Identifying the Issues in Trade in Services

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Interest in the nature and extent of government intervention in trade in services has grown rapidly in recent years. From the domestic perspective the focus has been on the effects of government regulation on the distribution of resources and on consumer choice. From the international perspective the focus has been on government restriction of market access and barriers to trade in services. Because of the impact of government regulation of internationally-traded services, there have been proposals for the liberalisation of restrictions on service transactions, with strong pressure from the United States and some other developed countries, for the subject to be on the agenda of a new round of multilateral trade negotiations. But it is apparent that a conceptual framework for such negotiations is lacking and those engaged in discussion of services as a sector are not always working from a common base.

In the absence of a developed ‘theory’ of trade in services, the theory of trade in goods has often been applied on an ad hoc basis. This follows from the suggestions by some economists that international trade in services is the same, from an analytical point of view, as trade in goods.

But a host of very different types of services are traded internationally, ranging over computing services, shipping, insurance, medical services, tourism, construction, building design and banking. In order to examine the extent to which trade in services is ‘the same’ as trade in goods, a simple classification of traded services is developed in this article. It becomes clear that some services are very similar to goods; others are not. Policies relating to the movement of factors of production and to the movement of the receivers of services may distort trade in some services more than in the case of goods. Such policies may be of more importance to trade in services than restrictions on trade in the services themselves.

Thus one purpose of this article is to identify the characteristics of international transactions in services which may distinguish them from international transac-

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tions in goods. Unlike previous classifications we have seen, the classification is based on how and where the services are produced and traded, rather than on the physical characteristics of the services themselves. It would appear that adopting classifications based on the nature of the service may have clouded some of the issues in attempts to negotiate internationally the regulation of trade in services.

It is desirable to start from the basics. First, what are international transactions? In this article a 'residential' concept of national income is adopted. Thus an international transaction is a transaction between the resident of one country and a resident of another. The transaction may take place entirely within one country, geographically defined. If a geographical basis were to be adopted, a whole range of what are normally regarded as international service transactions would be excluded — tourism, for example.²

Next it is perhaps wise to recall that goods and services are both produced by factors of production. It is the 'services' of these factors which create value added or output. Goods are a physical embodiment of factor services while 'services' are more directly supplied by the owners of factors of production to their clientèle.

In a great number of cases, services require the supplier of the service and the receivers to be in physical proximity. The concept of 'receiver' is referred to frequently in this article. Receivers of services could be persons (as in medical services), commodities (as in painting or transport) or resources (as in ploughing). But the physical proximity of provider and receiver is not an ubiquitous requirement. As pointed out by Jagdish Bhagwati, of Columbia University in New York, the electronic transfer of information and some forms of entertainment is enabling the separation of provider and receiver to develop rapidly.³ For some services such separation has existed for many years. Bridges, for example, can be designed in countries other than those where they are built. For many purposes the distinction between those services which require the physical proximity of the supplier of the service and the receiver of it and those services (like goods) which do not is unimportant. In trade across national frontiers, however, it can carry major policy implications.

A CLASSIFICATION OF TRADED SERVICES

International trade in services may be divided into four categories. The first category comprises services transacted without the physical proximity of factors and receiver. For the other three categories there is physical proximity.

(a) Transactions may occur without the movement of factors of production or of the receiver of the service. Such services are produced in the exporting country and then traded internationally. Like goods, they cross the borders of the importing and exporting countries. Examples include consulting services, life-assurance business and architectural design which are handled through correspondence and produced in the exporting country. These can be referred
to as ‘separated’ services, for they are separated from both factors of production and receivers. Separated services may become incorporated into goods and may be identified as goods rather than services. The demarcation of ‘goods’ from ‘services’ along a spectrum including books, floppy disks full of retrievable data, drawings of the plans of a bridge and data transmitted telegraphically is not at all clear. Are disks full of data and construction plans ‘goods’ or ‘services’?

(b) Transactions may occur as a consequence of the movement of the factors of production, but not of the receiver of the service. Examples of such services are the product of guest workers, including imported construction teams, and the services of imported financial capital. An essential part of international trade in these services is that part or all of the means to produce the services in the country of consumption crosses the borders of the importing and exporting countries. In other words, there is an international flow of the factors of production — labour and/or capital.

(c) Transactions may occur with the movement of the receiver of the service, but not of the provider. A patient may move to a foreign country to be treated by a surgeon. A further example is the provision of services for international tourists. The Rocky Mountains, the Taj Mahal and the Eiffel Tower cannot be shifted. A foreign consumer of these tourist services has to travel to the United States, India and France. Foreign students travel to Australian universities to be educated. Likewise, doctors do not usually move to Upper Volta to carry out heart-transplant operations. (If university lecturers or a medical team moved internationally, then these services would be in category ‘b’ above.) Again, some services may be incorporated into goods and there is a question of demarcation of goods from services. When a product is sent abroad for processing and then re-imported, is there trade in goods or in services?

(d) Transactions may occur with the movement of both factors of production and the receiver of the service. Here the transaction would take place in a third country. A surgeon and a patient may meet in a third country where the patient is treated. Three countries will now be transacting, with the host country selling the services of clinics.

All services may thus be classified into those which are traded with the movement of the factors of production and/or the movement of the receivers of the service and those for which there are no such movements. Policies restricting trade in services may then be divided conveniently into (i) those that restrict the service transactions per se, (ii) those that restrict the movement of factors producing the service and (iii) those that restrict the movement of the receivers of services.

In many cases alternatives among the four categories of transaction face transactors. Choice between the categories may depend on transport and other
transaction costs; it also depends on various impediments at national frontiers — impediments not only to the movement of goods or animals but also to the movement of 'separated' services, persons and assets and liabilities. Visa and guest-worker policy, as well as foreign investment policy, may be involved. These policies may affect not only the form in which transactions take place but also whether transactions occur or not. They may also determine whether services are 'splintered' or 'disembodied' or not; that is, whether trade takes place in goods incorporating the service or whether the service is traded separately from the relevant goods.

Some examples of these 'trading' choices are as follows:

one, the choice between trade in computing services or bridge design — by having computer programmes written, or bridges designed, abroad — and allowing the foreign programmers or designers to work in the purchasing country;

two, the choice between the movement of medical patients or students abroad and the movement of the providers of the services to the receivers; and,

three, the choice between the movement of a commodity to be serviced and the movement of the servicer to the commodity.

This framework can assist in considering whether trade in services is similar to trade in goods, so that the standard theories of international trade and of commercial policy can be applied. For separated services, those that fall into category 'a' above, the standard theories of international trade, which assume international immobility of factors of production, apply. But those services that fall into the other three categories are not addressed by theories which assume the immobility of factors of production or of receivers between countries. This 'non-separation' is the essential difference between trade in goods and trade in some services.

Some services that are non-tradeable without the proximity of producer and receiver become tradeable with the movement of factors of production or receivers. The same applies to some goods, although for a different reason. Roads and constructed buildings are two examples of 'goods' that are not tradeable between countries, not because of the requirement of proximity of producer and consumer but because they cannot easily be transported. But construction teams can, and do, move between countries. This implies that visa and work-permit policy as well as, perhaps, foreign investment policy not only may determine whether services are traded but also may be relevant in determining the extent of effective protection received by activities which produce non-tradeable goods.

In the next section, those services associated with movements of factors of production (category 'b') are addressed, while the following section focusses on services associated with movement of the receiver of the service (category 'c').
Considerations relevant to category ‘d’, in which there is movement of both factors of production and the receiver, embrace those in both categories ‘b’ and ‘c’.

SERVICES ASSOCIATED WITH FACTOR MOVEMENTS

Category ‘b’ above includes those services for which the factors of production shift from one country to another. Are we concerned with factor movements themselves or with what the factors produce? What is produced — be it surgery, insurance, road construction, motor vehicles, banking or household services — is associated with characteristics of the factors themselves. For present purposes, it appears to be useful to look at the characteristics of the factor services and the contribution of those characteristics, rather than the various goods and services which they produce.

Factors of production which may move internationally are physical capital, labour and financial capital.

Physical capital comprises goods and its movement internationally can generally be dealt with under merchandise trade. With leasing, however, there is a hiring of the ‘services’ of capital equipment without change of ownership and policy provisions other than those which apply to normal trade in goods may be involved.

Turning to the international movement of labour as a factor of production, this could take the form of temporary migration — for example, as a guest worker — or it could even be a business trip, examining a site, giving lectures or entertaining. Permanent migration is not relevant here since change in the country of residence is involved. The movement of labour may be unskilled labour, as with South Korean or Philippine construction teams, or it could involve the movement of substantial knowledge and expertise. Surgeons, architects, financiers, opera singers and ballet dancers are examples. Visa and work-permit policy and registration of professions may affect the manner in which labour-related services are transacted between countries. Payments for the labour may incorporate payment for substantial accumulated skill.

As far as the services which may be attributed to financial capital are concerned, the payments for the capital will incorporate payments for the current rather than future use of goods and services (inter-temporal substitution), for knowledge and for risk sharing. Much has been written on the ‘unpackaging’ of the bundle of services associated with capital and on the extent to which these services can be separated from the international movement of capital. Looking at the three characteristics which can be associated with the services of financial capital, namely inter-temporal substitution, risk sharing and the transfer of knowledge, the major points are as follows.
Inter-temporal substitution: The sale of the service of inter-temporal substitution (that is, being able to acquire goods and services now rather than later) is the essence of the capital transactions and is therefore inextricably linked to them. But this service is not linked to equity participation or control. It is equally provided through debt. Restrictions on capital flows thus necessarily inhibit the international trading of inter-temporal choice.

Risk: Many risks can be shared internationally — that is, there is trade in the service ‘risk bearing’ — without there being foreign investment. Some examples are contractual arrangements in which the contract price depends on movements in wages or in other prices and insurance and futures contracts. But international movements of capital provide the possibility of other ways to spread risk internationally — for example, by borrowing in the same currency as that in which contract prices are denominated and through equity participation, where the return payable on foreign investments depends on the rate of return on the activities for which the funds are used. Thus restrictions on capital flows between countries will not inhibit all trading in risk bearing, but they will prevent some forms of it.

Knowledge: Knowledge can be transferred internationally in a variety of ways. Some forms of knowledge may require the movement of labour. Other forms appear to be closely related to the ownership of the enterprise. Skills in hotel management, construction techniques, banking and merchant-banking facilities and credit-card operation are possible examples, although in all these cases it seems that, on occasion, much of this expertise has been transferred internationally without the movement of capital. The possessors of some forms of expertise, however, do seem reluctant to supply it without equity participation. This reluctance could be attributable to (i) it being less costly to transfer knowledge internationally within the corporate empire than outside it and/or (ii) retaining knowledge within the corporate empire limits competition. This being so, restrictions on capital flows may prevent the international dissemination of knowledge, although such restrictions could in some situations be warranted on economic criteria if they constrain the monopoly power associated with the possession of knowledge.

INTERNATIONAL MOVEMENT OF SERVICE RECEIVERS

Some services involve the receiver moving to the provider (category ‘c’ above). Tourism is an example in which there is no full substitute for movement of the receiver: viewing films of the Amazon is not a perfect substitute for seeing the real thing. Other examples in which there may be a choice between the movement of the provider and that of the receiver are education and medical services and repairs of many types of equipment, particularly transport equipment. Restrictions on the
international trading of such services may be imposed as restrictions on the
departure of residents through government decrees or through high departure
taxes. (The flow of Indonesians to purchase services in Singapore has been
reduced by the latter.) Other restrictions may be imposed by quarantine regula-
tions, in the case of animals, or by the system of import taxes and regulations, in
the case of items sent abroad for repairs and then re-imported. Restrictions may
also be imposed by the country which could provide the service. Not all countries
allow the unrestricted access of foreigners to their educational or medical services,
particularly when these services are subsidised.

INTERACTION OF TRADE, VISA AND INVESTMENT POLICIES

What comprises 'free trade in services'? What has been said so far leads to the
conclusion that free trade in services would require freedom of movement of
factors of production, of 'separated' services and of service receivers. What, then,
are the consequences of concentrating on those services which can be separated, in
the sense that movement of neither the factors of production nor the receivers of
the service is required? For these services, freedom of international trade is
similar to freedom of international trade in goods. It requires the absence of
barriers to international contracting and to sending and receiving mail and
electronic and telegraphic transmissions. Freedom of movement of factors of
production or receivers of the services would not be required.

The theory of second-best teaches us that liberalising trade in some com-
modities, while trade in other commodities continues to be restrained, will not
necessarily improve the allocation of resources. Thus, for example, a reduction of
protection for some goods or services could result in a reduced price for a factor of
production. If a highly protected good or service also uses this factor, the lower
price of the factor could lead to increased output of this highly protected product.
The allocation of resources would be worsened. Applied to services, this seems to
imply that liberalising trade in 'separated' services, for example, will not neces-
sarily improve the allocation of resources, while trade remains restricted in other
services — by direct restriction, by visa or foreign investment policy or by
restrictions on receivers — which can be produced by the same factors of
production. Liberalising trade in, say, insurance services by reducing the dom-
estic demand for clerks could lead to increased employment of clerks, and other
factors of production, in a highly protected service (for example, until recently,
foreign-exchange dealing in Australia).

Does this imply that it would be unwise to pursue a policy of free movement of
services, as such, without it being accompanied by free movement of factors of
production and receivers? (Note that this does not require free migration on a
long-term basis, for that implies change of country of residence.) As a general
proposition, the broader the front across which the liberalisation of trade operates, the more likely that the allocation of resources will be improved. Thus it is more likely — again as a general proposition to which there can be exceptions — that liberalising trade in goods and separated services will be more likely to improve the allocation of resources than liberalising trade in goods alone. It is also most likely that reductions in the highest trade barriers to services, as well as to goods, will improve the allocation of resources. But, in looking at the effects of such liberalisation, an eye should be kept on the effects on industries which remain protected.

In the case of services for which physical proximity of factors of production and receivers is required, a problem arises when taking the line that liberalisation is most likely to be beneficial when it is across the broadest possible front. One is then forced to define the absence of protection or an efficient allocation of resources as complete freedom of international movement of factors of production and service receivers that are resident in a country. More usually, however, factors and receivers are assumed to be immobile and goods and services separable from them. The standard argument for free trade is then that it will maximise real national income subject to the constraints of the supplies of factors of production and of receivers with which a country is endowed.

As soon as trade is introduced that requires the physical proximity of the receiver of a service and the factor supplying it and the possibility of factors or receivers moving, the standard reference point breaks down. No longer are the factor endowments and receivers which are resident in a country a binding constraint. In such circumstances a new reference point to specify 'efficient trade' has to be defined. Complete freedom of movement of factors (and of receivers) appears to be the obvious candidate. (Note, again, that this does not imply unrestricted long-term migration.) Other specifications may be made for one reason or another, but it is important that the constraints are specified. Otherwise one will not know what are the optimal policies — that is, those that maximise real national income subject to constraints. And for whom is 'national' income being maximised?

**TRADE AS A SUBSTITUTE FOR FACTOR MOVEMENTS**

It is a well-known proposition that international trade can have the same effect on the prices of factors of production as the international movement of factors of production. The import of unskilled labour-intensive products may tend to reduce the real wages of the unskilled, just like the inward migration of such labour. The full flowering of this analysis is the theorem of factor-price equalisation in which factor prices are equalised internationally by international trade, even though factors are immobile internationally, for one reason or another. Such factor-price
equalisation can occur on special assumptions, as is well recognised in the literature. The starting point is a separation of trade in goods from trade in factor services. It could be expected, however, that trade in factors of production would increase the likelihood of factor-price equalisation.

Holding the discussion to goods for the moment, it has been seen already how in some situations, rather than trade being a substitute for the movement of factors of production, the movement of factors may act as a substitute for trade. This may occur where trade is not possible because of transport costs. Thus construction teams can build roads in foreign countries.

Turning to trade in services, it is apparent from the discussion above that not all services may be traded separately from the factors of production which create them. In such cases, trade cannot be a substitute for factor movements, for movement of factors (or of receivers) is required to accomplish the trade. Restricting the movements of factors (or of receivers of services) will inhibit (i) the international movement of the services, (ii) the equalisation of the prices of these services internationally and (iii) the tendency to narrow the international differences in the prices of factors of production. Barriers to the movement of factors or receivers will thus provide protection to some factors of production, even if there are no barriers to trade in goods or ‘separated’ services.

INTERNATIONAL TRANSACTIONS AS A CONSTRAINT ON MONOPOLY

In the literature on multinational enterprises much has been written on foreign investment as a means to extend market power. Similarly, a considerable body of writing has focussed on the restraint to domestic monopoly power that is provided by the availability of foreign substitutes. The theoretical trade literature on constraining domestic monopoly has focussed on goods, but it also applies to separated services. It can also be extended to those services which require the physical proximity of the receivers of the service and the factors supplying them. Thus Australia is opening her doors to investment by foreign banks in order to improve competition, the Government apparently being confident that it, and/or competition in general, will be able to restrain the anti-competitive or other disruptive actions which are often attributed to multinational enterprises.

ISSUES IN SERVICES

Separated services, those in category ‘a’ above, are those which can be ‘separated’ from the receivers of the service and the factors of production that provide the service. In the case of these services, particularly when traded
internationally, many of the issues, *in principle*, resemble those relating to goods. In particular, barriers to trade in separated services can take the form of impediments to trade in the service as it crosses the frontier. There could, for example, be a tax on the transmission of data as it crosses the frontier. *In practice*, however, there are many important differences. Unlike goods, many internationally-traded (separated) services do not pass through customs houses. Taxing the transferral of electronically-transmitted data must be difficult. Information may move via satellites or along telephone lines — so, too, for international news transmission and various entertainment services. But it is not beyond the wit and power of some governments to inhibit trade in all such services.

Some services may be best (or only) exported if there is a presence of the factors of production in the importing country. (Such transactions are in categories ‘b’ or ‘d’ above.) In these instances the issue may be related to the right to ‘establish’ in the country purchasing the service and/or the right to import foreign labour. In such cases the link between the attitude of the host government to foreign investment and the granting of work permits is crucial. Thus the ‘barrier’ to imports of services may well be the rules applying to foreign investment and work permits.

Government regulations relating to the provision of factor services may be general in nature (applying to all foreign investment or all foreign labour) or sector specific (for example, no foreign investment in domestic banks). Sector-specific policies often take the form of measures relating both to initial establishment and to operations after establishment. Thus it is not surprising that the focus of discussions on trade liberalisation in services has been on the issues of not only ‘rights of establishment’ but also ‘national treatment’ for foreign firms once established.

The attitude of governments to foreign investment and work permits may be important for services that can be produced either in the country from which the service is exported or in the country in which the service is consumed. There are cases where a domestic presence may be desirable, but not always crucial. An example is construction-engineering consultancy. Plans for a new bridge to be built in Sydney could be drawn up in Los Angeles after visits to Sydney. Alternatively, an agency of the parent engineering company could be established in Sydney. The same is true for legal services, the provision of life assurance, shipping services, air transport and so on. Once again, the attitude to foreign investment and work permits (including business trips) is important. In these instances the restriction on movements of factors of production may not be a total barrier to trade in services, but it may distort it and make it difficult to provide a service satisfactorily.

Government measures affecting services are often imposed for reasons unrelated to trade and are not directed to the maintenance of internationally uncompetitive industries. This is mainly due to the nature of many service activities. For
example, although national banking laws may directly affect a foreign bank’s operation within a host country, the laws exist primarily for domestic reasons, such as protection of the consumer, protection against monopolies and control over monetary policy. Regulations concerning the operations of insurance companies and investment-management companies, for example, specifying the areas where they can invest their funds, are also for the purpose of protecting the consumer from undue risk or for attempting to guarantee a market for some types of securities. These regulations are of concern in the context of international trade and investment only when they treat foreign operations differently from domestic ones.

Clearly foreign investment is central to the discussion and the issues embrace matters of national sovereignty. Indeed, some countries suspect that the services issue in the General Agreement on Tariffs and Trade (GATT) is principally about de-regulation of foreign investment. This suspicion is strengthened by the fact that the United States, the prime mover behind the attempts to liberalise trade in services, is by far the world’s largest gross earner of foreign-investment income. But work-permit policy is also crucial in many areas of trade in services. Some countries may not wish to discuss ‘separated’ services and investment-related services without also discussing labour-related services.

Finally, it may be recalled that restrictions on the movement of service receivers may also comprise important barriers to trade in services. (Relevant transactions fell into categories ‘c’ and ‘d’ in the classification above.) These barriers may be imposed by either the producing country or the receiving country. Restriction on access to subsidised medical services is an example of the former while restrictive exit visas, punitive departure taxes and exchange controls are examples of the latter.

1. This article was originally prepared for the Industries Assistance Commission in Canberra, Australia. The authors are grateful for perceptive comments from officers of the Commission and from Peter Lloyd, Martin Wolf, Jan Tumlir and Roger Kerr.
2. Statistics of international transactions do not always consistently follow the ‘residential’ definition. An international ‘service’ transaction occurs when an enterprise engages a guest worker; and an international ‘goods’ transaction, when the guest worker buys a beer. In practice, these transactions are not recorded in the international accounts; what is recorded is the transmission of funds home by the guest worker — a transaction which is not in fact international, it being between residents of the same country.
4. Ibid.
5. See, for example, Brian Hindley and Alasdair Smith, ‘Comparative Advantage and Trade in Services’, The World Economy, December 1984.
6. In categories ‘c’ and ‘d’ above where ‘receivers’ are commodities or animals rather than people, the standard theories can be applied easily.
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40. T. G. Congdon, *Economic Liberalism in the Cone of Latin America* (1985), 130 pp., £5.00.

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