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Economic Perspectives on Trade in Professional Services

Jagdish Bhagwati
Jagdish.Bhagwati@chicagounbound.edu

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Jagdish N. Bhagwati†

This paper will bring an economist's perspective to bear on three questions raised at this conference by some of the other important contributions:

(1) How are services different from goods;

(2) What implications do these differences have for the rules we seek to negotiate to free trade in services; and

(3) How can we induce the key developing countries, such as Brazil, Egypt and India, which have generally opposed liberalization of trade in services, to support it?

Answers to these questions will naturally bear critically on the narrower question of international trade in professional, and especially legal, services, since recommendations and decisions on a component of the service sector cannot properly be made until the broader perspectives and principles are addressed and understood.

I. The Distinction Between Goods and Services

As Geza Feketekuty has made abundantly clear,[1] the interest in service trade is very recent. One byproduct of this is that the relevant data are both unreliable and far too limited. The limitations on data now available are a function not only of logistical problems in data collection, but also of unresolved conceptual questions which impair our present ability to generate meaningful and adequate statistics on the matter at hand. It is still not clear, for example, how services are to be defined, or how they are different from goods.

A. Non-Storability

Perhaps the earliest useful attempt to define the distinction

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† Arthur Lehman Professor of Economics and Political Science, Columbia University. This paper is based on comments made at the University of Chicago Legal Forum symposium on "Barriers to International Trade in Professional Services", February 8, 1986.

[1] Geza Feketekuty, Trade in Professional Services: An Overview, 1986 U. Chi. Legal F. 1.

between services and goods was made by T.P. Hill only one decade ago.[2] Hill focused on the non-storability of services, stressing that services must be consumed as they are produced and cannot be put into stock by producers. This key characteristic does not cover all items which we customarily report as services; "answering services," for example, do store messages nowadays. Such exceptions, however, do not detract from the usefulness of a definition of services that characterizes them as non-storable because they require simultaneous provision and use.

B. User-Producer Interaction

If services must be used as they are produced, there must be *interaction* between the user and the provider of the service. A producer of goods, by contrast, can generally store the finished product and transact with users at any subsequent time. This interaction, in turn, implies that we can contemplate two essential categories of services: those that necessarily require the physical proximity of the user and the provider, and those that do not, though such physical proximity may indeed be useful even in the second category.[3] "Basically one has to draw a distinction between services as embodied in the supplier of the services and requiring [the supplier's] physical presence where the user happens to be and services which can be disembodied from the supplier and provided without a physical presence being necessary."[4]

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[2] See T.P. Hill, On Goods and Services, Review of Income and Wealth 315-38 (1977). There is, however, no dearth of earlier discussion, beginning with Adam Smith and John Stuart Mill. See Adam Smith, The Wealth of Nations, Book I, ch. 3 (1776); John Stuart Mill, Essays on Some Unsettled Questions of Political Economy, Essay III (1844).

[3] If the interaction of economic agents were omitted from the definition of services, all activity and value-added would fall within the service sector; yet this is far from the meaning normally attributed to the word "services." Because services can exist only when economic agents interact, every definition of services assumes the existence of an economic organization or "market structure." This has what appears to be the arbitrary result that if a worker paints a car on the assembly line inside an auto plant as an employee, his or her wages are part of goods production and value-added. But if the same person does the same job from his or her own establishment, the resulting wages or income are part of service production and value-added. For a detailed discussion of this question, see Jagdish N. Bhagwati, International Trade in Services and Its Relevance for Economic Development, Xth Annual Lecture of the Geneva Association, delivered at the London School of Economics and the Graduate Institute of International Studies, Geneva, Services World Forum, Geneva (November 1985) (drawing upon earlier commentary by several distinguished economists including Irving Kravis, Peter Bauer and Basil Yamey); Jagdish N. Bhagwati, Splintering and Disembodiment of Services and Developing Nations, 7 World Econ. 133 (1984).

[4] Bhagwati, 7 World Econ. at 141 (cited in note 3). In that article, I discuss the *latter* class of services (here called "long-distance" services). I evaluate how the "disembodiment"

1. *Physical Proximity Essential.* The class of services where physical proximity between provider and user is essential is usefully thought of as consisting of three categories.

Category A: Immobile-User, Mobile-Provider. There is an important class of services which *requires* that the provider go to the user, where the reverse mobility is simply impossible. For example, when the Connecticut Turnpike was being built, an Indian or South Korean construction firm bidding for the contract could perhaps have provided the designs and skilled inputs from home base. But such a firm simply could not have supplied the labor services, except by moving Indian or South Korean labor to Connecticut where the turnpike was to be built. Services of this sort are aptly referred to as "temporary-factor-relocation-requiring" services.

Category B: Mobile-User, Immobile-Provider. There is another important class of services where the user really must move to the provider rather than the provider to the user. This location-specificity of the provider arises from the fact that the service provided is a vector of characteristics, some key elements of which are simply not transferable geographically to the user's location. Complex neurosurgery, for example, simply cannot be done in Gabon because, even though the Massachusetts General Hospital can fly their surgeons over there, there is no way the necessary support services and hospital care can be duplicated or even approximated.

Category C: Mobile-User, Mobile-Provider. Finally, there is a range of services where mobility is symmetrically possible. For example, haircuts and lectures are in principle transmittable between user and provider in the location of either, the only difference being the cost of providing the service in one location rather than the other.

2. *Physical Proximity Inessential: The "Long-Distance" Services.* In the second broad class of services, physical proximity between providers and users may be useful, but it is not, strictly speaking, necessary. These are basically "long-distance" services, in the sense that the transactions do not require the immediacy of geographical proximity. Traditional banking and insurance services would fall into this category, because loans and insurance policies

effect can frustrate immigration restrictions on skilled labor, and discuss the implications of this effect for the developing countries' comparative advantage in services. Gary Sampson and Richard Snape have drawn on this twofold distinction to explore instead the *former* class of services, where physical proximity of the provider and the user is required, articulating a useful taxonomy for such services which I draw upon in the text below. Gary Sampson and Richard Snape, Identifying the Issues in Trade in Services, 8 World Econ. 171-82 (1985).

can be secured by mail or phone. The type of legal services here discussed, however, presumably require continual contact with the client. Because an attorney serving a corporation may have to interact face-to-face with many of the corporation's employees, legal services could be provided long-distance only in an extremely inefficient and hence expensive fashion. This applies equally to a large class of other professional services such as accounting or management consulting.

II. THE IMPLICATIONS OF THIS TAXONOMY FOR SERVICE TRADE NEGOTIATIONS

The above taxonomy of the service sector has significant implications for the optimal structure of international negotiations in service trade. I will focus here on the special considerations relevant to trade in temporary-factor-relocation-requiring services, which require the provider to move to the user.

First, because it requires factor relocation, trade in such services simultaneously implies *either* direct foreign investment *or* labor migration *or* both. Permitting trade in services, therefore, is tantamount to permitting such factor flows. It is thus inappropriate to think of such service trade in the customary category of trade as distinguished from the category of factor flows: the two are inextricably tied together. For this reason, it is preferable to think of service *transactions* rather than of service *trade*.

Second, the opening up of such service transactions between nations creates immediate difficulties stemming from the differences between what has traditionally been considered acceptable with regard to factor flows as against trade, differences which often reflect political sensitivities as well as economic considerations. Thus, Frank Rossi, in his excellent contribution regarding the restraints on the operations of international accounting organizations, cites as one obstacle possible restrictions on the repatriation of earnings encountered in several developing countries.[5] Yet these are precisely the kind of restraints that apply to all direct foreign investment in these countries. Moreover, domestic enterprises in the same service sectors are subjected to the very same restrictions arising from exchange control.

Yet analyzed as a trade issue, rather than as a transactional issue, such restraints look totally unreasonable: the trade access is

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[5] Frank A. Rossi, Government Impediments and Professional Constraints on the Operations of International Accounting Organizations, 1986 U. Chi. Legal F. 135.

not meaningful unless profits can be repatriated. The lobbies favoring increased facilitation of transactions in services will have to keep this aspect of the problem very much in mind and pursue their objectives slowly and delicately so as not to pressure hesitant countries to the point where they opt out of negotiations that seem to make impossible demands. Perhaps it is not for nothing that Geza Feketekuty, who deserves much of the credit for opening up the important subject of trade in services, keeps stressing the trade, rather than the factor-movement, aspects of service transactions.

The third implication of this two-sided nature of service transactions is that attention must be paid to factor-mobility restrictions. Because they are in essence factor flows, service transactions can be readily impeded simply by preventing the requisite factor flows, rather than by establishing trade tariffs or prohibitions. This critical issue is abundantly highlighted in several of the papers presented today.[6]

Restraints on factor mobility can arise simply from visa restrictions, or, as with legal services, from the restrictions imposed by regulatory bodies such as the Bar or the Bench on the foreign nationals desiring to provide such services.[7] In the case of the United States, complications also arise from the difficulty of getting all states to adopt uniform policies, thus making the question of reciprocity as a way of opening access even more intractable than it is otherwise.[8]

Fourth, it is important to understand why I keep emphasizing the *temporary* aspect of "factor-relocation-requiring" services. What John Barton calls "migratory" (or permanent) as distinct from "transient" (or temporary) labor flows[9] raise a different, and more difficult, set of issues which, if brought into the discussion, would compromise the possibility of making significant progress on the issue. Two critical reasons underlie this judgment.[10]

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[6] See particularly Sydney M. Cone, III, Government Trade Policy and the Professional Regulation of Foreign Lawyers, 1986 U. Chi. Legal F. 169; John H. Barton, Negotiation Patterns for Liberalizing International Trade in Professional Services, 1986 U. Chi. Legal F. 97.

[7] See Cone, 1986 U. Chi. Legal F. at 169-73 (cited in note 6).

[8] Id.

[9] See Barton, 1986 U. Chi. Legal F. at 100-02 (cited in note 6).

[10] There is substantial literature on the subject of international migration which develops the important differences between "transient" (or "to-and-fro") and "permanent" migration. See in particular, Jagdish N. Bhagwati, International Factor Mobility, in Robert Feenstra, 2 Int'l Econ. Theory, chs. 42-45 (1983); Jagdish N. Bhagwati, Dependence and Interdependence, in Gene Grossman, ed., 2 Essays in Development Economics (1985);

One reason is best seen through Figure 1, a highly simplified model which teaches an important lesson. Imagine a world populated only by lawyers.

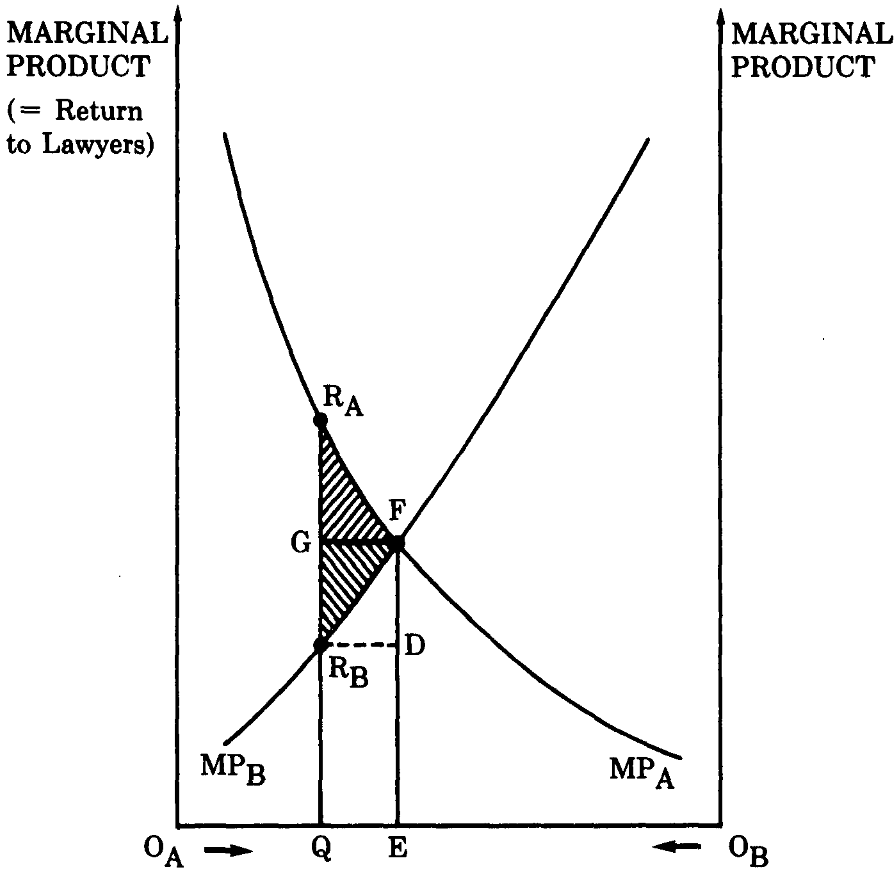

FIGURE 1

Koichi Hamada, Taxing the Brain Drain: A Global Point of View, reprinted in Jagdish N. Bhagwati, ed., The New International Economic Order: The North-South Debate, ch. 5 (1978).

O_AO_B is the total number of lawyers in countries A and B together. O_AQ is the pre-migration number of lawyers in country A, O_BQ in country B, with O_A as the origin for country A and O_B for country B. Given other factors and know-how in each country, the marginal product of more lawyers is assumed to decline in each country: MP_A and MP_B being the marginal-product curves for countries A and B respectively.

Now, before migration, R_AQ is the marginal product, and hence the return (assuming that factors are paid their marginal product) to lawyers in A. Similarly, R_BQ is the return to lawyers in B. Since R_AQ exceeds R_BQ, lawyers will migrate from B to A until their returns become equalized and further movement is not attractive. This will happen when EQ number of lawyers have moved to A, equalizing the return in both countries at FE.

What is the impact of this migration on economic welfare? The answer can depend upon whether the migration is considered "permanent" or "transient". This is because, while the non-migrants in A and the migrants from B are both better off, the non-migrants in B are worse off. If the migration is permanent, the country of emigration B may well consider this to be an undesirable phenomenon by excluding these migrants' welfare improvements from its calculus. On the other hand, if the migration is temporary, the sociological and political basis for including their gains in the overall calculus of national benefits from migration is clear.

Remembering that the *entire* area under the marginal product curve represents the *total* increment in product as the number of lawyers increases, the total gains and losses in this model are as follows:

B:

Gain of Migrants from B	:	$GFDR_B$
Loss of Nonmigrants in B	:	FDR_B
Total Gain of Migrants and Nonmigrants in B	:	GFR_B $(=GFDR_B - FDR_B)$

A:

Total Gain of Non-migrants in A	:	R_AFG

A+B:

World Gain (including all 3 Groups)	:	R_AFR_B $(=GFR_B + R_AFG)$

Evidently, migration improves world welfare, as well as the welfare of non-migrant nationals in the country of immigration A. Welfare improves for the country of emigration B, however, only if the welfare of the migrants is counted. If migrant welfare is not counted, total welfare in country B diminishes.[11]

These income-distributional conflicts between migrants and non-migrants could be moderated if only fiscal policy instruments could be devised to effect income redistribution. The exit tax, abused by the Soviet Union, may be thought of as an approximate exercise of such a policy option. The preferred alternative is the exercise of income tax jurisdiction on nationals abroad, following, in effect, the practice of global taxation based on the citizenship nexus. The United States and the Philippines are the only countries currently practicing this precept, however; and, despite many discussions at the United Nations Conference on Trade and Development and in several academic fora, it does not seem probable that the elites of the developing countries which could profit from changing their tax systems will follow the egalitarian U.S. model and begin to extend their income tax jurisdiction to their prosperous citizens abroad.[12]

The second reason for distinguishing temporary from permanent immigration is that permanent immigration is generally judged by moral-philosophical principles very different from the utilitarian calculus that underlies the economic case for free trade and free investment flows. The "right to exclude" is simply not consistent, in general, with the efficient allocation of world resources, because it prevents some labor inputs from being put to their highest valued use. Instead, a country's exclusion of immigrants is often defended on the basis of "communitarian" ideas such as those developed by philosophers such as Michael Walzer.[13] Such communitarian arguments flatly reject efficiency as the standard against which government policy is to be judged; they are based instead on other moral judgments.

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[11] It should be stressed that this model sharply illustrates the consequences of the distinction between temporary and permanent migrants through migration's differential impact on the welfare of migrants and non-migrants. The model is not intended to provide a complete analysis of the welfare consequences of migration *in practice*.

[12] Considerable literature now exists on this subject. See in particular Oliver Oldman and Richard D. Pomp, The Brain Drain: A Tax Analysis of the Bhagwati Proposal, 3 World Dev. 754 (1975); Richard D. Pomp, The Experience of the Philippines in Taxing its Nonresident Citizens, 17 N.Y.U.J. Int'l L. & Pol. 245 (1985); Jagdish N. Bhagwati and Martin Partington, eds., Taxing the Brain Drain: A Proposal (1976); Jagdish N. Bhagwati and John Wilson, eds., Income Taxation and International Personal Mobility (1987).

[13] Michael Walzer, Spheres of Justice: A Defense of Pluralism and Equality (1983).

An added reason for concern is that the professional groups that fear substantial loss of earnings are exceptionally well organized, and can often adduce attractive arguments to support their protectionist goals. The American Medical Association, for example, can invoke the possibility of deleterious impact on public health to reject an open-ended services compact permitting free and permanent immigration. It is important therefore that the *temporary* nature of factor relocation, designed to permit service transactions to transpire, be made explicit in negotiations on service trade regulation. If it is not, the possibility of negotiating anything worthwhile will be lost.

III. Bringing Developing Countries into the Negotiations

I turn finally to the question of how to convince developing countries that it is in their best interest to negotiate an international compact on service transactions. The central cause of their hesitation to support negotiations on service trade is the fear that comparative (i.e. export) advantage in service transactions belongs entirely to the developed countries. Lobbying for a GATT-type compact on services has indeed come from sectors in the United States, such as insurance and banking, which see themselves as expanding rapidly in world markets and thus seek the global reach that such a services compact would make feasible. In addition, the proposed service compacts have tended to exclude the temporary-factor-relocation-requiring services in which the developing countries are strong, especially services such as construction, defined so as to include the use of unskilled foreign workers.

Such developing countries as India and Egypt, which are most reluctant to enter international service trade agreements, will see a clearer comparative advantage for themselves if the compact permits increased transactions involving temporary relocation of factors such as skilled and unskilled labor.[14] Interestingly, South Korea has already tried to get into both the European Economic Community and Canada with offers to undertake construction projects using Korean workers on a *temporary* basis, exactly as in the Middle East. These attempts have not been successful, but

[14] See generally Bhagwati, Dependence and Interdependence (cited in note 4); Jagdish N. Bhagwati, Opening Up Trade in Services: U.S. Should Heed Third World Demands, N.Y. Times, Section III, col. 1, p. 3 (November 10, 1985); Jagdish N. Bhagwati, GATT and Trade in Services: How Can We Resolve the North-South Debate, Financial Times, p. 27, col. 6 (November 27, 1985); and Trade in Services: How to Change India Strategy, Economic Times (Bombay), Editorial Page (Dec. 2, 1985).

they are totally consonant with the objective of expanding service transactions in theory and in practice. Excluding labor service transfers because they involve unskilled workers is conceptually untenable, because such services clearly belong to the category of "Immobile-User, Mobile-Provider" described above. Such exclusion could also be self-serving on the part of developed countries, which should seek rules that are informed by basic principles, as with GATT on goods, rather than crippled by self-interest.

Even if a services trade compact were initially limited to the professional service sectors, it should still interest the developing countries that presently oppose the U.S. initiatives. The expansion of transactions in professional services will result in a mutual, rather than one-sided, export advantage. The developing countries must not be misled into thinking otherwise simply because the initiative to include such trade in a services compact comes almost wholly from multinational firms in the developed countries.

The mutual export advantage stems from the fact that professional services are not uniform. It is best to think of "dualistic" structures here: within a service sector such as law or accounting there are both more sophisticated, high-quality services and less sophisticated, bread-and-butter services. The advantage in tendering services at the "upper" multinational level is certainly likely to inhere in developed countries: multinational service providers are following their multinational clients in other sectors as the clients begin operations abroad. But even here, as the developing countries expand their own multinationals in non-service sectors, as they are only just beginning to do, they will begin to piggy-back their own professional services multinationals on their multinational producers of goods. Developing country providers of more sophisticated services will therefore stand to benefit from liberalization of service trade.

Moreover, at the "lower" end of the spectrum, the advantage surely must belong to lawyers, doctors, accountants, etc. in the developing countries, simply because they are not only bright, accessible and agreeable, but they can also work more cheaply. If they are allowed to come in under "temporary-factor-relocation" visas to facilitate service transactions, there seems to be no reason why they cannot increasingly take a sizeable fraction of the market at that level.

Such a "dualistic" view is consonant with the modern view of trade in goods in which international economists have increasingly come to terms with mutual trade in "similar products."[15] A product has numerous characteristics and different countries may well have an advantage in some characteristics but not in others. This view is all the more relevant to service transactions where physical proximity accentuates such differential elements and can lead to mutual comparative advantages within a sector for suppliers from different countries.

Although developing countries could find export possibilities in professional services alone, negotiations between the developing and the developed countries should certainly proceed, either simultaneously or sequentially, in both the professional and the unskilled-labor sectors. Once the agenda on services is explicitly broadened to include all varieties of temporary-factor-relocation-requiring services, more developing countries should see the *mutuality* of interests and benefits for themselves in including services in the forthcoming trade talks. Broadening the agenda, so that the developing countries see a clear prospect of gaining their own export advantage within the service sector, would also provide a salutary lesson to the negotiators of the service compact in the developed countries. For, driven by the momentum of domestic lobbying, the developed countries tend to overlook the legitimate concerns of countries that hesitate to open up this new area to GATT-type rules. The "role reversal" created by requiring developed countries to face up to concerns about competitive disadvantage in service sectors where *they* would face successful import entry would be most helpful in making the negotiations fair, equitable and genuinely two-sided.

In particular, this would lead to the realization that we should be prepared to move only gradually towards establishing a comprehensive service trade accord. As in GATT, we should aim at general principles, especially such things as most favored nation status, bindings and national treatment. Yet we should not forget that we are dealing with areas in which countries have traditionally behaved as if the GATT-type "rule-of-law" could not be allowed to decide "who gets what" in world commerce. Banking and insurance raise specters of loss of fiduciary and monetary control as well as loss of effective regulation over vital infrastructure; transborder flows of information create worries about loss of political sovereignty;[16] and temporary entry of foreign professionals generates

[15] See, e.g., Kelvin Lancaster, Variety, Equity and Efficiency (1979); Elhanan Helpman and Paul Krugman, Market Structure and Foreign Trade (1985).

[16] See, for example, the acute concerns expressed by Deepak Nayyar, a former official

fears of dilution of service quality and possible hazard to national efficiency and health. It is not by chance that services have remained out of the bounds of a GATT-type compact to date. Imagine what would happen if a humorless economist were to propose that the international location of armaments production should be determined by comparative advantage!

The ideal way to handle the problem of gradualism may well be to seek a compact that is based on a set of general principles and rules as GATT is, but which simultaneously allows for appropriate Article XIX-type safeguards to hedge against the "quantity-outcomes" of such rules.[17] The reverse route of beginning with quantity-swaps (e.g., India admits ten U.S. banks in exchange for the U.S. allowing in ten Indian ones), in the hope that general rules will ultimately emerge, is unlikely to succeed.

in the Indian Ministry of Commerce, in International Trade in Services: Implications for Developing Countries, ExIm Bank of India Annual Lecture (1986).

[17] Article XIX of GATT permits the adoption of trade restraints when market-disruption-related difficulties emerge in industries facing import competition. It therefore builds into the GATT an explicit safeguard against unmanageable consequences of adherence to GATT rules on binding trade commitments.