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Working Paper

The importance of measuring the delivery of services via commercial presence of offshore foreign affiliates: Some case studies from Australian business experience

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ADB Working Paper Series

**The Importance of Measuring the
Delivery of Services via
Commercial Presence of Offshore
Foreign Affiliates: Some Case
Studies from Australian Business
Experience**

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Abstract

6TThere are major difficulties associated with measurement of each of the four modes of services trade delivery as defined in the General Agreement on Trade in Services (GATS): cross-border supply, consumption abroad, commercial presence, and movement of natural persons. The consequence is that the extent of global trade in services is hugely underestimated and the services sector does not receive the trade and economic policy attention it deserves. The global economy meanwhile misses out on the productivity gains that focused reform of services sectors could generate.

Australia is one of the world's most services-intensive economies. Of the 20 largest world economies, Australia's is fourth only to the United States, United Kingdom, and France in services. This means Australia's future economic growth will be substantially determined by improvements in productivity and competitiveness in services. Just a small rise of 0.1% in services sector productivity would result in a sustained annual rise of over A\$1 billion in Australia's gross domestic product. But the services sector does not receive the policy focus these economic fundamentals would justify. This is largely because the balance of payments data measures Australia's services exports at less than 25% of total exports, consistent with World Trade Organization estimates that services account for roughly 20% of world trade.

In Australia's case, sufficient business survey work has been done to leave no remaining doubt that the balance of payments data have needed to be both improved in their own right as well as supplemented with foreign affiliates' trade in services (FATS) data to shed greater light on the services sector's share in international business. This paper highlights recent business case studies in Australia, which demonstrates the importance of intensifying official efforts to enhance collections of services export data and to measure specifically Mode 3 (Commercial Presence) delivery of international services. The studies are drawn chiefly from legal services and financial services but also cover the information and communication technology and architecture/building design sectors. This paper focuses on some of the problems commonly experienced in relation to statistics regarding international trade in services. It deals moreover only with case studies drawn from Australian business experience; and refers to practices and collections of the Australian Bureau of Statistics (ABS).

JEL Classification: F14, F23, M16, M21

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1. DEFINING SERVICES

“Services” encompasses a very broad and diverse range of activities, but tend to be intangible and difficult to measure. In its broadest sense, the services sector has tended to be thought of negatively—that is, services include all economic activity that is not mining, manufacturing, agriculture, forestry, and fishing. Services are generally poorly understood, therefore, as activities that do not produce tangible “things” or “goods.”

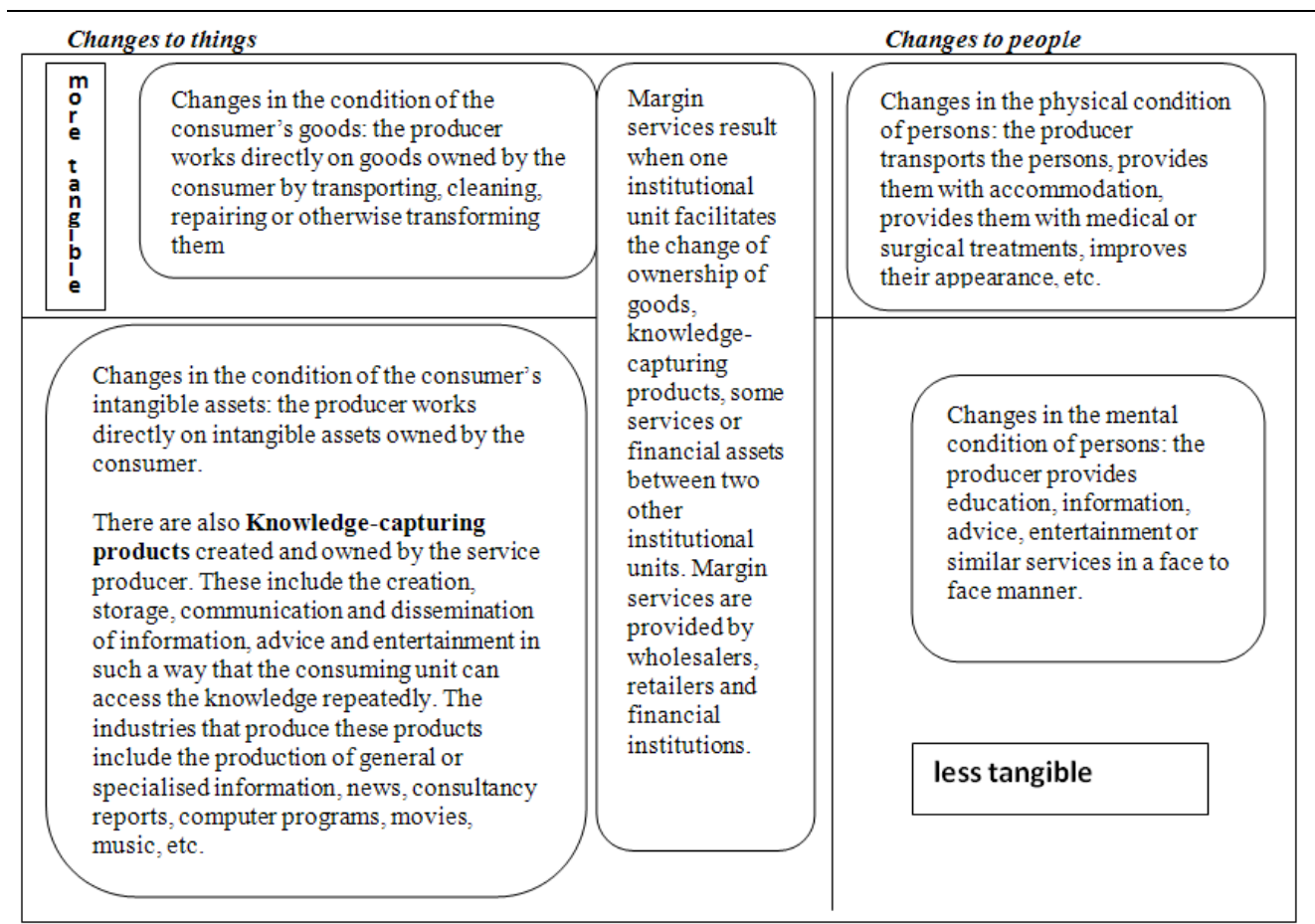
This negative conception of services is nonsensical in practice. Many services activities do, in fact, result in production of a “thing”—e.g., a restaurant “meal”, a “movie” or a published consultancy “report.” Similarly, significant services sector activities are embedded within every goods-producing industry. A more positive and accurate definition of services is needed to focus attention directly on services activities in their own right; this is essential if progress is to be made in identifying the drivers of competition and innovation specifically in services and hence in defining a strategy to help meet the policy needs of actual and potential services providers.

To describe what services are, rather than what they are not, some definitions focus on the intangibility of services. But while all goods are tangible, not all services are intangible, such as repair, transport, or construction. Other definitions place an emphasis on ownership, noting that services provide temporary possession, rather than ownership and that payments for services typically take the form of rentals or access fees. Other definitions again, tend to focus on the intellectual property content of services. Elements of each of these definitions are mirrored in the internationally agreed economic definition of services as set out in the System of National Accounts (SNA 2008:section 6.17) that services are “the result of a production activity that changes the conditions of the consuming units, or facilitates the exchange of products or financial assets.”

According to SNA 2008, there are two major types of services, namely change-effecting services (which can apply to goods or to people) and margin services (which can apply to goods and services). A feature of both margin and change-effecting services is that they are not separate entities over which ownership rights can be established—they cannot be traded separately from their production. By the time their production is completed, the services must have been provided to the consumers. In addition to change-effecting services and margin services, SNA 2008 defines as services a range of knowledge-capturing products, noting that they have many of the same characteristics as goods in that ownership rights over these products can be established and they can be used repeatedly.

Figure 1 shows the various categories of economic activities defined as services in SNA 2008. It illustrates that neither tangibility nor ownership is sufficient to distinguish services from goods, and that while there are several unifying themes the economic definition of services encompasses a range of complex and subtly different activities.

Figure 1: Conceptual Framework for Defining Services



Source: United Nations, the European Commission, the Organisation for Economic Co-operation and Development, the International Monetary Fund and the World Bank Group 2009, System of National Accounts, 2008 section 6.17

2. MEASURING SERVICES

If defining services is conceptually complicated, devising appropriate methodologies for the collection of national services statistics has proved no easier. In practice, the lazy solution has been adopted; the services sector has simply been measured as a straightforward residual after allowing for agriculture, fisheries, forestry, mining, and manufacturing. The evident result of this under-investment in the collection of services statistics is that the sector lacks a good statistical database.

The intangibility of many services and the fact that services can change in quality and nature quite rapidly are consistently cited as the chief reasons for lack of progress in improving measurement methodologies for services. Constant improvements in technology add to the complexity of collecting data on services as new services are developed in areas such as finance and communications. It is only in the last decade, that these various factors have been recognized as signals of innovation and hence

relevant to measures of productivity, justifying further public investment to improve the statistical database for services.

This paper focuses on some of the problems commonly experienced in relation to statistics regarding international trade in services. It deals moreover only with case studies drawn from Australian business experience, and refers to practices and collections of the Australian Bureau of Statistics (ABS).

It must be noted right at the outset that trade statistics, even under the framework of the latest Balance of Payments Manual 6th edition (BPM6), are collected only for relatively aggregated sets of services activities. Australia was the first Organisation for Economic Co-operation and Development (OECD) country to implement BPM6; the ABS releases 7000 disaggregated trade categories for goods but still only 70 for services, the latter being more detailed than what is actually required by the international standards (i.e., the Extended Balance of Payments Services (EBOPS) Classification). The introduction of BPM6 saw significant improvements, mainly the release of more detailed data more frequently, but significant data gaps remain.

Defining and Measuring International Trade in Services

A definition of services trade, encompassing four modes of supply, was incorporated into the General Agreement on Trade in Services (GATS) at the conclusion of the Uruguay Round of multilateral trade negotiations in the World Trade Organization (WTO).

Mode 1—Cross-border Supply: the services are delivered (for example electronically) to the territory of the non-resident client. This is really the only mode of delivery that most statistical collections cover. If delivery is direct to the non-resident client, the ABS is likely to pick this up as an export via its sample survey of those Australian services providers known to export services. However, if the delivery (and invoicing and accounting) takes place via a local office in the territory of the non-resident, then depending on the nature of the office and the extent of bundling of different services together, it might be categorized as “services between affiliated enterprises” or, more likely, it will not be classified as an “export” (as explained under Mode 3 below).

Mode 2—Consumption Abroad: the non-resident client travels to the territory of the Australian services provider to obtain and pay for the services. Depending on corporate invoicing practices, the ABS would not necessarily pick up all of these export transactions via its International Trade in Services Survey. Special effort is made, however, to estimate travel services exports and imports (including education-related travel, business, and other travel) because any business that provides goods or services to a non-resident traveling within Australia, is providing a travel service. In order to capture this information, via a survey, all businesses—and many households (mainly those that rent holiday accommodation)—are potentially providing a service to a non-resident. Education services and tourism are Australia’s largest measured services exports.

Mode 3—Commercial Presence: the Australian services provider establishes a local presence in the territory of the foreign clientele; the local presence might be a representational office, a franchise or a registered subsidiary or branch. The local presence is considered a “foreign affiliate” when over 50% of the stock or voting rights are Australian-owned. The foreign client engages with the resident Australian-owned service provider via this office. The ABS does not measure earnings into that office in the trade in services collections. The ABS measures the earnings of the office via ABS’

International Investment Survey and they are included in the balance of payments (BOP) current account, income. The transactions are not considered as exports because they are not between residents and non-residents, the foreign affiliate being considered to be a resident of the country in which it is located.

Mode 4—Movement of Natural Persons: service providers travel temporarily (visits of durations under 12 months) to the territory of the foreign client to supply the service. The ABS would not necessarily pick this up via the International Trade in Services survey unless it is specifically so declared by the exporter.

Estimation of transactions under each of these modes is problematic. This paper reports a number of recent business efforts in Australia to improve the measurement of services exports via Modes 1, 2, and 4, but it focuses specifically on the information gains that can be achieved by efforts to measure Mode 3 – Commercial Presence.

Mode 3 differs fundamentally from the other modes in that it breaks the traditional pre-GATS convention as to what constitutes trade, the transactions involved being quite unlike the conventional concepts of imports or exports (imports by convention being services delivered by non-residents to residents, and exports by convention being services delivered by residents to non-residents).

The concept of Mode 3 delivery of services hence pushes awkwardly up against the statistical conventions of the BOP and the framework of the SNA and, as a result, in most countries, goes completely unmeasured, unlike Modes 1, 2, and 4, which are imperfectly measured, but measured nonetheless.

Upon conclusion of the GATS, six international economic organizations including the WTO, International Monetary Fund (IMF), OECD, and United Nations Committee on Trade and Development (UNCTAD) agreed on a set of recommendations for appropriate methodologies for the measurement of trade in services and these were set out in the Manual of Statistics on International Trade in Services (MSITS 02) first published in 2002.

MSITS 02 recommended that both inward and outward services transactions of foreign-affiliated companies should specifically be measured as part of national collections of trade data because services supplied through this mode are governed by the disciplines in the GATS (United Nations Statistical Commission [UNSC] 2002). Few governments have implemented, or even made partial progress toward implementing, this recommendation. The ABS does not regularly produce either inward or outward Foreign-Affiliates Trade statistics (FATS) for Australia. This is a serious problem because recent estimates, based even on the limited empirical information available, suggest that Mode 3 (commercial presence), accounts for more than half of world trade in services.

There has been a tendency to dismiss this problem, on the assumption that traditional collections of statistics on foreign direct investment (FDI) could serve as a proxy guide to what might be happening with respect to Mode 3 services trade. FDI statistics have been useful as a proxy because, given that they are based on 10% ownership/voting stock, they cover a much broader stock of FDI than Mode 3. One flaw in this approach is that services are now coming to dominate the FDI statistics as well. According to the *World Investment Report 2004: The Shift Towards Services* (UNCTAD 2004), the services sector accounts for 60% of the global stock of FDI. The data gaps in mode 3 delivery of services are meanwhile prejudicing the associated international research agenda. The business case studies presented in this paper demonstrate that the traditional BOP data,

even when supplemented by FDI statistics, are not up to the task of capturing global trends in international business.

A revised edition of the manual, *MSITS 2010*, was recently completed. It notes that “the development of statistics on international service supply has lagged behind the changing reality of the marketplace” (UNSC 2010:section 2.7) *MSITS 2010* draws attention to the disconnect evident between data showing, on the one hand, that service industries are the largest recipients of global outflows of FDI, and yet comprise about one fifth of worldwide trade in BOP terms.

MSITS 2010 notes that “there are currently few reliable international comparisons of FATS, but according to information available for OECD economies, it is estimated [by UNCTAD] that the value of services delivered to markets through foreign affiliates is at least as high as the value of exports (or imports) of services recorded in the balance of payments” (UNSC 2010:section 2.5)

Work by the WTO Secretariat staff likewise estimates that commercial presence accounts for 55-60% of total global world trade in services (Table 1).

Table 1: Share of Global Services Trade by Mode of Supply

Mode of Supply	Relevant Statistical Domains	Share of Services Trade
Mode 1: Cross border supply	BOP: commercial service (excluding travel and construction services)	25–30%
Mode 2: Consumption abroad	BOP: travel	10–15%
Mode 3: Commercial presence	FATS statistics—only US has regular survey BOP: FDI data, construction services; for confidentiality reasons very little data is available	55–60%
Mode 4: Presence of natural persons	Insufficiently covered Construction services BOP: commercial service (excluding travel) BOP statistics: compensation of employees’ and workers’ remittances	< 5%

Source: Joscelyn Magdeleine, Andreas Maurer 2008, Measuring GATS Mode 4 Trade Flows, Staff Working Paper ERSD-2008-05, World Trade Organization, Geneva.

3. PILOT SURVEY OF AUSTRALIAN-OWNED FIRMS OPERATING IN OTHER COUNTRIES

At nearly 23% of measured exports, Australia's services exports are roughly on par with manufactures exports and now clearly outdo Australia's rural exports. But there can be no doubt that the above percentage is a significant understatement.

In 2003, the ABS conducted an experimental *Survey of Outward Foreign Affiliates Trade*. The conceptual framework was aligned as closely as possible to that articulated in MSITS 02. The survey frame was obtained by combining the frames of the *Survey of International Investment* and the *Survey of International Trade in Services*, which collects data quarterly on a wide range of services. Further to this, the frame was supplemented by additional units considered to be in-scope. Information was collected on the industry category, number of businesses, fixed capital formation, total assets, sales, value added, gross operating surplus, and employment. The scope of the survey was limited and the published results fell short of meeting the needs of potential users, partly as a result of constraints arising from confidentiality issues.

Despite its shortcomings, the survey results suggested that the official Australian data on services exports as measured by the BOP had probably been measuring less than one third of Australia's actual offshore supply of services.¹ For confidentiality reasons, data for certain industry sub-sectors were suppressed. Based on the published data, the underestimation appeared to be particularly significant for financial services, including insurance, and for a range of professional services, including legal services.

Other key findings from the pilot survey include:

In 2002–2003, Australian companies had approximately 4,000 foreign affiliates employing over 300,000 staff. Interestingly, the vast bulk (86%) of the Australian companies that have foreign affiliates are also Australian-owned companies.

Australian foreign affiliates generated A\$142 billion in sales revenues, of which A\$65 billion was sales of services (A\$31 billion in the Americas, A\$20 billion in Asia-Pacific, and A\$14 billion in Europe).

In Europe, sales of services appeared, to the extent that confidentiality of data enabled allocation to specific industry-sub-sectors, to be dominated by finance and insurance; in Asia sales also appeared to be strong in property and business services (including legal services).

Foreign affiliates were primarily established initially to service the markets where they were domiciled, with around 90% of sales within the host country.

Unfortunately, despite persistent and voluble business support for further work, the pilot survey has never been repeated due to lack of government funding for this important work.²

¹ The results were released in October 2004.

² The Australian Department of Foreign Affairs and Trade (DFAT) recently funded the ABS to run a survey of Finance and Insurance Foreign Affiliates Trade Statistics. The results are expected to be released in mid-2011.

4. BUSINESS CASE STUDY EXPERIENCE

Given concerns about the evident and persistent lacunae in the official ABS data, a number of initiatives have been taken by other bodies over the last decade to try to get a better understanding of the extent of participation of Australian services industries in international trade. Some other government agencies and some services industry associations hoped that the implementation of industry-led sectoral surveys might assist in avoiding some of the confidentiality issues faced in the ABS survey.

4.1 International Legal Services

Groundbreaking survey work has been undertaken by Australia's International Legal Services Advisory Council (ILSAC), which is chaired by the federal attorney-general and acts as the foremost public-private sector consultative and advisory forum for Australia's international legal services sector. The statistical project was undertaken as a collaborative exercise by the Attorney-General's Department, Law Council of Australia, Austrade, and eight leading Australian law firms, all of which contributed financially to the project. The survey itself was outsourced to FMRC Legal Pty Ltd.

This project was conceived in direct response to concerns that the global market for Australian legal services³ was being underestimated in the official data, given that the ABS does not identify earnings of overseas branch offices of Australian law firms as legal services "exports," but rather, in accordance with international standards, as "returns on investment."

4.1.1 Definitional Issues

The project aimed to measure income arising from Mode 3 commercial presence and also to obtain data about different types of legal services and the ways in which they were delivered. It is important to note that the survey also deliberately measured legal services provided by Australian resident legal practices to Australian companies where the work originated from an overseas-based project.

These latter transactions cannot be considered, under any definition, to comprise international trade in services. They are, however, highly relevant to studies, for example, of how Australian firms become acquainted with the international marketplace or how Australian services might add value to exports of other industry sectors or how Australian services compete in the resident market vis-à-vis potential imports. And they are often difficult to separate in company records from genuine export transactions. Nevertheless, inclusion of these transactions, as well as Mode 3 transactions in what ILSAC describes as "cross-border income" can lead to a number of potential confusions and some care is consequently required in interpreting the survey results.⁴

In particular, "Fly-in, Fly-out" is defined as work that is only undertaken by legal service providers normally resident in Australia, either on a "fly in/fly-out" basis or from their

³ Legal services comprises commercial legal services and barrister services, patent and trademark attorney services, commercial dispute resolution services (including arbitration and mediation), and other services.

⁴ ILSAC is working with the ABS to more accurately align its surveys with the international definitions of the four modes of delivery. Some of the definitional problems have arisen from the need to compile a comprehensible and easy to complete survey that aligns with company records.

“desk” in Australia if it is not necessary to actually fly to undertake the work. This category therefore presumably includes Mode 1, Mode 2 and Mode 4 exports.

“Australian Projects” covers residual exports that are neither “totally [n]or predominantly” characterized as “Fly-in, Fly-out” nor Commercial Presence. They also include international work performed for Australian residents. It is not possible from the published survey results to obtain any specific breakdown in the “Australian projects” data between genuine exports and resident-to-resident transactions.

It should also be noted that the ILSAC survey will have overestimated “legal services” in the sense that it included not only professional legal fees but also “disbursements” (funds billed to clients and spent as expenses on behalf of clients); the ABS does not include disbursements under “legal services.” Similarly, the ILSAC survey picked up some other services which corporate accounting practices did not necessarily separate out as distinct from legal services; the ABS would categorize these to the appropriate service category.

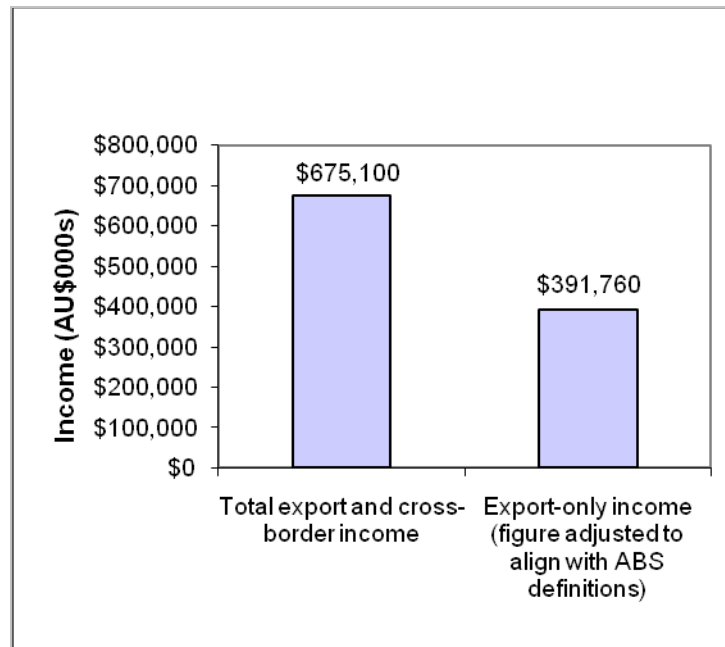
Flaws resulting from definitional issues aside, the ILSAC survey results are nevertheless extremely interesting and allow for considerably more extensive and more useful trade related analysis than the export data provided by the ABS.

4.1.2 Survey Results

ILSAC conducted two surveys—the first in financial year 2004-2005 and the second in financial year 2006–2007—and released the results of the latter in February 2009.⁵ The second survey was sent to 170 Australian law firms, legal practices, patent and trademark practices, international arbitrators and mediators, and other legal and related services providers. Of this number, 86 (51%) returned the survey, with 61 (36%) providing a positive response.

Both sets of survey results confirmed that there was major underestimation in provision of Australian legal services offshore, including as a result of failure to measure Mode 3. Figure 2 illustrates the magnitude of the potential underestimation. Total combined legal services “export and cross-border income” was reported at A\$675 million (increasing from A\$543 million in 2004–2005) or 142% higher than the official ABS export figure reported at A\$278 million at the time.

⁵ Since this paper was written, ILSAC has completed a third survey for 2008–2009, the results of which are available at [http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_AnalysisofILSACsThirdStatisticsSurvey\(2008-09\)](http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_AnalysisofILSACsThirdStatisticsSurvey(2008-09))

Figure 2: Export and Cross-border Trade in Legal Services 2006–2007

Source:

ILSAC http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10)

It is interesting that even conventional exports, estimated by ILSAC to have contributed A\$392 million to the above total, were some 41% higher than the ABS figure, which was reported as A\$278 million in 2006–2007.

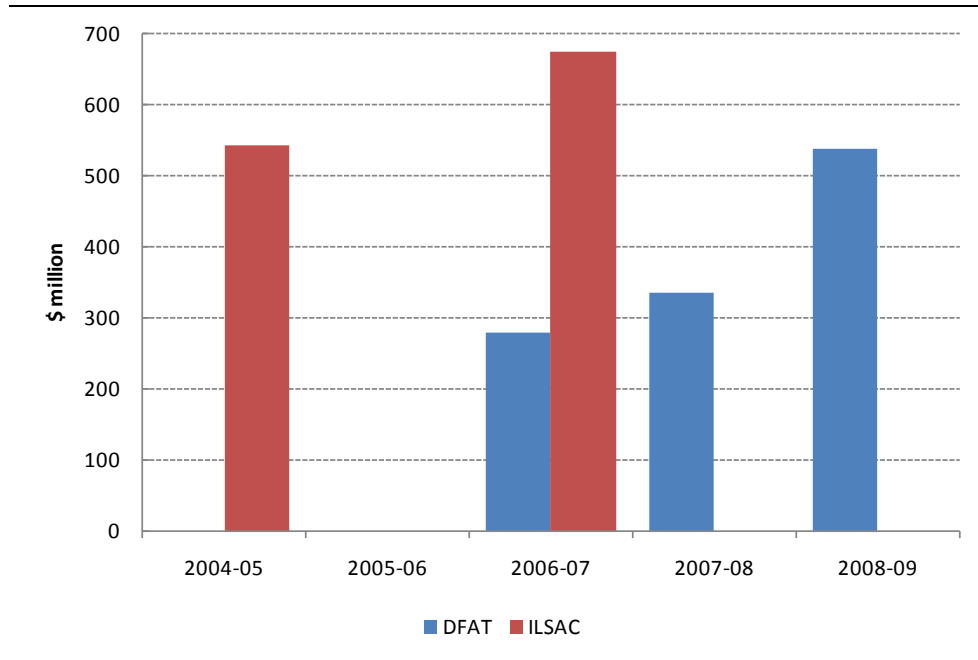
This significant discrepancy of A\$114 million seems largely, in hindsight, to have been caused by inadequacies in the frame for the ABS survey, which have now been addressed thanks to the effective working relationship with ILSAC. For 2008–2009 data, the ABS adjusted its frame in line with the ILSAC surveys, the consequence being a reported 60% jump in legal services exports in 2008–2009 (whereas many legal services firms report anecdotally that 2008–2009 was a difficult year. Backcasting of the data came on stream on 4 November 2010 and the revised data confirm that enlargement of the ABS survey frame has largely fixed the survey discrepancies. (The ABS figure has now been revised to A\$406 million, leaving a remaining discrepancy of only A\$14 million.) The point to be made here is that without the ILSAC work, and the attention given to improving the data by Australia’s top legal services firms, the impetus to improve the ABS survey frame would not have developed so quickly, and the improvements in the ABS export data would not yet be on stream.

Before drilling in any further detail into the ILSAC survey results regarding conventionally defined exports—if A\$392 million of the A\$675 million is conventional exports, then what is the remaining A\$283 million? Importantly for the purposes of this paper, Commercial Presence abroad (Mode 3) was estimated to contribute more than half of the remainder—i.e., A\$149 million in 2006–2007 (compared to A\$85.193 million in 2004–2005).⁶

⁶ Net of disbursements, the figure was A\$145.1 million (compared to A\$79.50 million in 2004–2005).

Comparing the survey results in 2006–2007 and 2004–2005, the contribution of commercial presence grew extremely rapidly—by 75% over the two years to account for 22% of “export and cross-border” earnings, compared with 16% two years earlier. This evident growth in commercial presence is remarkable and without the ILSAC survey may have gone unnoticed in the official statistical collections.

Figure 3: Legal Services “Exports”—Comparison of ABS/DFAT Export Data and ILSAC Data on Exports and “Cross-border Income”

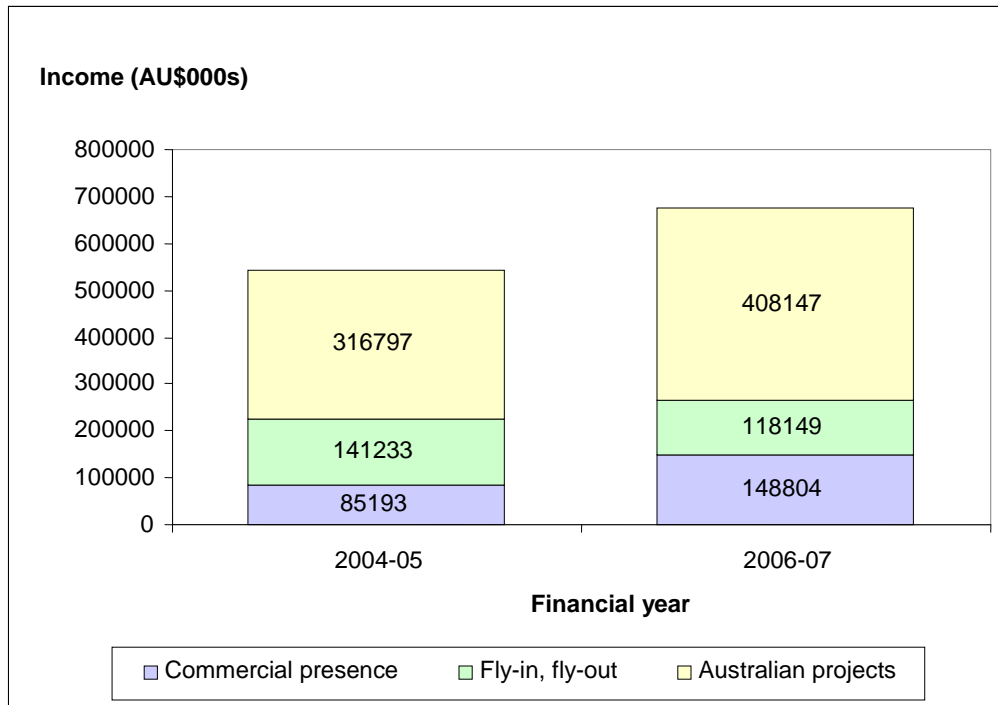


Source: McCredie et al. 2010.

The ILSAC survey was able to deliver a wealth of additional information. For example, the ILSAC survey showed that international work is very concentrated, with ten firms accounting for almost 80% of earnings in 2006–2007. Importantly, the survey provides a detailed breakdown by geographic market than is normally available from ABS export data, along with related insights into the relative importance of individual mode of delivery into different geographic locations.⁷

⁷ Some detailed information on legal services by geography can be requested from the ABS as a special data service at a charge.

Figure 4: Export and Cross-border Trade in Legal Services by Mode of Service Delivery



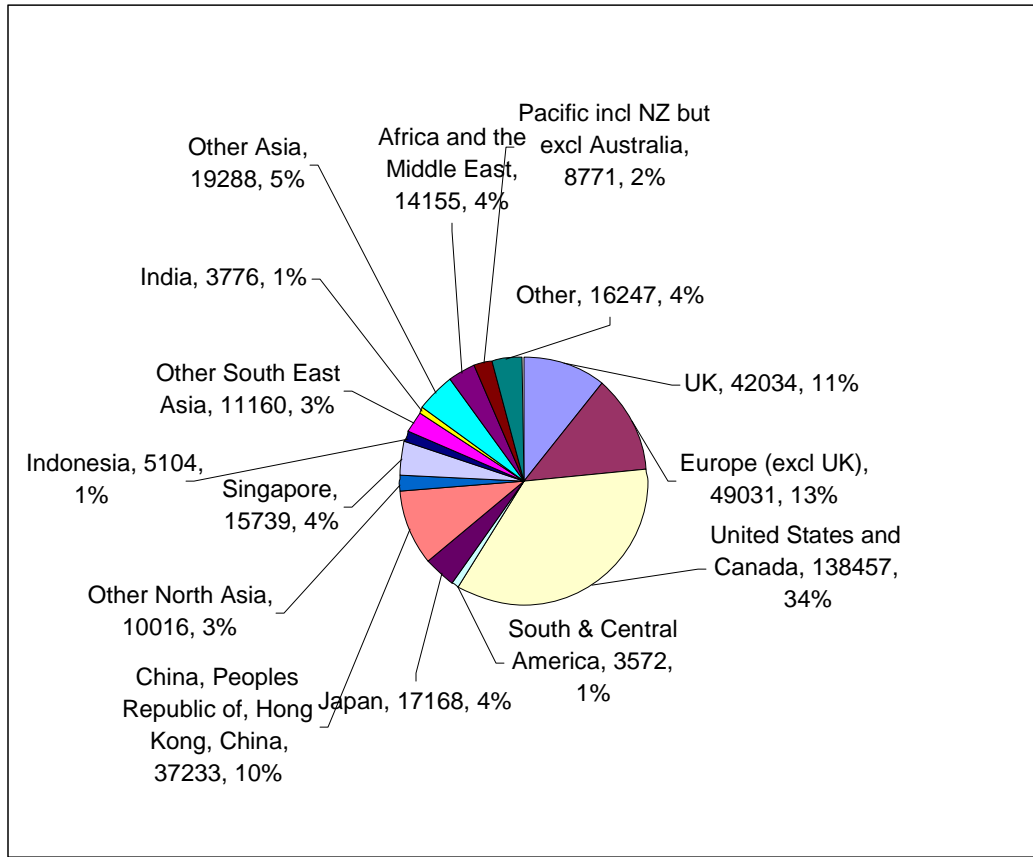
Source: ILSAC,

http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10)

Together accounting for 66% of total “export and cross-border” sales, the ILSAC survey showed the most important locations for international legal work for Australian lawyers were:

- (i) United States/Canada: A\$192 million in 2006–2007 (29%) compared to A\$134 million in 2004–2005
- (ii) Peoples Republic of China (PRC) and Hong Kong, China: A\$105 million (16%) in 2006–2007, up significantly from A\$74 million in 2004–2005 and now displacing the United Kingdom in second place.
- (iii) United Kingdom: A\$82 million (12%) compared to A\$87 million in 2004–2005.
- (iv) Continental Europe: A\$66 million (9%)

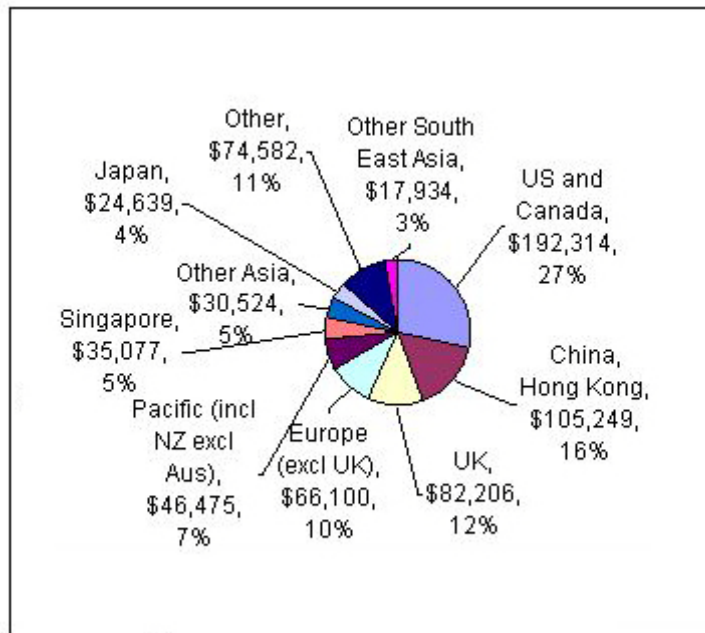
Figure 5: Legal Services Export Destinations



Source: ILSAC, http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10)

Although the United States and Canada remains overwhelmingly the largest single market location for Australian international projects, there is no longer any office of an Australian law firm established in North America. Commercial presence has been shifting towards Asia. The data for conventional legal services exports alone shows North America accounting for just over one third of all transactions and Asia as a whole accounting for just under one third. But the combined data for “exports and cross-border” transactions, including Mode 3—Commercial Presence, show Asia now in the ascendancy, accounting for more than one third of the total and North America dropping below.

Figure 6: Top Ten Geographic Markets

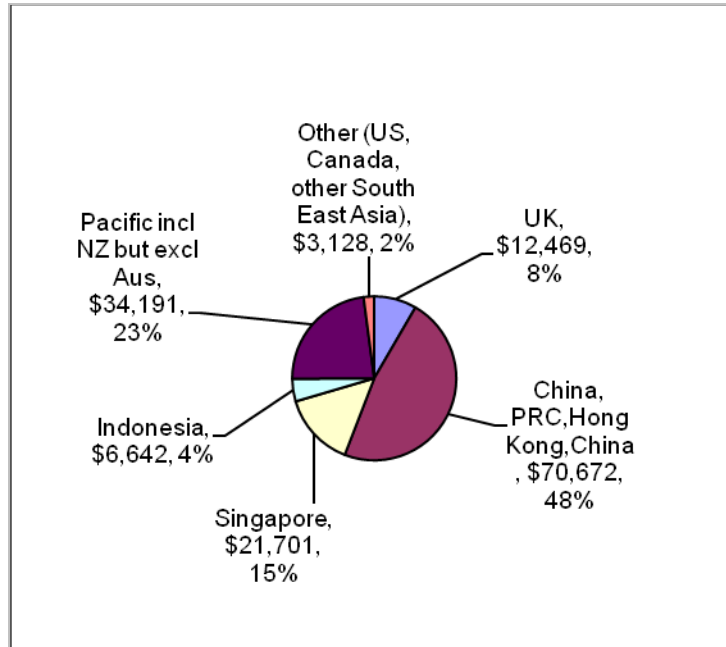


Source: ILSAC

http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10).

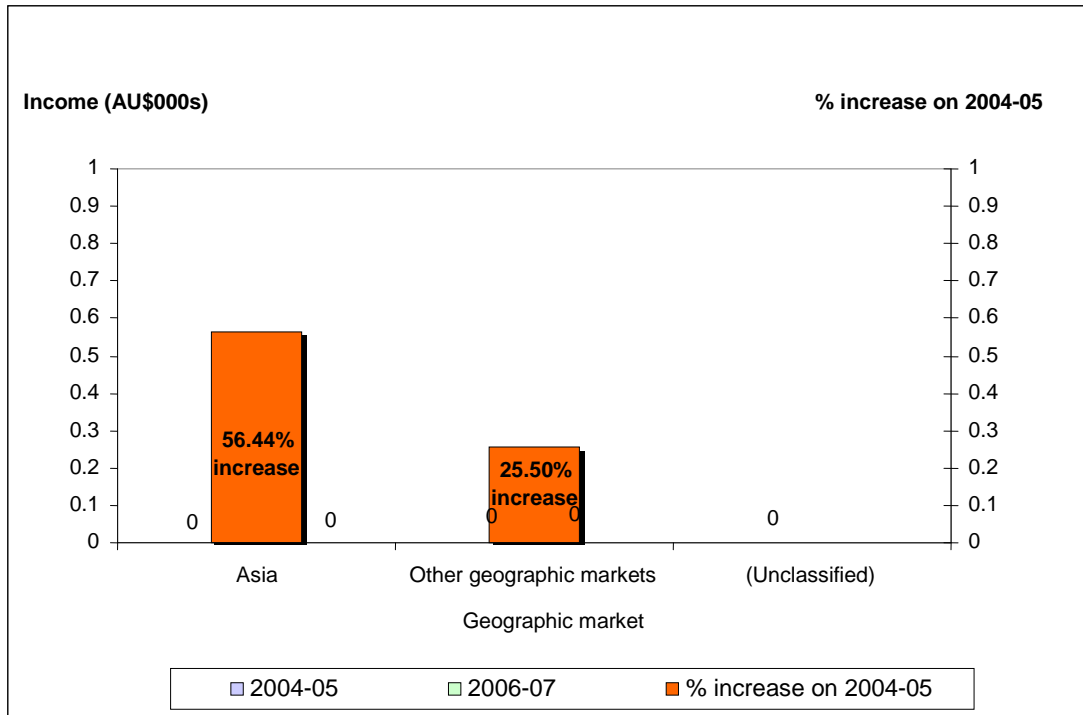
Over the two-year period between the two ILSAC surveys, Asia whole has grown the fastest (more than twice as fast as the rest of the world) as a location for Australia's international legal services work. Commercial presence plays a particularly important role in the delivery of Australian legal services into the PRC, now accounting for A\$57 million, or more than half of the total Australian legal services earnings, from projects in the PRC and Hong Kong, China.

Figure 7: Commercial Presence Income by Office Location



Source: ILSAC http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10).

Figure 8: Asia vs. Other Geographic Markets—Total Export and Cross-border Trade in Legal Services

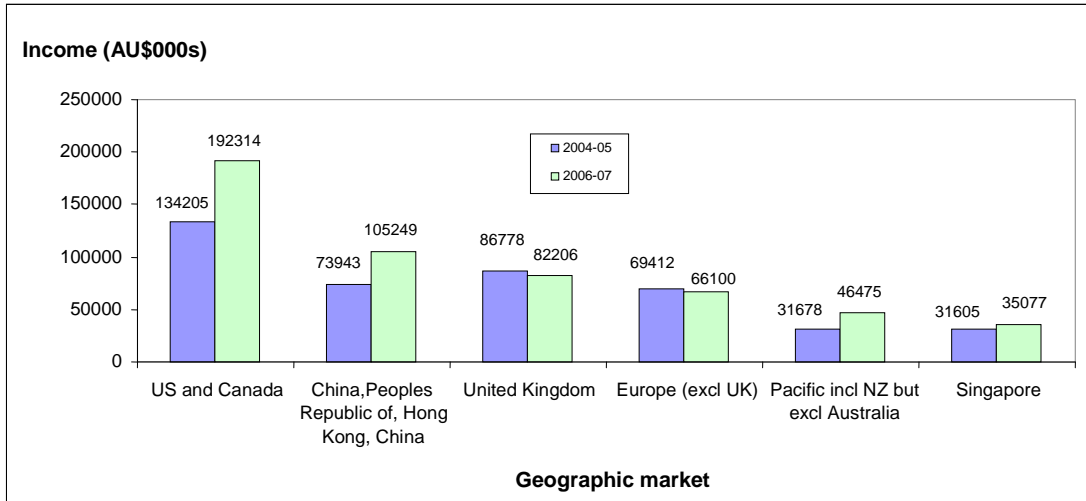


Source:
 ILSAC http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatistics_Survey_ILSACsSecondSurvey (accessed 03/09/10)

The most important markets (by office location) for Mode 3 delivery are:

- (i) PRC and Hong Kong, China (47.5% of total Mode 3 transactions)
- (ii) New Zealand and Papua New Guinea (23%)
- (iii) Singapore (15%)
- (iv) United Kingdom (8%)

Figure 9: Export and Cross-border Trade in Legal Services—Top Six Geographic markets



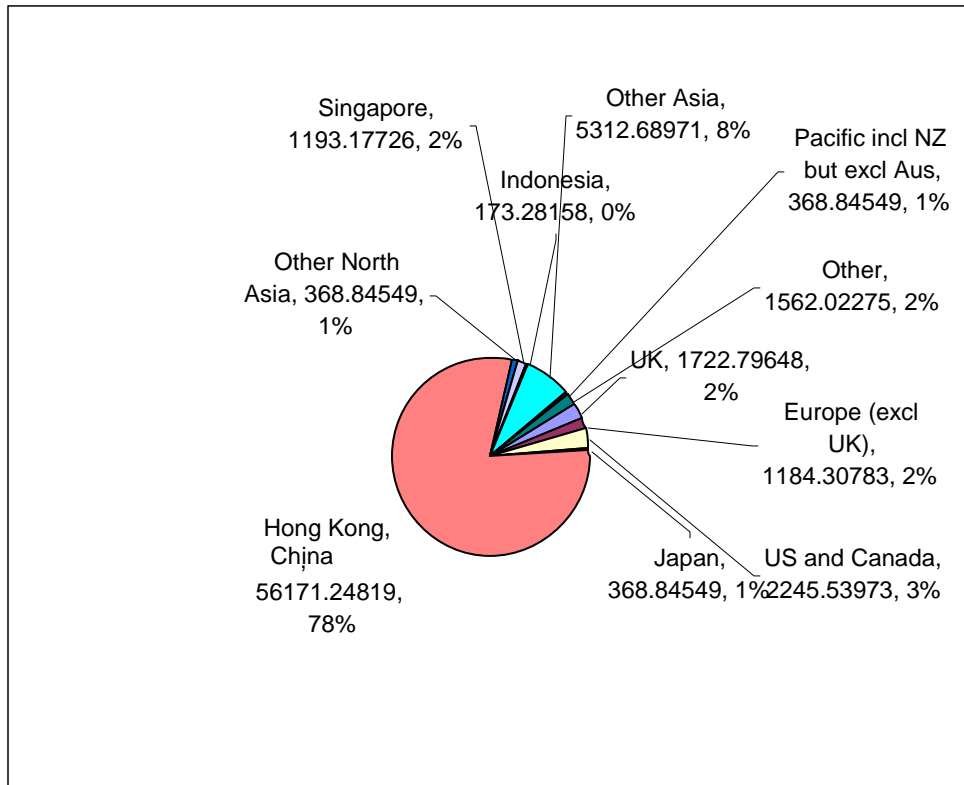
Source: ILSAC http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10).

Commercial presence in these four geographic destinations accounted for 93.4% of the income derived by the overseas offices of Australian law firms and patent and trademark attorney firms.

Interestingly, the ILSAC study showed the geographic source of income into each of these offshore office locations to be quite diverse, unlike the ABS pilot study, which covered all services as a whole and which had concluded that 90% of sales took place in the host country.

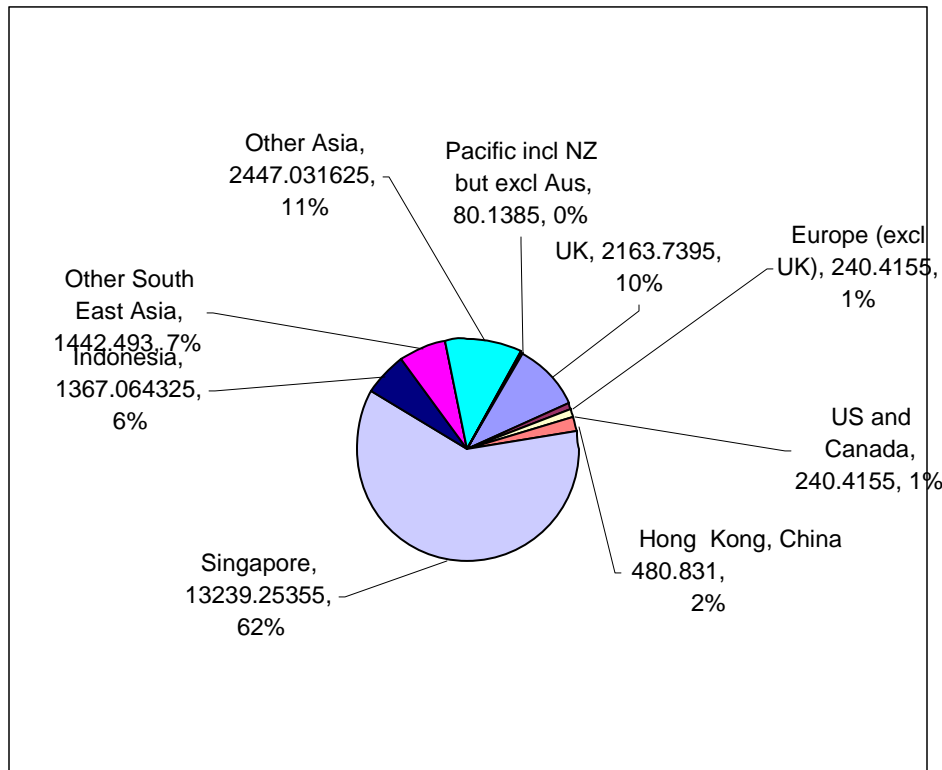
Figures 10,11, and 12 show the source of income for Australian firms with a commercial presence in the PRC, Singapore, and United Kingdom. Contrary to the ABS pilot survey results for all services, the data illustrates that legal firms are establishing a presence in a convenient location to provide services to the surrounding regions.

**Figure 10: Commercial Presence in the PRC and Hong Kong, China:
Income by Geographic Market
(A\$000s)**



Source; ILSAC, http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10)

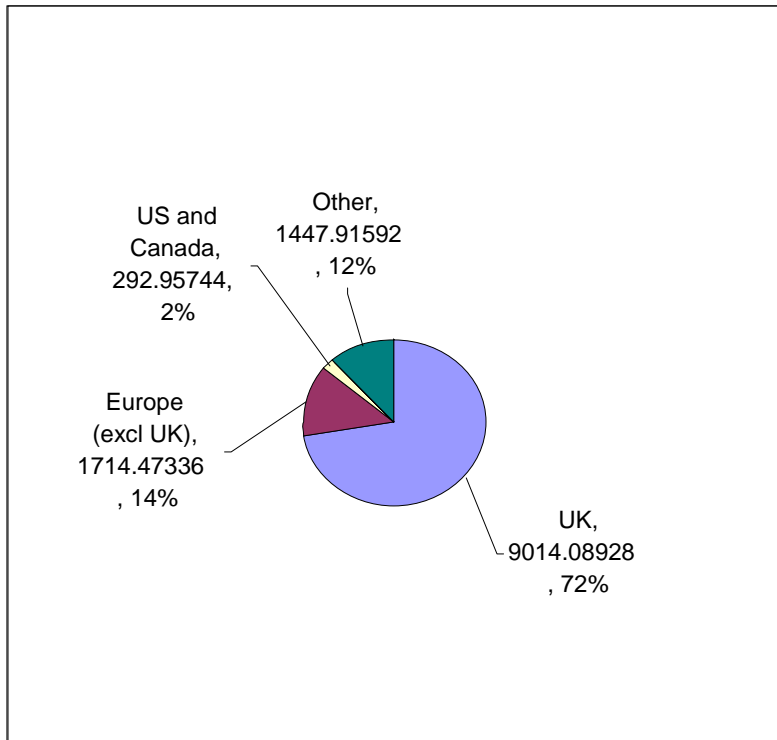
**Figure 11: Commercial Presence in Singapore:
Income by Geographic Market
(A\$000s)**



Source:
 ILSAC http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10)

For legal services, the ILSAC survey shows the diversity to be greatest in Singapore, where only 62% of income derives from within Singapore, and the remaining 38% from other regional markets. Australian foreign affiliates based in the United Kingdom earned 28% of their earnings in markets other than the United Kingdom and firms based in the PRC and Hong Kong, China earned 22% of their earnings from other geographic markets.

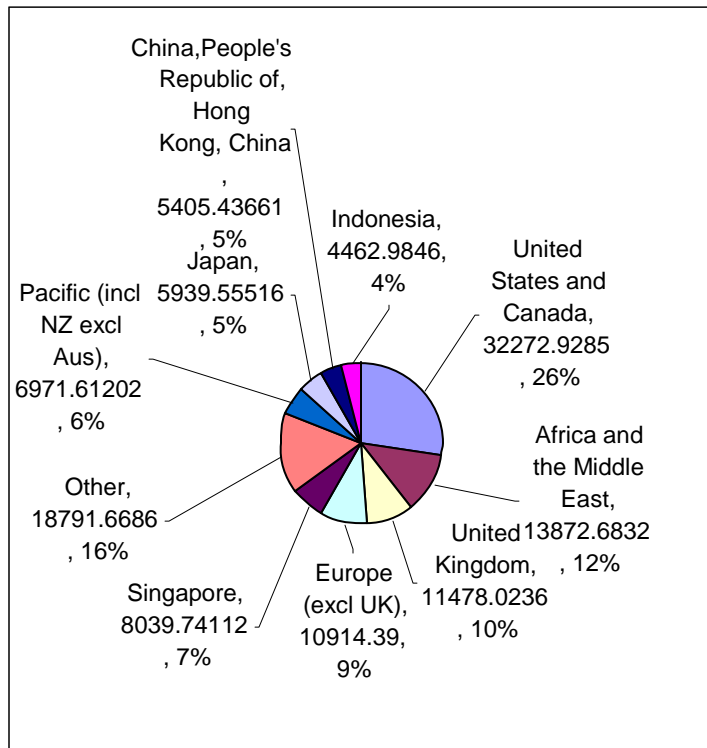
**Figure 12: Commercial Presence in United Kingdom:
Income by Geographic Market
(A\$000s)**



Source:
 ILSAC http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10)

The ILSAC survey results allow for some valuable comparison with the market orientation of other modes of delivery. Figure 13 shows that “Fly-in, Fly-out” exports are focused on the United States and Canada (26%), Africa and the Middle East (12%), as well as the United Kingdom (10%) and Europe (9%), which together account for more than half of the work, and Asia accounting for the rest.

Figure 13: Fly-in, Fly-out Incomes—Top Ten Geographic Markets



Source: ILSAC, (heading removed and labels editable from spreadsheets)

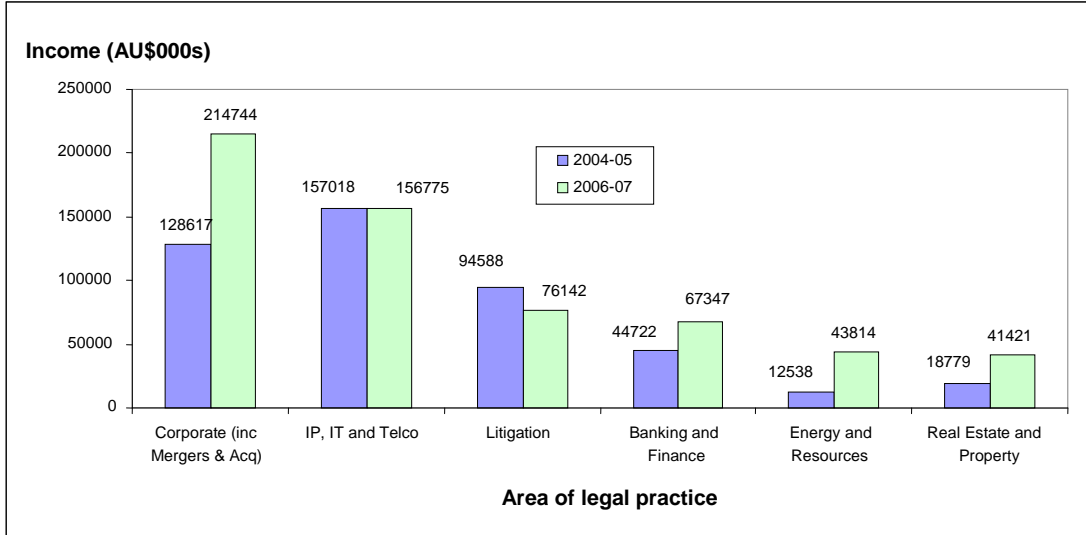
http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10)

4.1.3 Type of Legal Work, by Mode and Market

The top areas of legal services work, globally, for Australia were:

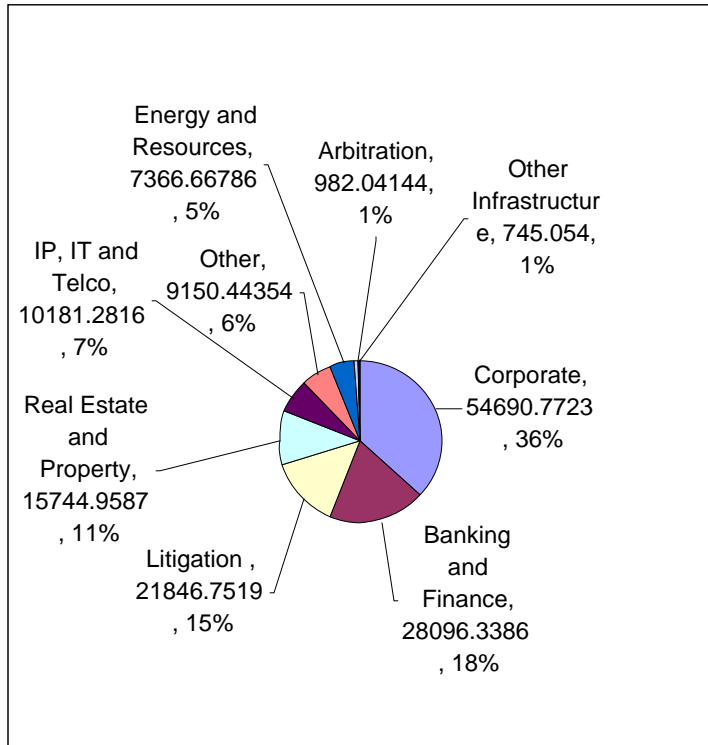
- Corporate Legal Services, including mergers and acquisitions (M&A) (32%)
- Intellectual property, information technology, and telecommunications (ICT) (23%)
- Litigation (11%)
- Banking and finance (10%).
- These four categories accounted for 76% of all international work.

Figure 14: Export and Cross-border Trade in Legal Services 2006–2007



Source: ILSAC http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10)

Figure 15: Commercial Presence Income by Area of Practice

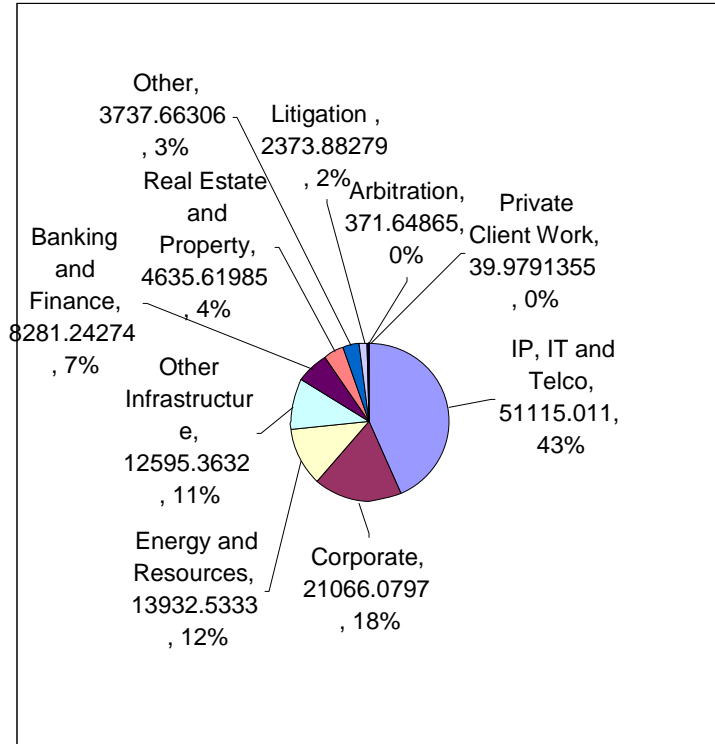


Source: ILSAC http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/GlobalLegalServicesandMarketAccess_ILSACStatisticsSurvey_ILSACsSecondSurvey (accessed 03/09/10).

For foreign affiliates abroad, services were focused on corporate and M&A, banking and finance, and litigation. Banking and finance was nearly twice as important a source of earnings for foreign affiliate offices than for total international earnings.

“Fly-in, Fly-out” work was relatively more focused on intellectual property, ICT, and on mining, resources, and other infrastructure.

Figure 16: Fly-in, Fly-out Income by Area of Practice



Source: ILSAC .

4.1.4 Implications for Strategic Business and Policy Decision-Making

The ILSAC survey provides valuable potential insights into the process of globalization of the Australian legal services industry. It has served to assist the ABS to correct gaps in the export frame and so to improve the conventional BOP data on legal services. It has also significantly extended the available data on Australian foreign affiliates’ trade in services.

The survey results have thereby enabled a significant further research agenda, which was simply inconceivable given the gaps in the official database. The detail that now exists on the geographic distribution of particular kinds of legal work has allowed ILSAC to move forward with its agenda of identifying priority markets with respect to which it makes sense to devote resources to documenting and then reforming the barriers to legal services trade and investment. Furthermore, the data enables this work to proceed with a measured understanding of the modes of delivery involved for every geographic market.

The surveys have elicited rich qualitative and anecdotal material in addition to the sheer statistical numbers. This material is vital to understanding how legal services trade

actually takes place and how it is classified, recorded, and valued by firms. The survey's departure from the constraints of international statistical standards is therefore as much an asset as an imperfection. It certainly equips Australian negotiators to achieve more commercially meaningful outcomes—and perhaps to reconsider the structural design features of present intergovernmental negotiating vehicles, to make them more directed to achieving commercially useful gain.

Most importantly, because the surveys have been conducted in the context of a high level government-business partnership, they have allowed the major players in the legal services sector to get together to take stock, to assess Australia's competitiveness in the global market, and to consider the policy settings that might promote greater innovation and efficiency in the future.

4.2 International Financial Services (Funds Management)

Australia's financial services sector has become much more globally integrated over the past decade, bringing it in line with those of other developed countries. Despite a current enthusiasm for policies to continue to grow Australia as an international financial centre, little is actually known about the extent to which Australia already exports, inter alia, its investment management expertise. And exactly how the increased globalization of the financial services sector can best be captured in the trade statistics is relatively complex and far from fully resolved.

To help fill in the information gaps, the Investment and Financial Services Association (IFSA) commissioned a private sector survey-based study in 2008.⁸ In the funds management sector, determining the value of exports derives primarily from estimates of the value of overseas-sourced funds under management (FUM) because every transaction relevant to those funds incurs a financial services fee from non-residents.

The study focused on gathering market intelligence on the extent to which Australian investment managers source FUM from overseas clients, the countries these funds are sourced from, and from which types of clients. To put this in trade terminology, like the ILSAC study, this study's objective was to estimate the level of funds management exports, identify the key geographic market destinations, and the types of services sold.

As of the end of December 2007, the ABS estimate for overseas-sourced FUM was A\$58 billion. For the same period, the IFSA/Rainmaker Information study estimated the value of overseas sourced FUM at A\$161 billion, or 178% higher than the official (and conceptually different) ABS figure. The IFSA/Rainmaker Information survey also found that overseas sourced FUM grew about one-third faster than Australian sourced FUM, which means exports (i.e., from non-resident clients) were growing faster than the domestic market (Rainmaker Information 2008;5).

The study found no room for complacency however. On the contrary, the study concluded that even on the basis of this much higher than the official figure that "Australia is playing way below its weight in this important global market for investment destinations" (Rainmaker Information 2008;5). Argumentation based on the Rainmaker Information survey data⁹ suggests that with a bit of consistent effort, by 2017 Australian investment managers could be sourcing as much as A\$740 billion from overseas clients.

⁸ Rainmaker Information Pty. Ltd. conducted the study.

⁹ Rainmaker Information, 2008, p 5.

Despite the consultation process that took place, the IFSA/Rainmaker Information surveys and the relevant ABS survey were ultimately not comparable. The private sector survey professed to have adopted “radically different methodologies, definitions, sample sizes, scope, and even different asset class categorizations” (Rainmaker Information 2008:5). By way of example, IFSA/Rainmaker Information considered the ABS definitions of asset classes, based on international statistical standards, to be out of date and irrelevant to contemporary market realities. “For example, the ABS category of ‘equities and units in trust’ confuses underlying assets with the investment instrument used to package those asset holdings, while the single combined ‘overseas assets’ figure is also very vague” (Rainmaker Information 2008:14). Rainmaker Information measured investment at a different vertical point in the investment flow and required different classifications from those used by the ABS. Table 2 outlines the differences between the two data collection methods.

Table 2: Key Differences between IFSA/Rainmaker Information and ABS Data Collection Methods

	Rainmaker Information	ABS (based on Rainmaker Information understanding)
Sample size and coverage	Quarterly survey of 140 fund managers that manage externally sourced FUM on a fee-for-service basis.	<ul style="list-style-type: none"> • Quarterly survey of 60–70 fund managers. • Limited coverage of boutiques and hedge fund managers.
Inclusion of certain areas of industry		Only count wholesale FUM as retail FUM is picked up in the public unit trust (managed fund) surveys. Rainmaker Information points out that not all retail FUM is managed funds.
Definitions	<p>Asset classes are defined by the contemporary market. Classes include:</p> <ul style="list-style-type: none"> • Total local assets <ul style="list-style-type: none"> – Australian equity – Australian fixed – Property – Cash – Other • Assets overseas <ul style="list-style-type: none"> – International equity – International fixed 	<p>Asset classes are defined by “international statistical standards.” Classes include:</p> <ul style="list-style-type: none"> • Equities and units in trusts • Australian fixed assets <ul style="list-style-type: none"> – Loans and placements – Short term securities – Long term securities • Total local assets <ul style="list-style-type: none"> – Land and buildings – Cash and deposits – Other • Assets overseas

Source: Rainmaker Information 2008.

In attempting to interpret these differences, IFSA/Rainmaker Information suggested that perhaps the Rainmaker Information figures could be considered as constituting an upper estimate and the ABS figure as constituting a lower estimate, resulting in a conservative mid-point estimate of A\$110 billion. This is still very significant; as Rainmaker Information pointed out, “it is equivalent to almost one-third the entire Australian equities sector, two-thirds the entire Australian fixed interest sector, half the entire cash sector, or two-thirds the entire alternatives investment sector. Indeed it also equivalent to the entire size of Australia’s biggest investment manager or nearly twice the size of the Future Fund” (Rainmaker Information 2008:5).

The IFSA/Rainmaker Information study found that slightly more than one third of Australia’s funds managers are involved in the export of investment management services. Half the leading managers of overseas sourced FUM are indigenous to Australia and of these managers, Australian-originated managers account for the top four places, with a 68% market share (Rainmaker Information 2008). Expressing this in trade terms, IFSA/Rainmaker Information unearthed the valuable information that as many as half of the Australian based managers of overseas sourced FUM are foreign affiliates of non-resident firms and that inward foreign affiliates have a market share of nearly one third.

The study also found that the overseas-sourced FUM market in Australia was more than twice as concentrated as the overall market. While the five biggest managers of Australian-sourced FUM control 30% of the market, the five biggest managers of overseas-sourced FUM, one of which is an inward foreign affiliate, control 75% of the market.

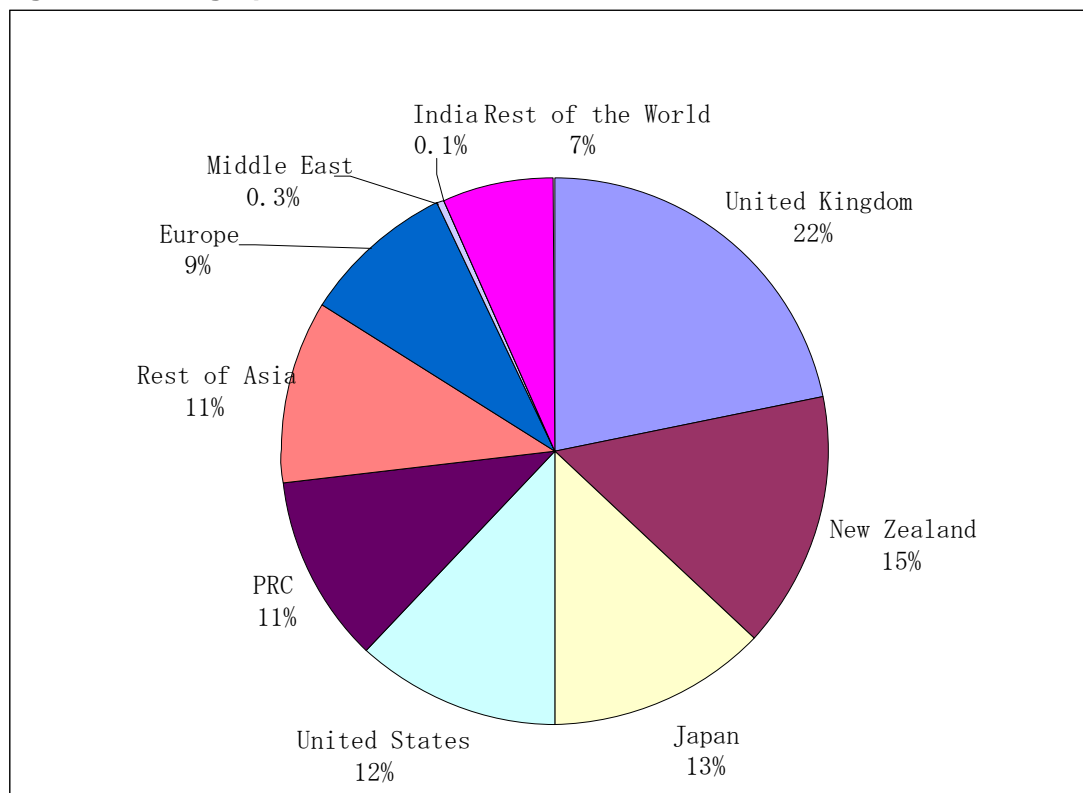
4.2.1 Geographic Markets for Funds Management Exports

As shown in Figure 17, the United Kingdom provides 22% of overseas-sourced FUM, followed by New Zealand with 15%, Japan with 13%, the United States with 12%, the PRC with 11%, the rest of Asia with 11%, and Europe with 9%. The Middle East and India accounted for only 0.3% and 0.1%, respectively, while the rest of the world accounted for 7%.

It will come as no surprise that this detailed level of information is available from the official statistics collections. As the Rainmaker Information report described it:

“The top three countries—the United Kingdom, New Zealand and Japan—accounted for 50% of the business. The new market of the PRC has exploded out of the blocks to already represent 11% almost matching the developed United States market as a source of FUM. But despite the much talked about potential of India and the Middle East it seems Australian investment managers are yet to develop a viable business model in these bustling marketplaces” (Rainmaker Information 2008:10).

Clearly this is valuable information for strategic investment decision-making for the private sector; unfortunately as in so many other services sectors, such assessments simply cannot be achieved from use of ABS data alone.

Figure 17: Geographic Markets—Australia's Overseas-sourced FUM

Source: Rainmaker Information 2008:10.

4.2.2 Exports by Type of Work (Clients)

The IFSA/Rainmaker Information pilot study revealed that from a sub-sample comprising A\$61 billion from 11 investment managers, 36% of overseas-sourced FUM was sourced from pension funds, 15% from mutual funds, 13% from sovereign funds, and 24% was sourced from other institutional managers; 7% was sourced from individuals, less than 1% from insurers, and 5% from undefined other sources.

4.2.3 Exports of Financial Intermediation Services Indirectly Measured (FISIM)

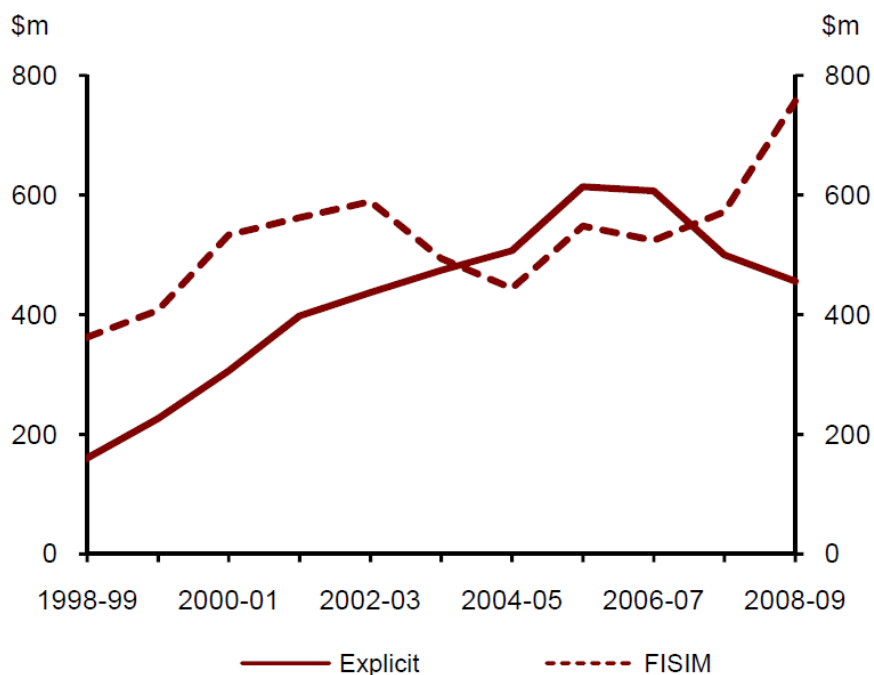
Having noted the underestimation of FUM in Australia's statistical collections, it is important to look at how successfully Australia assesses its exports of financial intermediation services, based on the estimates of FUM. DFAT (2009) reported¹⁰ that in 2008–2009 the value of Australia's financial services exports rose by more than 13% to A\$1.2 billion, with a rise in export volumes of nearly 10%. Such strong export growth in a period of a global financial downturn demands some explanation.

Figure 18 breaks down the financial services export data into both explicit charges and financial intermediation services indirectly measured (FISIM). In fact, explicit charges turn out to have fallen by 8.8% (to A\$456 million)—in line with expectations during the global financial crisis—but FISIM rose 32% (to A\$757 million). FISIM relates to the margins between interest paid to depositors and charged to borrowers and has only

¹⁰ Trade in Services in Australia 2009

recently been included in the ABS' calculation of financial services exports, having recently been included in the latest IMF guidelines for BOP accounts. During the recent financial crisis, there was a high risk of default on debt, and this may have given rise to an unanticipated increase in FISIM. When the risk of credit default is lower, FISIM exports may be expected to drop, with the counterintuitive outcome that measures of total financial services exports might likewise suffer.

Figure 18: Australia's Exports of Financial Services



Source: DFAT 2010.

4.2.4 Implications for Strategic Business and Policy Decision-Making

It is essential for effective policy formulation that policymakers be equipped with excellent information. What is clear, however, is that policymakers are not equipped currently with the quality information they need. Having identified a major underestimate in Australian exports of funds management services, IFSA/Rainmaker Information simply concluded that “the real problem is that the ABS survey in its current form distorts official perceptions for how important our industry actually is for Australia’s economy, with dire policy consequences” (Rainmaker Information 2008:14). Obviously this cannot be quantified precisely given the definitional differences involved. That sentiment does, unfortunately, tends to echo the thinking across most services sectors.

The IFSA/Rainmaker Information study is a key resource capable of being mined for further trade policy research and for trade negotiation purposes. It was entirely privately funded. In the case of funds management services, unlike legal services, no explicit work has yet been done on commercial presence, though as noted in the text, some information can be gleaned. This suggests there is a significant outstanding statistical agenda with respect to financial services.

4.3 Other Services Sectors

The ILSAC work has evident potential application to other professional and technical services particularly architecture, engineering, ICT, media and entertainment, and services related to mining and agriculture. There is very good reason to suspect that the scale of Mode 3 exports of these services are similar to legal services, and that the problems of inadequacy of the frame for measuring Modes 1, 2, and 4 exports are also present.

The Victorian Department of Industry, Innovation and Regional Development has estimated ICT exports from the State of Victoria to be several times larger than the ABS figure. The Australian Capital Territory (ACT) Chamber of Commerce has claimed that ABS estimates of the ACT's ICT exports are a fraction of what the Chamber of Commerce considers to be the case. The Export Finance and Insurance Corporation's Global Readiness Index survey for 2010 (EFIC 2010) found that overseas expansion of services continues to outpace other sectors, with half the companies surveyed in the information, media and telecoms, professional services, and other services categories planning to expand their offshore operations during 2010–2011.

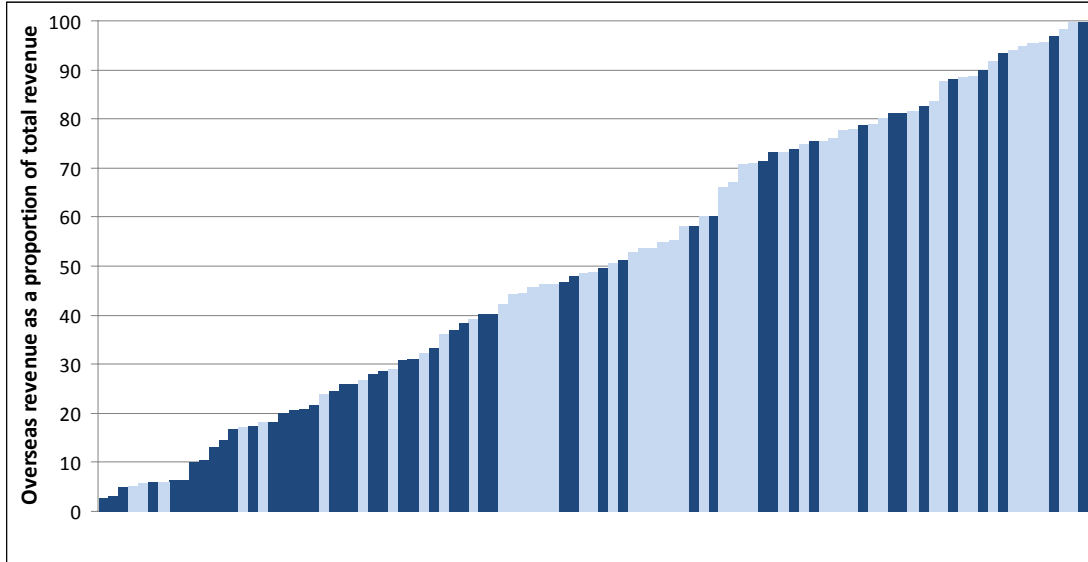
The Australian Institute of Architects reports anecdotally that approximately 25% of revenue earned by large Australian architectural practices is generated from projects outside Australia, some, but not all, via commercial presence abroad. The institute's internal survey results suggest that current data on the export value of the design professions is disjointed, incomplete, and unable to provide an indication of the economic benefit that the export of design services brings to Australia.

What globalization has done across all these professions is to bring a lot more companies into the services exporting business, and it is a costly task for the ABS services export surveys to remain up-to-date. In the case of legal services, the ABS was able to fix the frame because ILSAC had done much of the preliminary work required, including providing compelling evidence of the need for change. It is vitally important that sufficient resources are devoted to undertaking regular updating of frames to measure services exports.¹¹

The anecdotal evidence at the subsectoral level is also mirrored in anecdotal and survey evidence at the broader services-wide level. An article (Hartcher 2007: 28-35) in the April/May 2007 issue of *Diplomat* magazine commented on the ABS pilot survey results, noting that "corporate Australia's 4,012 foreign affiliates were selling [A]\$142 billion worth of goods and services directly into foreign markets in 2002-03, according to an ABS estimate. This means that Australia-invested subsidiaries, branches and majority-owned joint ventures abroad were selling 96% as much directly into offshore markets as Australia was selling in conventionally-measured goods and services exports." The same edition of the magazine drew on EFIC's Global Readiness survey data for 2007 to list the Top 100 companies, based on offshore revenues, as set out in Figure 19. Almost half (47) of these firms were services firms; on average, offshore revenue as a proportion of total revenue for these services firms was 42%, with financial services being slightly above the total average (58%).

¹¹ In Australia's case, the ABS has always shown a willingness to avoid duplication of effort and ensure efficient information usage by using information that private sector bodies have on businesses exporting services.

Figure 19: Top 100 Offshore Revenue as a Proportion of Total Revenue

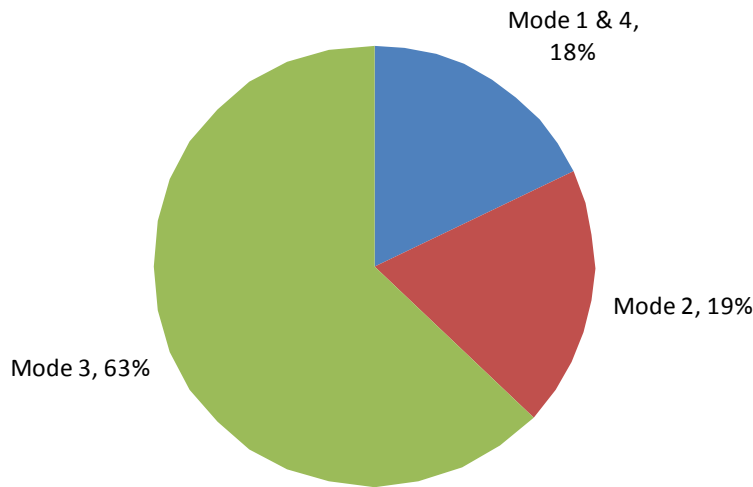


Note: The darker shading denotes a services company.

Source: Hartcher 2007.

In a similar vein, data analyzed by the WTO has shown that Mode 3 comprises around 63% of Australia’s international supply of services (Madeleine and Maurer 2008).

Figure 20: Australian Supply of International Services by Mode, 2002–2003



Source: WTO calculations reported in Magdeleine, J and Maurer, A, 2008,

Taking all the official, semi-official, and private sector evidence into account, it does seem that around two thirds of Australia’s outbound services trade takes place via Mode 3 supply, which is out of scope of the BOP statistics and not regularly measured by the ABS.

Adding the missing 63% of Australia's international supply of services to the ABS trade data would mean that services comprise, conservatively, around 39% of Australia's international supply of goods and services. This figure is conservative because the ABS data on conventional exports is itself an underestimate, as the business case studies show.

5. CONCLUSIONS

World FDI growth has outpaced growth in world trade and world gross domestic product for the last three decades. In turn, Mode 3 – Commercial Presence via FDI has enabled the bulk of recent growth in international services supply. Given the nature of services—i.e., that they tend to be rendered and consumed over the same period of time—the rise in importance of delivery via foreign affiliates is not unexpected.

More favorable policy in relation to FDI has also helped, as most countries are seeking to attract FDI including in the services sectors. Many governments have unilaterally liberalized their investment rules, including some of those applicable to services sectors. Over the last decade, improvements in ICT including the internet have also greatly lowered the cost and complexity of managing foreign affiliates, and enabled networking with a wider range of business process suppliers, including foreign suppliers.

Foreign affiliates of Australian companies employ mainly foreigners and pay mainly foreign taxes. On the face of it, this might seem to suggest that Mode 3 sales may not be worth as much to the Australian economy as Modes 1, 2, and 4 exports. This ignores the fact, however, that profits from foreign affiliate sales are either repatriated to Australia or build the value of foreign assets and that Australian headquarter functions such as marketing, research and development, engineering, design, accounts, and management benefit from productivity gains and scale economies made possible by foreign affiliate sales. Headquarter jobs also tend to be highly paid, and growth in these jobs is a significant source of services productivity growth across a wide range of business services.

Most of the value of exports to an economy lies in their contribution to profits and productivity, and in generating these outcomes the sales of foreign affiliates can make a contribution equal to or even greater than cross-border services sales.

The importance of the activities of Australian-based companies' foreign affiliates has increased markedly over the last several decades, along with the global growth in the activities of multinationals, business services trade, and international business process outsourcing.

The absence of an agreed economic framework within government for assessing the value of foreign affiliate activities has meant in effect that it has been easier for Government agencies and departments to ignore the contribution of foreign affiliates, even though it is recognized that this is no longer appropriate.

The resources allocated to the measurement of services trade consequently remain a fraction of those for goods, long after the historical reasons for this have ceased to be relevant. The result is an incomplete understanding of both the importance of trade in services and the opportunities for future growth. This is an inhibitor to realizing the vision of Australia as a regional high value services center and means that:

- businesses lack an understanding of the opportunities;

- economists lack data to demonstrate the benefits of further services regulatory reform and trade liberalization;
- trade agencies lack data to support and improve their trade facilitation activities;
- education institutions' and related planning on future skill needs is constrained;
- policy and regulatory reform needed to raise competitiveness lacks champions.

The purpose of measuring imports and exports is to understand the integration of the local economy with the global economy because this is such a crucial driver of economic growth. Traditionally this integration took place mainly through movement of goods and some services across borders. The terms “export” and “import” are strongly linked in the public mind with physical movements, which are easily seen and understood. But increasingly, integration with the global economy takes place in a variety of ways, including all four modes of services trade. Unless this can be carefully measured, as goods trade has been, formulation of services sector policy, public understanding and support for that policy, and business focus on exploiting opportunities cannot be properly achieved.

As summed up in the MSITS 2010:

“5.1 The outcomes of trade negotiations depend on governments' policy objectives and constraints, as well as their negotiators' skills and strategies. In this context, research and analysis are important factors to identify issues of commercial importance to an economy. The parties involved need to identify their economies' strengths and weaknesses, assess impacts of different policies and identify opportunities offered by their partners' markets.

5.2 Statistics play an important information role in building strategies based on individual performances of domestic services industries and/or the existence of regulatory barriers. While available statistics allow the analysis of trade at the global level, it is much more difficult to analyse bilateral flows of individual service sectors by mode of supply, given the lack of adequate disaggregated data.

5.4 While governments need statistics on service sectors and modes of supply to negotiate commitments and assess economic impact, in many instances, available statistics do not allow for detailed analyses...

5.80...Additional information is also necessary for a more complete economic analysis and to evaluate market access opportunities section” (UNSC 2010:5.1–80, pages 95–119)

The inescapable conclusion is that implementing the recommendations in the Revised Manual for Statistics for International Trade in Services matters and governments need to devote resources to achieving this.

Most particularly, the “official” data showing services as 20% of Australia’s exports cannot be allowed to stand.

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