

# CRS Report for Congress

## U.S. Foreign Trade in Services: Definition, Patterns and Policy Challenges

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William H. Cooper  
Specialist in International Trade and Finance  
Foreign Affairs, Defense, and Trade Division



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Committees of Congress

# U.S. Foreign Trade in Services: Definition, Patterns and Policy Challenges

## Summary

The term “services” refers to a broad and widening range of economic activities such as accounting and legal services, banking, transportation, tourism, and telecommunications. Services are a significant sector of the U.S. economy, accounting for more than 50% of U.S. gross domestic product (GDP) and for nearly 80% of U.S. civilian employment.

Services have become an important element of U.S. foreign trade, consistently generating surpluses. The European Union is by far the most important U.S. trade partner in services, accounting for more than 50% of U.S. trade in services.

The increasing importance of services in domestic and global trade have placed them on the U.S. agenda for bilateral and regional trade agreements, and services trade occupies a prominent place on the agenda of the United States and the other 147 members of the World Trade Organization (WTO) in the Doha Development Agenda round of multilateral negotiations. Furthermore, disputes related to trade in services have arisen increasingly between the United States and the European Union, Japan, Canada, and other major trading partners.

The 109<sup>th</sup> Congress will have a number of trade agreements to consider, and services will be an important part of the deliberations. An overview of barriers, of the disputes in services trade and of the rapidly changing characteristics of the services sector, suggest that the negotiations and the agreements they produce will become increasingly complex. With the passage and enactment of the Bipartisan Trade Promotion Authority Act of 2002, these agreements are expected to be considered by Congress under “fast-track” procedures, with limited debate and no amendments, but with considerable executive branch consultation with Congress as the negotiations proceed.

The United States presses its trading partners to liberalize their services sector as much as possible, because U.S. services providers are very competitive in world markets. However, to accomplish its objectives, the United States is pressed by its partners to make concessions that might adversely affect “import-sensitive” industries in the United States. U.S. negotiators and, ultimately, the U.S. Congress will have to judge whether the agreements strike an appropriate balance for U.S. interests. This report will be updated as events warrant.

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# U.S. Foreign Trade in Services: Definition, Patterns and Policy Challenges

The term “services” refers to a broad and widening range of economic activities such as accounting and legal services, banking, transportation, tourism, and telecommunications. Services are a significant sector of the U.S. economy, accounting for more than 50% of U.S. gross domestic product (GDP) and for nearly 80% of U.S. civilian employment.

Services are becoming an important element of U.S. foreign trade and of global trade in general, although their intangibility and other characteristics along with other barriers have limited foreign trade in services. Because services are fundamentally different from goods, trade in services generates a unique set of trade policy issues. In addition, advances in technology continue to broaden the range of available services and the means to deliver services, making the policy challenges very dynamic.

The increasing importance of services in U.S. and global trade has placed them on the U.S. agenda for bilateral and regional trade agreements, and services trade occupies a prominent place on the agenda of the United States and the other 147 members of the World Trade Organization (WTO) in the Doha Development Agenda round of multilateral negotiations. Furthermore, disputes related to trade in services have arisen increasingly between the United States and the European Union, Japan, Canada, and other major trading partners.

U.S. suppliers of services are among the most competitive in the world. The United States has taken the lead in encouraging foreign trade partners to reduce barriers to trade in services through bilateral, regional, and multilateral negotiations. Congress has a significant role to play in these efforts. In fulfilling its responsibilities for oversight of U.S. trade policymaking and implementation, the Congress monitors trade negotiations and the implementation of any agreements reached as a result of the negotiations. More directly, the Congress must pass any agreements requiring changes in U.S. law before they can go into effect. FTA negotiations that include services as part of the agenda, are in progress or are expected to begin in the near future, while negotiations in the WTO continue.

This report provides background information and analysis on U.S. foreign trade in services. It includes an examination of definitions and examples of services to indicate their nature and scope; a review of the importance of services to the U.S. economy including U.S. foreign trade; and an analysis of the policy challenges that confront the United States, especially the challenge of negotiating a set of international rules on trade in services and the challenge of resolving disputes over trade in services with trading partners. This report will be updated as events warrant.

## Services and the U.S. Economy

“Services” encompass a very broad and widening range of economic activities. According to one definition, services are “... a diverse group of economic activities not directly associated with the manufacture of goods, mining or agriculture. They typically involve the provision of human value-added in the form of labor, advice, managerial skill, entertainment, training intermediation, and the like.”<sup>1</sup> Services differ from manufactured goods primarily in that they are intangible, so they cannot be stored and must be consumed at the point of production (trips to the doctor, enjoying a meal at the restaurant). However, rapid changes in technology are reducing even these restrictions on services (computer software that can be stored online, on disks, tape, etc.).<sup>2</sup> Illustrative examples of services include wholesale and retail trade; transportation and warehousing; information; finance and insurance; professional, scientific, and technical services; education; arts and entertainment; health care and social assistance; food and accommodation services; construction; communication; and public administration.<sup>3</sup>

Services are an increasingly significant sector of the U.S. economy. In 1965, they accounted for 41% of U.S. GDP. In 2003 they accounted for 58% of U.S. GDP.<sup>4</sup> In 2002, workers in the services sector accounted for nearly 83% of the total civilian workforce.<sup>5</sup>

The significance of services to a national economy and to the global economy go beyond what can be measured by data. Many services not only have intrinsic value but are also critical to running other parts of large economies. For example, financial services (banking, investment, insurance) are the means by which capital flows throughout an economy from those who have it (savers, investors) to those who need it (borrowers). Financial services are often called the lifeblood of an economy.

There is a symbiotic relationship between many services providers and manufacturers — demand for one creates demand for the other. Many manufacturers are dependent on transportation, communication and distribution services networks to ensure that inputs are available for the production of goods and to deliver final goods to consumers. For example, car manufacturers depend on transportation services (trucking, rail, etc.) to make sure that component parts are available for assembly and that completed cars are delivered to dealers. At the same time, demand for services creates demand for manufactures. For example, the production of communication services leads to demand for telephones, radios, computers and other communications apparatuses.

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<sup>1</sup> OECD. Science Technology Industry Business and Industry Policy Forum Series. *The Service Economy*. 2000. Paris. p. 7.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid. OECD, p. 39.

<sup>4</sup> Calculations based on data in White House. Council of Economic Advisers. *Economic Report of the President*. February 2004. Washington. Table B-8. p. 284.

<sup>5</sup> Ibid. Table B-46. p. 338.

## U.S. Trade in Services

U.S. trade in services, as narrowly measured, plays an important role in overall U.S. trade, albeit a much smaller role than domestic services play in the overall U.S. economy. And the relative importance of trade in services has remained quite constant. Between 1986 and 2001, for example, the share of services in overall U.S. exports in goods and services remained at around 28%, although it increased to 30% by 2003. From 1986 to 2003, the share of U.S. imports of goods and services accounted for by services has been 17%-18%. These data are presented in **Table 1**. These shares are substantially lower than one might expect from a sector that dominates the domestic economy.<sup>6</sup> **Table 1** also shows that the United States continually realizes surpluses in services trade which have partially offset large trade deficits in goods trade in the U.S. current account. These figures only measure trade in services that take place across borders as presented in the U.S. official balance of payments data.

**Table 1. U.S. Trade in Goods and Services, 1986-2003**  
(Billions of Dollars)

Year	Exports		Imports		Balances	
	Goods	Services	Goods	Services	Goods	Services
1986	223.3	85.4	368.4	80.1	-145.1	5.3
1991	416.9	163	491	118.5	-74.1	44.5
1996	612.1	237.7	803.3	150.8	-191.2	86.9
1997	679.7	258.8	876.4	166.9	-196.7	91.9
1998	670.2	263.7	917.2	181	-247	82.7
1999	684.6	272.8	1030	189.2	-345.4	83.6
2000	772.2	293.5	1224.4	217	-452.2	76.5
2001	718.8	279.3	1145.9	210.4	-427.2	68.9
2002	682.6	289.3	1407.4	240.5	-484.4	48.8
2003	713.1	307.4	1260.7	256.3	-547.6	51

**Source:** U.S. Department of Commerce. Bureau of Economic Analysis.

Because most services require direct contact between supplier and consumer, many service providers prefer to establish or must establish a presence in the country of the consumer. For example, hotel and restaurant services by their very nature require a presence in the country of the consumer. Providers of legal, accounting,

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<sup>6</sup>U.S. Department of Commerce. Bureau of Economic Analysis. *U.S. International Accounts Data*. October 14, 2004.

and construction services prefer a direct presence because they need access to expert knowledge of the laws and regulations of the country in which they are doing business and they require proximity to clients. Thus, cross-border services trade data do not capture all of the trade in services.

Data on sales of services by foreign affiliates of U.S.-owned companies and by U.S. affiliates of foreign-owned firms help to provide a more accurate, albeit still incomplete, measurement of trade in services. In 2002 (the latest year for which published data are available), U.S. firms sold \$401 billion in services to foreigners through their majority-owned foreign affiliates. In 2002, foreign firms sold to U.S. residents, \$387 billion in services through their majority-owned foreign affiliates located in the United States.<sup>7</sup> The data for cross-border trade and for sales by majority-owned affiliates are not directly compatible; therefore, it is difficult to derive an accurate overall measure of services trade. Even these two sets of figures do not capture the total value of trade in services. Two other modes of services delivery are through the temporary movement of consumers to the location of the provider and the temporary movement of the provider to the location of the consumer. U.S. data on the sales of services via these two modes of delivery are not readily available. (See text box.)

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<sup>7</sup> Bureau of Economic Analysis. U.S. Department of Commerce. *Sales of Services to Foreign and U.S. Markets Through Cross-Border Trade and Through Affiliates*. [<http://www.bea.gov>].

## The Four Modes of Delivery for Trade in Services

International agreements on trade in services, including the General Agreement on Trade in Services (GATS), which is administered by the World Trade Organization (WTO), identifies four modes of supply of services:<sup>8</sup>

**Mode 1 — Cross-border supply:** The service is supplied from one country to another. The supplier and consumer remain in their respective countries, while the service crosses the border. Example: A U.S. architectural firm is hired by a client in Mexico to design a building. The U.S. firm does the design in its home country and sends the blueprints to its client in Mexico.

**Mode 2 — Consumption abroad:** The consumer physically travels to another country to obtain the service. Example: A Mexican client travels to the United States to obtain the services of a U.S. architectural firm.

**Mode 3 — Commercial presence:** The supply of a service by a firm in one country via its branch, agency, or wholly-owned subsidiary located in another country. Example: A U.S. architectural firm establishes a subsidiary in Mexico to sell services to local clients.

**Mode 4 — Presence of natural persons:** Individual suppliers travel temporarily to another country to supply services. Example: A U.S. architect travels to Mexico to provide design services to her Mexican client.

Identifying the various modes of delivery of services is important for measuring the volume of services trade that takes place. Each mode requires a different method of measurement, and the data derived from these measurements are not likely to be compatible across the four modes, that is, one cannot combine the data on services traded via mode 1 with data derived from services traded via mode 3 in order to obtain a total. Identifying the modes is also important for policy purposes because issues raised by trade in mode 1 can be different from issues raised by trade in another mode. For example, the trade barriers faced by providers in mode 1 are not necessarily the same as those faced by providers in mode 4. Therefore, knowing the different modes helps to frame policy issues and solutions.

**Source:** The description and examples of modes of delivery are based on and adapted from the description contained in OECD. *GATS: The Case for Open Services Markets*. Paris. 2002. p. 60.

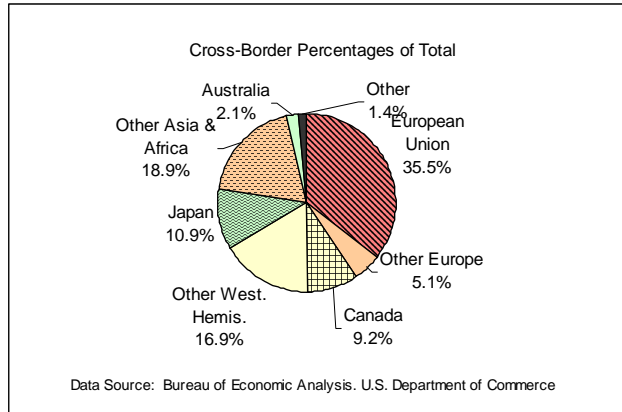
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<sup>8</sup> The following description and examples of modes of delivery is based on and adapted from the description contained in OECD. *GATS: The Case for Open Services Markets*. Paris. 2002. p. 60.

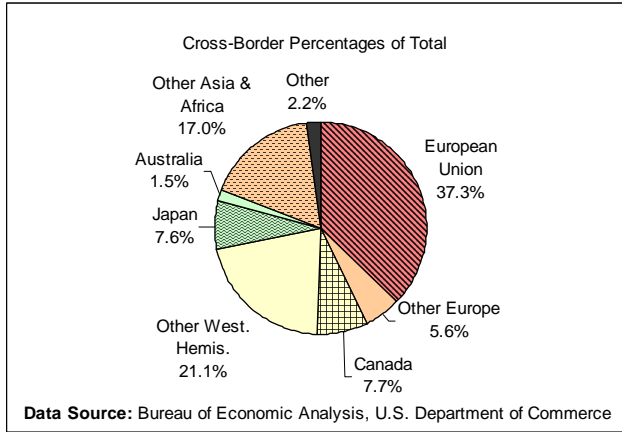


The United States conducts trade in services (both via cross border trade and foreign direct investments) with many different regions of the world. However, the graphs contained above in **Figures 1 and 2** show that much of the U.S. cross-border trade in services in 2003 occurred with EU-member countries. **Figure 1** indicates that more than one-third of U.S. services exports were to the European Union and more

**Figure 1. U.S. Exports of Services by Area, 2004**



**Figure 2. U.S. Services Imports by Area, 2004**

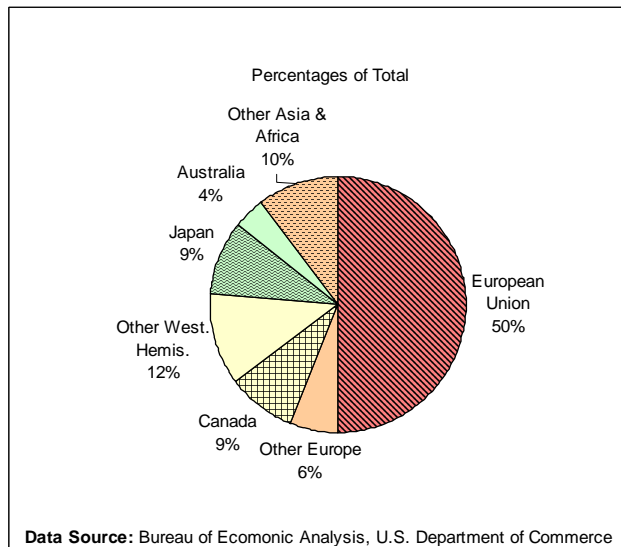


than one third of U.S. imports of services were from the European Union. In contrast, Canada accounted for only 9.1% and 8.4% of U.S. services exports and imports, respectively.

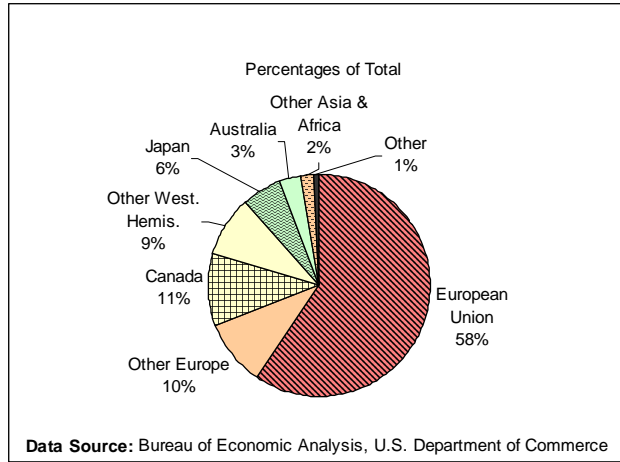
The EU's dominance in U.S. services trade is even more apparent when taking into account services that are provided through multinational corporations (MNCs).

**Figure 3** shows shares by region of sales of services in 2002 (the latest data available) by U.S. majority-owned companies to foreign persons, a measurement comparable to U.S. exports.

**Figure 3. Sales of Services to Foreign Persons by U.S. MNCs, by Region, 2003**



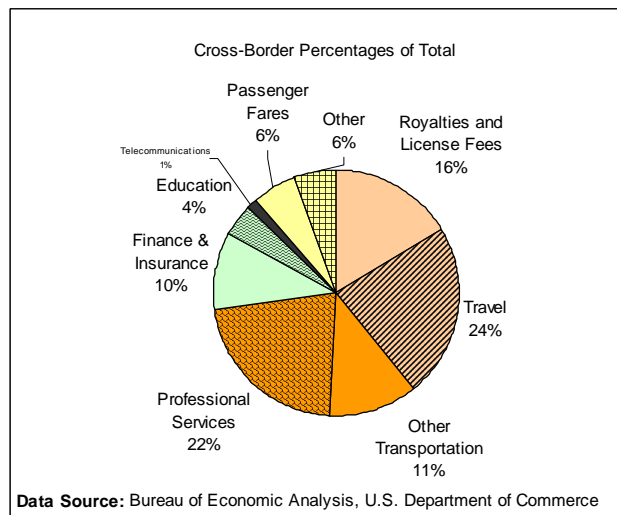
**Figure 4. Sales of Services to U.S. Persons by Foreign MNCs, by Area, 2003**



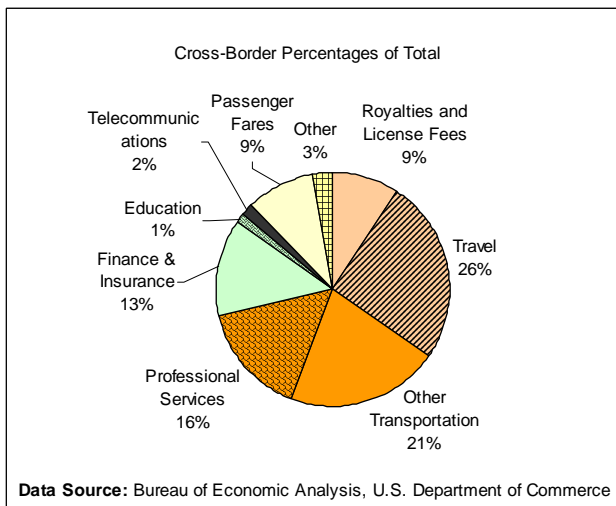
**Figure 4** shows shares by region of sales in 2002 to U.S. persons by foreign majority-owned MNCs, a measurement comparable to U.S. imports. The figures indicate that the EU accounted for 49.3% of sales to foreign persons and 60.6% of sales to U.S. persons services through MNCs. Canada accounted for 10.0% and 11.5% of the total sales.

**Figures 5 and 6** show the shares of U.S. services exports and imports accounted for by types of services. Travel and related services dominate U.S. cross-border services trade, accounting for 21.9% and 24.8% of U.S. services exports and imports, respectively, in 2003. Passenger fares accounted for another 5.3% and 9.2% and other transportation services accounted for an additional 10.8% and 17.9% of U.S. services exports and imports. The dominance of these services is not altogether surprising,

**Figure 5. U.S. Services Exports by Type, 2004**



**Figure 6. U.S. Services Imports by Type, 2004**



given the relative ease with which such services can be traded across borders.

## U.S. Policy Challenges in Foreign Trade in Services

As U.S. service providers strive to increase foreign trade, U.S. policymakers are faced with a number of challenges in constructing an international environment that is conducive to increased trade in services. One challenge is identifying the foreign government laws, regulations, and policies that impede trade flows and prevent the international system of trade in services from operating efficiently. While some of these barriers are similar to those that exist in goods trade, many are different and more complex and, therefore, sometimes difficult to identify. A second challenge derives from the first — working with trading partners to build and administer “rules of the road” to facilitate trade in services. The current rules, the General Agreement on Trade in Services (GATS), are a recent phenomenon and are at an early stage of development. A third challenge is managing disputes that arise when trading partners do not agree on how trade in services should be conducted.

### Barriers to Trade in Services

Because of the fundamental differences between goods and services, the barriers that foreign service providers face are different from those faced by goods suppliers. Many barriers in goods trade — tariffs and quotas for example — are at the border.

Restrictions on services trade occur largely within the borders of the “importing” country and are in the form of government regulations. The right of governments to regulate some services industries is widely recognized as prudent and necessary to protect consumers from dangerous or unqualified providers. For example, doctors and other medical personnel must be licensed by government-appointed boards; lawyers, financial services providers, and many other professional service providers must be also certified in some manner.

Governments regulate to protect the economy from sudden and potentially harmful shocks. For example, controls on foreign currency transactions are designed to protect the economy from “panic” capital flight and to maintain stable exchange rates. The question in foreign trade is whether these regulations are applied in a discriminating and unnecessarily restrictive manner. Because services transactions more often require direct contact between consumer and provider than is the case with goods trade, many of the “trade barriers” that foreign companies face pertain to the establishment of a commercial presence in the consumers’ country in the form of direct investment or to the temporary movement of people (Mode 4) — sellers and consumers — across borders.

**General Trade Barriers.** Some trade barriers are evident across services industries. In most cases the restrictions are ostensibly legitimate but may have unintentional adverse affects on foreign services trade. Examples of such barriers include:

- restrictions on international payments, including repatriation of profits, mandatory currency conversions, and restrictions on current account transactions;

- restrictions on the movement of personnel, including visa, work permit, and immigration restrictions; requirements that foreign professionals pass certification exams or obtain extra training that is not required by local nationals; permission for entry and provision of services contingent on local labor supply requirements;
- restrictions on information transfer imposed to protect data and maintain privacy;
- “buy national” requirements in government procurement;
- lack of national treatment in taxation policy or protection from double taxation;
- government-owned monopoly service providers and requirements by foreign service providers to use a monopoly’s network access or communications connection provider;
- government subsidization of domestic service suppliers;
- limitations on foreign direct investment, such as equity ceilings; local employment and sourcing requirements; restrictions on the form of investment, that is, a branch, subsidiary, joint venture, etc.; “net national benefit” requirements; quotas imposed on number of foreign service suppliers; requirements that the chief executive officer or other high level company officials be local nationals or that a certain proportion of a company’s directors be local nationals; and
- licensing requirements to market and sell services.<sup>9</sup>

**Industry-Specific Barriers.** In most cases, a service industry confronts barriers that are largely specific to that industry. The following examples of major service industries and the barriers they confront are illustrative.

**Construction and Related Services.** This category includes firms that are involved in the construction of both residential and commercial buildings; firms that are involved in the construction of transportation infrastructures, such as roads, bridges airports, tunnels, and similar structures; firms that install prefabricated structures; and firms that provide finishing work to structures. It is a category of services in which U.S. firms have proved highly competitive in the global market. In 1999, U.S. firms won bids on international construction contracts worth \$29

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<sup>9</sup> World Trade Organization. *Guide to the GATS*. Kluwer Law International. Boston. 2001. OECD. Working Party of the Trade Committee. *Assessing Barriers to Trade in Services — Revised Consolidated List of Cross-Sectoral Barriers*. Paris. February 28, 2001.

billion. Although this figure was a small fraction of total U.S. construction business, it represented 24% of all international construction contracts awarded worldwide.<sup>10</sup>

Construction and related engineering services is very labor intensive work, combining low and highly specialized-skilled labor. Firms that provide services in foreign markets usually require a presence in the country either temporarily or through foreign direct investment often in the form of a partnership with a local firm that has knowledge of local laws and other requirements. Because these firms compete by offering specialized skills, they frequently must be able to move highly skilled workers across borders.

In most countries, the construction and related services industry is tightly regulated. For quality control and safety reasons, governments require construction firms to meet technical standards and may also require developers to adhere to land use and environmental controls. Some restrictions might be applied ostensibly on a non-discriminatory basis but may be a greater burden to foreign suppliers, e.g., a requirement that a certain percentage of labor be locally sourced.

In a number of countries, local or regional trade associations have the authority to rule on applications of construction firms for required permits, thereby, creating a conflict of interest as association members would have an interest in limiting competition. Some countries employ “buy national” policies that favor domestic construction firms in bidding on government projects. In addition, some governments tolerate private company collusive practices. For example, in Japan local construction companies have practiced bid-rigging called *dango*. Under this practice a small group of Japanese construction firms agree which of them would submit the lowest bid and therefore get the contract. They rotate the “winning bidder” among them from project to project. The practice would guarantee work among the participants but would keep foreign and other domestic competitors out.<sup>11</sup>

**Travel and Tourism.** Travel and tourism is a multifaceted industry. It encompasses lodging and restaurants (including catering), travel agencies and tour operators, and tourist guide services. It ranks among the top five service industries in more than 75% of the countries, and is among the top sectors in U.S. cross-border services trade. For many smaller countries, it is the primary means of earning foreign exchange.

Travel and tourism is a labor-intensive industry that is highly dependent on other service sectors — transportation; construction (to insure that sufficient and appropriate lodging and other facilities are available to tourists); advertising; telecommunications and distribution services, among others. It is an industry that is undergoing major changes as the use of the Internet and the introduction of other technologies change how tourism and travel services are delivered. The industry faces few direct trade barriers but is indirectly affected by regulations pertaining to

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<sup>10</sup> United States International Trade Commission. *Recent Trends in Services Trade — 2002 Annual Report*. May 2002. Publication No. 3514. pp. 4-5.

<sup>11</sup> United States Trade Representative. *2002 National Trade Estimates Report on Foreign Trade Barriers*. Washington. pp. 227-228.

the movement of people (immigration, visas); transportation (for example, the distribution of slots to foreign airlines at major airports); movement of money (for example, foreign exchange requirements); and construction standards (for example, the quality of hotels and other tourist necessities).

**Banking and Financial Services.** Banking and financial services cover a wide range of economic activities: maintaining deposits; lending money; brokering of securities (stocks and bonds); brokering of many types of insurance (health, life, auto, home, and specialized insurance); managing pension funds and other assets; financial planning; and more. It is also an industry in which American firms have proved to be highly competitive and have a growing global presence. In addition, among the industries that comprise the services sector, it is perhaps the most complex not only because of its scope of activities but also because of its importance.

A viable financial sector is critical to an economy. It functions primarily to protect the financial assets of residents and to facilitate the flow of capital from savers and investors to borrowers. The sector has undergone rapid changes recently. Technology, especially the emergence of the Internet, has facilitated sales of insurance, the transmission of deposits, and the purchase and sale of securities across international borders. Furthermore, many countries have liberalized regulation of financial industries allowing for increased foreign ownership and the reduction of “firewalls” between financial industries.

At the same time, because of their importance to the maintenance of economic stability, financial services are a heavily regulated sector. Many regulations are applied to protect investors and depositors and to ensure the viability of the sector. These regulations, such as deposit insurance, reserve requirements, capitalization requirements, and the like are considered prudent to maintaining a healthy financial system. However, a fine line exists at times between prudent requirements and requirements that are used to protect the domestic industry from foreign competition. For example, governments often require insurance brokers and other financial agents to be licensed to protect customers from unqualified or otherwise questionable providers. But licensing can also be used to restrict competition and protect favored companies. Foreign banks frequently face restrictions on the type of direct investment they can make in a country, the types of services they can provide, or the number of facilities they can establish in the country or in a region of the country. Foreign-owned insurance companies may confront restrictions on the type of insurance they can sell; for example, some countries prohibit foreign companies from selling life insurance or auto insurance.<sup>12</sup>

## **Establishing Rules on Trade in Services**

The United States is working with trading partners to develop and implement rules on trade in services on several fronts. The broadest and most challenging are the multilateral rules contained in the General Agreement on Tariffs and Trade

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<sup>12</sup> World Trade Organization. pp. 331-352. For more information on U.S. foreign trade in financial services, see CRS Report RL31110, *U.S. Trade in Financial Services: An Overview*, by Patricia A. Wertman and William H. Cooper.

(GATS) that is administered by the World Trade Organization (WTO). Rules on trade in services are also part of the North American Free Trade Agreement (NAFTA) and other regional and bilateral free trade agreements. Furthermore, they will likely be an aspect of free trade agreements (FTAs) now under negotiation or discussion.

**The WTO and GATS.** The seeds for multilateral negotiations in services trade were planted more than a quarter century ago. In the Trade Act of 1974, the Congress instructed the Administration to push for an agreement on trade in services under the General Agreement on Tariffs and Trade (GATT) during the Tokyo Round negotiations. While the Tokyo Round concluded in 1979 without a services agreement, the industrialized countries, led by the United States, continued to press for its inclusion in later negotiations. Developing countries, whose service sectors are less advanced than those of the industrialized countries, were reluctant to have services included. Eventually services were included as part of the Uruguay Round negotiations launched in 1986.<sup>13</sup> At the end of the round, countries agreed to a new set of rules for services, the GATS, and a new agency, the WTO, to administer the GATS and other agreements reached.

**The GATS.** The GATS provides the first and only multilateral framework of principles and rules for government policies and regulations affecting trade in services among more than 100 countries representing many levels of economic development. The GATS remains a work in progress, and its expansion is a part of the new round of WTO negotiations launched in November 2001 in Doha, Qatar.

The GATS agreement, most of which was completed by December 1993, is divided into six parts.<sup>14</sup> Part I (Article I) defines the scope of the GATS. It provides that the GATS applies —

- to all services, except those supplied in the routine exercise of government authority;
- to all government barriers to trade in services at all levels of government — national, regional, and local; and
- to all four modes of delivery of services.

Part II (Articles II-XV) presents the “principles and obligations,” some of which mirror those for trade in goods while others are specific to services. These principles and obligations include:

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<sup>13</sup> Feketekuty, Geza. *International Trade in Services: An Overview and Blueprint for Negotiations*. American Enterprise Institute. Ballinger Publishers. 1988. p. 194.

<sup>14</sup> This description of the GATS is based on WTO Secretariat — Trade in Services Division. *An Introduction to the GATS*. October 1999. [<http://www.wto.org>]. Not all services issues were resolved when the Uruguay Round was completed in 1993. Negotiations on financial services and telecommunications services continued until agreements were reached in 1997.

- unconditional most-favored-nation (*MFN*) *non-discriminatory treatment*; that is, services imported from one member country cannot be treated any less favorably than the services imported from another member country;<sup>15</sup>
- *transparency*, that is, governments must publish rules and regulations;
- *reasonable, impartial and objective* administration of government rules and regulations that apply to covered services;
- *monopoly suppliers* must act consistently with obligations under the GATS in covered services;
- a member incurring *balance of payments difficulties* may temporarily restrict trade in services covered by the agreement; and
- a member may circumvent GATS obligations for *national security purposes*.

Part III (Articles XVI-XVIII) of the GATS establishes market access and national treatment obligations for members. The GATS —

- binds each member to its commitments once it has made them, that is, a member country may not impose less favorable treatment than what it has committed to;
- prohibits member-country governments from placing limits on suppliers of services from other member countries regarding: the number of foreign service suppliers; the total value of service transactions or assets; the number of transactions or value of output; the type of legal entity or joint venture through which services may be supplied; and the share of foreign capital or total value of foreign direct investment;
- requires that member governments accord service suppliers from other member countries *national treatment*, that is, a foreign service or service provider may not be treated any less favorably than a domestic provider of the service; and
- allows members to negotiate further reductions in barriers to trade in services.

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<sup>15</sup> The GATS differs from the GATT in that it has allowed members to take temporary exemptions to MFN treatment. The exemptions are listed in a special annex to the GATS. The GATS allows only these one-time exemptions. The GATS (as is the case of the GATT) also allows MFN exemptions in the cases of regional agreements.



*Importantly*, unlike MFN treatment and the other principles listed in Part II, which apply to all service providers more or less unconditionally, the obligations under Part III are restricted. They apply only to those services and modes of delivery listed in each member's schedule of commitments. Thus, unless a member country has specifically committed to open up its market to service suppliers in a particular service that is provided via one or more of the four modes of delivery, the national treatment and market access obligations do not apply. This is often referred to as the *positive list* approach to trade commitments. Each member country's schedule of commitments is contained in an annex to the GATS.<sup>16</sup> The schedules of commitments are, in essence, the core of the GATS.

Parts IV-VI (Articles XIX-XXIX) are technical but important elements of the agreement. Among other things, they include the requirement that, no later than 2000, the GATS members start new negotiations (which they have done) to expand coverage of the agreement and establish the requirement that conflicts between members involving implementation of the GATS be handled in the WTO's dispute settlement mechanism. The GATS also includes eight annexes, including one on MFN exemptions. Another annex provides a "prudential carve out," that is, a recognition that governments take "prudent" actions to protect investors or otherwise maintain the integrity of the national financial system. These prudent actions are allowed even if they conflict with obligations under the GATS.

Evaluations of the GATS in its first seven years range from those who view the "glass as half empty" to those who see "the glass as half full." The more pessimistic school argues that not much has been accomplished in GATS, that, at best members committed themselves to maintain the status quo before the GATS went into effect. These critics argue that some countries actually made commitments that were more restrictive than their current practices. Furthermore, critics question the value of the so-called positive list approach to members' commitments which can lead to slower and more tedious trade liberalization negotiations.

The more optimistic school considers the mere establishment of the GATS to be an important accomplishment considering that many countries strongly resisted even negotiating on services at the beginning of the Uruguay Round. In addition, even though the initial commitments may have only locked members in at the status quo, they are bound by those commitments from sliding back into more protectionism and may actually open up their services sectors as negotiations proceed.

***Continuing Negotiations.*** Article XIX of the GATS required WTO members to begin a new set of negotiations on services in 2000 as part of the so-called WTO "built-in agenda." In so doing, it guaranteed that WTO members will pursue negotiations on services even if they are not able to begin a new full round. Article XIX stipulates that participants work to resolve some conceptual and procedural issues, for example, how to give negotiating credit to governments that

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<sup>16</sup> Archived CRS Report 95-1051, *Services Trade and the Uruguay Round*, by Arlene Wilson. p. 17.

had unilaterally liberalized their services sectors since the conclusion of the first set of negotiations and whether to provide special treatment to least developed countries.

The new set of GATS negotiations began in February 2000, and during the remainder of that year, the members reviewed the status of commitments already made and developed a set of guidelines. In addition to the issues mandated by Article XIX, the guidelines stipulate that negotiators will continue to use the service-specific, mode-specific (positive list) approach.

At the November 2001 WTO Ministerial in Doha, Qatar, WTO members launched a new round of multilateral negotiations. The negotiations on services were folded into the agenda of the new round at the November 2001 WTO Ministerial in Doha, Qatar. In their declaration establishing the agenda for the new round, the ministers affirmed their support for the work that had already been accomplished in the services negotiations. Each WTO member first indicates what general concessions they request from the other members and then, separately, each member indicates what concessions it is willing to offer. Members stipulated on the Doha documents that by June 30, 2002, GATS members should have submitted their requests for commitments from other members to liberalize trade in services and, by March 31, 2003, should submit their offerings of what their initial commitments would be toward liberalizing trade in services in their economies.

The United States had completed its requests for commitments from other member countries on July 1, 2002. The U.S. requests call for many of the countries to improve transparency in regulations of services to boost efficiency across all services industries. In addition, U.S. requests centered on reduction of trade restrictions in 12 service industries: telecommunications; finance; express delivery; energy; environment; distribution services; education and training; lodging and other tourism services; professional services; computer and related services; advertising services; and audiovisual services.<sup>17</sup>

Other countries, including the 15 members of the EU, submitted their own requests, including requests made of the United States to reduce trade barriers in services. Of note, is a request by the EU, Japan, South Korea, and Norway that the United States provide greater access to its markets for foreign maritime services providers. Japan, for example, points to the Jones Act of 1920, which limits shipping within the United States to vessels manufactured, owned, and operated by U.S. companies. The EU has also focused some of its requests on the U.S. financial sector, particularly restrictions on the foreign establishment of state-chartered subsidiaries, branches, or representative offices.<sup>18</sup>

On March 31, 2003, the United States submitted its offer on reducing trade barriers in services to meet the deadline established in the Doha Ministerial statement. The U.S. offer covers 15 areas: accounting services; advertising and

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<sup>17</sup> Office of the United States Trade Representative. *U.S. Proposals for Liberalizing Trade in Services: Executive Summary*. July 1, 2002. [[http://www.ustr.gov/assets/Document\\_Library/Press\\_Releases/2002/July/asset\\_upload\\_file224\\_2009.pdf](http://www.ustr.gov/assets/Document_Library/Press_Releases/2002/July/asset_upload_file224_2009.pdf)].

<sup>18</sup> *Washington Trade Daily*. July 5 and July 6, 2002.

related services; audiovisual and related services; distribution services; education and training services; energy services; environmental services; express delivery services; financial services; legal services; movement of natural persons (mode 4); small and medium-sized services enterprises; telecommunications, value-added network, and complementary services; and transparency in domestic regulation.<sup>19</sup>

The negotiations on services have gone slowly since the Doha Development Agenda was launched. Besides the United States, only 43 other WTO members (the EU is counted as one member) have made offers on reducing their trade barriers. Some negotiators and other observers have argued that not much progress would be made until the WTO negotiators resolved how agricultural issues would be addressed.<sup>20</sup> Developing countries were reluctant to make offers on services until they saw how far some of the developed countries were willing to go on agriculture. Because the framework agreement addressed many agricultural trade issues, supporters of liberalized trade in services are anticipating that the services negotiations will gain momentum.

The Doha Development Agenda negotiations stagnated for many months. In July 2004, after fits and starts, the WTO members agreed on a new “framework” for the negotiations during the round having overcome critical questions on agriculture. The framework itself mentions services only briefly because they were not the focus of the negotiations over the framework and the parameters of the negotiations had already been established as part of the “built-in agenda” and in the Doha Ministerial Declaration that launched the new round. The framework reaffirms the commitments made in the Doha Ministerial Declaration and charges the negotiators to complete and submit their initial offers as soon as possible, to submit revised offers by May 2005 and to ensure that the offers are of high quality. The framework also charges the negotiators to bear in mind when making their offers the sectors and modes of supply that are of interest to developing countries.

The negotiating framework notes the particular interest that developing countries have in issues pertaining to mode-4 supply of services. A number of developing countries, including African countries and India, have complained that developed countries’ offers to date have been largely deficient in the area of mode-4. They assert that the developed countries often require a commercial presence by the foreign supplier and/or employ strict requirements, such as pre-employment conditions, economic needs tests, and quota restrictions on visas before permitting temporary entry of foreign professionals.<sup>21</sup> Because developing country concerns run head-on into U.S. and EU heightened post-9/11 concerns about entry of foreigners, this issue could be difficult as the services negotiations progress.

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<sup>19</sup> For more information on the U.S. offer, see CRS Report RS21492, *Services Negotiations in the WTO: An Overview of the U.S. Offer*, by James K. Jackson.

<sup>20</sup> Coalition of Services Industries. *US Services Industry Association Welcomes WTO Agreement to Move Ahead with Doha Round Trade Talks*. Press release. July 31, 2004.

<sup>21</sup> Developing Nations Again Criticize Lack of Mode 4 Offers in WTO Services Talks. *International Trade Reporter*. April 8, 2004. p. 600.

In many member countries, services are a large portion of economic activity. Yet, services account for only a small portion of total trade, indicating many untapped opportunities for trade in services if barriers are eliminated. However, for many countries, especially developing countries, liberalization in services trade is a very sensitive issue that may make achieving the opportunities difficult if not elusive.

**The Role of Services in U.S. Regional and Bilateral Free Trade Agreements.** The United States has in place several bilateral and regional free trade agreements and is conducting negotiations on others. This section provides a brief overview of the treatment of services in these agreements and negotiations.

***The North American Free Trade Agreement (NAFTA).*** NAFTA, which went into effect on January 1, 1994, is the largest free trade agreement in which the United States participates. NAFTA's coverage of services trade is very broad reflecting the comprehensive integration of the three participating economies. Chapter 12 contains NAFTA's coverage of most "cross-border" services trade (defined as all services trade except that requires a commercial presence). The exceptions are financial services (which are covered in chapter 14) services purchased by state enterprises or governments (which are covered in chapter 10) and international air transportation and related services, which are not covered at all. Services trade related to the commercial presence of the provider in the country of the consumer is covered in Chapter 11 on foreign direct investment.

Chapter 12 of NAFTA requires Canada, the United States, and Mexico to provide national treatment and most-favored-nation treatment to one another's services and service providers and prohibits the participating governments from requiring services providers to establish a local presence in order to sell their services. The three countries may exercise exceptions to these principles:

- where restrictions are already in place and listed in Annex I of NAFTA;
- in certain services sectors and subsectors listed in Annex II; and
- certain non-discriminatory quotas listed in Annex V.

In Annex VI, the three parties list their specific commitments to liberalize cross-border trade in services.

A major controversy erupted over trucking services. As part of NAFTA, the United States made a commitment to permit Mexican truckers to transport goods to the southern U.S. border states beginning in 1995 and to the entire United States by January 2000. However, in 1995 the Clinton Administration banned Mexican truckers access beyond the border regions because of concerns raised by the U.S. trucking industry and others over the safety of Mexican trucks. The issue became a source of tension between the two NAFTA partners.

On February 6, 2001, in response to a complaint filed by Mexico against the U.S. ban, an arbitration panel formed under NAFTA determined that the United States was violating its obligations but also ruled that the United States could impose

requirements on Mexican trucks entering the United States to guarantee safety since U.S. and Mexican regulations were different.<sup>22</sup> Provisions contained in the FY2002 transportation appropriations bill required a system of certifying the safety of Mexican trucks before they would be allowed access to the rest of the United States. On June 27, 2002, Secretary of Transportation Norman Mineta indicated that the system was almost complete and that certification of Mexican trucking companies would probably begin before the end of the summer of 2002.<sup>23</sup>

**Other FTAs.** The U.S.-Israeli FTA, the first in which the United States has participated, went into effect in August 1985. Because services are a small component of U.S.-Israeli trade, they are not a significant part of the agreement. In the agreement, the United States and Israel committed themselves to provide national treatment to each other's services and to make their laws and regulations affecting services transparent.

The U.S.-Jordan FTA entered into force on December 17, 2001. U.S.-Jordan trade is small and services are not a significant part of that trade but are nevertheless covered in Article 3 of the agreement. Article 3 essentially requires the two countries to make commitments to open up trade in services that are no less liberal than the commitments each has made under the GATS.

**Ongoing Negotiations on FTAs.** The United States completed bilateral negotiations and has implemented FTAs with Singapore, Chile, Australia, and Morocco. In addition, the Bush Administration completed negotiations with five Central American countries (CAFTA) and with Bahrain. It is currently negotiating with the South African Customs Union (SACU) to create a subregional free trade area and with such countries as Thailand to create bilateral FTAs. The Administration has expressed interest in beginning FTA negotiations with a number of other countries. In each case, services trade plays a role in the negotiations.<sup>24</sup>

## Major Disputes in U.S. Trade in Services

The multilateral rules contained in the GATS or in bilateral or regional agreements are tailored for the trade that takes place among their participants. The GATS is largely considered to be a bold effort at creating a multilateral regime on services trade but still weak because it must conform to the consensus of a very large group of countries from different levels of development. Regional and bilateral regimes can be more comprehensive in their coverage because they are smaller. However, there are some leading-edge issues that no regime covers but have emerged in U.S. disputes with major trading partners.

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<sup>22</sup> For more information on this issue see CRS Report RL31028, *North American Free Trade Agreement: Truck Safety Considerations*, by Paul Rothberg.

<sup>23</sup> *Daily Report for Executives*. June 28, 2002. p. A-14.

<sup>24</sup> For more information on FTAs, see CRS Report RL31356, *Free Trade Agreements: Impact on U.S. Trade and Implications for U.S. Trade Policy*, by William H. Cooper.

One such issue is the protection of privacy in data transfers across borders that is important to the European Union. A second issue is infrastructure inefficiencies in the telecommunications sector, an ongoing issue with Japan. These and other issues demonstrate a key challenge that U.S. policy faces as new, cutting-edge technology expands the frontiers of trade in services — grappling with issues that are not covered by international rules. These negotiations will likely set precedents for U.S. bilateral negotiations with other countries and negotiations within the WTO.

**The EU.** The United States and the EU are engaged in path-setting negotiations over the issue of protecting the privacy of personal information. In October 1995, the EU enacted a directive requiring member states to pass national laws setting standards for the transfer of personal data in order to ensure the privacy of the subject of the data. The directive also prohibits private and public institutions in EU states from transmitting personal data to non-EU countries whose data protection laws and procedures do not meet EU standards. Many businesses consider the transfer of data to be vital in conducting trans-Atlantic business. In order to facilitate data transfers, the EU and the United States negotiated the “Safe Harbor” agreement. The agreement allows U.S. firms to voluntarily comply with EU standards and thus send and receive data from EU companies and institutions. The “Safe Harbor” became operational on November 1, 2000.<sup>25</sup>

However, the “Safe Harbor” does not apply to banking, insurance, and other financial companies to whom data transfer is the most critical. The EU has imposed a “standstill,” refraining from any restrictions on financial data transfers between the United States and EU as negotiators try to work out an agreement that would cover this category. The United States claims that the Gramm-Leach-Bliley Act of 1999 (PL. 106-102) protects personal financial data to meet EU standards. Among other things, the law requires financial institutions to provide their customers with notice of their privacy policies, prohibits financial institutions from sharing personal customer information with third parties without the consent of consumers, and prohibits financial institutions from providing account numbers to third parties for marketing purposes. The law also requires financial institutions to safeguard the security and confidentiality of customer information.<sup>26</sup> The EU has argued that the law does not provide adequate protection. The negotiations are expected to continue. Although financial data transfers between U.S. and EU institutions continue, many in the financial sector are concerned that the EU may lift the “standstill” before an agreement is reached, causing irreparable harm to financial business between the two regions.<sup>27</sup> This issue and how it is resolved could have implications for how other countries decide to handle the rapidly growing traffic in personal data.

**Japan.** The services sector in Japan is notorious for its inefficiencies, bogged down by heavy regulations designed to protect entrenched domestic providers from

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<sup>25</sup> For more information on “Safe Harbor” see, CRS Report RS20823, *The EU-U.S. “Safe Harbor” Agreement on Personal Data Privacy*, by Martin A. Weiss.

<sup>26</sup> CRS Report RS20185, *Privacy Protection for Customer Financial Information*, by M. Maureen Murphy.

<sup>27</sup> *International Trade Reporter*. July 25, 2002. p. 1303.

competitors, both from within Japan and foreign. A prime example has been the Japanese telecommunications sector.

In the 1970s and 1980s, the U.S. government waged disputes with the Japanese government on behalf of American producers of telecommunications *equipment*, such as mobile phones, claiming that unnecessary government regulations prevented them from competing in the Japanese market — the regulations were written to favor local producers. Since the 1990s, the United States has shifted its focus to pressing Japan to open its domestic market to competition in telecommunications *services*, such as long distance services, faxing, and Internet access. The United States has argued that by permitting more competition, the government would help improve the efficiency of the telecommunications sector and improve Japan's capabilities for meeting the technological challenges of the 21<sup>st</sup> century. U.S. negotiators also reasoned that because American telecommunication service providers were highly competitive, they would be in a good position to compete in the Japanese market if it were opened up.

The United States has targeted the high fees Nippon Telephone and Telegraph Company (NTT) has charged non-NTT providers to use its wires. Although NTT is privatized, most of its shares are still held by the Japanese government. NTT has a virtual monopoly on a land-wire system that competitors must connect into in order to provide local and long distance telephone services and other services, such as Internet connections.

The United States first approached the issue with Japan in 1995, suggesting that the methodology used by the Ministry of Posts and Telecommunications (MPT) (the regulatory body for NTT) results in interconnection charges far higher than those charged in the United States and other industrialized countries, thus keeping non-NTT providers at bay. Government regulation of the Japanese telecommunications industry became part of discussions under the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy, a framework that President Clinton and Japan's Prime Minister Hashimoto formed to negotiate key economic issues between 1997 and 2001. After much, sometimes heated discussions between the United States and Japan and within the Japanese government, the Japanese MPT agreed to change the methodology on interconnection charges and to phase in fee decreases.<sup>28</sup> The Bush Administration has continued discussions with Japan under a new but quite different framework, the Regulatory Reform Initiative. The issue remains an ongoing one.

## Implications for U.S. Trade Policy and the Congress

The background information and analysis presented here indicate that services are a significant component of the U.S. economy, accounting for a major portion of

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<sup>28</sup> Kawabata, Eiji. *Still Bilateral After All of These Years: U.S.-Japan Trade Negotiations in Telecommunications*. A paper prepared for the conference on "After the Cold War and Globalization: Changes in the Japanese International Political Economy." Institute of Social Science, University of Tokyo. June 20-22, 2002.

U.S. employment. It is also a component in which U.S. firms have proved to be globally competitive. The services sector is also very broad and encompasses an ever expanding range of economic activities of varying types.

The broad scope of the services sector presents policy challenges to U.S. policymakers, including the Congress, as the United States works with trading partners to build regimes under which they will conduct trade in services. Disputes with the EU over data privacy and with Japan over regulations in telecommunications services show that the regimes that are developed must be flexible enough to respond to the the growing challenges presented by technology.

The United States is expected to conclude free trade area (FTA) negotiations with Chile and Singapore soon, to launch FTA negotiations with other countries in the near future and to complete negotiations with the FTAA countries in 2005. Services are or will probably be an important aspect of each of these sets of negotiations. Furthermore, the United States plays a leading role in the overarching negotiations to expand the GATS that are part of the Doha Development Agenda of the new round of WTO negotiations and are scheduled for completion by the end of 2005.

The number of variety of negotiations planned or already underway suggests that the 109<sup>th</sup> Congress will have a number of trade agreements to consider and that services will be an important part of the deliberations. An overview of barriers, of the disputes in services trade and of the rapidly changing characteristics of the services sector, all suggest that the negotiations and the agreements they produce will become increasingly complex. With the passage and enactment of the Bipartisan Trade Promotion Authority Act of 2002, these agreements are expected to be considered by Congress under “fast-track” procedures involving limited debate and no amendments, but with considerable executive branch consultation with Congress as the negotiations proceed.<sup>29</sup>

The United States presses its trading partners to liberalize their services sector as much as possible, because U.S. services providers are very competitive in world markets. However, to accomplish its objectives, the United States is pressed by its partners to make concessions that adversely affect “import-sensitive” industries in the United States. U.S. negotiators and, ultimately, the U.S. Congress will have to judge whether the agreements strike an appropriate balance for U.S. interests.

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<sup>29</sup> Contained in Title XXI of P.L. 107-210, the Trade Act of 2002, which was signed on August 6, 2002.