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**Emerging conceptual issues in global production****Merchanting of services [Chapter 10 of the draft Guide to Measuring Global Production]****Prepared by Task Force on Global Production***Summary*

The document is an extract from the draft “Guide to measuring global production”, bringing together the measurement challenges with service related global production arrangements. It extends the notion of merchanting (of goods) to the domain of services and investigates the role of arrangers or intermediaries of international service transactions. This document follows up on previous, but rather brief, discussions in Balance of Payments and International Investment Position Manual, sixth edition (BPM6), Manual on Statistics of International Trade in Services (MSITS) 2010 and the Globalization Guide. The conclusions are tentative as the obtained evidence on the international services arrangers is still rather limited; however, a number of areas for further research are proposed.

Currently the Guide is sent for consultation with the Conference of European Statisticians (CES) member countries with view of presenting it for adoption to the CES Plenary in June 2015.



## I. Introduction

1. Most of the global production arrangements introduced in the draft Guide to Measuring Global Production involve the manufacturing of goods. This chapter pays attention to services related arrangements. Although clear evidence is still limited and scattered, it seems that the international trading of services through an intermediary is a newly emerging business model. The Globalization Guide mentions that merchanting of services is an area where considerable growth in activity has already been observed.

2. The international statistical standards, Balance of Payments and International Investment Position Manual, sixth edition (BPM6) and Manual on Statistics of International Trade in Services 2010 (MSITS2010), both speak of services merchanting or services subcontracting. This topic is further explored in this chapter, which has a more experimental character compared to other chapters in the Guide. The purpose of this chapter is primarily giving guidance where possible and identifying issues for future research, rather than providing strong recommendations on the recording of merchanting of services.

3. A key characteristic of services merchanting and services subcontracting is that the intermediary, the service producer and the service consumer are each located in a different country. Together they form a triangle of services related transactions which may blur a proper recording of these transactions in the balance of payments in several ways. The following accounting issues are further discussed in this chapter (but there are probably more):

(a) Are the producer and the consumer engaged in the purchase/sale of a service, or does the presence of an intermediary lead to a triangular sequence of service transactions?

(b) A related question addresses the nature of the output of the intermediary. Does it obtain an implicit or explicit margin, and if so, how should this margin be recorded?

(c) What is the best way to present the transactions of a country in which such activities are important or where a relatively large number of international intermediaries of services are active? For example, guidance already provided in BPM6 and MSITS 2010 suggests supplementary tables showing a net recording of services merchanting which may give a better reflection of transactions for some analytical viewpoints.

4. In this chapter an attempt is made to tentatively answer these questions. However, at this point in time, given the lack of compiling experiences it is impossible to provide firm guidance.

5. Before starting a discussion on each of these questions, the next section of the chapter summarizes the guidance already given in the international standards. It should be emphasised that although this chapter analyses the concepts presented in existing statistical frameworks, the intention is not to revise the existing guidelines. It puts forward a number of conceptual arguments that may help clarify the concept of merchanting of services. It also explores ways in which imports and exports of services that are supposedly subject to a merchanting arrangement could be presented in supplementary tables in order to improve the understanding of underlying transactions.

## II. Related concepts in existing international guidelines

6. Merchanting of goods is explained in the 2008 system of national accounts (2008 SNA), BPM6 and in Chapters 2 and 5 of the draft Guide to Measuring Global Production. Under this global production arrangement the domestic entity buys goods from a supplier

abroad and resells them to a customer abroad without further transformation. The key features of this arrangement are that (a) the goods never enter the domestic entity's territory while the sales are credited to the domestic entity, and (b) the physical form of the goods, while owned by the domestic entity, does not change. Following the recording principles of merchanting in the 2008 SNA and BPM6, the domestic entity's country records a negative export when the good is acquired and a positive export when the good is sold. The difference between the import and export values represents the trade margin received by the merchant. The details of this recording can be found in the Globalization Guide, Chapter 6.

7. The concept of merchanting of services is not entirely new and a reference can already be found in BPM3 (1961). BPM6 and the MSITS 2010 discuss service merchanting or subcontracting of services as being "similar in some ways to merchanting of goods, because the services are purchased and resold" (BPM6 par. 10.160 and MSITS 2010 par. 3.62) without any significant transformation. Both manuals recommend that the "value of services exported and imported in the economy of the service arranger is recorded on a gross basis" to avoid bilateral asymmetries. However, if the activity is significant for an economy, compilers could also publish additional data on a net basis.

8. In par. 10.160 of BPM6 and par. 3.62 of MSITS 2010 merchanting of services is discussed in close connection to subcontracting of services. MSITS2010 follows up on guidance provided in BPM6 (par. 10.160) by explaining that service subcontracting entails the purchase and sale of services without any significant transformation of the service between the purchase and the sale (in e.g. business, transport, construction or computing). A specialist service arranger who has been paid to provide back-office functions for a customer may subcontract to another contractor. It is mentioned that subcontracting is in some ways similar to merchanting of goods, as the services are purchased and resold by the service arranger. However, the degree of transformation involved may be harder to identify for services than for goods, for example, in the case of bundling and managing the services of different contractors.

9. Service merchanting of this kind is an important activity in some economies. The value of services exported and imported in the economy of the service arranger is recorded on a gross basis. This treatment is applicable because the arranger buys and sells the services. If the arranger acted as an agent on a commission basis, then only the commission would be recorded as a service provided by the arranger and these services would be classified to the appropriate specific service classification, for example, transport, construction, computer, or other business services.

10. Chapter 6 of the Globalization Guide included a case study of Ireland (Annex 6.2) that examined the BPM6 and MSITS 2010 recommendation to record services-merchanting type of transactions gross or net. This study confirms that a supplementary net recording of transactions in merchanting of services may help to provide a useful alternate perspective on balance of payments transactions.

11. At the same time, the Globalization Guide identifies merchanting of services as an issue for future research and indicated that the scale of the gross flows involved in merchanting of services may, at least in some countries, warrant a net treatment under a separate classification in business services (par. 6.31 to 6.37).

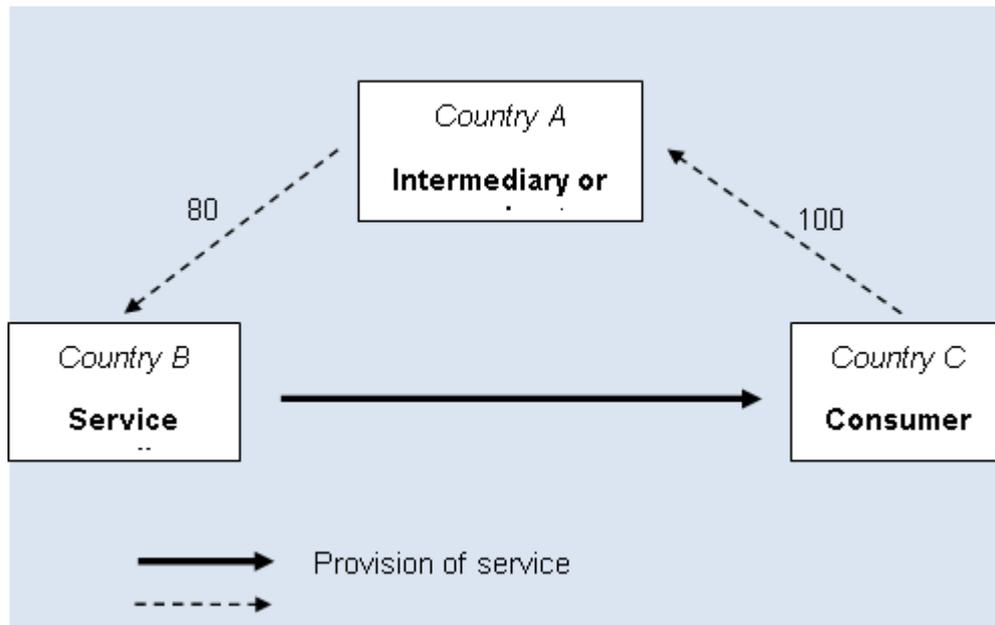
### III. Exploring the concepts

#### A. Merchanting of services

12. In general terms merchanting of services could be explained with the help of Figure 1. An entity in country A purchases a service, or purchases the right to use a service, from a service supplier in country B. The intermediary in country A subsequently resells the service, without transforming it in any way, to a customer in another country C.

Figure 1

#### A schematic presentation of merchanting of services



13. This triangular sequence of service related transactions clearly has a resemblance to merchanting of goods. Merchanting of goods leads to an arrangement in which the traded goods do not cross the borders of the resident country of the trader. In the case of merchanting of services, the intermediary arranges the supply of a service without being engaged in the actual operation of the service. This is highlighted by the service flow in Figure 1 moving directly from country B to country C.

14. Another similarity is that both merchanting of goods and merchanting of services lead to the generation of a (trade) margin (20) which is the difference between the purchase (80) and sales value (100).

15. A crucial step in this investigation involves identifying the ‘business models’ that underlie a merchanting of services arrangement. The evidence is currently too scarce to provide definitive answers, but a-priori the following models could be envisaged (without the assertion of being exhaustive):

(a) As mentioned, BPM6 and MSITS 2010 in particular discuss merchanting of services in connection to *subcontracting*. The degree of transformation is considered decisive in determining whether or not the service is actually traded, i.e. bought and resold without any change in the characteristics of the service. Some additional reference to other international standards (International Standard Industrial Classification (ISIC Rev.4)) is

given below to more closely examine the notion of merchanting of services in the context of subcontracting;

(b) A second possible business model is the *distribution of intellectual property products (IPPs)*. A head office in country A, creates a unit in country B with the main purpose of distributing copies (or licences to use) to yet another range of countries (C...M). Such a model is expected to be applied particularly inside the multinational enterprise (MNE) and may be tax driven, in the sense that the distributor is expected to be located in a country (B) having a favourable tax jurisdiction;

(c) A third model is an intermediary that functions as an *agent* with the competency of bringing together foreign producers and foreign consumers of a particular service, however without working on a commission basis. This model comes closest to the 'classic' model of merchanting of goods, but it is probably limited to some specific services sectors. At the time of writing, although there were indications that such a business model existed, no firm evidence was available as such information was not collected, nor compiled.

16. It is important to note that a net recording of merchanting of goods in the balance of payments is particularly motivated by the possible existence of speculative trade (gold, grain) and the huge expansion of imports and exports that may result from this. It is unlikely that such arbitrage opportunities exist in the area of service trading.

17. The possible existence of merchanting in services is further evaluated below by looking at seemingly related trade activities, and by looking at the main characteristics of services that could be subject to a merchanting arrangement. This evaluation is based on guidance given in the current international standards.

## **B. Other global services arrangements**

18. The international standards provide guidance on international services transactions which may have a correspondence with merchanting of services. For example, BPM6 clarifies the role of agents and the nature of transactions they are undertaking. Par. 3.10 states that an agent arranges a transaction to be carried out between two other units in return for a fee from one or both parties to the transaction. In such a case, the transaction is recorded exclusively in the accounts of the two parties engaging in the transaction and not in the accounts of the agent facilitating the transaction. In other words, the agent obtains a fee which is not the same as the trade margin obtained by a merchant from purchasing and selling goods or services.

19. MSITS 2010 refers to a separate category for trade-related services in its classification of balance of payments services transactions (consistent with BPM6 definition). Trade-related services cover commissions on goods and service transactions payable to merchants, commodity brokers, dealers, auctioneers and commission agents. Again, these commissions should not be confused with margins obtained from merchanting, or trading more generally.

20. As mentioned, BPM6 and MSITS introduce merchanting of services in close connection to subcontracting of services. ISIC Rev.4 refers to subcontracting in the context of outsourcing which is explained as a contractual agreement according to which the principal requires the contractor to carry out a specific production process. ISIC indicates (par.136) that outsourcing activities on a fee or contract basis may apply to both goods and services. ISIC makes the following recommendation about the principal of a subcontracting arrangement (par. 142): "In general, if the principal outsources the complete production process of a good or service, it is classified as if it were carrying out the production process itself. This applies in particular to all service-producing activities, including construction".

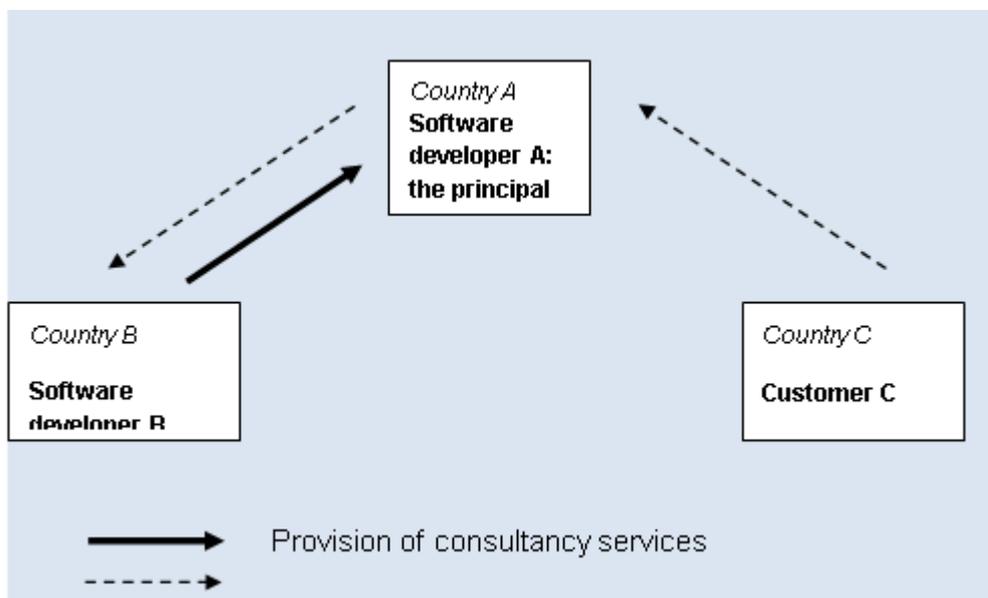
In other words, a principal outsourcing part (or all) of its production of services to a contractor abroad does not become a trader (of services). The principal is regarded as being the producer of the service, and this classification principle is in line with the gross recording of related foreign purchases and sales of services in the balance of payments as recommended by BPM6.

21. A principal may subcontract parts of its final output. For example, the complexity of large software development projects can be such that dedicated software developers must be subcontracted for taking care of particular parts of the project. The principal is responsible for bringing the different parts together, and takes the responsibility of the final product. Under such conditions the principal cannot be considered to act as a trader and the purchases of software development services needs to be recorded as intermediate consumption. The subcontracting model is illustrated in Figure 2.

22. Another related example is bundling of services. Generally it may be difficult to separate bundling of services from transformation which implies that agents involved in bundling of services should generally not be regarded as traders (or engaged in merchanting) of services. A reference to the European System of Accounts (ESA 2010) (par. 3.62) may help to support this point of view. In ESA 2010 travel agencies and tour operator services are distinguished by the fact that travel agency services amount only to intermediation on behalf of the traveller, while tour operators create a new product called a tour, in which travel, accommodation and entertainment services are bundled. This means that bundling of services should be understood as a form of transformation of services. In order to separately identify individually the embodied tourism related services, unbundling of package tours is recommended in the Recommended Framework on Tourism Satellite Accounts (par. 3.49). In case this unbundling is feasible, the tour operator could be identified as being engaged in merchanting of tourism related services.

Figure 2

**A schematic presentation of subcontracting of services**



**1. Characteristics of services subject to a merchanting arrangement**

23. BPM6 and MSITS 2010 follow the 2008 SNA definition of services (2008 SNA, par.6.17): “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. These types of

services may be described as change-effecting services and margin services, respectively.” Change-effecting services, or transformation services, change the condition of (consumer) goods, or the physical or mental condition of persons. Margin services result when one institutional unit facilitates the change of ownership of goods, knowledge-capturing products, some services or financial assets between two other institutional units. Margin services are provided by wholesalers and retailers and by many types of financial institutions.

24. Usually, services are not separate entities over which ownership rights can be established. They cannot be traded separately from their production and by the time their production is completed, they must have been provided to the consumers. In other words, they cannot be held in inventory. A clear exception to this principle is IPPs which can be subject to trading and storage.

25. Given the fact that transformation and margin services cannot be stored, a service transaction should be recorded at the moment of delivery and consumption. The provision of services should be recorded on an accrual basis in each accounting period, i.e., they should be recorded as they are provided, not when payments are made. This would imply that the service is indeed directly delivered by the producer in country B to the consumer in country C, as pointed out in Figure 1.

26. Otherwise, the role of the intermediary is bringing the producer and consumer of services together. The intermediary purchases the service on behalf of a client without actually consuming this service himself. This pragmatic view is supported by the international standards, for example when recording the tourism related services of tour operators. Similarly, in MSITS 2010 (par.3.3) services transactions are defined with respect to the residence of transactors, without a distinction with regard to the way the service is actually supplied (and consumed). Going back to Figure 1, according to MSITS the service is indeed traded (or purchased and resold) by the intermediary in country A. This means that the model of merchanting of services is not restricted to IPPs but may also apply to transformation services.

### **C. Tentative conclusions**

27. The concept of merchanting of services is not well explained in the current international standards. The recommendations of the industrial classification, national accounts and balance of payments all point in the direction of a gross recording (instead of trade margins), and the units engaged in merchanting type of transactions should be regarded as the producers of the services they obtained from other suppliers.

28. Certainly, this does not mean that merchanting of service is a non-existent phenomenon that can be ignored altogether by national accountants and balance of payments compilers. Under specific conditions explored in this section, merchanting of services can be understood as the distribution of services, and the principals of these arrangements could be regarded as traders of services. This alternative point of view is supported by the BPM6 and the MSITS 2010 by acknowledging that if the activity is significant for an economy, information on merchanting of trade in services based on a net (instead of gross) recording could be provided on a supplementary basis. The next section explores how such a net recording could be accomplished and discusses its advantages and disadvantages.

#### **IV. Recording merchanting of services on a gross or a net basis**

29. As already noted, one of the important reasons for recommending a net recording basis for merchanting of goods is that it eliminates potential problems associated with recording international transactions of commodity traders. Commodity traders often buy and almost immediately resell commodities (such as gold or grain) in order to generate short-term trading profits. The net basis of recording eliminates the distortion in goods imports and exports that would otherwise exist in commodity trading centres if gross transactions in tradable commodities were included in goods imports and exports.

30. Similar problems will not arise in the domain of services, i.e. the goal of service intermediaries is usually not generating short-term trading profits. However the gross recording of services transactions in the country of the intermediary can, for some analytical purposes, still be considered distorting the picture of the actual production of services and the international trade in services taking place in that country. Further expansion of merchanting of services as a new business model could generate shifts in a country's bilateral trade balances. The policy relevance of understanding the macroeconomic effects of these shifts seems beyond doubt.

31. Either gross or net data may serve certain analytic purposes. The significance of merchanting of services can also be emphasised quite easily by classifying related trade flows as separate 'of which items' or by presenting net information in supplementary tables.

32. Disadvantages of a net recording are that these may understate exposures to counterparties (suppliers and customers), and eliminate bilateral detail, because the net figure is typically recorded by merchants against the country to whom they export, and not against the country from whom they import, and thus cause bilateral asymmetries in trade data.

33. One way to overcome some of these negative side effects is to carefully define merchanting of services. According to BPM6 (par. 10.44), for merchanting of goods, the acquisition of goods by merchants is shown under goods as a negative export of the economy of the merchant, and the sale of goods is shown under goods sold under merchanting as a positive export of the economy of the merchant. The difference between sales over purchases of goods for merchanting is shown as the item "net exports of goods under merchanting".

34. As presented in Table 1, this format can be adopted to merchanting of services in the supplementary tables, as recommended by BPM6. The figures in the table correspond to those in Figure 1. The advantage of both showing 'services acquired under merchanting' (as a negative item on the credits side) and 'net exports of services under merchanting' is that the trade relationships at bilateral level are maintained. The net item shows the margin obtained by the intermediary in country A. The gross flows correspond to how these intermediaries are represented in the regular balance of payments and in the national accounts.

Table 1  
Recording merchandising of services in supplementary tables

	<i>Country A</i>	<i>Country B</i>	<i>Country C</i>
<b>Exports</b>			
Services	20	80	
Net exports of services under merchandising	20		
Services acquired under merchandising	- 80		
Services sold under merchandising	100		
<b>Imports</b>			
Services			100

## A. Some evidence

35. The Globalization Guide indicates that certain examples in telecommunications and internet services could be placed under the heading of merchandising of services. In this section some additional evidence is provided on the international trade in computer software and transformation services.

### 1. Computer software

36. Section III refers to the example of distribution of computer software as a possible example of merchandising of services. It is possible that other types of IPPs are subject to similar kinds of arrangements. The “intermediary” may obtain a licence to distribute copies of computer software to costumers in a designated area. This intermediary may resell this right in whole or in part. For example, it might sell exclusive rights to two different final purchasers, each covering only a portion of the designated area covered by the licensing agreement purchased by the merchant. The fact that the intermediary has been granted the rights to resell rights to use, i.e. selling copies, the software to multiple customers does not necessarily interfere with the general principles of regarding the transactions as a merchandising arrangement. One may argue that the suggested intermediary is not engaged in any transformation of the service provided to customers in case the characteristics of the software product remain unchanged.

37. The above mentioned arrangement may typically occur inside an MNE. A priori there is no reason to reject the possible presence of a merchandising of services arrangement inside the MNE group. However, it may be difficult to determine what kind of service the intermediary is actually providing, particularly because of problems with identifying economic ownership of IPPs inside the MNE (cf. Chapter 4). The intermediary could be an IPP holding special purpose entity (SPE) (a license to sell copies) when the main purpose of such an entity is minimising tax payments.

38. The intermediary is clearly not engaged in a merchandising type of arrangement in the case where a commission is being received from a parent for carrying out the software distribution. In such cases, the parent will directly obtain the turnover from the software sales. The intermediary is not expected to obtain economic ownership of the services distributed to customers.

39. Another case of merchandising of software is when an entity located in A has a web shop which also is value added tax (VAT) registered outside A and provides software from a producer in B to customers in C. The cases when VAT is paid to foreign tax authorities for transactions of software produced and consumed outside A may qualify as merchandising.

**Case Study 1****Merchanting of goods and software and telecommunication services in Ireland**

In some countries merchanting is having a substantial influence on the bilateral trade, a striking example in this respect being Ireland which is illustrated by the following table.

**Merchanting related transactions in Ireland, 2011, billion euros**

<b>Merchanting</b>	<b>Debit</b>	<b>Credit</b>	<b>NET</b>
Goods	47.3	52.5	5.2
Services	7.4	8.2	0.8
Computer software (services)	7.4	8.2	0.8
Telecommunications	0.017	0.04	0.023
<b>Total</b>	<b>54.7</b>	<b>60.7</b>	<b>6</b>

Given that Ireland's exports of services for 2011 were around USD 112 billion and imports approximately USD 116 billion (BPM5 basis) if a gross treatment would be applied for the transactions relating to merchanting of services, this would increase its exports of services by 7 and its imports by 6 per cent. This would also influence income flows. If a gross treatment was to be kept (as indicated in annex 6.2 of the Globalization Guide) a decision by a major MNE to transfer the role of the entity in Ireland, which serves to route the various transactions within the group to another country, may result in a large discontinuity in the service data and profit/loss information.

**2. Transformation services**

40. Besides computer software, other types of services may be distributed via online transactions or via business hubs such as Asia. Such hubs are used by overseas service providers as a marketing and sourcing platform for doing business with other economies of the region, as well as a springboard for service providers of other countries of the region for doing business worldwide.

41. Some specialized companies will also bundle various types of services (and goods) and the final client will only make one payment for a package of goods and services (which will also cover the service fee for arranging these products). If it is not possible to unbundle the various components it may be a strong indication that the client is buying a different product than the ones the intermediary initially paid for. However, the Central Product Classification (CPC) may not necessarily identify these bundled products as a separate product. In that case the full amounts should be recorded as transactions of the arranger. Without significant bundling or transformation such activities may be identified as merchanting of services.

42. Other examples may relate to performing arts activities, where talent agents (intermediaries) may bill and collect the amounts due to the performance of actors, and then remit the net amount (i.e. retaining a commission) to the actors. In this example, it is possible that merchanting of services occurred. However, if the arranger sold a performance but still holds intellectual property rights (such as a recording of that performance) that could be rented or sold to multiple customers, this should not be regarded as merchanting of services.

43. In any case, merchanting of services can only occur in case the intermediary is buying the service. For example, the business hubs providing marketing and sourcing platforms are operating under merchanting of services regimes if they do buy the services being marketed in the platform. Similarly, talent agents are engaging in merchanting of services if they buy up the performance of the actors in the first place.

## V. Concluding remarks

44. This chapter is an attempt at conceptualizing statistically "merchanting of services". Further discussions are needed to make this concept sound and statistically operational. This requires additional evidence such as case studies which are needed to help sizing the respective trade flows and to judge their possible impact in the context of globalization.

45. Despite several measurement uncertainties, it seems merchanting of services is of increasing importance for several major service trading economies throughout the world. Once the conceptual underpinnings are more precisely defined, it may be worthwhile undertaking a survey of compilers to assess the size of merchanting of services in several of these countries. At present the existence of merchanting of services related activities is difficult to evaluate, particularly since their separate identification is currently not required in the relevant international manuals (e.g. BPM6, MSITS 2010).

46. If in questionnaires respondents report substantial outlays and receipts for specific services this may indicate the presence of a case of merchanting of services. Similarly, the respondents may report relatively minor local costs which equally points in this direction. The development of more advanced detection methods is clearly an area for future research. Paragraph 6.27 of the Globalization Guide provides some guidelines for identifying entities active in the merchanting of goods. This guidance could be used as a point of departure for detecting cases of merchanting of services.

47. In some countries such as Ireland, merchanting related service flows are already separately identified since they significantly influence the international trade picture. In such cases, supplementary tables may show merchanting of services on a net basis, following the principles of Table 1. As mentioned, such supplementary presentations are already proposed in BPM6.

48. The preliminary findings in this chapter are summarized as follows:

(a) The concept of merchanting of services is not well explained by the current international standards. The recommendations on the industrial classification, national accounting and balance of payments all point in the direction of a gross recording;

(b) There is evidence from a limited number of countries that merchanting of services may substantially influence bilateral trade flows. For these countries it is recommended to present this new phenomenon in supplementary tables on a net basis (cf. Table 1);

(c) An item for future research is the examination of new cases, and based on this new evidence, the further refinement of detection methods and compilation guidance which should address, among other things, the main characteristics of services arrangers in terms of service transformation, the correct measurement of trade margins and income obtained from commission fees.