamas and the Cayman Islands. The IFCs in each of these jurisdictions were first developed during the 1960s, in response to US-imposed capital controls. The US government's decision to tax interest payments received from foreign securities, to reduce its balance of payments deficit, meant that British banks could lend at lower rates than US banks. To capitalise on this, establishments were created in the Caribbean, in a time zone that enabled them to compete with US banks, and with infrastructure costs lower than those found in London.<sup>2</sup> This example demonstrates how IFCs often develop in response to changes in the international financial architecture and the specific niches that may be created within particular jurisdictions.

As well as offering a generally stable and predictable legal environment, jurisdictions may offer a legal system that enables the ready creation of financial-sector entities such as banks, or structures such as unit trusts, corporate entities or limited partnerships used for asset management. They also often offer a skilled workforce and an accommodating regulatory environment (Lane and Milesi-Ferretti 2010). While taxation outcomes are not the sole driver of the use of an IFC, the level of taxation and how this compares to the 'parent' country can often be an important 'pull' driver of capital flows. Usually in the context either

of no corporate tax system, or of a system that specifically provides for either no or very low levels of taxation for certain defined, 'offshore' financial-sector entities, MNEs can utilise such entities to lower their global effective tax rate through, for example, allocating income-producing assets to those entities.

Other motivations for the incorporation of IFCs based in small states into the transactional networks of globally operating firms include the presence of attractive tax treaty networks, with investment destinations that may have the effect of lowering withholding taxes on returning income streams or producing capital gains tax benefits. The presence of strong tax secrecy laws and non-disclosure provisions has also traditionally been a driver, though often more so as a driver of tax planning practices of high-wealth individuals. However, as noted below, this has become less of a driver as the tax transparency agenda has gathered momentum.

## 6.5 Responding to regulatory change

Having often been established in response to the tax or regulatory framework of other, larger jurisdictions, it is perhaps not surprising that small states which host IFCs continue to be affected by, and need to adapt to, the broader international regulatory environment. Although there are major trade policy dimensions to the regulation of investment and capital flows (with clauses and references increasingly included in bilateral deals), it is fair to say that a soft-law approach continues to dominate at the international level. Increasingly, a 'name and shame' approach towards regulatory reform has been taken by international bodies.

An example of this, and also an example of where the role of IFCs in the structuring of GVCs by MNEs has been challenged, was the OECD's Project on Harmful Tax Practices, which began in the early 2000s. At that

time, the OECD, an international economic organisation consisting predominantly of high-income countries and whose membership now numbers 35, listed a number of jurisdictions as ‘tax havens’ based on an assessment of their tax regimes against criteria designed to identify harmful regimes. The four key factors used as the criteria are identified in Box 6.2.

Of the 35 jurisdictions identified at that time by the OECD, using their defined criteria, 26 were Commonwealth member countries or jurisdictions otherwise affiliated with a Commonwealth member. This identification process led to a number of outcomes. The ‘naming and shaming’ process effected not only the host country but also, in some cases, the reputation of the lead firms and investors using IFCs in those countries; this led to some changes in the host countries’ domestic tax and regulatory regimes. Moreover, it led to increased international efforts to promote greater collaboration between revenue authorities. One tangible outcome of these efforts and the exchange of information

generated has been the creation of the world’s largest multilateral taxation platform. The *Global Forum on Transparency and Exchange of Information for Tax Purposes* was mandated by the G20 to monitor the implementation of these standards (Box 6.3).

Although the outcomes now embodied in the Global Forum are laudable, the process that led to its development raised many concerns for small states affected at the time. There had been limited engagement with the jurisdictions affected by the process, concerns were raised in relation to the nature of the identification process and the extent to which this was based on criteria applied objectively and in a transparent way, and also about the manner in which non-OECD jurisdictions were treated relative to OECD members. It was in this context that the Commonwealth Secretariat took on a role with a number of its small state members, advocating a fairer process. The issue was the subject of discussions at Commonwealth Finance Ministers Meetings held in 1999 and 2000.

#### Box 6.2

#### OECD Criteria for identifying tax havens (OECD 1998)

##### i) No or only nominal taxes

No or only nominal taxation on relevant income is the starting point to classify a jurisdiction as a tax haven.

##### ii) Lack of effective exchange of information

Tax havens typically have in place laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities, thereby preventing the effective exchange of information on

taxpayers benefiting from the low-tax jurisdiction.

##### iii) Lack of transparency

A lack of transparency in the operation of the relevant legislative, legal and administrative provisions is another factor in identifying tax havens.

##### iv) No substantial activities

The absence of a requirement that the activity be substantial is important, since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven.



## Box 6.3

## The Global Forum on Transparency and Exchange of Information for Tax Purposes

The Global Forum as it now exists is the continuation of a forum that was created in the early 2000s in the context of the OECD's work to address the risks to tax compliance posed by non-co-operative jurisdictions. The original members of the Global Forum consisted of OECD countries and jurisdictions that had agreed to implement transparency and exchange of information for tax purposes. The Global Forum was restructured

in September 2009, in response to the G20's call to strengthen implementation of these standards.

The Global Forum now has 137 members on equal footing. Through an in-depth peer-review process, the restructured Global Forum ensures that its members fully implement the standard of transparency and exchange of information they have committed to.

The need to respond and adapt to a reform agenda driven largely by other groupings remains a challenge for small states. As outlined below, a number of recent and ongoing developments in international taxation regimes are likely to exert a significant influence on the business models of IFCs, and to redefine their place in GVCs.

## 6.6 The G20-led international tax agenda

The GFC saw the revenue base and overall budgetary situation of many of the world's developed countries sharply decline. The enhanced understanding of global production networks and aggressive tax planning by multinational enterprises subsequently became a central issues on domestic political agendas. Invariably, these discussions have been raised to the international level. The OECD, under the stewardship of the G20 – an enlargement of the G8 group, and reinvigorated in response to the GFC – has henceforth suggested a number of reforms to international financial architecture.

The first of these, of most relevance in the context of a discussion on GVCs and the role of small state IFCs, are the efforts being taken

to curb tax avoidance practices among MNEs. Although there is no international tax law as such, the aspects of domestic taxation law that evolved to deal with cross-border investment focused, among other things, on seeking to clearly identify jurisdictional taxing rights and avoid the negative investment effects that might arise from so-called double taxation – that is, two jurisdictions seeking to tax the same income. These domestic provisions were supplemented by bilateral agreements in the form of double-taxation agreements. However, these provisions and treaties, and the underlying principles and norms that inform them, are ill suited to the modern global economy. They were developed at a time in which cross-border investment was less focused around the role of MNEs, involved clear, more direct forms of investment such as investment in bricks and mortar factories, and did not cater for the rise of the digital economy or the increasing importance of intangible and highly mobile assets such as intellectual property. As such they were open to manipulation by MNEs, including through the use of affiliated entities located in IFCs, that could lead to significant decreases on global effective tax rates for the MNE and often double non-taxation for particular streams of income.

To address this legal tax avoidance, G20 leaders endorsed an ambitious OECD action plan to address so-called base erosion and profit shifting (BEPS), at their 2013 summit in St Petersburg (G20 2013). Under the 15-point BEPS Action Plan, a range of work was undertaken by both OECD and G20 members with the broad goals of limiting the abilities of MNEs to artificially shift profits to low- or no-tax jurisdictions by better aligning taxation outcomes with underlying economic activity.

The work under the Action Plan was broad and ultimately culminated in the delivery of 15 reports to the G20 at the end of Turkey's presidency in 2015. In a number of areas the reports flagged a need to undertake further work, but the BEPS project has since moved on to an implementation phase, focused around four so-called 'minimum standards', the implementation of which will be overseen and monitored by a group now numbering around 100 jurisdictions.

The first minimum standard will involve the introduction of provisions into bilateral tax treaties to prevent treaty abuse – that is, the setting up of companies in jurisdictions simply for the purpose of taking advantage of favourable tax treaty arrangements in investment destinations. To avoid the need to renegotiate over 3,000 bilateral tax treaties, a multilateral instrument that will update the treaties of all signatory countries has been developed.

The second minimum standard is the implementation of so-called country-by-country reporting – a requirement for certain large MNEs to provide reports to tax administrations on a global breakdown of profits, tax paid and economic activities reported. The reports are intended to provide tax authorities with a better opportunity to assess the risk of MNEs mispricing the transfer of assets and services between related entities in the group as a means of shifting profits to lower-tax jurisdictions.

The third minimum standard is the rejuvenation of the OECD's work on addressing harmful tax practices. The work undertaken during the 2-year BEPS Action Plan focused generally on reviewing tax regimes, and specifically on attracting intellectual property (so-called patent boxes) and, in that context, providing further guidance on the 'substantive activity' requirement used to assess harmful tax regimes (see above). Going forward, in the context of the BEPS implementation framework, a peer-review process is being developed to consider the harmful tax practices of jurisdictions beyond the OECD and G20 that have otherwise been the focus of the work to date. The focus on processes that would appear to mirror those adopted by the Global Forum, emphasising a review by peers and the participation of jurisdictions on an equal footing, may go some way to allay the concerns of jurisdictions, including many small states, recalling the early stages of the OECD's work on harmful taxation.

The final minimum standard is not so much a minimum standard but rather an agreement by members of the framework to progress the work on developing effective mechanisms to resolve disputes in international taxation matters.

While the above developments, particularly those relating to the first three minimum standards, will reshape the role that small states hosting IFCs play in MNE GVCs, it is worth highlighting another aspect of the G20 international tax agenda that is having an impact on small states. This is the development of a new standard for the automatic exchange of tax information between revenue authorities as a further means of combating global tax evasion. The 'Common Reporting Standard' (CRS) (OECD 2014) closely mirrors the key elements of the US Foreign Account Tax Compliance Act (FATCA)<sup>3</sup> in requiring financial institutions to report to tax authorities information regarding non-resident account

holders. As well as endorsing and committing to the standard themselves at the end of the Australian G20 presidency in 2014, G20 leaders also made it clear that jurisdictions hosting IFCs would also be expected to comply by 2018 (G20 2014).<sup>4</sup> All Commonwealth members hosting IFCs have committed to this timeframe, the implementation of which will again be overseen by the Global Forum.

## 6.7 The re-emergence of 'blacklists'

As an example of the soft-law approach to the enforcement of emerging global norms, two processes evolved in 2016 to promote compliance with these new international tax developments, both involving the listing of jurisdictions that fail to meet or commit to relevant standards. The first of these, developed by the OECD and agreed by G20 leaders at their summit in Hangzhou, will focus on jurisdictions that fail to meet international tax transparency standards (G20 2016). These criteria include:

- compliance with the existing tax transparency standard focussed on the exchange of tax information on request;
- a commitment to implement the new transparency standard for the automatic exchange of information (the CRS identified above); and
- having in place the legal basis for the exchange of tax information.

A list of jurisdictions that fail to meet the criteria will be finalised by the G20 summit in Hamburg in July 2017. In addition to the listing of jurisdictions, G20 countries also indicated a preparedness to apply so-called 'defensive measures' against jurisdictions so listed. A paper outlining possible 'defensive measures', or actions that one country might take against a listed jurisdiction, has already been prepared under the auspices of the G20 (OECD 2015)<sup>5</sup>.

This G20 process sits alongside the work being undertaken by the European Union (EU) as part of its work on good tax governance. EU Ministers have committed to the development of a list of 'uncooperative jurisdictions' that will be finalised at the end of 2017 (European Council 2016). The development of the list also includes three criteria that, notably, extend beyond the G20/OECD list's focus on the implementation of tax transparency standards to consider aspects of a jurisdiction's tax regime considered to facilitate aggressive tax planning and tax avoidance. The criteria are that jurisdictions must have:

- met/committed to international tax transparency standards (largely aligned with the G20/OECD criteria identified above);
- met the EU's 'fair taxation' criteria, meaning that the jurisdiction does not have harmful tax measures as defined by the EU, nor facilitate the creation of offshore structure that can be used for profit shifting; and
- committed to the BEPS implementation framework, including the four minimum standards (see above).

Initial indications suggest that a number of Commonwealth small states that host IFCs will be a part of the screening process that will take place throughout 2017 (BNA 2016). The last criteria may involve a number of small-state IFCs being asked to engage and sign up to the BEPS implementation framework. Similar to the G20 process, the EU process may see certain 'counter-measures' applied against listed jurisdictions (European Commission 2016).

## 6.8 Other recent developments

### 6.8.1 Effectively tracing company ownership structures

As an example of the fluid regulatory environment in which small states hosting IFCs operate, 2016 also saw the emergence of new transparency initiatives. While not



representing ‘international standards’ in the sense that they have been endorsed by the G20, emerging initiatives related to identifying the beneficial (or ultimate) owners of entities have nonetheless received significant attention, in large part because of the domestic political context in a number of G20 countries in the wake of the ‘Panama Papers’ and the increasing influence of non-governmental organisations in the international narrative. While the push to create publicly searchable registers of beneficial owners, which received attention at the time of the UK-hosted anti-corruption summit in London in May 2016, appears unlikely at this stage to receive broad international support, a related initiative for the automatic exchange of beneficial ownership information between jurisdictions has already been supported by over 50 jurisdictions.

### 6.8.2 Withdrawal of correspondent banking relationships

A concerning development that has emerged over the last few years, and is increasingly receiving significant international attention, is the withdrawal of correspondent banking relationships (CBRs). These relationships with global banks allow businesses and financial institutions in other jurisdictions to access the global financial system, facilitating for example wire transfers and other cross-border business transactions. The well-reported closing of these relationships by global banks has affected many small jurisdictions, particularly in the Caribbean (Commonwealth Secretariat 2016b), posing challenges for all such jurisdictions but representing a significant challenge for the operation of IFCs dependent on the smooth flow of capital. While the drivers of this withdrawal are multiple and complex, the increasing international dialogue focused on solutions has emphasised the need for affected jurisdictions to continue to strive to implement global regulatory standards. Reflecting in part the role that jurisdictional reputation may have as a contributor to the withdrawal of these

relationships, a recent IMF staff report called on states hosting offshore financial centres to reconsider the sustainability of business models that rely on opaque or offshore structures (Erbenová *et al.* 2016).

## 6.9 Concluding remarks

The above highlights that small states that host IFCs operate in a quickly evolving and complex regulatory environment, one that continues to see soft-law ‘listing exercises’ used as a means of enforcing evolving global norms.

This has a number of implications for states. The first is simply the immediate challenge it poses to jurisdictions needing to allocate scarce resources to understand and then effectively implement new standards. This will require not only technical resources but also political will – will that the impending development of blacklists linked to the meeting of such standards is intended to support.

The second, of more significance in the context of this article, is the challenge faced by small states seeking to understand and respond to the broader implications of the international tax and regulatory agenda in terms of the role they have sought to play in GVCs, particularly in the structuring of MNEs. While the international tax transparency agenda is already and will continue to have an impact on the role played by small state IFCs, the broader tax avoidance agenda, which has focused on curbing the ability of MNEs to artificially shift profits to low- or no-tax jurisdictions, will clearly affect the role that some IFCs have played in GVCs. The BEPS process, both in its policy scope and possibly its implementation, is of course not perfect, with the overall stated goal of the project tempered by a reluctance of major economies to act too boldly such that national firms are placed at a competitive disadvantage or inward capital flows currently facilitated through IFCs are placed at risk. Nonetheless the BEPS project, and the fact that the public

discourse around multinational anti-avoidance is likely to remain strong (and likely to provide the basis for further unilateral or multilateral action) seems likely to reduce the role of some IFCs in corporate finance.

This of course is not the end of the story for small states that have sought to develop IFCs as a means of economic diversification and indeed, depending on the business model employed, aspects of any one IFC may be largely unaffected by the unfolding international agenda. Nonetheless, for those that are affected, the need remains for these economies to identify viable ways to support their growth and development, including through their ongoing participation in GVCs despite challenges posed by their size and geography. For many of the more successful IFCs, having now established both the infrastructure and professional base to provide high-value financial services, this will involve identifying further opportunities to consolidate and build on the substantive activities already taking place in those jurisdictions – drawing on other non-tax advantages offered by the jurisdiction, including proximity to key investment destinations, physical infrastructure and a strong reputation in terms of meeting international standards and regulations.

## Notes

- 1 Economic Adviser, Commonwealth Secretariat. The views expressed in this paper are the authors and do not reflect those of the Secretariat.
- 2 See Stoll-Davey (2007) for further information.
- 3 A unilateral measure of the US Congress designed to ensure that non-US financial institutions report accounts held by US citizens abroad.
- 4 With first exchanges to occur by 2018.
- 5 See in particular Annex 1, 'Report on tougher incentives for failure to respect the international exchange of information standard'.

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