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Towards a Regional Integration of Professional Services in Southern Africa

Nora Dihel, Ana M. Fernandes and Aaditya Mattoo

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Professional services are vital for development in Southern Africa. Accounting, legal and engineering services contribute directly and indirectly to economic growth, including by lowering transactions costs, being key inputs and creating spillovers of knowledge to other sectors. Accountancy is critical for accountability, sound financial management, and good corporate governance (Trolliet and Hegarty, 2003). Effective law and justice systems and access to legal services improve the predictability of the business environment, facilitate engagement in contracts and mitigate investment risks (Cattaneo and Walkenhorst, 2010). Engineering services is a knowledge-intensive sector essential to the productivity and sustainability of other economic activities. For example, civil engineering is critical for the development and maintenance of a country's physical infrastructure, while electrical engineering is important to the operation of public networks such as utilities or commercial facilities and communication systems (Cattaneo et al., 2010). Greater usage of professional services is associated with higher labor productivity for firms - particularly small firms - across countries in Southern Africa. Finally, professional services can become an important source for export diversification in Southern Africa.

While professional services are among the fastest growing services sectors in Southern Africa[1], their weaknesses and underdevelopment are dwarfing their current contribution to growth in the region. Southern African countries have initiated regional integration in the context of the Southern African Development Community (SADC) but negotiations on the liberalization of services - professional services in particular - have made little progress.

[1] The available data for South Africa and Zambia indicates that the average annual growth rates of business services outputs (of which professional services constitute an important part) were of 7% in South Africa and 21% in Zambia over the 2000 to 2009 period.

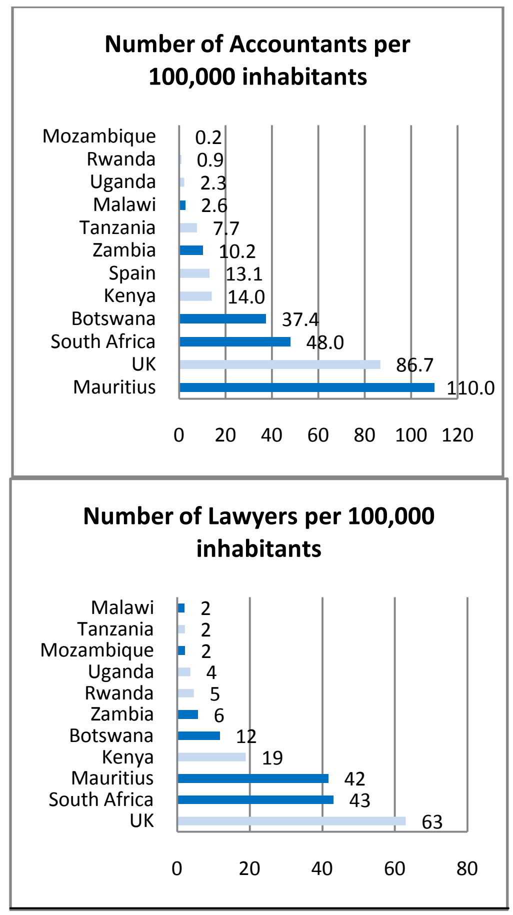
This policy note examines the current state of accounting, engineering, and legal services in Southern Africa. It analyzes the reasons for the underdevelopment of those services and for the limited trade in those services, particularly at a regional level. It also provides policy recommendations for enhancing growth and development of these professional services sectors in Southern Africa through deeper regional integration.

Regional integration could bring gains given the differences in endowments and levels of development of professional services within Southern Africa

The heterogeneity of professional endowments and differences in sectoral earnings and the capacity for professional training across countries suggest that there is substantive scope for increased regional trade in professional services in Southern Africa. Increased cross-border exchange of foreign professionals and foreign professional firms could help address the underdevelopment of the sectors and the unmet needs in Southern Africa.

The potential for regional trade in professional services is significant. Countries in Southern Africa exhibit striking differences in the level of development of their professional services sectors. A relative abundance of professionals characterizes South Africa and Mauritius, for example, while there is relative - or in some cases acute - scarcity in the smaller countries such as Malawi and Mozambique (Figure 1). In South Africa, although the absolute numbers of available professionals are large, the needs from its growing and increasingly sophisticated economy are also very large. Hence, the country is suffering from acute net shortages of chartered accountants, auditors, and engineers. Labor scarcity in the engineering and construction sectors have resulted in delays and lost business opportunities to some of the Southern Africa countries (Development Network Africa, 2009).

Figure 1: Availability of accounting and legal professionals



Source: World Bank Regulatory Surveys in Eastern Africa, 2009, World Bank Regulatory Surveys in Southern Africa, 2010, Paterson et al (2003), and CEPEJ (2008).

Regional integration could help address the underdevelopment of professional services markets. Evidence from recent firm-level surveys in Southern Africa suggests that demand for professional services is highest for large firms regardless of their sector in all countries. But interestingly, usage of accounting services by small firms is not negligible: more than 50% of small and micro firms in Southern African countries (except Mozambique) indicate that they outsource these. The usage of externally outsourced legal services is high for medium and large firms but is much less prevalent among smaller firms, and the same is true for engineering services. The monotonically increasing relationship between the degree of external usage of professional services and firm size observed in Southern African countries for all services confirms anecdotal evidence that the prices of professional services are prohibitive for many small firms.

Regional integration could help reduce the high costs of accessing professional services…. Although professionals in Southern Africa receive low nominal wages relative to their counterparts in developed and other developing countries, once their wages are adjusted for purchasing power, professionals in South Africa, Botswana, Mozambique, and Malawi are comparatively well paid – reflecting their scarcity relative to the demand for their services. However, in legal services, the very high wages earned by professionals are not necessarily indicative of their scarcity but rather of the power of professional bodies which impose strict entry and conduct regulation that enable incumbents to capture high rents and thus limit the potential contribution of the sector to growth in the region.

Regional integration could help alleviate skills shortages and skills mismatches in professional services. Some similarities in the development of professional services sectors across Southern African countries relate to the limited availability of middle-level professionals in all sectors that hurts access to services, and to skills mismatches. Middle-level professionals can play a crucial role in providing services to often underserved groups of clients. For example in accountancy, accounting technicians can provide basic record-keeping services needed by small firms. Skills mismatches are a serious issue across Southern Africa. For example, accounting associations in Malawi and Mozambique report that there are jobless accountants despite high demand for qualified accountants. The Big Four in Mozambique indicate that they face shortages of professionals because many applicants have poor academic qualifications.

The continued implementation of international financial reporting standards (IFRS) will most likely accentuate the skills shortages and skills mismatches in accounting in Southern Africa. In South Africa, the mismatches in accounting are of a different nature: some firms in the private sector hire chartered accountants (CAs) registered with the South African Institute of Chartered Accountants (SAICA) because of their perception of quality but in reality the work that they hire the chartered accountants to perform could be performed by a less highly qualified accountant. This inappropriate (too high) standard is likely to reduce access to services by many firms, especially SMEs.

Regional trade in professional services remains limited due to complex market structures and market fragmentation

Data on the presence of foreign professionals in Southern Africa suggests that in Malawi and Zambia registered foreign professionals represent less than 3 percent of the total number of registered accounting professionals, while in Malawi and Mozambique registered foreign professionals represent less than 5 percent of the total number of registered engineering professionals. However, for some countries trade in professional services is more important. For example, in Botswana and Mauritius foreign professionals account for substantive shares of the total number of accounting and engineering professionals.[2]

Similarly, in terms of commercial presence, in accounting and auditing services firms with foreign affiliation dominate the markets but there is only a limited presence of foreign engineering firms operating across the region. Evidence from World Bank supported civil works procurement contracts since 1994 reflects a lack of integration in the Southern African market for engineering services. Domestic companies generally win most of the contracts, except in energy and mining and transportation, and, for some countries non-African companies have the lion's share in sectors such as water and sanitation. There is virtually no regional participation in these contracts with the limited exception of South African firms having projects in several Southern African countries and some Malawian projects in Mozambique. A significant presence of foreign law firms is verified in Mauritius, Mozambique, and to a lesser extent Botswana but not in South Africa nor Zambia. As of 2008, in a universe of 8200 registered law practices in South Africa only 3 were foreign-owned.

In general, the market structures of professional services sectors in Southern Africa show elements of both oligopoly and competition. Accounting and auditing services are dominated in most countries by the large affiliates of the "Big Four" multinational firms.[3] The engineering and legal sectors are dominated by domestic providers, which are often small firms and microenterprises. The combined capacity of these small firms, though large, is too scattered to meet demand for large possibly more sophisticated projects in their home countries or in other countries in the region. All markets for the three professional services are characterized by vertical fragmentation and are heavily fragmented at the bottom.

What are the obstacles to the emergence of strong professional services sectors and increased regional trade in professional services?

First, skill shortages and skills mismatches persist at the regional level

Despite the demonstrated need for professional services from an economic development perspective and the demand for those services by formal sector firms, Southern Africa currently experiences skills shortages and skills mismatches in professional services region-wide. Some key reasons for these shortages and mismatches that hurt access to services are as follows.

Educational costs: First, professional education is very expensive in all Southern African countries. While skills premia for professionals exist and internal rates of return to education are high in the region, the average cost of acquiring a professional degree across all countries and professions is more than USD 22,000. These costs represent more than four, and for a few countries more than six, times the countries' GDP per capita in 2008. This makes attaining professional qualifications

[2] It should be noted, however, that a high level of emigration (very high even by African standards) of tertiary graduates from Southern African countries to OECD countries also contributes to the skills shortages of professionals identified in the region. The emigration levels of university-educated citizens from Mauritius and Mozambique are particularly high.

[3] The Big Four firms are Deloitte Touche Tomatsu, Ernst & Young, Klynveld Peat Marwick Goerdeler, Price Waterhouse Coopers.

unaffordable for the majority of the population in these countries, especially given the underdeveloped nature of the markets for educational loans.

Education quality and capacity: Secondly, weaknesses in secondary education across Southern African countries limit the ability of students to acquire professional skills. The general erosion of mathematical skills in all countries explains the declining number of applicants in science, engineering, and technology courses, leading to shortages in the engineering sector, for example.

Furthermore, the capacity and quality of professional education institutions are limited. In several Southern African countries, institutions that offer specialized post-graduate courses, as well as institutions that offer academic and professional training courses for middle-level professionals are entirely absent.

Education-Private sector links: Fourthly, there is an absence of links between educational systems, employers, and users of services. This in turn leads to unmet needs and unemployed professionals, explaining the attrition of skills in several professions in Southern Africa. Stakeholders from the private sector across countries emphasize the severe lack of coordination between employers, professional associations, and education institutions with regards to the content of educational programs for accountants and engineers.

Second, domestic regulation limits entry and competition and further segments the regional market for professional services…

Domestic regulation on the entry and on the operations of professional services firms often undermines competition and constrains the growth of strong professional services sectors in Southern Africa. Entry regulation covering licensing requirements, quantitative restrictions on the number of suppliers of professional services exclusive rights granted to professional services suppliers in certain activities, as well as regulations on the operations of firms, such as restrictions on prices and fees, advertising, form of business, and inter-professional cooperation, are particularly heavy in Southern African countries when compared to those in emerging economies and in OECD countries in all three sectors. For example, in Zambia - the most heavily regulated Southern African country in accounting services - prices are regulated, and there are restrictions on the business structure of accounting firms as well as restrictions on multidisciplinary practices.

Firm-level surveys of private providers of professionals services in Southern Africa reveal that disproportionate accreditation and qualification requirements are an important constraint in the accounting sector, while regulations on fees and prices and advertising restrictions are the major constraints in the legal sector. Non-transparent procurement procedures also hurt accounting and engineering services providers while slow licensing and accreditation procedures hurt engineering services providers.

… and finally significant services trade barriers and labor mobility restrictions are in place

Trade barriers limit competition and the efficiency of professional service providers in Southern Africa. Countries in the region differ importantly in their openness to trade: Mauritius, South Africa and Zambia exhibit generally the most restrictive policies on trade in professional services while Malawi and Mozambique's regimes are relatively more open. Trade in legal services is more heavily restricted than trade in accounting or engineering services, with South Africa exhibiting the most restrictive trade policy affecting legal services.

Trade in professional services through the movement of natural persons across national borders (mode 4 in GATS) is restricted in Southern Africa by explicit trade barriers, and by stringent regulatory requirements and immigration policies. Chief among them are discretionary limits through labor market tests imposed on the entry of any type of foreign professionals by all countries except Mauritius, de jure or de facto nationality requirements to practice domestic law in all countries except Botswana and Mozambique, and limited recognition of foreign licenses for accounting and engineering professionals as well as work permit issues in several countries.

Trade in professional services through the establishment of foreign commercial presence (mode 3 in GATS) is also limited by different types of restrictions across Southern African countries. The restrictions on the entry of foreign accounting and law firms are generally more stringent than those applied to foreign engineering firms. The entry of foreign law firms is not permitted in South Africa, whereas ownership by foreign-licensed professionals is prohibited in Zambia and is limited in Mozambique. Ownership and control of accounting firms by foreign-licensed professionals is prohibited in Malawi, Mauritius, Mozambique, and Zambia.

All Southern African countries restrict cross-border trade (mode 1 in GATS) in certain types of professional services, such as advice on matters relating to domestic law, audits, as well as tax representation and tax advice.

Policy reform at the national and regional levels is key to better integrate the regional market for professional services

The Southern African regional market for professionals remains generally underdeveloped and fragmented by restrictive policies and regulatory heterogeneity. Given these limitations and constraints, policy action is necessary. An effective reform agenda will require policy action in four areas: education, regulation, trade policy and labor mobility at both the national and the international level.

Reforms at the National Level

Reforms at the national level should focus on the development of framework conditions that address skills shortages and skills mismatches and attempt to facilitate the growth of professional services across the Southern Africa region.

Reforms related to education should focus on the following issues:

- Financial constraints prevent individuals from acquiring an professional education, so *developing new and expanded means of financing higher education* such as student loans schemes should be a priority.
- Weaknesses in the education systems mean that students are ill-equipped to acquire professional skills, therefore *enhancing the quality of and capacity of schools, especially in mathematics, sciences, and technical studies,* should be a key item on the policy agenda.
- Given the capacity constraints and quality limitations of professional education institutions, *improving*

existing institutions and encouraging the creation of new ones is necessary.

- Policy action to *encourage closer collaboration and consultation between employers, professional associations, and education institutions* could help professionals acquire the job-market relevant skills and the crucial practical training.

Reforms should also focus on incremental, qualitative improvements in domestic regulation including:

- *Relaxing disproportionate entry qualitative requirements.* For example, narrowing the scope of exclusive tasks[4] in certain professions would contribute to accomplishing this goal. The argument in favor of exclusive rights is that they can lead to increased specialization and guarantee a higher quality of service. But exclusive rights that create monopolies can have adverse price and allocation effects, especially if they are granted for services for which adequate quality can be provided at a lower cost by middle-level professionals.
- *Eliminating disproportionate restrictions on competition, namely:*
  - *Price regulations* often supported by the Southern African countries' professional associations which claim that they are useful tools to prevent adverse selection problems. Southern African countries could adopt less restrictive mechanisms such as increased access to information on services and services providers to accomplish the same goals at lower economic cost.
  - *Restrictions on the ownership structure of professional services firms, the scope of collaboration within the profession and with other professions, and, in some cases, the opening of branches, franchises, or chains*. Southern African countries should eliminate regulations that are clearly anti-competitive and may harm consumers by preventing providers from developing new services or cost-efficient business models.
  - *Advertising prohibitions* imposed by several Southern African countries on many of their professional services sectors. Southern African countries should allow advertising of professional services that facilitates competition by informing consumers about different products and that can be used as a competitive tool for new firms entering the market.

Reforms at the Regional and Multilateral Levels

The fragmentation of regional markets for both professional services and professional education in Southern Africa by restrictive policies and regulatory heterogeneity prevent countries from taking advantage of gains from trade based on comparative advantage, as well as gains from enhanced competition and economies of scale. Policy action is required in the following key areas.

Steps must be taken to relax the explicit trade barriers applied by Southern African countries to the - movement of natural persons, establishment of commercial presence, and cross-border supply of professional services, as well as through discriminatory procurement.

Trade barriers would ideally be liberalized on a most favored nation (MFN) or non-

[4] Highly skilled professionals in all sectors have exclusive rights to perform certain activities (e.g., auditing, representation of clients before courts, advice on legal matters, feasibility studies, design and planning).

preferential basis since that would generate the largest welfare gains for the Southern African countries. - Examples of possible reforms to reduce the explicit trade barriers prevailing in Southern Africa are: (i) relaxing the nationality and residency requirements; (ii) developing transparent criteria and procedures for applying any quantitative restrictions on the movement of professionals such as economic needs tests[5]; (iii) developing a transparent and consistent framework for accepting professionals with foreign qualifications; (iv) minimizing restrictions on the forms of establishment allowed (for example by replacing the prohibition of partnerships between foreign professionals and local professionals by joint liability of foreign and local partners and unlimited liability for the partnership's debts). The reduction of explicit trade barriers should be complemented with a reform of immigration laws.

Trade liberalization should be coordinated with regulatory cooperation at the regional level. Trade barriers would ideally be liberalized on a non-preferential basis. But such liberalization may not always be technically feasible nor politically acceptable, especially when impediments arise from differences in regulatory requirements. Deeper regional integration through regulatory cooperation with neighboring partners, which have similar regulatory preferences, can usefully complement non-preferential trade liberalization. Deeper regional integration would also enhance competition between services providers, allow these providers to exploit economies of scale in professional education, and produce a wider variety of services. Regional integration brings further benefits in that a larger regional market is able to attract greater domestic and foreign investment, and regionalization may help to take advantage of scale economies in regulation, particularly where national agencies face technical skills or capacity constraints. Regulatory cooperation to overcome regulatory heterogeneity within the SADC would be particularly useful in the following areas:

- SADC countries should consider steps towards implementing a regional framework for *mutual recognition of qualifications and licensing* in professional services. The model adopted by the East African countries in the context of the 2009 East African Community Common Market Protocol could be followed by the Southern African countries. Inappropriate standards can stifle demand for services. In accounting, IFRS (?) are applied to different degrees in the Southern African countries. While the benefits from IFRS are comparability, increased transparency and improvements in governance, complying with IFRS is considered to be excessively costly by small and medium firms in Southern Africa.
- *The development of an appropriate standard may be desirable at a regional rather than national level* in order to exploit economies in regulatory expertise, prevent fragmentation of the market by differences in standards, and limit the scope for regulatory capture. Common regional standards would reduce the costs to market participants of operating across national borders. Recent developments in Southern Africa are already moving in this direction. The

[5] An ENT can generally be characterized as a provision in national regulations, legislation or administrative guidelines imposing a test which has the effect of restricting the entry of service suppliers, based on an assessment of "needs" in the domestic market. Such measures may operate to restrict access for foreign suppliers to a market based on the level of existing supply.

new set of accounting standards developed by South Africa's SAICA - the "Reporting Framework for Non-public Entities" - will be applied domestically but is also scheduled to be adopted for small and medium enterprises by the Eastern Central and Southern African Federation of Accountants (ECSAFA), a regional body that serves as a forum for regional cooperation on accounting standards. However, it will be crucial for the national professional accountancy bodies of the Southern African countries to engage with policy-makers and other national stakeholders to incorporate such regional accounting standards for SMEs into their national legislations.[6] (this is repeated in footnote 4).

- Differentiated accounting standards for different types of firms - say large versus SMEs - may be most efficiently delivered by different classes of accounting professionals. As such, Southern African countries could benefit from implementing *common training standards for accounting technicians* such as the Occupational Standards for Accounting Technicians developed by ECSAFA or the accounting technician scheme recently introduced by the Association of Accountancy Bodies in West Africa (ABWA).
- *Regional cooperation on the reduction of restrictions on the free movement of labor including visa and stringent immigration laws is crucial for Southern Africa.* Streamlining immigration processes for business travelers and workers and temporary residence of business people are key areas that need to be addressed to create a truly integrated market within Southern Africa. The SADC has attempted to regulate labor mobility, but so far has not been able to adopt any regional labor mobility agreements, mostly due to the disagreements among national governments. Measures to enhance labor mobility by streamlining immigration and temporary residence processes for foreign workers need to be implemented in Southern Africa.
- *Regional cooperation to eliminate the fragmentation of the regional market for education would be desired.* Regarding financing of professional education, cooperation among countries in terms of sharing information and experiences to increase the recovery rate of student loans while increasing students' access to higher education could improve the impact of educational loan schemes in Southern Africa. Regarding capacity constraints, the fragmentation of the regional market for education by differences in regulation can prevent the emergence of regional hubs for higher education that could for example address the absence of institutions offering specialized often post-graduate courses (e.g., in legal services on e-commerce, technology transfer and multilateral investment, financial services law, medical law and ethics, arbitration, international litigation) and institutions offering training courses for middle-level professionals noted across Southern Africa. Smoothing regulatory differences in education – addressing in particular issues of portability of course credits and scholarships - can lead to higher quality and lower costs for higher education students in Southern Africa.

[6] One important issue that will need to be addressed is the national definition of an SME that may need to differ across countries to appropriately reflect the level of development of its private sector. To facilitate this process, an ECSAFA – World Bank initiative is currently developing training modules for the implementation of regional reporting guidelines by SMEs.

While the economic benefits from regional integration are evident, the pace of integration is largely dependent upon Southern African countries' political motivation and conviction that the various reforms are beneficial to their domestic constituencies. So far, Southern African countries have initiated liberalization and deeper regional integration negotiations in a number of services sectors in the context of the SADC Services Trade Negotiations. However, further work is needed, and the policy discussion and recommendations outlined here can form the basis for a revitalized and reformed professional services sector that can sustain long-term economic growth and development in Southern Africa.

About the Authors

Nora Dihel is Trade Specialist with the Africa Poverty Reduction and Economic Management unit. Ana Margarida Fernandes is Economist in the Development Research Group - Trade and Integration. Aaditya Mattoo is Research Manager, Development Research Group - Trade and Integration. *Ephraim Kebede, Nicholas Strychacz and Toru Nishiuchi provided valuable statistical and research assistance. This work is funded by the Multi-Donor Trust Fund for Trade and Development supported by the governments of the United Kingdom, Finland, Sweden and Norway. The views expressed in this paper reflect solely those of the authors and not necessarily the views of the funders, the World Bank Group or its Executive Directors.*

The authors can be contacted at:

ndihel@worldbank.org
afernandes@worldbank.org
amattoo@worldbank.org

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