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International Trade: Services Included

The European Union's strong positions in international services trade are mainly in finance and insurance, as well as in computing where they are now challenged by large emerging countries. The United Kingdom appears to be the only large European country specialized in services with strong growth. But a large share of international "trade" in services is in the activity of companies located abroad. In certain cases, notably that of France, including them changes the picture substantially. The advantages of the various European countries could be reshaped by the realization of the single market in services. By eliminating certain regulations, the services directive will open markets to competition that are, in some cases, still very closed. It could boost intra-European exchanges that are relatively under-developed today.

While services play a predominant role in developed economies, they make up only a fifth of world trade. This modest position is due to the nature of these activities, which often call for proximity of the supplier and customer and which are much more subject to national rules than other sectors. Only the rules imposed on producers makes it possible to offer users the necessary prior guarantee of quality of the service provided. These national rules often constitute barriers to international trade. Eliminating these barriers affects these domestic regulations directly, which is obviously not the case when tariff barriers for trading goods are lowered. International liberalization of services is thus more complex at the outset than that of goods Additionally, trade in services includes and often combines with trade in goods and with movement of factors (establishments abroad, movements of people).

However, the development of companies' demand for services, the complementary nature between trade in goods and services, as well as the development of firms' multinational business are exerting pressure on the international liberalization of services, facilitated by progress in communications and by domestic deregulation of many sectors. Since 1994, the GATS[1] has provided the framework for multilateral negotiations in the field of services. At the same time, liberalization is advancing in certain regional agreements. In the European Union, the services directive, which should be adopted before the end of 2006, aims at creating a single market for services by suppressing the obstacles to freedom of establishment of service providers and to the free movement of services among the member States. Here, we describe the main characteristics of world trade in services and the position the European Union occupies in it, to put the objectives of intra-European liberalization in the international context.

More "exchanges" than exports

A limited number of services can, just as goods, cross the border of the exporting country to reach the importer (mode 1 according to the GATS terminology). This is true, for example, of a television program exported by satellite, a telephone consultation of a lawyer established abroad, or a financial operation performed in a foreign market. But this is not the case of tourist services, retail banking, or the famous Polish plumber. In the case of tourism, it is not the service but rather the consumer that crosses the border (mode 2 according to the GATS). In the case of retail banking, it is the legal entity that crosses the border to set up an establishment or subsidiary in the importing country, to serve local consumers (mode 3). Lastly, the Polish plumber (or his employees) must themselves go to the importing country, and it is thus the service provider who

1. General Agreement on Trade in Services.

crosses the border to reach the consumer (mode 4). As a matter of fact, this latter mode is quantitatively of minor relevance (table 1). The dominant mode of trade in services is mode 3, as measured by the amount of sales abroad by affiliates of service companies – banking networks, distribution chains, *etc.* Thus, the fact that trade in services in the strictest sense (modes 1 and 2) is under-developed compared to trade in goods is partly, and to a varying degree for each country, compensated by a relatively greater commercial presence abroad.[2]

Table 1 – The four trade modes* (US$ billions)

	United-States		Japan		France		Germany	
	Goods	Services	Goods	Services	Goods	Services	Goods	Services
Mode 1	803	144	335	62	280	25	481	65
Mode 2		94		22		42		41
Mode 3	1 000	1 164	302	335	118	181	327	214
Mode 4		5		0		5		4

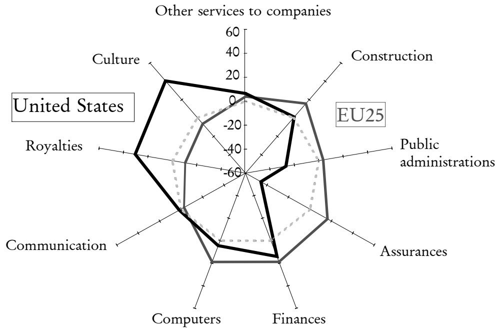
* 2000-01 averages of exports and imports or sales and purchases.
Sources: CEPII, CHELEM-BAL & OECE, FATS.

Trade in services in the strict sense is not particularly dynamic. On average, its annual growth rate in value over the period 1995-2003 was 5%, or the same rate as that of trade in goods. However, this average is misleading: travel and transport, which represent more than half the exchanges in 2003, increased at a rate of only 3% while "other services" (services to companies, culture and leisure, communication) increased by 7% per year. In this latter category, certain services experienced very strong growth: 23% per year for computing services, 10% for financial and insurance services, 9% for culture and leisure, and 8% for royalties. These various sectors constitute a major field of international competition today.

Positions on dynamic sectors

The European Union and the United States are by far the two main players in international services trade,[3] in particular if only "other services" (excluding transport and travel) are considered. In this field, their 2003 shares are 33% and 27% of world exports (excluding intra-EU trade) and 28% and 22% of imports. The two zones show a large surplus in these "other services." Their positions on the various activities grouped under this heading display contrasting patterns, however. They are represented in graph 1 by an indicator that is, for each activity, a ratio of the balance of the zone to the corresponding world trade. The European positions appear globally less pronounced than those of the United States. The EU's strong points are notably in insurance (where the United States runs a very large deficit), financial services, computing and information. The United States' position is especially strong in fees and licenses (use of patents, copyright, trademarks) and cultural services (licenses, audiovisual services). The Lisbon strategy and innovation and research policies in Europe aim at recovering the European position in the fields the U.S. is currently dominating. All the more so that, on one of its strong points – computing and information– the EU is largely in competition today with India and Israel.

Graph 1 – Positions of the EU25 and the United States on the markets for "other services"*



S Balances in % of world trade in each category, 2003.
Source: OECD, TSI.

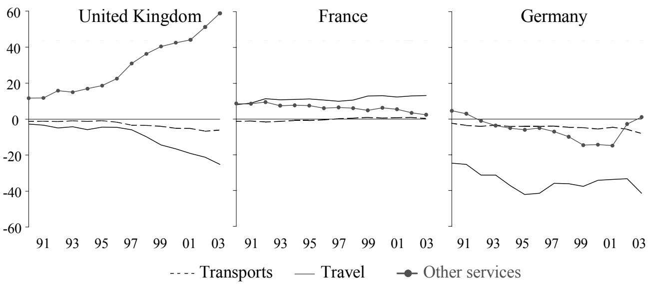
An examination of the positions of the various member countries by market indicates that the EU's strong points we have just indicated are essentially attributable to the United Kingdom even though, in computing services, Ireland is in the lead (but with a large deficit in royalties in return) and while Luxembourg adds its surplus to that of the United Kingdom in financial services. The growth of the British position in all of the "other services" can be seen in graph 2 where the variation of the balances of the three large European countries since 1990 is shown in the three main services activities. Over the period, the French surplus in "other services" was divided by four, notably due to a very weak growth in its exports. France is thus accentuating its specialization in travel, where Spain and Italy also occupy strong positions. On the other hand, Germany, the world's leading debtor in all of the services, is especially at a deficit in "travel" while it recovers its position in the "other services" at the end of the period.

Overall, of the five largest European countries, only the United Kingdom appears to be specialized in high-growth services. This picture should nonetheless be tempered by noting that the affiliates of French companies abroad achieve considerable sales (mode 3) in specialized services to companies and in financial intermediation, much larger than

2. The statistical data is piecemeal in this field. The OECD's FATS data (mode 3) exist only for a limited number of countries. For those shown in graph 1, the share of mode 3 in services trading is about 70-80%. For his part, G. Karsenty (2000) puts the share of mode 3 at only 40% at the world level (see P. Sauvé & R.M. Sern (eds.), CATS 2000: New Directions in Services Trade Liberalisation, Brookings Institution). Great prudence is thus called for with these statistics.
3. Their 2003 shares are respectively 29% and 24% of world exports (excluding intra-EU trade) and 26% and 20% of imports.

that of foreign affiliates located in France. This is also true of Germany, but to a lesser extent.

Graph 2 – Balances in the three categories of services (US$ billion)



Source: CEPII, CHELEM-BAL-CIN.

In the EU, it is the "other services" that will be directly concerned by the European services directive (see below). In this respect, it is interesting to note that the intra-European share in trade of these services is smaller than in trade of manufactured products: In 2003, it accounts for only 56% of EU25 trade as against 69% for manufactured goods.

This difference can be explained in several ways. Trade in goods and services are not determined by the same factors (or determined differently: the lack of a common language, for example, is more of an obstacle to services trade than to trade in goods. But it may also be that the rules applied to service activities by different European countries are creating a "distance" among them that suppresses the advantage of geographical proximity.

National rules and single market

In the context of the Lisbon strategy,[5] the draft European services directive aims at applying the principles of the single market to the services sector and, more generally, to reduce the rigidity existing in this market.[6] According to the Commission, greater flexibility in the domestic market for serviceswill stimulate productivity, growth and employment in a sector that employs 70% of the active European population and will strengthen the competitiveness of the sectors using these services. The expected gains in efficiency will favor the recovery of the Union's innovation capacity.

In February 2006, the European Parliament presented amendments to the text proposed by the Commission in January 2004. These amendments suppress the controversial principle of the "country of origin" and exclude some sectors from the field of the directive. A second version of the directive that essentially included these amendments was presented by the Commission in April 2006. An agreement between the Commission and Parliament should be found by mid-2006, in view of adoption by the Council by the end of the year.

The sectoral coverage of the directive is still large, as it notably includes distribution, hotel-restaurants and most business services (table 2). Concerning services trade mode 3 (commercial presence), the directive introduces simplified authorization procedures, especially thanks to the creation of "one stop offices" and lists conditions on establishment that will now be prohibited or subject to evaluation.[7] In the same way, the directive lists the regulations on services trade modes 1 and 2 that will now be prohibited.[8]

Table 2 – Activities concerned by the Services Directive*

- (Electricity, gas and water)
- Construction
- 'Wholesale and retail commerce
- Hotels and restaurants
- Transports
- (Communications)
(postal services)
Telecom
- Finance
- Real estate
- Equipment rental
- Computiing services
- R&D services
- Other services to companies
Accounting audit, legal services except notaries…
Architecture, engineering, advertising
Other except tempory services and private security
- Education*
- Health and social services
- (Waste treatment, sewage)
- Culture, Leisure Sports, except audiovisuals and moneys games

* The services concerned by the directive are only those provided in exchange for an economic compensation (which excludes national education, justice, *etc.).*

Note: Activities are presented according to the CITI nomenclature. Those excluded from the directive's field of application (revised 04/06) are in green while those that are covered by another European directive are underlined. Services of general economic interest that are subject to partial exclusions are shown in parenthesis.

For some activities covered by the European services directive, indices of the degree of regulation in different countries are available, among others from the OECD.[9] The level of regulation is evaluated from 0 (minimum regulation) to 6 (maximum) by aggregation of legal measures such as the obligation to acquire a professional license locally or the obligation to submit to an economic needs test. Note that

4. F. Kimura & H-H. Lee (2006), "The Gravity Equation in International Trade in Services," *Review of World Economics*, vol. 142, no. 1.
5. To make the European Union "the most competitive and dynamic knowledge economy on the horizon 2010."
6. See C. Schwellnus (2006), "Services Directive: An Economic Analysis," CEPII newsletter no. 252, January.
7. For example, tests of "economic need" in retail commerce will be prohibited.
8. For example, the obligation of establishment in the service consumer country, tax non-deductibility of professional services entrusted to foreign suppliers, the obligation to affiliate with the professional association in the target country and administrative authorization procedures will be prohibited.
9. P. Conway & G. Nicoletti (2006), "Product Market Regulation in Non-Manufacturing Sectors: Measurement and Highlights," *OECD Economics Department Working Paper*, to be published. Comparable measurements are made by the Australian Productivity Commission, "Measures of Restrictions on Trade in Services Database:" http://www.pc.gov.au/research/rm/servicesrestriction/index.html. As these two series of measurements are largely convergent, we use only those of the OECD here.

these regulations are not necessarily discriminatory toward foreign service providers, but they have the effect of setting up barriers to entry or restrictions on the exercise of an activity. The resulting indicators are obviously imperfect, and should therefore be interpreted with caution.

These indicators are given in table 3 for the largest exporters and importers of services in the EU15. Among them are the country that is on average the most regulated of the Fifteen for the four business services (Italy) and the least regulated one (Denmark). The highest/lowest level of regulation obtained by one of the Fifteen is indicated on the "maximum"/"minimum" row of the table. The median indicator of the four largest new members is also given in the table.

Table 3 – Synthetic indicator of the degree of regulation in professional services and retail business, 2003.
Minimum regulation = 0, Maximum = 6

	Accounting	Architecture	Engineering	Legal services	Retail
Italy	4,0	3.1	3.8	3.6	2.4
Germany	2.8	3.1	3.1	3.6	3.1
Spain	2.1	2.5	1.5	3.6	3.4
France	3,0	2.1	0	2.8	3.1
Netherlands	2.9	0	1.5	2,0	1.6
Ireland	1.6	0.7	0	2.8	1.1
United Kingdom	2.1	0	0	2.1	2,0
Denmark	1.2	0	0	2,0	2.5
Maximum of 15	4,0	3.5	3.8	4.5	4.5
Minimum of 15	0.3	0	0	0.3	0.5
EU15	2.2	1.6	1.2	2.8	2.6
NEM4 median	2.5	2.3	2.3	3.5	1.5
For reference					
United States	1.7	1.7	1.9	1.8	2.6

Note: The EU15 countries are classified by decreasing order of the mean index of the four professional services. NEM4: Czech Republic, Slovakia, Poland and Hungary.
Source: P. Conway & G. Nicoletti (2006).

The differences are large among the Fifteen in each of the activities, with a maximum regulation of two to three times higher than the median level of regulation. However, the median level of regulation of the Fifteen is not systematically higher than that of the United States and is, on the whole, lower than that of the new member States (except for retail trade).

In the European Union as in all OECD countries, there has been adecrease in the level of regulation of service activities over the past ten years (as can be seen by comparing the indicators calculated for 1996/98 and 2003). There remain nonetheless a few heavily regulated countries in the EU. In each of the reported activities, it is always an EU15 member which holds the highest indicator among all the OECD countries, except in accounting where the high level of Italy (4) is smaller than that of Turkey (4.5).

The directive's objectiveis to eliminate regulations that restrict the access of European suppliers to national markets (those listed among the prohibited measures), while preserving national preferences on consumer protection,. This will by itself reduce not only the level of regulation but also the heterogeneity of rules among countries[10] which constitutes a barrier to services trade in itself. Furthermore, the administrative simplification measures (one stop office) may contribute to reducing the cost of regulatory heterogeneity.

Implementing the services directive in Europe could thus provide service providers with opportunities for boosting their exports to other countries of the Union, whether by mode 1 (exports in the strict sense) or by mode 3 (sales of affiliates located abroad) and could help them to progress toward services with higher added value. This is particularly true for business services , where the growth potential is high. Increased intra-European openness may thus reconfigure service activities in Europe, bring new specialization schemes and, eventally, reshape the advantages of European countries in world competition.

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10. Aside from any attempt at harmonization, the principle of the country of origin included in the initial version of the Directive went further in this sense, by subjecting the operator on any market to the rules of his country of origin. On this point, see C. Schwellnus (2006), *op.cit.*

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