

Recent Trends in U.S. Services Trade

2003 Annual Report

**May 2003
Publication No. 3599**

**Investigation No. 332-345
United States International Trade Commission**



U.S. International Trade Commission

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PREFACE

On August 27, 1993, on its own motion and pursuant to section 332(b) of the Tariff Act of 1930 (19 U.S.C. 1332(b)), the U.S. International Trade Commission (USITC) instituted investigation No. 332-345, *Annual Reports on U.S. Trade Shifts in Selected Industries*. The current report format was developed by the USITC in response to Congressional interest in establishing a systematic means of examining and reporting on the significance of major trade developments, by product, and with leading U.S. trading partners, in service, agricultural, and manufacturing sectors. A significant amount of the information contained in this recurring report reflects basic research that is required to maintain a proficient level of trade expertise. The Commission has found such expertise to be essential in its statutory investigations and in apprising its varied customer base of global industry trends, regional developments, and competitiveness issues.

On December 20, 1994, the Commission on its own motion expanded the scope of this report to include detailed coverage of service industries. Under the expanded scope, the Commission publishes two reports annually, one entitled *Shifts in U.S. Merchandise Trade* (June) and the second entitled *Recent Trends in U.S. Services Trade*¹ (May). Services trade is presented in a separate report in order to provide more comprehensive and timely coverage of the sector's performance.

The current report begins with a statistical overview of U.S. trade and foreign direct investment in services and a discussion of key trends. Thereafter, the report presents industry-specific analyses that focus on trends in exports, imports, and trade balances during 1996-2001. Industry-specific analyses also identify major trading partners during the subject period, and discuss the competitive U.S. market situation for each industry.

Recent USITC publications focusing on the service sector include *Electric Power Services: Recent Reforms in Selected Foreign Markets* (USITC publication 3370, November 2000), *Examination of U.S. Inbound and Outbound Direct Investment* (USITC publication 3383, January 2001), *Natural Gas Services: Recent Reforms in Selected Markets* (USITC publication 3458, October 2001) and *Oil and Gas Field Services: Impediments to Trade and Prospects for Liberalization* (USITC publication 3582, March 2003).

The information and analysis in this report are for the purpose of this report only. Nothing in this report should be construed to indicate how the Commission would find in an investigation conducted under other statutory authority.

¹ Starting with the 1997 issue, the title of the report on services was changed from *U.S. Trade Shifts in Selected Industries: Services* to *Recent Trends in U.S. Services Trade*.

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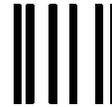
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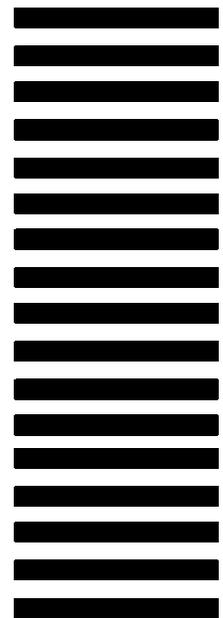
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CHAPTER 1

INTRODUCTION

Scope

The U.S. International Trade Commission (USITC) routinely monitors trade developments in the service, agricultural, and manufacturing sectors. This report, prepared annually, analyzes significant trends in services trade as a whole, assesses trade and trade-related issues in selected service industries,¹ and identifies major U.S. trading partners. Data are presented for cross-border transactions, sales through affiliates established abroad, and for direct investment. All three sets of data are presented to illustrate clearly the international commercial dimensions of U.S. service industries.

Approach

Data presented in this report are drawn principally from the most recent annual data available for U.S. trade in services and foreign direct investment, which are estimated and published by the U.S. Department of Commerce (USDOC), Bureau of Economic Analysis (BEA). Information presented for purposes of analyzing trade data and examining broad industry trends is drawn from a wide variety of sources, including individual firms, trade associations, industry journals, other government agencies, and electronic media. Chapter 2 of this report describes the nature and extent of cross-border trade, affiliate transactions, and direct investment in the service sector as a whole and provides, to the extent permitted by available data, an overview of U.S. private-sector services trade and investment by industry and by trading partner. Chapters 3 through 12 examine advertising, accounting, banking, computer, equipment leasing, franchising, health care, legal, telecommunication, and utility (i.e., energy and water) services. These chapters define the scope of industry activities; specify the extent to which those activities are captured by trade data; provide an analysis of trends in cross-border trade, affiliate transactions, and direct investment, as appropriate;² and identify broad industry trends. The trade analysis compares cross-border trade performance and foreign direct investment position in 2001 to trends evident during 1996–2000 and/or reviews affiliate transactions during 1997–2000. Due to recent industry reclassifications, comparable data on sales by U.S.-based affiliates of foreign parent firms are reported for 1997–2000 only, and data on sales by foreign-based affiliates of U.S. parents are reported for 1999–2000 only.³ The overview of industry trends comprises a discussion of factors affecting the growth of U.S. service industries and the global competitive environment. Depending on the industry, factors determined to affect growth and competition may

¹ In order to present the most complete picture of the service sector possible, the report covers several service industries in detail, rotating the industry coverage each year.

² Complete data are not available for all industries.

³ For more information regarding this reclassification, see box 2-1 in ch. 2.

include current and evolving market structure, regulation, and trade policy; merger and acquisition activity; and recent and emerging technological innovation. Where available, chapters 3-12 conclude with a brief description of negotiating proposals submitted to the Council on Trade in Services, a subsidiary body of the World Trade Organization (WTO), as part of the ongoing Doha Round of multilateral trade negotiations.

Services Trade in Context

U.S. merchandise trade is not discussed in this report. As noted in the *Preface*, it is the subject of a separate USITC annual report. However, to put U.S. services trade in perspective with merchandise trade, cross-border services trade accounted for 21 percent of total U.S. cross-border trade volume in 2001 (figure 1-1).⁴ U.S. cross-border trade in services generated a \$73.9-billion surplus in 2001, in contrast to a U.S. merchandise trade deficit of \$427.2 billion.⁵ The service sector accounted for 81 percent of U.S. private-sector gross domestic product (GDP) and employment in 2001 (figures 1-2 and 1-3).⁶

According to data reported by the World Trade Organization (WTO), global cross-border exports of services totaled \$1.5 trillion in 2001.⁷ The United States was by far the largest services exporter, accounting for 18 percent of such exports worldwide (figure 1-4). Other significant services exporters included the United Kingdom (7 percent); Germany and France (each with 6 percent); and Japan, Spain, and Italy (each with 4 percent). Among those countries for which 2001 trade data were reported by the WTO, the United States posted the largest services trade surplus (\$75.7 billion) while Germany posted the largest services trade deficit (\$52.9 billion) (figure 1-5).⁸

⁴ Total trade volume is the sum of the value of imports and exports.

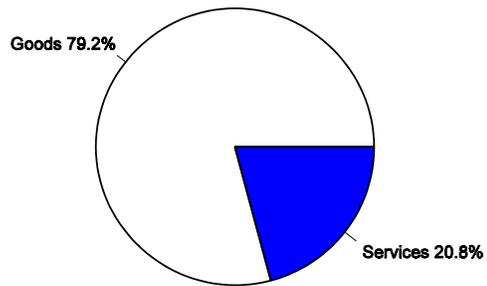
⁵ For purposes of comparison with the merchandise trade deficit, the figure cited for the services trade surplus reflects public- as well as private-sector transactions. Elsewhere in this report, services trade data reflects private-sector transactions only. USDOC, BEA, *Survey of Current Business*, July 2002, p. 51.

⁶ USDOC, BEA, *Survey of Current Business*, Aug. 2002, p. 80; and Oct. 2002, p. D-31.

⁷ World Trade Organization (WTO), "World Exports and Imports of Commercial Services, by Selected region and Economy, 1980-2001." The WTO data do not include affiliate transactions.

⁸ These surplus figures reflects private-sector transactions only. Further, WTO figures treat trade in insurance services differently than BEA, accounting for the difference between the surplus reported by the WTO and that reported above. WTO, "World Exports and Imports of Commercial Services, by Selected Regions and Economy, 1980-2001."

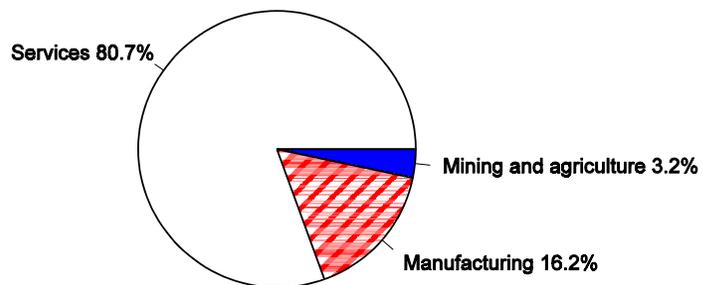
Figure 1-1
U.S. cross-border trade volume, by sector, 2001



Total trade volume = \$2.4 trillion

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, p. 39.

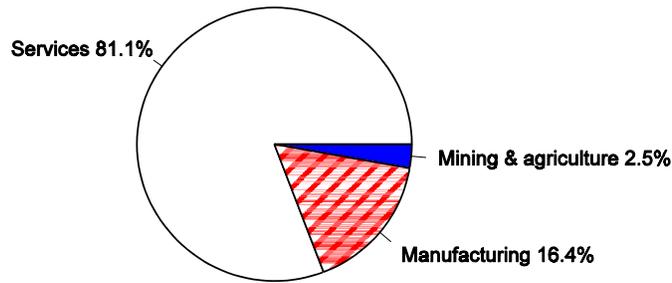
Figure 1-2
U.S. private-sector gross domestic product, by sector, 2001



Total private-sector GDP = \$8.8 trillion

Source: U.S. Department of Commerce, Bureau of Economic Analysis, "Gross Domestic Product by Industry in Current Dollars, 1994-2001," found at Internet address <http://www.bea.doc.gov/bea/dn2/gpoc.htm>, retrieved Dec. 16, 2002.

Figure 1-3
U.S. private-sector employment, by sector, 2001¹

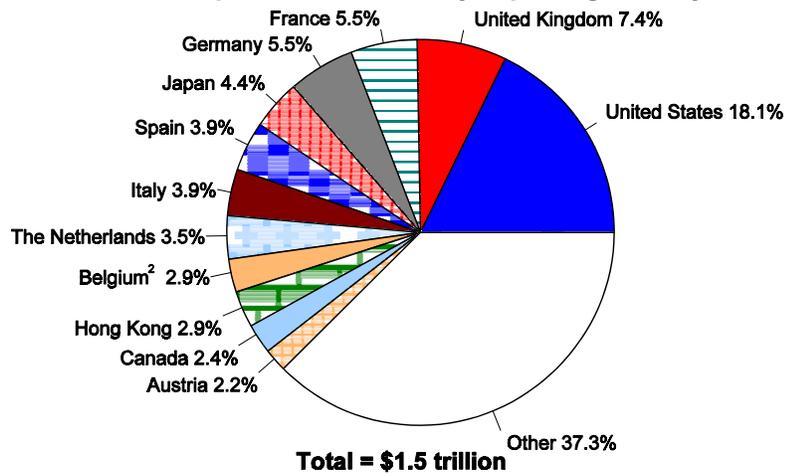


Total full-time equivalent employees = 105.5 million workers

¹ Total may not equal 100 percent due to rounding.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Aug. 2002, p. 80.

Figure 1-4
Global cross-border exports of services, by exporting country, 2001¹



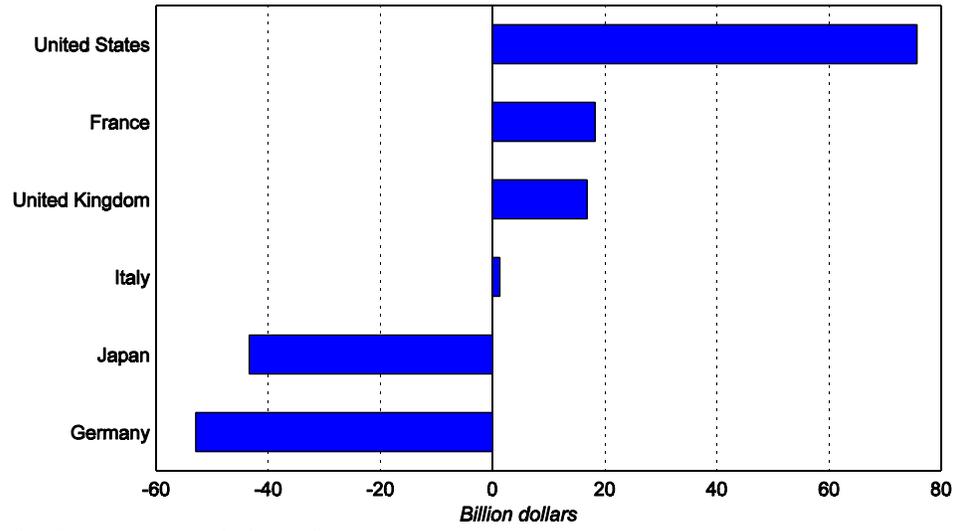
¹ Total may not equal 100 percent due to rounding.

² Includes Luxembourg.

Note.—Excludes public sector transactions.

Source: World Exports of Commercial Services by Selected Region and Economy, 1980-2001, World Trade Organization, found at Internet address http://www.wto.org/english/re_e/statis_e/statis_e.html, retrieved Jan. 7, 2003.

Figure 1-5
Services trade balances of leading exporting countries, 2001



Note.--Excludes public sector transactions.

Source: World Exports and Imports of Commercial Services by Selected Region and Economy, 1980-2001, World Trade Organization, found at Internet address http://www.wto.org/english/re_e/statis_e/statis_e.html, retrieved Jan. 7, 2003.

CHAPTER 2

U.S. TRADE IN SERVICES

Nature of Trade in Services

Nations trade services through two principal channels. The first channel, cross-border trade, entails sending individuals, information, or money across national borders.¹ The second channel, affiliate transactions, entails selling services through affiliated firms established or acquired by multinational companies in foreign markets.² Such affiliates are funded through foreign direct investment. In 1990, the majority of U.S. services exports were delivered to foreign consumers through cross-border channels. However, the relative importance of affiliate sales and cross-border trade gradually shifted during the 1990s. In 1996, sales of services by U.S.-owned, foreign affiliates surpassed U.S. cross-border services exports, and by 2000, the former exceeded the latter by \$115.3 billion (figure 2-1).³ U.S. purchases of services from foreign-owned affiliates have exceeded cross-border service imports in every year since 1989, with the former exceeding the latter by \$144.6 billion in 2000.

Cross-Border Trade

As noted, the U.S. current account reported a surplus on trade in private services⁴ of \$73.9 billion in 2001 (figure 2-2).⁵ The private cross-border services trade surplus decreased at an average annual rate of 3 percent during 1996-2000, and by a further 2 percent in 2001. Exports decreased by 4 percent to \$266.2 billion in 2001, following the average annual growth of 6 percent experienced during 1996-2000.

¹ Employing terminology found in the General Agreement on Trade in Services (GATS), this channel encompasses modes of supply one (cross-border supply), two (consumption abroad), and four (movement of natural persons).

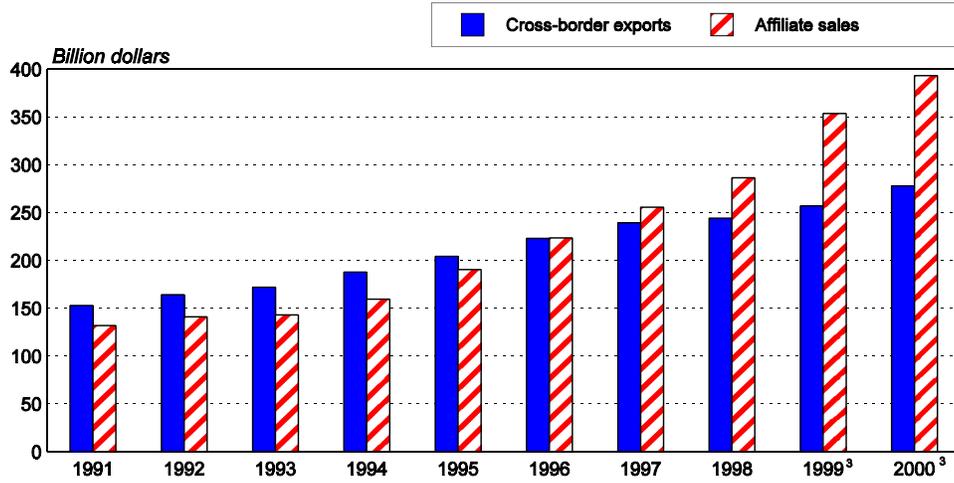
² Employing terminology found in the GATS, this channel encompasses mode of supply three (commercial presence).

³ For a more detailed discussion of the relative importance of cross-border trade and affiliates sales, see United States International Trade Commission (USITC), *Examination of U.S. Inbound and Outbound Direct Investment*, USITC publication 3383, Jan. 2001, pp. 5-1 - 5-3 and 5-11 - 5-13.

⁴ Cross-border services trade, as reported in the current account, includes both private- and public-sector transactions. The latter principally reflect operations of the U.S. military and embassies abroad. However, because public-sector transactions are not considered to reflect U.S. service industries' competitiveness and may introduce anomalies resulting from events such as international peace-keeping missions, this report will focus on private-sector transactions.

⁵ Values are reported before deductions for expenses and taxes, as gross values are most directly comparable across countries, industries, and firms. U.S. Department of Commerce (USDOC), Bureau of Economic Analysis (BEA), *Survey of Current Business*, June 1992, pp. 68-70.

Figure 2-1
U.S. cross-border exports¹ of services and U.S.-owned foreign affiliate sales of services, 1991-2000²



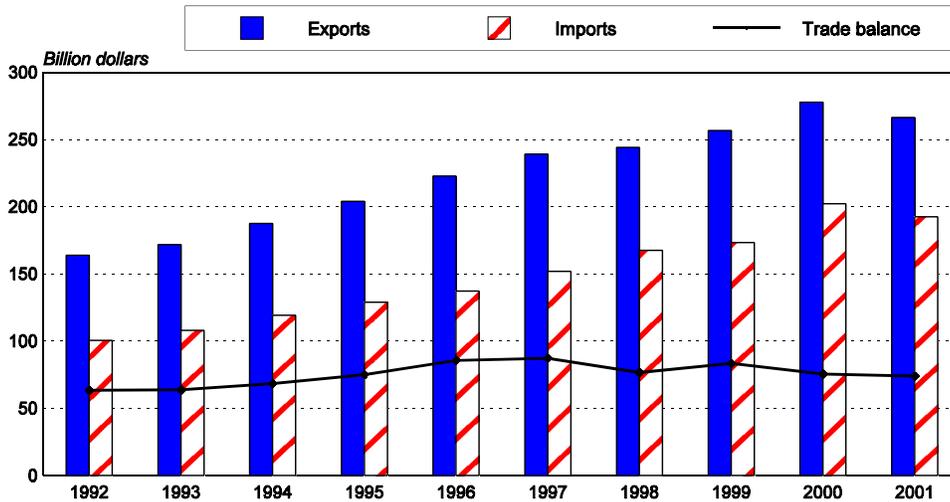
¹ Trade data exclude public-sector trade.

² Affiliate sales data for 2001 is not available.

³ Affiliate sales data for 1999 and 2000 were reported under a new industry classification system. For more information, see text box 2-1.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, p. 67.

Figure 2-2
U.S. cross-border trade in private services: Exports, imports, and trade balance, 1992-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, p. 67.

Cross-border service imports decreased by 5 percent to \$192.3 billion in 2001, after growing at an average annual rate of 10 percent during 1996-2000.⁶

The principal factor behind the decrease of both U.S. exports and imports in 2001 was weak economic growth in the United States and in many of the major U.S. trading partners.⁷ In the United States, the terrorist attacks of September 11, 2001, and upheavals in the U.S. corporate arena and financial markets further contributed to the economic slowdown.⁸ The effects of the Sept. 11th attacks were particularly severe for the tourism and insurance industries, both of which registered significant declines in both exports and imports. In the case of tourism services, travel restrictions into and out of the United States, combined with public concern about possible new attacks, helped reduce exports by 11 percent, while imports were reduced by 7 percent. In the insurance industry, cross-border premium payments both into and out of the United States increased, but claims payments increased even further, due largely to the terrorist attacks, resulting in a 99-percent reduction in net exports and a 40-percent reduction in net imports in 2001.⁹

Despite reduced tourism in 2001, travel and tourism services accounted for 28 percent of U.S. service exports, the largest share of total service exports accounted for by a single industry (figure 2-3).¹⁰ Other industries accounting for large shares of total U.S. service exports were those related to intangible intellectual property (resulting in the payment of royalties and license fees),¹¹ which represented 15 percent; maritime and air freight transport services (including port services), 11 percent; and business, professional, and technical services (hereafter, professional services), 10 percent. Intrafirm exports, which principally reflect transactions between U.S. parent firms and foreign affiliates, accounted for 23 percent of total service exports in 2001, reflecting the continued globalization of service providers.¹² Prominent transactions between parent firms and their affiliates included those related to intellectual property, research and development, financial services, film and television tape rentals, management consulting, operational leasing, and computer and information services.¹³

⁶ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 67.

⁷ In 2001, the United States and all of its largest trading partners experienced declines in GDP growth rates of 1 to 7 percentage points over the previous year. World Bank, World Development Indicators database, found at Internet address <http://www.devdata.worldbank.org/data-query/>, retrieved Jan. 3, 2003.

⁸ Another factor may have been the strengthening of the U.S. dollar, which appreciated 3 percent against the euro, 13 percent against the Canadian dollar, and 5 percent against the pound. USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 70.

⁹ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 84-85.

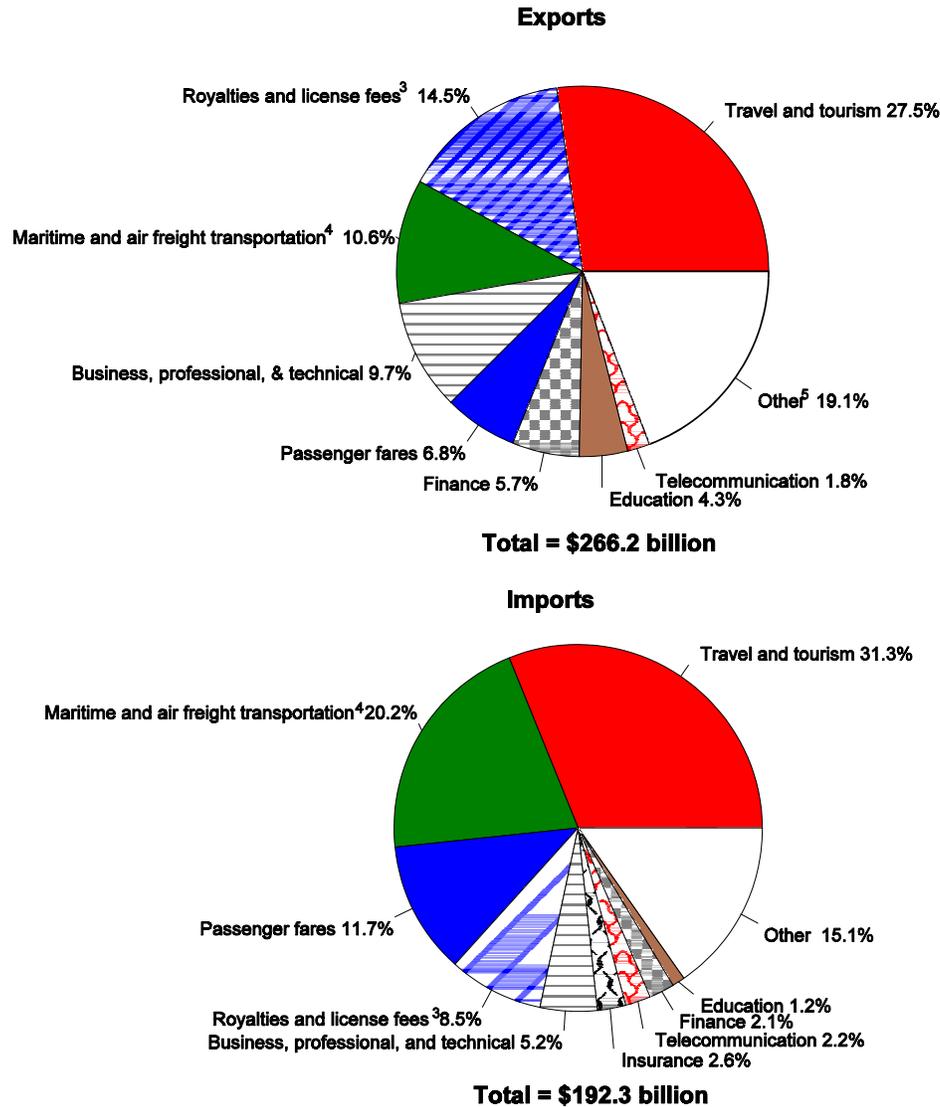
¹⁰ The table in appendix C delineates, where applicable, the activities reflected in official cross-border services trade data.

¹¹ These services principally include management services and sales of rights to industrial processes; broadcasts and records of live events; books, records, and tapes; business format franchises; trademarks; and distribution, use, and reproduction of computer software.

¹² USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 70.

¹³ *Ibid.*, p. 75.

Figure 2-3
U.S. cross-border service exports and imports,¹ by industry, 2001²



¹ See appendix C for a description of service industries.

² Totals may not equal 100 percent due to rounding.

³ Intrafirm trade between affiliates of multinational corporations represented 66.9 percent of U.S. exports and 79.5 percent of U.S. imports of intellectual property in 2001.

⁴ Reflects freight transport and port services only. Excludes ground transport services.

⁵ Includes insurance services, which totaled \$18 million.

Note.—Trade data exclude public-sector transactions.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-107.

With respect to imports, travel and tourism, maritime and air freight transport, and passenger fares figured prominently in 2001, accounting for 31 percent, 20 percent, and 12 percent of total service imports, respectively.¹⁴ In 2001, intrafirm trade accounted for 22 percent of total cross-border service imports. The largest

¹⁴ Ibid., p. 85.

component of intrafirm trade reflected U.S. affiliates' payments of royalties and license fees to foreign parents.¹⁵

In 2001, as in most other years, the majority of U.S. service industries registered cross-border trade surpluses. Prominent exceptions included passenger transport, freight transport, and insurance services. Certain professional service industries, such as the advertising and accounting industries, also experienced trade deficits in 2001. However, the professional services industry as a whole posted a \$21.7-billion surplus, led by the construction, engineering, architectural, and mining; installation, repair, and maintenance; operational leasing; legal; and database and other information industries. In a pronounced departure from historical patterns, U.S. telecommunications carriers posted a small surplus in 2001, as staged reductions in international settlement rates continued to drive down imports.¹⁶

In 2001, the European Union (EU) was the largest market for U.S. cross-border exports of services, accounting for 32 percent of such exports. Japan, the United Kingdom, and Canada were the largest single-country U.S. export markets, accounting for 12 percent, 11 percent, and 9 percent, respectively (figure 2-4). With regard to U.S. imports of services, the EU supplied the predominant share (34 percent). The United Kingdom (12 percent), Canada (9 percent), and Japan (9 percent) were the largest single-country suppliers of U.S. imports of services. In 2001, the United States registered cross-border trade surpluses measuring \$20.3 billion with the EU, \$13.7 billion with Japan, \$6.1 billion with Canada, and \$3.6 billion with Mexico.¹⁷

Foreign Direct Investment

The provision of many services requires that the service provider be proximate to the consumer for both practical and regulatory reasons. For example, accounting firms prefer to provide services to overseas clients through foreign affiliates, in part because regulations may restrict, or render uneconomic, cross-border transmission of financial data. Similarly, architectural and engineering firms find that the establishment of a commercial presence in a foreign market is often a necessary legal prerequisite for obtaining contracts. Consequently, many firms establish a commercial presence abroad through foreign direct investment.

Data on foreign direct investment position track parent firms' equity holdings in all foreign affiliates,¹⁸ plus the net value of loans between parents and affiliates. These data indicate that the U.S. direct investment position in foreign service industries totaled \$885.5 billion in 2001. Such investment increased by 3 percent in 2001, slower than the 13-percent average annual growth rate recorded during 1996-2000.

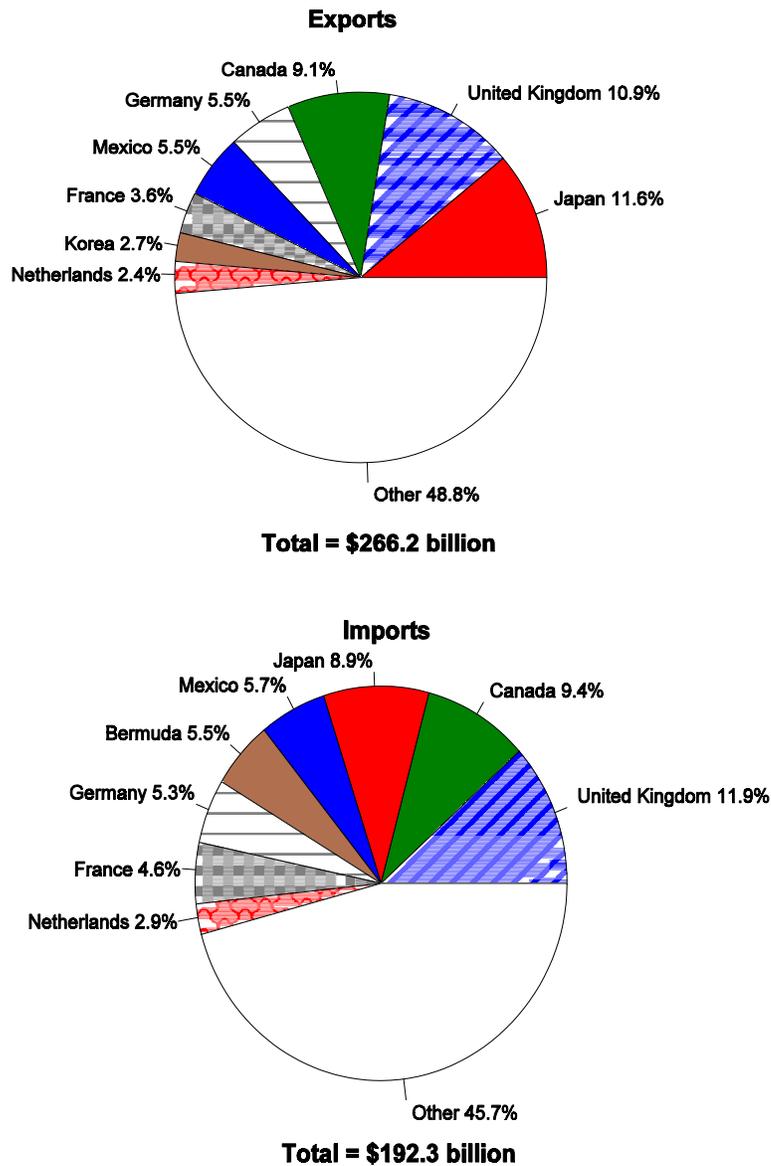
¹⁵ Ibid., p. 75.

¹⁶ Ibid., pp. 73-74.

¹⁷ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 71.

¹⁸ An affiliate is defined as a business establishment in which there is investment of 10 percent or more by a single natural (or juridical) person who is a national of (or based in) a country other than that of the establishment.

Figure 2-4
U.S. cross-border service exports and imports, by country, 2001¹



¹ Totals may not equal 100 percent due to rounding.

Note.—Trade data exclude public-sector transactions.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 86-87.

The foreign direct investment position in U.S. service industries increased by 19 percent to \$655.5 billion in 2001. This was consistent with average annual growth of 18 percent recorded during 1996-2000.¹⁹

¹⁹ Compiled by the Commission based on data from USDOC, BEA, *Survey of Current Business*, Sept. 2002, pp. 66-67 and 95-96; Sept. 2001, pp. 108-109; and Sept. 2000, pp. 58-59 and 88-89.

The U.S. direct investment position in foreign service markets is largest in holding companies,²⁰ the financial services industry,²¹ and the wholesale trade industry (figure 2-5). In 2001, U.S. direct investment in holding companies reached \$348.3 billion, or 39 percent of U.S. direct investment abroad in the service sector, while the financial services and wholesale trade industries accounted for \$157.6 billion and \$92.8 billion of such investment, respectively. In 2001, insurance, wholesale trade, and depository institutions attracted the largest shares of foreign direct investment in the U.S. services sector, accounting for \$120.4 billion, \$113.0 billion, and \$78.1 billion of such investment, respectively.²²

In 2001, the United Kingdom was the top host country of U.S. direct investment abroad in services, accounting for holdings of \$176.9 billion (table 2-1). Financial services (excluding depository institutions) accounted for more than 60 percent of these holdings, reflecting London's position as a global financial center and the fact that most large U.S. financial institutions maintain operations in the United Kingdom. U.S. direct investment in the British service sector increased by 3 percent in 2001, following average annual increases of 20 percent during 1996-2000. Other countries that hosted large shares of U.S. services investment included Canada and Switzerland, which respectively accounted for holdings valued at \$60.2 billion and \$57.7 billion in 2001.²³

Japan was the top source of foreign direct investment in the U.S. service sector in 2001, accounting for holdings valued at \$103.9 billion. Investment in the wholesale trade industry accounted for almost one-half of these holdings, reflecting the strong position of many Japanese manufacturing firms in the U.S. market. Other leading sources of service sector investment in the United States included Germany, France, and Canada, which respectively accounted for holdings of \$87.5 billion, \$72.3 billion, and \$63.2 billion in 2001.²⁴

²⁰ Holding companies are designed primarily for tax purposes, to channel funds to operating companies in both service and non-service industries. As a consequence, the end use activity of such investment in holding companies cannot be determined.

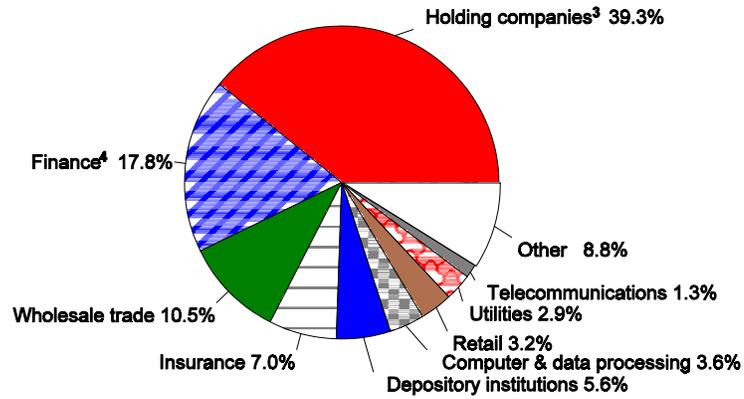
²¹ Includes securities and commodities brokerage. Excludes depository institutions, insurance, business franchising, holding companies, and real estate.

²² USDOC, BEA, *Survey of Current Business*, Sept. 2002, pp. 65-66 and 95-96; and Sept. 2000, pp. 58-59 and 88-89.

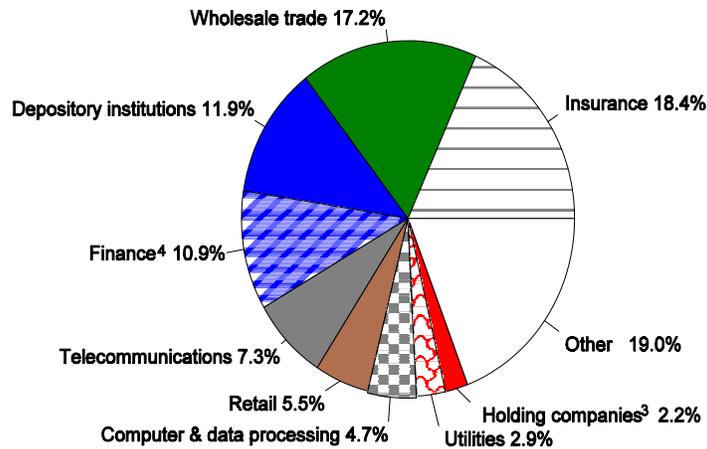
²³ The data discussed in this paragraph reflect Commission estimates of total service sector investment. The estimates are compiled by adding investment in the wholesale trade, retail trade, depository institutions, financial services, insurance, and business and professional services industries to an estimate of investment in the construction, transportation, telecommunications, and utilities industries.

²⁴ USDOC, BEA, *Survey of Current Business*, Sept. 2002, pp. 47 and 77.

Figure 2-5
Investment in the service sector:¹ U.S. direct investment position abroad and
foreign direct investment position in the United States, by industry, 2001²



U.S. direct investment position abroad = \$885.5 billion



Foreign direct investment position in the United States = \$655.5 billion

¹ Compiled by the Commission.

² Total may not equal 100 percent due to rounding.

³ Holding companies exist primarily for tax purposes, and are used to channel funds to operating companies in a wide variety of industries.

⁴ Includes securities and commodities brokerage.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Sept. 2002, pp. 65-66 and 95-96.

Table 2-1**U.S. direct investment position abroad (USDIA) and foreign direct investment in the U.S. (FDIUS), estimates for selected countries, 1996, 2000, and 2001**

	1996	2000	2001	Average annual growth, 1996-2000	Percentage change, 2000-2001
	—————Million dollars—————			Percent	
USDIA					
Canada	35,732	58,266	60,164	13.0	3.3
France	16,577	(¹)	(¹)	(²)	(²)
Germany	17,532	24,854	24,041	9.1	-3.3
Japan	14,285	41,943	45,873	30.9	9.4
Mexico	6,787	17,613	(¹)	26.9	(²)
The Netherlands	39,633	(¹)	(¹)	(²)	(²)
Switzerland	25,437	50,511	57,658	18.7	14.1
United Kingdom	82,877	171,061	176,861	19.9	3.4
FDIUS					
Canada	27,697	53,193	63,165	17.7	18.7
France	15,653	(¹)	72,253	(²)	(²)
Germany	(¹)	63,335	87,542	(²)	38.2
Japan	80,241	115,869	103,895	9.6	-10.3
Mexico	991	6,486	6,382	60.0	-1.6
The Netherlands	35,464	83,409	(¹)	23.8	(²)
Switzerland	13,740	34,702	(¹)	26.1	(²)
United Kingdom	49,940	81,109	(¹)	12.9	(²)

¹ Data were suppressed to avoid the disclosure of data of individual companies.² Not available.Source: Compiled by the U.S. International Trade Commission based on data from U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*.

Affiliate Transactions²⁵

As noted above, transactions carried out by foreign affiliates account for the largest share of total U.S. services deliveries to foreign clients.²⁶ Unlike data on direct investment position, which reflect equity holdings in all foreign affiliates, the data on affiliate transactions presented herein track only majority-owned affiliates' sales to

²⁵ Appendix D describes the activities reflected in official data regarding affiliate transactions.

²⁶ Affiliate sales and purchases figures reflect total services transactions by affiliates from all industries. Thus, these data include services transactions by affiliates in the services, manufacturing, agriculture, and mining sectors. For example, manufacturing firms may provide repair services in addition to producing and selling goods.

unaffiliated foreigners in the host market.²⁷ The recent conversion to the NAICS-based data collection methodology also precludes comparisons between affiliate sales in 1999-2000 and those in prior years, and between affiliate purchases recorded during 1997-2000 and years prior to 1997 (box 2-1).

In 2000, sales by majority-owned, foreign-based affiliates of U.S. companies increased by 11 percent to \$392.8 billion.²⁸ Sales by U.S.-owned insurance affiliates in foreign markets accounted for 16 percent of total services sales by foreign affiliates of U.S. firms, representing the largest share for any single industry (figure 2-6). U.S.-owned affiliates in the public utilities industry and the financial services industry each accounted for 10 percent of total services sales. Other industries with large shares of affiliate sales were the telecommunications industry (7 percent), transportation and warehousing (5 percent), and wholesale trade (5 percent).²⁹

In 2000, purchases from majority-owned, U.S.-based affiliates of foreign firms totaled \$346.7 billion, up 18 percent over the previous year. Services purchased from U.S.-based insurance affiliates accounted for 23 percent of total U.S. purchases of services from foreign-owned affiliates in 2000. Purchases from financial services affiliates, transportation and warehousing affiliates, utilities affiliates, telecommunications affiliates, and wholesale trade affiliates of foreign firms accounted for 8 percent, 7 percent, 6 percent, 4 percent, and 3 percent of total purchases, respectively.³⁰

The majority of U.S. affiliate sales and purchases of services are transacted with EU member states, which jointly accounted for 49 percent of sales. Among EU-member countries, the top markets for U.S. affiliate sales were the United Kingdom, Germany, and France, which in 2000 accounted for 26 percent, 7 percent, and 5 percent of total U.S. affiliate sales of services, respectively (figure 2-7). U.S.-owned

²⁷ Majority-owned foreign affiliates of U.S. firms are defined as foreign affiliates for which the combined direct and indirect ownership interest of all U.S. parents exceeds 50 percent. Majority-owned U.S. affiliates of foreign firms are U.S.-based affiliates for which the combined direct and indirect ownership interest of all foreign parents exceeds 50 percent. For reporting purposes, the country in which the U.S.-based affiliate's "ultimate beneficial owner" resides receives credit for sales to U.S. persons. An ultimate beneficial owner of a U.S. affiliate is the entity, proceeding up the affiliate's ownership chain, that is not owned more than 50 percent by another person. Sales by majority-owned affiliates account for the vast majority of sales by all foreign affiliates. In 1998, sales by U.S. majority-owned affiliates abroad accounted for 83 percent of sales by all U.S. affiliates abroad, while U.S. purchases from majority-owned foreign affiliates in the United States accounted for 86 percent of U.S. purchases from all foreign affiliates. USDOC, BEA, *Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies, Preliminary 1998 Estimates*, Table J-1; and USDOC, BEA, *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and their Foreign Affiliates, Preliminary 1998 Estimates*, Tables II.A 1 and III.A 1.

²⁸ Sales receipts are reported before deductions for expenses and taxes, as gross sales figures are more directly comparable across countries, industries, and firms. USDOC, BEA, *U.S. Direct Investment Abroad: 1994 Benchmark Survey, Final Results*, May 1998, p. M-17; and USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 122 and 124.

²⁹ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 122.

³⁰ *Ibid.*, p. 124.

Box 2-1**U.S. Purchases from Affiliates: Changes in Definition and Classification in 1997**

BEA uses the North American Industry Classification System (NAICS) to report on U.S. purchases of services from U.S.-based affiliates of foreign parent firms for 1997 and all subsequent years, and U.S. sales of services by foreign-based affiliates of U.S. parent firms for 1999 and all subsequent years.¹ Affiliate transactions prior to these years were based on industry classifications found in the 1987 U.S. Standard Industrial Classification (SIC). The NAICS was developed jointly by the statistical agencies of the United States, Canada, and Mexico.

Adoption of the NAICS system entailed a redefinition of services classifications, which is believed to raise the estimated value of total U.S. sales and purchases of services from affiliates. The reason for this increase is that those transactions defined as sales and purchases of services under the NAICS that were previously defined as sales and purchases of goods under the SIC system exceed sales and purchases of goods under the NAICS that were formerly defined as sales and purchases of services under the SIC system. Examples of transactions newly classified in service industries under the NAICS include sales and purchases of newspapers, periodicals, books, and records. Alternatively, NAICS-based definitions of sales and purchases of services exclude some transactions that SIC-based definitions include, such as sales by and purchases from dental laboratories and firms that reproduce software and video.²

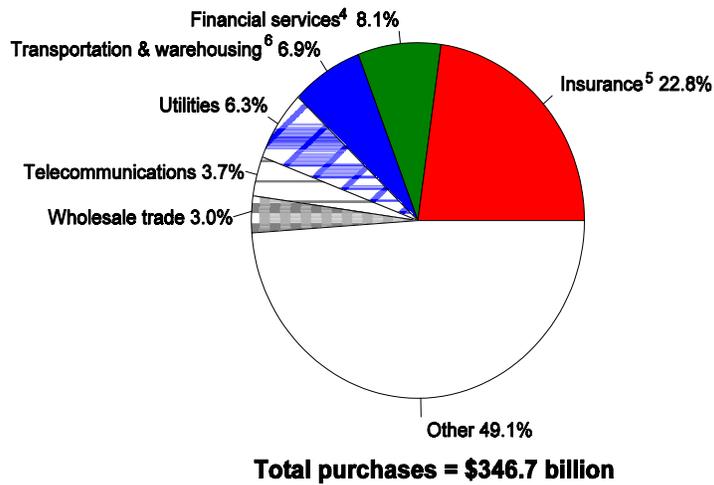
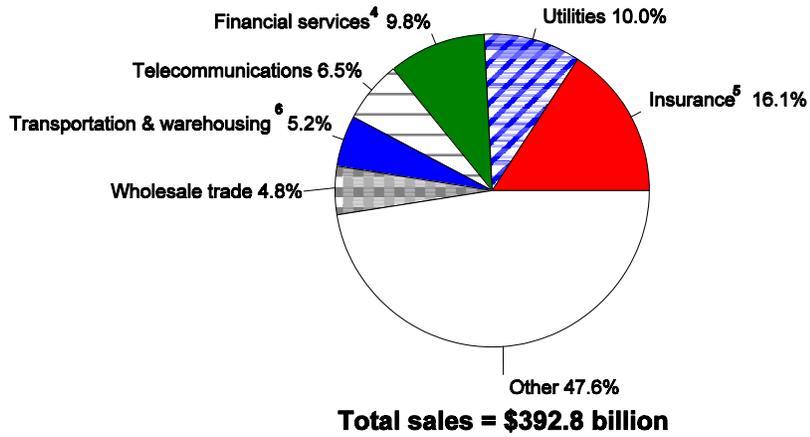
The implementation of the NAICS provides certain advantages over the SIC-based classifications, including enhanced industry detail, better reflection of new and emerging technologies, and a more logical distinction between goods and services.³ For example, restaurants are included in retail trade in the SIC; accordingly, sales by restaurants are treated as sales of goods. Under the NAICS classification, restaurants are included in the service industry "accommodation and food services," and their sales are classified as sales of services. The treatment under NAICS better reflects meal preparation, table service, and the provision of facilities for on-site meal consumption, which differentiate restaurants from grocery stores and other establishments providing unprepared food to retail customers, whose sales are treated as sales of goods.

¹ Office of Management and Budget, *North American Industry Classification System: United States, 1997* (Washington, DC, 1998).

² For additional information on differences between the NAICS and SIC classification systems, see Bureau of the Census, *1997 Economic Census: Bridge Between NAICS and SIC*, found at Internet address <http://www.census.gov/epcd/ec97brdg/>.

³ USDOC, BEA, *Survey of Current Business*, Oct. 1999, p. 61.

Figure 2-6
Affiliate service transactions: U.S. sales¹ and purchases,² by industry, 2000³



¹ Sales of services by majority-owned foreign affiliates of U.S. parent firms.

² Purchases of services from majority-owned U.S. affiliates of foreign parent firms.

³ Total may not equal 100 percent due to rounding.

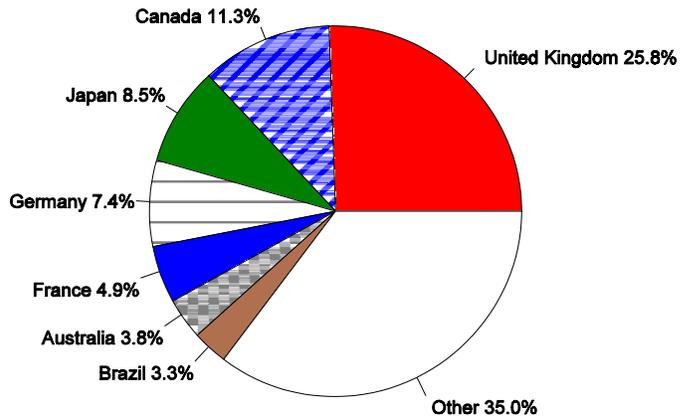
⁴ Does not include depository institutions.

⁵ Premiums only.

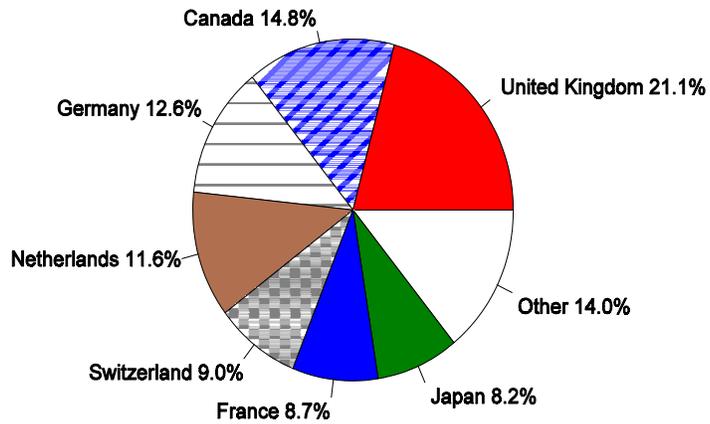
⁶ Includes air, rail, water and truck transportation, and support activities for transportation.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 122 and 124.

Figure 2-7
Affiliate service transactions: U.S. sales¹ and purchases,² by country,³ 2000



Total sales = \$392.8 billion



Total purchases = \$346.7 billion

¹ Sales of services by majority-owned foreign affiliates of U.S. parent firms.

² Purchases of services from majority-owned U.S. affiliates of foreign parent firms.

³ Total may not equal 100 percent due to rounding.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, p. 120.

affiliates in Canada and Japan accounted for 11 percent and 9 percent of affiliate sales of services, respectively.³¹

U.S.-based affiliates owned by EU parent companies accounted for 58 percent of total U.S. purchases of services from foreign-owned affiliates in 2000. Purchases from British-owned affiliates alone accounted for 21 percent of U.S. purchases, while purchases from German- and Dutch-owned affiliates respectively accounted for 13 percent and 12 percent of total U.S. purchases. Affiliates of Canadian, Swiss, and Japanese parent firms accounted for 15 percent, 9 percent, and 8 percent of U.S. purchases, respectively.³²

³¹ Ibid., p. 122.

³² Ibid., p. 124.

CHAPTER 3

ACCOUNTING SERVICES¹

Introduction

Accounting services include auditing of accounting records, designing accounting systems, preparing financial statements, developing budgets, and providing advice on matters related to accounting. Establishments primarily engaged in providing accounting services may also prepare tax returns, process payrolls, and perform bookkeeping and billing services. Accounting services are provided to foreign clients both across borders and through affiliates. Cross-border trade data report the provision of accounting, auditing, and bookkeeping services. Data on sales by foreign affiliates comprise accounting, research, management, and related services, while data on U.S. purchases from foreign-owned affiliates comprise accounting, tax preparation, bookkeeping, and payroll services. Affiliate transactions in accounting services far exceed cross-border transactions due to regulations that prohibit transmitting sensitive financial data across borders, and to the commercial advantages of establishing permanent operations in overseas markets. Commercial advantages include the improved ability to evaluate local market conditions and hire locally licensed practitioners, who may provide services to foreign clients more expeditiously.

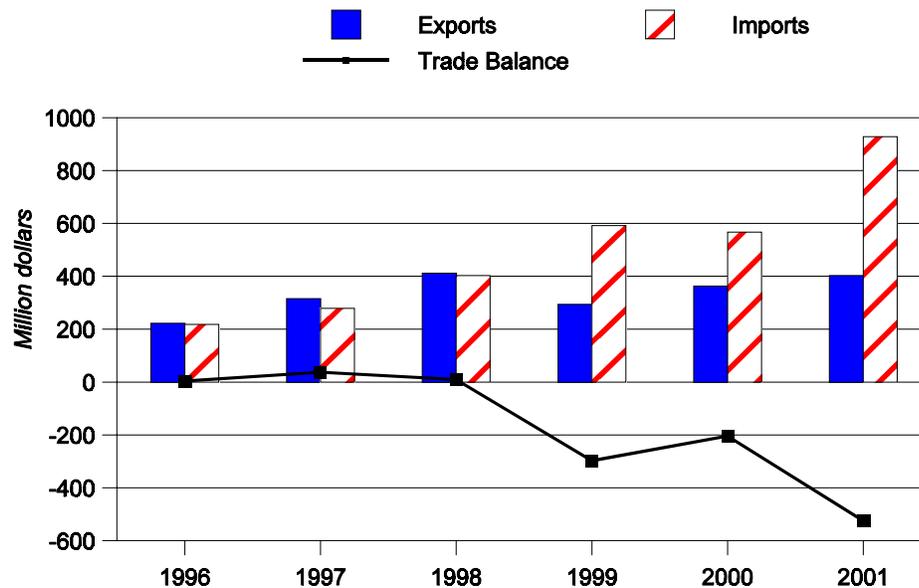
Trade and Investment Trends

Cross-Border Trade

In 2001, U.S. exports of accounting services totaled \$403 billion while imports amounted to \$928 billion, yielding a \$525-billion deficit (figure 3-1). Exports increased by 11 percent in 2001, slightly slower than the 13-percent average annual growth rate recorded during 1996-2000. In 2001, the principal U.S. export markets and import sources for accounting services were believed to be the United Kingdom

¹ Due to the recent decisions by many accounting firms to divest management consulting divisions, data regarding trade in management consulting services are no longer included in this chapter.

Figure 3-1
Accounting services: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

and Canada.² U.S. imports of accounting services grew by 64 percent in 2001, more than twice the 27-percent annual rate of increase during 1996-2000.³

Foreign Direct Investment and Affiliate Transactions

In 2001, the U.S. direct investment position in foreign accounting and related service industries⁴ totaled \$506 million, a 39-percent increase over the previous year. Growth in 2001 was substantially faster than the 5-percent average annual growth rate in such investment abroad during 1996-2000.⁵ In 2000, U.S.-owned foreign affiliates in accounting and related services firms generated sales to foreign persons of \$721 million, a 70-percent increase from the previous year (figure 3-2). Sales to

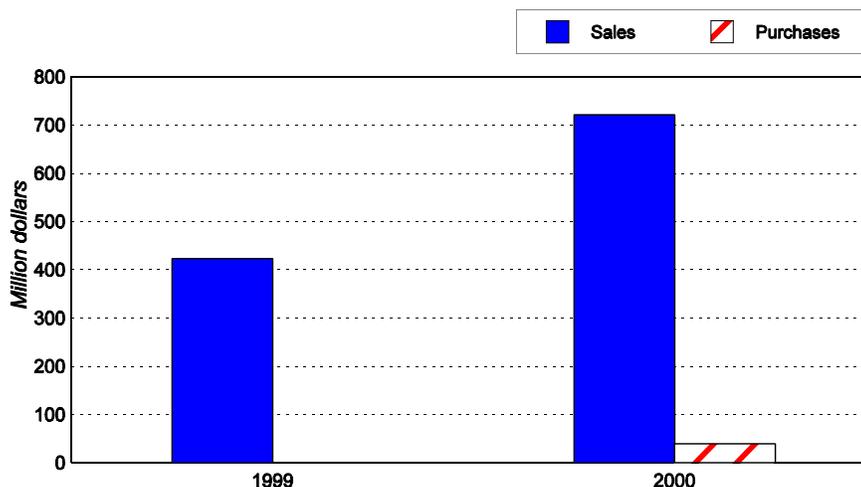
² U.S. cross-border trade statistics reported by country combine data on accounting services with those for certain “other business, professional, and technical services.” The United Kingdom and Canada are the primary U.S. export markets and import sources reported for “other business, professional, and technical services” as well as for “management, consulting, and public relations services,” which suggests the similar prominence of these markets with regard to U.S. trade in accounting services.

³ U.S. Department of Commerce (USDOC), Bureau of Economic Analysis (BEA), *Survey of Current Business*, Oct. 2002, pp. 84-85.

⁴ Investment position data group auditing and bookkeeping services together with accounting.

⁵ USDOC, BEA, “U.S. Direct Investment Abroad,” *Survey of Current Business*, Sept. 2002, p. 96, and Sept. 2000, p. 89.

Figure 3-2
Accounting¹ services: Sales by U.S. majority-owned affiliates, and purchases from foreign² majority-owned affiliates, 1999-2000



¹ Includes tax preparation, bookkeeping, and payroll services.

² 1999 purchases data were suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Canadians accounted for 44 percent of total sales to foreign persons by U.S.-owned affiliates in this industry group.⁶

By contrast, in 2001, foreign firms held a total investment position of \$72 million in accounting and related services in the United States, up by 13 percent over the 2000 total. Foreign-owned accounting affiliates sold services valued at \$39 million to U.S. persons in 2000, the first year such data were disclosed. Affiliates of Swiss parent firms accounted for 69 percent of such sales.⁷

Competitive Environment

In 2000, the accounting industry in the United States consisted of 54,300 offices of certified public accountants (CPAs) and 28,900 non-CPA offices that principally provided accounting services, which together employed about 576,000 workers.⁸

⁶ USDOC, BEA, *Survey of Current Business*, Oct 2002, p. 122.

⁷ USDOC, BEA, "Foreign Direct Investment in the United States," *Survey of Current Business*, Sept. 2002, p. 66. BEA suppressed such data for 1996-98 so as not to disclose information on individual firms. The prominence of Switzerland is the result of the fact that a major accounting firm, Deloitte & Touche LLP, is the U.S. accounting practice of Deloitte Touche Tohmatsu, a Swiss-based firm.

⁸ U.S. Bureau of the Census, "2000 County Business Patterns (NAICS)," statistics for NAICS industry codes 541211 and 541219, found at Internet address <http://censtats.census.gov/cgi-bin/cbpnaic/cbpdet.pl>, retrieved Oct. 7, 2002. Establishments primarily engaged in tax preparation services and payroll services are not included.

Although most CPA firms employ fewer than 10 workers,⁹ the bulk of accounting service revenues is highly concentrated in a few large firms with a global scope. In 2002, the four largest accounting firms in the United States, ranked by revenue, -- PricewaterhouseCoopers, Deloitte & Touche, Ernst & Young, and KPMG¹⁰ -- each had more than a thousand U.S. partners, employed tens of thousands of other U.S. professionals, and generated annual global revenues exceeding \$4 billion.¹¹ Together, the four firms perform about 97 percent of the audits of the leading publicly-traded companies and mutual funds registered with the U.S. Securities and Exchange Commission (SEC).¹² Moreover, the major firms account for about 77 percent of the revenues of the 40 largest international accounting networks.¹³

The structure of the accounting industry changed significantly in September 2002 when, following its indictment and conviction in U.S. Federal court for obstruction of justice, accounting firm Arthur Andersen, formerly ranked among the top five, surrendered its license to practice accounting in every U.S. State, ceased auditing publicly traded U.S. companies, and retained only about 1,000 of its 28,000 employees in the United States.¹⁴ Former Andersen partnership groups in foreign markets severed connections with Andersen Worldwide, the non-operating entity to which all Andersen partnerships had been contractually tied. Most subsequently agreed to contract with another global accounting firm locally.

Andersen's exit from the accounting services business is likely to have important ramifications for the U.S. market. Most of Andersen's 1,400 publicly traded U.S. clients have chosen one of the remaining "Big Four" global accounting firms as their next independent auditor. However, more than 80 former Andersen clients have switched to an auditor among the second largest tier of accounting firms (ranked by revenue), and other former clients had yet to choose an auditor as of October 2002. The second tier -- McGladrey & Pullen, Grant Thornton, and BDO Seidman -- had revenues in fiscal year 2001 ranging from \$380 million to \$507 million, less than one-sixth that of KPMG. In 2000, each of these firms audited at most several

⁹ Of the 43,327 member firms of the American Institute of Certified Public Accountants (AICPA) in 2001, about 23,000 were sole practitioners.

¹⁰ "The 2002 Top 100 Tax and Accounting Firms," *Accounting Today*, Mar. 18-Apr. 7, 2002, p. 36.

¹¹ Commission estimate, based on data from *Accounting Today*, Mar. 18-Apr. 7, 2002, p. 36.

¹² "A Good Year for Outsiders," CFO.com, Oct. 2, 2002, found at Internet address <http://www.cfo.com>, retrieved Oct. 11, 2002.

¹³ International accounting networks are integrated organizations of accounting firms. Member firms in the networks may exchange staff and expertise, and may collectively serve clients with a competency and geographical coverage that surpass the extent possible as an individual firm. Lawrence J. White, *Reducing the Barriers to International Trade in Accounting Services*, American Enterprise Institute for Public Policy Research (Washington, DC: AEI Press, 2001), p. 14.

¹⁴ "Andersen Surrenders Accounting Licenses," *Wall Street Journal*, Sept. 3, 2002, p. A6.

hundred mainly medium-sized, publicly and privately owned companies.¹⁵ Ranked below these firms, the majority of U.S. accounting firms recorded annual revenues of less than \$100 million, served fewer than 100 public clients each, tended to specialize along industry sector or geographic lines, and have limited international activities apart from participation in networks of professional firms such as Horwath International and Moores Rowland International.¹⁶

Historically, major accounting firms maintained decades-long relationships with most of their large public-company clients, primarily performing independent external audits as required by federal law. The relationship was based largely on the accounting firm's reputation for technical competency and its familiarity with the complexity of a client's multinational businesses, subject to widely varied corporate tax regimes and legal environments. Increasingly during the latter half of the 1990s, the largest U.S. accounting firms began offering their clients non-audit services¹⁷ to such an extent that revenues from these services in many cases surpassed revenues from external audits,¹⁸ creating potential conflicts of interest between external auditors charged with reporting accounting irregularities and employees of the same firms who were closely involved in the internal operations of their clients.

In a series of high-profile cases in recent years, a number of large, publicly traded U.S. multinational corporations significantly restated downward their financial results, eroding investor confidence in financial reporting. The problems have been at least partly attributable to problematic accounting treatments and inadequate oversight of corporate officers by external auditors and corporate boards of directors, and have triggered regulatory investigations and shareholder litigation.¹⁹ Following what was then the largest U.S. bankruptcy filing in history by Enron Corp. in December 2001, the related federal conviction of its auditor, Arthur Andersen, and a large restatement of earnings by WorldCom in 2002, among other examples of problematic financial reporting, Congress enacted the Sarbanes-Oxley Act of 2002, signed into law on July 30, 2002.²⁰ The comprehensive Act is intended to improve corporate disclosure and accountability, strengthen regulation of the accounting industry, and restore investor confidence in capital markets. The main provisions

¹⁵ Although these second-tier firms are likely to retain their middle-market-client focus, Grant Thornton recently hired more than 50 former Andersen partners and more than 400 other Andersen staff, and added certain services formerly provided by Andersen. "Arthur Andersen Raleigh Office, Additional Middle-Market Professionals Join Grant Thornton," July 15, 2002, press release, found at Internet address <http://www.grantthornton.com>, retrieved Oct. 11, 2002.

¹⁶ Horwath International is an international accounting network with 110 member firms and correspondent firms. Moores Rowland International, formed in 1985, is an association of national and regional firms in the accounting and business advisory fields.

¹⁷ Non-external audit services include internal audits; management advisory services on corporate acquisitions, financial risk assessment, tax planning, and human resources; and information technology systems design and implementation.

¹⁸ "Accounting Firms Are Still Consulting," *Wall Street Journal*, Sept. 23, 2002, p. C1, and *Accounting Today*, various issues.

¹⁹ "The Reform of Corporate Reporting and Auditing," testimony of Prof. Baruch Lev, New York University, before the U.S. House of Representatives, Committee on Energy and Commerce, Feb. 6, 2002, found at Internet address <http://www.accountingweb.com>, retrieved Feb. 8, 2002.

²⁰ P.L. No. 107-204.

affecting the accounting industry include the creation of a Public Company Accounting Oversight Board²¹ with investigative and enforcement powers; the prohibition on auditors performing certain non-audit services²² contemporaneously with external audits; and a mandatory change every five years in the lead or coordinating partner who directs the external audit of a public company. Recent regulatory changes pertaining to the accounting profession also have occurred at the state level, as California adopted legislation that parallels or surpasses some federal regulatory requirements on auditors and accountants imposed under the Sarbanes-Oxley Act.²³

As a consequence of the requirements of the new Act, premiums on professional liability insurance for accounting firms that audit public companies are expected to increase dramatically.²⁴ Accounting firms with relatively few public audit clients may find the Act's requirements on auditors prohibitive, motivating many such firms to merge or withdraw from the practice of external auditing of public companies.²⁵ Audited public companies are reported to be likely to face above-average price increases from their independent auditors, compared to recent years in which prices for audits grew at about the same rate as inflation.²⁶

²¹ Board members are appointed by and responsible to the SEC. Two board members may be accountants, while the other three members must come from outside the profession. The board is to be financed by fees levied on publicly audited companies and mutual funds. As of May 2003, the board members have been appointed and staff have begun operations, including establishing rules for registration of U.S. and foreign firms that audit U.S.-listed companies and mutual funds.

²² The proscribed non-audit services include bookkeeping or other services related to the accounting records or financial statements of the audit client; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment advisor, or investment banking services; legal services and expert services unrelated to the audit; and any other service that the Oversight Board determines, by regulation, is impermissible. Preapproval by the audit committee of a public company must be obtained by auditors seeking to perform any other non-audit services, including tax services, for the audit client. Nevertheless, the Oversight Board has the authority to override the prohibition, on a case-by-case basis, subject to review by the SEC.

²³ In August 2002, California enacted legislation transforming the State Board of Accountancy and placing additional requirements on State-licensed practicing accountants (State of California Assembly bills No. 270, 2873, and 2970, found at Internet address <http://www.leginfo.ca.gov>). With these changes, California became the first U.S. State to require non-accountants to comprise a majority on the board that licenses and regulates practicing public accountants. The legislation also creates audit document retention requirements absent in Federal law and prohibits accountants who participate in an external audit of a public company from accepting employment within a year at the same public company if responsibilities would include significant authority over accounting and financial reporting.

²⁴ "Scandals To Impact Malpractice Rates," *Accounting Today*, July 22-Aug. 4, 2002, pp. 1 and 37.

²⁵ "Coming: Auditor Cataclysm?" CFO.com, Oct. 2, 2002, found at Internet address <http://www.cfo.com>, retrieved Oct. 11, 2002.

²⁶ "Audit Fees Rise, and Investors May Pay Price," *Wall Street Journal*, Aug. 13, 2002, p. C1.

Most large accounting firms have spun off or sold portions of their non-audit businesses in recent years, especially consulting units that design, install, and service financial-related computer systems.²⁷ Although revenues at the major accounting firms are expected to decline by at least one-third due to the loss of these consulting units,²⁸ other forms of permissible non-audit work are likely to remain a mainstay of major accounting firms' revenues. For example, public company investors' demand for more disclosure and authentication of a firm's performance in environmental management and compliance activities is likely to accelerate non-audit opportunities for accounting firms engaged to attest to these client activities.²⁹

Recent regulatory reform in the accounting industry also extends beyond the United States, in large part a reaction to the recent U.S. corporate accounting revelations. Canadian accounting and securities regulators established a new Canadian Public Accountability Board to supervise, inspect, and discipline the six auditing firms that conduct 90 percent of public company audits in Canada. Proposed rule changes under consideration include rotation of lead partners on specific accounts and application of broad principles to safeguard auditor independence.³⁰ The Monetary Authority of Singapore announced a new ruling that requires incorporated banks in Singapore to change auditors every five years. The Government of Singapore was reported to be considering a similar ruling for listed non-bank companies.³¹ Accounting regulatory reform is also under review by the British Parliament, primarily reflecting concern over the increasing market concentration of the four primary accounting firms that perform most audits of public companies.³²

WTO Update

Only Australia and the United States submitted negotiating proposals on accounting services specifically.³³ The proposals identify specific impediments to trade in accounting services, many of which were cited in both submissions. Both countries' proposals also cited the importance of the WTO Disciplines on Domestic Regulation in the Accountancy Sector, adopted by the Council for Trade in Services in

²⁷ In October 2002, PricewaterhouseCoopers completed the sale of its global management consulting and technology services unit to IBM for approximately \$3.5 billion in cash and stock. Deloitte has announced plans to separate from its consulting unit, as the latter becomes a privately owned partnership in which Deloitte would retain a minority interest, subject to regulatory approval. As of February 2003, no date for the separation had been announced. Ernst & Young and KPMG separated from their consulting units in 2000 and 2001, respectively.

²⁸ "Accounting Firms Are Still Consulting," *Wall Street Journal*, Sept. 23, 2002, p. C1.

²⁹ "Accountants Find New Niche," *Financial Times*, Mar. 22, 2001, found at Internet address <http://news.ft.com>, retrieved Apr. 3, 2001.

³⁰ "Accountants Propose Tougher Standards," *Globe and Mail*, Sept. 5, 2002, found at Internet address <http://www.theglobeandmail.com>, retrieved Sept. 15, 2002.

³¹ "PwC Hit By New Singapore Bank Audit Rule," *Reuters*, Mar. 13, 2002, found at Internet address <http://www.business.com>, retrieved Mar. 13, 2002.

³² "U.K. Takes Slower, Gentler Approach to Audit Reform," *Accounting Web*, July 26, 2002, found at Internet address <http://www.accountingweb.com>, retrieved Aug. 12, 2002.

³³ World Trade Organization (WTO), "Communication from Australia: Negotiating Proposal for Accountancy Services," S/CSS/W/62, Mar. 28, 2001, and "Communication from the United States: Accounting Services," S/CSS/W/20, Dec. 18, 2000.

December 1998. Australia proposes strengthening and reviewing the Disciplines in order to clarify and elaborate GATS obligations, and to ensure that domestic regulations, including those on the temporary entry of natural persons, do not constitute unnecessary barriers to trade. Australia further proposes that WTO members review limitations on establishing a commercial presence and eliminate those not justifiable on commercial grounds. The U.S. proposal seeks commitments from WTO members that have not yet scheduled commitments on accounting services. The United States also seeks additional commitments by asking members to endorse a reference paper consisting of the above-mentioned Disciplines on Domestic Regulation in the Accountancy Sector, as revised by the United States.³⁴

Proposals submitted by Canada, Colombia, the European Union, and Switzerland deal with negotiations on professional services without differentiating among them.³⁵ Proposals from Chile, Colombia, the European Union, Japan, and Switzerland cite nationality and/or permanent residency requirements as likely subjects for consideration in negotiations.³⁶ Colombia and Switzerland asked members to eliminate nationality and residency measures; others stated that such measures are seldom justifiable. Canada, Colombia, and Switzerland propose discussions on ways to reduce barriers to the movement of natural persons into foreign countries to provide services; similarly, numerous countries seek discussions on ways to enhance the process of recognizing the qualifications of foreign professionals.

The GATS schedules of commitments submitted by most members acceding to the WTO since the organization's founding indicate a considerable propensity to bind open regulatory regimes with regard to market access and national treatment on accounting services. Seven of 16 newly acceded WTO members -- Albania, Estonia, Georgia, Kyrgyz Republic, Moldova, Mongolia, and Oman -- bind fully open market access and national treatment commitments for all accounting services in three modes of supply,³⁷ excluding the fourth mode of movement of natural persons. Bulgaria, Croatia, Jordan, and Lithuania bind similar open market access and national treatment in the same three modes of supply for all accounting services except auditing, where some restrictions are included.³⁸

³⁴ At the adoption of the WTO accounting disciplines in 1998, parties agreed that the provisions would not take effect until completion of the next round of services negotiations, when the disciplines would be integrated into the GATS, at which point they would become binding on the signatories. WTO, "Communication from the United States: Accounting Services," S/CSS/W/20, Dec. 18, 2000.

³⁵ WTO, "Communication from Canada: Initial Negotiating Proposal on Professional Services," S/CSS/W/52, Mar. 14, 2001; "Communication from Colombia: Professional Services," S/CSS/W/98, July 9, 2001; "Communication from the European Union and their Member States: GATS 2000: Professional Services," S/CSS/W/33, Dec. 22, 2000; and "Communication from Switzerland: GATS 2000: Professional Services," S/CSS/W/75, May 4, 2001.

³⁶ WTO, "Communication from Chile: The Negotiations on Trade in Services," S/CSS/W/88, May 14, 2001, and "Communication from Japan: The Negotiations on Trade in Services," S/CSS/W/42, Dec. 22, 2000.

³⁷ The three modes are cross-border supply, consumption abroad, and commercial presence.

³⁸ WTO, "Accession: Technical Note, Annex 4 - Sector Specific Commitments," found at Internet address <http://www.wto.org/>, retrieved Sept. 23, 2002.

CHAPTER 4

ADVERTISING SERVICES

Introduction

Advertising services include the preparation of advertisements¹ and their placement in various media. Preparatory services encompass the development of advertising plans and the production of creative work, whereas placement services involve the negotiation and purchase of space or time in advertising media, including newspapers, magazines, radio, television, cable, satellite, the Internet, billboards, transportation displays, and circulars.² Trade in the sector comprises both cross-border trade and affiliate transactions. Of these two delivery channels, affiliate transactions are the predominant mode of trade in advertising services. Establishing a presence in foreign markets permits advertising firms to cultivate knowledge critical to the successful creation and administration of advertising services, including knowledge of the local culture, language, consumer tastes, and the media environment. Consequently, foreign-based affiliates tend to develop a competitive advantage over agencies that export advertising services directly from home offices. Aside from the need to develop local knowledge, U.S. advertising agencies increasingly transfer the production of commercial footage to foreign countries to take advantage of lower costs, favorable exchange rates, and increasingly sophisticated advertising firms abroad.³ For example, the number of advertising films shot in Los Angeles dropped to 5,580 in 2000 from 6,569 the previous year.

Trade and Investment Trends

Cross-Border Trade

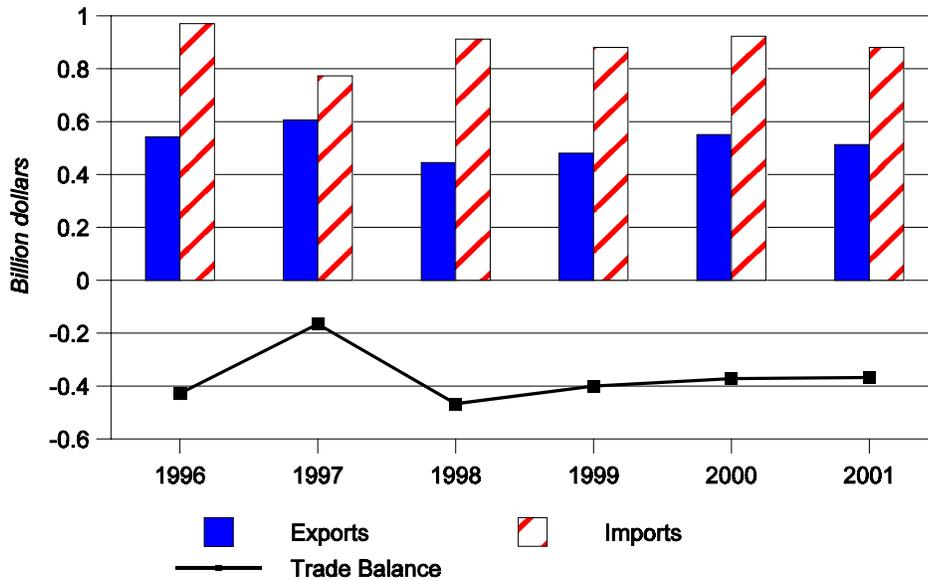
U.S. cross-border exports of advertising services totaled \$513 million in 2001, compared to cross-border imports of \$881 million, yielding a trade deficit of \$368 million in advertising services (figure 4-1). U.S. exports increased by an average annual rate of 0.4 percent during 1996-2000, but declined by 7 percent in 2001, likely connected to the acquisition of several large U.S. advertising agencies by foreign firms during 2000. Canada represented the largest U.S. export market for the industry, accounting for exports of \$85 million in 2001 (figure 4-2). Other major

¹ An advertisement is a paid announcement, delivered through a public medium, that promotes a particular product, service, or idea.

² Traditional media comprise printed matter, such as newspapers and magazines, and broadcast media, including television and radio. Cable and satellite television, direct mail, outdoor advertising (e.g., billboards), the yellow pages, and the Internet are more recent advertising media.

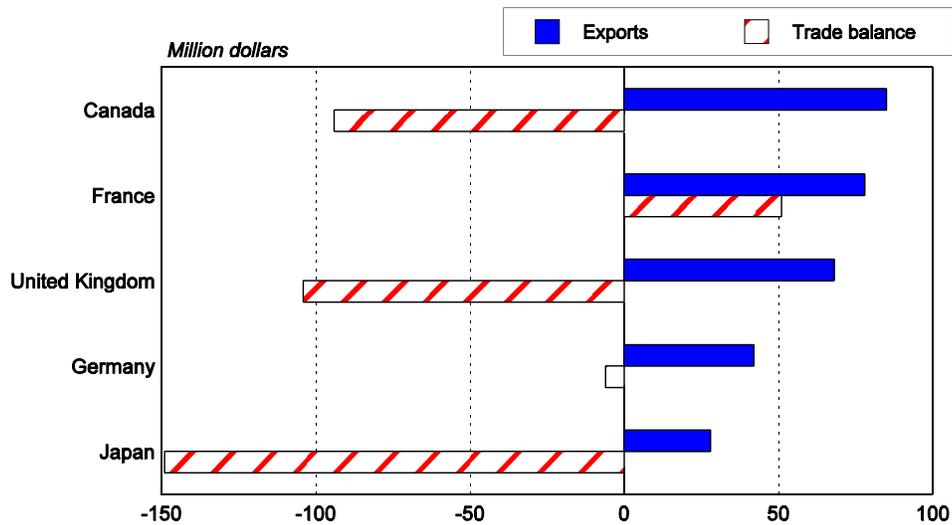
³ Ana Campoy, "U.S. Agencies Shift Work Overseas," *The Wall Street Journal*, June 24, 2002, p. B.5.

Figure 4-1
Advertising services: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure 4-2
Advertising services: U.S. cross-border exports and trade balance, by major trading partners, 2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 118-119.

export markets included France, the United Kingdom, Germany, and Japan, with U.S. exports of \$78 million, \$68 million, \$42 million, and \$28 million, respectively. France was the only major trading partner with which the United States registered a cross-border trade surplus in advertising services, of \$51 million. U.S. imports of advertising services recorded an average annual decline of 1 percent during 1996-2000, with a further decline of 5 percent in 2001.

Foreign Direct Investment and Affiliate Transactions

As noted above, advertising agencies do significantly more business through affiliates overseas than through cross-border trade, as reflected in the data on foreign direct investment and affiliate transactions. The U.S. direct investment position abroad in advertising services grew by 1 percent in 2001, to \$7.6 billion, compared to average annual growth of 27 percent during 1996-2000.⁴ The U.S. outbound investment position spiked in 2000, with U.S. investment flows to foreign markets increasing by 51 percent, reflecting U.S. companies' purchases of foreign advertising firms. Examples include the Interpublic Group's purchase of a 20-percent stake in Daiko Inc., the fifth largest advertising company in Japan, and True North Inc.'s acquisition of 35.5 percent of Springer & Jacoby, a major German advertising agency.⁵ Consistent with this outbound investment, U.S.-owned advertising affiliates abroad recorded sales of \$8.8 billion in 2000, a 35-percent increase over 1998 (figure 4-3). Sales of U.S.-owned affiliates in the United Kingdom accounted for 26 percent of this total (\$2.3 billion), followed by affiliates in France, with 12 percent (\$1.0 billion).⁶

The growth of the inbound foreign direct investment position in U.S. advertising services slowed to 11 percent in 2001, following 94-percent average annual growth during 1996-2000. The rapid growth rate was due primarily to a one-time surge in inbound investment in 2000, reflecting capital inflows of \$13.0 billion.⁷ This inflow reflects the sales of several U.S.-based advertising firms to foreign owners during 2000, the largest of which was the acquisition of Young & Rubicam, a major U.S. advertising firm, by WPP Group of the United Kingdom for \$4.7 billion.⁸ French-based Publicis acquired three U.S. advertising firms in 2000: Fallon, Frankel,

⁴ U.S. Department of Commerce (USDOC), Bureau of Economic Analysis (BEA), "FDIUS: Balance of Payments and Direct Investment Position Estimates, 1987-99," Table 15-9401, "Detailed annual balance of payments and position estimates, 1982-2001," found at Internet address <http://www.bea.doc.gov/bea/di/di1usdbal.htm>, retrieved Oct. 11, 2002.

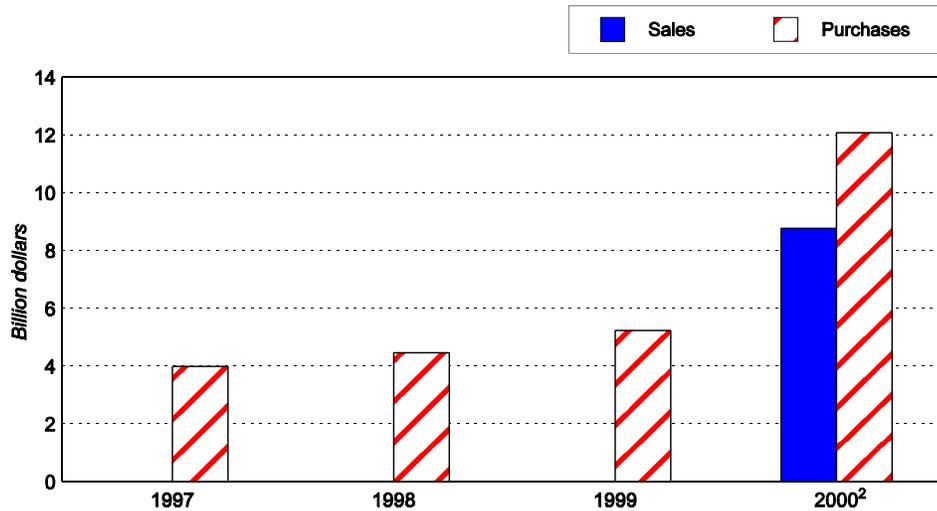
⁵ Japan U.S. Business Report, American Companies in Japan, No. 368, May 2000, found at Internet address http://www.jei.org/Archive/BR00/368x/368_USinJ_Misc.html, retrieved Oct. 11, 2002; and Adbrands.net, found at Internet address http://www.mind-advertising.com/de/springer_de.htm, retrieved Oct. 11, 2002.

⁶ Data for 1999 are not available. Sales by foreign advertising affiliates of U.S. parents were suppressed to avoid disclosure of individual company data. USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 121-122; and Oct. 2000, p. 159.

⁷ USDOC, BEA, *Survey of Current Business*, Sept. 2002, p. 66.

⁸ CNNMoney, "WPP pays \$4.7B for Y&R: British No. 1 Buys U.S. Rival Creating World's Biggest Advertising Firm," May 12, 2000, found at Internet address <http://money.cnn.com/2000/05/12/europe/wpp/>, retrieved Oct. 7, 2002.

Figure 4-3
Advertising and related services: Sales¹ by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



¹ 1999 sales data was suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

DeWitt Media; Winner & Associates; and Nelson Communications.⁹ In 2000, U.S. purchases from foreign-owned advertising affiliates jumped 131 percent to \$12.1 billion, consistent with the entry of several large, foreign-owned advertising agencies into the U.S. market. A total of 96 percent of all U.S. purchases of advertising services were from affiliates of European-based firms, including \$2.7 billion from U.S. affiliates owned by British parents.¹⁰

Data for French-owned affiliates were suppressed to avoid disclosing the data of particular companies, but it is likely that affiliates of Publicis accounted for the majority of sales by European-owned affiliates.

Competitive Environment

The global advertising industry is concentrated in a few multinational advertising conglomerates. The five largest advertising holding companies are Omnicom Group (United States), the Interpublic Group of Companies (United States), WPP Group (United Kingdom), Publicis (France), and Dentsu (Japan), with 2001 worldwide gross incomes of \$8.2 billion, \$8.0 billion, \$7.4 billion, \$4.8 billion, and \$2.8 billion, respectively.¹¹ Each of these holding companies owns several well-known agencies

⁹ Publicis Groupe S.A., "Annual Report for the Fiscal Year Ended December 31, 2000," July 13, 2001, found at Internet address <http://www.sec.gov/Archives/edgar/>, retrieved Oct. 10, 2002.

¹⁰ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 123-124.

¹¹ "World's Top 100 Advertising Organizations," *AdAge.com*, found at Internet address <http://www.adage.com/page.cms?pageId=883>, retrieved Nov. 14, 2002.

or brands.¹² For example, the holdings of WPP Group, the largest advertising organization, include Ogilvy & Mather, J. Walter Thompson, and Young & Rubicam. Interpublic Group owns Lowe, McCann-Erickson, the FCB Group, Advanced Marketing Services, and Initiative Media. The industry is undergoing further consolidation. In 2002, for example, Publicis Groupe SA (France) acquired the Bcom3 Group, a U.S.-based multi-brand company, to form the fourth largest advertising organization worldwide.¹³

The U.S. industry leads the advertising sector worldwide, accounting for 58 percent of worldwide advertising revenues in 2001, or \$18.5 billion.¹⁴ Eight of the ten largest advertising agencies, and two of the three largest advertising organizations in the world, were based in the United States.¹⁵ The advertising industry in the United States experienced a drop in billings and income in 2001 because of the U.S. economic slowdown which began in 2001.¹⁶ For example, the Grey Global Group, the top U.S. advertising company in terms of billing, reported a net loss of \$24.4 million for 2001, compared with net income of \$19.4 million during 2000.¹⁷ Worldwide industry revenues also declined by 2.5 percent to \$31.7 billion.

One factor behind the declining revenues was the collapse of many Internet companies in 2000, which negatively impacted a number of agencies that had invested heavily in Internet advertising strategies. While Internet advertising represents only a fraction of advertising companies' total income,¹⁸ agencies dedicated to the new medium suffered a 32-percent decline in revenue in 2001, resulting in office closings, a 34-percent reduction in employment, and agency consolidation.¹⁹ Internet advertisers Agency.com, Red Sky Interactive and Organic were purchased by Seneca Investments; Lot21 was absorbed by Aegis Group's Carat Interactive; and Scient and iXL merged.

Advertising companies compete on the basis of creative reputation, knowledge of and ability to secure multiple advertising media for their clients, and quality of service. Geographic coverage and cultural diversity also are important factors in agencies' competitiveness. The ability of a single advertising firm to serve large multinational

¹² Scott Donaton, "Life after the Publicis-bcom3 Merger: All Eyes Are on the Remaining Players," *AdAge.com*, Mar. 7, 2002, found at Internet address <http://www.adage.com/news.cms?newsId=34179>, retrieved Oct. 10, 2002.

¹³ Kate MacArthur, "Publicis Completes Bcom3 Acquisition," *Advertising Age*, Sept. 25, 2002, found at Internet address <http://www.adage.com/news.cms?newsId=34227>, retrieved Oct. 8, 2002.

¹⁴ R. Craig Endicott, Agency Report, *Advertising Age*, Apr. 22, 2002, p. 1.

¹⁵ R. Craig Endicott, "Agency Report," *Advertising Age*, Apr. 22, 2002, p. 1; and Mercedes Cardona, "Grey Reports Losses For 2001, 4th Quarter," Mar. 13, 2002, found at Internet address <http://www.adage.com/news.cms?newsId=34227>, retrieved Oct. 10, 2002.

¹⁶ WPP Group plc, Annual Report for the fiscal year ended Dec. 31, 2001, Form 20-F, found at Internet address <http://www.sec.gov/Archives/edgar/>, retrieved Oct. 10, 2002.

¹⁷ Mercedes Cardona, "Grey Reports Losses For 2001, 4th Quarter," Mar. 13, 2002, found at Internet address <http://www.adage.com/news.cms?newsId=34227>, retrieved Oct. 10, 2002.

¹⁸ For example, interactive advertising accounted for approximately 6.5 percent of WPP's U.S. revenue in 2001. Mark Schumann, "The Ad Age Annual Interactive Agency Report," May 30, 2002, found at Internet address <http://www.adage.com/news.cms?newsId=34898>, retrieved Oct. 10, 2002.

¹⁹ *Ibid.*

clients in many markets plays an important role in the selection of an agency, encouraging global advertising firms to acquire local affiliates with current knowledge of the local culture, or smaller agencies which concentrate on specific media such as television, radio, or the Internet.²⁰

WTO Update

Fifty-one countries, including the members of the EU,²¹ made GATS commitments in advertising services, most of which apply to the entire advertising sector. However, the United States is the only country to have submitted a negotiating proposal on advertising services for the Doha Round. In its submission, the United States lists a number of existing impediments to trade in advertising services, and calls on all WTO Members to make and/or improve their commitments in such services under the GATS, permitting full market access and national treatment.²² Specific impediments encountered by foreign providers of advertising services worldwide include restrictions on importing and broadcasting foreign-produced television commercials, local participation requirements for electronically transmitted advertising, local processing requirements, residency requirements for employees of advertising agencies, foreign equity ownership limitations on advertising firms, requirements to hire host-country nationals as managers in foreign-owned advertising firms, and requirements that certain advertising be carried only by local cable or satellite programs.²³

Of the 16 members that have joined the WTO since the Uruguay Round trade negotiations, Albania, Bulgaria, Estonia, Georgia, the Kyrgyz Republic, Latvia, Lithuania, Oman, and Taiwan scheduled full commitments on advertising services; China, Jordan, Moldova, and Panama scheduled partial commitments. Croatia, Ecuador and Mongolia declined to schedule commitments on advertising services.²⁴

²⁰ The Interpublic Group of Companies, Inc., Annual Report for the Fiscal Year ended Dec. 31, 2000, Form 10-K, July 2, 2001, found at Internet address <http://www.sec.gov/edgar/searchedgar/webusers.htm>, retrieved Oct. 11, 2002; and WPP Group plc, Annual Report for the Fiscal Year ended Dec. 31, 2001, Form 20-F.

²¹ The EU members are bound by a joint Schedule of Commitments in the GATS treaty.

²² World Trade Organization (WTO), "Communication from the United States: Advertising and Related Services," S/CSS/W/100, July 10, 2001, found at Internet address <http://www.wto.org/>, retrieved Nov. 14, 2002.

²³ Ibid.

²⁴ WTO, Accession: Technical Note, "Annex 4 - Sector Specific Commitments," found at Internet address <http://www.wto.org/>, retrieved Mar. 2, 2003.

CHAPTER 5

BANKING AND SECURITIES SERVICES

Introduction

For the purposes of this discussion, banking and securities services comprise both fee-based commercial banking services and securities-related services. Fee-based commercial banking services include financial management and transaction services, advisory services, custody services,¹ credit card services, and other credit-related services, such as the provision of standby letters of credit for trade financing.² Securities-related services include brokerage services, securities lending services,³ securities clearance and settlement services, securities trading services, private placements,⁴ and securities underwriting services. Deposit-taking and lending services are excluded from this discussion.⁵ Both fee-based commercial banking services and securities-related services can be traded across borders or sold through affiliates.

Trade and Investment Trends

Cross-Border Trade

U.S. cross-border exports of banking and securities services declined by 7 percent to \$15.2 billion in 2001, following average annual growth of 19 percent during 1996-2000. U.S. imports of banking and securities services also declined in 2001, by 10 percent to \$4.0 billion, representing the largest annual decline since 1996. Simultaneous declines in exports and imports resulted in a U.S. trade surplus of \$11.2

¹ A custodian holds securities under a written agreement for a client and buys and sells when instructed. Custody services include securities safekeeping as well as collection of dividends and interest. Thomas P. Fitch, *Dictionary of Banking Terms* (New York: Barron's, 1990), p. 172.

² A standby letter of credit represents an obligation by the issuing bank to a designated third party (the beneficiary) that is contingent on the failure of the bank's customer to perform under the terms of the contract with the beneficiary. A standby letter of credit is most often used as a credit enhancement, with the understanding that, in most cases, it will never be drawn against or funded. Fitch, *Dictionary of Banking Terms*, p. 591.

³ A securities loan is a loan made by broker-dealers, banks, or other organizations to finance the purchase of securities. Fitch, *Dictionary of Banking Terms*, p. 552.

⁴ A private placement is the sale of an entire issue of securities to a small group of investors. Fitch, *Dictionary of Banking Terms*, pp. 481-482.

⁵ BEA does not report data on trade in deposit-taking and lending services provided by commercial banks.

billion in banking and securities services (figure 5-1), down 5 percent from 2000. The declines in exports and imports principally reflect the sustained downturn in global financial markets and the worldwide economic slowdown during 2001.⁶

The United Kingdom, Canada, Bermuda, Japan, and Germany remained the largest markets for exports of U.S. banking and securities services in 2001, purchasing \$2.6 billion, \$1.0 billion, \$983 million, \$829 million, and \$591 million of such services, respectively (figure 5-2).⁷ However, exports to all of these countries except Bermuda declined by at least \$100 million. Exports to Caribbean countries declined by \$795 million, or 29 percent, the largest decline (in dollar terms) recorded for any region or country. This decline coincides with enhanced efforts by the Financial Action Task Force on Money Laundering (FATF), begun in 2000, to counter international money-laundering activities.⁸ Exports to Bermuda and Hong Kong increased by 27 percent and 22 percent, respectively. The increase in exports to Bermuda may be the result of U.S. corporations, formerly registered in the United States, re-locating to Bermuda for tax purposes. Increased exports to Hong Kong may be related to the leasing agreements involving rolling stock for the Hong Kong mass-transit authority and passenger aircraft for a commercial airline.⁹

The largest share of the decline in exports reflected a decline in advisory and custody services resulting from reduced mergers and acquisitions activity by foreigners in U.S. markets.¹⁰ This was closely linked to the collapse of the stock market valuations of many Internet and telecommunication firms, which were leading players in mergers and acquisitions throughout the 1990s. Because services related to mergers and acquisitions are often funded through company shares, rather than cash, and priced as a percentage of the total transaction value, declining market values tend to result in lower overall fees collected by banking and securities firms.

⁶ In 2001, the United States and all of its largest trading partners experienced declines in GDP growth rates of 1 to 7 percent over the previous year. World Bank, World Development Indicators database, found at Internet address <http://www.devdata.worldbank.org/data-query/>, retrieved Jan. 3, 2003.

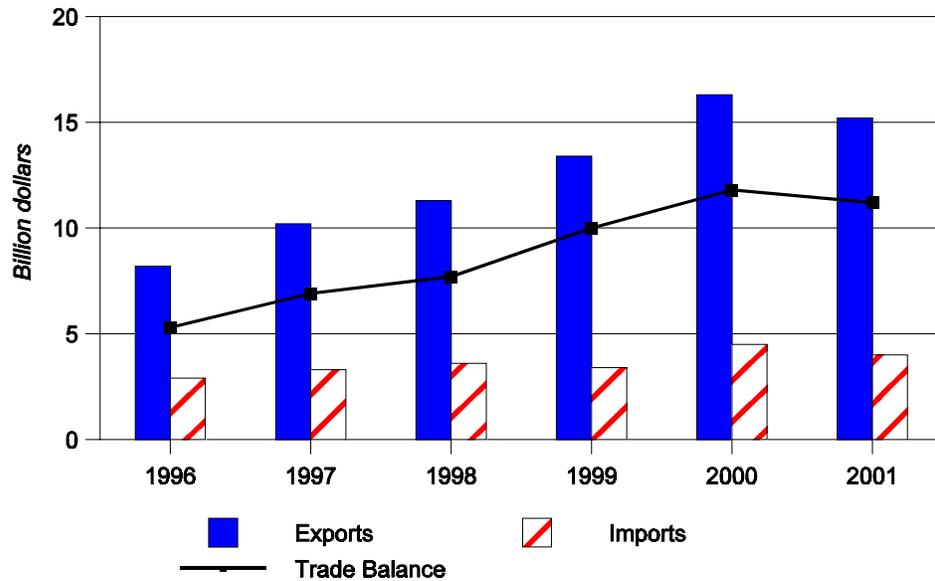
⁷ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 100-107.

⁸ The Financial Action Task Force on Money Laundering (FATF) is an inter-governmental organization established by the G-7 summit in 1989 specifically to combat international money laundering activities. FATF reports indicate that several Caribbean countries previously identified as Non-Cooperative Countries and Territories (NCCTs), including the Bahamas, the Cayman Islands, Dominica, and St. Kitts and Nevis made important progress in late 2000 and early 2001. The Bahamas and the Cayman Islands were removed from the list of NCCTs in June 2001, at which time another Caribbean country, Grenada, was added to the list. FATF, *Review to Identify Non-Cooperative Countries and Territories*, June 22, 2001, found at Internet address <http://www.fatf-gafi.org>, retrieved Jan. 9, 2003. Dominica and St. Kitts and Nevis have also been removed from the NCCT list. As of Jan. 7, 2003, Grenada, and St. Vincent and the Grenadines are the only Caribbean countries listed as Non-Cooperative Countries and Territories. FATF "Non-Cooperative Countries and Territories," found at Internet address <http://www.fatf-gafi.org>, retrieved Jan. 9, 2003.

⁹ Industry representative, telephone interview by USITC staff, Jan. 7, 2003.

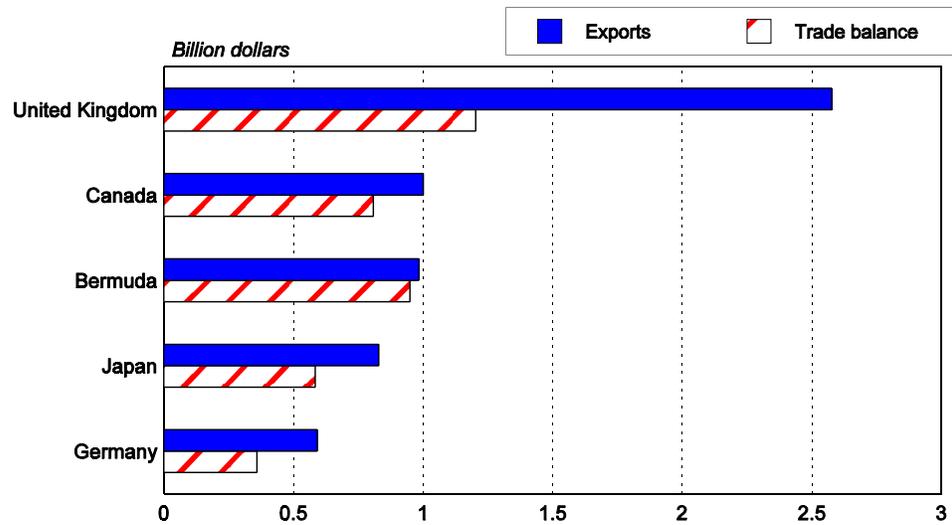
¹⁰ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 77; and Securities Industry Association (SIA), *Securities Industry Fact Book 2002* (New York: SIA, 2002), p. 23. The number and value of mergers and acquisitions announced in the United States in 2001 declined by 32 percent and 53 percent, respectively, from 2000 levels. The average value in 2001 declined by 30 percent from \$15.7 million to \$11.0 million.

Figure 5-1
Banking and securities: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure 5-2
Banking and securities services: U.S. cross-border exports and trade balance, by major trading partners, 2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 106-107.

As fee income declined in absolute terms, increased competition among banking and securities firms for the remaining business pressured securities firms to lower their fee-percentages, further reducing total fees. Other factors contributing to decreased exports include reductions in underwriting activity, as foreigners reduced their issuances of securities in the United States, and declining demand for financial management services.¹¹ In 2001, U.S. issuers underwrote a total of 613 international securities offerings, a decline of 36 percent from 2000.¹²

Similarly, the decline in imports of banking and securities services was attributable to declines in the issuance of U.S. stocks and bonds abroad, and reduced demand by U.S. firms for advisory, custody, and financial management services from securities firms in foreign markets.¹³ Imports from the United Kingdom, which accounted for 34 percent of total U.S. imports of banking and securities services, declined by 16 percent in 2001 to \$1.4 billion. Japan, Switzerland, Germany, and Canada were the next leading suppliers of such services, with imports from these countries totaling \$245 million, \$240 million, \$232 million, and \$193 million, respectively, all of which were lower than their 2000 levels.¹⁴ Imports from the United Kingdom represented a particularly large share of the total due to the fact that the majority of foreign orders for U.S. banking and securities services are placed through the London offices of multinational financial service companies.¹⁵

Foreign Direct Investment and Affiliate Transactions

The U.S. direct investment position abroad in security and commodity brokerage and related financial services totaled \$157.6 billion in 2001, a 2-percent decline from the peak of \$161.5 billion in 2000.¹⁶ In 2000, sales of financial services by majority-owned foreign affiliates of U.S. multinational companies totaled \$38.6 billion, a 22-percent increase over 1999 (figure 5-3).¹⁷ Sales by United Kingdom affiliates totaled \$18.2 billion in 2000, accounting for 47 percent of the total. Strong sales in the United Kingdom reflected the importance of London in global financial markets. Sales by affiliates in Canada, Japan, and Australia totaled \$3.5 billion, \$2.9 billion, and \$1.9 billion, respectively, in 2000.¹⁸

¹¹ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 77. The declining demand for banking and securities services is also evident in the declining level of employment in the industry. In 2001, total employment at NYSE member firms dropped by 19,160 workers, or 5.2 percent. SIA, *Securities Industry Fact Book 2002*, p. 33.

¹² SIA, *Securities Industry Fact Book 2002*, p. 77.

¹³ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 77.

¹⁴ *Ibid.*, pp. 100-107.

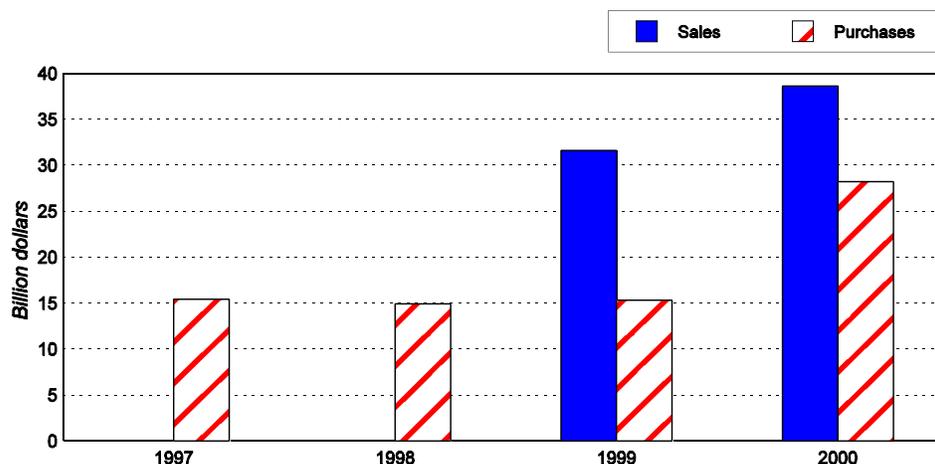
¹⁵ Industry representative, telephone interview by USITC staff, Oct. 25, 2002.

¹⁶ USDOC, BEA, *Survey of Current Business*, Sept. 2002, p. 96. For the purposes of this discussion, financial services excludes business franchising. Other financial services, such as depository institutions, insurance, real estate, and holding companies, are also excluded.

¹⁷ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 121-122.

¹⁸ Data for affiliate sales in the Netherlands and Switzerland, usually strong markets for U.S.-owned affiliates, were suppressed in 1999 and 2000 to avoid disclosure of individual companies' data.

Figure 5-3
Financial¹ services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



¹ Excludes depository institutions.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

The foreign direct investment position in U.S. financial services totaled \$71.5 billion in 2001, a 9-percent increase over 2000.¹⁹ The 2001 increase was the fourth annual increase in succession, but was well below the annual average increase of 22 percent recorded during 1996-2000. U.S. purchases of financial services from majority-owned U.S. affiliates of foreign parent companies totaled \$28.2 billion in 2000, an 84-percent increase over 1999. Almost half of the increase is due to sales by Swiss-owned affiliates, which totaled \$9.1 billion in 2000. These affiliates accounted for 32 percent of total U.S. purchases, the largest share held by any single country.²⁰ Sales by Swiss-owned affiliates recorded a large increase due to two acquisitions of U.S. financial services firms by Swiss parents during 2000: the \$11.5-billion acquisition of Donaldson, Lufkin & Jenrette, the U.S. investment bank, by Credit Suisse Group,²¹ and the acquisition of Paine Webber, another U.S. investment bank, by UBS AG (formerly Union Bank of Switzerland) for an estimated \$10.8 billion.²² U.S. purchases in 2000 from affiliates of parent companies based in Canada, Germany, the United Kingdom, and France totaled \$4.4 billion, \$4.1 billion, \$4.0 billion, and \$2.3 billion, respectively.²³

¹⁹ USDOC, BEA, *Survey of Current Business*, Sept. 2002, p. 96. For the purposes of this discussion, financial services excludes business franchising, depository institutions, insurance, real estate, and holding companies.

²⁰ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 123-124.

²¹ Donaldson, Lufkin & Jenrette, press release, found at Internet address <http://www.dlj.com>, retrieved Sept. 13, 2000; and "Credit Suisse First Boston to buy DLJ," found at <http://www.nytimes.com>, retrieved Aug. 30, 2000.

²² Paine Webber, "UBS to Merge with Paine Webber," press release, July 12, 2000, found at Internet address <http://www.painewebber.com>, retrieved Sept. 13, 2000.

²³ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 124.

Market Overview

U.S. Output

During 1990-2000, real gross output among U.S. securities and commodities brokers increased by 22 percent per annum, on average, to \$486.0 billion (figure 5-4).²⁴ Increasing demand for financial services caused increases in gross output, with increases in intermediate inputs rising slightly faster than those in primary inputs. Annual increases in gross output were larger in the latter half of the decade, coinciding with rapidly rising stock market valuations during the period. Rapid increases in primary inputs are likely related to purchases of proprietary information technology systems. Increased spending on intermediate inputs largely reflects the continuing efforts of financial firms to outsource financial and administrative functions to more specialized companies. The single largest intermediate input into securities and commodities brokerage services was financial services provided by outside parties, which accounted for 48 percent of the total in 1998. Other business and professional services, except medical services, were the second-largest category, accounting for 9 percent of intermediate inputs.²⁵ Such business services likely included computer services, consulting services, legal and accounting services, and data processing services.

Competitive Environment

In recent years, the U.S. banking and securities markets have been characterized by consolidation of firms and increasing concentration of assets. There were 7,029 broker-dealers registered with the U.S. Securities and Exchange Commission in 2001, compared to a peak of 9,515 in 1987. Consolidation is primarily due to liquidations following the 1987 stock market crash, and acquisitions of U.S. broker-dealers by both foreign firms and domestic, commercial bank-owned financial service firms in the past few years.²⁶ As a result, although the 261 broker-dealer firms that constitute the membership of the New York Stock Exchange (NYSE) represented less than 4 percent of all broker-dealers, they accounted for 81 percent of total assets and 70 percent of total revenue and capital of such firms in 2001. Further, the largest ten firms accounted for 59 percent of NYSE-member revenue, up from 48 percent in 1998.²⁷ U.S. securities firms are the largest in the world. Globally, as of year-end 2002, the ten largest investment banking firms, as ranked by sales, were Morgan Stanley, Merrill Lynch, Goldman Sachs, Salomon Smith Barney (a Citigroup subsidiary), and Lehman Brothers (all based in the United States), followed by UBS Warburg (Switzerland), CSFB (Switzerland), Nomura Holdings (Japan), Bear Stearns (United States), and UBS Paine Webber (Switzerland).²⁸

²⁴ Compiled by the Commission.

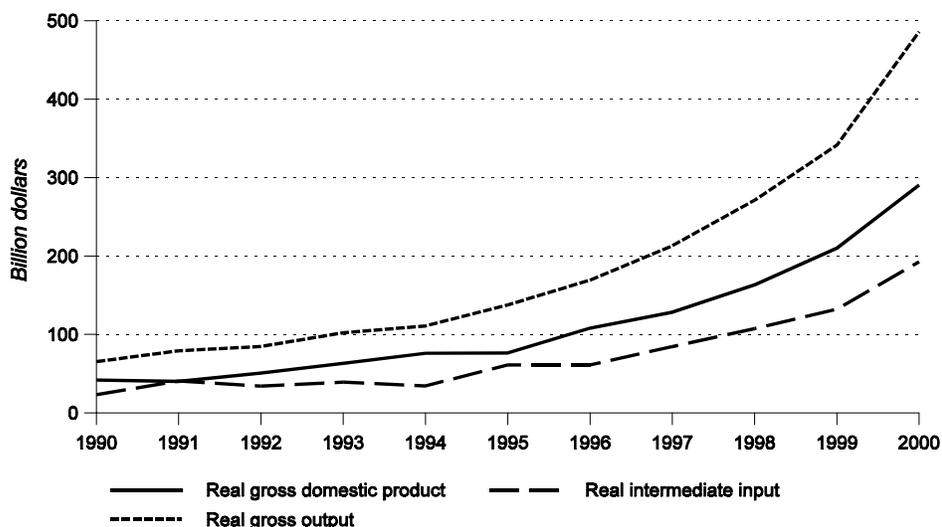
²⁵ USDOC, BEA, *Survey of Current Business*, Dec. 2001, pp. 41-70.

²⁶ SIA, *Securities Industry Fact Book 2002*, p. 28.

²⁷ *Ibid.*, p. 28 and p. 40.

²⁸ Hoover's Online, Financial Services Industry Snapshot, found at <http://www.hoovers.com/industry/snapshot/0,2204,18,00.html>, retrieved Jan. 28, 2003.

Figure 5-4
Securities and commodities brokers: Real gross domestic product, real gross output and real intermediate input, 1990-2000



Source: Compiled by the U. S. International Trade Commission.

Only two U.S. commercial banks are among the world's ten largest commercial banks, ranked by assets: Mizuho Holdings (Japan), Citigroup (United States), Sumitomo Mitsui Banking Corp. (Japan), Mitsubishi Tokyo Financial Group (Japan), Deutsche Bank (Germany), Allianz AG (Germany), UBS AG (Switzerland), BNP Paribas (France), HSBC Holdings PLC (United Kingdom), and JP Morgan Chase & Co (United States). Combined, these banks account for 18 percent of all assets of the world's 100 largest commercial banking companies. Only Mizuho and Citigroup hold assets greater than \$1 trillion. Top-ranked Mizuho's assets are nearly twice those of tenth-ranked JP Morgan Chase & Co.²⁹

Foreign financial firms continued to show interest in entering the U.S. market through acquisitions. There were a number of notable mergers and acquisitions in 2001. For example, BNP Paribas (France) acquired Hawaii-based BancWest for \$2.45 billion,³⁰ and Royal Bank of Canada followed its \$1.3-billion purchase of Minneapolis-based securities broker Dain Rauscher in January with the \$625-million acquisition of Boston-based broker Tucker Anthony SutroRoyal.³¹ Allianz AG (Germany) completed its \$980-million acquisition of U.S. mutual fund manager Nicholas-Applegate Capital Management LP in the first quarter of 2001.³² In a major

²⁹ *American Banker*, World's Top Banking Companies by Assets, found at Internet address <http://www.americanbanker.com>, retrieved Oct. 31, 2002.

³⁰ "BNP Paribas Buys Control of BancWest for \$2.45bn," *Financial Times*, May 7, 2001, found at Internet address <http://www.ft.com>, retrieved May 8, 2001.

³¹ "Royal Bank of Canada to Pay \$625m for US Broker," *Financial Times*, Aug. 1, 2001, found at Internet address <http://www.ft.com>, retrieved Aug. 2, 2001.

³² "Banks Face Slowdown," *Financial Times*, Mar. 7, 2001, found at Internet address <http://www.ft.com>, retrieved Mar. 8, 2001.

outbound acquisition, Citigroup acquired Banacci, one of Mexico's largest banks, for \$12.5 billion.³³

The bases for competition are similar for commercial banks and investment banks (securities/commodities brokerages). Commercial banks and investment banks generally compete on the basis of interest income and return on assets, risk management, global reach, and operational efficiency, with the latter primarily referring to the integration and effective use of technology. Investment banks, however, also encounter competition in terms of fee price, flexibility and adaptability of their products, and market coverage. Increasingly, commercial banks and investment banks are housed within the same financial services holding company structure, and these large firms compete to provide their corporate customers with the most complete package of integrated financial services.

Two recent regulatory changes have the potential to affect the international operations of global financial firms. The Financial Services Modernization Act of 1999 (also known as Gramm-Leach-Bliley), together with the partial repeal of the Glass-Steagall Act of 1933, removed prohibitions against a single holding company controlling a securities firm, an insurance firm, and a commercial bank. Gramm-Leach-Bliley was intended to enhance the ability of U.S. firms to compete internationally with European and Japanese firms that were already licensed to operate in all segments of financial markets. Through early 2002, U.S. financial firms were slow to take advantage of the Act, and its impact on the U.S. financial sector remained unclear. However, several announcements in late 2002 and early 2003 indicate that this situation may be changing. As of January 2003, for example, two large brokerage firms, Charles Schwab and Merrill Lynch, may soon offer federally-insured checking accounts, thereby entering into direct competition with retail-level commercial banks.³⁴

On another front, revisions to the Basel Capital Accords (Basel II), under consideration by the Basel Committee for Banking Supervision under the auspices of the Bank for International Settlements (BIS), also have the potential to reshape the financial services industry. Basel II proposes to revise the system of minimum capital reserve standards for internationally active banks to better account for the differing levels of risk that banks carry on their balance sheets.³⁵ The revised Basel II accords are expected to take into account banks' levels of supervisory review and market discipline when developing risk-weighted capital reserve requirements. The revisions should allow banks with better risk management systems to improve their return on capital. U.S. firms are expected to benefit from the revisions. Under Basel II, the advanced risk-management techniques that many U.S. banks already employ will likely allow them to hold less capital in reserve than foreign competitors that

³³ "Citigroup to Acquire Mexico's Banacci for \$12.5 bn," *Financial Times*, May 18, 2001, found at Internet address <http://www.ft.com>, retrieved May 18, 2001.

³⁴ Source: "Coy No More, Merrill Pushes 'Total' Package," *American Banker*, Jan. 9, 2003, p. 1; and "Schwab Move May Rekindle Deposit Fight," *American Banker*, Jan. 13, 2003, p. 1.

³⁵ Bank for International Settlements, Basel Committee, information found at Internet address <http://www.bis.org>, retrieved Nov. 14, 2002. See also "Too Nice in Basel," *Economist*, Oct. 5, 2002, pp. 68-69; and L. Jacobo Rodriguez, "International Banking Regulation," Cato Institute, Policy Analysis No. 455, Oct. 15, 2002.

have not yet adopted similarly advanced risk-management techniques.³⁶ Basel II is expected to be finalized in 2003, and go into effect in 2006.

The terrorist attacks of September 11, 2001, reportedly had little long-term impact on the banking and securities sector. The U.S. financial system continued to function despite the physical destruction, loss of life, and widespread dislocation of personnel and corporate operations.³⁷ Equity and bond markets remained closed for three days following the attacks, but were open by the beginning of the following week. Disrupted transactions were reconciled or re-created during the following months, a process which continued through February 2002. According to observers, although the banking and securities industry has rebounded from the impact of the attacks, business declined sharply and the industry experienced large, widespread layoffs during 2001 and 2002, largely in response to the attacks, the decline in stock prices, the threat of economic recession, and the revelations of irregular corporate accounting practices.³⁸ The greatest long-term effect of the terrorist attacks on the banking and securities industry may prove to be regulatory. The USA Patriot Act passed by Congress in the wake of the attacks, which entered into law in October 2001, imposes new regulatory requirements on banks to identify and “know” their customers, in an effort to trace the sources of terrorists’ financing.³⁹

WTO Update

Eleven negotiating proposals addressing financial services have been submitted to the World Trade Organization. Proposals were submitted by Australia, Canada, Colombia, Cuba, the EU, Japan, Kenya, Korea, Norway, Switzerland, and the United States.⁴⁰ The proposals vary in size and detail, but many address similar issues. The ability to impose prudential regulation, and affirmation of the ability of domestic governments to freely regulate markets for financial services, is common to all proposals to some degree. Several less developed countries indicate that prudential regulation must be appropriate to a country’s relative level of economic development,

³⁶ “Too Nice in Basel,” *Economist*, Oct. 5, 2002.

³⁷ U.S. Securities and Exchange Commission (SEC), “Summary of ‘Lessons Learned’ from Events of September 11 and Implications for Business Continuity,” Feb. 13, 2002, found at Internet address <http://www.sec.gov>, retrieved Dec. 4, 2002.

³⁸ David Boraks, “What Has Changed, and What Hasn’t,” *American Banker*, Sept. 9, 2002, pp. 9-14.

³⁹ *Ibid.* *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001*, Public Law 107-56, entered into law Oct. 26, 2001.

⁴⁰ World Trade Organization (WTO), negotiating proposals found at Internet address <http://www.wto.org>, retrieved Dec. 3, 2002. *Communication from the United States*, S/CSS/W/25, Dec. 18, 2000; *Communication from the European Communities and their Member States*, S/CSS/W/39, Dec. 22, 2000; *Communication from Japan*, S/CSS/W/42, Dec. 22, 2000; *Communication from Canada*, S/CSS/W/50, Mar. 14, 2001; *Communication from Norway*, S/CSS/W/59, Mar. 21, 2001; *Communication from Australia*, S/CSS/W/66, Mar. 28, 2001; *Communication from Switzerland*, S/CSS/W/71, Mar. 21, 2001; *Communication from Korea*, S/CSS/W/86 June 12, 2001; *Communication from Colombia*, S/CSS/W/96, July 9, 2001; *Communication from Kenya*, S/CSS/W/109, Sept. 26, 2001; and *Communication from Cuba*, S/CSS/W/143, Mar. 22, 2002.

and cite a common concern that financial or economic crises may be fostered by excessive liberalization or lack of regulation. More developed countries focus on the need for transparency in regulation, and cite the principle of national treatment and the need to eliminate the use of Most-Favored-Nation (Article II) exemptions, ensuring that all foreign service suppliers, whether foreign or domestic, are treated equally. Developed countries also seek market access and national treatment commitments pertaining to a broader range of financial services, and propose additional commitments that would remove quantitative measures that limit investment and, as a result, the provision of financial services through commercial presence (Mode 3). Another issue common to many proposals is that, in light of the increasing use of electronic commerce in the conduct of financial service transactions, the distinction between cross-border supply (Mode 1) and supply by consumption abroad (Mode 2) is dissipating. As a result, potential inconsistencies between a member's commitments in Mode 1 and Mode 2 may need to be resolved.

Of the 16 members that have joined the WTO since the Uruguay Round trade negotiations, Estonia, Georgia, Latvia, Lithuania, and Moldova scheduled full commitments on banking and securities services; Albania, Bulgaria, China, Croatia, Jordan, Mongolia, Oman, Panama, and Taiwan scheduled partial commitments. The Kyrgyz Republic scheduled full market access commitments with national treatment restrictions that are due to be lifted in 2003. Ecuador scheduled full commitments with some national treatment restrictions in a footnote.⁴¹

⁴¹ WTO, Accession: Technical Note, "Annex 4 - Sector Specific Commitments," found at Internet address <http://www.wto.org>, retrieved Mar. 2, 2003.

CHAPTER 6

COMPUTER AND DATA PROCESSING SERVICES

Introduction

Computer and data processing services include software implementation services such as systems and software consulting, systems analysis and design, systems maintenance, and custom programming services; data processing services, including input preparation, data entry, and tabulation;¹ consultancy services related to the installation of computer hardware; maintenance and repair of computer-related machinery; and other computer-related services such as timesharing. In 2001, computer services became the leading sector within the information technology (IT) industry,² with worldwide spending on IT services exceeding expenditures on IT hardware for the first time.³

U.S. firms sell computer and data processing services in foreign markets primarily through foreign-based affiliates. Services most often provided to foreign clients by affiliates include computer consulting, systems integration, outsourcing,⁴ and custom programming. Though affiliate transactions predominate, cross-border delivery of these services has benefitted from the development of the Internet and other long-distance electronic transmission technologies. As technologies have become simplified and more economical, computer and data processing firms have been able to increase the volume and diversity of their cross-border transactions. However, the benefits have not been universally realized. U.S. workers within many segments of the IT services industry are facing increasing wage or employment pressure as firms take advantage of these technological improvements to hire employees or purchase services from firms in low-cost markets abroad.⁵

Internet-related activities are of significant importance to the computer and data processing services industry, but available statistics may understate the volume of such activities because they are frequently classified as other types of services. Internet services, as well as many new or evolving IT services, often are captured in data reported for the information, computer, audiovisual, and telecommunication

¹ Excludes data and message transmission services (value-added network services).

² The IT industry includes hardware, software, and services.

³ USTR, *U.S. Proposals for Liberalizing Trade in Services*, press release, July 1, 2002, found at Internet address <http://www.ustr.gov/sectors/services/>, retrieved Oct. 11, 2002.

⁴ Outsourcing is a generalized term referring to the practice of contracting out internal functions, ranging from low-skill services such as data entry to more complex functions such as payroll, invoicing, or the management of a client's telecommunication and computer networks.

⁵ Information Technology Association Of America, "Maximize Savings with Offshore Sourcing Strategies," ITAA event, Sept. 26, 2002, found at Internet address <http://www.ita.org/events/>, retrieved Oct. 23, 2002.

service industries. For example, under the United Nations' CPC classification nomenclature, web page development and hosting are considered data processing services, while related activities such as web search engines and Internet publishing are classified as on-line information provision services.

Trade and Investment Trends

Cross-Border Trade

In 2001, U.S. cross-border exports of computer and data processing services totaled \$2.6 billion, while imports totaled \$1.0 billion, yielding a trade surplus of \$1.6 billion (figure 6-1). After increasing by an average of 17 percent per annum during 1996-2000,⁶ U.S. exports decreased by 13 percent in 2001, reflecting the general economic weakness in foreign markets,⁷ which, in turn, exacerbated the problems of the U.S. high-tech industry. Exports to Europe, which accounted for 58 percent of total U.S. cross-border exports of computer and data processing services in 2001, decreased by 10 percent from the 2000 level. Exports to the United Kingdom were \$917 million in 2001, by far the largest to any single country (figure 6-2). Exports to Canada ranked second, at \$259 million, followed by Japan, Germany, and Australia, with U.S. exports of \$146 million, \$137 million, and \$91 million, respectively.⁸ In the United States and abroad, many corporate clients, uncertain of when the economy will improve, have chosen not to upgrade their business software as rapidly as in the past. Further, customers such as telecommunication and networking equipment providers, once important purchasers of IT services, have virtually eliminated non-critical⁹ expenditures on computer services because of their own financial difficulties. Exports to Asia and the Pacific and Latin America and the Caribbean also declined relative to 2000.¹⁰

U.S. cross-border imports of computer and data processing services increased by 10 percent in 2001, compared to average annual growth of 35 percent during 1996-2000. Imports from Canada, Europe, and the Asia-Pacific region accounted for 54 percent, 22 percent, and 21 percent, respectively, of total U.S. cross-border imports in 2001. While imports from Canada declined by 2 percent to \$547 million, imports from Europe and Asia-Pacific increased by 28 percent and 22 percent, respectively.¹¹ Canada remained the largest source of U.S. imports of computer and data processing

⁶ U.S. Department of Commerce (USDOC), Bureau of Economic Analysis (BEA), *Survey of Current Business*, Oct. 2002, pp. 84-85.

⁷ In 2001, the United States and all of its largest trading partners experienced declines in GDP growth rates of 1 to 7 percent over the previous year. World Bank, World Development Indicators database, found at Internet address <http://www.devdata.worldbank.org/data-query/>, retrieved Jan. 3, 2003.

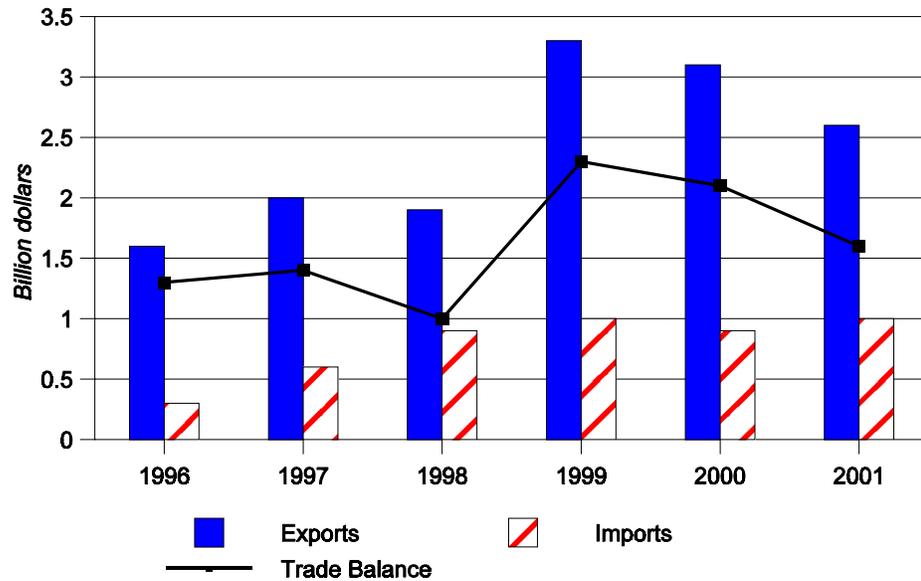
⁸ Ibid., p. 118.

⁹ Ibid.

¹⁰ Ibid., pp. 116, 118.

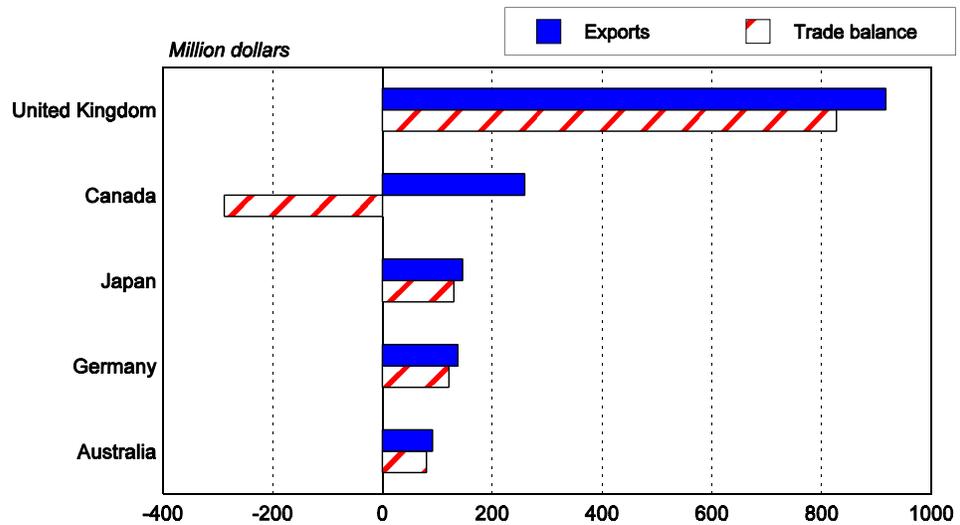
¹¹ Ibid.

Figure 6-1
Computer and data processing services: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure 6-2
Computer and data processing services: U.S. cross-border exports and trade balance, by major trading partners, 2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 118-119.

services in 2001, followed by India (\$122 million) and the United Kingdom (\$90 million).

Imports from India have risen sharply in recent years, increasing from \$2 million in 1996, to \$122 million in 2001, reflecting average annual growth of 128 percent during the period.¹² During the late 1990s, when the worldwide IT industry was expanding rapidly, global demand for computer and data processing services was strong enough to fuel employment growth in India, the United States, and other markets simultaneously. More recently, however, as the global IT industry has continued to contract, India has achieved a growing share of the global IT services industry, largely because of decisions by many firms in the United States and other higher wage countries to shift employment to India to reduce costs.¹³

Foreign Direct Investment and Affiliate Transactions

The U.S. direct investment position abroad in computer and data processing services totaled \$32.1 billion in 2001, an increase of 7 percent from 2000. This was significantly slower than the 25-percent average annual growth rate achieved during 1996-2000. The slowdown was partially the result of the collapse of many Internet companies in 2000, which sent worldwide IT stock prices and investment plummeting. By contrast, the foreign direct investment position in computer services in the United States totaled \$30.6 billion in 2001, an increase of 23 percent from 2000. Like U.S. outbound investment, inbound investment slowed in 2001, compared with the 83-percent average annual growth rate achieved during 1996-2000.¹⁴ Still, the increase is significant and may be partially explained by the widespread practice within the IT industry, particularly among the largest participants, of signing long-term service contracts. Consequently, although the IT industry broadly faltered in 2001, strong investment flows may have continued in order to provide the equipment necessary to meet contractual obligations assumed in more prosperous times.

Data for total sales of computer and data processing services by U.S.-owned affiliates in foreign markets were suppressed for the year 2000, but some regional data are available. Sales by affiliates in Europe, the largest regional market for affiliate sales, totaled \$23.1 billion in 2000, a 3-percent decrease from the previous year. Sales by affiliates in Japan totaled \$8.1 billion. U.S.-owned affiliates operating in Japan increased their sales of computer systems design and related services in 2000, partially because Japanese corporations expanded their outsourcing of information technology services.¹⁵ For example, IBM Japan's sales of outsourcing services doubled in fiscal 2000, compared to the previous year. In addition to conventional large-scale, full-scope outsourcing, which involves the operation and maintenance of mainframe systems, IBM Japan also saw an increase in e-business hosting services, such as the development and maintenance of e-business websites. Worldwide, IBM's

¹² USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 113-119; and Oct. 2000, pp. 154-155.

¹³ Pete Engardio, "Perilous Currents in the Offshore Shift," *Business Week*, Feb. 3, 2003, found at Internet address <http://www.businessweek.com>, retrieved Jan. 31, 2003.

¹⁴ USDOC, BEA, *Survey of Current Business*, Sept. 2002, Sept. 2001, Sept. 1999, various pages.

¹⁵ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 82.

web hosting business also experienced growth in 2001, while consulting and systems integration contracted as customers remained cautious about signing new contracts.¹⁶

In 2000, U.S. purchases from U.S.-based computer and data processing affiliates of foreign companies totaled \$4.5 billion,¹⁷ virtually unchanged from 1999, but up a total of 18 percent from 1997 (figure 6-3). Affiliates of Japanese, French, Canadian, and British parents were the leading suppliers in 2000, with sales in the United States totaling \$951 million, \$865 million, \$603 million, and \$498 million, respectively. These four countries accounted for 65 percent of total purchases from U.S.-based affiliates in 2000.

Competitive Environment

The United States is the world's largest market for computer and data processing services. As noted, the industry provides very diverse services, and while some of the major participants may offer similar services, they often work to differentiate themselves to increase value added and gain market share. In terms of revenues, the U.S. computer and data processing services market is highly concentrated. The current industry downturn has promoted consolidation as firms combine resources through mergers and acquisitions, or leave the market altogether. In 2001, the five largest firms combined earned twice the revenues of the next 20 combined.¹⁸ However, in terms of number of firms and employee distribution, the industry is highly fragmented. Overall, the average firm is relatively small and offers overlapping IT services. Approximately 80 percent of the industry's firms have fewer than 10 employees.¹⁹

Generally, the largest U.S. computer and data processing firms are also the largest worldwide. IBM Global Services is the world's largest IT services company, operating in more than 150 countries and deriving more than half of its revenues from sales outside the United States. The firm reported revenues of \$35.0 billion in 2001, an increase of 5 percent over 2000.²⁰ Electronic Data Systems is the second largest firm, both in the United States and the world. In 2001, EDS employed more than 140,000 workers in 60 countries and recorded revenues of \$21.5 billion, more than 40 percent of which came from outside the United States.²¹ However, the company reported less than expected revenues in 2002, citing, among other factors,

¹⁶ IBM Japan, *Service Businesses and Outsourcing in IBM*, found at Internet address <http://www-6.ibm.com/jp/provision/english/no30/forefront1-e.html>, retrieved Oct. 9, 2002.

¹⁷ This total is the sum of computer systems design and related services, and data processing services.

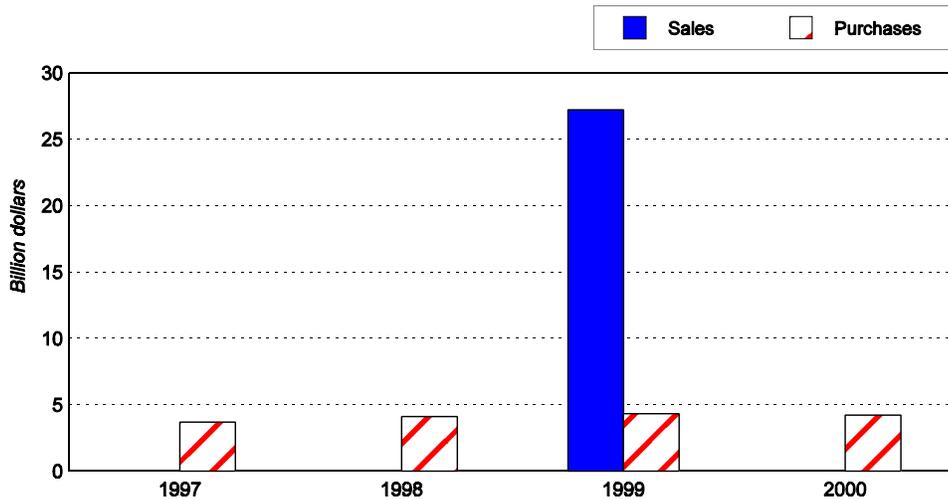
¹⁸ "Global 500 - Industry Snapshot," *Fortune*, found at Internet address <http://www.fortune.com>, retrieved Oct. 12, 2002.

¹⁹ Bureau of Labor Statistics, *Career Guide to Industries - Computer and Data Processing Services*, found at Internet address <http://www.bls.gov/>, retrieved Sept. 17, 2002.

²⁰ *IBM Annual Report 2001*, found at Internet address <http://www.ibm.com/annualreport/2001/>, retrieved Sept. 17, 2002.

²¹ EDS, found at Internet address <http://www.eds.com>, retrieved Sept. 17, 2002.

Figure 6-3
Computer and data processing services: Sales¹ by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



¹ 2000 sales data was suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 123-124; Nov. 2001, pp. 93-94; and Oct. 2000, p. 160.

the disappointing financial performance of some European contracts.²² EDS provides outsourcing services and a wide range of IT consulting services. Accenture, the former management consulting arm of Arthur Andersen, ranked third with revenues of \$13.3 billion. The firm provides consulting, implementation, and outsourcing services in 47 countries through alliances, affiliated companies, and other relationships.²³ Computer Sciences Corporation (CSC) had revenues of \$11.5 billion for the 12 months ended June 28, 2002, and employs more than 66,000 workers worldwide.²⁴ CSC provides a wide range of consulting, systems integration, and outsourcing services. The fifth largest computer and data services provider in the United States is Automatic Data Processing (ADP). ADP is one of the largest global providers of computerized transaction processing and data communication services, specializing in payroll, human resources, and benefits administration services. For fiscal 2001, ADP's revenues grew by 12 percent to \$7.0 billion.²⁵ In the global market, the French-U.S. firm, Cap Gemini Ernst & Young Group, nudged out ADP as the fifth largest firm. Cap Gemini operates worldwide and recorded revenues

²² EDS reported that the weakness would continue into 2003. EDS, press release, found at Internet address <http://www.eds.com>, retrieved Sept. 27, 2002.

²³ Accenture became an independent company in Aug. 2000, when lengthy arbitration proceedings with Arthur Andersen were finalized. Accenture, *About Accenture*, found at Internet address <http://www.accenture.com>, retrieved Oct. 9, 2002.

²⁴ CSC, *CSC at a Glance*, found at Internet address <http://www.csc.com>, retrieved Sept. 18, 2002.

²⁵ ADP, found at Internet address <http://www.adp.com>, retrieved Sept. 17, 2002.

of \$8.4 billion for the fiscal year ending in December 2001, up from \$6.9 billion in 2000.²⁶

While U.S. firms are the predominant service providers in Western Europe, the rank of leading providers generally changes from country to country, and includes a number of European firms. For example, in France, which has one of the largest IT services markets in Europe, more than 6,000 French firms specialize in software services.²⁷ The five largest software services firms in France are Cap Gemini Ernst & Young, IBM Global Services France, Atos Origin,²⁸ Accenture, and Altran.²⁹ Other competitors across Europe, in addition to the U.S. firms previously mentioned, include the French-based firms Bull Services,³⁰ Unilog, and Steria.³¹ Within the French market, these three firms have yearly revenues of less than \$1 billion each.

As noted, the global computer and data processing services industry has witnessed extensive consolidation recently. IBM purchased PricewaterhouseCoopers' (PwC) consulting and technology services unit in October 2002, for \$3.5 billion. Schlumberger, the Franco-American oil-services company, bought Anglo-French IT services firm Sema in February 2001, for \$5.3 billion.³² Sema had been Europe's second largest technology services company before the merger, but had experienced declining profitability. In August 2002, Atos Origin completed the purchase of KPMG Consulting's operations in the United Kingdom and the Netherlands. Atos Origin has annual revenues of \$3.5 billion, operates in more than 30 countries worldwide, and has over 30,000 employees.³³

The IBM-PwC transaction leaves a single major U.S. accounting firm, Deloitte Touche Tohmatsu, with a large consulting operation. Deloitte Consulting, a unit of

²⁶ Cap Gemini Ernst & Young, "2001 Audited Final Results," press release, Feb. 21, 2002, found at Internet address <http://www.cgey.com/news/2002/results2001-en.shtml>, retrieved Oct. 9, 2002.

²⁷ USDOC, International Trade Administration (ITA), *Market Research Briefs - Computers, Software, and Peripherals*, found at Internet address <http://www.buyusa.gov/>, retrieved Oct. 9, 2002.

²⁸ Atos Origin, *About Atos Origin*, found at Internet address <http://www.atosorigin.com>, retrieved Nov. 20, 2002.

²⁹ Altran reported revenues of \$1.3 billion for the year ending Dec. 31, 2001, an increase of 42 percent compared with the previous year. Altran, "Altran Technologies: Objectives for 2001 Surpassed," press release, Feb. 5, 2002, found at Internet address <http://www.altran-group.com/finance/releases/>, retrieved Nov. 20, 2002.

³⁰ Bull recorded revenues of \$2.5 billion for the financial year 2001, a decrease of 9 percent compared to the previous year. Bull, "BULL: 2001 Results and Future Development Plan," press release, Mar. 14, 2002, found at Internet address <http://www.bull.com/>, retrieved Nov. 20, 2002.

³¹ In early 2002, the Steria group acquired Bull's service businesses in the United Kingdom, Spain, Germany, Switzerland, Belgium, Luxembourg, Sweden, Norway, and Denmark. Steria, "Strong 2001 Revenue Growth," press release, Feb. 12 2002, found at Internet address http://www.steria.com/2002_v3/press/release.htm, retrieved Nov. 20, 2002.

³² *Networking News Review*, Vol. 8, Iss. 1, Apr. 2001, found at Internet address <http://www.eurolanresearch.com/news0401.htm>, retrieved Sept. 17, 2002.

³³ The acquisition was valued at approximately \$515 million. Atos KPMG Consulting, "Atos Origin 1st Half Results for 2002," press release, Sept. 11, 2002, found at Internet address <http://www.atoskpmgconsulting.co.uk/>, retrieved Nov. 20, 2002.

the global accounting firm, expects to complete a deal to become an independent firm, privately held by its partners, during 2003. Ernst & Young sold its consulting business to French IT company Cap Gemini in 2000, and KPMG spun off KPMG Consulting in 2001. Consulting firms owned by accounting firms are facing several challenges not encountered by other IT services providers. In July 2002, President Bush signed the Sarbanes-Oxley bill,³⁴ significantly limiting the ability of accounting firms to provide consulting services to companies for which they also perform external audits, forcing auditing companies to divest some of their IT-related consulting businesses.³⁵ Consulting firms formerly connected to accounting firms are also experiencing difficulties. In the wake of recent events such as the bankruptcy of Enron and the legal charges against its former auditor Arthur Andersen, many such consulting firms have lost clients due to lingering worries about potential conflicts of interest or liability.³⁶

Worldwide, computer and data processing firms are facing difficult market conditions including fewer customers, disappointing revenues, employee cutbacks, and a scarcity of capital. Existing clients have severely reduced spending, and new clients are scarce. In the past, contracts to expand computer hardware and systems frequently included additional consulting services; more recently, the scope of new contracts has narrowed. Outsourcing³⁷ and consulting services have been two of the more dynamic segments within the technology sector, but even these areas are slowing. Clients are taking longer to sign consulting contracts, and negotiating harder to reduce prices.³⁸ The global contraction of the IT industry has led to an oversupply of certain IT services, forcing many firms to reduce fees and compete on price. In response to a survey, approximately 75 percent of Europe's largest users of computer services reported that they were increasingly able to negotiate lower prices with their IT service providers.³⁹ By some estimates, European companies are paying 15-20 percent less for the same services compared to a year ago. Further, European computer firms are joining U.S. firms in shifting as much work as possible to lower-cost employment centers such as India and Eastern Europe.⁴⁰

The terrorist attacks of September 11, 2001, contributed to, but did not significantly accelerate, the IT industry's troubles. For a short time after the attacks, offshore service providers, particularly those in India, experienced a drop in new contract signings and other difficulties. However, such setbacks have largely subsided. Business has increased for several sectors in the wake of the attacks, including

³⁴ P.L. 107-204.

³⁵ Kathleen Day, "IBM to Pay \$3.5 Billion For PwC Consulting: Accounting Firm Lacked Funds for Unit," *The Washington Post*, July 31, 2002, p. E01.

³⁶ For further information on developments in the accounting industry, see Ch. 3 of this report. "Accounting Services."

³⁷ When faced with a poor economy, firms often outsource computer services to reduce costs; however, the current market downturn is so severe that many firms are eliminating the work altogether.

³⁸ Industry representative, telephone interview with USITC staff, Sept. 19, 2002.

³⁹ Kevin Delaney, "Technology Services Firms Fight to Survive as Business Tightens," *The Wall Street Journal*, Sept. 20, 2002, found at Internet address <http://online.wsj.com/>, retrieved Sept. 26, 2002.

⁴⁰ Ibid.

computer security, disaster recovery, and other services that seek to counter the effects of unforeseen business disruptions.⁴¹

WTO Update

WTO members submitted five negotiating proposals regarding computer and data processing services for the current round of negotiations: Canada, Costa Rica, the EU, India, and MERCOSUR.⁴² The proposals share numerous features, including expressions of concern over whether existing GATS commitments will be able to adequately accommodate the increasingly imprecise distinction between computer, information, telecommunication, audiovisual, and related services.⁴³ The EU proposes that WTO members should clearly define the scope and coverage of computer and related services and continually revise the scope to reflect advances in information technology.⁴⁴ Canada proposes that WTO members examine methodologies to more exactly define activities that might blur distinctions between computer and telecommunication services, and monitor how regulatory measures are applied in other sectors that can impact on computer and related services. Several proposals have a common interest in removing restrictions on national treatment and market access within the sector. Canada encourages members to improve their commitments for the temporary entry of information technology workers not linked to commercial presence.⁴⁵ India, also concerned with the paucity of full commitments on market access for natural (i.e., non-juridical) persons, believes that restrictions on the number of natural persons is one of the major barriers to the

⁴¹ Stacy Cowley, "Sept. 11 Keeps Disaster Recovery in Forefront," *IDG News Service*, Sept. 3, 2002, found at Internet address <http://www.computerworld.com/>, retrieved Oct. 9, 2002.

⁴² WTO, *Communication from Canada: Initial Negotiating Proposal on Computer and Related Services*, S/CSS/W/56, Mar. 14, 2001; WTO, *Communication from Costa Rica: Computer and Related Services*, S/CSS/W/129, Nov. 30, 2001; WTO, *Communication from the European Communities and Their Member States / GATS 2000: Computer and Related Services (CPC 84)*, S/CSS/W/34/Add.1, July 15, 2002; WTO, *Communication from India: Negotiating Proposal on Computer and Related Services*, S/CSS/W/141, Mar. 22, 2002; WTO, *Communication from Mercosur: Computer and Related Services*, S/CSS/W/95, July 9, 2001.

⁴³ United Nations Statistics Division - Classification Registry, Technical Subgroup on Classifications, found at Internet address <http://unstats.un.org/>, retrieved Oct. 9, 2002.

⁴⁴ The EC is seeking only to clarify, not re-classify computer and related services. WTO, *Communication from the European Communities and Their Member States / GATS 2000: Computer and Related Services (CPC 84)*.

⁴⁵ Commercial presence refers to the establishment of a physical presence in a host country such as a branch office. Commercial presence may or may not involve employees from the country establishing the presence, as the office may be staffed entirely by local personnel. Further, foreign suppliers of services are not always linked to a commercial presence. The foreign supplier may be an employee of a host-country firm, or may be providing services as an independent individual.

supply of services.⁴⁶ The members also believe that commitments in computer and related services should be extended to cover all the subcategories within the sector.⁴⁷

Of the 16 members that have joined the WTO since the Uruguay Round trade negotiations, Albania, Bulgaria, Croatia, Jordan, the Kyrgyz Republic, Lithuania, Panama, and Taiwan scheduled full commitments on computer and related services; China, Ecuador, and Moldova scheduled partial commitments. Georgia scheduled full commitments with the exception of maintenance and repair services of office equipment. Latvia scheduled full commitments with the exception of airline computer reservation systems. Oman scheduled full commitments, with commercial presence of wholly foreign-owned subsidiaries permitted as of January 2003. Estonia and Mongolia declined to schedule commitments on computer and related services.⁴⁸

⁴⁶ India expresses a general need for greater transparency, simplicity, and certainty in the visa regime. WTO, *Communication from India: Negotiating Proposal on Computer and Related Services*.

⁴⁷ The GATS Services Sectoral Classification List includes five categories, most of which are broken down into sub-categories, which are often further divided. For example, software implementation services includes the sub-categories: systems and software consulting services, systems analysis services, systems design services, programming services, and systems maintenance services.

⁴⁸ WTO, Accession: Technical Note, "Annex 4 - Sector Specific Commitments," found at Internet address <http://www.wto.org>, retrieved Mar. 2, 2003.

CHAPTER 7

EQUIPMENT LEASING SERVICES

Introduction

The equipment leasing services industry includes the leasing of movable equipment such as industrial machinery, computers, aircraft, automobiles, transportation equipment without operators,¹ telecommunication or medical equipment, and ships. Unless otherwise noted, the leasing industry data presented in this chapter comprise commercial equipment leasing services, but exclude real estate leases,² lease contracts involving personal consumers, and automobile leasing. Cross-border trade in leasing services occurs when a lessor and lessee are based in different countries, and they structure a lease that transfers equipment across international borders. The contract under which the asset is sold to the lessor, which occurs before the lease begins, falls under the national laws of the lessor's country, whereas the leasing contract falls under the jurisdiction of both countries.³ Affiliate trade in leasing services occurs when a leasing firm establishes an office in a foreign country, and provides leasing services to local residents.⁴

Trade and Investment Trends

Cross-Border Trade

U.S. cross-border exports of operational leasing services totaled \$2.8 billion in 2001, down 5 percent from the previous year (figure 7-1), as the industry dealt with the effects of the general slowdown in business investment and the uncertainty over the

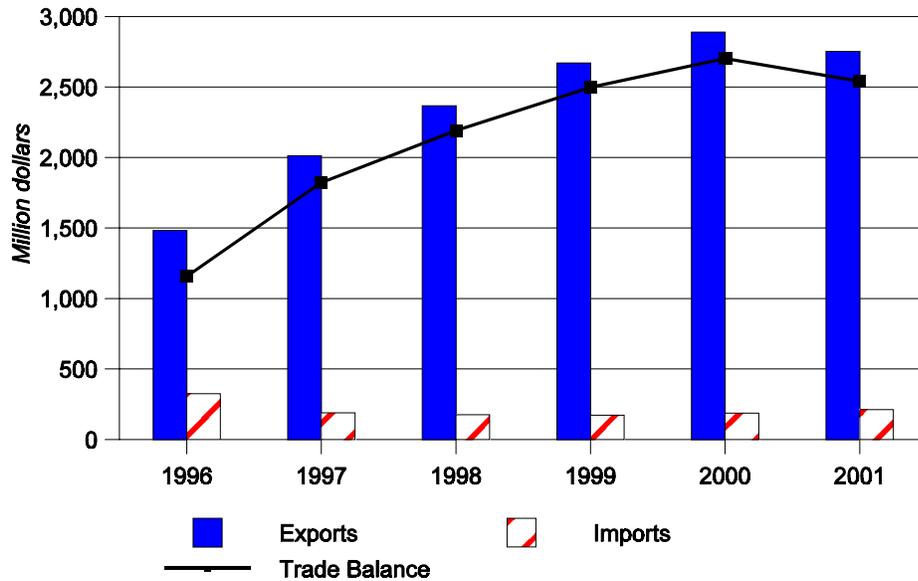
¹ Transportation equipment with operators is classified under "transportation services."

² Real estate leasing pertains to the leasing of property that is defined as immovable, such as buildings, houses, office space, warehouses, and farmland.

³ Official trade data on cross-border trade in equipment leasing services only cover operational leases. The data exclude capital (or finance) leases, which are defined as leases under which the lessee has the option to take title of the leased asset at the end of the lease term. Financial flows related to cross-border capital leases are recorded separately from the services trade data, as part of BEA's International Transactions Accounts, except for fees that a firm collects for arranging or entering into a financial lease contract. These fees are separate from the actual lease payments, and are included as part of cross-border trade in financial services, but a breakout of such fees related specifically to leasing services is not available. USDOC, BEA, email communication with USITC staff, Oct. 23, 2002.

⁴ Official data on sales of leasing services by foreign affiliates exclude commercial bank lessors (both bank affiliates and bank parents), because commercial banks (depository institutions) are not required to report affiliate trade data to the BEA. These data include automobile leases.

Figure 7-1
Operational leasing services: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

future of the foreign sales corporation (FSC) tax regime.⁵ The slowdown in new investment was particularly evident in two important categories of leased equipment: computer hardware sales declined by 17 percent, and sales of telecommunications equipment declined by 20 percent in 2001.⁶ By contrast, exports increased at an average rate of 18 percent per annum during 1996-2000,⁷ as business investment rose during the latter half of the 1990s, particularly in the information processing and software segment. According to industry estimates, leased assets account for approximately one-third of external financing of total capital investment in the United States.⁸ Cross-border imports of operational leasing services were \$212 million in 2001, an increase of 13 percent over 2000, after declining at an average annual rate of 13 percent during 1996-2000. In 2001, the United States recorded a cross-border trade surplus of \$2.5 billion in operational leasing services.⁹ Beyond U.S. exports and imports among unaffiliated firms, U.S. multinational corporations

⁵ Further details on the FSC tax regime are presented later in this chapter. See also Laura S. Bloodgood, "International Trade in Commercial Equipment Leasing Services," *International Trade and Technology Review*, USITC Publication No. 3562, Oct. 2002.

⁶ "State of the Industry Report 2002," Equipment Leasing and Finance Foundation, p. 10, found at Internet address <http://www.elaonline.com/>, retrieved Oct. 23, 2002.

⁷ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 84-85.

⁸ Financial Institutions Consulting, Inc., estimates that 2002 investment in business equipment will total close to \$655 billion, of which \$204 billion is expected to be financed through leasing. "State of the Industry Report 2002," Equipment Leasing Association of America, pp. 7 and 9.

⁹ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 84-85.

recorded \$1.8 billion in exports of intrafirm leasing services in 2001, and \$1.0 billion in intrafirm leasing services imports.¹⁰

Foreign Direct Investment and Affiliate Transactions

U.S. direct investment abroad in equipment leasing services totaled \$5.2 billion in 2001, slightly less than the \$5.3 billion in foreign direct investment position in the United States. The outbound U.S. investment position increased steadily during 1996-2000, at an average annual rate of 15 percent, compared to 2001 growth of 25 percent.¹¹ The inbound direct investment position increased at an average annual rate of 53 percent during 1996-2000, although it fell to \$169 million in 1997 before rebounding. The decrease in 1997 may be linked to the effects of the Asian financial crisis.¹²

In 1999 and 2000, data were suppressed for total sales by rental and leasing affiliates of U.S. multinational companies overseas, to avoid disclosing data of individual companies in Asia. However, data are available for several major leasing markets. U.S.-owned affiliates recorded total sales of \$7.0 billion in Europe, primarily in the United Kingdom, France, the Netherlands, and Germany, where U.S.-owned affiliates recorded sales of \$2.5 billion, \$1.2 billion, \$822 million, and \$555 million, respectively. Sales to Canada were valued at \$1.5 billion in 2000, with sales to Japan measuring \$420 million. U.S. purchases from foreign-owned leasing affiliates in the United States totaled \$3.9 billion in 2000 (figure 7-2), with the largest purchases accounted for by affiliates with parent firms in the United Kingdom (\$1.0 billion), Japan (\$371 million), and Australia (\$346 million). U.S. purchases increased by 5 percent in 2000, compared to average annual increases of 37 percent during 1997-99.¹³

Competitive Environment

Equipment leasing services companies primarily comprise four types of lessors. Bank lessors are commercial banks that offer both direct financing of equipment purchases (loans) and financial leasing services. Industrial affiliates are leasing subsidiaries of larger firms which finance a broad assortment of products. Captive lessors, also known as vendors, are leasing subsidiaries of equipment manufacturers which exist to finance sales of their parent company's products,¹⁴ such as IBM Global Financing, Caterpillar Financial, John Deere Credit, and Boeing Capital. Independent lessors have no parent company with majority interest. In 2001, bank affiliates held the largest share of leasing assets in the United States with 32 percent

¹⁰ Ibid., p. 75.

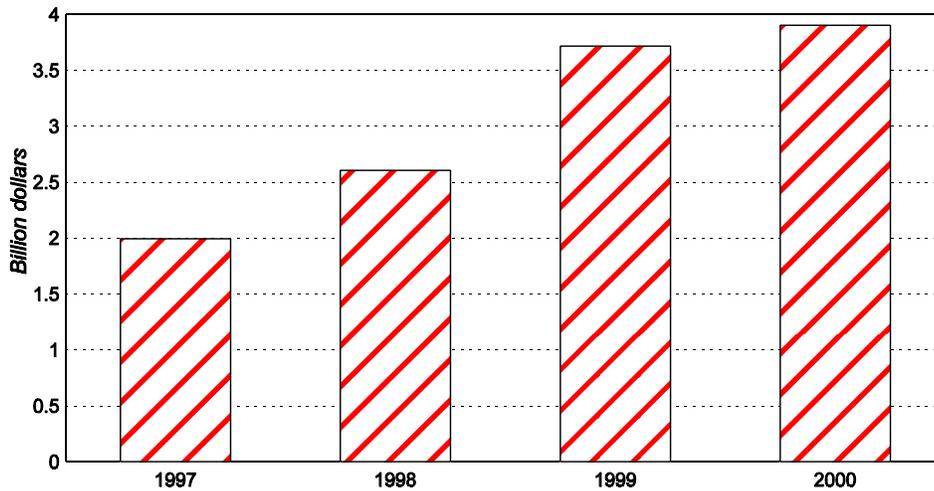
¹¹ USDOC, BEA, *Survey of Current Business*, Sept. 2002, p. 96; and Sept. 2001, p. 109.

¹² USDOC, BEA, *Survey of Current Business*, Sept. 2002, p. 66; and Sept. 2000, p. 59.

¹³ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 121-124.

¹⁴ Captive lessors usually hold 50 percent of their assets in products their parent company produces.

Figure 7-2
Rental and leasing services: U.S. purchases from foreign majority-owned affiliates, 1997-2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

of the market, followed by industrial affiliates with 27 percent and captives with 23 percent.¹⁵

The top 100 U.S. leasing companies accounted for \$482.5 billion in net leasing assets in 2001. This represented an increase of 1 percent over the previous year, marking significantly slower growth than the average annual increases of 17 percent during 1995-2000. As noted in the trade data discussion above, the slowdown corresponded with the broader downturn of the U.S. economy in 2001,¹⁶ which caused many firms to cancel or postpone plans for investment in new equipment.¹⁷ The top ten U.S. equipment leasing firms accounted for \$299.4 billion, or 62 percent of all leasing assets held in the United States.¹⁸ In the United States, transportation equipment accounts for the largest share of leased assets (35 percent), followed by computer hardware and software, construction, and industrial and manufacturing equipment.¹⁹ By comparison, computer equipment accounts for the largest share of total leasing volume in Japan (33 percent), followed by industrial equipment (13 percent).²⁰ In

¹⁵ For the purposes of this report, the U.S. leasing market is defined as the top 100 U.S. equipment leasing companies, ranked by net assets, as reported by *Monitor Leasing & Financial Services*. "Monitor 100," *Monitor Leasing and Financial Services*, June 2002.

¹⁶ The U.S. GDP increased by 2.6 percent in 2001, following average annual growth of 5.4 percent during 1990-2000. Compiled by the Commission, from data found in IMF, *International Financial Statistics Yearbook 2002* (Washington, DC: International Monetary Fund, 2002), p. 1041.

¹⁷ "Monitor 100," *Monitor Leasing and Financial Services*, June 2002.

¹⁸ *Ibid.*

¹⁹ *World Leasing Yearbook 2002*, p. 447.

²⁰ Data for 2001. Japan Leasing Association, "Market Review," found at Internet address <http://www.leasing.or.jp/>, retrieved Oct. 4, 2002.

Europe, passenger cars account for the largest share of leased equipment (32 percent), followed by industrial equipment (26 percent).²¹

By far the largest equipment leasing company in the United States, and the world, is GE Capital, an affiliate of U.S.-based multinational General Electric. GE Capital reported net assets of \$110.2 billion in 2001, equal to almost one-fourth of the total assets of the industry's top one hundred leasing companies (table 7-1).²² GE Capital also ranked first in terms of foreign activity, with new foreign business volume of \$23.6 billion in 2001. CitiCapital, the largest bank lessor, ranked number two in the United States, with \$41.4 billion in net assets and \$4.0 billion in new foreign business volume during 2001. The largest independent lessors were CIT Group Inc.,²³ with \$30.2 billion in net assets, and GATX Financial, with \$10.6 billion in net assets.²⁴ The largest reported European leasing firms in 1999 (latest available) were KG Allgemeine Leasing, a German bank subsidiary with reported assets of \$27.6 billion, and BNP Lease Group, a subsidiary of France-based BNP bank, with 1999 assets of \$10.5 billion. The top ten European leasing firms reported \$75.1 billion in leased assets, accounting for 56 percent of the total of all reporting companies.²⁵

Globally, the United States is by far the world's largest leasing market, with \$260.0 billion in new leasing volume during 2000 (latest available), compared with Japan, which ranked second at \$69.6 billion (table 7-2). The top ranking of the U.S. leasing market is attributable to two factors: the size of the U.S. economy and the high penetration rate of leasing services as a method of financing the acquisition of new commercial equipment. In the United States, 32 percent of new equipment purchases were financed through leases in 2000, compared to 9 percent in Japan. Other large leasing markets include Germany, the United Kingdom, France, and Italy, with 2000 leasing volumes of \$32.3 billion, \$19.1 billion, \$18.9 billion, and \$16.1 billion, respectively.²⁶

²¹ Data for 2000. Leaseurope, "Global Leasing Market Figures," found at Internet address <http://www.leaseurope.org/>, retrieved Oct. 3, 2002.

²² In July 2002, General Electric reorganized GE Capital, its financial services business, into four separate GE divisions of the company: GE Commercial Finance, GE Insurance, GE Consumer Finance, and GE Equipment Management. The bulk of GE Capital's leasing assets will become part of GE Commercial Finance, which will control the aviation services, commercial equipment financing, commercial finance, and structured finance functions. "GE Announces Reorganization of Financial Services," company press release, July 26, 2002, found at Internet address http://www.ge.com/company/breakingnews/news_release.htm, retrieved Sept. 10, 2002.

²³ CIT was acquired by Tyco International Ltd., a manufacturing and services conglomerate based in Bermuda, in June 2001. "Tyco International Ltd. Acquires The CIT Group, Inc.," company press release, June 1, 2001, found at <http://www.cit.com/>, retrieved Oct. 3, 2002.

²⁴ GATX ranked eleventh on the Top 100 list. "Monitor 100," *Monitor Leasing and Financial Services*, June 2002.

²⁵ This survey relies on data submitted by national leasing associations to Leaseurope, the European leasing industry trade association. The British leasing association, which represents a large market, did not submit data to this survey, which is consequently incomplete. Data reported by Leaseurope in Euros, converted to U.S. dollars at the Federal Reserve rate as of Jan. 3, 2000. (\$1 = €1.0653).

²⁶ *World Leasing Yearbook 2002*, p. 3.

Table 7-1
Top ten U.S. lessors, 2001

Firm	Net assets	Asset growth rate (2000-2001)	New business volume	New foreign business volume	Type of lessor
GE Capital	110.2	19.3	55.0	23.6	Industrial affiliate
CitiCapital	41.4	7.6	15.9	4.0	Bank affiliate
CIT Group (Tyco)	30.2	-18.9	15.2	0.9	Industrial affiliate
IBM Global Financing	26.4	-8.0	16.5	(¹)	Captive
International Lease Finance ..	21.1	17.4	4.1	(¹)	Other
Fleet Capital	15.9	11.3	5.3	0.5	Bank
Caterpillar Financial	15.3	-4.6	6.8	2.9	Captive
Banc of America	13.9	-4.6	2.7	1.0	Bank
Wachovia Leasing	13.7	25.0	1.9	1.3	Bank
John Deere Credit	11.3	4.3	8.3	1.7	Captive
Total (top 10)	299.4	² 7.0	131.7	35.9	(¹)
Total (top 100)	482.5	² 7.2	198.9	³ 47.9	(¹)

¹ Not applicable.

² Average growth.

³ Only 36 of the Monitor 100 companies reported new foreign business volume data in response to the survey.

Source: Monitor Leasing and Financial Services, June 2002.

Table 7-2
Top ten global leasing markets, 2000

Rank	Country	Annual leasing volume	Growth in leasing volume, 1999-2000	Market penetration ¹
1	United States	260.0	11.1	31.7
2	Japan	69.6	7.3	9.1
3	Germany	32.3	1.1	14.8
4	United Kingdom	19.1	-4	13.8
5	France	18.9	9.9	9.2
6	Italy	16.1	19.1	12.3
7	Canada	11.1	4.3	22.5
8	Spain	7.6	4.3	5.1
9	Brazil	5.3	0	11.4
10	Sweden	5.1	20.1	12.9

¹ Share of new equipment purchases financed through leases.

Source: *World Leasing Yearbook 2002*.

The International Finance Corporation (IFC), an affiliate of the World Bank, has been active in promoting the global leasing industry outside of these major markets, in an effort to widen financing opportunities for private sector firms in developing countries. Between 1977 and 2001, the IFC approved investments of \$969.4 million in 96 equipment leasing companies in 50 countries. In 25 countries, IFC investment was directed toward the country's first commercial equipment leasing company. The IFC has also mobilized an additional \$445 million in external source financing for its leasing company investments.²⁷

As noted above, the most important influence on the prosperity of the leasing industry is the overall state of the economy. The demand for equipment leasing services is a reflection of the demand for new business equipment across the economy. Thus, the recent economic downturn and declines in stock market values have ushered in difficult times for the leasing industry. In particular, industry representatives have pointed to overcapacity in the construction, telecommunications, and computer/internet industries, and economic problems in the airline industry. Until demand for equipment in those areas recovers, it is unlikely that leasing firms will prosper.²⁸ As a reflection of the difficult economic situation, nine major U.S. leasing companies declared bankruptcy in 2000, 13 announced that they were for sale, and an additional 46 were acquired by competitors.²⁹ Twelve additional leasing companies on the Monitor 100 list either declared bankruptcy, were acquired by, or merged with competitors during 2001.³⁰ Industry representatives predict that consolidation will continue, as leasing firms seek ways to remain profitable in a slow economy.³¹

Another issue that impacts the cross-border leasing industry is the dispute over foreign sales corporations (FSCs). An FSC is a foreign corporation, generally a subsidiary of a U.S. parent, that is exempt from U.S. tax on those portions of its income derived from sales and leases of goods produced in the United States and exported to foreign countries. By leasing equipment to foreign firms through an FSC, rather than directly from the U.S. parent, leasing companies have been able to reduce their U.S. income taxes on foreign profits by an effective rate of 15-30 percent.³² The use of FSCs increased rapidly during the 1990s as their tax benefits

²⁷ Ibid., p. 37.

²⁸ "2002 Industry Future Council Report: More Juice for the Squeeze," Equipment Leasing and Finance Foundation, pp. 4-5, found at Internet address <http://www.elaonline.com/>, retrieved Oct. 23, 2002.

²⁹ "Monitor 100," Monitor Leasing and Financial Services, June 2001, pp. 4-6.

³⁰ "Monitor 100," Monitor Leasing and Financial Services, June 2002, p. 6.

³¹ Industry representatives, telephone interviews with USITC staff, Oct. 18-24, 2002.

³² Joint Committee on Taxation, "Overview of Present-Law Foreign Sales Corporation Rules," *Description of H.R. ___ (The "FSC Repeal and Extraterritorial Income Exclusion Act of 2000")* (JCX-87-00), July 27, 2000; and H. Franklin Bloomer, Jr., "Cross-Border Equipment Leasing," presented at American Bar Association National Institute conference, "Negotiating and Structuring International Commercial Transactions," June 10-11, 1999, Washington, DC, found at Internet address <http://www.morganlewis.com/spc71399.htm>, retrieved Oct. 15, 2002.

became well known. In 1999, the WTO estimated that FSCs generated total tax benefits for all U.S. industries in the range of \$1.2 billion to \$1.5 billion annually.³³

In October 1999, in response to a complaint from the European Union, a WTO Dispute Settlement Panel ruled that FSCs created a subsidy to U.S. firms that was contingent upon export performance, in contradiction of the United States' WTO obligations.³⁴ The WTO finding recommended that the United States abolish the use of FSCs by October 1, 2000. In response to the ruling, the United States replaced the FSC system with an extraterritorial income (ETI) regime that offered a 15-30 percent tax exclusion from U.S. taxes for income received from qualifying transactions, including certain cross-border equipment leasing transactions.³⁵ In January 2002, the WTO ruled on appeal that the ETI regime also constituted an illegal export subsidy, and subsequently found that the European Union was entitled to impose retaliatory duties on U.S. products.³⁶ In August 2002, a WTO panel of trade arbitrators determined that the EU was entitled to \$4.0 billion in retaliatory sanctions. As of April 2003, the European Union had not imposed trade sanctions, in the expectation that the U.S. Government would change its tax laws to conform to WTO rules without retaliatory measures being enacted.³⁷

Tax treatment has always been one of the primary reasons to lease rather than purchase new equipment. According to an industry source, by casting doubt on the future tax treatment of cross-border leasing contracts, the WTO rulings regarding FSCs and the ETI tax regime have already contributed to a downturn in the cross-border leasing industry. The cost and complexity of arranging cross-border contracts have increased significantly, and the number of new leasing opportunities has dwindled. A significant share of new cross-border leasing business has largely been placed on hold, awaiting the final U.S. tax rules regarding the FSC/ETI tax regime.³⁸ The terrorist attacks of September 11, 2001, have also had an important, indirect negative impact on the U.S. equipment leasing industry, largely related to the impact

³³ WTO Report, "United States: Tax Treatment for Foreign Sales Corporations," WT/DS/108/R (99-4118), Oct. 8, 1999, found at Internet address <http://www.wto.org>, retrieved May 13, 2002; and "New Rules for Taxing Extraterritorial Income," *The Tax Adviser*, May 2002, found at Internet address <http://www.proquest.umi.com/>, retrieved Sept. 17, 2002.

³⁴ Specifically, the WTO ruled that FSCs were in direct violation of Articles 3.1(a), 3.2, and 4 of the Agreement on Subsidies and Countervailing measures and Articles 3.3, 8, and 10.1 of the Agreement on Agriculture. WTO Report, "United States: Tax Treatment for Foreign Sales Corporations" WT/DS/108/R.

³⁵ Foreign leasing firms are eligible for the tax deduction if they waive U.S. treaty benefits and elect to be treated as a domestic corporation. "FSC Repeal and Extraterritorial Income Exclusion Act of 2000." Public Law 106-519. 106th Congress. Pg. 114, STAT 2423 (DOCID: f:pub1519.106), November 15, 2000.

³⁶ WTO Report, "United States – Tax Treatment for "Foreign Sales Corporations": Recourse to Article 21.5 of the DSU by the European Communities," WT/DS108/AB/RW, Jan. 14, 2002.

³⁷ WTO, "United States - Tax Treatment for "Foreign Sales Corporations": Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement," WT/DS108/ARB, Aug. 30, 2002; and "W.T.O. Allows Europe to Impose Record Sanctions Against U.S.," *The New York Times*, Aug. 30, 2002, found at Internet address <http://www.nytimes.com/>, retrieved Aug. 30, 2002.

³⁸ Industry representative, telephone interview with USITC staff, Oct. 18, 2002.

of those events on the overall economy. As noted above, the general economic slowdown of the past several years, which was exacerbated by the attacks, has been difficult for the leasing industry. In particular, the precarious economic state of the airline industry has effectively shut down the aircraft leasing business until the industry recovers. Aircraft leasing represented 26.2 percent of new business volume in the large-ticket segment of the leasing industry in 2001.³⁹ The terrorist attacks, however, may also hold a positive element for the industry. Increased investment in security technologies, defense spending, and business continuity (disaster recovery) planning may offset some industry losses from declines in aircraft and other large-ticket leasing segments.⁴⁰

³⁹ “State of the Industry Report 2002,” Equipment Leasing and Finance Foundation, p. 15.

⁴⁰ Ibid.

CHAPTER 8

FRANCHISING SERVICES

Introduction

Franchising is a method of selling products or services through an agreement under which a franchisee purchases the right to use a business format designed by, or sell certain products or services trademarked by, a franchisor. A franchisee generally pays a fee and/or royalty to the franchisor for these rights. In the case of trademark franchising, a franchisee can purchase the right to use a franchisor's trademark name in exchange for royalties and an obligation for product sales exclusivity. Business format franchising is characterized by an ongoing business relationship between franchisor and franchisee that includes not only the product, service, and trademark, but the entire business format itself. This may include a marketing strategy and plan, operating manuals and standards, quality control, and advertising. This discussion will focus on business format franchising, addressing trademark franchising only where it is a part of the business format franchise. Cross-border exports and imports of franchising services entail the purchase of business format franchising rights in exchange for payment of royalties and license fees. Official trade data do not capture affiliate sales of franchising services. Sales by affiliates of overseas franchises are classified by the industry of the product sold.

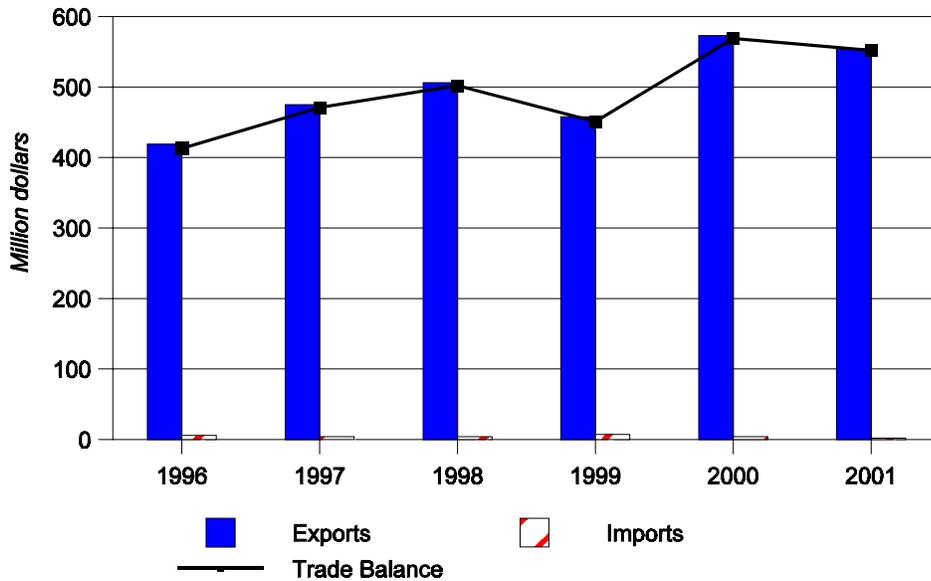
Trade and Investment Trends

Cross-Border Trade

In 2001, U.S. cross-border exports of franchising services totaled \$554 million, and imports totaled \$2 million, resulting in a trade surplus of \$552 million (figure 8-1). U.S. exports decreased by 3 percent in 2001, in contrast to the average annual growth rate of 8 percent noted during 1996-2000. Canada was the largest market for these services in 2001, accounting for \$68 million in exports. The United Kingdom was the second largest market, accounting for \$53 million in exports, followed by Germany with \$28 million, Korea with \$21 million, and Mexico with \$20 million (figure 8-2).¹ In 2001, exports to Mexico, the United Kingdom, and Germany declined by 17 percent, 10 percent, and 7 percent, respectively, accounting for a

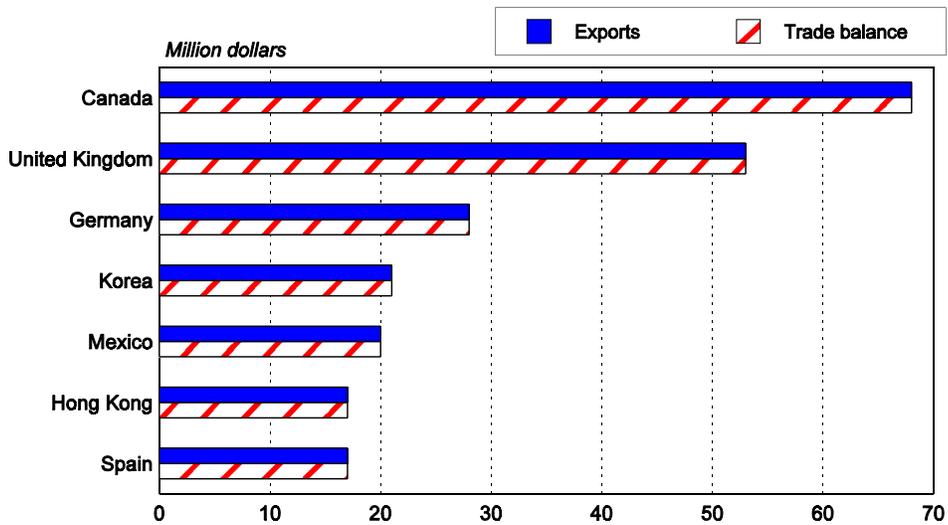
¹ Japan was the third largest export market in 1999, but data were suppressed in 2000 and 2001.

Figure 8-1
Franchising services: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure 8-2
Franchising services: U.S. cross-border exports and trade balance, by major trading partners, 2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 98-99.

large portion of the overall decline in exports.² In Mexico, slow economic growth³ and strong competition from Mexico-based franchisors explain the decline.⁴

U.S. cross-border imports of franchising services decreased by 50 percent in 2001, a much sharper decline than the average annual decrease of 10 percent during 1996-2000. Slow economic growth, coupled with the maturity of the U.S. franchising market, underlies declining exports. Europe accounted for substantially all U.S. imports in 2001.

Foreign Direct Investment

The U.S. direct investment position abroad in business format franchising services totaled \$572 million in 2001, a decrease of 16 percent from 2000.⁵ This decline was faster than the average annual decline of 3 percent noted during 1996-2000, and likely reflected the increasing maturity of certain foreign markets and increased competition from local and other foreign firms. The decline mirrored the downward trend in cross-border exports observed in major markets for U.S. franchising services, such as Mexico. Foreign direct investment in the U.S. business franchising services market is much smaller. In 2001, in fact, such investment was recorded at -\$30 million.⁶

Competitive Environment

The market for franchising in the United States is fragmented. Many different types of businesses are franchised, from fast-food restaurants like McDonald's and Subway, to business services like The UPS Store⁷ and Jackson-Hewitt Tax Service, and franchises in different business segments do not typically compete with one another. For example, a fast-food restaurant competes on price, convenience, and service, while a business service provider such as The UPS Store, competes on convenience, and the number of postal and communication services it provides. Although the limitations of official data preclude more detailed analysis of the

² U.S. Department of Commerce (USDOC), Bureau of Economic Analysis (BEA), *Survey of Current Business*, Oct. 2002, pp. 92-99; Nov. 2001, p. 72; and Oct. 2000, p. 138.

³ Mexico reported GDP growth of 4 percent in 1999, and 7 percent in 2000, but a decline of 0.3 percent in 2001. World Bank, online database, found at Internet address <http://devdata.worldbank.org/data-query/>, retrieved Feb. 3, 2003.

⁴ USDOC, International Trade Administration (ITA), Industry Sector Analysis, "Franchising Market: Mexico," June 20, 2002, found at Internet address <http://www.stat-usa.gov>, retrieved Jan. 7, 2003.

⁵ USDOC, BEA, *Survey of Current Business*, Sept. 2002, p. 96.

⁶ Direct investment position is negative when the value of loans or dividend payments made by U.S. affiliates to their foreign parents exceeds the value of the parents' equity holdings in their affiliates plus the value of loans and dividend payments made by foreign parents to their affiliates.

⁷ UPS purchased Mail Boxes Etc. in 2001. In April 2003, over 3,000 Mail Boxes Etc. franchisees began re-branding their stores to The UPS Store. International franchises will remain Mail Boxes Etc. "The UPS Store Debuts More Than 3,00 Strong," Apr. 7, 2003, MBE News and Updates, found at Internet address <http://www.mbe.com>, retrieved May 6, 2003.

franchising market in the United States, the International Franchise Association estimates that business format franchising accounts for 27 percent of total franchising sales, and 68 percent of all franchised businesses.⁸ Food service franchises (fast food, bakeries, restaurants, and food retailers) make up 34 percent of total franchised businesses, followed by retail franchises with 11 percent, service franchises with 9 percent, automobile franchises with 8 percent, maintenance with 7 percent, and business services and lodging with 5 percent each.⁹

In the United States, the franchising industry is regulated at the national level by the Federal Trade Commission (FTC), under the *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*.¹⁰ This franchising rule requires franchisors to provide franchisees with information in writing about the franchisor, the business, and the franchise relationship, giving potential franchisees the necessary information to weigh the risks and benefits of a particular investment. Franchisees must be given 10 days to review the disclosure before investing.¹¹ The franchising rule is enforced by the FTC, and violators face injunctions and other civil penalties. Additionally, several U.S. States¹² have franchise laws that require franchisors to provide pre-sale disclosures, or "offering circulars," to potential franchisees. Of these states, only Michigan and Oregon do not require franchisors to file an offering circular in advance of a franchise sale.¹³

The global spread of franchising has resulted in the development of similar regulations in other markets. In France, for instance, the Doubin Law (1989) and its application decree (1991) protect the interests of commercial networks in general, as well as the interests of the franchisor, the network and potential franchisees. Additionally, Decree No. 89-1003, similar to the U.S. franchise rule, requires franchisors to provide franchisees with operational information 20 days prior to signing a contract.¹⁴ In Indonesia, Government Regulation No. 16 (1997) regulates the franchising industry, describing the relationship between the franchise, franchisor, and franchisee. In addition to requiring franchise agreements to be written in Indonesian and subject to Indonesian laws, GR 16 also requires every franchisee to register and obtain a registration certificate and requires priority use of

⁸ The remainder of total franchising sales consists of product and trademark franchising. International Franchise Association (IFA), "Franchise FAQ," found at Internet address <http://www.franchise.org>, retrieved Oct. 18, 2002.

⁹ Retail franchises are categorized as beauty-related retail, computer products and services retail, clothing and accessories retail, party-related products and services retail, pet-related goods and services retail, photographic products and services retail, video retail, and other retail franchises. Service franchises are categorized as health and fitness, publications, security-related, and other service franchises. "The Profile of Franchising, Volume III: A Statistical Abstract of 1998 UFOC Data," found at Internet address <http://www.franchise.org>, retrieved Oct. 2, 2002.

¹⁰ 16 C.F.R. Part 436, or the FTC "Franchising Rule," entered into effect on Oct. 21, 1979.

¹¹ Federal Trade Commission (FTC), "Guide to the FTC Franchise Rule," found at Internet address <http://www.ftc.gov>, retrieved Oct. 10, 2002.

¹² California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

¹³ Federal Trade Commission (FTC), "State Offices Administering Franchise Disclosure Laws," found at Internet address <http://www.ftc.gov>, retrieved Oct. 10, 2002.

¹⁴ USDOC, ITA, Industry Sector Analysis, "Franchising: France," Sept. 12, 2002, found at Internet address <http://www.stat-usa.gov>, retrieved Jan. 7, 2003.

domestic goods. In an effort to protect small- and medium-sized establishments located outside the Indonesian capital, government policies promote franchising in areas designated as provincial capitals. In Mexico, Article 142 of the Industrial Property Law and Article 65 of its regulations govern franchising. The Law for the Promotion and Protection of Industrial Property contains disclosure requirements similar to the U.S. Uniform Offering Circular.¹⁵

In terms of system size, U.S. franchising firms are among the largest worldwide, as eight of the top ten largest franchise firms are U.S.-owned (table 8-1). In France, 35 percent of all foreign franchises are U.S. firms.¹⁶ In Indonesia, foreign franchisors dominate the market. There are currently 274 foreign franchisors in Indonesia, of which 232 are foreign. One hundred twenty-eight of these are U.S. firms. Indonesia's franchising market grew from 35 franchisors (29 foreign and 6 local) in 1991 to 253 (230 foreign and 23 local) in 1997 as a result of urbanization and an increase in the size of the middle class. As a result of the economic downturn in the wake of the Asian financial crisis in 1997-98, approximately 500 outlets were closed.¹⁷ Mexico is a mature franchising market with strong domestic growth in franchise concepts. In fact, Mexican franchisors are exporting their domestic franchise concepts, such as Pollo Loco, to the United States, the Philippines and Malaysia.¹⁸ Mexican franchisors represent 64 percent of total franchise sales in Mexico, followed by the United States with 28 percent, Spain with 3 percent, and Canada with 2 percent.¹⁹

The success of U.S. franchisors in foreign markets can be credited to domestic experience in franchise development, quality services and products, and good prices. Many foreign consumers find U.S. products appealing and U.S. franchisors benefit from strong name recognition. Additionally, demand for food, retail, and services franchises is growing in many markets. However, U.S. firms also face obstacles abroad, such as the difficulty of finding financially sound franchisees, and a lack of understanding regarding the franchising business concept.²⁰ In certain markets, such as Mexico, foreign franchises are at a competitive disadvantage since the initial

¹⁵ USDOC, ITA, Industry Sector Analysis, "Franchising Market: Mexico," June 20, 2002.

¹⁶ USDOC, ITA, Industry Sector Analysis, "Franchising: France," Sept. 12, 2002, found at Internet address <http://www.stat-usa.gov>, retrieved Jan. 7, 2003.

¹⁷ USDOC, ITA, Industry Sector Analysis, "Franchising: Indonesia," Aug. 5, 2002, found at Internet address <http://www.stat-usa.gov>, retrieved Jan. 7, 2003.

¹⁸ El Pollo Loco was acquired by Denny's in 1983, which was acquired in turn by TW Services, Inc. (now known as Advantica Restaurant Group, Inc.) in 1987. El Pollo Loco company website, found at Internet address <http://www.elpolloloco.com>, retrieved Feb. 5, 2003.

¹⁹ USDOC, ITA, Industry Sector Analysis, "Franchising Market: Mexico," June 20, 2002.

²⁰ USDOC, ITA, Industry Sector Analysis, "Franchising: France," Sept. 12, 2002; and USDOC, ITA, Industry Sector Analysis, "Franchising: Indonesia," Aug. 5, 2002.

Table 8-1
Top global franchise chains, by number of locations, 2002¹

Chain	Country	Industry	Number of locations ₂
Kumon Math and Reading . . .	Japan	Education	22,043
McDonald's	United States	Fast food	21,958
7-Eleven	Japan	Convenience store	19,992
Subway	United States	Fast food	17,708
Burger King	United States	Fast food	10,425
Jani-King	United States	Janitorial services	9,564
KFC ³	United States	Fast food	9,166
Century 21	United States	Real estate	6,317
Dairy Queen	United States	Fast food	5,739
Dunkin Donuts	United States	Fast food	5,537
Jazzercise	United States	Fitness services	5,456
Taco Bell ³	United States	Fast food	5,348
Yogen Früz Worldwide	United States	Fast food	5,229
Curves for Women	United States	Fitness services	4,190

¹“Franchise 500 2003 Rankings” *Entrepreneur Magazine*, found at Internet address <http://www.entrepreneur.com>, retrieved Jan. 21, 2003.

² Does not include company-owned stores.

³ KFC and Taco Bell are part of the Yum Brands, Inc., family of fast food restaurants. Yum Brands also controls Pizza Hut and Long John Silver's.

franchise investment is often expensive and financing is difficult to obtain.²¹ In Russia, franchising growth lags due to the lack of transparent franchising regulations.²²

WTO Update

None of the negotiating proposals on distribution services submitted by Canada, the European Union (EU), Korea, MERCOSUR, Switzerland, and the United States, and

²¹ USDOC, ITA, Industry Sector Analysis, “Franchising Market: Mexico,” June 20, 2002.

²² USDOC, ITA, Industry Sector Analysis, “Franchising: Russia,” Oct. 1, 2002, found at Internet address <http://www.stat-usa.gov>, retrieved Jan. 7, 2003; and Helque, Cric, “Franchising Sags in Russia, Forum Told,” *The Russian Journal*, Oct. 28, 2000, found at Internet address <http://www.therussianjournal.com>, retrieved Jan. 22, 2003.

the more general negotiating proposals submitted by Japan and Chile,²³ cover franchising specifically. However, all of these proposals recognize the paucity of commitments on, and the continuing obstacles to market access and national treatment in, the distribution services sector. Proposals focus on narrowing the scope of product exclusions, liberalizing the sector by removing impediments to market access and national treatment, and promoting transparency in domestic regulation. These improvements are important to franchisors, particularly transparency in domestic regulation. A transparent regulatory environment is crucial since franchisors rely on agreements and contracts with foreign franchisees.

During the Uruguay Round, only 35 current World Trade Organization (WTO) members made commitments on franchising services. Of that group, 27 members offer full commitments on franchising services and 8 members offer partial commitments.²⁴ Yet, nine of these scheduled full or partial commitments with product exclusions, including tobacco; alcoholic beverages; pharmaceutical, medical and orthopaedic goods; weapons, munitions, and arms; chemical products; military equipment; precious metals, precious stones and art; or petroleum and petroleum products. As with other distribution services, product exclusions limit the effectiveness of scheduled commitments.

Of the 16 members that have joined the WTO since the Uruguay Round trade negotiations, Albania, Croatia, Estonia, Georgia, the Kyrgyz Republic, Latvia, Lithuania, Moldova, Oman, and Taiwan scheduled full commitments on franchising; Bulgaria, Panama, Jordan, and China scheduled partial commitments; and Ecuador and Mongolia declined to schedule commitments. China will have full franchising commitments within three years of its accession.²⁵

²³ These proposals address distribution services as a whole, and include commission agents' services, franchising services, retailing services, and wholesaling services. WTO, CTS, "Communication from the European Communities and their Member States: GATS 2000: Distribution," S/CSS/W/37, Dec. 22, 2000; "Communication from Canada: Initial Negotiating Proposal on Distribution Services," S/CSS/W/57, Mar. 14, 2001; "Communication from the United States: Distribution Services," S/CSS/W/22, Dec. 18, 2000; "Communication from the Republic of Korea: Negotiating Proposal for Distribution Services," S/CSS/W/85, May 11, 2001; "Communication from Switzerland: GATS 2000: Distribution Services," S/CSS/W77, May 4, 2001; "Communication from MERCOSUR: Distribution Services," S/CSS/W/80, May 4, 2001; all found at Internet address <http://www.wto.org/>, retrieved Aug. 9, 2001.

²⁴ Full commitments guarantee market access and national treatment with no restrictions in Modes 1, 2, and 3, while partial commitments guarantee access with some restrictions. Most countries have restrictions pertaining to Mode 4.

²⁵ WTO, Accession: Technical Note, "Annex 4 - Sector Specific Commitments," found at Internet address <http://www.wto.org/>, retrieved Oct. 10, 2002.

CHAPTER 9

HEALTH CARE SERVICES

Introduction

Health care services encompass a broad range of services provided by medical professionals and health care institutions. For the purposes of this report, health care services include services provided by hospitals and hospital chains; offices and clinics of medical doctors and other health care professionals; nursing homes and other long-term care providers; rehabilitation facilities; home health care providers; certain health maintenance organizations (HMO); medical and dental laboratories; kidney dialysis centers; and specialty outpatient facilities.

Health care services are traded across borders and sold through affiliates established in foreign markets. Cross-border trade occurs when health care providers in one country provide services to citizens of another country. Most U.S. cross-border exports involve the treatment of foreign persons by hospitals, clinics, and health care service professionals such as medical doctors, which are located in the United States. Cross-border imports comprise the treatment of U.S. citizens by foreign health care service providers. Affiliate transactions comprise health care services provided to persons in their home countries by foreign-owned affiliates located in those countries. Cross-border exports account for the majority of services provided to foreign clients, whereas the value of affiliates sales is greater than the value of cross-border imports.

Trade and Investment Trends

Cross-Border Trade

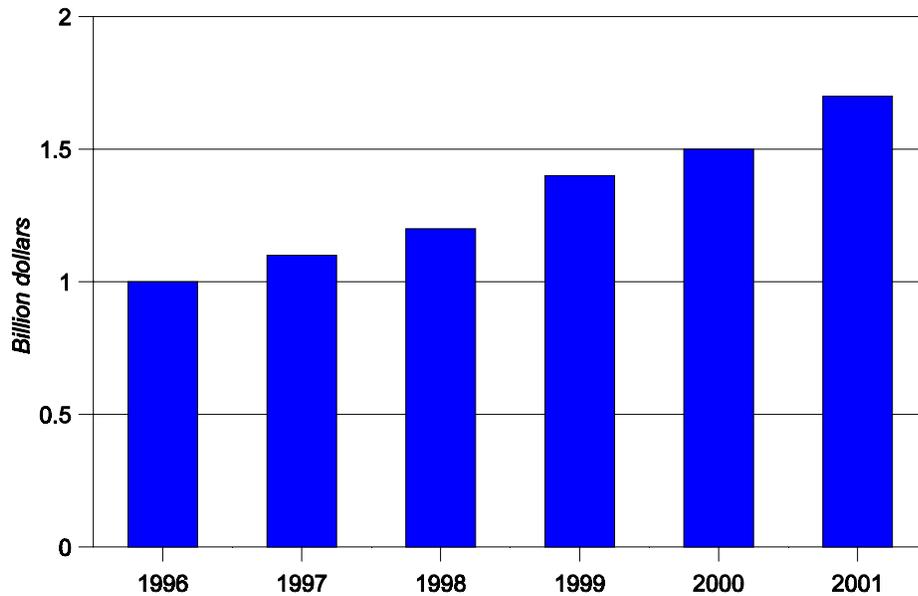
In 2001, U.S. cross-border exports of health care services totaled \$1.7 billion, an increase of 12 percent from 2000. This roughly mirrors the average annual growth rate of 11 percent experienced during 1996-2000 (figure 9-1).¹ Import statistics are not collected by official data collecting agencies, and therefore are not included in this analysis.

Although U.S. exports of health care services are small compared to exports of many other services, official figures are likely understated.² For example, much of the

¹ United States Department of Commerce (USDOC), Bureau of Economic Analysis (BEA), *Survey of Current Business*, Oct. 2002, pp. 84-85.

² *U.S. Industry & Trade Outlook 2000*, pp. 43-44 and "Americans Flock South to Mexico for Cheap Medicines," *Reuters*, Sept. 5, 2001, found at Internet address <http://www.kpmginsiders.com>, retrieved on Sept. 6, 2001.

Figure 9-1
Health care services: Cross-border exports, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

trade in health care services between Mexico and the United States is not reflected in U.S. trade statistics. While U.S. hospitals in the border region often provide uncompensated health care services to foreign nationals living in the United States illegally,³ these services are not reported as U.S. exports. In addition, significant amounts of medical services are likely buried in transactions such as fees charged for laboratory services.

Foreign Direct Investment and Affiliate Transactions

In 2001, U.S. health services firms held a direct investment position of \$256 million in foreign markets, a decrease of 4 percent from 2000, and in line with the average annual decrease of 7 percent during 1996-2000. The foreign direct investment position in the United States was \$6.2 billion in 2001, up 3 percent over 2000, compared to average annual growth of 76 percent during 1995-2000.⁴ This rapid growth reflects the 94-percent increase during 1997-98, when German-owned Paracelsus Healthcare Corporation purchased several U.S. hospitals.

³ Mary Chris Jaklevic, "Care For Undocumented Immigrants Costly: Study," *Modern Healthcare's Daily Dose*, Sept. 30, 2002, found at Internet address <http://www.modernhealthcare.com>, retrieved Sept. 30, 2002 and "Immigrant Care Endangered in Texas," *KPMG Insider Alert*, July 16, 2001, found at Internet address <http://www.kpmginsiders.com>, retrieved July 18, 2002.

⁴ Data for 1996 are not available.

Health care services continue to be publicly provided in most countries, limiting the extent of sales by U.S. affiliates abroad. Yet, sales of health care services by foreign-based affiliates of U.S. firms totaled \$614 million in 2000, an increase of 79 percent over the previous year (figure 9-2).⁵ Slightly more than half of the total in 2000 represented sales by affiliates located in Europe. The United Kingdom accounted for the largest share, with sales of \$120 million, followed by Switzerland, with \$104 million. U.S. purchases of health care services from U.S.-based affiliates of foreign-owned firms increased by 8 percent to \$5.7 billion in 2000, rising faster than the average annual growth of 5 percent during 1997-99. Canadian-owned affiliates accounted for 21 percent of such purchases.⁶

Market Overview

U.S. Output

During 1990-2000, real gross output in the U.S. health care industry grew on average by 3 percent per annum, to \$763.0 billion (figure 9-3).⁷ While one component of the number, real intermediate inputs, increased by an annual average of 5 percent during this period, the overall rate of growth was limited by a 1-percent annual increase in the primary inputs of capital and labor. Overall, the steady rate of growth in health care output reflects not only the average growth rate of the U.S. economy, but also the cost-containment efforts of health maintenance organizations (HMOs) during the 1990s.

Competitive Environment

The United States enjoys a worldwide reputation for both providing high quality health care services and conducting advanced medical research. As a result, foreign nationals travel from around the world to seek medical treatment in the United States. The treatment of overseas patients is a small but growing export market segment for U.S. health care service providers. U.S. hospitals estimate that international patients represent 3 percent of inpatient admissions at U.S. medical centers and other specialized facilities. Traditionally, the international programs of a few elite medical centers such as the Mayo Clinic in Rochester, Minnesota, and the Johns Hopkins Medical Center in Baltimore, Maryland, dominated the U.S. market. In recent years, however, the number of health care service providers with dedicated international programs has grown substantially and includes more than two dozen hospitals and research centers.

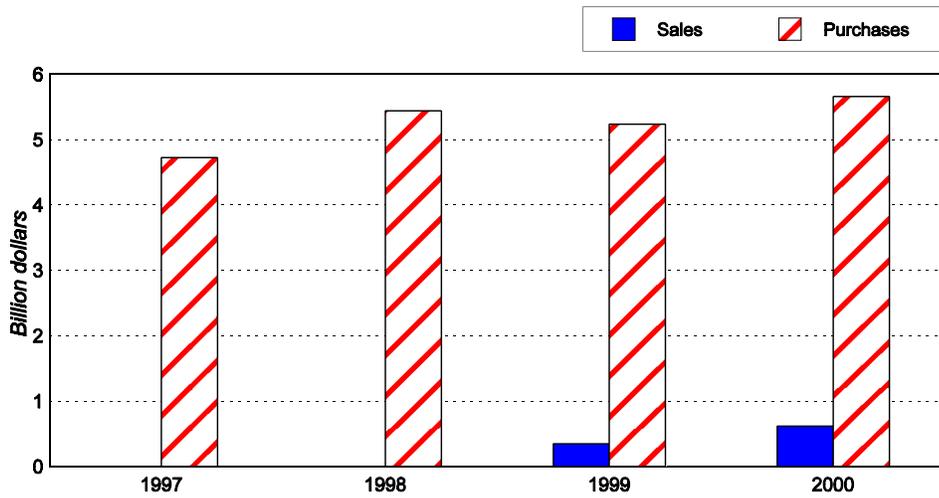
Such institutions often rely on revenue from foreign patients to fund advanced research programs and offset increasing costs. As a result, these programs typically

⁵ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 121-122.

⁶ *Ibid.*, pp. 123-124.

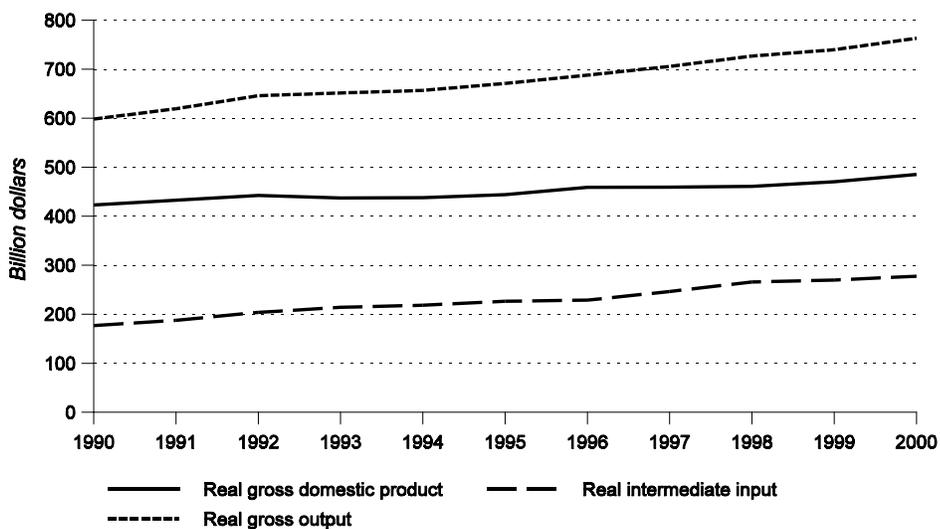
⁷ USDOC, BEA, *Survey of Current Business*, Dec. 2001, p. 45.

Figure 9-2
Health care and social assistance services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure 9-3
Health services: Real gross domestic product, real gross output and real intermediate inputs, 1990-2000



Source: Compiled by the U.S. International Trade Commission.

cater to affluent foreign patients that are capable of fully financing their treatment costs and travel expenses from personal resources. According to one survey,⁸ many of these patients come from the Middle East and Latin America, areas where the national health care infrastructure has fewer resources, and patients have less access to advanced treatment procedures.⁹

Increasing competition for wealthy foreign patients among premier U.S. medical facilities has motivated some hospitals to try to differentiate their product offerings from those of their competitors. In addition to hotel-like floors, some hospitals are beginning to offer special services and amenities to affluent clients. For example, Johns Hopkins International not only provides medical interpreters in more than 30 languages but also maintains a guest services unit offering one-stop-shop travel arrangements and concierge services.¹⁰

The emergence of the premium medical care market niche has also attracted a new breed of health care intermediary, which specializes in coordinating a patient's health care needs and selling luxury amenities to wealthy foreigners and U.S. nationals who can afford to pay for medical treatment out-of-pocket. For example, WorldClinic, a division of the Lahey Clinic in Burlington, Massachusetts, guarantees 24-hour access to leading doctors anywhere in the world for wealthy individuals and corporate clients.¹¹ WorldPath Medicine, LLC, helps wealthy clients negotiate the complex U.S. health care system and gain access to physicians in top-flight Boston hospitals and research centers.¹² Hotel Recovery, Inc., offers luxurious recovery facilities and 24-hour assistance from registered nurses and personal care aides at top-tier hotels in the Boston area. Other product offerings include clinical services such as rehabilitation therapy and non-medical services including limousine transportation, medical travel escorts, salon services, and massage treatment.¹³

The September 11th terrorist attacks continue to have a serious negative impact on U.S. exports of health care services. The directors of several international programs report that foreign patient volume in U.S. hospitals dropped by roughly one-third in 2002.¹⁴ Children's Hospital in Boston estimated that international business declined by 22 percent in 2002, and Philadelphia International Medicine reported a 27-percent decline in foreign patient revenue.¹⁵ While economic weakness in many parts of the world has likely contributed to this decline, U.S. hospitals principally attribute post-September 11th declines in foreign patient arrivals to new State Department visa

⁸ Ron Shinkman, "Survey Shows Small but Growing Emphasis on Attracting Overseas Patients," *Modern Healthcare*, Mar. 26, 2001, p. 46.

⁹ USDOC, *U.S. Industry & Trade Outlook*, 2000, p. 43-1.

¹⁰ Johns Hopkins International website, found at Internet address <http://www.jhintl.net/English/Patients/patientsGuest.asp>, retrieved Nov. 4, 2002.

¹¹ WorldClinic website, found at Internet address <http://www.worldclinic.com>, retrieved Nov. 4, 2002.

¹² WorldPath website, found at Internet address <http://www.worldpathmed.com>, retrieved Nov. 4, 2002.

¹³ Hotel Recovery website, found at Internet address <http://www.hotelrecovery.com>, retrieved Oct. 10, 2002.

¹⁴ Mary Chris Jaklevic, "Is It Worth The Wait?" *Modern Healthcare*, April 8, 2002, p. 12.

¹⁵ Helen Palmer, "Foreign Patients at US Hospitals," aired on *Marketplace* (National Public Radio), Dec. 30, 2002, found at Internet site <http://www.marketplace.com>, retrieved Jan. 8, 2003.

procedures that include security review periods of six to eight weeks, particularly for patients from the Middle East.¹⁶ Indeed, Children's Hospital Boston reported a 67-percent decrease in new patients from the Middle East, while Philadelphia International estimated that most of its revenue shortfall is attributable to a fall-off in Middle Eastern patients. Further, some commentators contend that the perceived existence of anti-Arab sentiment in the United States by many residents of Middle Eastern countries also has contributed to declining patient volumes from that part of the world.¹⁷

According to the U.S. health care industry, lengthy security reviews not only delay the entry of foreign patients, but also encourage foreign doctors to refer their patients to non-U.S. hospitals, placing U.S. hospitals at a disadvantage.¹⁸ Similarly, U.S. hospitals assert that non-referral patients facing an eight-week waiting period may seek health care elsewhere.¹⁹ While many hospitals are reticent about disclosing foreign patient volumes and revenues, the economic impact could be significant. One survey conducted by the U.S. Department of Commerce, in conjunction with U.S. embassies in Saudi Arabia and the United Arab Emirates, determined that the impact of the September 11th attacks ranges from \$750 million to \$1.3 billion dollars in reduced patient care from those two countries.²⁰ Because hospitals estimate that each dollar foreign patients spend on inpatient care generates another \$3 elsewhere in the U.S. economy, the ultimate cost of reduced patient volumes ranges between \$3 billion and \$5.2 billion.²¹ To minimize economic disruptions, hospitals are working with the Immigration and Naturalization Service and U.S. consulates abroad to design processes to speed visa procedures, including providing doctor signatures and faxing documents to consulate officials abroad.²²

The U.S. health care industry has also expressed concern over a recent policy decision by Great Britain's National Health Service (NHS).²³ Responding to rising public dissatisfaction with lengthy waiting lists for medical treatment, the NHS recently reversed longstanding policy by announcing that patients facing delays longer than six months would be allowed to seek treatment in European hospitals at NHS expense.²⁴ The number of British patients waiting for surgery and other treatments is estimated at one million, with approximately 46,000 on the list for more than a year. The initial pilot program, launched in October 2001, gave patients in test regions the option of traveling to other European countries for low-risk procedures

¹⁶ Industry representatives, letters dated June 19, 2002, June 20, 2002, June 24, 2002, June 25, 2002, and June 28, 2002.

¹⁷ Helen Palmer, "Foreign Patients at US Hospitals," aired on *Marketplace* (National Public Radio), Dec. 30, 2002.

¹⁸ Industry representatives, letters dated June 19, 2002, and June 25, 2002.

¹⁹ Mary Chris Jaklevic, "Is It Worth The Wait?"

²⁰ Helen Palmer, "Foreign Patients at U.S. Hospitals."

²¹ Mary Chris Jaklevic, "Is It Worth The Wait?"

²² Helen Palmer, "Foreign Patients at U.S. Hospitals."

²³ "Medicine sans frontiers," *The Economist*, Sept. 1, 2001, found at Internet address <http://www.economist.com>, retrieved Sept. 4, 2001.

²⁴ Alan Cowell, "Health Gap Has British Looking Abroad," *New York Times*, Sept. 1, 2001, found at Internet address <http://www.nytimes.com>, retrieved Sept. 4, 2001.

such as cataract surgery or joint replacements.²⁵ According to some U.S. hospitals, the new NHS policy may discriminate against U.S. medical centers with international programs by limiting NHS insurance payments only to European hospitals, effectively excluding U.S. hospitals from international referrals under the program. As a result, U.S. hospitals are currently seeking eligibility for NHS insurance payments.²⁶

Several U.S. firms own and operate health care affiliates in foreign markets. For example, health care giant HCA, Inc., operates five private hospitals in the United Kingdom and two in Switzerland. Similarly, Tenet Healthcare Corporation operates a private health care facility in Spain. The total number of overseas facilities is relatively small, however. Moreover, following an overseas investment binge in the 1970s and 1980s, many health care companies have retrenched from their overseas operations. At one point in the 1970s, for example, HCA owned and operated hospitals in Australia, Brazil, Panama, and the United Kingdom, and managed hospitals in Italy, Pakistan, Saudi Arabia, and Singapore. However, political and economic risks, currency fluctuations, and flagging profitability led HCA to sell off many of its international hospitals in the late 1980s.²⁷ As noted above, another common obstacle to U.S. hospitals seeking to expand abroad is the public provision of health care in many countries. The health care system in most countries is owned, operated, and funded by the government. Since such programs typically do not cover treatment in private facilities, such a structure can act as a significant impediment to privately-operated hospitals. As a result, U.S.-owned hospitals abroad typically rely on wealthy patients who fund health care expenses through personal resources, a factor that severely limits international growth opportunities.

Foreign-owned health care service providers operating in the United States represent only a small percentage of all U.S. providers, but several foreign firms have invested in U.S. health care facilities. For example, Swedish-owned Gambro Healthcare provides dialysis treatment to over 42,000 patients at 544 clinics in the United States.²⁸ Similarly, German-owned Fresenius Medical Care North America treats more than 75,000 people with chronic kidney failure at more than 1,000 U.S.-based clinics.²⁹

²⁵ "More Patients Go Abroad For Treatment," *NHS Update*, Oct. 15, 2001, found at Internet address <http://www.nhs.uk/nhsupdate/news.asp?newsid=322>, retrieved Oct. 15, 2002.

²⁶ Industry representatives, letters dated June 19, 2002, June 20, 2002, June 24, 2002, June 25, 2002, and June 28, 2002.

²⁷ Barbara Kirchheimer, "Global Ambition," *Modern Healthcare*, May 7, 2001, p. 32.

²⁸ Gambro website, found at <http://www.gambro.com>, retrieved Jan. 10, 2003.

²⁹ Fresenius Medical Care website, found at <http://www.fmcna.com>, retrieved Jan. 10, 2003.

CHAPTER 10

LEGAL SERVICES

Introduction

Legal services include legal advisory and representation services in various fields of law, advisory and representation services in statutory procedures of quasi-judicial bodies, and legal documentation and certification services. International trade in legal services occurs through both cross-border trade and affiliate transactions. Cross-border trade occurs when legal professionals travel abroad to provide services to clients, when clients travel abroad to engage the services of foreign attorneys, or when legal documents or advice are transmitted across national borders via telecommunication networks, postal carriers, or other modes of correspondence. Affiliate trade occurs when a law firm in one country establishes an office in another country and provides services in the local market.

Under certain circumstances, legal service providers may become members of foreign bars, allowing them to appear in foreign courts and provide advice on foreign law. However, most lawyers practicing outside their home jurisdiction are not locally accredited and, therefore, function more narrowly as foreign legal consultants.¹ Typically, U.S. foreign legal consultants working abroad may provide advice regarding U.S. law, international law, and third-country law, but are precluded from appearing in host country courts or giving advice on host country law, unless that advice is based on the counsel of a member of the local bar. Internationally, this arrangement is fairly common and is not widely regarded as a barrier to trade by U.S. legal service providers.

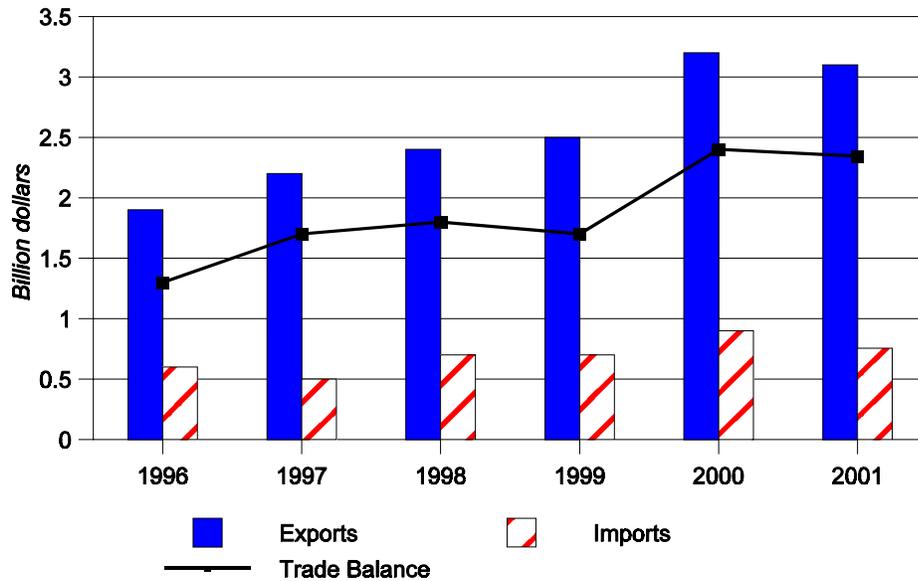
Trade and Investment Trends

Cross-Border Trade

In 2001, U.S. cross-border exports of legal services totaled \$3.1 billion, while imports totaled \$755 million, yielding a trade surplus of \$2.4 billion (figure 10-1).

¹ The American Bar Association's Model "Foreign Legal Consultant" Rule proposes that foreign lawyers be allowed to establish offices in the United States without taking a U.S. bar exam. They would be registered by the local bar; be able to hire, be hired by, or become a partner with a local lawyer; and may advise on most matters in which they are competent, other than the local law of the admitting jurisdiction. Although the ABA has urged all U.S. States to adopt such a Rule, less than half have. House Committee on Small Business, "Impact Of Financial And Professional Service Exports On Small Business," prepared remarks of Peter Ehrenhaft, Oct. 24, 2001, found at Internet address <http://www.house.gov/smbiz/hearings/>, retrieved Oct. 22, 2002.

Figure 10-1
Legal services: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

U.S. exports decreased by 3 percent in 2001, compared with average annual growth of 14 percent during 1996-2000. Exports to Europe and the Asia-Pacific region declined in 2001, while exports of legal services to Canada, Latin America, and the Middle East increased. Exports to Latin America and the Caribbean totaled \$225 million in 2001, an increase of 9 percent over 2000 exports. U.S. cross-border imports of legal services decreased 14 percent in 2001, reflecting declines in imports from all regions. By contrast, imports increased by 9 percent per annum on average, during 1996-2000.² While many legal service providers faced a difficult market in 2001, firms that specialized in representing technology clients and emerging growth companies were particularly hard hit. Beyond the bearish technology sector, firms with large capital markets practices also suffered due to depressed global financial markets³ and a drop in the number of initial public offerings and mergers and acquisitions (M&As). Firms focusing on bankruptcy and restructuring generally fared better in 2001.

In 2001, the largest U.S. cross-border export markets for legal services were the United Kingdom, Japan, Germany, Canada, and France, which accounted for exports of \$635 million, \$511 million, \$274 million, \$257 million, and \$255 million,

² U.S. Department of Commerce (USDOC), Bureau of Economic Analysis (BEA), *Survey of Current Business*, Oct. 2002, pp. 118-119.

³ A capital markets practice usually provides legal advice on debt and equity transactions, especially securities transactions and other products sold into the capital markets. Such practices are vulnerable to cyclical movements in the world's financial markets, which are currently in recession.

respectively (figure 10-2). With respect to cross-border imports, the United Kingdom remained the largest supplier of legal services in 2001, accounting for U.S. imports of \$216 million. London is one of the world's leading financial centers, home to many of the world's largest international investment banks and multinationals firms, which create substantial demand for legal services among U.S. banks and financial corporations, especially those active in the mergers and acquisitions market. Other leading suppliers were Japan, Germany, and Canada, which accounted for imports of \$75 million, \$62 million, and \$44 million, respectively.

Foreign Direct Investment and Affiliate Transactions

The U.S. direct investment position abroad in legal services totaled \$687 million in 2001, an increase of 10 percent from 2000, compared to 31-percent average annual growth during 1996-2000.⁴

In 2001, total sales of legal services by U.S.-owned affiliates in foreign markets totaled \$865 million, a 5-percent increase over the previous year (figure 10-3). Sales to Europe, the largest regional market for affiliate sales, grew 6 percent to \$637 million in 2000. The United Kingdom and France accounted for the majority of affiliate sales of legal services, with \$302 million (35 percent) and \$167 million (19 percent), respectively. Affiliates in Japan and Germany recorded 2000 sales of \$62 million and \$55 million, respectively.

By contrast, the foreign direct investment position in the U.S. legal services industry totaled \$4 million in 2001, unchanged from the 2000 figure. Within the U.S. legal services market, prime areas of interest for foreign law firms included New York-based work in securities and project finance.⁵ In 2000, U.S. purchases from U.S.-based legal affiliates of foreign companies totaled \$23 million, a 10-percent increase from 1999. Affiliates of British parents were the leading suppliers in 2000, with sales to U.S. persons totaling \$13 million, an 8-percent increase over the previous year.⁶

Competitive Environment

The U.S. legal services industry is highly fragmented, with the largest firms accounting for only a small percentage of the total market. Still, a number of firms have expanded rapidly in recent years, and as the larger firms capture a growing share of the legal services market, small- and medium-sized firms are increasingly focusing on niche markets. U.S. firms report that their global work, whether for foreign clients in the United States, for U.S. clients overseas, or for non-U.S. clients overseas, accounts for an increasing share of gross revenue.⁷ At least 20 of the

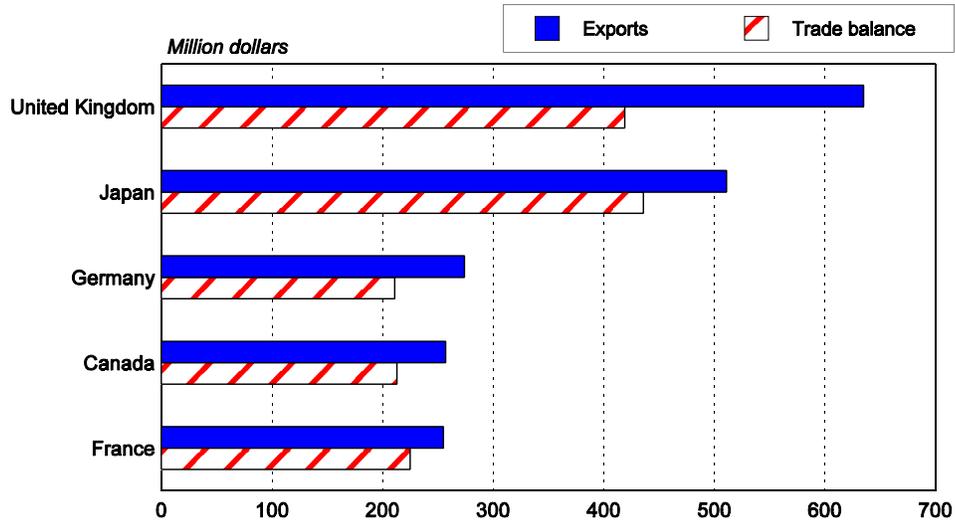
⁴ USDOC, BEA, *Survey of Current Business*, Sept. 2002, p. 96; and Sept. 2001, p. 109.

⁵ USDOC, BEA, *Survey of Current Business*, Sept. 2002, p. 66; and Sept. 2000, p. 59.

⁶ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 124.

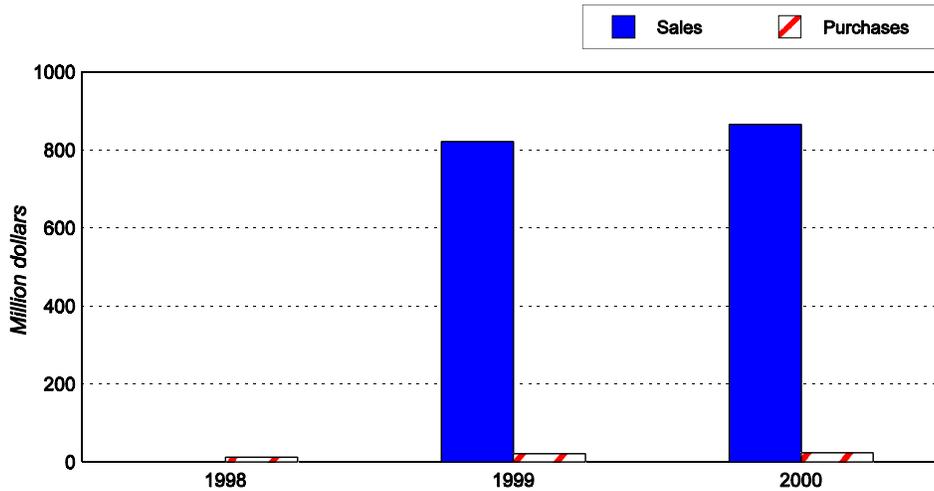
⁷ Industry representatives, telephone interviews by USITC staff, Oct. 2002.

Figure 10-2
Legal services: U.S. cross-border exports and trade balance, by major trading partners, 2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 118-119.

Figure 10-3
Legal services: Sales by U.S. majority-owned affiliates and U.S. purchases¹ from foreign majority-owned affiliates, 1998-2000



¹ 1997 purchases data were suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

largest U.S. law firms now have more than 10 percent of their lawyers stationed in overseas offices.⁸

Measured by 2001 revenue, the largest law firms in the United States were Skadden, Arps, Slate, Meagher & Flom, based in New York (\$1.2 billion);⁹ Baker & McKenzie International, based in Chicago (\$1.1 billion);¹⁰ Jones, Day, Reavis & Pogue National, based in Cleveland (\$790 million);¹¹ and Latham & Watkins National, based in Los Angeles (\$770 million).¹² Measured by number of lawyers, the largest U.S. firm is Baker & McKenzie, with 3,225 attorneys in 64 offices in 35 countries worldwide. Baker & McKenzie's competitive strategy is to have a presence in virtually every important financial and commercial center in the world. In recent international developments, Baker & McKenzie merged with local firms in Belgium and Italy, leading to new offices in both countries during 2002.¹³ With approximately 1,800 attorneys in 23 offices outside the United States, Skadden, Arps was the second largest U.S. law firm in 2001.¹⁴ Jones, Day, Reavis & Pogue ranked third, with more than 1,600 lawyers in 24 foreign locations.¹⁵ Latham & Watkins has more than 1,400 attorneys in 21 offices worldwide.¹⁶

In previous years, international law firms based in the United States have been the largest in the world, but 2001 witnessed changes in the international legal services market. For the first time, five of the top 10 highest-grossing firms in the world were based in London, and a non-U.S. firm, Clifford Chance,¹⁷ ranked as the leading firm worldwide by revenue and by number of lawyers, ousted the long-standing revenue leader Skadden, Arps, Slate, Meagher & Flom (table 10-1). Firms from Australia and Canada were included in the top 100 for the first time in 2001. Still, U.S.-based firms accounted for roughly 75 percent of the leading 100 legal firms' gross revenue.¹⁸ In 2002, Clifford Chance became the first law firm in the world to bill fees in excess of £1 billion (\$1.6 billion). This represents a 7-percent increase in

⁸ "The American Lawyer 100," *The American Lawyer*, July 2002, found at Internet address <http://www.law.com/special/professionals/amlaw/2002/amlaw100/>, retrieved Oct. 3, 2002.

⁹ *Ibid.*

¹⁰ Baker & McKenzie, "Baker & McKenzie - A Year in Review," Oct. 7, 2002, found at Internet address <http://www.bakerinfo.com/BakerNet/News/Press+Releases/>, retrieved Oct. 22, 2002.

¹¹ Jones Day, "Firm Overview," found at Internet address <http://www1.jonesday.com/about/>, retrieved Sept. 25, 2002.

¹² Latham & Watkins, "Firm Overview," found at Internet address <http://www.lw.com/firm/>, retrieved Sept. 25, 2002.

¹³ Baker & McKenzie, "Baker & McKenzie - A Year in Review," Oct. 7, 2002.

¹⁴ Skadden, Arps, "Firm Overview," found at Internet address <http://www.skadden.com/PracticeIndex.ihtml>, retrieved Nov. 5, 2002.

¹⁵ Jones Day, "Firm Overview."

¹⁶ Latham & Watkins, "Firm Overview."

¹⁷ The firm was created through the Jan. 2000 merger of New York-based Rogers & Wells, London-based Clifford Chance, and Frankfurt-based Pünder, Volhard, Weber & Axster. The merger accounted for some of the firm's growth.

¹⁸ "Lessons From the Global 100," *The American Lawyer 100*, July 2002, found at Internet address <http://www.law.com/>, retrieved Oct. 3, 2002.

Table 10-1
Leading global law firms, by revenue and number of lawyers, 2001

Firm	2001 revenue	Home country	Number of lawyers
	<i>Million dollars</i>		
Clifford Chance International	1,600	United Kingdom	2,868
Skadden, Arps, Slate, Meagher & Flom	1,154	United States	1,800
Baker & McKenzie	1,100	United States	3,225
Freshfields Bruckhaus Deringer International	938	United Kingdom	2,440
Jones, Day, Reavis & Pogue	790	United States	1,600
Latham & Watkins	770	United States	1,400
Linklaters International	750	United Kingdom	2,000+
Allen & Overy International	741	United Kingdom	1,912
Andersen Legal International	590	United Kingdom	2,880
Shearman & Sterling	590	United States	887

Sources: The American Lawyer 100 and individual firm websites.

billings over the previous year, though it was achieved, in part, by including the billing results from the firm’s recently acquired Italian practice.¹⁹

In mid-2002, Andersen Legal, the world’s second-largest law firm ranked by number of lawyers, was dismantled.²⁰ Andersen Legal and the now defunct Arthur Andersen LLP were part of a global services network, but the two organizations were separate legal entities.²¹ Nevertheless, prospective hiring firms were reportedly concerned that the Andersen Legal attorneys might be held liable for any wrongdoing committed by the Andersen accountants.²² Many national law firms that were part of the Andersen Legal global network have now become independent firms. Others have joined former rivals. For example, Andersen’s former law firms in France and Germany joined the legal arm of Ernst & Young International. In the United Kingdom, the national Andersen firm Garretts is in talks with KLegal International, KPMG’s network of law firms.

¹⁹ Clifford Chance, “Clifford Chance Bills £1 billion, but Investment Holds Back Profits,” press release, Aug. 20, 2002, found at Internet address <http://www.cliffordchance.com/uk/news/press-releases/>, retrieved Oct. 15, 2002.

²⁰ At the time, Andersen Legal employed 2,880 lawyers in 36 countries. The firm reported 2001 revenues of \$590 million.

²¹ Andersen Legal International was based in the United Kingdom.

²² *The National Law Journal*, found at Internet address <http://www.nylawyer.com/pay/02/070902a.html>, retrieved Oct. 15, 2002.

Internationally, there has been a trend within the legal services industry towards consolidation.²³ This is particularly true in Europe, where many of the major German firms have recently merged or formed alliances with British firms. For example, the British firm Linklaters' continuing expansion has included recently completed mergers in Belgium, Sweden, Germany, Poland, and the Czech Republic.²⁴ Freshfields has grown to 33 offices after merging with a second German firm.²⁵ Although the U.S. restricts the bundling of legal advice and accounting services, U.S. accounting firms have vigorously lobbied the American Bar Association to permit the practice, arguing that clients would prefer the convenience of getting legal advice and accounting services from the same firm. Five European Union countries also ban the practice, although it is legal in Germany and Italy. A hurdle to future consolidation in Europe and the United States may result from the February 2002 affirmation by the European Court of Justice, Europe's highest court, of a Dutch ban on bundling auditing and legal services.²⁶

Law firms operating internationally follow a variety of business plans based on geographical coverage, major legal markets, or specific business areas. Firms also differ as far as the mix of local and non-local staff. Some of the largest international law firms, such as Clifford Chance and Baker & McKenzie, hire qualified local lawyers in foreign outposts and work to build a local client base. Other firms mostly forgo local business in favor of attracting clients among large multinational corporations. Firms also offer different compensation structures. While some firms adjust salaries to the local market, others pay all partners the same, regardless of location. A downside of this universal approach is that it often excludes firms from opening offices in markets that cannot support high billing rates.

WTO Update

Only Australia and the United States have submitted negotiating proposals on legal services.²⁷ Australia's proposal addresses the definitions relating to the international provision of legal services, and the distinctions between host-country, international, home-country and third-country law. Australia proposes that these definitions be clarified by expanding them to include a number of subcategories. Australia's initial

²³ Here, consolidation refers to the establishment of relationships between law firms, and between law firms and other professional services providers, such as accounting and consulting firms.

²⁴ Linklaters, "Facts and Figures," found at Internet address http://www.LINKLATERS.com/pdfs/factsheet/global_factsheet_aug02.pdf?, retrieved Sept. 25, 2002.

²⁵ Freshfields Bruckhaus Deringer, "News," found at Internet address <http://www.freshfields.com/news/>, retrieved Sept. 25, 2002.

²⁶ Paul Hofheinz, "European Court Rules Accounting Firms Can't Bundle Legal and Auditing Services," *The Wall Street Journal*, Feb. 20, 2002, p. C16.

²⁷ WTO, "Communication From the United States - Negotiating Proposal: Legal Services Classification," S/CSS/W/28, Dec. 18, 2000; WTO, "Communication From Australia - Negotiating Proposal: Legal Services Classification (Supplement)," S/CSS/W/67/Suppl.2, Mar. 11, 2002; WTO, "Communication From Australia - Negotiating Proposal: Legal Services Classification (Revision)," S/CSS/W/67/Suppl.1, July 10, 2001.

proposal also identified some impediments to further liberalization and proposed six guiding principles for the liberalization of trade in legal services.

The United States' proposal requests increased market access for U.S. lawyers in host country markets, which would allow legal professionals to serve clients more effectively as foreign legal consultants (FLCs) or fully licensed legal professionals. For example, it is proposed that host countries remove citizenship requirements for licensing, restrictions on foreign ownership of law firms, and restrictions on FLCs' organization or association with local professionals.

Of the 16 members that have joined the WTO since the Uruguay Round trade negotiations, Bulgaria, Ecuador, Georgia, Lithuania, Mongolia, and Oman scheduled full commitments on legal services; Albania, Croatia, Estonia, Jordan, the Kyrgyz Republic, Latvia, Moldova, Panama, and Taiwan scheduled partial commitments. China scheduled full commitments in Modes 1 and 2, with geographic and quantitative limitations in Mode 3 which are due to be lifted one year after accession, which took place in December 2001.²⁸

²⁸ WTO, Accession: Technical Note, "Annex 4 - Sector Specific Commitments," found at Internet address <http://www.wto.org>, retrieved Mar. 2, 2003.

CHAPTER 11

TELECOMMUNICATION SERVICES

Introduction

Telecommunication services trade encompasses basic¹ and value-added² services, both of which can be provided across national borders and through foreign-based affiliates. Cross-border trade, which predominantly involves placing a call that terminates in a foreign market, is the principal mode of trade. Cross-border trade data are derived from the accounting rate system fashioned by European carriers in the latter half of the nineteenth century. Under this system, telecommunication carriers bilaterally negotiate fees, or accounting rates, for carrying international traffic, which is measured in calling minutes. Each carrier's portion of the accounting rate is referred to as the settlement rate, which in almost all cases is equal to one-half of the negotiated accounting rate. Calls are billed in the originating country, so as bilateral imbalances in international calling traffic occur, a carrier whose outbound calling minutes exceed its inbound calling minutes makes a net settlement payment to its foreign counterpart. This payment is essentially calculated by multiplying the settlement rate by the number of imbalanced calling minutes.³ Net settlement payments are recorded as imports on the balance of payments, whereas net settlement receipts are recorded as exports. Cross-border trade data also includes payments for private leased channel services and support services,⁴ all of which account for an increasing share of cross-border transactions in telecommunication services.⁵

Affiliate transactions are increasing in importance as foreign countries continue to privatize state-owned monopolies and liberalize foreign ownership restrictions, thereby creating more opportunities for overseas participation by U.S. carriers. Affiliate transactions data predominantly reflect the payment of network access fees by wireline and wireless telecommunication services providers, and capacity leasing fees charged to resellers and other telecommunication services providers.

¹ Basic services entail the transmission of voice and data without change in form or content.

² Value-added services include services such as electronic mail, electronic data interchange, electronic funds transfer, enhanced facsimile, and on-line database access.

³ Settlement payments may also reflect surcharges that some countries impose on collect and country-direct calls.

⁴ Private leased channel services are services offered over a telephone line that is rented from a facilities-based telecommunication company for exclusive use by the customer; support services include telecommunication equipment repair and maintenance, ground station services, capacity leasing, and satellite launching services.

⁵ U.S. receipts of such services as a percentage of total telecommunication receipts increased from 21 percent in 1996 to 33 percent in 2001. U.S. Department of Commerce, (USDOC), Bureau of Economic Analysis (BEA), *Survey of Current Business*, Oct. 2002, p. 79.

Trade and Investment Trends

Cross-Border Trade

In 2001, U.S. exports of telecommunication services totaled \$4.8 billion, while U.S. imports totaled \$4.3 billion, resulting in a \$500-million surplus (figure 11-1).⁶ Exports increased by 1 percent during 2001, significantly slower than the 10-percent average annual growth recorded during 1996-2000. U.S. imports declined by 22 percent during 2001, faster than the 10-percent average annual decrease recorded during 1996-2000. Because imports declined significantly in 2001, while exports rose slightly, the telecommunication services trade account changed from deficit to surplus for the first time on record.

Despite a 56-percent total increase in outbound international minutes during 1996-2000, net U.S. settlement payments declined from an all-time high of \$8.3 billion in 1996 to \$5.5 billion in 2000.⁷ This decline, and the resulting decline in U.S. imports of telecommunication services, is attributable primarily to a reduction in accounting rates, which the Federal Communications Commission (FCC) moved to lower with its 1997 Benchmark Order. The Order established a five-year time frame during which settlement rates would be reduced to \$0.15 per minute for upper income countries, \$0.19 per minute for middle income countries, and \$0.23 per minute for lower income countries.⁸ During the first four years of the staged reductions, which commenced January 1, 1998, the average settlement rate declined from \$0.27 per minute to approximately \$0.16 per minute.⁹

U.S. revenues from the international accounting rate system have also been affected by the availability of alternative means of completing international telephone calls, such as international simple resale (ISR) and Internet protocol (IP) telephony. These have created opportunities for carriers to entirely bypass the accounting rate system. ISR traffic is routed over leased lines that are attached to the public network at one or both ends.¹⁰ Reportedly, such arrangements have enabled U.S. carriers to send up to 46 percent of international telecommunication traffic outside the traditional settlement system.¹¹ In 2000, U.S. carriers reported almost 9.7 billion U.S.-billed ISR

⁶ USDOC, BEA, *Survey of Current Business*, Oct. 2002, pp. 106 and 107.

⁷ Estimate by the Commission. U.S. billed minutes includes all minutes billed by U.S. carriers, and includes most calls that originate in the United States. Estimate based on Federal Communications Commission (FCC), *1996 Section 43.61 International Telecommunications Data*, Oct. 1997; and FCC, *2000 International Telecommunications Data*, both found at Internet address http://www.fcc.gov/Bureaus/Common_Carrier/Reports/, retrieved Jan. 2, 2003.

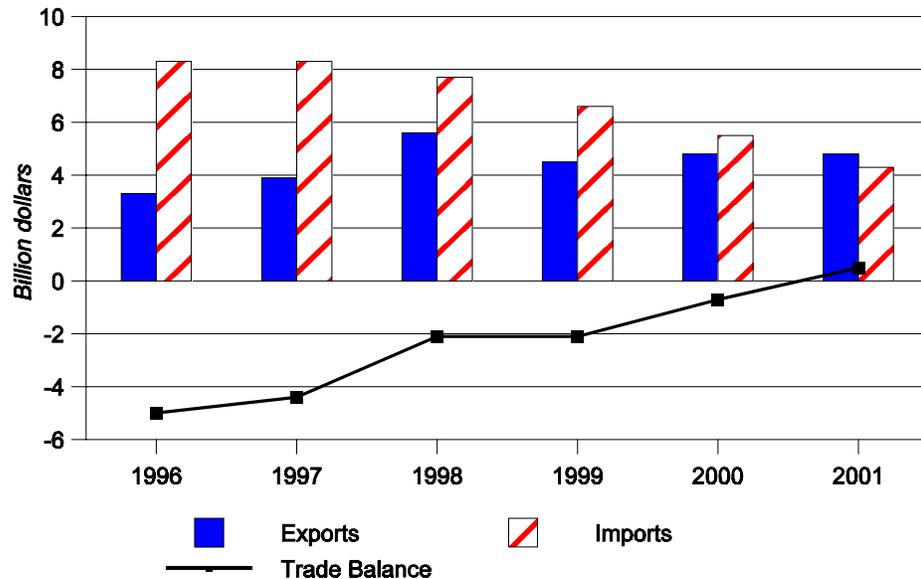
⁸ FCC, *Benchmark Order*, 12 FCC Rcd 19,806 (1997).

⁹ Commission estimate. Data based on FCC, *IMTS Accounting Rates of the United States, 1985-2002*, Nov. 1, 2002, found at Internet address <http://www.fcc.gov/ib/pd/pf/account.html>, retrieved Nov. 20, 2002.

¹⁰ FCC, *2000 International Telecommunications Data*, p. 6.

¹¹ FCC, *International Simple Resale*, found at Internet address <http://www.fcc.gov/ib/pd/pf/isr.html>, retrieved Jan. 3, 2003.

Figure 11-1
Telecommunication services: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

minutes, resulting in revenues of approximately \$3.4 billion.¹² This represents a significant increase from 1.1 billion U.S.- billed ISR minutes and \$293 million ISR revenues in 1997.¹³

IP telephony uses packet switching technology¹⁴ to transmit voice signals over data networks. The transmissions can be sent over the public Internet or through private networks. IP telephony transmissions are also settled outside the traditional accounting rate system, and the technology used to route calls is relatively inexpensive. Consequently, IP telephony firms are able to offer low international calling rates,¹⁵ thereby appealing to consumers that make high volumes of international telephone calls. Low IP telephony calling rates, together with improving sound quality, have contributed to significant growth in IP telephony minutes

¹² FCC, *2000 International Telecommunications Data*, Table A40, revised Sept. 27, 2002.

¹³ 1997 is the first year for which ISR data is available. FCC, *1997 Section 43.61 International Telecommunication Data*, Oct. 31, 1997, found at Internet address http://www.fcc.gov/Bureaus/Common_Carrier/Reports/, retrieved Jan. 2, 2003.

¹⁴ Packet-switching networks transmit signals in electronic blocks, or packets. Each packet is assigned an identification number and a destination code, which allows network nodes to properly route data to its final destination. Each packet can be sent along a different route and then reassembled in the correct order at the intended destination, which results in more efficient utilization of network capacity. This method is more efficient than circuit switching, which relies on a single dedicated circuit to send information.

¹⁵ For example, IP telephony provider Net2Phone charges 3.9, 7.0, and 3.9 cents per minute to call Canada, Mexico, and Germany, respectively. Comparatively, AT&T charges 7.0, 21.0, and 14.0 cents to call these countries, respectively. Data compiled by the Commission from company websites.

worldwide. According to one industry report, worldwide IP telephony calling minutes totaled 18 billion in 2002, representing almost an 82-percent increase from 9.9 billion in 2001, and accounting for over 10 percent of all international calling traffic.¹⁶ One IP telephony service provider expects IP-based telecommunication service to account for 35 percent of all international telephone traffic by 2005.¹⁷

The United Kingdom, Canada, Mexico, Japan, and Italy were the top five export markets for U.S. telecommunication services in 2001 (figure 11-2). The United Kingdom replaced Mexico as the largest U.S. export market in 2001, as exports to Mexico declined by 22 percent to \$424 million, while exports to the United Kingdom decreased by 6 percent to \$564 million. The decrease in U.S. exports to the United Kingdom was significantly slower than the 19-percent average annual decline recorded during 1998-2001, which was largely attributable to a 40-percent decline in the U.S.-United Kingdom accounting rate in 1997.¹⁸ Canada remained the second largest U. S. export market, with 2001 exports of \$512 million. Japan and Italy accounted for U.S. exports of \$279 million and \$199 million, respectively. Mexico remained the top source of U.S. telecommunication services imports. U.S. imports from Mexico totaled \$767 million in 2001, representing a decrease of nearly 32 percent from \$1.1 billion in 2000. The decrease reflects a return to more normal call volumes, after a large increase in 2000 as U.S. consumers took advantage of lower calling rates to Mexico.¹⁹

Foreign Direct Investment and Affiliate Transactions

The outbound direct investment position of U.S. telecommunication firms totaled \$11.7 billion in 2001, down 32 percent from 2000.²⁰ The decline reflected sales of foreign holdings by U.S. firms, the proceeds of which were intended to bolster financial positions weakened by the overbuilding of U.S. and foreign networks. The decline contrasted the 14-percent average annual increase recorded during 1996-2000, when rapid technological change, market reform, and privatization spurred

¹⁶ Simon Romero, "Web Calling Roils the Telecom World," *New York Times*, Dec. 16, 2002.

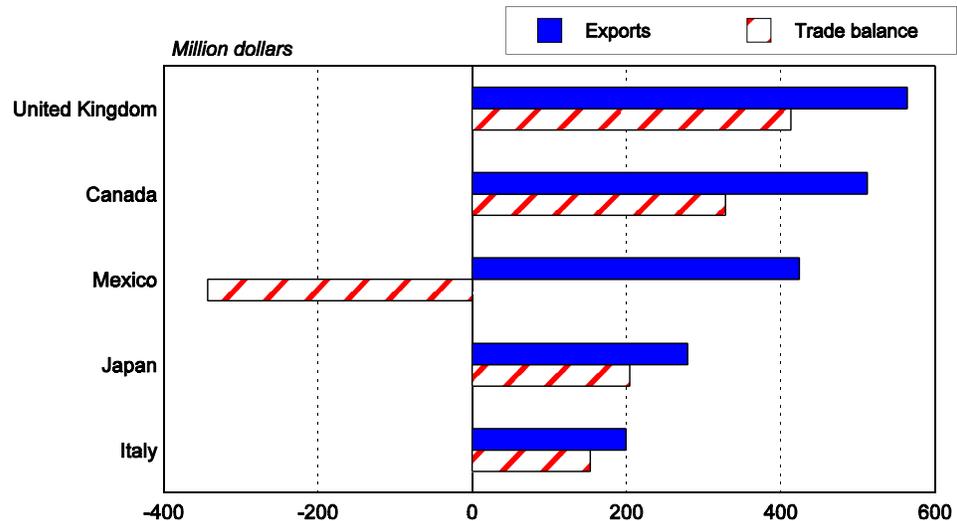
¹⁷ International Telecommunication Union (ITU), *ITU Internet Reports: IP Telephony* (Geneva: ITU, 2000), p. 26.

¹⁸ A decline in accounting rates results in smaller U.S. settlement receipts, reducing U.S. exports to that country.

¹⁹ FCC, *Trends in the International Telecommunications Industry*. In 2001, former Mexican telecommunication services monopoly Telmex reached an agreement with U.S.-based Worldcom, Inc., to progressively lower settlement rates to \$0.10 per minute in 2003 from \$0.19 per minute in 2001. Although the rate reduction applies to other telecommunication service providers, AT&T has not signed on to the agreement, claiming that the rate remains too high. *Inside U.S. Trade*, "USTR Backs off U.S. WTO Threat In Wake of Telecom Company Deal," June 1, 2001; and *Inside U.S. Trade*, "U.S. Pushes Mexico Telecom Case Forward, Blocks Japan Sunset Case," Apr. 19, 2002.

²⁰ USDOC, BEA, "U.S. Direct Investment Abroad," *Survey of Current Business*, July 2002, p. 96.

Figure 11-2
Telecommunication services: U.S. cross-border exports and trade balance, by major trading partners, 2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 106-107.

merger and acquisition activity as a means to achieve growth.²¹ Foreign affiliates of U.S. telecommunication companies sold services valued at \$25.5 billion in 2000 (figure 11-3). European markets, particularly Germany and the United Kingdom, accounted for 52 percent of these sales, with another 33 percent going to Latin American markets.

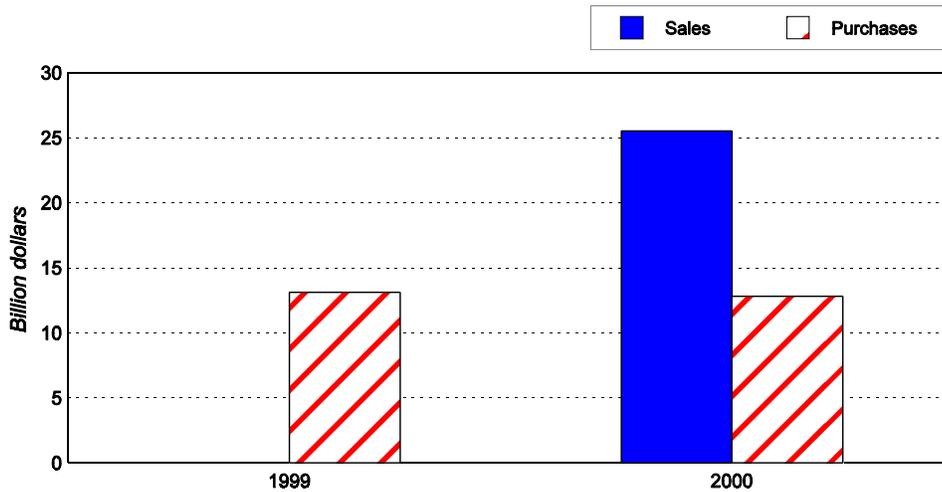
The foreign direct investment position in the U.S. telecommunication services industry totaled \$48.0 billion in 2001.²² This represents a 105-percent increase over 2000, after a 47-percent average annual increase achieved during 1996-2000. Much of the 2001 increase is attributable to Deutsche Telekom's \$26-billion acquisition of U.S.-based VoiceStream Wireless in May 2001. By comparison, purchases of telecommunication services from U.S.-based affiliates of foreign firms were valued at \$12.8 billion in 2000.²³ Individual country data for these purchases were suppressed to avoid disclosure of individual company information.

²¹ USDOC, BEA, "Direct Investment Positions for 2001: Country and Industry Detail," *Survey of Current Business*, July 2002, p. 27.

²² USDOC, BEA, "Foreign Direct Investment in the U.S.," *Survey of Current Business*, Sept. 2002, p. 66.

²³ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 124.

Figure 11-3
Telecommunication services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1999-2000¹



¹ Data for 1999 sales and 1997-1998 purchases was suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Competitive Environment

In terms of revenue, U.S. telecommunication service providers lead the world, with 2000 revenues of over \$292 billion, representing 32 percent of the global total.²⁴ In the U.S. market, more than 700 companies provide long-distance telephone services, and approximately 1,300 companies provide local telephone services.²⁵ However, more than 90 percent of U.S. telecommunication service revenues are generated by three long-distance companies and the four Regional Bell Operating Companies (RBOCs).²⁶ In the U.S. wireless services market segment, eight service providers dominate the market, accounting for 84 percent of total U.S. wireless subscribers in 2001.²⁷

U.S. wireline telecommunication service carriers increasingly face competitive pressure both from alternative communication media and from other industry players. In the long-distance voice service market, competition has resulted in reduced prices

²⁴ International Telecommunications Union (ITU), *World Telecommunication Indicators, 2002* (ITU: Geneva, Switzerland, 2002), p. A55.

²⁵ Standard & Poor's, *Telecommunications: Wireline*, Industry Survey, May 31, 2002.

²⁶ The three long-distance companies are AT&T Corp., Sprint Corp., and Worldcom, Inc. The four Regional Bell Operating Companies are Verizon Inc., BellSouth, SBC Communications, and Qwest Communications International.

²⁷ The eight largest U.S. wireless service providers are Verizon, Cingular, AT&T, Sprint PCS, Nextel, Voicestream, Alltel, and US Cellular, with 2001 subscribers of 30.3 million, 22.1 million, 20.0 million, 14.6 million, 9.6 million, 8.0 million, 6.8 million, and 3.5 million, respectively. Standard & Poor's, *Telecommunications: Wireless*, Industry Survey, Oct. 10, 2002.

for consumer calls. Additionally, product substitution, such as e-mail and wireless technologies, has resulted in a decrease in overall call volumes and a shift to lower-price calling plans.²⁸ These trends have impacted long-distance service providers' revenue significantly. For example, during the fourth quarter of 2001, AT&T's business and consumer long-distance units recorded voice revenue declines of approximately 15 percent and 18 percent, respectively, over the same period in 2000.²⁹ Similarly, Worldcom's and Sprint's 2001 wireline voice services revenue, including long-distance, declined by 13 percent and 6 percent, respectively.³⁰

In an effort to reverse revenue declines, in January 2003, AT&T, WorldCom, and Sprint announced rate increases, for the first time in six years.³¹ Long-distance service providers' immediate need to increase revenue appears to outweigh concerns over competitive pressure from RBOCs, which have slowly been gaining regulatory approval to offer long-distance services.³² Reportedly, the RBOCs will attract customers through discounted telephone service packages that combine local, long-distance, wireless, and high-speed Internet services on a single bill, rather than offering lower long-distance prices.³³

Although the U.S. Congress attempted to open the local phone service market to competition with the 1996 Telecommunications Act, the RBOCs still dominate local phone services, collectively controlling 78 percent of revenues. Since the 1996 Act, the local telecommunication services market has experienced rapid consolidation. Verizon Communications, the largest RBOC in terms of revenue, was formed through the mergers of Bell Atlantic with NYNEX in 1997 and with GTE in 2000. SBC Communications, the nation's second largest RBOC, was formed through Southwestern Bell's 1997 acquisition of Pacific Telesis and its 1999 acquisition of Ameritech. In June 2000, long-distance carrier Qwest Communications acquired U.S.

²⁸ AT&T, Company 10K report, filed with the Securities and Exchange Commission on Apr. 1, 2002, found at Internet address <http://www.sec.gov/Archives/edgar/data/5907/000095012302003272/e56632e10-k.txt>, retrieved Oct. 17, 2002.

²⁹ AT&T Group, *Earnings Commentary*, Jan. 30, 2002, found at Internet address http://www.att.com/ir/pdf/014q_cmnt.pdf, retrieved Oct. 17, 2002.

³⁰ Worldcom, Company 10K report, filed with the Securities and Exchange Commission on Mar. 13, 2002; and Sprint, Company 10K report, filed with the Securities and Exchange Commission on Mar. 4, 2002; reports found at Internet address <http://www.sec.gov>, retrieved Oct. 17, 2002. On June 25, 2002, WorldCom announced its intention to restate its financial statements for 2001 and the first quarter of 2002.

³¹ For example, in December 2002, WorldCom's MCI Group subsidiary announced a 2 cent increase for several of its long-distance plans. Similarly, AT&T raised its monthly subscription rate by 25 percent and Sprint is expected to raise rates shortly. Christopher Stern, "Telephone Price Wars Called Off," *Washington Post*, Jan. 7, 2003, p. E01.

³² The 1996 Telecommunications Act permits RBOCs to offer long-distance services if the Federal Communications Commission (FCC) finds that the RBOCs' regional market has been opened to competition. By April 2002, RBOCs had received approval to offer long-distance service in 10 states, and approval in the remaining states is expected by 2004.

³³ Verizon's local and long-distance service package offers a discount of less than 5 percent to long-distance customers. Verizon's prices are therefore still comparable to AT&T's rates and WorldCom's rates, despite the recent rate increases. Stern, "Telephone Price Wars."

West in a deal valued at \$35 billion.³⁴ The 1996 Act permitted the RBOCs to retain ownership of their local networks, with the intention of allowing competitors to negotiate access. However, the RBOCs have been slow to negotiate equitable network access, resulting in fines imposed by regulators.³⁵

In part as a result of high network prices, many Competitive Local Exchange Carriers (CLECs) have been forced into bankruptcy. CLECs compete on a selective basis in the markets for local, long-distance, international and Internet services.³⁶ In the local markets, CLECs pay wholesale rates for access to the networks of local exchange carriers, such as RBOCs, and then resell services to their customers at retail rates. However, RBOCs have kept competitors out of their markets by maintaining high network access prices, narrowing CLEC resale margins to the point that the companies are unable to become profitable. Further, as capital markets dried up after 2000, CLECs found it increasingly difficult to fund growth and service debt. In 2001, only four of approximately forty CLECs reported positive earnings.

Several inter-exchange carriers (IXCs) have also faced financial difficulties. IXCs are facilities-based voice and data long-distance carriers that generally offer capacity over fiber-optic networks on a wholesale basis. During the 1990s, the IXCs spent billions of dollars deploying fiber-optic cables across long distances, which required large up-front investments to acquire the necessary property rights and to lay the cable.³⁷ During the deployment process, many companies decided to lay “dark fiber”³⁸ to avoid future deployment costs. In the interim, technological advances permitted the division of wavelengths, which enabled single fiber strands to handle more information. However, demand for data transmissions did not increase to the extent anticipated, and the oversupply of fiber-optic networks rendered many IXC business models unsustainable.³⁹ As a result, companies such as Global Crossing, Flag Telecom, and Williams Communications Inc. were forced to file for bankruptcy protection.

In addition to overcapacity, allegations of corporate misconduct have impeded the profitability of telecommunication service firms. For instance, allegations have surfaced that Global Crossing inflated revenues by swapping capacity, giving the appearance of up to \$375 million in revenues for what may have been false transactions during the first quarter of 2001.⁴⁰ In addition, the Energy and Commerce Committee of the House of Representatives is investigating a series of transactions between Global Crossing and Qwest Communications to determine if the exchange

³⁴ Standard & Poor’s, *Telecommunications: Wireline*, Industry Survey, May 31, 2002.

³⁵ In October 2002, for example, the FCC fined SBC Communications \$6 million for failing to allow competitors to access its network. Some analysts speculate that the fines may be less costly to the RBOCs than the more competitive pricing that would result from broader network access. *Communications Week International*, “News in Brief,” Oct. 21, 2002, found at Internet address: <http://www.totaltele.com/>, retrieved Nov. 21, 2002; and George Leopold, “Roots of Carrier Collapse Lie in '96 Telecom Act,” *Electronic Engineering Times*, July 15, 2002, p. 6.

³⁶ Harry Newton, *Newton’s Telecom Dictionary* (New York: CMP Books, 2001), p. 150.

³⁷ *Ibid.*

³⁸ Dark fiber is optical fiber that lays dormant until activated as demand arises.

³⁹ Standard & Poor’s, *Telecommunications: Wireline*.

⁴⁰ Michael Weisskopf, “What did Winnick Know?,” *Time*, Oct. 7, 2002, p. 28.

of fiber between the two entities may have been deceptive in nature.⁴¹ Prior to a hearing before the Committee in September 2002, Qwest announced a plan to retract most of the money it had reported as a result of capacity swaps.⁴² Separately, legal actions against WorldCom and certain senior executives continue. WorldCom currently is seeking bankruptcy protection and reportedly will restate its earnings for 2001 and the first quarter of 2002 to reflect true earnings.⁴³

As of 2001, the 5 largest foreign wireline telecommunication service carriers in terms of revenue were Nippon Telegraph and Telephone (NTT) (Japan), Deutsche Telekom (Germany), France Telecom, Telefonica (Spain), and Telecom Italia. Together these firms registered 2001 revenues of \$224.0 billion, representing 24 percent of the global telecommunication services market. By comparison, the top 5 U.S.-based telecommunication firms registered 2001 revenues of \$225.0 billion (table 11-1).⁴⁴

A trend toward privatization continues to transform the global telecommunications industry. Traditionally, telecommunication services in many countries have been provided by incumbent state-owned monopolies. By 2002, however, more than one-half of the world's countries had privatized their incumbent telecommunication carrier. Regionally, most countries in North and South America, Europe, Southeast Asia and the Pacific had introduced partial or full privatization in their telecommunication service markets. By comparison, less than one-half of the countries in the Middle East and Africa had introduced privatization, although this is starting to change. The first round of major privatization in Africa occurred during 1995-97 when shares in 6 incumbent carriers were sold to private investors.⁴⁵ During 2000-01, shares in four additional companies were sold to private investors,⁴⁶ and by 2002, a total of 19 countries in the region had partially privatized.⁴⁷

Competition in international markets has been slower to develop than privatization, however, with the majority of countries retaining monopolies in their local and long-distance telecommunication markets, particularly in the wireline segment.⁴⁸ The lack of competition enables governments to protect monopolies' profits, which helps to ensure that carriers are able to meet their universal service obligations and provide

⁴¹ "Tauzin Pursues Global Crossing, Qwest 'Sham Transactions'," *Communications Today*, Oct. 8, 2002, p. 1.

⁴² "Tauzin Pursues Global Crossing, Qwest", *Fiber Optic News*, Sept. 30, 2002, p. 1.

⁴³ "Restructuring Information Desk," *Worldcom*, found at Internet address <http://www.worldcom.com/infodesk/>, retrieved Feb. 27, 2003.

⁴⁴ The fifth largest U.S. firm, BellSouth, reported 2001 revenues of \$24.1 billion. BellSouth company website, found at Internet address <http://www.bellsouth.com/investor/>, retrieved Feb. 6, 2003.

⁴⁵ These include national carriers in Ghana, Cote d'Ivoire, Guinea, Senegal, Central African Republic, and Cape Verde. ITU, *World Telecommunication Development Report: Reinventing Telecoms* (Geneva, Switzerland: ITU, Mar. 2002), p. 3; and USITC, Telecommunication Services Privatization Database.

⁴⁶ Two national carriers in Cameroon and the national carriers in Uganda and Nigeria. USITC, Privatization Database.

⁴⁷ *Ibid.*

⁴⁸ ITU, "World Telecommunication Development Report, p. 3.

Table 11-1
Ten largest global telecommunication wireline firms, by revenue and total employees,
2001

Company	Country	Total revenue	Total employees
		<i>Million dollars</i>	
Nippon Telegraph and Telephone (NTT) . . .	Japan	86,734	213,000
Verizon	United States	67,200	247,000
AT&T Corp	United States	52,500	117,800
SBC Communications	United States	45,908	192,550
Deutsche Telekom	Germany	43,058	257,058
France Telecom.	France	38,349	206,000
WorldCom	United States	¹ 35,179	¹ 85,000
Telefonica	Spain	28,400	161,527
Telecom Italia	Italy	27,500	109,956
British Telecom	United Kingdom	26,300	108,600

¹ Revenue numbers do not reflect restated earnings for 2001. Employment numbers do not reflect recent layoffs at the company.

Source: Compiled by the U.S. International Trade Commission.

adequate returns to private investors. Competition is more common in market segments that require significant network investment, such as wireless and Internet communication services. By 2001, approximately 60 percent of countries worldwide allowed competition in their wireless telecommunication markets, and approximately 85 percent of Internet markets were competitive.⁴⁹

⁴⁹ Ibid.

CHAPTER 12

UTILITY SERVICES

Introduction

Utility services comprise activities related to the provision of electric power, natural gas, potable water, and wastewater management services. These include generation, transmission, distribution, and marketing of electric power; transmission and distribution of natural gas; collection, transportation, purification, and distribution of potable water; removal, treatment, and disposal of wastewater; and incidental services such as system operation services, metering, and billing. Utility services can be traded across borders or sold by foreign affiliates to host country consumers. For example, if natural gas is transported from Alberta, Canada, to a customer located in the United States, the owner of the Canadian portion of the pipeline receives payment for a cross-border export. Alternatively, if a Canadian affiliate of a U.S. parent company owns a natural gas pipeline that runs from Alberta to Toronto, transmission services provided by that pipeline constitute sales through a foreign affiliate.

Trade and Investment Trends

Cross-Border Trade

Official data on cross-border transactions in utility services are not available, as trade data are not collected in sufficient detail. However, it is clear that the vast majority of U.S. cross-border trade in energy services takes place with Canada. There does not appear to be any significant cross-border trade in water and wastewater utilities services, for which there are no major international pipelines. In the natural gas segment, imports accounted for 15 percent of total U.S. consumption of natural gas in 2000.¹ Approximately 94 percent of U.S. imports of natural gas are delivered via pipeline, with the remainder arriving by liquefied natural gas (LNG) container ships. Approximately 99.6 percent of U.S. pipeline imports originate in Canada, with the remainder coming from Mexico.² In dollar terms, U.S. imports of natural gas by pipeline measured \$1.4 billion in 2000, the service component of which is estimated to be in the range of \$179 million.³ By contrast, U.S. exports of natural gas by pipeline measured only \$71 million in 2000, the service component of which is estimated at \$9 million. Approximately 63 percent of U.S. exports of natural gas

¹ U.S. Department of Energy (USDOE), Energy Information Administration (EIA), *Natural Gas Monthly August 2001*, Table SR1.

² *Ibid.*, Table SR2.

³ The transportation cost component was estimated to be 12.9 percent based upon the differential between U.S. average well-head and city-gate prices as reported by the USDOE, EIA, *Natural Gas Annual 2000*, Nov. 2001, Overview - Table 1, p. 6, found at Internet address <http://www.iea.doe.gov>, retrieved Oct. 7, 2002.

were transported to Mexico, with the remaining 37 percent being delivered to Canada.⁴

Cross-border trade in the electric utility segment similarly takes place predominantly with Canada. In fact, in 2001, trade with Canada accounted for all U.S. international trade in electric power. As with natural gas, U.S. imports far exceed exports. However, electricity imports have considerably less importance in the overall electric power sector as they account for only 1 percent of total U.S. consumption.⁵ In 2001, U.S. exports of electric power to Canada measured \$1.3 billion, which was less than half the level of U.S. imports of \$2.7 billion.⁶ The service component of trade in electric power is difficult to quantify because the unbundled pricing structure is not as well defined as with natural gas. However, assuming that transmission and distribution services represent 2.5 percent of the retail price to the end user, the service components of U.S. exports and imports measured \$31 million and \$66 million in 2001, respectively.⁷

Foreign Direct Investment and Affiliate Transactions

Unlike cross-border trade in utility services, which is limited to contiguous countries, sales through foreign affiliates can take place with any country that permits foreign investment in these sectors. International direct investment in utilities increased dramatically during the 1990s as privatization and regulatory reform programs made such investment possible. The bulk of U.S. direct investment abroad took place between 1996 and 1998, with the largest investments going to the electric power sectors in the United Kingdom and Australia. By 2001, U.S. utilities held direct investments abroad measuring \$25.9 billion, as compared with \$6 billion in 1995.⁸ However, rapid growth in U.S. direct investment abroad in the utilities segments appears to be tapering off. In 2001, U.S. direct investment abroad in the utilities sector increased by 8 percent, as compared with average annual growth of 22 percent recorded during 1996-2000.⁹ Data from subsequent years are likely to reflect either slower growth or perhaps even a decline, as adverse market conditions in the U.S. domestic energy market in 2002 prompted many U.S. utilities to reduce their

⁴ USDOE, EIA, *Natural Gas Monthly August 2001*, Table SR2.

⁵ USDOE, EIA, *Annual Energy Review 2000*, Table 8.1.

⁶ Electric power trade data from the U.S. Department of Commerce (USDOC), found at Internet address <http://dataweb.usitc.gov>, retrieved Oct. 7, 2002.

⁷ Service component estimate of 2.5 percent is based on transmission and distribution operating expenses for major U.S. investor-owned electric utilities as reported in USDOE, EIA, *Electric Power Annual 2000 Volume II*, Nov. 2002, p. 38.

⁸ USDOC, Bureau of Economic Analysis (BEA), *Survey of Current Business*, Oct. 1998, pp. 154-155, and Sept. 2002, pp. 95-96.

⁹ USDOC, BEA, *Survey of Current Business*, Sept. 2002, pp. 95-96.

involvement in foreign markets (see further discussion below). Affiliate sales through utilities, which measured \$39.2 billion in 2000¹⁰ (figure 12-1), may fall as well.

In 2001, the cumulative foreign direct investment position in U.S. electric, gas, and sanitary services measured \$19.3 billion, generating income of \$651 million. Official data for foreign direct investment in U.S. utilities report a decline of 23 percent during 2001, as compared with average annual growth of 96 percent recorded during 1996-2000.¹¹ This decline of nearly \$9 billion does not reflect actual outflows of investment, however, but rather an alteration caused by shifting one or more foreign affiliates into a different industry code.¹² In fact, \$2.9 billion in new foreign direct investment flowed into the utilities sectors in 2001. U.S. purchases from foreign affiliates measured \$21.9 billion in 2000, representing a one-year increase of 15 percent as compared to the 23-percent average annual growth rate recorded during 1997-99.¹³

Most inbound foreign direct investment in utilities has occurred since 1999. Much of this investment originated in the United Kingdom and was directed toward the electric power sector, although some significant foreign investments were made in the U.S. water sector as well. Foreign investment in the electric utility segment principally involved two British companies, Scottish Power and National Grid. In 1999, Scottish Power acquired Pacificorp, a major west-coast utility, in a transaction valued at \$10.9 billion.¹⁴ In 2000, National Grid acquired New England Electric System for \$3.2 billion, as well as Eastern Utility Associates for \$643 million.¹⁵ National Grid further extended its reach into the northeastern U.S. market in January 2002 through a \$3-billion acquisition of New York state electricity and gas company Niagara Mohawk Holdings, Inc.¹⁶ To date only one major foreign firm has acquired a presence in the U.S. natural gas utility market. In 2000, Powergen (U.K.) acquired LG&E Energy Corp. of Kentucky for \$3.2 billion.¹⁷ Powergen itself was subsequently acquired by E.ON AG, a German conglomerate, in 2002. Significant foreign investments in the water sector include the \$1.4-billion acquisition of United Water by Suez Lyonnaise des Eaux (France), the \$607-million acquisition of

¹⁰ Official data on sales of services by electric, gas, and sanitary utilities do not distinguish between the transportation service component and the commodity component. For example, sales of services by a water utility would include the charge for the water in addition to charges for services such as collection, purification, and transportation.

¹¹ USDOC, BEA, *Survey of Current Business*, Sept. 2002, p. 66.

¹² U.S. direct investment position data consolidates all investment by any given firm into the industry category responsible for the largest share of revenues. Consequently, changes at the corporate level that alter the relative proportion of a firm's revenues can result in all investment by that corporation being shifted into another industry category.

¹³ USDOC, BEA, *Survey of Current Business*, Oct. 2002, p. 124.

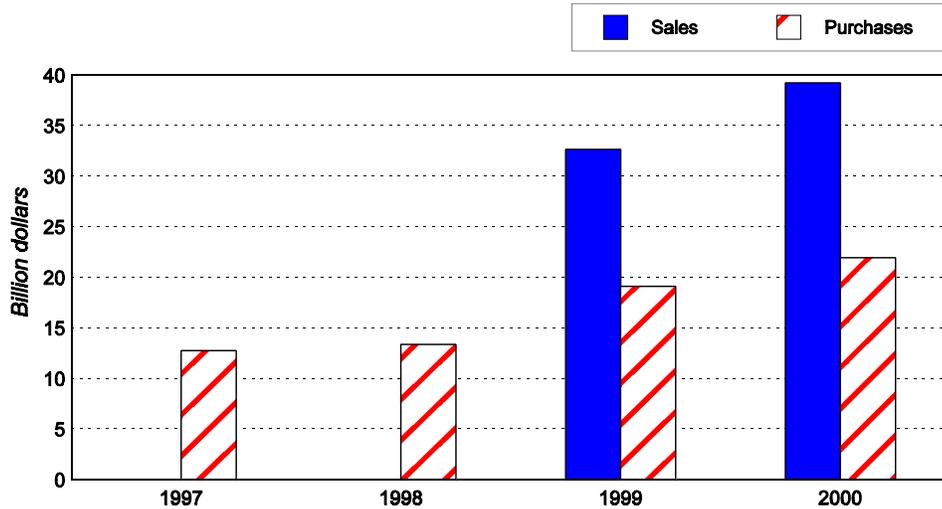
¹⁴ USDOE, EIA, "U.S. Energy Assets Attract Foreign Investment in 1999," found at Internet address <http://www.eia.doe.gov>, retrieved Oct. 10, 2002.

¹⁵ National Grid Group, found at Internet address <http://www.nationalgrid.com>, retrieved Oct. 10, 2002.

¹⁶ Ibid.

¹⁷ Standard & Poor's Industry Surveys, *Natural Gas Distribution*, May 16, 2002.

Figure 12-1
Utilities: Sales¹ by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



¹ Sales data for 1997 and 1998 are not available.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

E'Town by Thames Water PLC (U.K.),¹⁸ and the \$444-million purchase of Aquarion by Kelda Group PLC (U.K.), all of which took place in 1999.¹⁹

Market Overview

U.S. Output

Real gross output of the utilities industries increased steadily at an average annual rate of 1.3 percent during 1990-2000. This slow and steady growth demonstrates that consumption of utilities services is closely aligned with general economic growth and that utilities services generally remain under some form of price regulation whereby rates are adjusted in order to assure that utilities receive a reasonable and consistent

¹⁸ The water-related companies of Suez Lyonnaise des Eaux were united into a single subsidiary called Ondeo in 2001; and Thames Water PLC. was acquired by RWE of Germany in 2000. National Research Council, *Privatization of Water Services in the United States* (Washington, DC: National Academy Press, 2002), p. 17; and corporate information found at Internet addresses <http://www.ondeo.com> and <http://www.thames-water.com>, retrieved Nov. 15, 2002.

¹⁹ The combined value of recent U.S. acquisitions by foreign firms, as reported in the media, may exceed the total foreign direct investment position in the United States for several reasons. Most prominently, the balance-of- payments data used to determine investment position cover only transactions between foreign parent groups and their U.S. affiliates. Therefore, the investment position data do not include transactions financed through funds borrowed in the United States. For further information, see USDOC, BEA, *Survey of Current Business*, "A Guide to BEA Statistics on Foreign Direct Investment in the United States," Feb. 1990, pp. 29-37.

rate of return on investment. The primary intermediate inputs to utilities are the commodities necessary for service provision (coal, natural gas, and water) as well as maintenance and repair services. As shown in figure 12-2, real gross domestic product appears to have an inverse relationship to real intermediate inputs. One possible explanation for this trend could be that utilities delay capital improvements during periods when fuel costs rise. For example, the 1998 increase in real intermediate inputs appears to correspond with rising prices for natural gas. Then, as natural gas prices receded during 1999-2000, utilities appear to have increased capital spending proportionately such that the overall trend in real gross output reflected no significant variation.

Competitive Environment

In 2001, the United States had approximately 3,300 electric power utilities, 1,400 local gas distribution utilities, 54,000 community water systems (serving more than 25 people per day on a continuous basis), and 16,000 wastewater treatment facilities.²⁰ In numerical terms, the majority of these utilities were owned by public municipalities. However, in terms of market share, investor-owned utilities play a dominant role in the electric power and natural gas segments, as large private firms serve most major population centers.

The largest investor-owned electric power companies in the United States in 2001 were American Electric Power and Duke Energy, which had operating revenues of \$61.3 billion and \$59.5 billion, respectively.²¹ Other major U.S. electric power companies included Reliant Energy, Dynegy, and Aquila, each of which had revenues exceeding \$40 billion; as well as Mirant, TXU, and PG&E, each of which recorded revenues in the range of \$20 billion to \$30 billion. By comparison, there are significantly fewer foreign electric power companies that have achieved the same scale, including State Power of China, with 2001 sales of \$48.4 billion, Tokyo Electric Power (\$41.8 billion) and Electricité de France (\$36.5 billion).²²

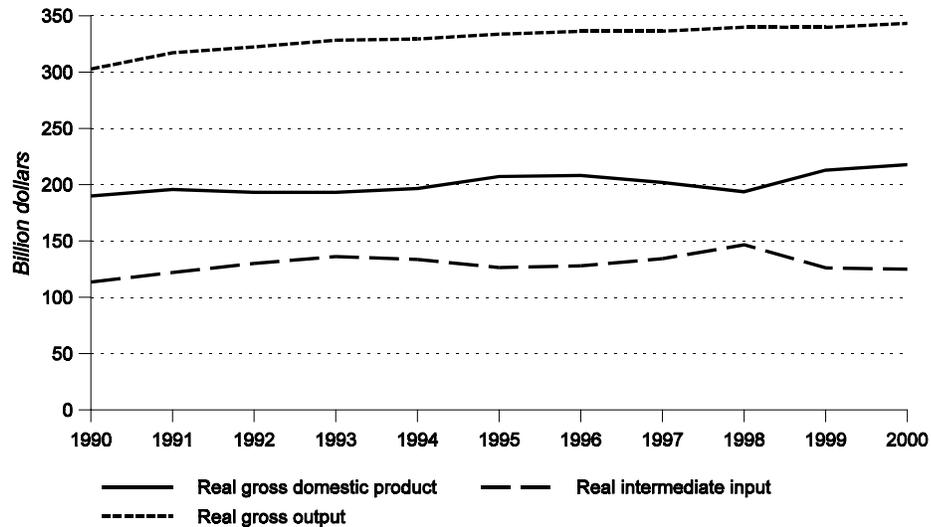
In the gas sector, El Paso Corp. was by far the largest U.S. player in 2001, with operating revenues of \$57.5 billion. Other major U.S. gas pipeline companies included the Williams Companies, with sales of \$11.0 billion, NiSource (\$9.5 billion), and Sempra Energy (\$8.0 billion). Due to growing convergence between the gas and electric power industries, a significant number of companies are very active in both sectors, including Duke Energy, Aquila, Dynegy, and Mirant. Major foreign firms with activities in the natural gas utility industry included E.ON AG (Germany), with 2001 revenues of \$66.5 billion (revenues included non-utility

²⁰ USDOE, EIA, *Electric Power Annual 1999 Vol. II*, Oct. 2000, p. 1, and *Natural Gas Annual 2000*, Nov. 2001, p. 198, found at Internet address <http://www.iea.doe.gov>, retrieved Nov. 20, 2002; and United States Environmental Protection Agency, "The Clean Water and Drinking Water Infrastructure Gap Analysis," Sept. 2002, found at Internet address <http://www.epa.gov>, retrieved Oct. 10, 2002.

²¹ Includes revenue from electric power and natural gas operations, and all other sources. Standard & Poor's Industry Surveys, *Electric Utilities*, Aug. 8, 2002.

²² Fortune, "The 2002 Global 500," found at Internet address <http://www.fortune.com>, retrieved Aug. 30, 2002.

Figure 12-2
Utilities: Real gross domestic product, real gross output and real intermediate inputs, 1990-2000



Source: Compiled by the U. S. International Trade Commission.

business segments),²³ Repsol YPF of Spain with 2001 sales of \$39.1 billion (which also may have included crude petroleum and natural gas production revenues), Gazprom of Russia (\$20.2 billion), and Gaz de France (\$12.9 billion).²⁴

In the water sector, privately-owned utilities represented 33 percent of all community water systems but only 12 percent of systems that served more than 10,000 households.²⁵ As of 2001, the largest U.S. investor-owned water companies were American Water Works Company and Philadelphia Suburban Corporation, which had sales of \$1.4 billion and \$307 million, respectively. Other leading U.S.-owned companies, including California Water Service Group and American States Water Company, were less than one quarter the size of Philadelphia Suburban. By contrast, European investor-owned utilities were several times larger, with the largest being Suez Lyonnaise (France), RWE AG (Germany), and Vivendi Environment (France), which recorded 2001 sales of \$37.8 billion, \$26.6 billion, and \$25.7 billion, respectively.²⁶ With RWE due to acquire American Water Works by mid-2003, U.S. firms will fall even further in the ranking of the world's leading water utilities. This is principally a result of the U.S. market structure, which remains highly fragmented and dominated by local municipalities. However, these same factors suggest that the U.S. market offers considerable potential for consolidation, either through mergers and acquisitions or through the expansion of firms that provide facilities management on a contractual basis.

²³ Standard & Poor's Industry Surveys, *Natural Gas Distribution*, May 16, 2002.

²⁴ Fortune, "The 2002 Global 500."

²⁵ National Research Council, *Privatization of Water Services in the United States*, p. 15.

²⁶ *Ibid.*, p. 17.

The most significant development affecting the utilities sectors in 2002 was the broad-based accounting crisis that swept through the U.S. industry. Due to allegedly improper accounting practices that were first identified at Enron during 2001, the entire energy industry has been subjected to increased scrutiny from regulators and investors. Continued fallout from the failure of California's competitive retail power market during the summer of 2001 further tarnished the reputation of the industry, as allegations concerning manipulation of both California's electric power and natural gas markets mounted. Meanwhile, the energy trading business as a whole suffered a severe setback with a series of revelations that energy traders engaged in "round-trip" trades that artificially inflated trading volumes.²⁷ The cumulative effect of these events is an atmosphere of considerable uncertainty concerning both the outcome of pending litigation and the potential lasting effects on market structure. In practical terms, virtually all energy utilities have had difficulty raising capital and many have been forced to undertake major financial restructuring in order to reassure investors. Standard & Poor's reported credit rating downgrades in the electric utilities segment quadrupled in 2002.²⁸ Due to its poor credit rating, Dynegy, one of the leading U.S. energy traders in 2001, announced plans to cease its energy trading operations in October 2002.²⁹ El Paso followed with a November 2002 announcement that it plans to exit the energy trading business in 2003.³⁰

As noted, many U.S. firms have decided to retrench from foreign markets in order to strengthen their financial positions. For example, several have scaled back their participation in Europe's energy markets significantly; the Williams Cos. announced plans to exit the market; Aquila Energy ceased its European energy trading operations; Duke Energy announced staffing reductions at its European trading unit; and TXU announced plans to abandon its European wholesale and retail electricity businesses.³¹ U.S. companies have similarly begun to reduce their involvement in the Australian market, as NRG Energy, EMS Energy, and American Electric Power

²⁷ A "round trip" trade consists of offsetting purchase and sale transactions with the same counterparty. Because no physical transaction takes place, the only effect is to give the appearance that the trading companies are trading more energy than they are in actuality. However, by artificially increasing trading volumes, these firms appear to have provided investors with inaccurate information concerning both their operations and the nature of the energy trading market.

²⁸ Rebecca Smith, "Electric Industry Hits Credit Crisis," *The Wall Street Journal*, Oct. 15, 2002, p. A2.

²⁹ Rebecca Smith, "Dynegy to Stop Trading Energy; President Bergstrom Resigns," *The Wall Street Journal*, Oct. 17, 2002, p. B7.

³⁰ El Paso Corporation, "El Paso Corporation Announces Third Quarter 2002 Results and Plan to Exit the Energy Trading Business," Nov. 8, 2002, found at Internet address <http://www.elpaso.com>, retrieved Nov. 15, 2002.

³¹ *Reuters*, "Duke Energy Says Cutting Jobs at Europe Trading Unit," Sept. 17, 2002, found at Internet address <http://www.energycentral.com>, retrieved Sept. 18, 2002; and Kathryn Kranhold, "TXU is Set to Cut Europe Business, Lowers Estimate," *The Wall Street Journal*, Oct. 15, 2002, p. A2.

have already announced sales or the intention to sell assets, and analysts anticipate that Aquila and AES will soon follow.³²

The terrorist attacks of September 11, 2001, have significant bearing on all of the utility industries as critical infrastructure is reportedly a potential target for further incidents. In response, security measures have been increased nationwide to enhance protection of the water and energy delivery systems. For example, in August 2002, additional security measures recommended by the Nuclear Regulatory Commission were put into place, which include barrier systems and more extensive security teams.³³ Owners of gas pipelines, power transmission facilities, and water facilities have similarly increased hiring and training of security personnel and expanded patrols and surveillance.³⁴ The net effect of these efforts is greater expenditures on security, which will in turn likely be felt by ratepayers and investors. However, relative to the entire economy, the impact of a sharp increase in private security spending is estimated to be small.

WTO Update

Utility services figure prominently in the ongoing WTO negotiations under the GATS. Energy utilities were addressed to some extent in seven of the eight negotiating proposals on energy services,³⁵ whereas water and wastewater utilities were addressed at least in part by the seven proposals on environmental services.³⁶ Despite the appearance of a division between energy and water-related utilities, the negotiating proposals shared many similarities, including the nature of trade

³² *Reuters*, "FACTBOX - Power Asset Sales in Australia," Sept. 12, 2002, found at Internet address <http://www.energycentral.com>, retrieved Sept. 13, 2002.

³³ Examples of barrier systems include concrete barriers arranged to form a serpentine track that prevents vehicles from exceeding 5 miles per hour as well as Delta barriers, which are flexible 20-foot barriers flanked by two concrete blocks positioned on opposite sides of the road such that, if a vehicle attempts to run through the barrier, the flexible barrier stretches until the two blocks become dislodged and crush the vehicle. Sean Adkins, "Three Mile Island Power Plant Security Plan Covers Many Bases," *York Daily Record*, Sept. 11, 2002, found at Internet address <http://www.energycentral.com>, retrieved Sept. 13, 2002.

³⁴ Deborah Circelli, "Florida's Nuclear Plants Beef Up Security in Response to Code Orange Alert," *The Palm Beach Post*, Sept. 11, 2002, found at Internet address <http://www.energycentral.com>, retrieved Sept. 13, 2002.

³⁵ Canada submitted a proposal that addressed energy services, however this proposal was limited to services provided at crude petroleum and natural gas fields. The energy sector proposals may be found at Internet address <http://www.wto.org> under the corresponding document symbol: Canada - S/CSS/W/58, Mar. 14, 2001; Chile - S/CSS/W/88, May 14, 2001; Cuba - S/CSS/W/144, Mar. 22, 2002; European Union - S/CSS/W/60, Mar. 23, 2001; Japan - S/CSS/W/42/Suppl.3, Apr. 10, 2001; Norway - S/CSS/W/59, Mar. 21, 2001; United States - S/CSS/W/24, Dec. 18, 2000; and Venezuela - S/CSS/W/69, Mar. 29, 2001.

³⁶ The environmental sector proposals may be found at Internet address <http://www.wto.org> under the corresponding document symbol: Australia - S/CSS/W/112, Oct. 1, 2001; Canada - S/CSS/W/51, Mar. 14, 2001; Colombia - S/CSS/W/121, Nov. 27, 2001; Cuba - S/CSS/W/142, Mar. 22, 2002; European Communities - S/CSS/W/38, Dec. 22, 2001; Switzerland - S/CSS/W/76, May 4, 2001; and the United States - S/CSS/W/25, Dec. 18, 2001.

impediments they seek to eliminate and the difficulties in negotiating liberalization posed by weaknesses in the industry classification system used by WTO members.

In general, the negotiating proposals share a common objective of improving market conditions for utility service providers by obtaining stronger commitments from WTO members on market access and nondiscriminatory treatment of foreign service providers. Inadequate regulatory transparency figures prominently among the list of impediments to trade that WTO members seek to address, as do limitations on foreign investment and the form of establishment. Other major impediments cited in the proposals include difficulties related to licensing procedures and restrictions on temporary movement of key personnel. Difficulties concerning access to natural gas and electric power networks were also raised as a subject for negotiation by the European Union, Japan, Norway, and the United States.³⁷

Industry classification issues present a central challenge to negotiations on utility services, principally because utilities are poorly defined in the classification system used by WTO members in negotiating commitments under the Uruguay Round. This classification system is based on the United Nations Provisional Central Product Classification (Provisional CPC), a product and service classification intended to provide a general framework for international comparison of data. Because the Provisional CPC was developed during the 1980s and published in 1991, it does not reflect the major changes in the structure of the utility industries brought about by the privatization and regulatory reform programs that proliferated during the 1990s. As a result, the CPC does not contain categories that adequately describe markets where production, transmission, distribution, and commercialization activities have been unbundled into discrete functions that are open to private participation and, to some degree, competition.³⁸

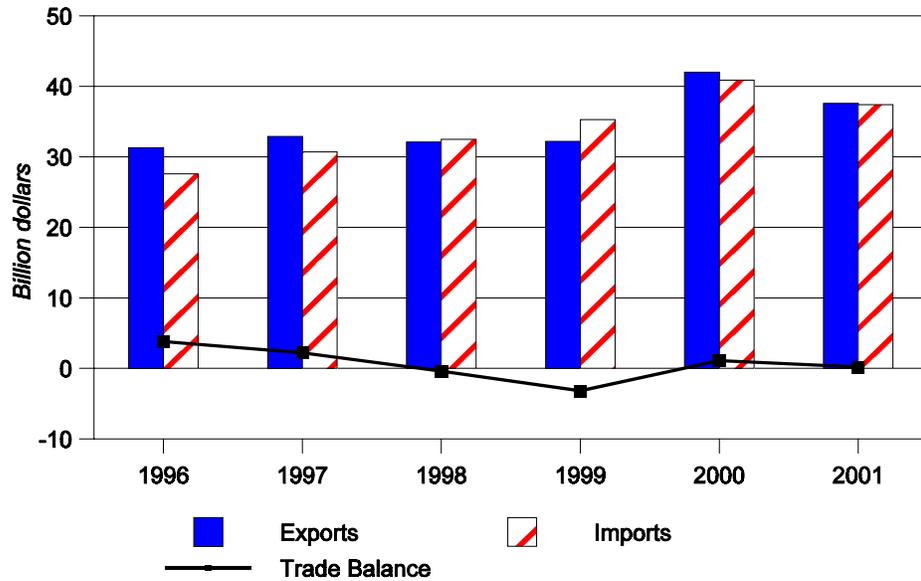
³⁷ The Commission has conducted two studies that address network access issues. See USITC, *Electric Power Services, Recent Reforms in Selected Foreign Markets*, (Inv. No. 332-411, Pub. No. 3370) Nov. 2000, and USITC, *Natural Gas Services: Recent Reforms in Selected Markets*, Inv. No. 332-426, Pub. No. 3458) Oct. 2001, both of which may be found at Internet address <http://www.usitc.gov>.

³⁸ The Provisional CPC was updated in 1998 with the publication of CPC Version 1, which does reflect some of the industry changes more accurately. However, because GATS commitments are based upon the Provisional CPC, shifting to Version 1 could alter the legal standing of existing commitments.

APPENDIX A
U.S. CROSS-BORDER TRADE IN
SERVICES, SELECTED INDUSTRIES

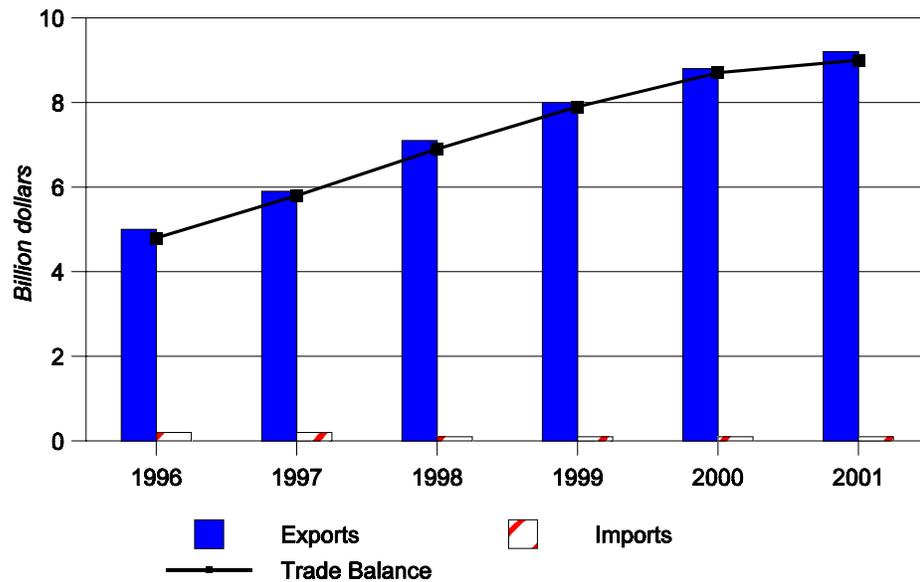
In an effort to cover as many service industries as possible in this report, and to present the information in a concise and readable format, the following figures present cross-border trade data for all available U.S. service industries that are not discussed in the preceding chapters. Where available, the figures present data for U.S. cross-border exports, imports, and trade balance for 1996-2001.

Figure A-1
Air transport: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

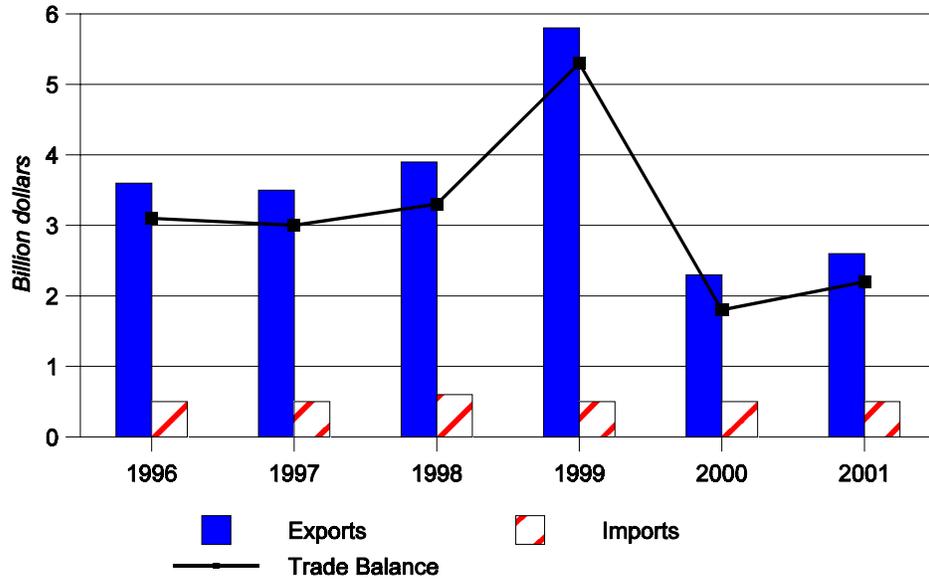
Figure A-2
Audiovisual services:¹ Cross-border trade, 1996-2001



¹ Comprises film and television tape rentals.

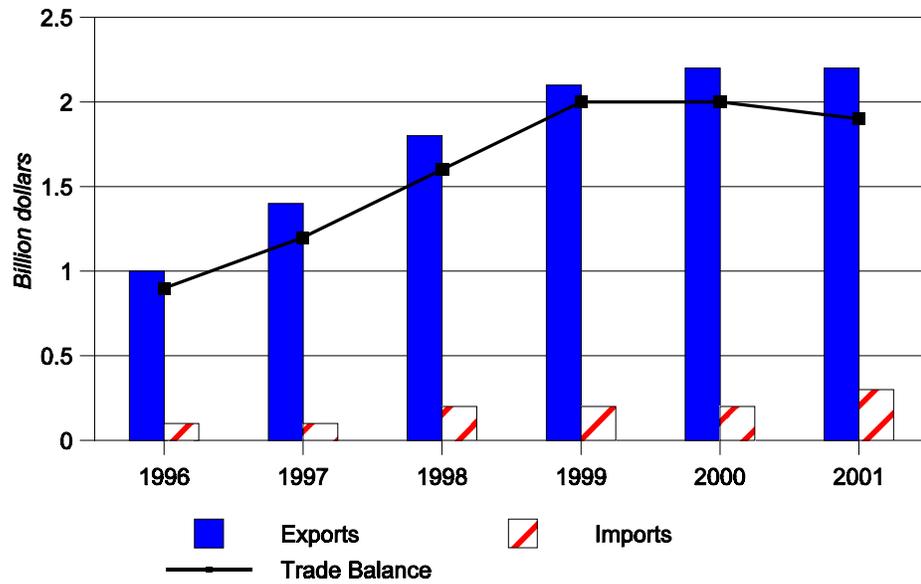
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-3
Construction, engineering, architectural, and mining services: Cross-border trade, 1996-2001



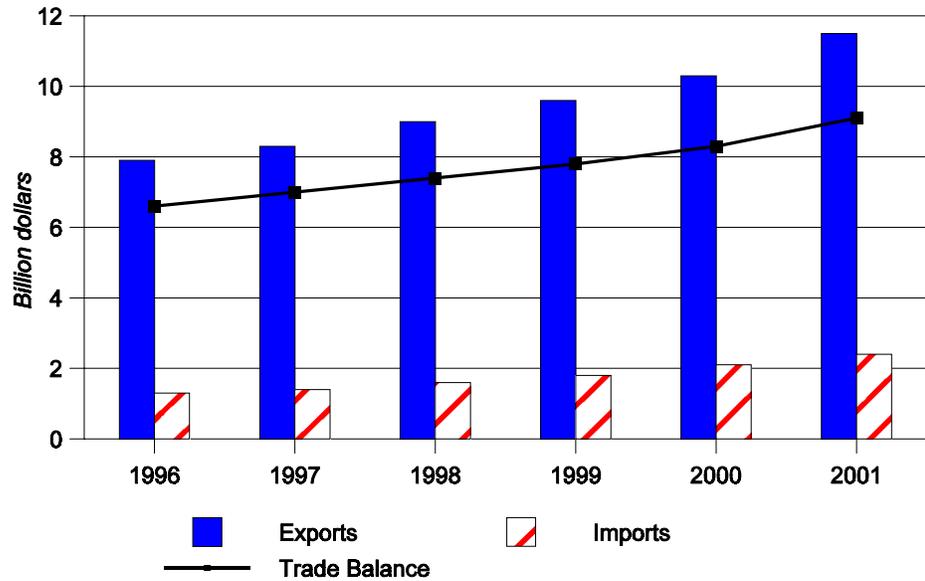
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-4
Database and other information services: Cross-border trade, 1996-2001



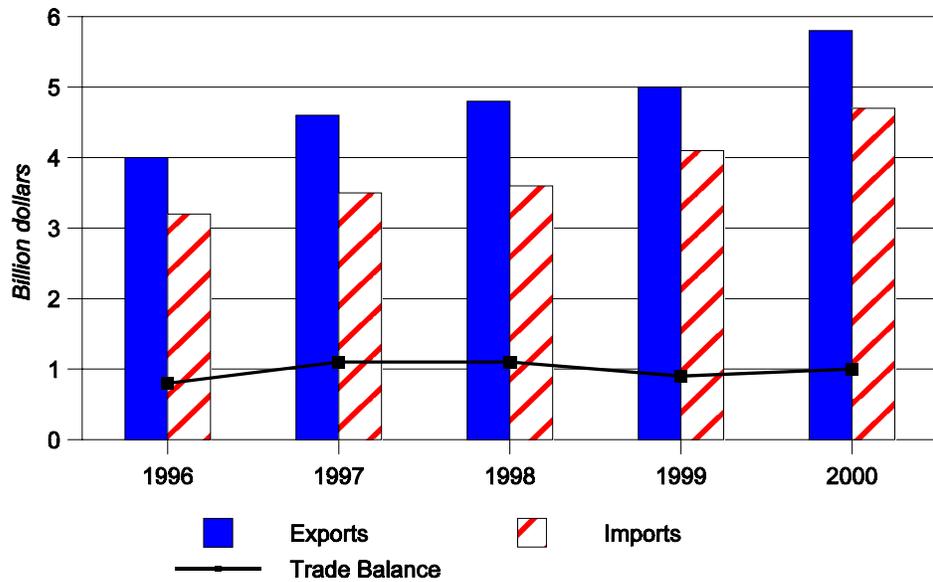
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-5
Education: Cross-border trade, 1996-2001



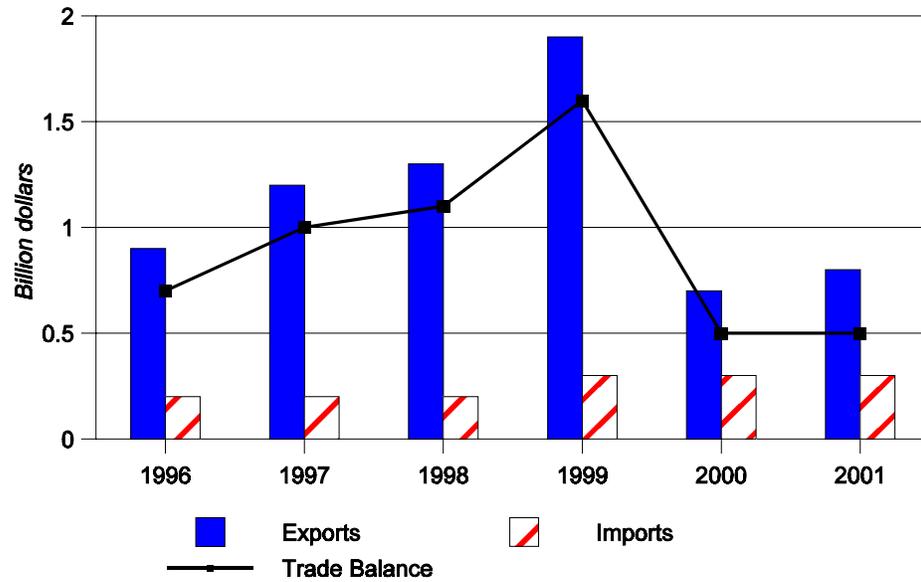
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-6
Express services: Cross-border trade, 1996-2000



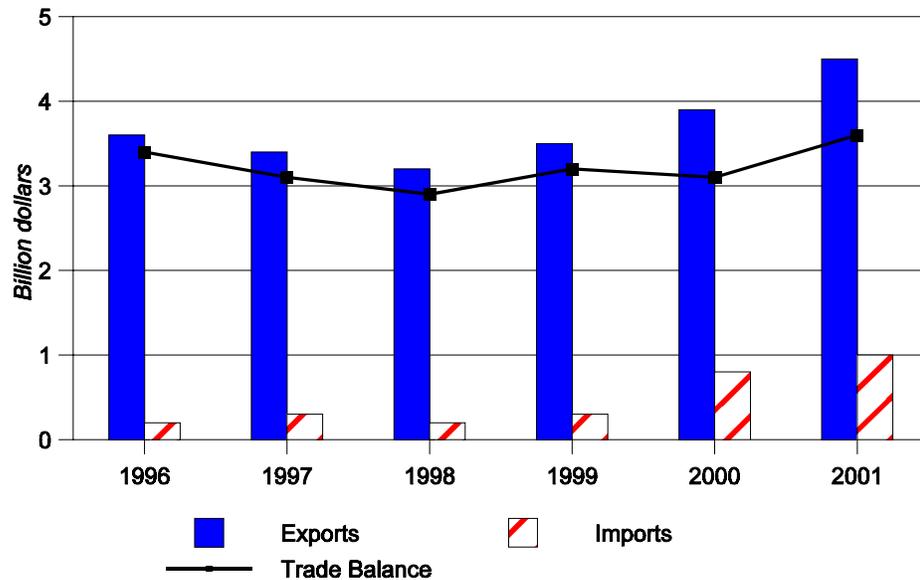
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-7
Industrial engineering services: Cross-border trade, 1996-2001



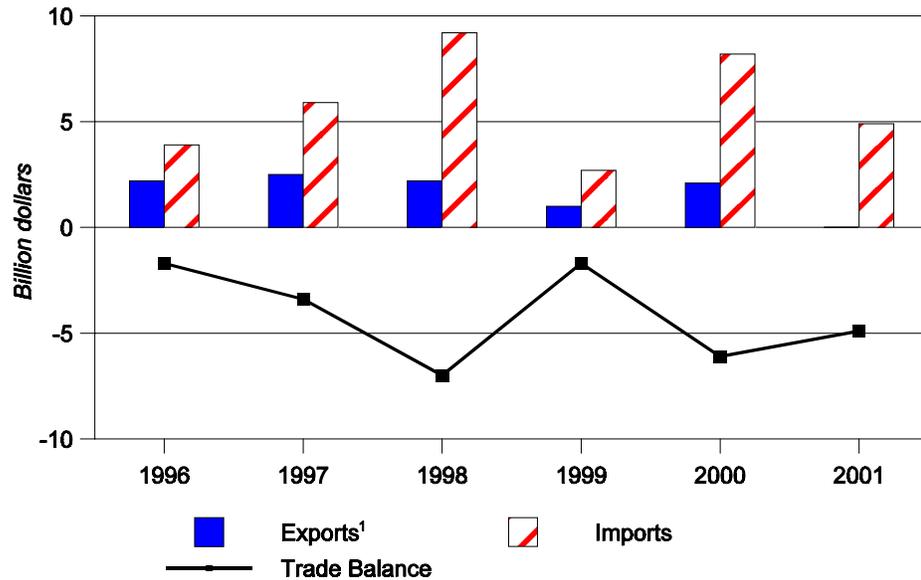
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-8
Installation, maintenance, and repair of equipment services: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

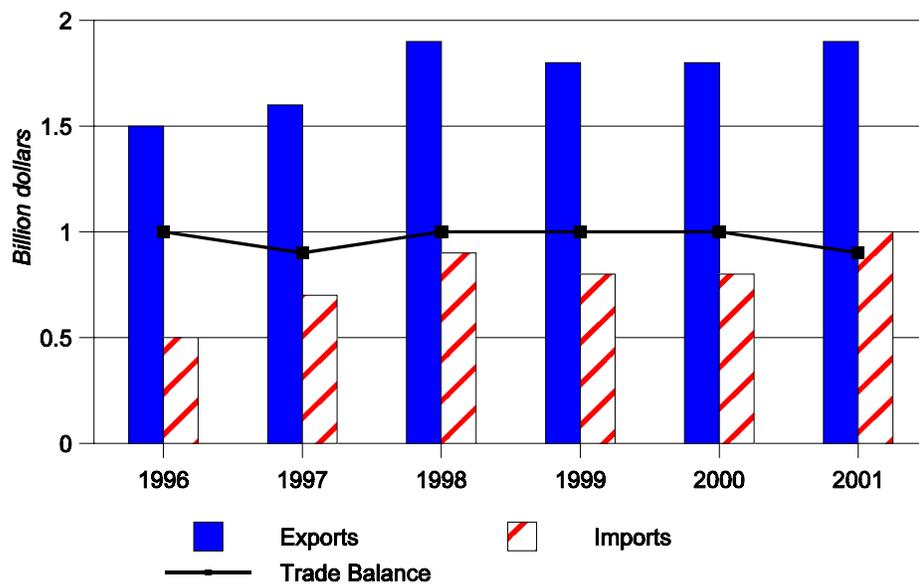
Figure A-9
Insurance services: Cross-border trade, 1996-2001



¹ U.S. exports of insurance services equaled \$18 million in 2001.

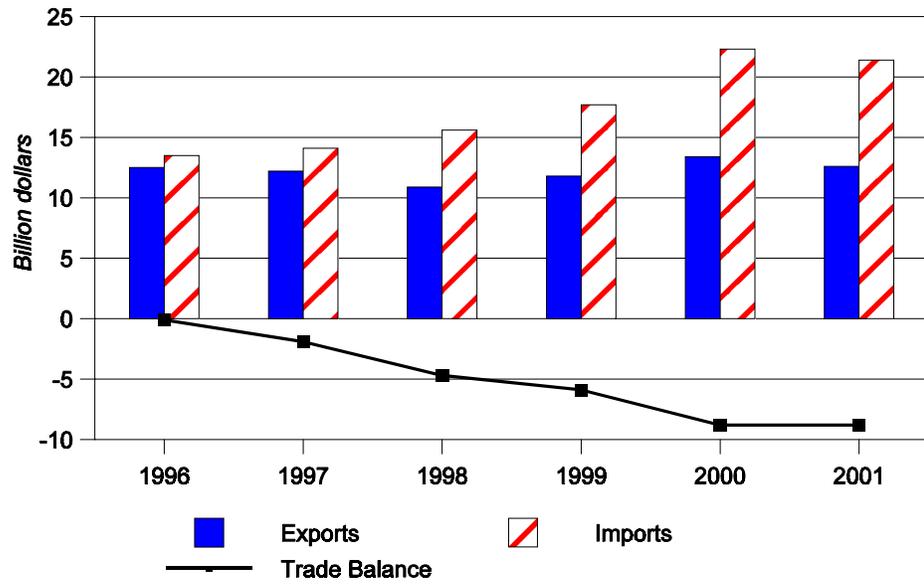
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-10
Management, consulting, and public relation services: Cross-border trade, 1996-2001



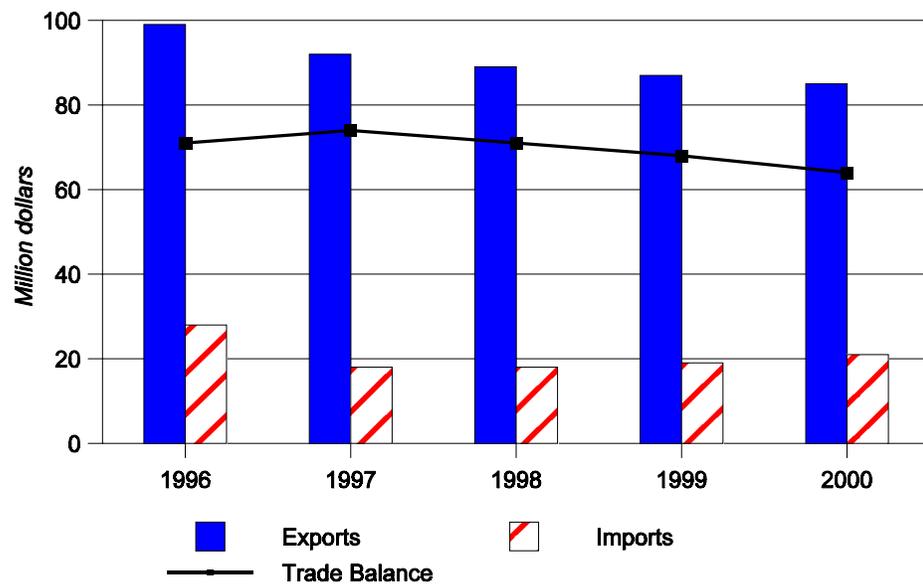
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-11
Maritime transport: Cross-border trade, 1996-2001



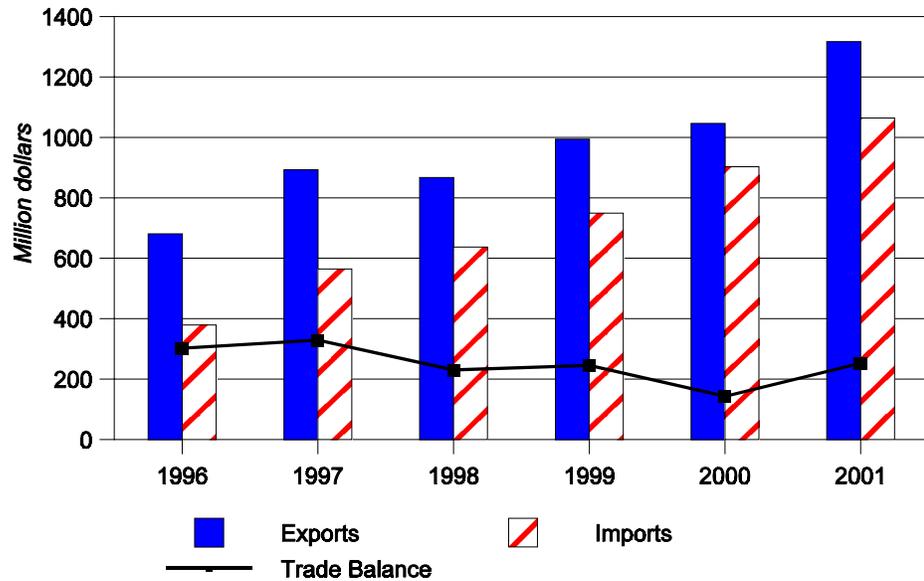
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-12
Personnel supply services: Cross-border trade, 1996-2000



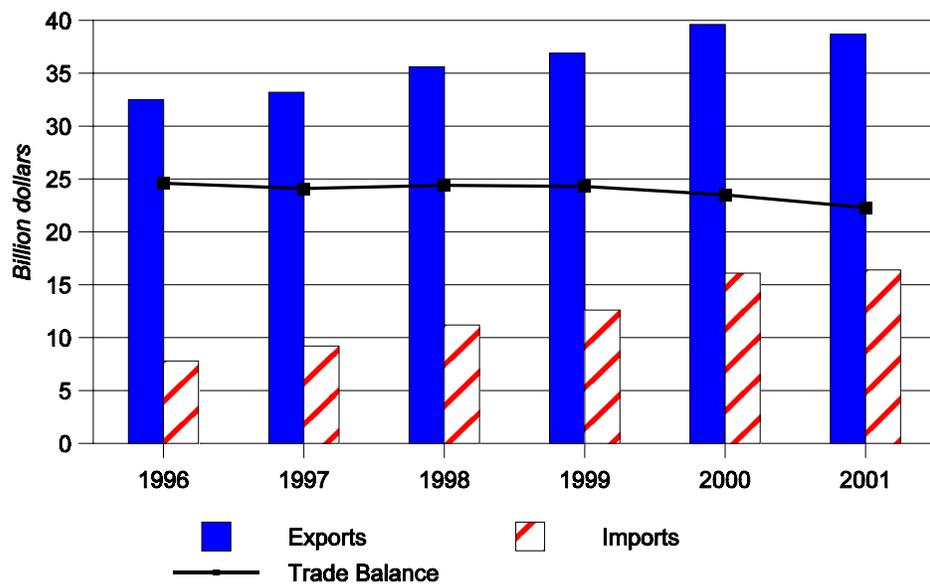
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-13
Research, development, and testing services: Cross-border trade, 1996-2001



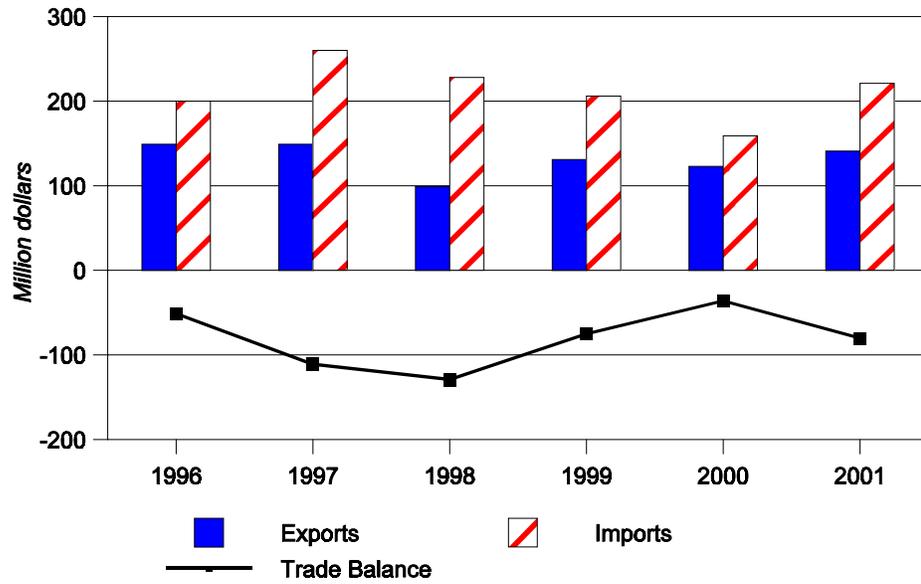
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-14
Royalties and license fees: Cross-border trade, 1996-2001



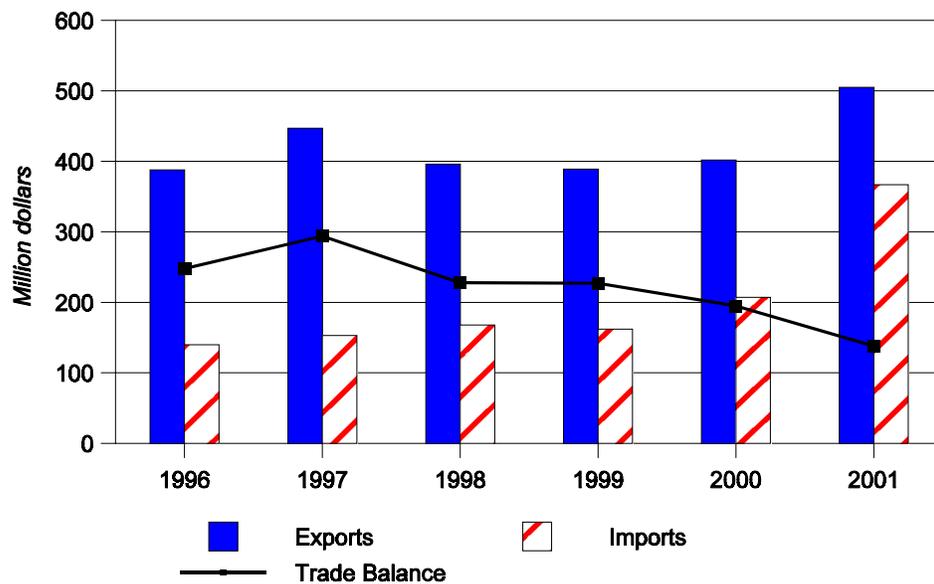
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-15
Sports and performing arts services: Cross-border trade, 1996-2001



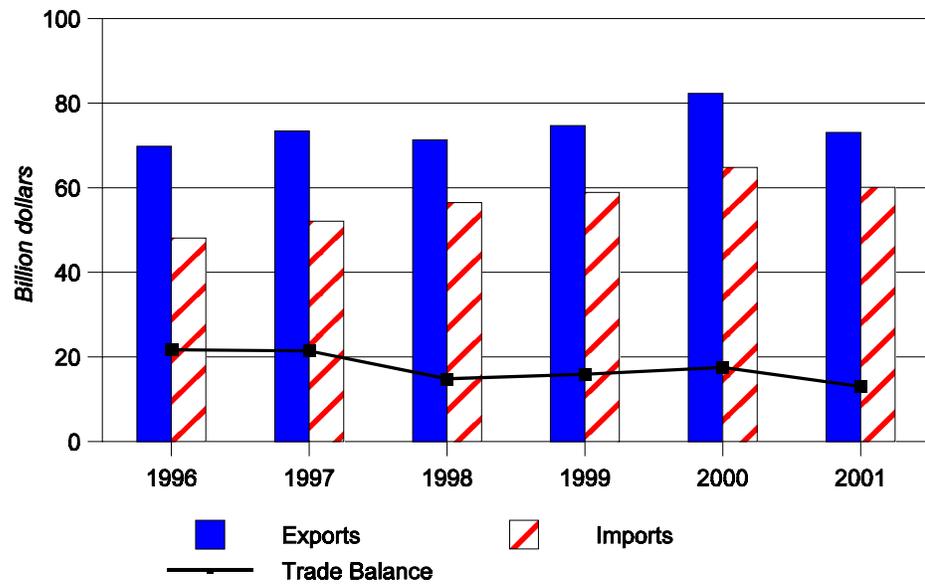
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-16
Training services: Cross-border trade, 1996-2001



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

Figure A-17
Travel and tourism: Cross-border trade, 1996-2001



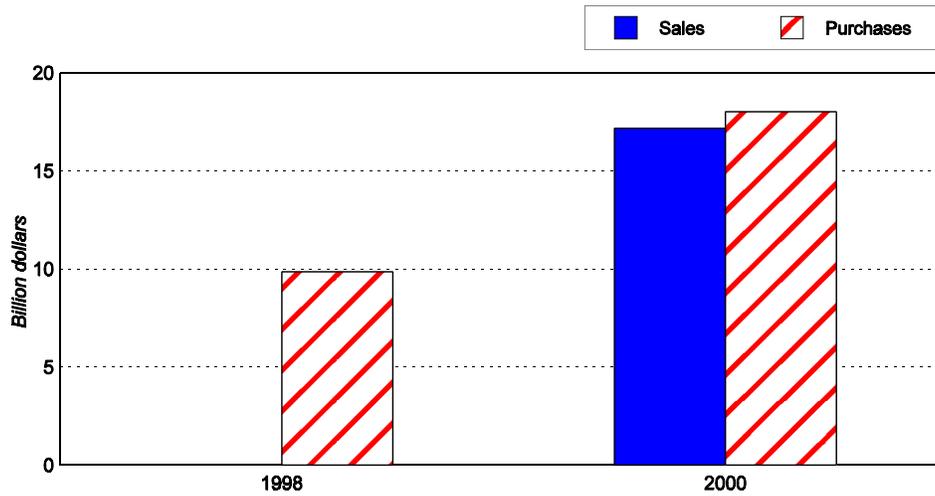
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 84-85.

APPENDIX B
U.S. AFFILIATE SALES AND
PURCHASES OF SERVICES,
SELECTED INDUSTRIES

In an effort to cover as many service industries as possible in this report, and to present the information in a concise and readable format, the following figures present sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates for all available U.S. service industries that are not discussed in the preceding chapters. The figures present data for affiliate sales for 1999-2000, and for affiliate purchases for 1997-2000.¹

¹ U.S. sales data using the North American Industry Classification System (NAICS) are available for most industries for 1999-2000. U.S. purchases data using the NAICS are available for most industries for 1997-2000. For further information, see box 2-1 in chapter 2.

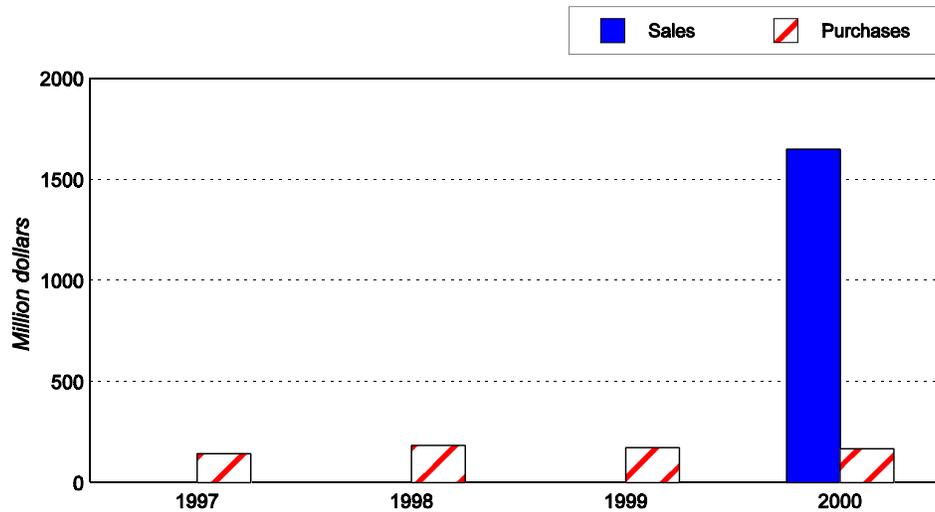
Figure B-1
Administrative and support services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1998 and 2000¹



¹ 1999 sales and purchases data were suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-2
Air transport services: Sales¹ by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000

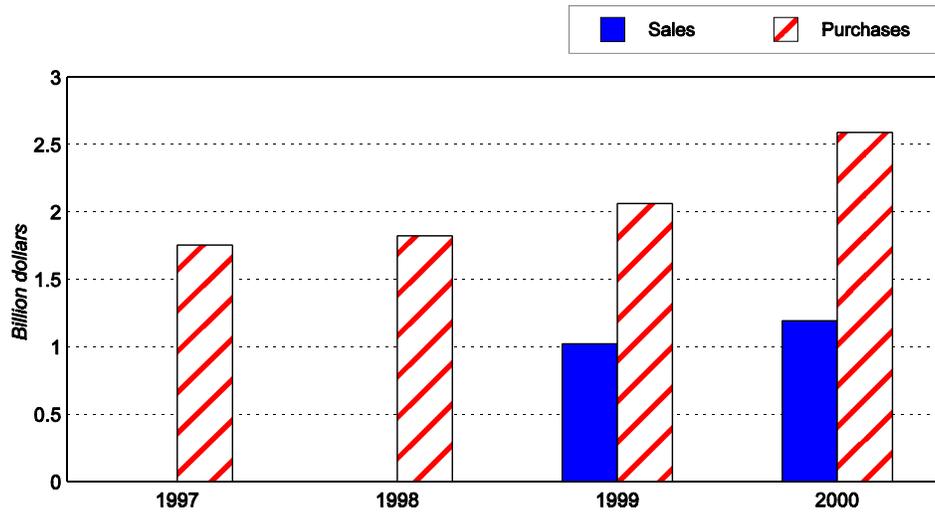


¹ 1999 sales data were suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-3

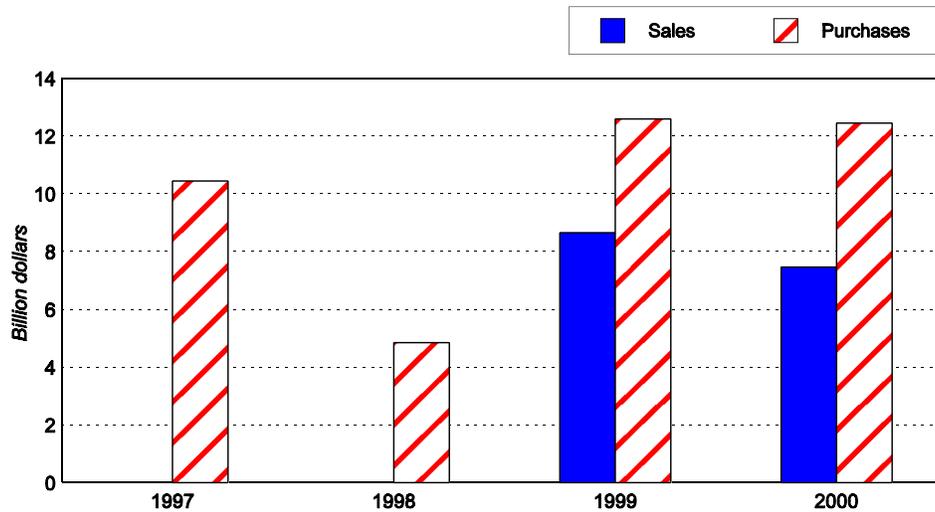
Art, entertainment, and recreation services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-4

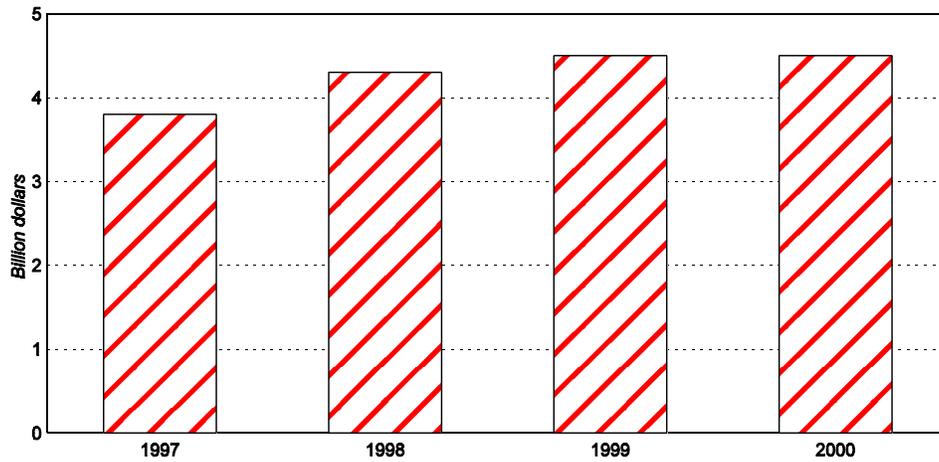
Audiovisual services: Sales¹ by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



¹ 2000 sales data do not include sound recording industries.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

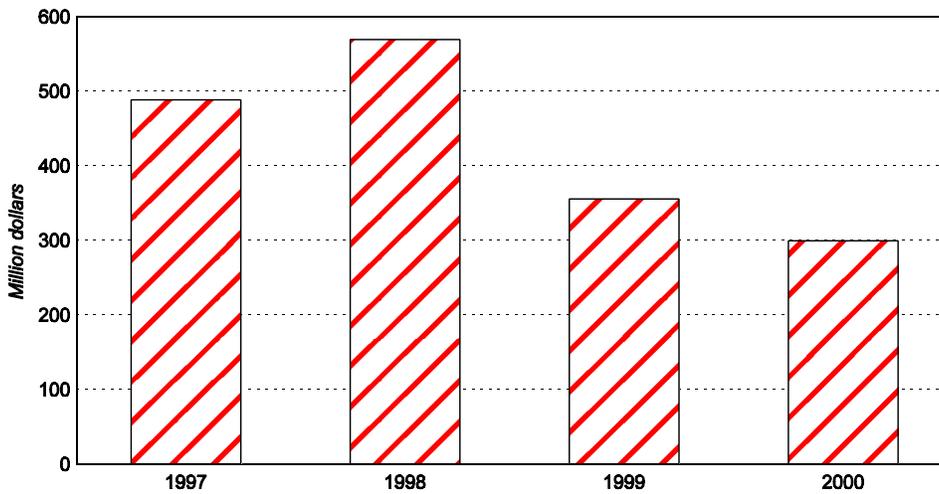
Figure B-5
Data processing and computer systems design and related services: U.S. purchases from foreign majority-owned affiliates, 1997-2000¹



¹ Data for sales were suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

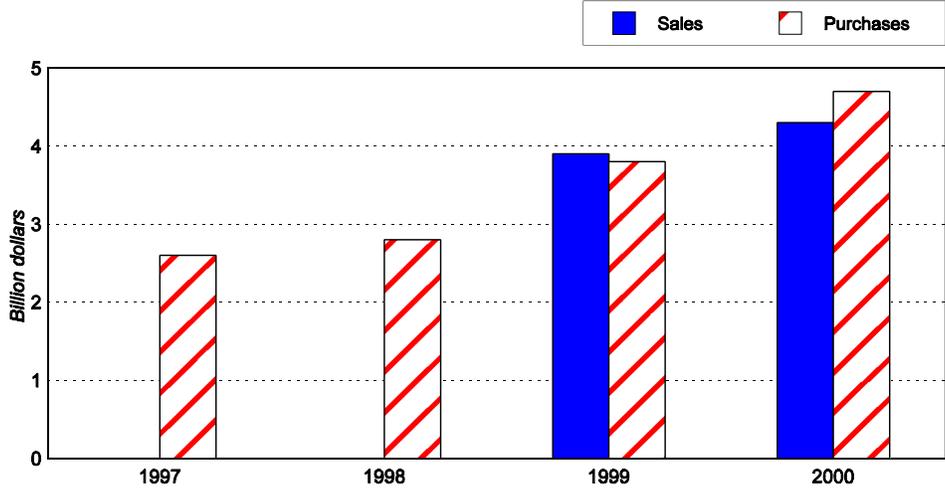
Figure B-6
Educational services: U.S. purchases from foreign majority-owned affiliates, 1997-2000¹



¹ Data for sales were suppressed to avoid disclosure of data of individual companies.

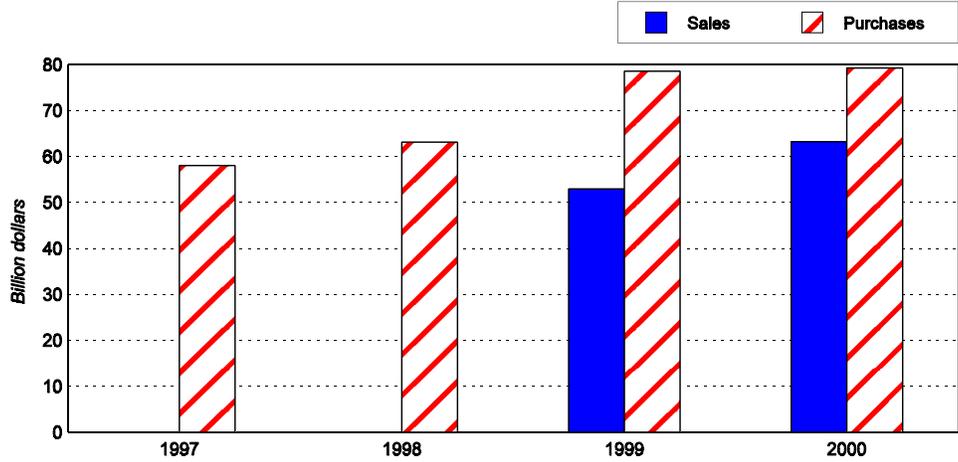
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-7
Information services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



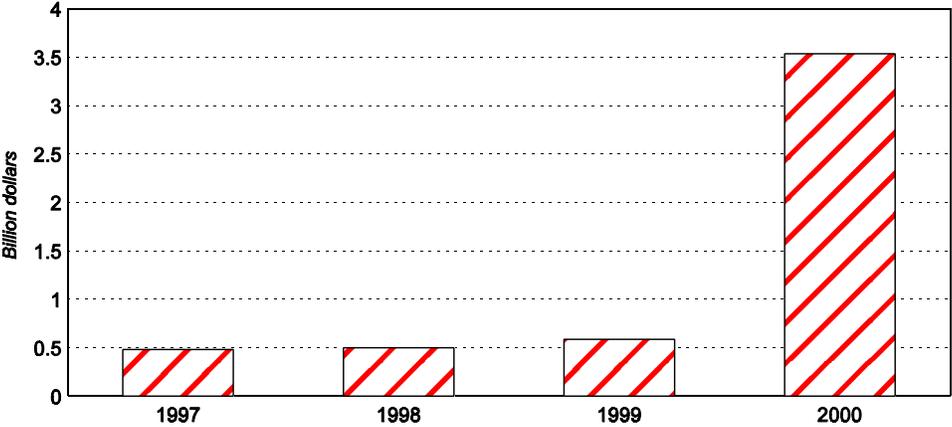
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-8
Insurance carriers and related services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

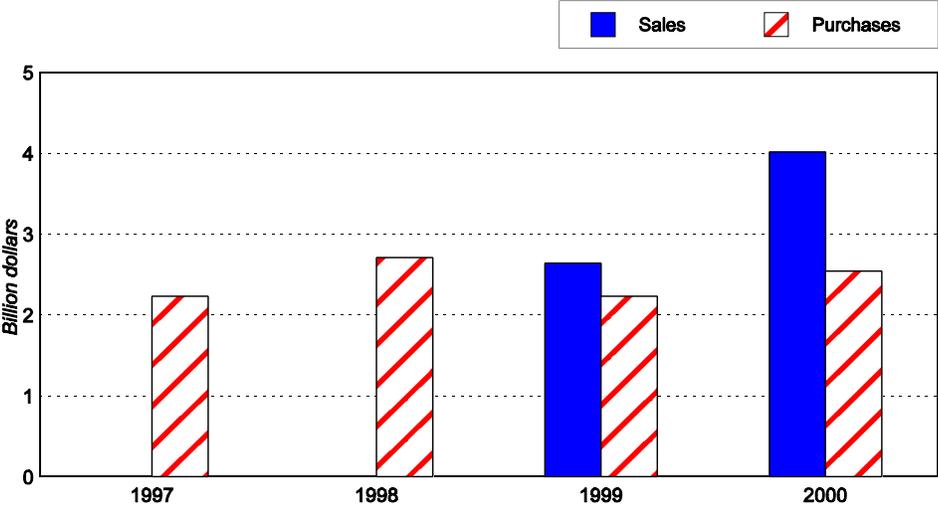
Figure B-9
Management, scientific, and technical consulting services: U.S. purchases from foreign majority-owned affiliates, 1997-2000²



¹ Data for sales were suppressed to avoid disclosure of data of individual companies.

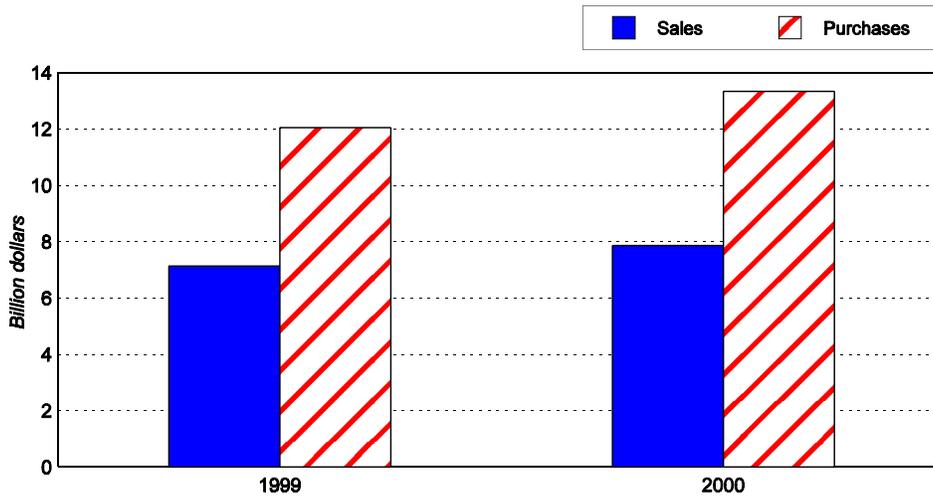
Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-10
Maritime transport services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-11
Other transport¹ services: Sales by U.S. majority-owned affiliates and U.S. purchases² from foreign majority-owned affiliates, 1999-2000

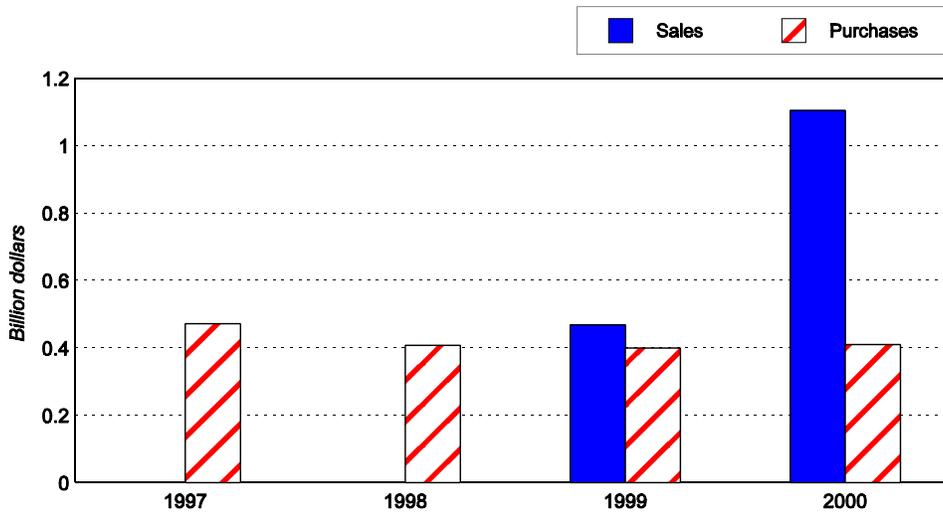


¹ Other transport services includes rail, truck, and support activities.

² 1997-1998 purchases data were suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124.

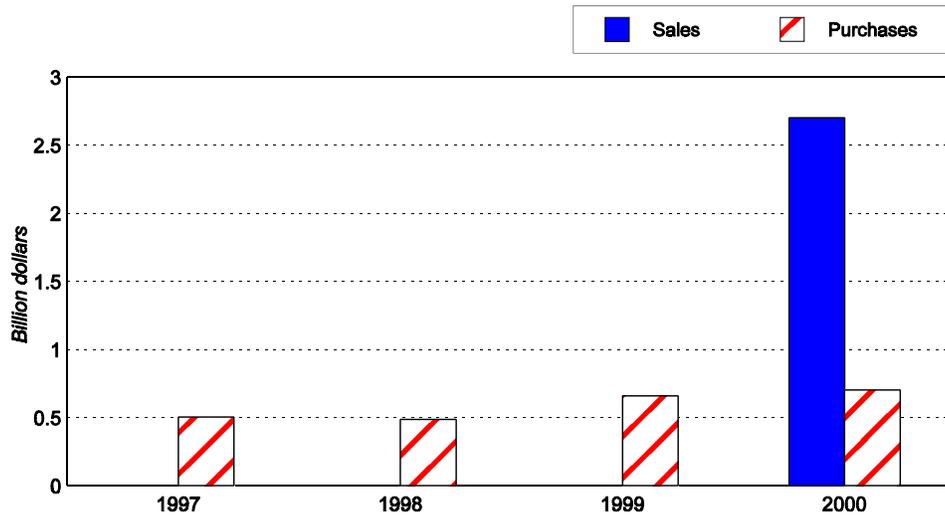
Figure B-12
Retail trade services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-13

Scientific research and development services: Sales² by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000

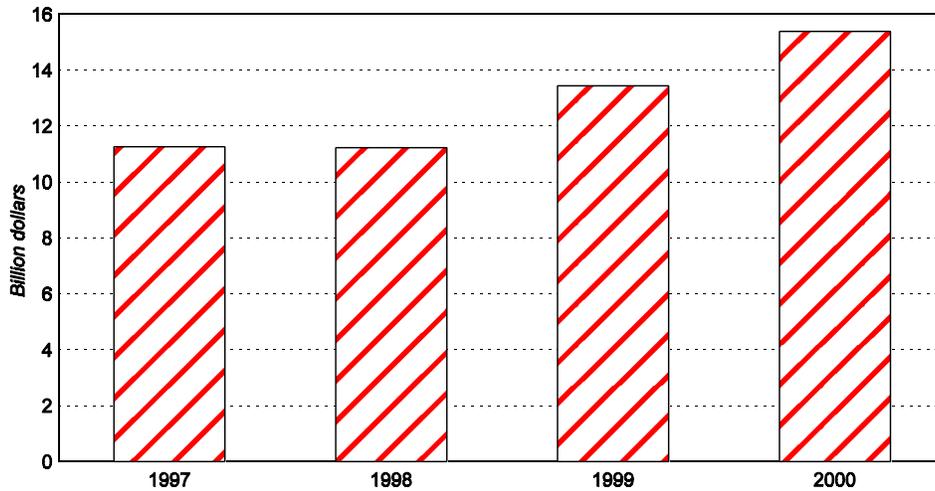


¹ 1999 sales data were suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-14

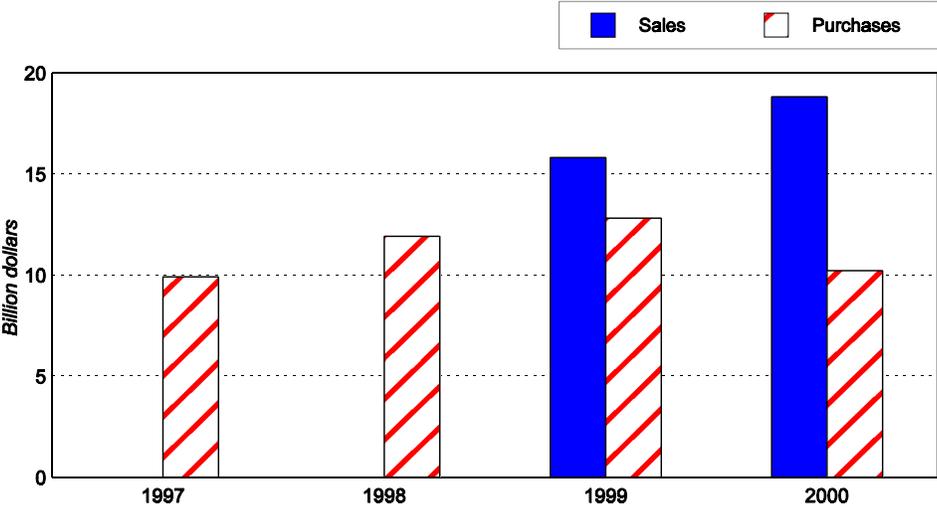
Travel and tourism services: U.S. purchases from foreign majority-owned affiliates, 1997-2000¹



¹ Data for sales were suppressed to avoid disclosure of data of individual companies.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

Figure B-15
Wholesale trade services: Sales by U.S. majority-owned affiliates and U.S. purchases from foreign majority-owned affiliates, 1997-2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Oct. 2002, pp. 121-124; Nov. 2001, pp. 94-95; and Oct. 2000, pp. 159-161.

APPENDIX C
ACTIVITIES CAPTURED IN OFFICIAL
U.S. DATA ON CROSS-BORDER TRADE
IN SERVICES BY INDUSTRY

Appendix C

Activities captured in official U.S. data on cross-border trade in services by industry

Service	U.S. Exports	U.S. Imports
Accounting	Includes accounting, auditing, and bookkeeping services. Excludes data processing and tabulating services.	Same
Advertising	Includes preparation of advertising and placement of such advertising in media.	Same
Air transport <i>Passenger fares</i> <i>Freight</i> <i>Port</i>	<p>Predominantly includes receipts by U.S. air carriers from passengers traveling between the United States and foreign countries and between two foreign points. Also includes receipts by U.S. ocean carriers for the transport of passengers.</p> <p>Includes receipts of U.S. air carriers for the international transportation of U.S. exports to foreign countries, and receipts of U.S. air carriers transporting U.S. exports between foreign points.</p> <p>Includes goods and services purchased in U.S. airports by foreign-operated carriers, including fuel and oil, station and maintenance bases, wages, and other goods and services except aircraft leasing expenses.</p>	<p>Predominantly includes payments to foreign air carriers by U.S. residents traveling between the United States and foreign countries. Also includes payments to foreign ocean carriers for the transport of passengers.</p> <p>Includes payments to foreign-operated air carriers for transportation of U.S. imports from a foreign country to the United States.</p> <p>Includes goods and services purchased in foreign airports by U.S.-operated carriers.</p>
Architectural, engineering, construction, and mining	Includes architectural, construction, engineering, and mining services, including oil and gas field services. Architectural services include services mainly for businesses, but exclude landscape architecture and graphic design services. Engineering services relate to construction and mining services projects only, and exclude industrial engineering services, such as product design services. Land-surveying services are included, as are services of general contractors in the fields of building and heavy construction, construction work by special trade contractors, and drilling wells or erecting and dismantling drilling rigs for oil and gas fields. Data are reported for services purchased in connection with proposed projects (i.e., feasibility studies) as well as projects contracted or underway, but exclude contractors' expenditures on merchandise and labor.	Same, except data include contractors' expenditures on intermediate inputs of wages, services, materials, and other expenses.
Audiovisual	Includes foreign rentals of films and tapes from U.S. sources.	Includes U.S. rentals of films and tapes from foreign sources.

See footnotes at end of table.

Appendix C--Continued

Activities captured in official U.S. data on cross-border trade in services by industry

Service	U.S. Exports	U.S. Imports
Banking and securities	Includes commissions and fees for brokerage services, private placement services, underwriting services, financial management services, credit card services, credit-related services, financial advisory and custody services, securities lending services, electronic funds transfer services, asset management services, and other financial services. Excludes deposit taking and lending services.	Same
Computer and data processing	Includes data entry, processing (both batch and remote), and tabulation; computer systems analysis, design, and engineering services; custom software and programming services; rights to produce, use, and distribute general use software, except prepackaged computer software physically shipped to or from the United States; integrated hardware/software services; and other computer services (e.g., timesharing, maintenance, and repair). Excludes operational leasing of computer and data processing equipment.	Same
Database and other information	Includes business and economic database services; medical, legal, technical, and similar database services; general news services; and credit reporting systems.	Same
Education	Includes tuition and living expenses of foreign students studying in U.S. colleges, universities, and other institutions of higher education.	Includes tuition and living expenses of U.S. students studying in foreign colleges, universities, and other institutions of higher education through "study abroad" programs sponsored by U.S. institutions.
Equipment leasing	Includes rentals for computer and data processing equipment, transportation equipment without crew or operators, and all other machinery and equipment. Excludes rentals under leases that have been capitalized, and rentals of any items other than machinery and equipment, such as real estate, film rentals, and employee leasing.	Same
Franchising	Includes fees received under business format franchising agreements. Business format franchising is characterized by an ongoing business relationship between franchisor and franchisee that includes not only the product, service, and trademark, but the entire business format itself. Excludes receipts for the use of trademarks, except where such trademarks are part of a business format franchise.	Includes fees paid under business format franchising agreements. Business format franchising is characterized by an ongoing business relationship between franchisor and franchisee that includes not only the product, service, and trademark, but the entire business format itself. Excludes payments for the use of trademarks, except where such trademarks are part of a business format franchise.

See footnotes at end of table.

Appendix C--Continued

Activities captured in official U.S. data on cross-border trade in services by industry

Service	U.S. Exports	U.S. Imports
Health care	Includes inpatient and outpatient fees charged to foreign residents. Inpatient fees include all hospital staff and outside physician fees, tests, drugs, and room and board. Outpatient charges include outpatient surgery, physical rehabilitation and therapy, dermatology, AIDS treatments, and consultations. Excludes fees for ambulatory treatment or drugs provided outside a hospital. ¹	Not available
Industrial engineering	Includes engineering services related to the design of movable products, including product design services. Includes services performed with the assistance of computers. Excludes engineering and architectural services that relate to immovable products, such as those that relate to proposed construction services projects.	Same
Insurance	Includes primary and reinsurance premiums paid by foreign persons to U.S. insurance carriers operating in the U.S. market, net of claims paid to foreign persons.	Includes primary and reinsurance premiums paid by U.S. persons to foreign insurance carriers operating in their home markets, net of claims received by U.S. persons.
Installation, maintenance, and repair of equipment	Includes maintenance services for machinery and equipment, small maintenance work on structures, and installation and training services that are provided by a manufacturer in connection with the sale of goods, when the price of these services is not incorporated into the price of the goods that is entered on the declaration files with the U.S. Customs Service.	Same
Intangible intellectual property (royalties and license fees)	Includes payments for the sale or use of intangible assets and proprietary rights. Includes, among others, license fees and royalties for industrial processes and products; royalties for use of copyrighted material in books, records, and audio tapes; payments for the use of trademarks and brand names; license and rental fees for rights to use or reproduce prerecorded performances and events; payments for rights to broadcast and record live performances; license fees for rights to distribute or reproduce general-use computer software; and fees for business-format franchising.	Same
Legal	Includes legal advice and other legal services.	Same

See footnotes at end of table.

Appendix C--Continued

Activities captured in official U.S. data on cross-border trade in services by industry

Service	U.S. Exports	U.S. Imports
Mailing, reproduction, and commercial art	Includes direct mail advertising services; mailing services, such as remailing services in connection with direct mail advertising; commercial photography, art, and graphic services; address list compilation; and stenographic services.	Same
Management, consulting, and public relations	Includes management services, except management of health care facilities; consulting services, including computer consulting but excluding consulting engineering services related to construction and mining projects; and public relations services, except those that are part of an advertising campaign.	Same
Maritime transport		
<i>Freight</i>	Includes receipts of U.S.-operated ocean carriers for the international transportation of U.S. exports, and receipts of U.S.-operated carriers transporting foreign freight between foreign points. Includes revenue on cargo outbound from U.S. ports, revenue on cross-trade cargoes, payments for charter hires, and expenses in foreign countries.	Includes payments to foreign-operated ocean carriers for international transportation of U.S. imports.
<i>Port</i>	Includes goods and services purchased in U.S. sea ports by foreign-operated carriers, including port call, cargo, fuel, and other vessel expenses.	Includes goods and services purchased in foreign sea ports by U.S.-operated carriers.
Oil and gas field	Not available. Data for this industry are included in the architectural, engineering, construction, and mining services category.	Same
Personnel supply	Includes fees paid for employment services and the provision of temporary help and personnel to perform services on a contract or fee basis, and the compensation of workers on the payroll of the agency.	Same
Research, development, and testing	Includes laboratory and other physical research, product development services, and product testing services. Also includes experiments and research and development activities aboard spacecrafts. Excludes medical and dental laboratory services.	Same
Sports and performing arts	Includes fees received for performing arts and sports events, paid through management companies, booking agents, promoters and presenters, and fees paid directly to U.S. performers by foreign persons.	Includes fees paid for performing arts and sports events, paid through management companies, booking agents, promoters and presenters, and fees paid directly to foreign performers by U.S. persons.

See footnotes at end of table.

Appendix C--Continued

Activities captured in official U.S. data on cross-border trade in services by industry

Service	U.S. Exports	U.S. Imports
Telecommunication	Predominantly includes net settlement receipts of U.S. carriers for terminating inbound foreign calls. Also includes telex, telegram, and other basic telecommunication services; value-added services, such as electronic mail, management of data networks, enhanced facsimile, and electronic funds transfer; telecommunication support services, such as repair and ground station services; and the launching of communications satellites.	Same, except predominantly includes net settlement payments by U.S. carriers to compensate foreign carriers for terminating outbound U.S. calls.
Training	Includes educational or training services provided on a contract or fee basis. Excludes tuition and fees charged to individual foreign students by U.S. educational institutions. Also excludes training performed by a manufacturer in connection with the sale of a good.	Includes educational or training services provided on a contract or fee basis. Excludes tuition and fees charged to individual U.S. students by foreign educational institutions. Also excludes training performed by a manufacturer in connection with the sale of a good.
Travel and tourism	Includes expenditures in the United States by foreign travelers (except foreign government personnel and their dependents, and other foreign citizens residing in the United States) for lodging, food, and transportation within the United States, and recreation and entertainment, personal purchases, gifts, and other outlays associated with travel in the United States. ²	Includes expenditures abroad by U.S. travelers (excluding U.S. Government personnel and their dependents, and other U.S. citizens residing abroad) for lodging, food, and transportation within foreign countries, and recreation and entertainment, personal purchases, gifts, and other outlays associated with travel abroad. ³

See footnotes at end of table.

Appendix C--Continued

Activities captured in official U.S. data on cross-border trade in services by industry

Service	U.S. Exports	U.S. Imports
Utilities	Includes electric power generation, transmission, and distribution; natural gas distribution; operation of water treatment plants or water supply systems; operation of sewer systems; and operation of sewage treatment facilities that collect, treat, and dispose of waste.	Same.

¹ BEA has revised its methodology, and uses newly available source data to determine total medical exports. Inpatient estimates were obtained from data collected from State regulatory agencies, hospital associations, hospitals with international medical centers, and emergency rooms. U.S. Department of Commerce (USDOC), Bureau of Economic Analysis (BEA), *Survey of Current Business*, July 1999, p. 69.

² Expenditures are estimated by the USDOC, BEA, based on data principally supplied by the USDOC, International Trade Administration, Tourism Industries, in conjunction with the U.S. Department of Justice, Immigration and Naturalization Service, and by Statistics Canada and the Banco de Mexico. Officials of BEA and Tourism Industries, telephone interviews with USITC staff, Oct. 22 and 23, 1998.

³ Ibid. Tourism imports were revised based on the results of a one-time survey that compared expected travel expenditures to post-trip expenditures. The survey results indicate that U.S. travelers' expected expenditures understate post-trip expenditures in Latin America and the Asia-Pacific region. Accordingly, data for 1998 were revised upward, increasing travel payments by \$1.7 billion. Data for 1997 were adjusted using one-half the value of the adjustments in 1997. USDOC, BEA, *Survey of Current Business*, July 1999, pp. 69-70.

Sources: USDOC, BEA, *U.S. International Transactions in Private Services: A Guide to the Surveys Conducted by the Bureau of Economic Analysis*, Mar. 1998; USDOC, International Trade Administration, Tourism Industries, in conjunction with the U.S. Department of Justice, Immigration and Naturalization Service, and Statistics Canada and the Banco de Mexico; OECD, *Services Statistics on International Transactions*, p. 119; USDOC, BEA, *Survey of Current Business*, July 1999, pp. 69-70; and USDOC, BEA, *Survey of Current Business*, July 2000, pp. 72-73.

APPENDIX D
ACTIVITIES CAPTURED IN OFFICIAL
U.S. DATA ON AFFILIATE
TRANSACTIONS BY INDUSTRY

Appendix D

Activities captured in official U.S. data on affiliate transactions, by industry

Service	Sales and Purchases
Accounting	Auditing of accounting records, designing of accounting systems, preparing financial statements, developing budgets, preparing tax returns, processing payrolls, bookkeeping, and billing services.
Advertising	The creation of advertising campaigns and placing such advertising in periodicals, newspapers, radio, television, and other media. Activities include advice, creative services, account management, production of advertising material, media planning, and placement of advertisements.
Audiovisual	Motion picture, television tape, film, and sound recording production; distribution services; post-production services such as editing, film/tape transfers, and subtitling; and operating motion picture theaters. Does not include video tape and disk rentals or wholesale distribution of video cassettes and sound recordings.
Banking and Securities	Includes nondepository credit intermediation (credit card issuing, sales financing, mortgage companies, mortgage broking, international trade financing, and consumer finance companies); investment banking and securities dealing; securities brokerage; commodity contracts dealing and brokerage; portfolio management services; investment advisory services; and trust, fiduciary, and custody activities. Excludes lending and deposit-taking activities of depository institutions.
Computer and Data Processing	Includes the provision of expertise in the field of information technologies through one of more of the following activities: writing, modifying, testing, and supporting software to meet the needs of a particular customer; planning and designing computer systems that integrate computer hardware, software, and communication technologies; on-site management and operation of clients' computer systems and/or data processing facilities; and other professional and technical computer-related advice and services.
Construction	The construction of buildings and other structures, heavy construction (such as highways, power plants, and pipelines), land subdivision and development, additions, alterations, installation, maintenance, and repair services. Includes demolition services or clearing of building sites, along with other land preparation services. Also includes "Special Trade Contractors" which often subcontract to general contractors, such as plumbing, painting, electrical, masonry, and carpentry contractors.
Education	Instruction and training in any subject, either for-profit or nonprofit, by either privately or publicly owned entities. Includes preschool, elementary school, secondary school, junior and four-year colleges, universities, and professional schools, and technical training schools specializing in various subjects, such as secretarial skills, computer training, cosmetology, language instruction, automobile driving, flight instruction, and fine arts. This category also includes educational support services, such as educational consultants, guidance counseling services, and student exchange services.
Environmental	Includes environmental testing and analytical services, wastewater treatment works, solid waste management, hazardous waste management, remediation and industrial services, and environmental consulting and engineering.

Appendix D—Continued

Activities captured in official U.S. data on affiliate transactions, by industry

Equipment leasing	Rental and leasing of commercial-type and industrial-type (nonconsumer) machinery and equipment. Establishments included in this group are generally involved in providing capital or investment-type equipment that clients use in their business operations. Includes construction, transportation, mining, and forestry machinery, and other commercial equipment rental and leasing. Excludes leasing affiliates of commercial banks.
Express delivery	<i>(Couriers and messengers)</i> Intercity and/or local delivery of parcels that may be handled by one person without using special equipment. May include collection, pick-up, and delivery operations using limited labor and minimal equipment.
Health care	Includes hospitals; offices of physicians, mental health specialists, and other health care providers; outpatient care centers, including family planning, mental health, and substance abuse centers; medical laboratories; home health care services; nursing and residential care facilities; and providers of social assistance services, including adoption agencies, youth centers, child day care services, and services for the elderly.
Insurance carriers and related activities	Insurance carriers primarily engaged in underwriting annuities and insurance policies and investing premiums to build up a portfolio of financial assets to be used against future claims. Includes direct life, health, and medical insurance carriers, property/casualty and title insurance carriers, and reinsurance carriers. Also includes insurance agencies and brokerages, which are primarily engaged in acting as agents in selling annuities and insurance policies, and insurance claims adjusters.
Legal	Includes the services of lawyers or attorneys primarily engaged in the practice of law, notaries, real estate settlement services, real estate title abstract services, and patent agent services.
Maritime transport	Deep sea, coastal, and great lakes water transportation, including both freight and passenger transportation, using ships, barges, and boats.
Oil and gas field services	Includes drilling of oil and gas wells and other support services for oil and gas operations performed on a contract or fee basis, such as excavating slush pits and cellars; grading and building foundations at well locations; and cleaning out, bailing, and swabbing wells.
Retail distribution	Sales of merchandise to the general public for personal or household consumption, and services related to such sales, including after-sale repairs. Retailers fall into store and non-store categories, such as catalogs, door-to-door sales, and the Internet.
Telecommunication	Includes the operation, maintenance, or provision of access to facilities for the transmission of voice, data, text, and full motion picture video between network termination points, and telecommunications reselling. Includes wired, wireless, and satellite telecommunications.

Appendix D—Continued

Activities captured in official U.S. data on affiliate transactions, by industry

Utilities	Includes generation, transmission, and/or distribution of electric power; distribution or marketing of natural gas for resale or to final consumers; and operation of water treatment plants, water supply systems, or sewage treatment and/or disposal systems.
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Sources: North American Industry Classification System, United States, 1997 (Lanham, Md: Berman Press, 1998); and USDOC, BEA, "Guide to Industry and Foreign Trade Classifications for International Surveys, Oct. 1997," found at Internet Address <http://www.bea.doc.gov/bea/surveys.htm>, retrieved Dec. 28, 2001.