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**Subsidies in the International Trade
in Services.
Will the New World Trade
Organization Negotiations Regulate
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by

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**SUBSIDIES IN THE INTERNATIONAL TRADE IN
SERVICES.
WILL THE NEW WORLD TRADE ORGANIZATION
NEGOTIATIONS REGULATE THE ISSUE?**

Abstract

Services are a dynamically growing sector of the global economy. They play a significant role in country development and providing social security. Their growing importance in the global economy has led policymakers to address the issue of regulating the international trade in services. Many of the problems were already settled during the Uruguay Round of World Trade Organization (WTO) negotiations. However, some of the areas were left unresolved, namely subsidies, emergency safeguards, and government procurement. The aim of this paper is to examine the issue of service subsidies regulation in international trade. It analyses the arguments for and against new provisions in the view of current regulation, possible solutions, and the barriers to achieving an agreement. It is an important problem since services are likely to play even greater role in the future and their subsidization can negatively influence the conditions of competition on the global market.

Keywords: *subsidies, services trade, international trade, WTO, trade regulation, negotiations*

JEL codes: *E61, F13, F23, F53, H25*

1. Introduction

Traditionally international trade was regulated only by bilateral agreements. Since the theory of mercantilism predominated in most countries, governments maintained high tariffs and other measures of domestic market protection. In the 19th century the idea of free trade became widespread contributing to lowering custom duties and international trade development. Multilateral regulations of the international trade developed only after the World War II with the idea of regulating international political and economic relations. The creation of the United Nations (UN) normalized the international political sphere, while the economic relations were dealt with through the creation of the World Bank and the International Monetary Fund (IMF) supervising the financial relations. International trade affairs, the importance of which was already recognized at the Conference in Bretton Woods in 1944, were to be regulated by the International Trade Organization (ITO).

Although attempts to create the ITO failed, a certain degree of multilateral regulations was achieved through the negotiations of the General Agreement on Tariffs and Trade (GATT). It regulated only the international trade in goods and was not directed at achieving free trade but rather trade liberalization that would improve the economic welfare of Members. The trade regulations of the GATT were mostly aimed at protecting market access (MA) obtained by tariff reduction and by disciplining other trade policy instruments that would otherwise nullify or impair the results of tariff liberalization.

The GATT, and later World Trade Organization (WTO), adopted a very pragmatic approach to trade regulation. It was based on economic rationale rather than on ideological grounds. The GATT/WTO has intervened only if a government of a member country raised a complaint regarding the violation of trade policy rules by another Member. In the area of subsidies, it has taken action only after an adverse effect of a certain trade policy measure had been proved. The introduced countervailing measures were designed just to offset the adverse effects and nullify the effects of the subsidy.

Besides, the GATT/WTO has had no supranational power but constituted a platform for negotiation, consultation and monitoring.

Subsidies were one of the trade policy instruments often used by governments for economic or social reasons. The issue of subsidies provisions has always been very controversial since it was not only politically sensitive but also economically disputable. Therefore it took long time and several rounds of multilateral trade negotiations before the disciplines on the use of subsidies achieved a meaningful level. Present subsidies regulations pertain mainly to trade in goods. As export of services differs from export of goods the international agreements to date do not sufficiently normalize the provision of subsidies in the cross-border services trade. Consequently, there may be a need to develop further regulation. Because services are a dynamically growing sector of the global economy it is important to assess the proposed solutions for services subsidies regulation and present the impediments to reaching an agreement within the current WTO negotiations Round.

The aim of this paper is to explore the problem of subsidization of the services industry in the international trade context. Services industry is defined as a sector of the economy in which companies earn revenue by providing intangible products or services. It is made up of companies involved in finance, retail, transport, distribution, communications, tourism etc. Services encompass a broad range of activities. It includes transforming a physical object, any intellectual or aesthetic activity as well as other activities providing the customers with a variety of experiences. Subsidies are more difficult to define. They constitute a direct or indirect transfer to support the provision of services or production of goods. They are granted by the government to private entities without an equivalent contribution being received in return. Their consequence is a change of the relative prices on the market.

The paper begins with a short presentation of the methodology used. It is followed by a theoretical background of services trade. Then the theory of subsidies provision is discussed. The subsequent section introduces the development of international trade negotiations in the area of services trade. It describes how international services trade has become regulated and reflects on the issues encountered during the negotiations process. The

next section presents the general rules on services trade contained in the General Agreement on Services Trade (GATS). Thereafter, the regulation of subsidies in the WTO Agreements is assessed. It presents the Agreement on Subsidies and Countervailing Measures (ASCM) and the Agreement on Agriculture (AoA) as well as their applicability to services trade. Afterwards, the present Doha Round negotiations are discussed. In this section some possible solutions to the problem are examined together with their limitations. Moreover, it includes an elaboration of the barriers to reaching an agreement. The last section concludes.

2. Methodology

Although the area of subsidies in the international trade of services is an interesting topic to investigate and an important issue to write about, it is relatively unexplored. Due to the limited availability of existing resources the research uses a case study design, in which the complexity and particular nature of the case in question is analyzed (Blumberg at al., 2008). A practitioner based approach has been adopted as the topic is of a practical application and has relevance not only for policymakers but also for international business managers.

This study is based on a literature review, qualitative research and case studies. It makes extensive use of the resources available in the WTO library in Geneva and materials gathered from the WTO Secretariat. The data was collected through a literature review and face-to-face interviews.

The literature review is a systematic analysis that provides a reliable foundation on which to conduct research. It is a suitable approach for this study as it is based on a comprehensive understanding of what we already know about the subject while seeking to understand the effects of the current developments. However, since there is relatively little literature regarding this particular topic, the research is heavily based on the analysis of legal texts and interviews with international policy experts. The semi-structured interviewing was employed as a means to understand the issue at hand through an examination of the interpretation of it by people directly involved.

The information about current developments in the negotiations and details concerning the present regulation of subsidies in the international trade in services were gathered during interviews with:

- **Rudolf Adlung**, Counsellor at Trade in Services Division in the WTO;
- **Gabriela Kulesza**, the First Secretary at the Permanent Representation of Poland to the WTO and Chairperson of the Working Party on GATS Rules, where the service subsidy regulations are being discussed;
- **Aik Hoe Lim**, the Secretary of the Working Party on GATS Rules;
- **Abdel-Hamid Mamdouh**, the Director of Trade in Services Division in the WTO;
- **Jan Woźnowski**, former Director of the Rules Division in the WTO, which is responsible for all subsidy rules in trade in goods.

3. The theory of trade in services

The theory of trade in services has been developed only recently, and thus is based mainly on hypotheses. Since the phenomenon of services trade is a relatively recent development there is, to a certain degree, a conceptual gap in explaining the services trade. Nevertheless, it can be proved that trade in services is a source of potential economic growth, influences the profitability of manufacturing, and increases synergies between and within firms (Francois and Hoekman, 2009, p.39). The theory of trade in services comprises of universal rules of trade conduct, advantageous for the trading partners. They can be divided into two groups (Bożyk, 2008, p. 121). First, consists of theories adapting the theory of trade in goods. Second, encompasses original concepts, based on unique features of trade in services.

3.1. Adapting the theory of trade in goods

Economists largely disagree on the extent to which services trade requires separate trade theory, distinct from the theory used to explain the trade in goods. According to Markusen and Strand (2009, p.6) no particular new theory is required as from an economic perspective there is no

difference between the production of goods and services. Consequently, just an adaptation of the concepts developed to explain trade in goods will be sufficient to explain the reasons why the international exchange of services occurs. It follows that the classical and neoclassical concepts of trade theory applicable to goods can be applied to explain the welfare gains arising from the international trade in services. Thus, the main explanations of trade between countries are: comparative advantage, abundance of factors of production, and gains from specialization arising from increasing returns to scale or agglomeration effects (Ricardo, 1817; Ohlin, 1933; Krugman and Vanables, 1996, p. 960; Salvatore, 2009).

3.1.1. Classical trade theory

The theory of comparative advantage by D. Ricardo can be applied to explain the causes of international trade in services (Hindley and Smith, 1984, p. 386). The difference in relative prices of comparable services in two countries determines the services trade flows. The international specialization in the service delivery brings about welfare gains as welfare is maximized when each country specializes in the production of a service they can deliver at the relatively lowest costs. The specialization maximizes production and trade making every country better off.

On the other hand, the theory of comparative advantages is limited by many assumptions like one-factor economy, perfect competition, occupational mobility and constant returns to scale (Krugman and Obsfeld, 2003, p. 12). In reality, all of those assumptions are difficult to fulfil. There are many market imperfections hindering competition, and the mobility between professions entails costs of adjustment and requires time, during which some of the labour force groups may suffer lower wages. In addition, returns to scale tend to be increasing with the size of production. Trying to build models reflecting the reality better by waving some of those assumptions leads to the consideration of other trade theories.

3.1.2. Neoclassical trade theory

An important role in explaining the flows of services trade plays the Heckscher-Ohlin theory (HO theory) of factor endowments. According to the theory the comparative advantage of certain countries over others is

determined by the abundance of certain factors of production (compare section 3.1.1.). It states that the differences in the amount of factors of production available in different countries generate flows of services trade. Services flow from countries where a factor used to their production is abundant to countries where it is scarce. Zhang and Jensen (2007, p. 226) verified the application of this theory on the example of tourism industry. Their tests proved that abundance of natural resources, technology, and infrastructure is positively correlated with tourism flows.

An important modification of the HO theory was the distinction of human capital as a factor of production by Becker (Sikander, 1999, p. 95). His observation finds a significant application in the theory of services trade. It allows the analysis of the impact of the skills set of labour available in particular countries on the services trade flows. Hence, it can be assumed that not only the number of workers, but also their skills generate trade flows. For example, the abundance of skilled medical personnel with good English language skills allowed American hospitals to outsource the interpretation of X-ray pictures to India (Hill, 2009, p. 36).

However, the HO theory does not fully reflect the reality as it assumes a simple two-good, two-factor model and no factor mobility between countries. Due to the complexity of the services trade involving a variety of types of skills, as well as foreign direct investment (FDI) the model is insufficient to explain why skilled-labour intensive services are offshored to countries where skilled labour is scarce (Lejour and Smith, 2008, p. 179). Moreover, according to the HO model factor mobility and international trade would be substitutes for each other (Mundell, 1957, p. 326). Instead of trading goods or services between countries factors would move to the locations where they would be in demand. Additionally, factor relocation would be stimulated by impediments to trade like tariffs or transportation costs.

3.1.3. The New Trade Theory

The New Trade Theory adds to the international trade models the economies of scale and the mobility of factors of production. According to this theory the gains from specialization arise from increasing returns to scale and agglomeration effects. Agglomeration enabled by factor mobility is

especially important for the consideration of services trade as most of it takes place via movement of factors of production, labour or investment (Copeland and Matoo, 2004, p. 22). Also, concentration of production generates positive spill-over effects and fosters the exchange of know-how. The New Trade Theory is well presented by Krugman (1991) who analyses an international trade model with increasing returns to scale, migration of factors of production, and transport costs. The author is showing how each of those aspects influences the location of production and the international trade flows. In this model trade is driven by economies of scale instead of factor endowments (Krugman, 1979, p. 483) (compare section 3.1.2.).

Even though, the New Trade Theory gets very close to the full explanation of the flows of trade it is not free from criticism. Although, there are some unquestionable benefits of agglomeration, the concepts seem to be working better for the goods trade than for the services trade (Markusen and Strand, 2008, p. 243). The concentration of services production occurs to a certain extent, but there are numerous examples of the production process being more and more spread geographically (compare section 3.2.2). As the transportation costs fall distance is no more a significant determinant of services trade flows (Walsh, 2006, p. 12).

3.2. *Building original concepts for trade in services*

The previous section clearly shows that concepts developed for the purpose of explaining trade in goods can only be to a certain extent applied to trade in services. Based on the unique features of trade in services and taking from the theory of movement of factors of production some original concepts of trade in services were developed (Bożyk, 2008, p. 121). The concept of trade in tasks relates to the fragmentation of production and increasing geographical stretch of the manufacturing process. There are also other theories which due to the limitations of this paper will not be discussed. One of them is the supply theory that takes account of the availability of factors of production. The theory of technological gap explores the influence of education and technological advancement on trade. Then, the demand theory analyses the similarity of preferences, diversity of products, and intra-industry trade in the services sector.

3.2.1. *Distinguishing services trade from goods trade*

Before the analysis of further theories is conducted, it is worth presenting how services trade differs from goods trade. Although goods and services trade are similar in one way: they potentially improve the allocation of resources and contribute to rising of the standard of living, it is generally accepted that trade in services is importantly different from trade in goods (White, 1999, p. 6). The bases for differentiating the goods and services trade are the modes of supply and some inherent characteristics of services like intangibility, heterogeneity, non-storability and simultaneous production and consumption.

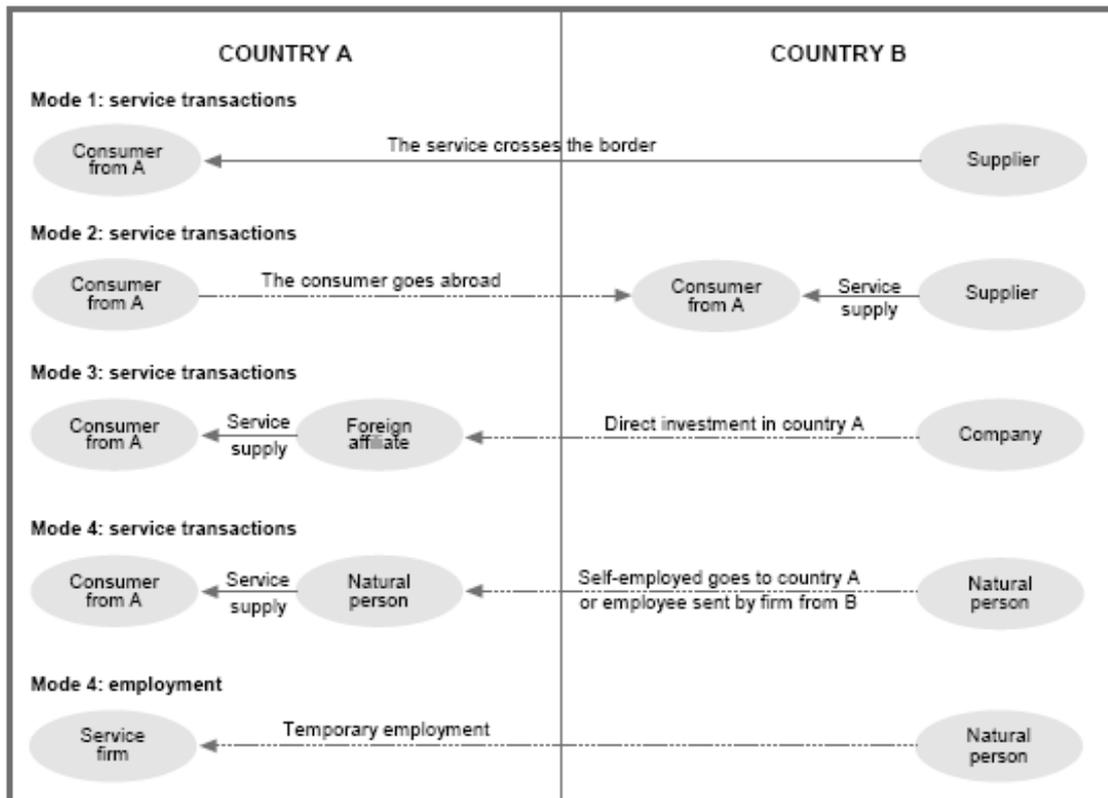
The international exchange of services takes place through different modes of delivery. The GATS distinguishes four modes of delivery in which services are supplied (Figure 1.). They are described in Article I of the GATS and were scrutinized by Hoekman (1993, p. 1532) as follows:

- Mode 1 or **cross-border supply** takes place when the consumer remains in his or her home territory while the service crosses national borders. The service can be delivered e.g. by telephone, fax, Internet, television or sending of documents, disks, tapes, etc.
- Mode 2 or **consumption abroad**, consumer moves outside his or her home territory and consumes services in another country, e.g. tourism, medical services or education. The movement of a natural person from abroad to the country where the supplier is residing is illustrated by the dotted line on Figure 1., Mode 2.
- Mode 3 or **commercial presence**, such as representative offices and branches e.g. insurance companies and banks. This instance requires a direct investment in the foreign country. The movement of capital is illustrated by the dotted line in Figure 1., Mode 3.
- Mode 4 or **presence of natural persons** occurs when an individual has moved into the territory of the consumer to provide a service, e.g. in the construction industry. The movement of natural person to the foreign country in order to deliver the service is illustrated by the dotted line in Figure 1., Mode 4. It pertains to either a self-employed or a person sent by a company to travel abroad. In addition, sometimes the proximity of the supplier and consumer is essential to deliver a particular service. Then a foreign establishment is required

and the presence of natural person (Mode 4) is linked with Mode 3, commercial presence (Francois and Hoekman, 2009, p. 6). However, it still encompasses only temporary migration, just for the time required to deliver the service.

Figure 1.

Modes of services trade



Source: Nyahoho, E. (2010, p. 2)

Secondly, the services trade differs significantly from the goods trade due to their natural characteristics (Kostecki, 1999, p. 82). Services are a broad concept covering very diverse activities (Lejour and Smith, 2008, p. 171). They span from hairdressers, through tourism and healthcare to financial services, but have some common features distinguishing them from goods. They are intangible, invisible and perishable, requiring simultaneous production and consumption and often characterized by high level of heterogeneity.

3.2.2. *Trade in tasks*

The concept of agglomeration discussed in section 3.1.3. explains to a great extent the pattern and determinants of international trade. However, its applicability to services trade is rather limited. Freight and transportation costs driving the agglomeration effects are not a core cost for services suppliers (Markusen and Strand, 2009, p. 12). Also, with the ever decreasing transportation and communication costs the concept of agglomeration in services trade is being significantly challenged. It is not the distance, but the GDP per capita and a common language that determine the services trade between two countries (Walsh, 2006, p. 8).

When communication and transportation were slow and expensive the specialization of production required proximity leading to agglomeration effects (compare section 3.1.3.). Due to the technological developments the link between specialization and geographic concentration was weakened resulting in value added activities being performed in many different locations where they could be carried out cheaper. The manufacturing process got sliced into single activities which are then performed in a variety of locations around the world. This fragmentation of production changes considerably the structure and pattern of trade. It takes now the form of "trade in tasks", i.e. trade in single production activities, rather than trade in goods or services (Grossman and Rossi-Hansberg, 2008, p. 2). The contemporary production process is characterized by vertical fragmentation and the newly traded services tend to be intermediates (Markusen and Strand, 2009, p. 15). Kox and Rubalcaba (2007, p. 3) argue that the main drivers of this change are the growing specialisation in knowledge services and the exploitation of the scale economies of human capital, leading to lower costs of outsourcing services which were previously delivered in-house. The cost reasons account for the sudden growth of international outsourcing of knowledge-intensive services and their international trade flows (Baldwin 2006, p. 43; Van Welsum and Vickery 2006, p. 12).

The international outsourcing of tasks described in the model developed by Grossman and Rossi-Hansberg (2008) changes the nature of international economic relationships. By breaking-up the production process and offshoring tasks the productivity of final goods industries improves. Also, lowering the costs of tasks trade, which may be achieved by trade

liberalization, affects factor prices in the source county. Productivity effect of task trade benefits the factor whose tasks are more easily moved offshore. Consequently, offshoring may benefit all factor-owners in the economy. The important conclusion of this concept is that trading tasks can generate welfare gains shared by all domestic factors, in contrast to the unequal division of the benefits resulting from trade in goods.

3.3. Summary

By and large, the theory of international trade shows that international trade in service is beneficial for all trading countries. It brings about global welfare gains, improves business profitability and contributes to the wellbeing of consumers. There are many theories that attempt to explain the determinants of services trade. Some of them adapt the concepts developed to analyse the trade of goods and some are theories basing on the assumption that goods and services differ to the extent that requires conceptualization of new theories for analysing flows of the latter. All of the models capture correctly part of the reality. Many are based on similar assumption and build new explanations using the theoretical achievements of the previous models. As the environment in which trade is conducted changes constantly, the technology improves dynamically, and new business models develop, the theory must adapt constantly to capture the new trends.

4. Economic perspective on subsidies

Government intervention in the economy and its use of subsidies is a highly controversial issue. While governments have often important social and political reasons for granting subsidies, economists disagree on their likely positive or negative effects as they are usually hard to be justified in economic terms (Smeets, 1983, p 560). It is commonly accepted that subsidies have a negative impact on perfectly competitive markets (WTO, 2006, p. 55). Nonetheless, in reality markets rarely meet this condition.

It is important here to distinguish export subsidies from production subsidies. Export subsidies are contingent on exports, i.e. are granted

depending on the export performance of a particular company. Conversely, production subsidies are granted regardless of the market destination of the output (WTO, 2006, p. 55). It has been commonly acknowledged that all subsidies can to some extent impact international trade (Smeets, 1983, p. 562). However, whether they have a positive or a negative influence is still disputable. According to Benitah (2004, p. 5) "subsidies could well distort trade and competitiveness, or enhance them". Although there are some arguments supporting the provision of subsidies it is generally accepted that export subsidies lead to market inefficiencies.

4.1. Rationale for granting subsidies

Subsidies are granted for many purposes. They are generally motivated by preventing or correcting misallocation of resources caused by market failures. Those arise due to an externality which effects cannot be eliminated by the market. They lead to resource misallocation and result in diminishing welfare in the economy as a whole. Furthermore, subsidies can be used to help achieve economic development and social objectives concerning education, culture, healthcare provision, social security, infrastructural development, market integration or regional convergence. Moreover, subsidies are granted in a situation of imperfect competition or when the entry barriers to a certain industry are high. A government pursuing a strategic trade policy may use subsidies to support the competitive position of their domestic businesses.

4.1.1. Externalities

The main rationale for government subsidies is an attempt to eliminate or correct misallocation of resources in the market. According to Pestiau (1977, p. 64) the misallocation of resources is usually due to an externality. An externality occurs when market prices do not fully reflect all of the costs of the product or service and "a difference exists between the actual price and the socially optimal price" (WTO, 2009, p. 58). It may be reflected in a disproportion between private and social gains from trade or the difference in costs of production between foreign and domestic producers. Externalities are usually a result of information asymmetry and coordination problems. When information is not perfect market participants make suboptimal

decisions. Equally, coordination problems, arising from a lack of appropriate institutions, hinder performing market transactions.

An externality may also occur in an 'infant industry' situation, i.e. an industry in an early stage of development that cannot independently challenge already established competitors on the international market and thus has to be protected. The argument is especially valid for developing countries that in the presence of more developed countries "cannot develop new industries without state intervention" (WTO, 2006, p. 66). They claim that the 'infant industries' need protection to give the domestic firms a chance to develop before they are exposed to international competition.

4.1.2. Promoting development and social objectives

Subsidies may be also justified by the desire to support industrial or regional development. They may be aimed at promoting R&D and new knowledge creation in situations where knowledge spill-overs can be expected or to facilitate infrastructural development. Additionally, subsidies are granted for redistribution purposes to attain social fairness (WTO, 2006, p.91). Governmental transfers are used to support regional and social policy purposes. They drive economic growth and promote development of disadvantaged regions. It results in regional cohesion and supports social objectives.

An important social goal of subsidies is ensuring universal access to services. It concerns mainly services that are crucial to the wellbeing of every individual in a society like e.g. education or telecommunication. However, their delivery in certain situations, geographical regions or for certain groups of the society may be not profitable enough and thus discontinued. In those circumstances governments often grant subsidies to give every individual access to the service.

4.1.3. Strategic trade policy

Higher government involvement in the economy and greater use of subsidies is supported by the New Trade Theory (compare section 3.1.3.). By subsidizing domestic industries or companies governments can help them build up economies of scale and thus dominate the world market (e.g.

Airbus). Such strategic trade policy is aimed at squeezing the economic advantage out of trading partners and improving domestic welfare.

Governments pursuing a strategic trade policy may grant subsidies to help industries enter new markets or sustain losses. It occurs usually when markets are not perfectly competitive and significant investment is required to enter new markets. Companies face large fixed costs of entry in industries where considerable R&D investment or specialized and expensive equipment is required. Some typical examples are aircraft, automotive and pharmaceutical industries. Because of the high entry costs large scale production is required to make the economic activity profitable.

Strategic trade policy may help a country gain a competitive advantage, improve their terms of trade and facilitate economic growth. However, subsidizing a loss-making domestic producer results in welfare gains for the local economy only if the national manufacturer is able to lower their marginal costs in the future below the level of a foreign supplier (WTO, 2006, p. 60). Nevertheless, strategic trade policy was strongly criticised by Krugman (1987, p. 135, 1994, p. 28), who claims that by supporting the national industry local governments distort trade, hinder competition and actually contribute to welfare losses. He states that the argument that through strategic trade policy national economies gain competitive advantage is not economically sound and often overused by politicians.

4.2. Arguments against the provision of subsidies

In contrast, there are subsidies that lead to trade distortions. Especially export subsidies are criticized for their detrimental effects on total global welfare. They create market inefficiencies as they lead to suboptimal allocation of resources. Nonetheless, the effect of granting subsidies depends on the size of the country. If it is not large enough to affect the world price its subsidy programmes will influence the quantities on the global market but not the price (WTO, 2006, p. xxiv).

4.2.1. Creation of market inefficiencies

Green and Trebilcock (2007, p. 660) maintain that with some limited exceptions export subsidies lead to market inefficiencies. They provide benefits to a narrow group of interest at the expense of more diffused

consumer and taxpayer group (Green and Trebilcock, 2007, p. 661). Although they lead to welfare gains for consumers in foreign countries who enjoy lower prices, they harm foreign producers, distort resource allocation and promote production in one country even though suppliers in another country could have done it more efficiently. Although subsidies can promote important social and environmental objectives, in general they can cause serious prejudice to trade. Hence, prohibiting export subsidies would increase the world welfare albeit the welfare of the importing country would decrease as a result of the worsening of its terms of trade (Collie, 2000, p. 230).

4.3. Summary

The analysis of subsidies presents the effects subsidization has on its beneficiaries, other entities and on the whole economy. Under the assumption of perfect competition subsidies lead to inefficiencies and welfare losses. However, the existence of market imperfections creates some arguments for governmental intervention into the functioning of the market mechanism. Subsidies may be justifiable in some circumstances, e.g. to correct market imperfections, pursue strategic trade policy, promote development or for social reasons. Nevertheless, government subsidies lead to artificially low prices, promote inefficient production, which draws resources from more productive organizations, and contribute to the emergence of monopolies, which hinders competition. Because WTO is concerned with the economic not the social dimension of international trade subsidies have been, to a certain extent, normalized by the WTO regulations.

5. International trade negotiations

Given the importance of services in most national economies and in the international trade many governments attempt to control or support their domestic business organizations. Consequently, the issue of protectionism in the international trade in services has been on the agenda of a number of international economic forums and negotiations for many years. The

discussion on service provisions in the GATT started already in 1980's but because of many impediments to starting the negotiations process it was not until the Uruguay Round when the agreement on services trade regulation was reached. The sensitivity and complexity surrounding service subsidies made negotiating their regulation very difficult and time-consuming, therefore they were left unregulated.

5.1. Political sensitivity and complexity of service subsidies negotiations

International agreements concerning subsidies are one of the most politically sensitive and complex areas of economic policy (Low, 1982). As no government is going to give up its right to protect the welfare of its own society WTO member countries are reluctant to limit their freedoms in the area of subsidies (Mamdouh, 2010). The issue is even more difficult and controversial because services have an important role in achieving public policy and development goals. Also, the political sensitivity arises from a conflict of interest between the developed and developing countries. Furthermore, services trade intensified only recently which made Members to first agree on general regulation. In addition, the complexity of the problem arises from the multiple delivery modes, difficulties in the identification of trade distorting effects and the lack of information regarding subsidy practices.

5.1.1. Public policy and development goals

Services play a very important role in the country development and achieving social goals. For example, in Botswana the government subsidises the provision of telecommunication services to rural areas, which facilitates the development of the remote regions (WTO document WT/TPR/S/114). Also, Australia provides financial aid for shipment of goods between Tasmania and the mainland, which supports the development of the region (WTO document WT/TPR/S/104). Therefore, service subsidies are politically extremely difficult to reduce. Despite the net economic and social benefits of cutting subsidies almost every national government intervenes in the market in a way that distorts international trade, as a means of protection or for its own political reasons (Anderson, 2004a). Because the subsidies

issue is a politically sensitive problem it is very awkward to approach in multilateral trade negotiations. The general services rules were already very controversial and subsidies regulation is even more so.

5.1.2. Conflict of interests

Negotiating services provisions proved to be complicated because of the ambiguity concerning the national interests involved. Especially least developed countries (LDCs) presented a negative attitude towards the negotiations. From the very beginning they opposed any proposals for new regulation. They assumed that even without liberalization their service will be competitive globally and suspected that the liberalization effort was started by the USA only to enable American multinational corporations (MNC) to seize the business opportunities on vulnerable underdeveloped markets. As a result, the discussion evolved into a conflict between the North and the South.

Furthermore, developing countries were opposed to imposing restriction on service subsidies provision since their governments view subsidies as a measure allowing development of local industries. They were wary of increasing liberalization because of the overwhelming economic power of some highly developed nations. As developed countries have a competitive advantage in services trade developing countries wanted to retain the ability to protect their markets from foreign suppliers while local industries develop (compare section 4.1.1.). They wanted to have some means of protection to be able to compete with foreign suppliers on international markets (Kulesza, 2010). The effect of subsidies granted to Airbus is a well-known example of how some countries can support their companies to successfully enter the international market.

Another disagreement arose from a different stance regarding commercial presence and international labour mobility. Least developed economies felt especially uncomfortable about giving MNCs the right to establish subsidiaries in their countries as it would have limited their control over foreign establishment. However, the production of services in most LDCs was labour intensive, and so, their trade required movement of personnel. In contrast, the industrialized countries opposed to giving concessions under delivery mode 4 (presence of natural persons) in a fear

of massive immigration (compare section 3.2.1.). As a result a trade-off emerged between labour movement and issues concerning foreign establishment. The North-South disagreement remains valid even today, after the successful agreement on the GATS.

5.1.3. Recent development of services trade

As international trade in services has developed only relatively recently there was literally no regulation of international trade in services. Only with the latest technological progress the industry dynamically developed and the cross-border trade in services thrived. As a result, general rules on services trade were agreed only in 1995 during the Uruguay Round. Achieving a general framework of services provisions was a prerequisite to start negotiations on details like subsidies (Woźnowski, 2010). Comparable goods trade disciplines took almost 50 years to develop. It may stipulate that the progress in services trade provisions will be slow, especially because services trade is a much more sensitive area (White, 1999, p. 35).

5.1.4. Multiple delivery modes

The main complication in service subsidy negotiations is the multi-modal delivery (compare section 3.2.1.). It was very well summarized by Ahuja (2005, p. 6) by stating that "merchandise trade involves only one type of transaction i.e., cross border movement and only one legitimate instrument of protection i.e., tariffs. Trade in services, on the other hand, involves four different types of transactions (categorized in terms of four different modes) and two different sets of negotiable trade obligations, namely, 'market access' and 'National Treatment'". To develop the issue further, mode 3 (commercial presence) may appear to be the least problematic. It may seem that the National Treatment (NT) provision already in place resolves the problem. However, regulating one mode of supply may alter the competitive conditions for companies delivering through the other three modes (Adlung, 2010). For example, by providing subsidies to companies located on its territory a Member hinders market access (MA) conditions for companies delivering through mode 1 (cross-border supply). Those companies would face competition with artificially low production costs. Also, suppliers delivering services under mode 2 (consumption abroad) and

4 (presence of natural persons) would be at a competitive disadvantage. Additionally, there is a need to deal with subsidies given to individuals that are commonly assumed to be non-trade distortionary (Ahuja, 2005, p. 14). Nevertheless, if a government grants subsidies to residents conditional on the use of domestic suppliers, or subsidies are granted for education services and professionals move temporarily abroad it may create trade distortions.

5.1.5. Lack of evidence

A significant obstacle to the negotiations was the difficulty of finding evidence of trade distorting effects. As stated by Adlung (2010) the scepticism of member countries towards the existence of trade distortions might be the main reason why service subsidies problem was not solved during the Uruguay Round. There was little information available concerning the subsidy practices of member countries. Additionally, it was complicated by the difficulties in calculating and valuating the exact services trade flows and the potential adverse effects of services sector subsidization. Due to the relative lack of information on service subsidy practices Members agreed only to "exchange information concerning all subsidies related to trade in services that they provide to their domestic service suppliers" (GATS Article XV: 1).

5.2. Summary

The development of services trade provisions took many years and many rounds of multilateral trade negotiations. Due to the complexity and sensitivity of the issue as well as political disagreements regulation of services trade was very controversial and the final agreement was reached only during the Uruguay Round. Many issues concerning services trade were embedded in the GATS. However, subsidies were left unregulated due to their even greater complexity and sensitivity. The GATS in its current form presents only a general framework for services trade. Nevertheless it can be argued that subsidies are to a certain extent regulated by other WTO Agreements.

6. General regulations of services trade

The General Agreement on Trade in Services (GATS) consists of general provisions and a Schedule of Commitments in which Members oblige themselves to liberalize trade in specific sectors. Although some of the general provisions apply regardless of whether commitments have been undertaken, some are conditional on the obligations that have been assumed in the Schedule of Commitments. In addition, services provided "in the exercise of governmental authority" (GATS Article I: 3b) are excluded from the coverage of the Agreement. These are services that are "neither on a commercial basis, nor in competition with one or more service suppliers" (GATS Article I: 3c). Some examples may be healthcare, education, social services or Central Bank activities. Also, most critical aspects of air transport services, such as traffic rights, are excluded from the coverage of the Agreement as they are regulated by bilateral agreements and are governed by the International Civil Aviation Organization (ICAO) (Self, 1996, p. 525). This section will focus only on the most crucial features of the Agreement.

6.1. Unconditional obligations

Unconditional obligations are those that apply regardless of whether commitments have been undertaken. They must be adhered to by all Members in all sectors covered by the GATS. These include Most-Favoured-Nation (MFN) treatment (GATS Article II), and some basic transparency provisions (GATS Article III).

6.1.1. The Most-Favoured-Nation Treatment

One of the unconditional obligations applicable regardless of the Scheduled Commitments is the MFN treatment (GATS Article II). It ensures that all signatories of the Agreement enjoy the same benefits. If a Member decides to undertake a commitment in a particular sector it must be extended to all signatories. However, there are some exceptions from this rule. A Member may specify in its Schedule of Commitments countries that are exempt from the MFN treatment (GATS Article II: 2). Exempted from this provision are also countries pursuing economic integration e.g. when

two or more countries set up a free-trade agreement or a labour market integration agreement. In such a situation Members forming the trading area are not obliged to grant the same treatment to other Members who do not join in the free-trade zone. Nevertheless, companies from third party countries that have already engaged in substantive commercial activity in one of the countries entering an integration agreement should be granted the same benefits in the whole free-trade area. For example, because of NAFTA Deutsche Bank gained access to the Canadian Market through its US subsidiary (Self, 1996, p. 527). Also, direct taxes are exempted from the MFN provisions. It lets Members enter into bilateral agreements without causing the problem of double taxation.

6.1.2. Transparency

The rules of the services trade must be transparent to ensure fair competition. Therefore, Members are required to publish "all relevant measures of general application" (GATS Article III: 1). Also, signatories are obliged to establish 'enquiry points' to promptly respond to inquiries and provide specific information about measures affecting services trade (GATS Article III: 4). However, Members are not obliged to provide information that might impede law enforcement, cause injury to public interest or legitimate commercial interest. Additionally, the Council for Services Trade must be notified about any new measures affecting trade in sectors where commitments have been undertaken (GATS Article III: 5).

6.2. Schedule of Commitments

In the Schedule of Commitments, Members declare to lift certain barriers to international trade in services and provide trade concessions to other WTO Members (GATS Article XX). They schedule a certain extent of market access (MA) and National Treatment (NT) commitments (GATS Article XVI and Article XVII) which are undertaken in particular sectors of services trade. The Schedules were established to achieve progressive trade liberalization. The commitments are negotiated on request from one of the Members and take a form similar to tariff negotiation in the international trade of goods. Only in sectors listed in the Schedule of Commitments MA and NT are guaranteed. Also, additional obligations can be scheduled (GATS

Article XVIII), allowing for greater trade liberalization and elimination of distortions that are not captured by the MA and NT.

The trade liberalization commitments in the GATS are made on a sector-by-sector basis and separately for every mode of supply (compare section 3.2.1.). In the Schedule of Commitments services sectors are divided into 12 broad categories (Table 1.). For every category presented in table 6.1. three possible levels of commitments can be made. If there are no trade restrictions for a given mode of supply in a given sector it will be described as "none" (GATS jargon) in the Schedule. If a Member has made no commitments to liberalize trade for a given mode of supply in a given sector and wants to maintain measures violating NT and MA it would be indicated as "unbound". Finally, Members can list some restrictions or limitations for a given mode of supply in a given sector which would be then described as "bound". More to the point, members can apply "horizontal" limitations to all services. For example, limit movement of natural persons or investment in all services sectors (OECD, 2001, p. 6). It may take a form of restricting temporary entry of certain types of service providers, especially high-skilled individuals, or reserving the right to review all inward FDI above a certain value.

Table 1.

Services sectors according to GATT Secretariat classification

<i>No</i>	<i>Services sector</i>
1	Business services
2	Communication services
3	Construction and related engineering services
4	Distribution services
5	Educational services
6	Environmental services
7	Financial services
8	Health-related and social services
9	Tourism and travel-related services
10	Recreational, cultural, and sporting services
11	Transport services
12	Other services not included elsewhere

Source: WTO (2010a, p. 1)

6.2.1. Market access (MA)

When MA is granted in a particular sector, it means that there are no limits on: the quantity of services which can be provided by foreign suppliers, the total number of services providers in the member country, the participation of foreign capital, or on the number of people employed in the services sector. Also, there should be no special requirements regarding the legal form of a company establishment in the foreign country and domestic company share in joint ventures. However, developing countries in their Schedule of Commitments often reserve the right to limit MA requiring establishment through a joint venture and a certain percentage of a domestic partner share. For example, China, in taxation and architectural services permits foreign establishment only in the form of joint venture (WTO services database, 2010). In India, companies providing engineering services can establish a subsidiary with no more than 51 percent foreign equity share (WTO services database, 2010). Additionally, in Malaysia foreign telecommunication companies can operate only in a joint venture with a local supplier and only as long as the aggregate foreign shareholding does not exceed 30 percent (WTO services database, 2010).

6.2.2. National Treatment (NT)

The commitments under the NT provision mean that foreign and domestic suppliers are given equal rights. However, formally identical treatment may be in breach of the NT if it "modifies the conditions of competition" (GATS Article XVII: 3). In principle, NT should ensure competition on a level ground for domestic and foreign firms. Noteworthy is the fact that the NT principle under the GATS is far more limited in scope than under the GATT where it applies not only to the committed industries, but to all sectors and products.

Worth highlighting is an important exception in the GATS that applies to financial services. The Annex on Financial Services contains a prudential exception that allows the treatment of foreign providers less favourably than domestic suppliers. The exception applies if it is "for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owned, or to ensure the integrity and stability of the financial system" (Annex on Financial Services, Article 2: a). The rationale behind this

provision is protection of the national economy in case the foreign provider is in financial difficulties. However, the prudential carve-out should not be used to avoid obligations from the country schedule.

6.3. Conditional obligations

Conditional obligations are the provisions that apply when certain commitments have been undertaken. They apply only to sectors listed in a Member's Schedule of Commitments. These include domestic regulation (GATS Article VI), compliance of monopolies and exclusive providers with the MFN obligation (GATS Article VIII), payments and transfers (GATS Article XI) and subsidies (GATS Article XV).

6.3.1. Domestic regulation

When commitments have been made a Member is required to adopt standards of domestic regulation that do not become a barrier to trade (Self, 1996, p. 530). In every individual sector where commitments have been made Members "shall ensure that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner" (GATS Article VI: 1). It pertains to e.g. licensing procedures and verification of the competence of professionals. The purpose of the provision is to ensure that domestic regulation does not leave foreign suppliers in a disadvantaged position compared with domestic providers.

6.3.2. Monopolies and exclusive service providers

National monopolies are not allowed to "abuse its monopoly position" (GATS Article VIII: 2) in sectors where commitments have been scheduled. This provision was introduced to ensure the compliance of monopolies and exclusive providers with the MFN obligation. When a monopoly decides to start providing services in a sector that is open to competition it must do so in a manner consistent with its country obligations.

6.3.3. Transfers and payments

For sectors where commitments have been made there should be no restrictions on international transfer of payments for currency transactions (GATS Article XI: 1). However, a Member is allowed to restrict transfers or

payments temporarily to safeguard its balance of payments. This provision does not apply to capital transactions (GATS Article XI: 2).

6.3.4. Subsidies

Subsidies have been covered only in a very general manner by the GATS giving Members only the right to request consultation in case they feel negatively impacted by subsidies granted by another Member (GATS Article XV). However, the provision contains a mandate to include a discussion on service subsidies in the subsequent rounds of WTO negotiations. Although present WTO rules on subsidies pertain mainly to the international trade in goods, they will be analysed in the next chapter.

6.4. Summary

International trade in services has been regulated by the General Agreement on Trade in Services. The Agreement includes general obligations concerning global services flows as well as Schedules of Commitments. Members can list there their market access and National Treatment commitments for every service category listed in the Agreement (Table 6.1.) in each services trade mode (compare section 3.2.1.). In the services sectors in which commitments have been undertaken Members are required to adopt objective rules of domestic regulation, do not allow domestic monopolies abuse their position and do not restrict international transfers and payments. In the area of subsidies the GATS provides only a general provision allowing Members to seek consultations if they feel adversely affected by the policy measures introduced by another member country.

7. Regulation of subsidies in the WTO agreements

At present the WTO regulates only subsidies affecting trade in goods. Specific rules can be found in two agreements concluded during the Uruguay Round: the Agreement on Subsidies and Countervailing Measures (ASCM) and the Agreement on Agriculture (AoA). In contrast, services subsidies are currently not explicitly regulated. Although the General

Agreement on Trade in Services (GATS) contains some provisions regarding subsidies, they provide in fact only a mandate for future negotiations (GATS Article XV). Also, the applicability of the rules contained in the ASCM and AoA to services is fairly limited.

7.1. Agreement on Subsidies and Countervailing Measures (ASCM)

The ASCM addresses multilateral disciplines regulating the provision of subsidies and rules regarding the use of countervailing measures to offset the adverse effects caused by subsidised imports. Multilateral disciplines result from the rules regarding whether or not a subsidy may be provided by a Member. They also address the question of actionable trade effects. They are enforced through the WTO dispute settlement system. Countervailing duties are instruments, such as special and additional tariffs, which may be applied by a Member on subsidised imports from another Member after an investigation and a determination of injury that those subsidized imports are causing.

The Agreement contains also the definition of the term 'subsidy'. A subsidy is defined as a financial contribution by a government or any form of income or price support that confers a benefit to the recipient. It includes: direct and indirect transfer of funds, foregone government revenue (tax exemptions and refunds), and provision of goods and services by the government on preferential terms (ASCM Article 1).

To be subject to multilateral disciplines a subsidy must be 'specific'. It means that it has to be provided only to some enterprises, some industries or a specific group of companies or industries. The underlying principle is that a subsidy that distorts the allocation of resources within an economy should be subject to disciplines. Where a subsidy is generally available within an economy, such a distortion in the allocation of resources is presumed not to occur. Only subsidies limited to one or a group of enterprises or industries, or limited to a specified regions or territories are countervailable (Horlick and Clarke, 1994, p. 42).

The ASCM is based on the economic rationale underlying the use of subsidies. From its inception GATT, and later World Trade Organization (WTO), adopted a very pragmatic approach to trade regulation. It was based on economic rationale rather than on ideological grounds. The

GATT/WTO has intervened only if a government of a member country raised a complaint regarding the violation of trade policy rules by another Member. In the area of subsidies, the organization can take actions only after an adverse effect of the trade policy measure had been proved, which is often difficult. Moreover, countervailing measures can be implemented only to offset the adverse effects and nullify the effects of the subsidy instead of excessively punishing member states for their introduction (Adlung, 2010). The level of disciplines applicable to subsidies depends on their trade distorting effect. All subsidies are categorised in three groups depending on their trade distortive effect. Table 2. provides a short description and examples of the different categories. This categorization is often described as a 'traffic light approach' since the subsidies are classified as red, amber or green (Steger, 2003, p. 5). More to the point, a subsidy to be prohibited or actionable must be proved to cause an adverse effect to the interest of another country such as injury to the domestic industry, serious prejudice or nullification or impairment of a tariff concession. For example, in 2002 Brazil raised a complaint to the WTO against the United States (US). It questioned the US upland cotton subsidies. However, to introduce countervailing measures it had to prove that the subsidies granted by the US harm its interests and show the magnitude of the injury (Schnepf, 2010, p. 6). Injury to the domestic industry would exist when subsidized exports of one country harm domestic producers on the territory of the complaining importing country. Consequently, Brazil had to prove that their domestic manufacturers were faced with unfair competition because of subsidised US exports to Brazil. It had to demonstrate that the US export subsidies (e.g. export credit guarantees under the GSM-102 programme), and actionable US domestic subsidies (e.g. marketing loan benefits), caused adverse effects against their commercial interests (Schnepf, 2010, p. 8). Conversely, serious prejudice refers to the adverse effects caused by the subsidized production of one Member to the domestic producers of another Member on the territory of the subsidising country or a third country market. In the example case, Brazil argued that the US upland cotton subsidies caused a decline in world cotton prices and a displacement of their sales in third-country markets (e.g. in China) (Schnepf, 2010, p. 2). Furthermore, nullification or impairment of a tariff concession occurs when

one Member provides subsidies to compensate domestic producers for the tariff concessions granted to another Member. Those subsidies offset or undercut the effects of the tariff reductions. This situation can be illustrated on the example of aid for commercial vessels granted by the European Communities to their shipbuilding industry. In the case from 2004 Korea argued that the subsidies granted under the provisions of the Framework on State Aid to Shipbuilding nullify or impair the benefits it gained under the GATT 1994 (WTO document WT/DS307/1).

Table 2.**Subsidies categorization according to the ASCM**

Category	Description	Example
<i>Prohibited subsidies</i>		
	<p>The red light subsidies include export subsidies and import substitution subsidies. The first group of subsidies is contingent on export performance. An illustrative list of export subsidies is presented in Annex 1 to the ASCM. The second group is subsidies contingent on the use of domestic over imported goods. Red light subsidies are considered to be most trade distortive because they are designed to affect trade and hence, they have been prohibited.</p>	<p>An example of export subsidy would be the China World Top Brand Programme. China provided companies with grants, loans, and other incentives which were depend on their export performance. (WTO document WT/DS390/1).</p> <p>A subsidy contingent on the use of domestic over imported goods would be the marketing Step 2 payments granted by the United States to domestic users of cotton under Section 1207(a) of the FSRI Act of 2002 (WTO, 2010b). When the cotton prices in the United States exceed a given benchmark, the government granted subsidies to cotton users and exporters. As a result domestic rather than imported cotton was utilized.</p>
<i>Actionable subsidies</i>		
	<p>The amber light subsidies are domestic subsidies which may have distortive effect on international trade. Most subsidies fall into this category. Actionable subsidies are not prohibited but if they cause adverse effects they may be subject to countervailing duty or dispute settlement procedure. These subsidies are not in principle prohibited, but may be challenged by another Member in the WTO. If an adverse effect is proved they must be withdrawn or the adverse effect must be removed.</p>	<p>Actionable domestic subsidies were Olive Oil production subsidies in the European Communities. Subsidized oil was exported to Mexico where it caused adverse effects to the interest of the domestic manufacturers (WTO document WT/DS314/1).</p>

Non-actionable subsidies

The green light subsidies in principle have no adverse effects or are considered not worth being deterred. They are neither prohibited nor actionable and they cannot be challenged in the WTO or be subject to countervailing measures. At present, they include only generally available subsidies. The provision that were included in this category like certain subsidies to regional development, research and development, and assistance to adapt existing facilities to new environmental requirements expired five years after the Agreement came into force. At present these subsidies are not considered as non-trade distorting any more (WTO, 2010c).

A non-actionable subsidy would be one available to all companies to help them cope with the current financial crises.

Source: Own compilation based on the ASCM (1995).

7.1.1. Countervailing measures

The most efficient measures against the use of subsidies causing adverse effects are countervailing measures (Woźnowski, 2010). Their imposition is strictly regulated by the ASCM. Countervailing duty can be imposed only after the dispute settlement procedure has been carried out and the responding party has been found responsible of causing nullification or impairment of the benefits of another member. It requires a solid proof of subsidization, the injury to the domestic industry of the complaining country and a causal link between the two. The amount of a countervailing duty cannot be higher than the amount of subsidy per unit of the imported product. However, the question of using countervailing duty in future disciplines on subsidies in trade in services is extremely complicated and therefore the details of the use of countervailing duties do not seem to be relevant to this subject at this stage (Woźnowski, 2010).

7.2. Agreement on Agriculture (AoA)

The AoA contains special rules regarding subsidies for agricultural products. It presents a different approach to subsidies reduction than the

ASCM. It accepts the existence of subsidies, even though they may have trade distortive effects, but obliges Members to reduce them all, across the board by a certain percentage.

During the Uruguay Round of multilateral trade negotiations WTO Members agreed to cut the expenditure on subsidies in agriculture by 36 percent in value terms, and the volume of subsidised exports for each commodity by 21 percent in relation to the base period 1986-90. Moreover, the AoA explicitly recognizes the important role of domestic subsidies in distorting trade and imposes their reduction (Anderson, 1994, 205). Domestic subsidies were to be lowered on average by 20 percent from the 1986-88 level. Also, WTO Members have agreed not to grant domestic support that exceeds a certain amount known as the 'Total AMS' (Total Aggregate Measurement of Support). It is "the sum of all domestic support provided in favour of agricultural producers..." (AoA Article 1h). Green, red and blue subsidies are exempted from the calculation of the 'Total AMS'. As a result, farm export subsidies are still tolerated under the AoA even though they may be trade distorting. Furthermore, Members in their Schedules of Commitments can exempt subsidies from the provisions of the GATT Article XVI (Subsidies) and the ASCM (Tangemann, 2004, p. 695). It is a peculiarity in the GATT system that generally prohibits export subsidies (Anderson, 2004b, p. 791).

The AoA also categorises subsidies into groups depending on their trade distortive effects (Table 3.). However, this classification differs from the one adopted in the ASCM (compare section 7.1.). The AoA divides subsidies into amber, green, red and blue. The 'blue box' was added to cover the half actionable subsidies granted by most develop countries to limit their agricultural production. Currently those subsidies are under strong criticism of developing countries for which agricultural production remains the biggest sector of the economy. Since the subsidies drive down prices of agricultural product in highly developed countries far below the costs of their production, they prevent imports from the developing world.

Table 3.**Subsidies categorization according to the AoA**

Category	Description	Example
The 'amber box'	The amber subsidies are trade distorting domestic and export subsidies existing in the 'base period'. They are 'half-actionable' and supposed to be reduced.	Trade distorting milk production subsidies granted by <i>Country A</i> between 1986 and 1990.
The 'green box'	The green subsidies are minimal trade distorting domestic subsidies and include environment subsidies, regional support, structural aid and other non-trade distorting policy instruments.	Minimal trade distorting subsidies granted by <i>Country B</i> to farmers using ecologically friendly fertilizers.
The 'red box'	The red subsidies are export subsidies that were not in place in the base period and are prohibited.	Egg production subsidies available to farmers in <i>Country C</i> that were not in place between 1986 and 1990.
The 'blue box'	The blue subsidies are direct payments under production-limiting programmes; they are 'half-actionable' and not to be reduced.	Subsidies granted by the EU to the farmers who decided to plant trees instead of crops on their fields.

Source: Own compilation based on the AoA (1995).

7.3. Regulation of service subsidies

The service subsidies provisions are currently underdeveloped. The GATS includes no specific disciplines for service subsidies and no remedies for the adverse effect they may cause. The rules included in the GATT and in the ASCM can be only to a certain extent applied to services trade as they have been developed to regulate the goods trade. Therefore, it can be concluded that provision of subsidies in the service sector is currently not sufficiently regulated within the WTO legal framework.

7.3.1. Regulation of subsidies in the GATS

The existing rules on services subsidies contained in the GATS follow a similar rationale to Article XVI: 1 of the GATT. They recognize that subsidies

may have a distortive effect on international trade. However, the GATS does not provide for any counter measures that could be applied in case trade distortions are proved, which makes this provision de facto toothless. If adverse effects are determined the affected country can only request consultation and should be granted "sympathetic consideration" (GATS Article XV: 2).

The difference between the GATT and the GATS with regards to subsidies is in the rules of non-discrimination (Mamdouh, 2010). While in the GATT subsidies are exempted from National Treatment (NT) provisions, in the GATS they are covered in the sectors where commitments have been undertaken. It means that if a Member undertakes a commitment in a particular sector it is obliged to provide subsidies to both domestic and foreign companies operating in that sector unless it otherwise specifies in its Schedule. Most members indeed listed such limitations on NT in its Schedule of Commitments which lets them subsidise national service suppliers on discriminatory basis (OECD, 2001, p. 9). Moreover, paragraph 10 of the Explanatory Note on Scheduling Commitments states that Members are not obliged to "take measures outside its territorial jurisdiction. It therefore follows that the National Treatment obligation in Article XVII does not require a Member to extend such treatment to a service supplier located in the territory of another Member" (WTO document MTN.GNS/W/164, p. 4). Consequently, the NT provision applies only to the delivery mode 3, when a foreign provider maintains a subsidiary in the host country.

Concisely, the GATS includes little disciplines regarding subsidies in services trade. Even though the National Treatment (NT) obligation seems to discourage Members from providing subsidies, it is not sufficient as most Members listed economy-wide restrictions on the provision of subsidies to foreign services providers (Business Briefing, 2010). Although there is a strong argument for applying the provisions design for goods trade to services, such an approach has many limitations.

7.3.2. Applying goods subsidy regulation to services trade

In contrast to services, the subsidy disciplines of trade in goods are already well developed (compare section 7.1.). However, the provisions

designed for trade in goods cannot be easily applied to trade in services. The GATT framework could not be applied to services by simply adding "and services" to the original agreement. It is mainly because export of services differs from export of goods (compare section 3.2.1.) due to the modalities as well as special characteristics of services.

Although the definition of a subsidy as well as the concept of specificity included in the Agreement on Subsidies and Countervailing Measures (ASCM) could have some application in the services trade, the four distinct modes of supply make the issue complicated. Specific subsidies would have to be treated differently depending on the delivery mode. In addition, there is a certain degree of interdependence between modes of supply which implies that trade policy measures regulating one mode affect the supply of services traded through another modes (Lennon, 2009, p. 2). Therefore, any influence that a regulation of one mode of delivery has on another mode would have to be taken into consideration.

Moreover, the special characteristics of services imply some peculiarities of the services trade which make a simple application of the ASCM to services trade unattainable. The intangibility of services makes the investigation of adverse effects and enforcement of countervailing duties very complicated. The situation gets even more complex in case of intercompany transfers. In the case of goods customs procedures at the border make trade flows controllable. In the case of trade in services, such a procedure is not applicable. It is because services supplied through a cross-border trade are often delivered using telecom-based means, which makes them virtually invisible. Even though it is possible to register the person travelling abroad with regards to services delivered through modes 2 or 4, the custom authorities would not be able to value or calculate the volume of services supplied (Poretti, 2008, p. 482). For example, a business operator travelling abroad to deliver a service or a tourist moving abroad to consume their holiday can be recorded. However, the value and the amount of the service would be not possible to trace. Additionally, because services are often tailored to the needs of the consumer they are difficult to define and classify. Also, the participation of the customer in the production process and the simultaneous production and consumption generate

additional obstacles to measurement and valuation of services flows (UN, 2002, p. 28).

7.4. Summary

In the light of the current regulations export subsidies are generally prohibited as the most distortive. The approach to domestic subsidies is more lenient. Domestic subsidies are more acceptable and international trade regulations do not rule them out, but discipline their use only if they lead to adverse effects. Nevertheless, service subsidies are not sufficiently regulated within the GATS framework. Because of the virtual lack of subsidy provisions included in the GATS and the difficulties of applying provisions designed for goods to the services trade there is a need to develop more regulation. However, the present services trade disciplines were already very controversial and there is much resistance to further regulation.

8. Present Doha Round negotiations

Although the GATS regulated many problems concerning the cross-border trade in services, there are many areas that still need to be normalised, like subsidies, safeguards, and government procurement. At the end of the negotiations round WTO Members agreed to leave those topics for further consideration with a view to develop trade disciplines in the future (OECD, 2001, p. 7). The Doha Round of multilateral trade negotiations is the current WTO trade negotiations round. The negotiations cover a range of topics from agriculture through intellectual property rights to services as well as issues concerning the implementation of current WTO Agreements. Services sector subsidies are on the agenda according to the mandate included in the GATS. Although some solutions to the problem can be proposed no agreement has been reached so far. The difficulties in the negotiations process arise mainly from the lack of information exchange, the political sensitivity of service sector subsidies and the nature of multilateral trade negotiations.

8.1. The Doha Round

The Doha Round commenced in November 2001 during WTO's Fourth Ministerial Conference in Doha, Qatar. It is an attempt to further liberalize international trade and address the development concerns of developing countries. Since some LDCs had argued that "no new round should be started until there has been full implementation of the agreements concluded in the last Round, and an evaluation of their effects done" the negotiating mandate strongly emphasises rectifying the imbalance in the exchange of concessions between the developed and the developing countries (WTO document WT/GC/W/451, p. 1). For that reason, the current round is often called the "development round" (Zutshi, 2011, p. 1).

Services trade negotiations are particularly important from a development perspective. Services such as telecommunications, financial and legal services, construction, transport and education help to enhance overall economic performance. Therefore, the Doha Declaration states that negotiations 'on trade in services shall be conducted with a view to promote the economic growth of all trading partners and the development of the developing and least-developed countries' (Doha Declaration paragraph 15). Nevertheless, while the technical work continues there is not much progress in any of the three services trade topics that is safeguards, government procurement and subsidies (WTO document TN/S/36).

8.2. Proposals for service subsidies disciplines

The issue of service subsidies had been on the agenda for many years but no conclusion has been reached. It is widely recognized that subsidies may have a distortive effect on trade in services but neither of the possible solutions found sufficient support at the negotiating table. Hence, with accordance to the negotiations mandate contained in the GATS the topic of service subsidies has been included in the current Doha Round of multilateral trade negotiations.

In a document from 28 January 2010 the delegation of Switzerland submitted a proposal for service subsidy disciplines (WTO document S/WPGR/M/67). The document contains a subsidy definition that closely follows the one included in the Agreement on Subsidies and Countervailing Measures (ASCM). The provisions suggested in the proposal attempt to

regulate only export subsidies maintained by Members in sectors in which they have already undertaken specific commitments. According to the proposed disciplines Members would be required to attach a list of export subsidies, which they maintain, to their revised Schedule of Commitments as well as specify how long those subsidies would be applicable. Then, Members shall progressively phase-out those export subsidies unless the Council for Trade in Services agrees to inscribe certain subsidies for an unlimited period of time. This proposal might have solved the problem of subsidy definition in services trade, but its weak point is the virtual lack of remedies as it recommends only a consultation procedure, hence not much more than is already included in the GATS.

Following the ASCM approach and its economic rationale to regulate service subsidies is rather impossible. The distinction between red, amber and green subsidies could not be applied because whether subsidies are prohibited or not depends on specific National Treatment commitments (Adlung, 2010). Hence, only a list of red light, prohibited subsidies that are not disciplined by National Treatment provisions could be created. Also, the ASCM required the complaining Member to prove the adverse effect of the subsidy granted by another Member. In case of service subsidies it is an extremely complicated issue. First of all, because it would require the calculation of subsidy per unit of imported service, like in the case of goods. However, determining a unit of service is virtually impossible due to the special characteristics of services. Secondly, because the difficulties with determining the value of imported service arising from the participation of the customer in the production process and complicated services flows. That problem brings about an additional issue of the rules of origin and the determination of the subsidy component of the service in question (Poretti, 2008, p. 475).

A better alternative, which would not be directly based on the requirement to prove the adverse effects, is the approach adopted by the Agreement on Agriculture (AoA). This method calls for a reduction of subsidies across the board regardless of their trade distortive effects. It could exclude services provided in the exercise of the governmental authority or only apply to the committed sectors (Benitah, 2001, p. 27). The framework might include an exemption box for non-actionable subsidies

relating to environment, economic and social development. For example, subsidies aimed at supporting the development of environmentally sound production methods, like promoting the use of renewable energy in transport services. Export subsidies and subsidies contingent on the use of domestic factors of production would be prohibited. Then, the residual subsidies would be reduced across the board by an agreed percentage.

Another possibility would be to include subsidies in the GATS by creating additional commitments. Such an approach would be feasible as Article XVIII of the GATS enables Members to undertake additional commitments with respect to measures effecting trade in services not subject to scheduling under Article XVI (Market Access) and Article XVII (National Treatment). However, such a solution has not been discussed by the negotiators (Adlung, 2010). Also, it would raise difficulties of a technical nature and negotiating further commitments might be politically difficult.

From an economic perspective trade in services would certainly have to be regulated on mode-by-mode bases. That approach is most likely to be implemented because of the complexity of the topic (Kulesza, 2010). However, some Members would argue that in the case of the delivery mode 4 (movement of natural persons) when, for example, member country residents are trained according to foreign standards of professional qualification, it may already constitute an export subsidy (Adlung, 2010). Adlung (2010) gives an interesting example of Thailand that could run a training programme for nurses to teach them according to the UK standards. It could be even done in collaboration with the British government which is looking for opportunities to source more healthcare or social workers. That programme could be already considered an export subsidy as it is targeting a particular market and it is at the expense of e.g. India or Malaysian nurses. Mode 4 suppliers from other countries also may want to have access to a programme which enables better adjustment to the conditions in a particular export market, its training or licensing requirements.

More to the point, certainly not all subsidies could be prohibited. Services subsidies cannot be perceived exactly in the same way as goods subsidies because services do have multiple policy objectives most of which are social (Mamdouh, 2010). Governments usually subsidize services

because they want to subsidize the consumers not the producers, like in the case of goods. Consequently, any exports of subsidised services would be rather incidental (Mamdouh, 2010). Nevertheless, if some trade distortions were proved, countervailing measures could be introduced. At least in some cases remedies could be applicable, but not prohibition.

However, devising remedies e.g. countervailing duties in the services trade poses some significant difficulties. Countervailing duties cannot be practically implemented in services trade due to the calculation and enforcement problems (Adlung, 2010). The main obstacle when adopting a countervailing duty is the calculation of its amount. That is, the amount of subsidy that the countervailing duty has to neutralize (Luengo, 2006, p. 427). It might be possible in the case of mode 1 (cross-border trade), although it is mostly conducted electronically. Imposing duties on electronic trade would be unworkable and it would also fly in the face of a moratorium on e-commerce of 1998 which rules out introduction of customs duties on e-transmissions (WTO document WT/MIN(98)/DEC/2). In the case of mode 2 (consumption abroad) the calculation of the amount of custom duties would not be easy. It can be demonstrated by the example of the tourism industry. For instance, verifying the nationality of a hotel's visitors and applying countervailing duties accordingly would be extremely burdensome (Adlung, 2010). Furthermore, applying countervailing duties on services delivered through mode 4 (movement of national persons) e.g. in the case of subsidization of professional education would require the calculation of the subsidy element, which is nearly impossible. Consequently, only prohibition of certain types of clearly defined subsidies is feasible and only remedies in the form of the dispute settlement procedure could be applied (Adlung, 2010). On the other hand, the prohibition of certain types of subsidies raises the problem of circumvention. The problem can be compared to the difference between the Civil and the Common law. In the former, rigid rules give raise to evasion and avoidance. In the latter, clear principles make escaping the rules more difficult.

8.3. Difficulties in the negotiations process

The discussion regarding service subsidies has gone on for many years already without any conclusion. It is partly a result of the lack of

information exchange to which countries were obliged under Article XV of the GATS. Partly, it is because of the difficulties in proving some adverse effects caused by service subsidies. Also, the political sensitivity of the issue and a general slowdown in the Doha negotiations poses additional challenges.

8.3.1. The lack of information exchange

The first stumbling block in the negotiations is actually a lack of a clear perception of the problem to be solved. Until now no trade distorting effects arising from service subsidies have been demonstrated. Thus, service subsidies provisions may seem to be more like a solution in search of a problem (Mamdouh, 2010). Furthermore, the service subsidies area is relatively unexplored as there has been little exchange of information regarding subsidies programmes maintained by member countries. One of the reasons for such a situation may be a fear that not all countries would contribute equally. Consequently, only Members disclosing their subsidy programmes would be exposed to challenges. Another reason may be a fear that certain subsidies would be prohibited even though they have an important social function (Woźnowski, 2010). There are also definitional issues that may hinder the negotiations process (Fernandes, 2008, p. 106). As long as subsidy definition could not be adopted in the services trade regulation, finding the evidence of trade distortionary effects of subsidies in services trade will remain a difficult issue. Consequently, there is certainly a need for a thorough economic research in this area (Lim, 2010). At the moment devising any provisions would be regulating something that does not constitute a problem. It might actually create unforeseen issues since the purpose of the regulation is not clear (Mamdouh, 2010).

8.3.2. The political sensitivity of service sector subsidies

Another obstacle is the political sensitivity of the problem. Its social dimension combined with the economic and political inequalities of member countries make the negotiations difficult. On the one hand, some developing countries are interested in new services regulations as they can potentially gain the most. On the other hand, developed countries are not willing to restrain their right to offer generous social benefits to their citizens.

Moreover, they do not want to allow competition from developing countries to threaten the position of their domestic companies.

Developing countries, which are usually abundant with well-trained and relatively cheap labour, fight for the access to developed country markets. Members such as India, China and Brazil argue especially for liberalization within mode 4 (movement of natural persons) to be able to export their labour-force to more economically advanced countries which offer significantly higher wages and usually lack workers or certain professionals (Kulesza, 2010). However, negotiations concerning delivery mode 4 often get mixed with migration-related aspects because, even though the labour-force movement is supposed to be temporary, governments are concerned that it may turn into permanent presence (Marchetti and Roy, 2009, p. 52). For example, the US does not seem to be really interested in reaching an agreement (Lim, 2010). One reason may be that it does not really see the need for developing new regulations. Another reason can be that it subsidises services to a great extent (WTO, 2001, p. 397). For instance, direct financial transfers are available to the US companies operating in the air transport and agricultural sectors (WTO document WT/TPR/S/126). Therefore, if new provisions are introduced, it could potentially lose the right to support its services trade so extensively in the future. More to the point, the US is able to impede the negotiations process because of its economic and political power (Kulesza, 2010). Hence, they can exert influence on the attitude of the other countries.

An additional complication is the special and differential treatment which developing countries enjoy within the ASCM (Woźnowski, 1999). To ensure the participation of developing countries in international agreements they are often granted concessions and long transitional periods. The lower a Member's level of development, the more favorable the treatment it receives with respect to subsidy disciplines. For example, least-developed countries, defined as Members with GNP per capita below \$1000, do not have to comply with the export subsidies prohibition from ASCM Article 3.21(a). That provision applies also to many tiger economies. For example, India falls into this category even though it has a dynamically developing economy and a great numbers of wealthy residents. As a result, highly developed countries are concerned that giving too many concessions to

developing countries with strong and growing services sectors would make them too competitive.

8.3.3. The nature of multilateral trade negotiations

One more difficulty lies in the nature of multilateral trade negotiations, which require trading off one commitment for another. The Doha Development Agenda includes topics like agriculture, industrial goods, services and rules¹, which all influence the flow of the whole process. The existence of a broader framework certainly increases the chances of reaching an agreement, as there are more trade-off opportunities. However, it makes the process much more complex and intensifies the political game. Therefore, the issue could be simplified if certain trade topics were negotiated separately (Kulesza, 2010). As services negotiations within Doha have a context it is difficult to negotiate an agreement that is part of a broader negotiation program in isolation. As a result, reaching a consensus in services depends on the success of the general negotiations.

Not without an effect on the international trade negotiations is the number of participants. Since decisions on the WTO forum are undertaken by consensus, the difficulty of reaching a decision increases with the number of Members taking part in the negotiations process. As WTO expanded quickly from 23 countries forming the organization to the current 153 Members the complexity has greatly increased.

8.4. Summary

The problem of services sector subsidies was already recognized when the GATS has been drafted. However, it did not find a solution within this Agreement. There were some suggested ways of solving this problem and even the first proposal was recently tabled by the Swiss. Nevertheless, there are many difficulties in approaching the problem and many complications that make the issue irresolvable at this stage.

9. Conclusions

The issue of subsidies regulation in international trade is a very complicated and extremely sensitive topic. The contemporary trade theory clearly supports the case of services trade liberalization and providing a level playing field for all suppliers. As subsidies like other non-tariff trade barriers lead to market distortions, impede competition and lead to unfair trade they should be subject to strong disciplines. Nonetheless, the discussion regarding the general liberalization of trade in services was already very controversial, and the current debate on service subsidies is even more so. Subsidization is an important instrument for achieving the social and political goals of most governments. Especially, when it pertains to services that encompass crucial for development sectors like education, healthcare or business services it is not going to be willingly discontinued. Subsidizing services is a way of providing public goods. Therefore, member countries are generally opposed to limiting their right to support the services sector. Governments grant subsidies in the services sector to subsidies the consumers, not the producers like in the case of goods. Hence, subsidies in services trade cannot be seen in the same way as in the goods trade.

Even though the negotiations on service subsidies have been taking place for many years, WTO Members have not yet reached a final conclusion. One of the obstacles in the services trade negotiations was the divergence of the attitude of developed and developing countries towards the regulation. Another problem was the increasing politicization of the negotiation process which added to the difficulties of reaching a conclusion. Nevertheless, the General Agreement on Services Trade was adopted by the WTO despite the fact that an agreement on several topics, including subsidies, was not achieved. Although it has to be recognized that completely free trade is an unrealistic goal the trend to services trade liberalization remains positive.

Despite the growing magnitude and importance of services, the present international trade regulations concerning subsidies are focused mainly on trade in goods. Notwithstanding the current regulation of subsidies in the Agreement on Subsidies and Countervailing Measures (ASCM) and the Agreement on Agriculture (AoA) and services provisions of the General

Agreement on Trade in Services (GATS) granting subsidies in the services sector is not sufficiently regulated in the international trade system. The provisions included in ASCM and in some articles of the AoA cannot be easily adopted to regulate also trade in services due to the multimodal delivery and special characteristics of services. Although the GATS in article XV addresses the issue of subsidies, it only gives a mandate to incorporate the topic in the subsequent negotiations rounds. Consequently, service sector subsidies are on the agenda of the Doha Round.

Although the GATS contains a mandate for future negotiations on service subsidies which may suggest there will be new provision it is rather unlikely that an agreement on service subsidies will be reached within the current round of negotiations. Even though some solutions to the problem can be conceptualized their applicability is rather limited. Moreover, there are numerous issues hindering the negotiations. The biggest obstacle in the negotiations process is certainly the lack of reliable information. There is little exchange of information regarding service subsidy programmes as well as the lack of proof of injury caused by service subsidies. The fact that until now no Member has managed to prove the trade distortions allegedly caused by services subsidization may be a direct result of the scarcity of information regarding subsidy programmes of member countries. As a result, the discussion so far is more on a theoretical than practical ground. In addition, the political sensitivity of services trade debate impedes the negotiations process. The multilateral negotiation process is heavily influenced by a conflict of interest between developed and developing countries. More advanced economies do not want to lose their advantage in services trade while developing countries, that already enjoy more favourable treatment, insist on greater concessions. The fact that many of those countries belong to the most dynamically developing economies generates concerns and resistance in the developed world. More to the point, the inclusion of numerous topics in the negotiation has led to trading concessions in one area for another making the process very complex. At the moment the negotiation focus more on the issue of market access and agricultural subsidies leaving service sector subsidies without much attention. In addition, the process is complicated because of the nature of multilateral trade negotiations which becomes even more complex as the

number of participating countries increases. Because of the barriers to reaching an agreement it is highly possible that the negotiators on service sector subsidies will end without a conclusion. The negotiators may simply leave the issue unresolved until future trade negotiation rounds. The problem certainly requires more research and analysis of statistical data. It needs also more time, like it was in the case of goods, to be better understood and thus gain a higher priority on the negotiations agenda and more interest of the member countries.

Notes

¹ Negotiation on WTO Rules include subjects related to the Anti-dumping Agreement; the Agreement on Subsidies and Countervailing Measures, WTO disciplines on fisheries subsidies, and WTO provisions applying to regional trade agreements (WTO, 2011).

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 - Simon, H.A. (1976). "From Substantive to Procedural Rationality", in: S.J. Latsis (ed.), *Method and Appraisal in Economics*, Cambridge, Cambridge University Press.
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