

Chapter 3

THE IMPACT OF STRUCTURAL POLICIES ON TRADE-RELATED ADJUSTMENTS AND THE SHIFT TO SERVICES

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Abstract. Long-term economic performance is closely linked to the capacity of countries to change their economic structure. This chapter examines the policy stances that facilitate labour mobility and remove impediments to service-sector development. The two issues are closely related. Barriers to service-sector expansion are harmful in themselves, and may also hamper the absorption of resources released by trade liberalisation and technological advances. At the same time, policies that impede the mobility of labour may also hold back the development of the service sector by slowing down the transfer of resources from declining to expanding activities. After a short scene-setting section on the link between structural changes and economic performance, this chapter focuses on general policies that influence labour and product markets. Drawing predominantly on previous work carried out within the OECD, the policy areas examined for labour-market adjustment relate to benefit systems, employment protection legislation, wage-setting arrangements, education and training and taxation, whereas the policy areas reviewed as impinging on product-market adjustment are domestic regulation, foreign trade and foreign direct investment, and the mode of provision of public services. For each area, the chapter attempts to document the stance of policies in member countries, outline their impact on adjustment capacities and review recent reforms.

Summary of main findings

All OECD member countries have experienced a strong shift to services over the past decade. Manufacturing employment has declined in most countries, in absolute as well as relative terms, but this has been more than compensated for by strong growth in service employment. Sustained high levels of unemployment and weak employment creation in several OECD countries illustrate, however, that adjustment has been insufficient. At the same time, the development of service activities varies considerably across countries, largely reflecting differences in overall employment rates.

Countries' adjustment capacities depend to a large extent on policies affecting labour and product markets. These policies have typically been put in place to attain specific policy aims (notably social

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objectives), but may inadvertently contribute to slowing down adjustment in labour markets. A summary of conclusions emerging from discussion later in this chapter are as follows:

- Unemployment and related benefits have a role to play in easing adjustment costs for affected individuals, and may to some extent reduce public resistance to structural change. However, benefits that are made available to displaced workers at a high rate and for a long duration may also slow down adjustments to structural change by reducing the pressure on affected individuals to find gainful employment – particularly when counteracting measures in the form of *e.g.* activation policies, job-search requirements and work-availability conditions are too weak.
- Overly strict employment protection may have adverse effects on firms' capacity to reorganise and implement new technologies. This may potentially hamper developments in sectors characterised by rapid technological change and large variations in demand, such as many producer services. Strict employment protection could also reduce the flow of new vacancies, thus hampering the reintegration of displaced workers, impeding job-to-job mobility and lowering the efficiency of active labour market policies.
- Rigidities in aggregate and relative wages can hold back structural adjustments, resulting in prolonged slack in the labour market and providing few incentives for workers to change industry, to move to another region and to invest in human capital. Relatively high statutory or bargained minimum wages may hamper wage flexibility for the low-skilled, and may depress low productivity service activities that provide the only viable job opportunities for some people.
- A well-educated workforce is better placed to adopt new technology and production methods and is more mobile across occupations, regions and industries. Service-sector jobs are also increasingly high-skilled, raising the risk that labour shortages could hamper developments in certain service segments. For displaced and unemployed workers, effective retraining systems could be of particular importance as new skills might be a precondition for successful reintegration.
- Development in some expanding service sectors could also be obstructed by high labour and consumption taxes. The personal service sector is likely to be most affected, as it relies disproportionately on workers with elastic labour supply (*e.g.* low-skilled, second-income earners) and delivers services where do-it-yourself or informal production is a viable alternative.
- Product market competition can act as a spur to innovation and strengthens firms' incentives to adopt best practices and to respond to clients' needs. It could further stimulate activity and increase labour demand by reducing rents and, thereby, the potential for rent sharing. Moreover, lower rents could help reduce resistance to change and allow benefit systems to function more efficiently.
- Trade and foreign direct investment (FDI) can help create a more efficient service sector by providing more competition, bringing new services to the market and creating new market possibilities through exports. Electronic commerce and global delivery of business services may provide significant opportunities in this respect.
- Important service sectors like education and healthcare are usually delivered in a non-market environment and provided free of charge, or at heavily subsidised prices, at the point of delivery. Markets for such social services tend to be characterised by heavy regulations and licensing requirements, as well as reliance on public production and financing. This setting

could diminish the development of services that nonetheless have high private return and positive externalities, by making producers less responsive to user needs. While opening up to private providers and relying more on market instruments is not the answer across the board (*e.g.* in cases where they conflict with fundamental equity objectives or where significant market failures exist), a greater role for market mechanisms could improve efficiency in social services.

Sectoral reallocation, economic performance and cross-country adjustment capacities

Sectoral reallocation and the shift to services

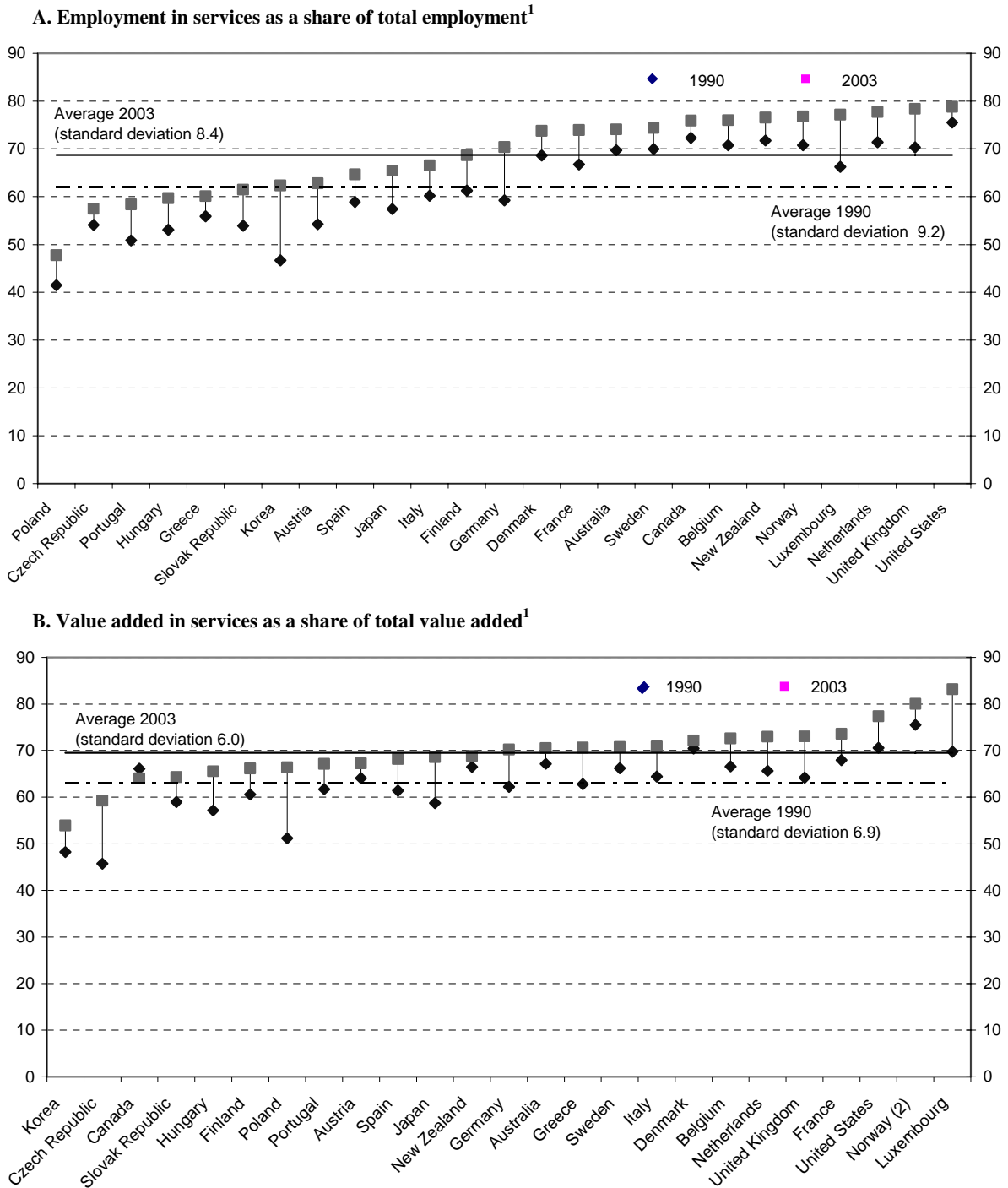
The sectoral composition of OECD member country economies has changed significantly over time, with services playing an increasingly important role. The service sector accounts now for roughly 70% of all jobs and value added in the OECD area, which is up by more than 5 percentage points since 1990 (see Figure 3.1). The expansion of services has changed the ongoing process of sectoral reallocation, with adjustments within services becoming a quantitatively more important component of overall reallocation.

This shift of employment to services has been driven by strong economic forces that have acted on all countries:

- *High income elasticity.* Some services are characterised by relatively high income elasticities of demand, implying a tendency for the share of services in total real expenditure to rise as income grows. High income elasticity may also help explain the strong increase in collective consumption, *i.e.* the expansion of the welfare state.
- *Low productivity growth in conjunction with low price elasticity.* Many service activities (but not all) have, at least historically, had less potential for productivity improvements than goods-producing sectors.¹ Since wages in services have tended to develop in line with those of other sectors of the economy, the relative price of services has increased, but without dampening demand markedly because the price elasticity is often relatively low. As a result, and in the context of high income elasticity, the share of services in nominal value added has tended to increase.
- *International trade.* The structure of the economy may also change in response to trade and international competition, as countries make use of their comparative advantages and specialise in services, goods production or resource-based industries. This is illustrated by the emergence of developing OECD non-member economies specialising in goods production (*e.g.* China). In addition, trade fosters the shift towards service in an indirect way to the extent that it contributes to increased incomes.
- *Outsourcing of service work.* A pure re-labelling effect has also been at play, as goods-producing firms have increasingly relied on deliveries of intermediate inputs from specialised domestic service firms as an alternative to in-house production. However, outsourcing seems to account for a relatively minor share of the observed strong growth in producer services over the past few decades (Russo and Schettkat, 2001).

1. The measurement of service-sector productivity is subject to some serious problems (Wölfl, 2003). This makes it difficult to assess precisely the separate impact of productivity growth, price elasticity and income elasticity on service-sector developments.

Figure 3.1. **Employment and value added in services (%)**

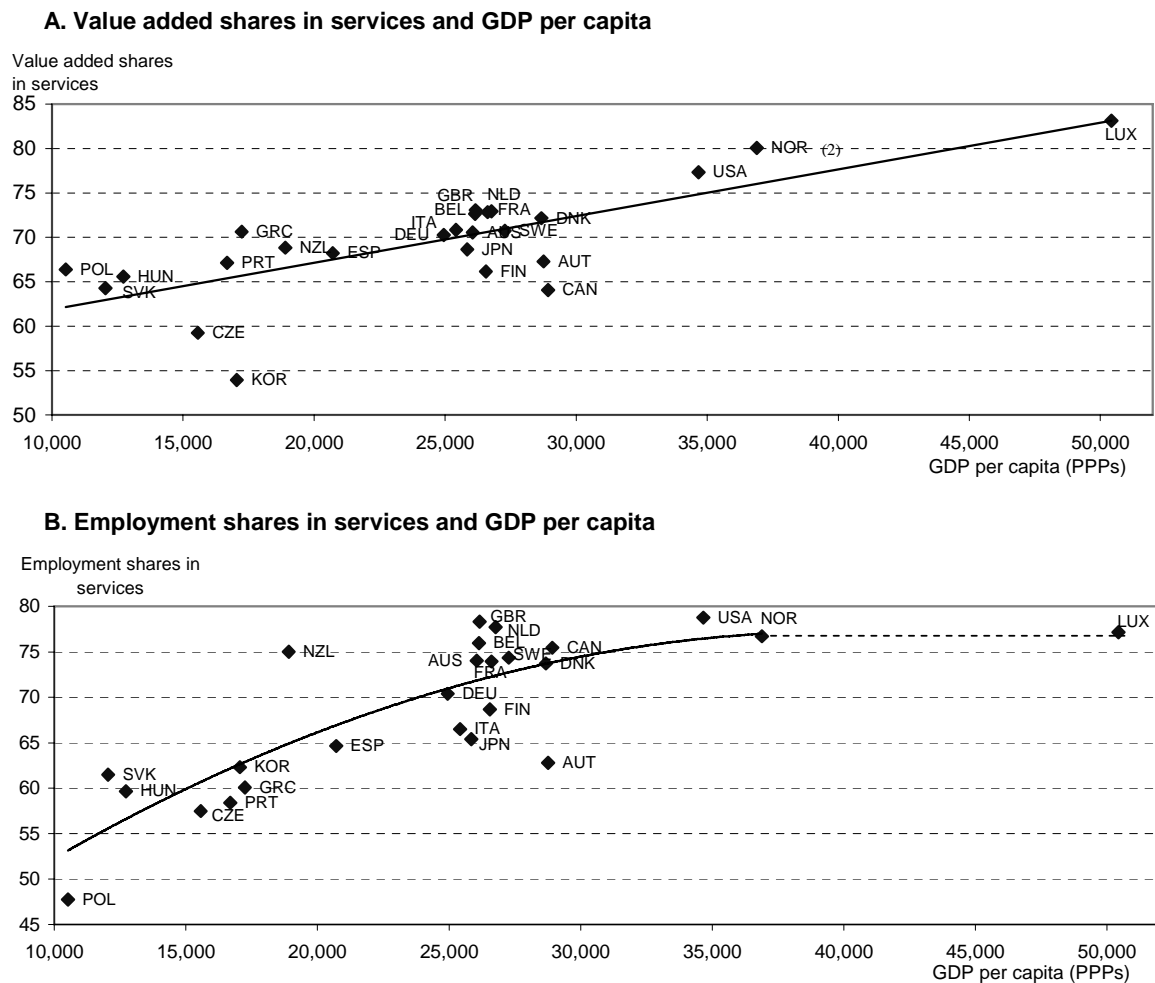


Notes: 1. Or first and most recent year available.
 2. Mainland Norway.

Source: OECD STAN Database for Industrial Analysis.

Large cross-country differences exist, however, regarding the role of services in the total economy. The employment share in services ranges from below 50% in Poland and 60% in Greece, Hungary and Portugal to close to 80% in the Netherlands, United Kingdom and the United States. Although these differences can to some extent be attributed to variations in gross domestic product (GDP) *per capita*, significant differences exist even between countries at roughly similar income levels (see Figure 3.2).

Figure 3.2. The size of the service sector and GDP *per capita*, 2003¹



- Notes: 1. Or most recent year available.
 2. The value added share for Norway refers to the mainland economy.

Source: OECD STAN Database for Industrial Analysis and OECD Analytical Database.

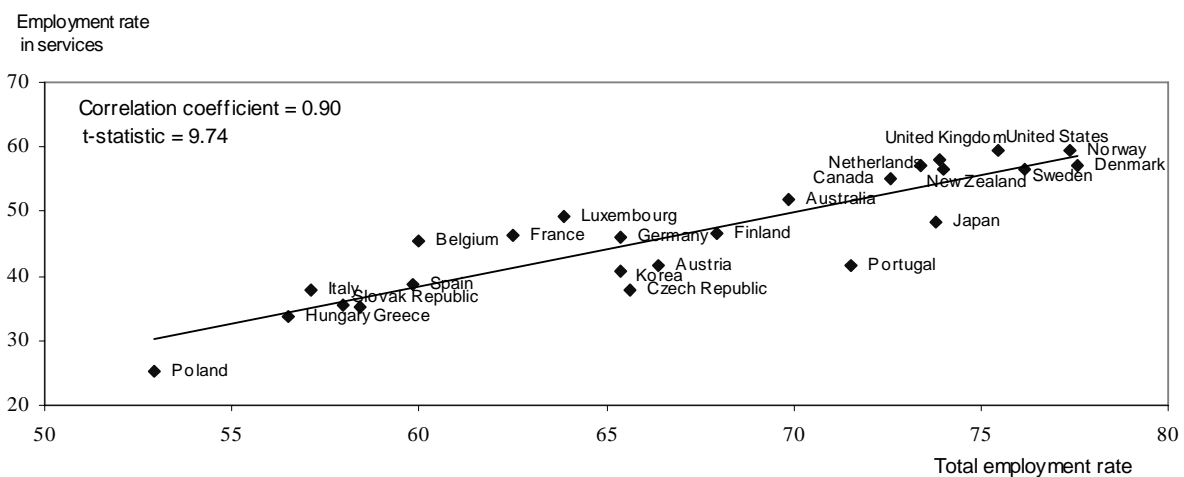
Structural adjustment and economic performance

The shift to services has taken place relatively smoothly in most countries. Labour resources have gradually shifted to services as new groups – cohorts of young people and women – have entered the labour market. This has been accompanied by adjustments of the capital stock as fixed investments have shifted towards expanding firms and industries. However, firm closures involving involuntary job displacements and premature scrapping of capital have been inevitable. The associated adjustment

can be painful for the individuals and communities involved, while costs for society as a whole can be large in terms of lost production, particularly if the adjustment mechanisms are weak (*i.e.* insufficient labour mobility and wage flexibility). Indeed, most OECD member countries have had problems in adjusting to structural change. Declining employment in manufacturing has, for example, often been associated with increasing aggregate unemployment levels.

There seems, however, to be a clear positive relationship between the size of the service sector and overall employment rates (see Figure 3.3). It underlines that for most OECD member countries, the expansion of services is largely about mobilising new worker groups and raising overall employment, and not only moving labour resources from goods-producing activities. The observed country differences may, therefore, signal that countries differ in their abilities to take advantage of the service sector as a vehicle for job creation and high labour-force participation. Indeed, service sectors may provide the kind of jobs needed to attract new worker groups (including part-time, evening, night and low-skilled work). Alternatively, the cross-country variations could indicate that higher labour-force participation provides an impetus to service-sector development, for instance through its effects on incomes.

Figure 3.3. **Total employment and employment in the service sector, 2003¹**
% of working age population

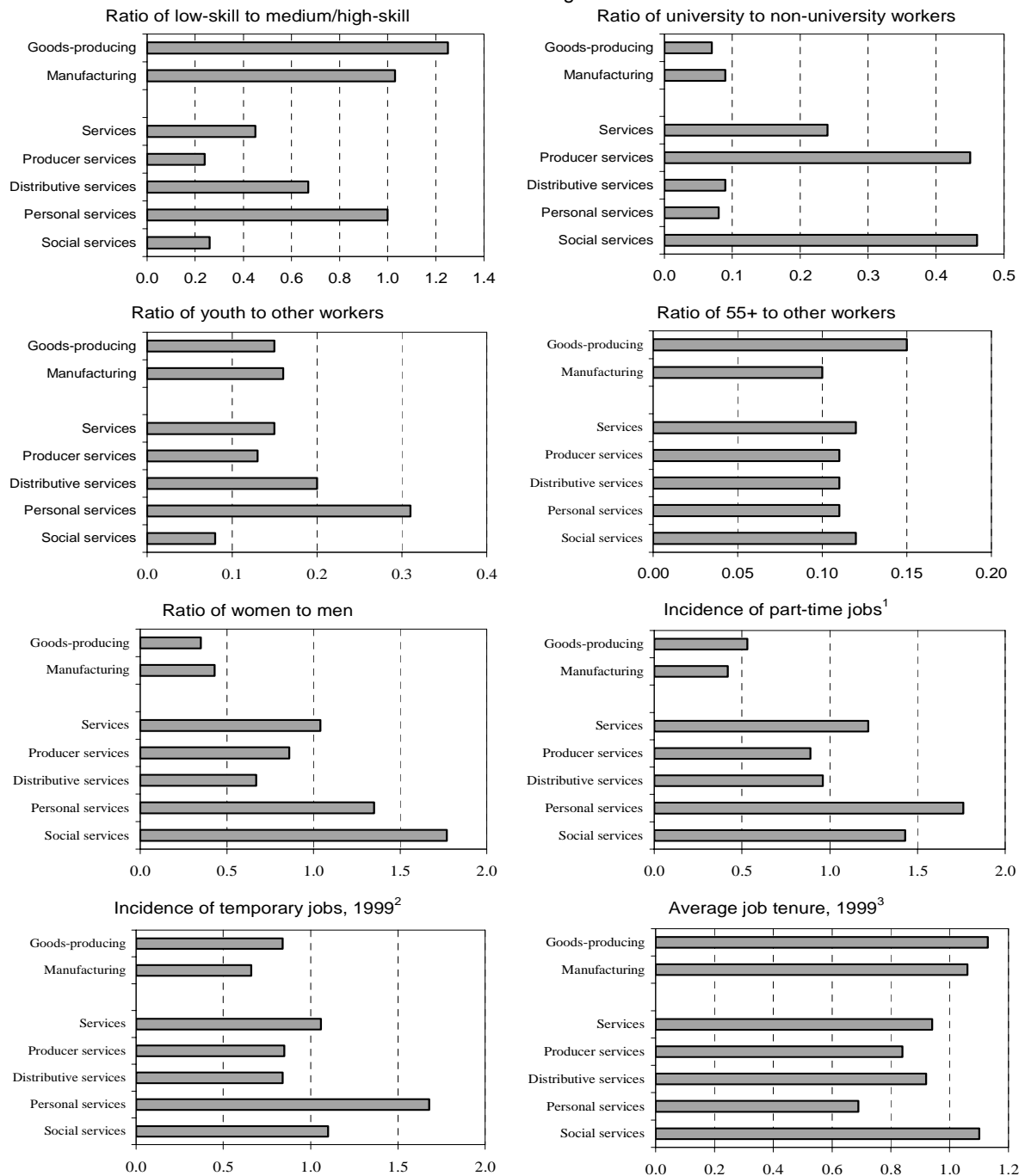


Note: 1. Or most recent year available.

Source: OECD STAN Database for Industrial Analysis; OECD Labour Force Statistics.

A key challenge with reallocation of labour resources is that the characteristics of jobs and workers differ markedly across sectors (see Figure 3.4). This makes it harder for low-skilled workers displaced from the declining manufacturing sector to find new jobs. Re-employment in social and producer services can be particularly hard, as they typically rely on workers with a much higher level of formal education. By contrast, personal and distributive services provide a large number of jobs for low-skilled workers, and both these sectors are also expanding in terms of employment in most OECD countries. This makes it easier for displaced manufacturing workers to enter these sectors. However, other job characteristics differ substantially from manufacturing, including the incidence of part-time jobs. Moreover, some personal and distributive services (including hotels and restaurants and retail trade) offer lower pay than manufacturing, even for workers with comparable skills and other characteristics.

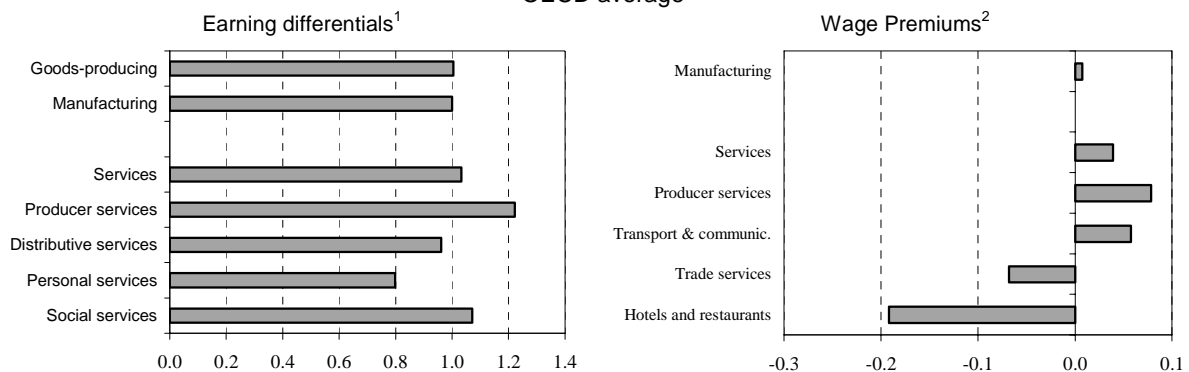
Figure 3.4. Job characteristics by sector
OECD average



- Notes:
1. Ratio of incidence of part-time employment in each sector to average incidence for all sectors.
 2. Ratio of incidence of temporary employment in each sector to average incidence for all sectors.
 3. Ratio of average tenure for each sector to average tenure for all sectors.

Source: OECD (2000), "Eligibility Criteria for Unemployment Benefits", *OECD Employment Outlook 2000*, OECD, Paris; OECD (2001), "The Characteristics and Quality of Service Sector Jobs", *OECD Employment Outlook 2001*, OECD, Paris; Jean, S. and G. Nicoletti (2002), "Product Market Regulation and Wage Premia in Europe and North America: An Empirical Investigation", *Economics Department Working Papers*, No. 318, OECD, Paris.

Figure 3.4. **Job characteristics by sector** (continued)
OECD average



- Notes: 1. Ratio of average earnings in each sector to average earnings in manufacturing.
2. In logarithm, compared to the economy-wide, employment weighted, average wage. Simple average of industry estimates.

Source: OECD (2000), "Eligibility Criteria for Unemployment Benefits", *OECD Employment Outlook 2000*, OECD, Paris; OECD (2001), "The Characteristics and Quality of Service Sector Jobs", *OECD Employment Outlook 2001*, OECD, Paris; Jean, S. and G. Nicoletti (2002), "Product Market Regulation and Wage Premia in Europe and North America: An Empirical Investigation", *Economics Department Working Papers*, No. 318, OECD, Paris.

Cross-country indicators on adjustment capacities

The capacity of countries to manage structural adjustments, including trade-related ones, is reflected in broad indicators of performance, such as GDP, productivity, employment and unemployment. More detailed indicators are, however, needed to highlight countries' performance along particular dimensions of adjustment. Labour mobility involves, for example, mobility between firms, industries and regions, as well as from unemployment and inactivity to employment.² Similarly, the extent to which countries have fostered the service sector, with its means to provide more jobs and raise overall employment, can be measured in different ways. The rest of this section presents a set of cross-country indicators for the size of the service sector.³

Admittedly, measuring the extent to which countries are able to foster growth of the service sector is fraught with difficulties and the indicators must, therefore, be interpreted with caution. In particular, cross-country comparisons need to take account of differences in GDP *per capita*, as the role of services tends to increase with income. But even a comparison between countries at roughly similar income levels is difficult because no uniform optimal service sector size exists. Some countries may, for instance, specialise in financial service or tourism, resulting in relatively high service shares, while others may have comparative advantages in goods-production or extraction of natural resources. However, as noted above, expanding the service sector is largely about mobilising more labour resources, at least for countries with low overall employment levels.

2. In addition, important adjustments take place through internal job mobility and skill upgrading within firms, although little cross-country evidence is available.
3. These indicators are all aimed at measuring the relative or absolute size of the service sector, including public services. Indicators of service-sector developments, *e.g.* growth in employment and productivity, have also been considered. It is, however, difficult to adjust for catching-up effects and cyclical developments. Alternative indicators for countries' capacities to adjust in labour markets are presented in Kongsrud and Wanner (2005).

Two of the three indicators suggested below (the value-added share and the employment share) adjust for different income-*per-capita* levels, although in an admittedly simple way by comparing outcomes with values predicted on the basis of country income (as indicated in Figure 3.2). No attempt is made to estimate the gap between the actual and optimal relative size of the service sector for each country. The last indicator (the employment rate in services) is included as a measure of the ability of countries to take the opportunities offered by the service sector to create more jobs and raise overall labour utilisation (see Figure 3.3). The indicators used to measure the capacity of countries to develop the service sector, and the broad picture they give, are as follows:

- The deviation between the actual value-added share in services and the predicted share based on income suggest that the size of the service sector is relatively small in Austria, Canada, Finland and Korea (see Figure 3.5, Panel A). Similarly, the difference between the actual employment share in services and the predicted share based on income suggests that service employment is relatively low in Austria, Italy, Japan and Poland (see Figure 3.5, Panel B).
- Finally, the employment rate in services (*i.e.* employment in services relative to the working age population) differs widely between countries, and is relatively low in Greece, Hungary, Poland and the Slovak Republic (see Figure 3.5, Panel C).

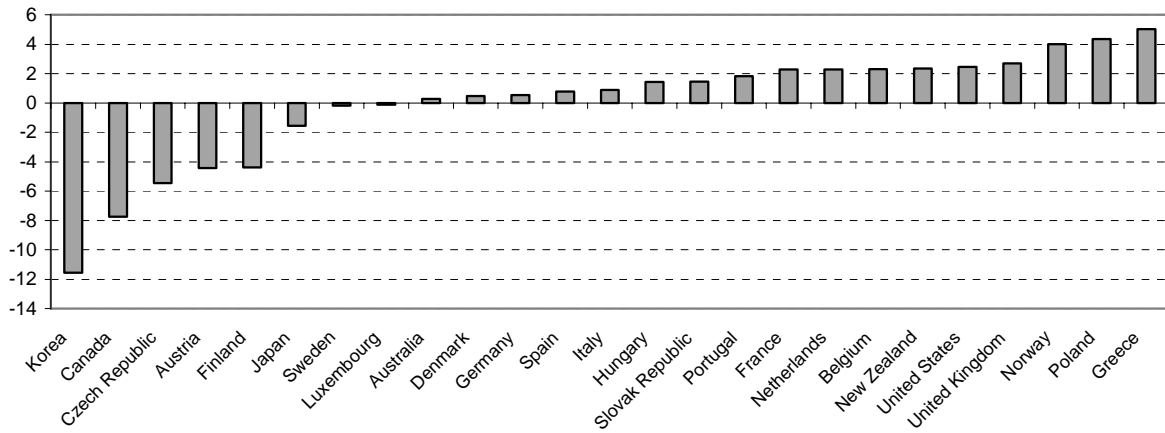
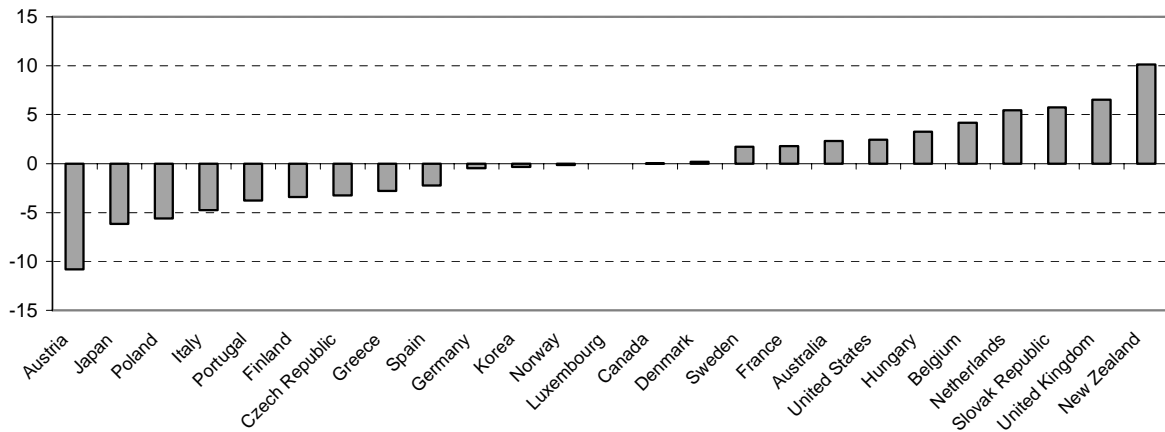
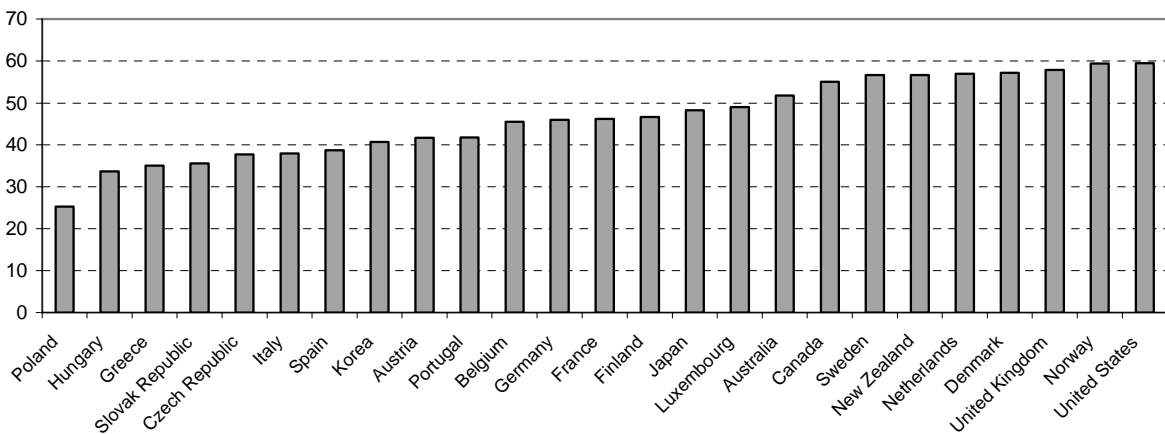
Policies to facilitate adjustment in labour markets

Countries' adjustment capacities are closely linked to the stance of policies that influence the functioning of the labour market. This section reviews the impact of policies in the following areas: re-employment incentives in public benefit schemes, employment protection regulations, wage-setting arrangements, education and training policies and labour taxation.

Providing appropriate re-employment incentives

Public benefit systems can help facilitate structural change by allowing more time for job matching and by easing public pressures for protectionist policy measures. On the other hand, they may also slow down adjustments to structural change by reducing the incentives of displaced individuals to find gainful employment. Available econometric evidence shows that economic incentives have important effects on transition rates from unemployment to employment, although the overall outcome also depends on the interaction with other policies. One recent micro study found, for example, that a 10% increase in the unemployment benefit replacement ratio reduces the transition rate from unemployment to employment by around 5% (Røed and Zhang, 2000).

Eligibility criteria in unemployment benefit schemes – including work availability and job search requirements, definition of suitable work and obligations to enter labour market programmes – can, in principle, have a greater impact on behaviour than variations in replacement rates. This is because the economic impact on individuals is much larger. Indeed, the impact of tighter eligibility has generally been found to be significant, with some studies finding more than a doubling of the transition rate to employment (OECD, 2000a). Similarly, transition rates from unemployment to employment have sometimes been found to increase prior to compulsory activation programmes.

Figure 3.5. Indicators of service sector developments, 2003¹A. Value-added shares in services, percentage point deviation from income-adjusted average²B. Employment shares in services, percentage point deviation from income-adjusted average²C. Employment rate in services, %³

Notes: 1. Or most recent year available.
 2. These deviations are based on Figure 3.2, Panels A and B.
 3. The employment rate is calculated as the employment level in services relative to the working-age population.

Source: OECD STAN Database for Industrial Analysis and OECD Labour Force Statistics.

Employment-conditional benefits and other “make-work-pay” policies (e.g. re-employment bonuses, minimum wages) can speed up adjustment by reducing the marginal effective tax rates associated with moving from benefit to low-paid employment. Experiences in Canada, the United Kingdom and the United States show that employment-conditional benefits have encouraged a return to employment by single parents and members of jobless households (OECD, 2003). Some adverse effects have, however, also been identified. The employment rate of married women with working spouses have been lowered by some programmes, while the working time of other employees may have been reduced because of higher marginal tax rates in the phase-out income range of the benefit.

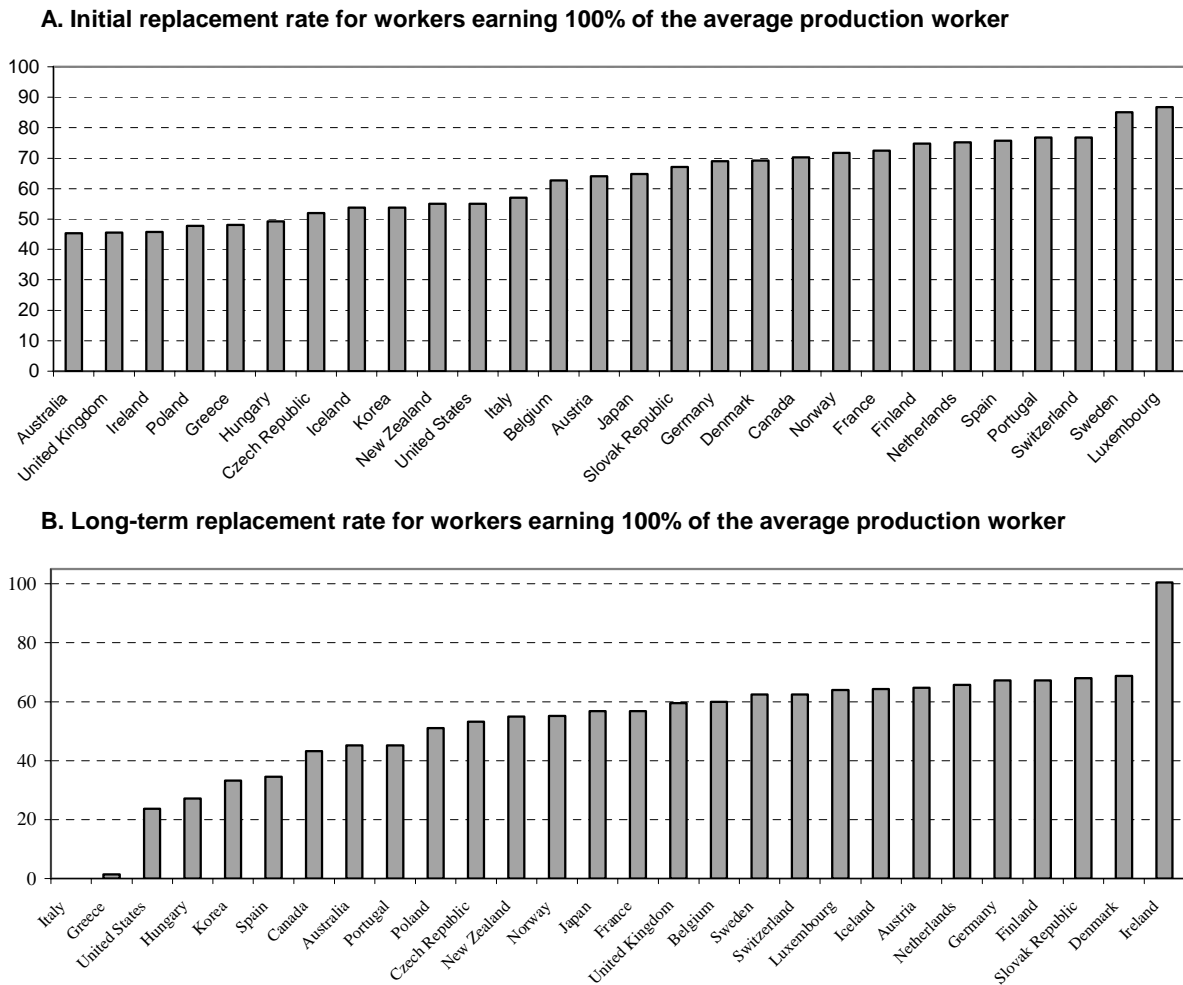
The level and duration of unemployment benefits relative to previous earnings differs widely between OECD countries, and is particularly high in some European countries (see Figure 3.6). Workers displaced from industries in decline may, however, not be able to find new employment at the same pay as they received in the previous job. Net replacement benefits relative to potential earnings in a new job – which provides a better measure of displaced workers’ re-employment incentives – can therefore be even higher than illustrated above. There are two main reasons for this. First, workers that have to change industry to find new employment may no longer capitalise on accumulated firm and sector-specific skills, reducing their productivity and potential earning in a future job. Second, different industries tend to pay very different wages to workers with roughly similar skills and other characteristics (Jean and Nicoletti, 2002), possibly reflecting rents originating in weak product-market competition and workers’ bargaining power in different industries. In general, net replacement rates can be close to or above 90% in many OECD countries for workers moving from declining manufacturing industries to expanding service activities when differences in the sectoral wage premiums are taken into account.

Replacement rates relative to potential earnings in new employment can be especially high for older job losers. One reason for this is that high-tenured workers often experience larger wage losses than other workers upon re-employment. The wage loss seems to be particularly pronounced for high-tenured blue-collar workers. However, available studies suggest important differences between countries, although these could reflect, in part, differences in data sources and methods. While relatively large wage losses are found in Belgium, Canada, United Kingdom and the United States, no wage losses are identified in mass lay-offs in France and Germany (Kuhn, 2002). These findings may indicate important variations in re-employment incentives between countries (smaller wage losses implying better employment incentives), but could also stem from a selection bias as countries’ capacities to reintegrate displaced workers differ (*i.e.* if not re-employed, no wage loss is registered).

In addition, re-employment incentives for older workers are adversely affected by various explicit or *de facto* early retirement programmes offering high replacement rates. Unemployment benefits are, for instance, often of longer duration and subject to less stringent job-search requirements for older workers (OECD, 2000). Early retirement and disability pension schemes provide, furthermore, possible routes out of the labour force, and replacement rates in these schemes are often high.

There are several different strategies that could be adopted to improve re-employment incentives for displaced workers in particular: cutting benefit levels and duration; tightening eligibility criteria in the relevant schemes; and using “make-work-pay” policies more extensively. OECD member countries have been reluctant in general to lower benefit levels and reduce duration in unemployment benefit schemes, although some adjustments have taken place in recent years in Denmark, Hungary, Ireland, Poland, Slovak Republic and Spain. In some countries, benefits have recently been made less dependent on previous income, thus lowering replacement rates for individuals with relatively high pay in their previous job (e.g. Germany). However, unemployment benefits sometimes depend positively on regional unemployment rates (e.g. Poland), reducing incentives for unemployed workers to move to another region.

Figure 3.6. **Net replacement rates in unemployment benefit schemes, 2002**
Relative to previous earnings,¹ (%)



Note: 1. Simple average of four family types: single, married couple, couple with two children and lone parent with two children. The initial replacement rate refers to the first month of benefit recipients, while the long-term replacement rate refers to the 60th month of benefit recipients.

Source: Benefits and Wages, OECD Indicators.

Eligibility conditions have been tightened in most OECD countries during the past decade, including requirements regarding job search, work availability and participation in training programmes. This has often taken place in the context of increased emphasis on the activities of unemployed workers (*e.g.* Denmark and the United Kingdom). In most countries, non-compliance by refusing work offers or failing to attend interviews may result in benefit sanctions, usually in the form of a benefit stop of defined duration. However, in many countries sanctions do not apply if the work involves a change of occupation, lower earnings, lengthy commuting times or geographic mobility. Eligibility conditions are also sometimes easier in regions with high unemployment levels (*e.g.* Canada). In the late 1990s, the incidence of unemployment benefit refusals and sanctions during the benefit period varied from close to zero in Germany, Japan and New Zealand to 40% of the average stock of beneficiaries in Switzerland and close to 60% in the United States (OECD, 2000). However, the sanction applied differ considerably across countries (*e.g.* the size and length of the benefit sanction), and seems to be relatively light in the United States.

Most OECD countries have introduced or extended “make-work-pay” policies in recent years to increase the financial incentives to become re-employed. Employment-conditional benefits have been used for a long time in the United Kingdom and the United States, and have more recently been adopted in a number of OECD member countries (including Belgium, Finland, France and the Netherlands). These programmes are usually targeted at low income families (OECD, 2003), particularly those with children, and may not reach all displaced workers. However, adjustment programmes aimed at encouraging displaced workers to search for and accept new jobs quickly are also used in some countries. The Trade Promotional Authority Act of 2002 in the United States introduced, for instance, a form of wage insurance for older workers that have been displaced because of trade. This programme strengthens re-employment incentives as payments start as soon as the worker takes a new job and stop two years from the date the worker was laid off.

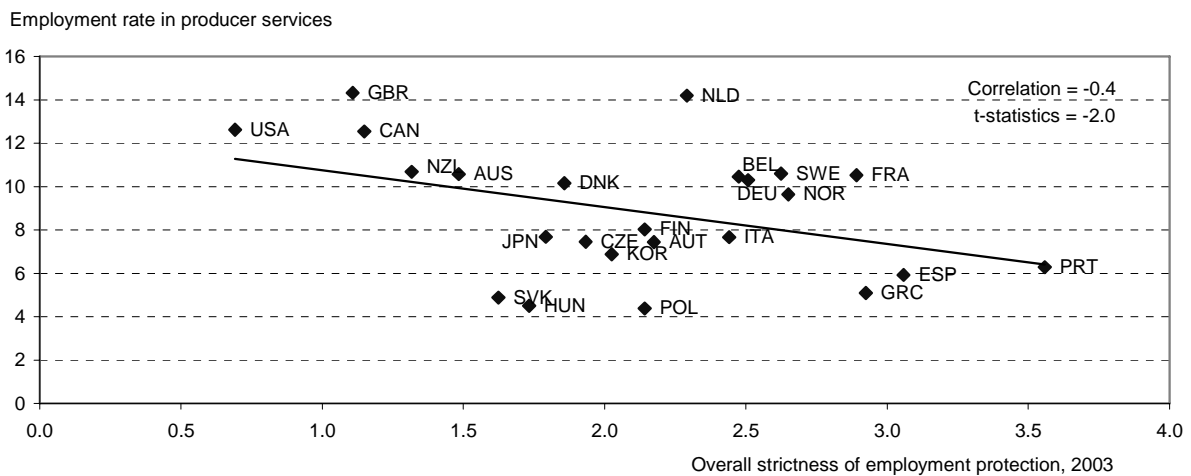
Avoiding overly strict employment protection

A certain degree of employment protection may facilitate structural adjustments by providing transparent procedures and time for all interested parties to plan and implement necessary adjustments. However, available econometric evidence suggests that strict employment legislation (EPL) significantly reduces the speed of adjustment to structural changes. For firms, strict EPL and uncertainties about adjustment costs may constrain their ability to cope with a rapidly changing environment, resulting in both lower job destruction and job creation rates. This may increase adjustment costs for displaced workers, as lower flows out of unemployment reduces re-employment probabilities and lengthens unemployment spells.

Moreover, workers’ incentives to change employer are likely to be negatively affected by strict employment protection, resulting in lower voluntary job mobility. This is because workers usually have to stay with the same employer for a certain time (*e.g.* three or five years) before being eligible for full employment protection, including the rights to severance pay in case of dismissal. Widespread use of temporary contracts in several countries may segment the labour market and further reduce the incentives for workers on permanent contracts to change employer, although it may also ease adverse effects of EPL on employers’ hiring incentives. For the inactive population, recent evidence also suggests that strict employment protection can impede work possibilities of youth and prime-age women (OECD, 2004a), with possible detrimental effects on industries relying disproportionately on such labour groups.

The impact of overly strict employment protection is likely to differ across industries. It could hold back expanding activities, thus obstructing the shift to services (Nickell, Redding and Swaffield, 2004). The impact could be especially detrimental for service industries with particular needs for flexibility, for instance due to large variations in demand or because developing new services involves a lot of experimentation and uncertainty. Recent econometric work suggests that the producer services sector is particularly vulnerable to strict employment protection (see Figure 3.7).⁴ However, very small service firms are usually exempted from EPL legislation as such regulation typically is only applicable above certain size threshold levels. This reduces the impact of employment protection regulations on small service firms, but may also discourage them from growing above the threshold level.

4. See OECD (2002a) and OECD (2000) for recent econometric evidence on the impact of employment protection regulation on employment in producer services.

Figure 3.7. **Employment protection and employment in the producer services sector, 2003¹**

Note: 1. Or most recent year available.

Source: OECD (2004), *OECD Employment Outlook*, OECD, Paris; OECD STAN Database for Industrial Analysis.

Countries have taken different approaches to ease the adverse effects associated with strict EPL. While protection for permanent workers has remained virtually unchanged, the use of temporary contracts has been liberalised in several OECD countries in recent years, including Belgium, Germany, Greece, Italy and the Netherlands. A few OECD member countries have also tried to reduce the uncertainties for firms associated with restructuring, without necessarily reducing job protection for workers. In Japan, for example, rules governing dismissal for economic and other reasons have been recently clarified, thereby curtailing the discretion of labour courts (OECD, 2004c). Furthermore, one OECD member country (Austria) has recently transformed the severance pay system into a system of individual savings accounts, thus moving a large part of firms' adjustment costs into ongoing monthly labour costs (OECD, 2004a). This reduces firms' adjustment costs at the margin, while removing an important impediment to labour mobility as the individual saving accounts are transferable across employers.

Ensuring sufficient wage flexibility

Flexible wage-setting systems can facilitate structural adjustment by fully utilising labour resources and encouraging workers to move to employment where their productivity is highest and improves their human capital. Evidence shows that the flexibility of wages differs across the main bargaining systems:

- Nationwide centralised bargaining systems may deliver low unemployment in a shock-free environment and can deal effectively with macroeconomic shocks, but they are sometimes associated with rigid relative wage structures (OECD, 2004b). This can hamper adjustment when structural change involves changes in the geographical pattern of production or in the relative demand of different skills.
- Industry-based bargaining systems could more easily result in wage differentiation across sectors, but may have the same disadvantage as centralised systems in responding to structural change with different regional impact. They may also risk responding poorly to macroeconomic shocks (Calmfors and Driffill, 1988).

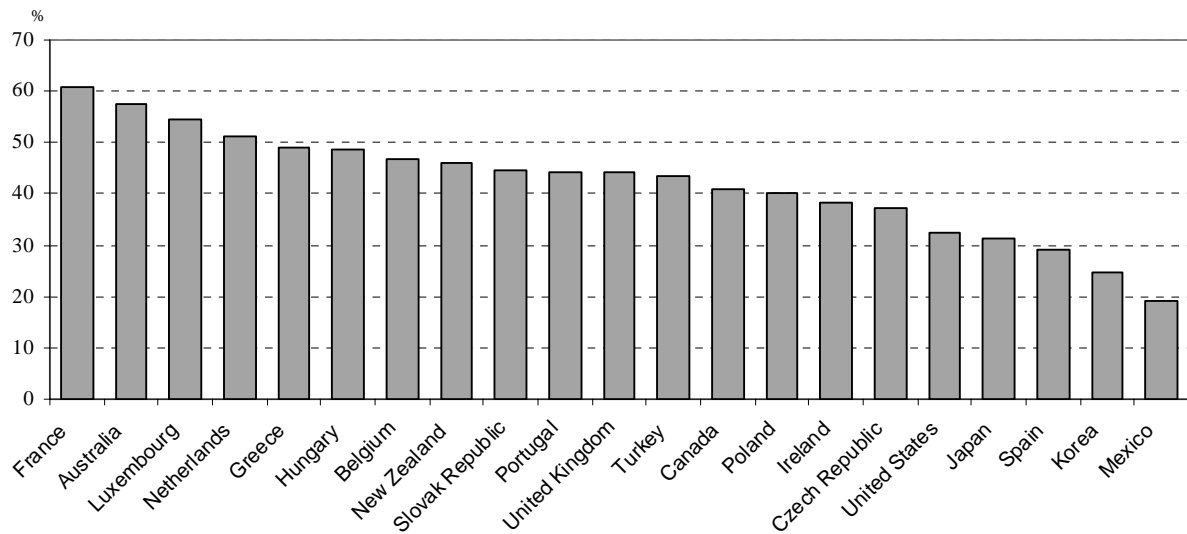
- Decentralised wage-setting systems tend to be more responsive to market forces and hence permit swifter changes in relative wages in periods of structural change. They may also retain some of the strengths of centralised bargaining if combined with sufficient co-ordination. Decentralised bargaining is, however, no guarantee for an efficient allocation of resources. For instance, if barriers to labour mobility exist, decentralised bargaining may result in persistent differences in real earnings for similar work across firms and regions, thus enabling less efficient firms to remain in operation.

Displaced low-skilled workers could be particularly affected by insufficient wage flexibility as too high wage floors, either established in bargaining or by statute, may prevent them from finding new employment. At the same time, a compressed wage structure could obstruct developments in expanding service activities relying on low-skilled labour. Recent econometric research has, for instance, identified a significant negative effect of centralised bargaining, with its typically high wage floors, on service sector employment, especially in the retail trade sector (Messina, 2004; OECD, 2000b).

The characteristics of collective wage-setting systems and industrial relations differ widely among OECD countries, as measured by a number of indicators. The Nordic countries and Belgium stand out with relatively high union density rates, as well as a high degree of centralisation and/or co-ordination in wage bargaining. In a few countries with predominantly industry-based wage bargaining, the coverage rate of collective agreements substantially exceeds the union density rate (*e.g.* Austria, France, Luxembourg, Portugal and Spain), reflecting extensions of collective wage agreements to non-unionised areas of the relevant sectors. Decentralised wage-setting systems, combining the absence of legal extensions of collective contracts, low degree of centralisation and little co-ordination of collective wage bargaining are mainly found in English-speaking countries.

Countries' bargaining structures have been relatively stable over the past decade. Australia and New Zealand moved towards more decentralisation and less wage-setting co-ordination in the early 1990s, while Belgium and Denmark introduced more wage-setting co-ordination in the second half of the 1990s (Denmark introduced more decentralised bargaining at the same time). Both the union density rate and the coverage rate of collective agreements continued to decline in most OECD member countries in the 1990s, but the union density rate declined more than the coverage rate of collective agreements (OECD, 2004b). The discrepancy between the union density rate and the coverage rate has thus increased. Some European countries have also adopted opt-out clauses or other provisions allowing elements of firm bargaining within a more centralised framework. However, despite the increased flexibility that opt-out clauses provide at the firm level, country experiences suggest that they are rarely used in practice.

The level of statutory minimum wages relative to the median wage level varies significantly across the countries that have legal wage floors (see Figure 3.8). In general, there has been no movement in reducing minimum wages. Ireland and the United Kingdom introduced statutory minimum wages in 1999-2000 as part of other labour-market reforms of these countries, notably the increased use of "make-work-pay" policies. However, a few countries have sought to lower labour costs by cutting payroll taxes on low earnings or by introducing employment subsidies. Broad programmes providing subsidies to all those in low-paid work are used in relatively few countries (mainly Belgium, France and the Netherlands). More targeted programmes aimed at disadvantaged groups are found throughout the OECD area, and they account for a significant share of overall spending on active labour-market policies in several countries.

Figure 3.8. Ratio of minimum wage to full-time median earnings, 2003¹

Note: 1. 2002 for France, Greece, Hungary and Portugal.

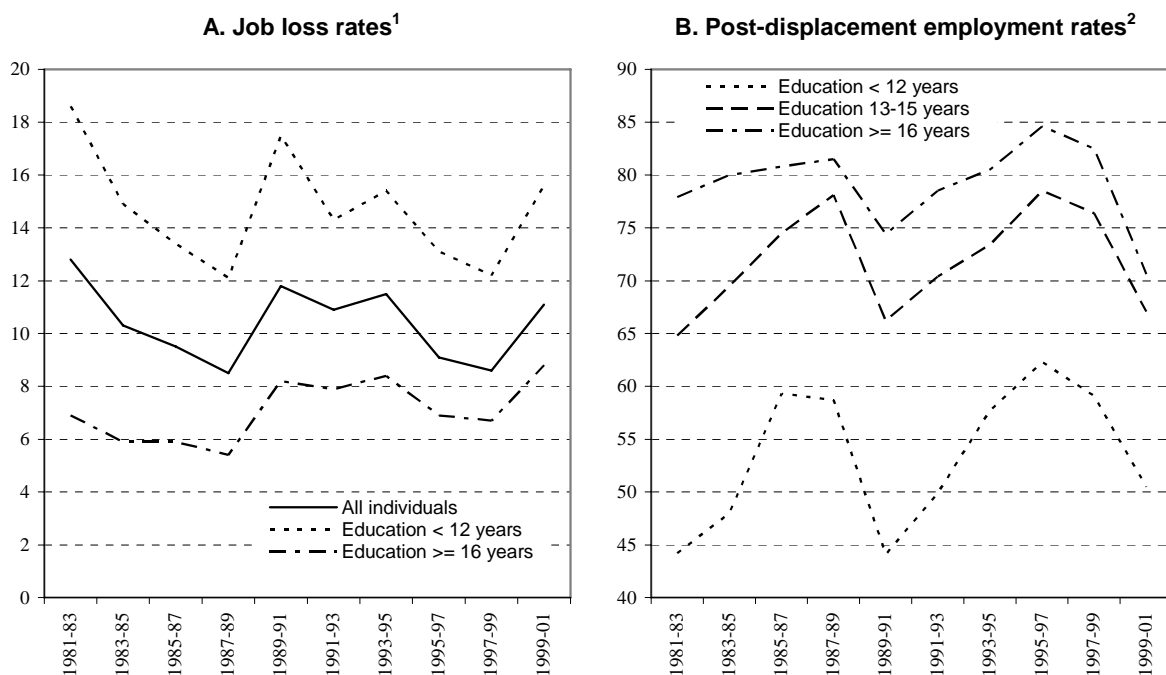
Source: OECD Labour Market Statistic Indicators.

Raising skill levels to create a more flexible workforce

Education and training systems that provide workers with adequate and adaptable skills can facilitate structural adjustments in several ways. New and expanding activities often demand specialised skills, and skill shortages are frequently reported as an important obstacle to growth. Also, on the global arena, availability of labour with the needed skills is a key factor affecting the localisation of international affiliates. The extent that countries manage to take full advantage of new possibilities to increase employment and welfare may thus depend on the responsiveness of education and training systems to evolving labour demand, as well as overall attainment rates.

Education and training are also positively associated with several aspects of labour mobility. Available micro evidence shows, for instance, that high-skilled workers have much higher job-to-job transition rates than low-skilled ones, and are more mobile across occupations, industries and regions (OECD, 2004d). US Data suggest that in the United States at least, high-skilled workers are less frequently displaced, and even when a worker loses his/her job, he/she has a relatively high probability being re-employed (see Figure 3.9). Similarly, workers receiving in-work training tend to have higher voluntary job mobility, lower involuntary separation rates and higher re-employment probabilities following job losses than non-trained employees. In addition to positive effects on labour mobility, in-work training has been found to lower the risk of substantial wage losses for displaced workers.

Figure 3.9. Job loss rates and re-employment probabilities: United States (%)



- Notes:
1. Three-year rates of job loss, which are computed as the number of workers reporting having lost a job in the three calendar years prior to the survey date divided by employment plus not-employed job losers at the survey date.
 2. Fraction of job losers employed at survey date.

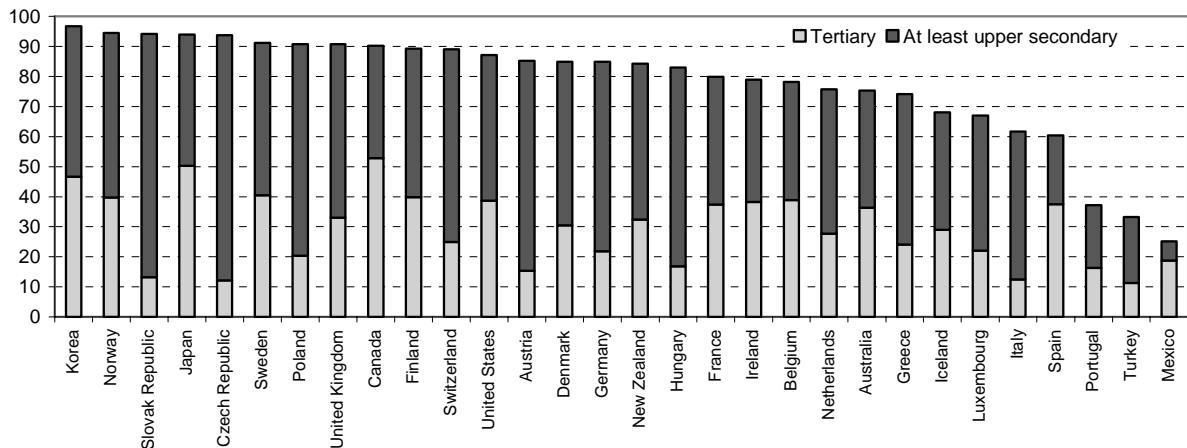
Source: US Displaced Worker Surveys. See Farber, H.S. (2003), "Job Loss in the United States, 1981-2001", *NBER Working Paper Series*, No. 9707, May, National Bureau of Economic Research, Cambridge, Massachusetts.

The large positive effects of education and training on different aspects of labour mobility documented in various micro studies may, however, significantly overstate the overall effect of expanding education and training levels. This is because high-skilled and trained workers to some extent compete with other workers in the labour market. Better employment possibilities for high-skilled and trained workers may thus come at the expense of less educated and untrained workers. A selection effect may also be at play, where the workers most likely to benefit from education and training already receive it. Furthermore, high-skilled workers are disproportionately employed in services, which traditionally have had lower displacement rates than the goods-producing sector (Farber, 2003). As more service jobs are becoming exposed to competition, this difference is likely to shrink. In fact, the impact of education on displacement and re-employment probabilities seem to have been somewhat reduced over the past two decades in the United States (see Figure 3.9).

The level of initial education differs widely among OECD member countries (see Figure 3.10). The percentage of young people with at least upper-secondary education varies, for example, from around 30% in Mexico and Turkey to well above 90% in Korea, Norway and the Slovak Republic. Country differences are even more pronounced for workers between 45 and 54 years of age, while the extent of employer-sponsored education and training also shows a wide variation across countries. The level of in-work training tends to be positively associated with the level of initial formal education, with some countries performing relatively poorly on both counts (including Belgium, Ireland and Italy). The access to in-work training differs significantly across worker groups, even in countries with relatively high overall levels (OECD, 2004d). Highly skilled workers typically receive much more training than lesser educated workers. Older workers, immigrants, part-timers and temporary workers

also tend to receive relatively little in-work training, probably to some extent reflecting a lower rate of return on investments in human capital.

Figure 3.10. **Percentage of 25-34 year olds that have attained a certain level of education, 2003¹**



Note: 1. 2002 for Denmark, Greece, Iceland, Italy, Japan, Luxembourg, Netherlands, Norway and Switzerland.

Source: OECD Education Database; OECD (2003), *OECD Employment Outlook*, Chapter 5, OECD, Paris.

For displaced and unemployed workers, effective training systems could be of particular importance in dealing with structural change, by strengthening productivity and thus improving employability and employment incentives (Swaim and Tejada, 2005). Public spending on training for the unemployed and other active labour-market policies (ALMPs) varies widely across OECD member countries, and is particularly high in Denmark, Netherlands and Sweden, particularly when compared with the level of unemployment. However, available evidence on the impact of government-funded training programmes on re-employment probabilities for the unemployed is mixed (Martin and Grubb, 2001). In general, large-scale programmes relying on classroom training do not improve re-employment probabilities of participants, while targeted on-the-job training programmes in the private sector do. Again, the overall impact could be overstated, as gains enjoyed by those receiving government-funded training might be offset by losses experienced by others not receiving such training.

Easing distortions created by high tax wedges

Some service activities have characteristics that make them particularly vulnerable to high labour taxes. Distributive and personal services rely, for example, disproportionately on workers with elastic labour supply, including students, the low-skilled, single parents and second-income earners in families (see the section on sectoral reallocation, economic performance and cross-country adjustment capacities above).⁵ As a consequence, high labour taxes cannot completely be shifted onto workers in the form of lower after-tax earnings, thus pushing up labour costs. In the case of high payroll taxes, this is sometimes reinforced by other policies effectively creating a wage floor for low-paid workers (see above). Demand for many personal services is also relatively price elastic, reflecting the

5. In contrast, labour supply of prime-age males is generally found to be relatively inelastic (Blundell and MaCurdy, 1999).

possibility of do-it-yourself work and recourse to non-declared work (*e.g.* childcare, cleaning and gardening). Together, elastic labour supply and elastic demand create a negative relationship between labour taxes and formal employment in affected services activities (see Box 3.1).

Box 3.1. Labour taxes and the number of hours required to pay for personal services

A high tax wedge may discourage demand for market-delivered personal services by increasing the number of hours of work required to pay for them (see table below). In Japan, Korea, Luxembourg and Mexico, the principal earner in a two-income household, earning 100% and 67% of the average production worker (APW) wage, respectively, with two children has to work slightly less than one hour to pay for one hour of work carried out by a low-paid casual worker. In Belgium, Germany and Italy, the principal earner must work roughly twice as long to be able to pay for the same work. For a skilled tradesman, *i.e.* for services that are subject to consumption taxes, the household in these countries would have to pay the equivalent of three hours or more of pay for one hour of bought-in services.

The reliance on in-house production of services varies significantly between countries, and this may explain some of the differences in market-based service deliveries observed between countries. Freeman and Schettkat (2002) found, for example, that women in Germany and the United States worked a similar number of hours each day, but that a larger share of this work was in market production in the United States. Cross-country information on the extent of do-it-yourself work is sparse, but available studies suggest that such activities are substantial in some countries with high labour taxes (Denmark and Sweden).¹

The level of undeclared work is significant in most OECD member countries. According to recent estimates, the share of hours worked in the informal economy ranges between 1% and 5% in Denmark, Germany, Netherlands, Norway, Sweden and the United Kingdom to more than 15% in Italy and Spain and more than 30% in Turkey (OECD, 2004e). Somewhat surprisingly, high tax rates *per se* do not appear to have a major influence on the extent of undeclared work. In fact, other factors have been found to be of greater importance, in particular the absence of effective taxation of business income, cumbersome regulations in product markets and strict employment protection (Friedman, *et al.*, 2000).

1. The estimated amount of do-it-yourself activities on household repairs and maintenance in Denmark in 2000, for example, corresponded to 50 000 full-time jobs or around 1.5% of the working-age population (Brodersen, 2002). A similar estimate has been made for Sweden (OECD, 2002b).

Box 3.1. Labour taxes and the number of hours required to pay for personal services (continued)

Hours of work required to pay for household services, 2003¹

	Casual labour		Tradesman	
	Low wage	Average wage	Average wage	High wage
Australia	1.0	1.5	1.7	2.8
Austria	1.5	2.3	2.7	4.5
Belgium	1.9	2.8	3.5	5.8
Canada	1.2	1.7	1.8	3.1
Czech Republic	1.2	1.8	2.2	3.7
Denmark	1.2	1.8	2.2	3.7
Finland	1.5	2.3	2.8	4.6
France ²	1.2	1.8	2.3	3.9
Germany	1.7	2.5	2.9	4.8
Greece	1.2	1.8	2.1	3.5
Hungary	1.6	2.3	2.9	4.8
Iceland	1.3	1.9	2.3	3.9
Ireland	1.0	1.5	1.8	3.0
Italy	1.6	2.4	2.8	4.8
Japan	0.9	1.4	1.5	2.5
Korea	0.8	1.2	1.3	2.2
Luxembourg	0.9	1.3	1.5	2.5
Mexico	0.9	1.4	1.6	2.6
Netherlands	1.4	2.1	2.5	4.2
New Zealand	1.0	1.5	1.7	2.8
Norway	1.2	1.8	2.2	3.6
Poland	1.2	1.8	2.2	3.7
Portugal	1.1	1.6	1.9	3.2
Slovak Republic	1.2	1.8	2.1	3.5
Spain	1.3	1.9	2.2	3.6
Sweden	1.4	2.1	2.6	4.3
Switzerland	1.0	1.5	1.7	2.8
Turkey	1.2	1.8	2.1	3.6
United Kingdom	1.1	1.6	1.9	3.2
United States	1.0	1.5	1.5	2.5
Unweighted average	1.2	1.8	2.2	3.6
Maximum	1.9	2.8	3.5	5.8
Minimum	0.8	1.2	1.3	2.2

Note: These calculations are illustrative only and do not attempt to take account of "all country-specific" factors. VAT is assumed to be paid at the standard rate on work carried out by a tradesman. Casual labour includes both occasional and regular employment by the household.

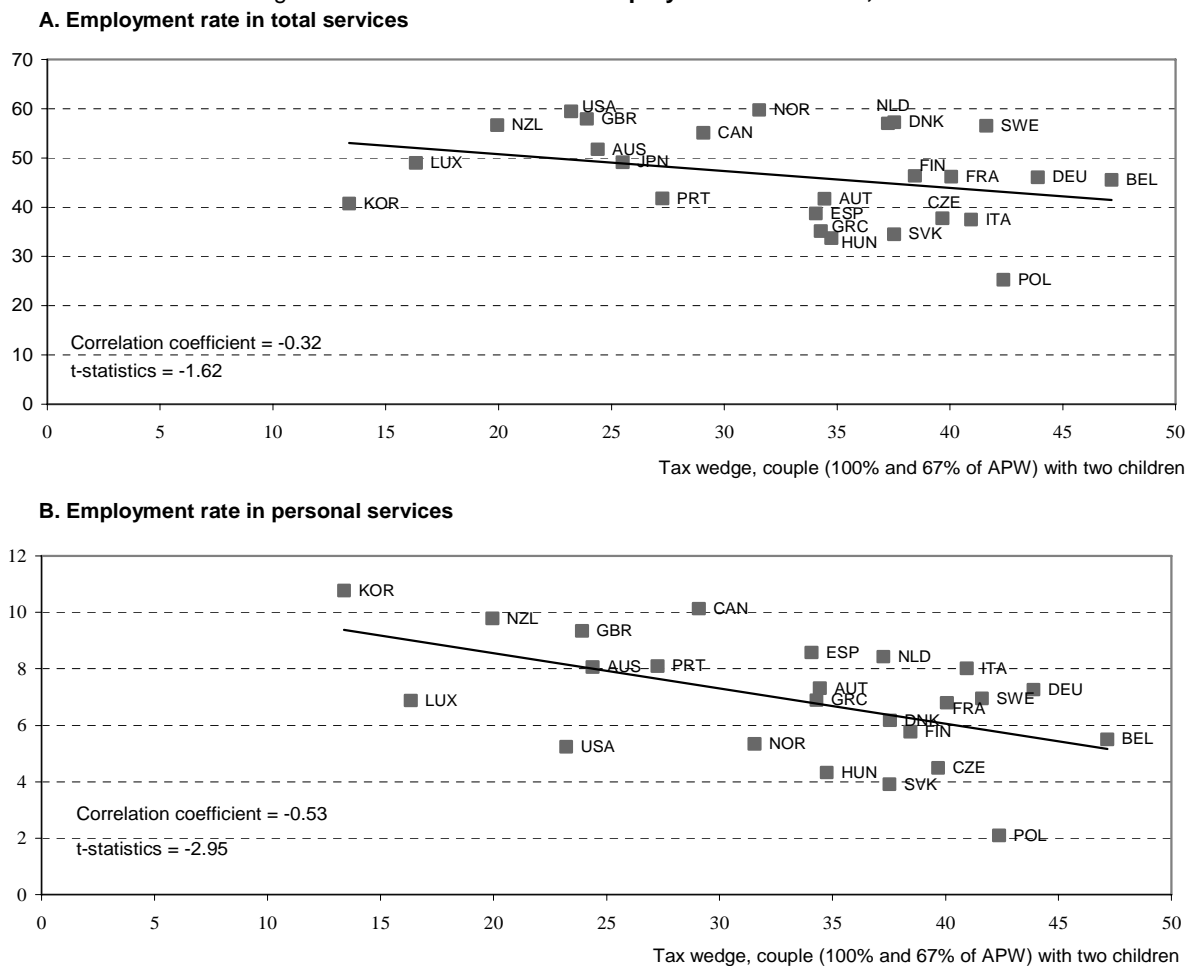
1. Calculated for a two-earner household with two children, where the principal earner earns 100% of the average production worker (APW) wage and the spouse earns 67% of the APW wage.

2. Calculations do not include tax credit on employer social security contributions, which apply to certain types of household work.

Source: OECD Taxing Wages Database.

Available empirical evidence is mixed on the effect of high labour taxes on service activities (see Figure 3.11). In line with the considerations above, a recent OECD study identified a negative effect of labour taxes on employment in personal services (OECD, 2000b). No significant effect was found on overall service employment, however, while the effect on social services was found to be positive. This may reflect that higher taxes are mirrored in higher public spending or subsidies linked to service activities (*e.g.* education allowances and childcare subsidies).⁶ Other studies have, however, identified a significant negative effect of high non-wage labour cost on overall employment levels (OECD, 2002a), particularly among low-skilled workers. High relative tax on second-income earners has also been found to significantly reduce the full-time participation rate of women (Jaumotte, 2003). Both single and married females seem to be particularly willing to substitute between market and in-house produced services (Rupert, 1994). Given the size of services in the overall economy and the reliance on low-skilled workers and women in certain service markets, these findings indicate a negative impact of labour taxes on service activities.

Figure 3.11. Labour taxes and employment in services, 2003¹



Note: 1. Or most recent year available.

Source: OECD Taxing Wages Database; OECD STAN Database for Industrial Analysis; Groningen Growth and Development Centre Database.

6. Moreover, the payment of labour taxes sometimes gives rise to benefit entitlements (*e.g.* pension and paid maternity leave), potentially altering the effect of taxation on labour supply.

The direct tax wedge on labour income varies considerably between countries and the ranking of countries depends to some extent on the measure used. For couples earning respectively 100% and 67% of the earnings of the average production worker (APW), the average tax wedge, including social security contributions, is particularly high in Belgium, France, Germany, Italy, Poland, Sweden and Turkey. Low-income earners are generally taxed at a more favourable rate than those with a higher income, although the total tax wedge is still above 30% in Greece, Poland, Sweden and Turkey. Moreover, second-income earners in families often face a relatively high tax wedge (Belgium, Denmark, Germany and Iceland), creating an extra disincentive to engage in market-based work. Indirect taxes are particularly high in Hungary, Poland and the Nordic countries (up to 25%).

The direct tax wedge on labour has been lowered in several OECD countries since the mid-1990s, in particular on low-income earners (OECD, 2004f). For single parents with two children earning 67% of the APW wage, for instance, the total direct tax wedge has been cut in more than two-thirds of OECD countries. In some cases, the cut from 1996 to 2003 amounted to more than ten percentage points (Ireland, Italy and the United Kingdom).

By contrast, consumption taxes have been relatively stable in most countries over the past decade, and have, on average, increased slightly in the OECD area (OECD, 2005a). General reductions in the consumption tax rate are costly in terms of foregone revenues, and alleviating adverse effects on certain services could arguably justify differentiated consumption taxes. Several countries already have VAT-rate differentiation and exceptions, but lower rates are mainly targeted at basic goods and services (*i.e.* not necessarily services with elastic labour supply and elastic demand). However, significant weight should be attached to the principle of having a neutral and simple tax system, and this argues against introducing lower rates on selected services.

A number of countries have relied on more targeted policies to counteract perceived negative effects of high labour taxes on the employment of low-skilled workers in personal services. Tax credits or subsidies for households employing domestic staff have been introduced in several countries (including Denmark, France, Germany and the Netherlands), while administrative procedures have also been simplified. In France, for example, private households employing labour are entitled, up to a ceiling, to a tax refund equal to 50% of the total amount of wages and social security contributions, while routines for tax and social security payment arrangements are simplified. Furthermore, several countries have introduced policies aimed more directly at stimulating female labour supply (see Box 3.2).

Removing barriers to competition and growth in service markets

The capacity of countries to adjust to changing circumstances and to improve the performance of the economy is influenced by the strength of competition in product markets. This section reviews product market regulations and border barriers that weaken competitive pressures. It also reviews the extent and scope of the use of market mechanisms in the provision of social services, which account for up to half of all service-sector employment in some countries.

Product-market regulations and domestic competition

A competitive domestic environment plays an important role in promoting an efficient and dynamic service economy. High administrative burdens to business start-ups have, for instance, been found to deter employment expansion in market services by acting as a barrier to the creation of new

firms (e.g. Messina, 2004). Industries that usually have relatively high entry rates, including communications and some producer services, seem to be particularly affected by stringent entry regulations (Klapper, Laeven and Rajan 2004). Adverse effects of regulations have also been identified in other large service industries. In the retail trade sector, for example, regulatory barriers to the establishment of large-scale retail outlets have been seen to significantly reduce productivity and employment (see below). Similarly, in the transport sector, regulatory hurdles have been seen as holding back investments (Alesina, *et al.*, 2003), with potential negative effects on both productivity and employment.

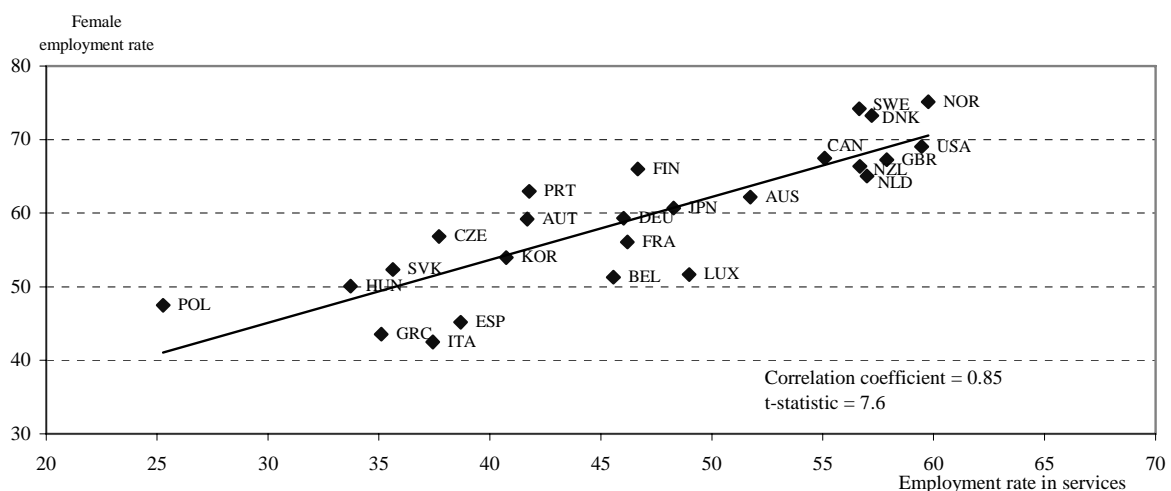
Box 3.2. Female labour supply and service-sector employment

Policies aimed at stimulating female employment can have important positive effects on developments in services by raising overall labour supply and by shifting some service activities into the formal market (see figure below). Female labour force participation is relatively low in several countries (in particular Greece, Hungary, Italy, Poland and Spain). Low employment levels may, to some extent, reflect cultural factors and different preferences. But the percentage of inactive women who would like to work is substantial in many OECD member countries, particularly among those who do not seek employment because of family responsibilities (Jaumotte, 2003). This indicates a significant potential for further employment growth in these countries.

A wide range of policies may help stimulate female labour force participation. Several countries have, for instance, introduced public subsidies for childcare. Empirical evidence suggests that this policy has succeeded by increasing the labour supply from single parents and second-income earners in couples with children, although the elasticity is not always found to be very high (Jaumotte, 2003). Other policies, including more flexible working-time arrangements and liberal regulations on opening hours, may further help stimulate female employment, by providing employment possibilities at times that may be more convenient for some workers.

Female employment rate and employment in services, 2003¹

(%)



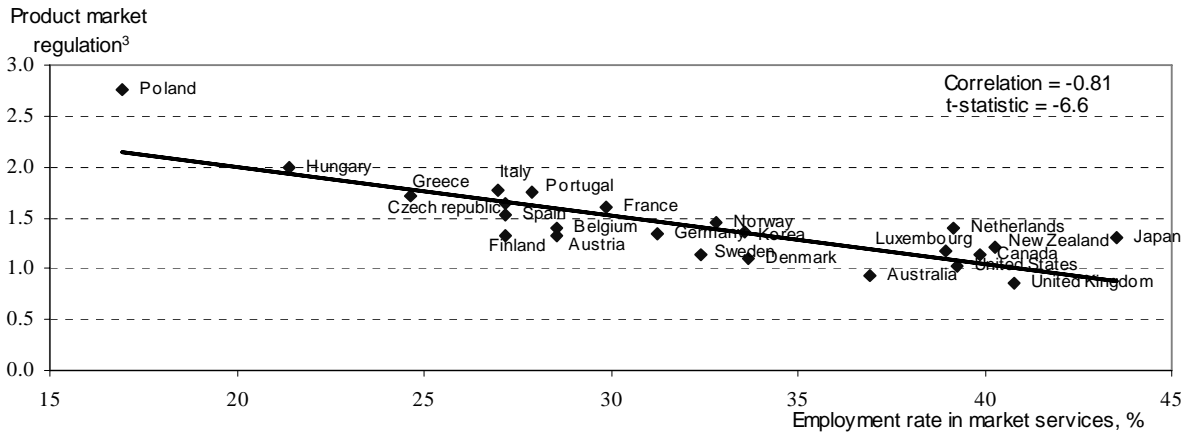
1. Or most recent year available.

Source: OECD Labour Force Statistics; OECD STAN Structural Analysis Database.

The evidence for the adverse effect of anti-competitive regulations on service sector developments is supported by other research that looks at the impact of stringent product-market regulations on overall economic performance. This work suggests that more competition can strengthen firms' incentives to innovate, respond to clients' needs and adopt best practices, while

reduced potential for rent creation lowers prices, stimulates activity and increases labour demand.⁷ Although these findings do not directly relate to the service sector, the results are likely to be relevant. Indeed, simple cross-country comparisons indicate that countries with strict overall product market regulations tend to have lower employment in market services than countries with less restrictive regulations (see Figure 3.12).

Figure 3.12. **Product market regulations and employment in market services,¹ 2003²**



Notes: 1. Employment in services excluding government employment, health and education.
2. Or most recent year available.
3. Index 0-6 scale from least to most restrictive.

Source: OECD Product Market Regulation Database; OECD STAN Database.

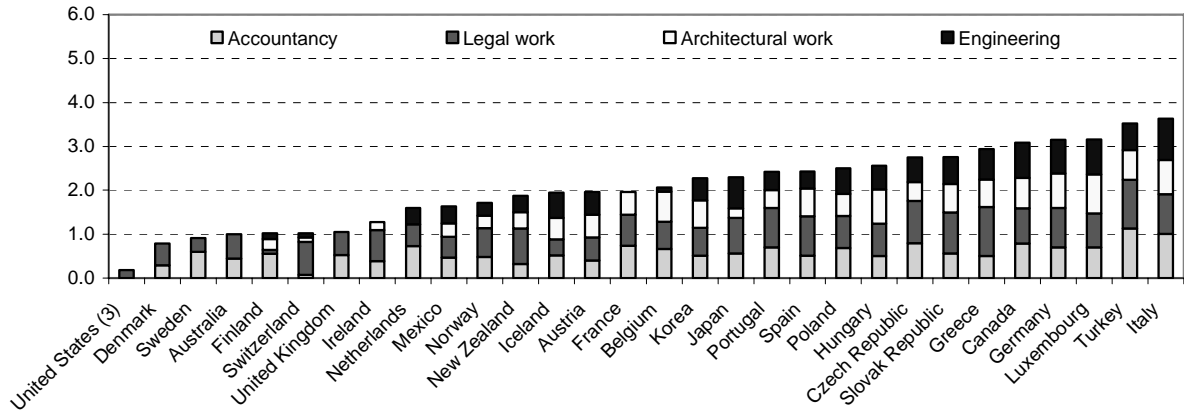
Despite most OECD countries having pursued substantial regulatory reforms over the past decade, anti-competitive regulations are still prevalent in many countries and, in particular, in many service industries. The rest of this section provides a brief overview of existing regulations that may deter competition and performance, as well as countries' experiences with liberalisation, in selected domestic service markets: professional services, transport and retail trade. These sectors have been selected on the basis of their size in terms of economic activity (retail trade) or because anti-competitive practices seem to be particularly pronounced (professional services and transport). More comprehensive overviews of regulatory regimes in member countries are provided in individual OECD Country Surveys and in Conway, Janod and Nicoletti, 2005.

Professional services, including legal work, architectural work and engineering, provide one example of a service sector subject to heavy anti-competitive regulations in many OECD countries. Professions are often given exclusive rights to provide certain services, while professional associations are given wide powers to decide on entry requirements, rules of conduct and even recommended or fixed prices. Membership in professional associations is also compulsory in some OECD countries, including Austria, Germany, Japan and Korea. Overall, entry and operational restrictions in professional services are particularly stringent in Germany, Italy, Luxembourg and Turkey (see Figure 3.13, Panel A).

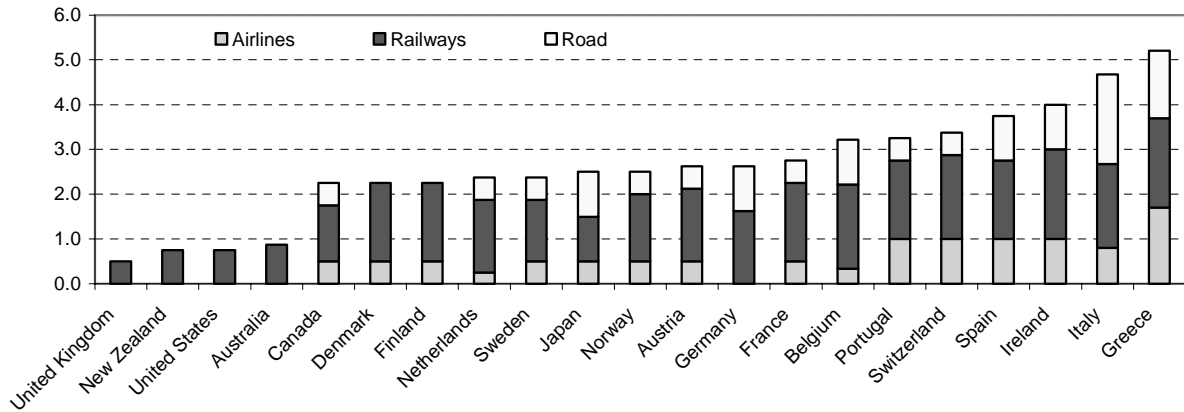
7. See, for instance, Nicoletti and Scarpetta (2003); Bassanini and Ernst (2002); Bartelsman, Scarpetta and Schivardi (2003); and OECD (2002a). A few authors have, however, also pointed out possible adverse effects from stronger product market competition on employment. Amable and Gatti (2004) argue, for example, that higher job turnover may create wage pressures due to the impact on efficiency wages premiums and the wage premium for potentially firing firms.

Figure 3.13 Regulations in selected service sectors¹

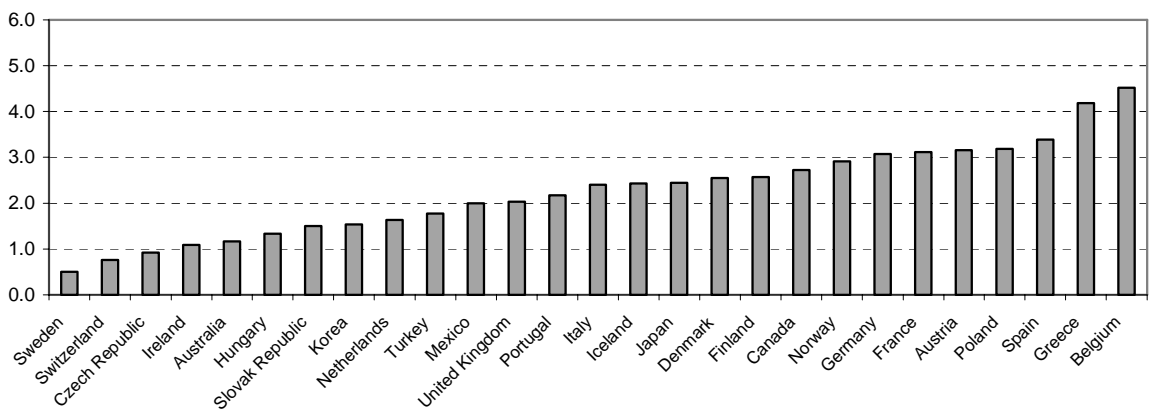
A. Professional services, 2003²



B. Transport, 1998



C. Retail trade, 2003²



- Notes:
1. Index 0-6 scale from least to most restrictive.
 2. Preliminary data.
 3. Legal work only.

Source: OECD Product Market Regulation Database.

The transport sector provides another example of a heavily regulated activity in many OECD member countries. Domestic air and road transport markets are, for instance, sometimes subject to strict entry and licensing requirements and characterised by significant government involvement, while price controls apply in some segments (*e.g.* road freight in Italy). Taxi services and local and long-distance bus operations are often subject to strict approval requirements, usually involving local government. This may result in inefficient zoning restrictions in local transport markets, and seriously complicate the provision of long-distance bus routes. The number of taxis is limited in several cities, implying that people wishing to obtain a taxi license often must purchase it from an existing license holder.⁸ Railway transportation is also generally characterised by strong government involvement and only one or a few service providers, while public subsidies for rail transport and cross-ownership of bus companies sometimes weakens effective competition on inter-city transport. According to OECD indicators (from 1998), regulations of transport services are particularly pronounced in Greece and Italy (see Figure 3.13, Panel B). Significant deregulation has, however, taken place in these industries in recent years.

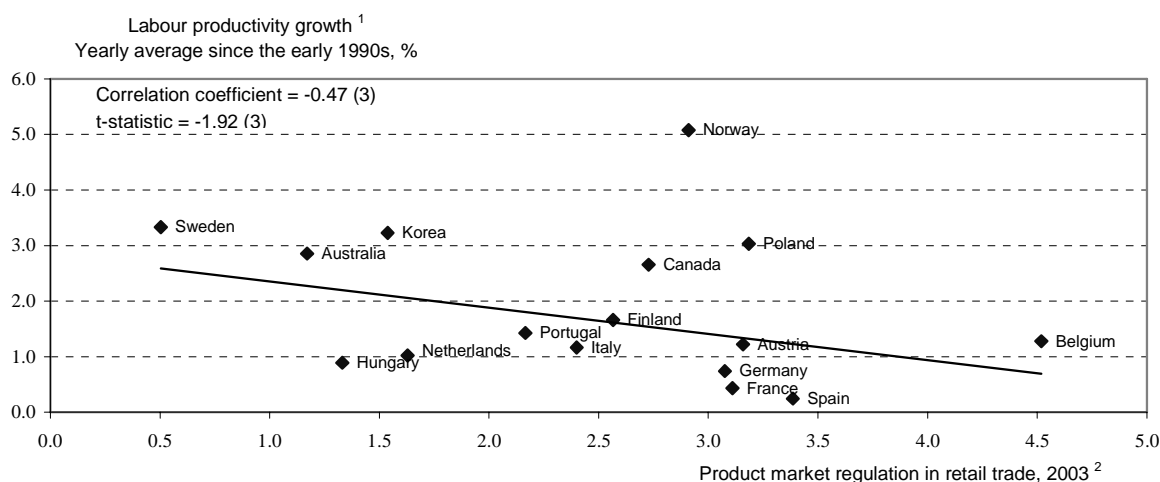
The retail sector is generally characterised by a large number of competitors and few barriers to firm entry. But the development of so-called hypermarkets has been obstructed in many countries by tight regulations on the establishment and expansion of large retail outlets, often with the objective of protecting small shops in town centres. Some countries have introduced a ban on new large shopping centres (*e.g.* Denmark), or introduced appeal processes that can delay the establishment of hypermarkets for years (*e.g.* France and Switzerland).⁹ In some countries, the entry of supermarket chains is resisted by local authorities, sometimes influenced by local business interests (*e.g.* Belgium, Italy and Japan). Barriers to the establishment of large retail outlets have been identified as a main obstacle to productivity growth and employment in retail trade.¹⁰ Given the importance of the retail trade sector, both in terms of employment and value added, the adverse impact on overall economic performance can be significant (see Box 3.3).

Regulations on business operations, including shop opening hours and the freedom to set prices, and on the use of labour resources, pose additional restrictions on retail trade in several OECD member countries. In France, for instance, restrictions on price competition have recently been recognised as significantly pushing up prices on some brand-name products compared with neighbouring countries. All in all, anti-competitive product-market regulations in retail trade seem to be particularly stringent in Belgium and Greece (see Figure 3.13, Panel C). In addition, strict regulations on the use of labour resources may further hamper labour productivity in retail trade. For example, restrictions on the splitting up of the working time for employees into two or more shifts per day might be particularly harmful, as it implies significant slack outside peak hours. Such arrangements should be subject to bargaining between employers and employees, so that inconvenient working time arrangements could be compensated by higher wages and not blocked altogether.

-
8. In the United States, for example, the number of taxi licences was unchanged in New York from 1937 to 1996, resulting in high costs and poor availability of taxis and substantial rents to license holders (*The Economist*, 2004). In France, the number of taxi licences in Paris is smaller than in 1926 (Cahuc and Kramarz, 2004). The taxi market has recently been deregulated in many OECD member countries, notably in Ireland.
 9. In Switzerland, for example, the appeal process can delay the building of a hypermarket by between 10 and 15 years (Giorno, Jimenez and Gugler, 2004).
 10. See, for example, Boylaud and Nicoletti (2001a) and Bertrand and Kramarz (2002).

Box 3.3. The wholesale and retail trade sector and overall economic performance

The wholesale and retail trade sector has delivered solid productivity growth over the past decade in several OECD countries (see figure below), often surpassing that of the manufacturing sector (Wöfl, 2005). Given the importance of this sector, it significantly affects productivity developments at the national level. In an analysis of productivity growth differentials between the United States and Europe, van Ark, Inklaar and McGuckin (2003) showed, for example, that more than half of the aggregate growth gap in the late 1990s could be explained by different developments in retail trade and another one-quarter could be explained by different developments in wholesale trade.¹

Regulation and productivity growth in the wholesale and retail trade sector**Notes:**

1. Growth rates are not adjusted for the cycle.
2. Preliminary data. Index 0-6 scale from least to most restrictive.
3. Excluding Norway.

Source: OECD STAN Database for Industrial Analysis; OECD Product Market Regulation Database.

1. See also Gordon (2004) for a recent discussion of factors behind the observed growth differential between Europe and the United States over the past decade. The use of hedonic price indices may artificially inflate productivity in retail trade as the volume of goods sold increases more than the number of items handled. This is, however, not likely to significantly alter the findings above (van Ark, Inklaar and McGuckin, 2003).

Countries' experiences with regulatory reforms in service markets are, on the whole, very positive. In retail trade, regulatory reforms have delivered significant economic gains. The liberalisation of the Large-Scale Retail Store Law in Japan in the early 1990s, for example, resulted in higher labour productivity, lower prices and higher retail employment, arguably boosting economy-wide GDP by around 1% (Høj and Wise, 2004). In the Netherlands and the United Kingdom, liberalisation of opening hours in the early 1990s led to a significant increase in employment (*Centraal Planbureau*, 1995) and a sharp acceleration in cyclically-adjusted value-added (Department of Trade and Industry, 2004). Similarly, deregulation of air passenger transportation and road freight has been associated with substantial gains in the form of lower prices, new services and higher labour and capital productivity (Gönenç and Nicoletti, 2001; Boylaud and Nicoletti, 2001b). In the rail sector, significant reforms have been introduced, with over half of OECD member countries now allowing independent train operators to provide services over large sections of the existing track infrastructure (OECD, 2005c). However, the experiences with regulatory reforms in this area are mixed and important issues regarding incentives and responsibilities remain to be resolved.

Although current regulations have often been introduced to alleviate the existence of externalities and information asymmetries in many service markets, countries' experiences suggest that feared adverse outcomes of regulatory reforms generally do not materialise. Deregulations of air and road transport have not been associated with declines in safety levels or, in the case of air transport, deprivation of small communities of air services. In road freight, in Australia and the United States after liberalisation, safety seems to have improved (Boylaud and Nicoletti, 2001b). Similarly, no major increase in bankruptcy among small shops could be identified after the liberalisation of shop opening hours in the Netherlands (OECD, 2004g). At the same time, developments in telecommunications suggest that the fulfilment of universal service obligations has not been threatened by the introduction of competition and cost-reflective tariff. Anti-competitive regulations in professional services have in a similar way been seen to deliver higher prices and less innovation, without necessarily improving quality (Paterson, Fink and Ogus, 2003).

Openness and foreign competition

Opening up domestic service markets to trade and FDI could provide more competition, bring new services to the market and create new possibilities for domestic providers through export. Recent studies have documented that foreign affiliates have a positive impact on the performance of the domestic economy, mainly by providing more investment and driving research and development (R&D) and productivity. Trade in services will also allow countries to better exploit their comparative advantage, thus further lowering costs and increasing real incomes, without necessarily having significant adverse effects on domestic labour markets, even in the short run (see Box 3.4). Globalisation of information and communication technology (ICT) services have, for instance, been seen as important in lowering ICT costs and thus spurring the adoption of ICT throughout the economy. This could boost productivity growth in ICT-using industries in all OECD member countries (Mann, 2003), giving rise to similar welfare gains as did lower prices on ICT hardware in the 1990s. In the context of establishing an internal market for services in the European Union (EU), a recent study identified significant economic gains to all member states in terms of higher employment, enhanced productivity, increased wages and lower prices (Copenhagen Economics, 2005).

Trade and FDI in services are potentially obstructed by a number of policies, including:

- Product market regulations and licensing requirements can effectively prevent foreign firms from entering domestic service markets. Nationality or residency requirements are, for instance, relatively common in professional services, while foreign firms sometimes are prevented from carrying freight and passengers in domestic air and road transport markets (so-called cabotage). Available econometric evidence suggests that stringent regulations on FDI and barriers to trade reduce bilateral FDI stocks and service trade (*e.g.* Nicoletti, Scarpetta and Boylaud, 2003). Regulatory barriers to trade and investment are pronounced in several OECD member countries, and in particular in Mexico and Poland (see Figure 3.14).¹¹
- Cross-country heterogeneity in product-market regulations have also been identified as an impediment to service trade and FDI, by making it more costly for service firms to establish a commercial presence in another country (Kox, 2004). Together with obstacles to foreign ownership, this could significantly reduce competition in domestic service markets and prevent or delay the introduction of new services and production methods.

11. See Conway, Janod and Nicoletti (2005), for more details about this indicator. Note that the data refer to 2003 and thus do not incorporate changes since then. This is likely to influence the stance of policy in some countries, notably the new EU member states.

Box 3.4. Globalisation of services and job losses in the service sector

Even though there are no official statistics measuring the extent of offshoring, anecdotal evidence suggests that international sourcing of intermediate services has increased in recent years. This development has been triggered by technological advances and supported by deregulation and trade liberalisation, as well as increased supply of highly skilled workers in several developing countries. In principle, the range of services that can potentially be offshored (*i.e.* outsourced abroad) is significant. It includes services jobs using information technology, both low-skilled activities such as data entry, word processing and call centres, and highly-skilled activities, such as software development and professional business supports. OECD estimates place the total number of jobs that could potentially be affected by domestic or global outsourcing at close to 20% of employment in Canada, the European Union and the United States (van Welsum and Vickery, 2005).

Current estimates, which are subject to significant uncertainty, indicate that offshoring will accelerate in most OECD countries in coming years. The number of jobs involved (*i.e.* gross and net job losses) is, however, likely to be modest:

- Available information indicates that service offshoring and its employment impacts are limited, compared to aggregate economic activity. In the United States, for example, the frequently cited estimate of 3.3 million white-collar jobs moving overseas by 2015 translates into an average quarterly job-loss rate of 55 000 jobs (McCarthy, 2004), which is small in comparison to the more than 7 million jobs destroyed on average every quarter over the past decade as a result of the normal functioning of the economy. A roughly similar picture is observed in the United Kingdom, while other OECD countries such as France, Germany and Italy are experiencing even more moderate movements of service jobs abroad.
- Although some job displacements will occur due to offshoring, the net impact on employment possibilities and real wages could be positive even in the short run. The creation of jobs abroad does not necessarily imply job losses at home. Evidence from large financial firms in the United States, for example, shows that a majority of workers affected by outsourcing are repositioned within the firm. Moreover, by raising productivity and profitability, offshoring of certain tasks can secure other domestic jobs.
- Jobs are also moving in both directions, as firms in developing countries import business services from the OECD area. Significant international sourcing of services also takes place within the OECD area. As a consequence, several OECD member countries have actually experienced a net inflow of service jobs from offshoring in recent years (Amiti and Wei, 2004).

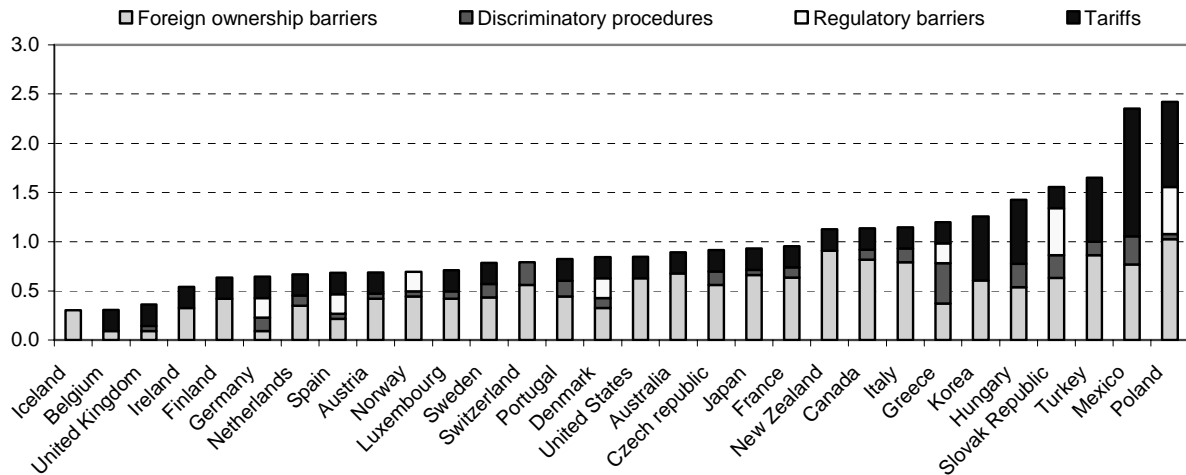
Despite increased offshoring, the exposed service sectors have continued to grow in terms of employment in most OECD member countries. This is also reported to be the case in the call centre industry, which has been highlighted as most at risk of offshoring. In any case, offshoring should not permanently lower employment and production as resources are redeployed in other activities, while the short-run impact depends on countries' adjustment capacities.

- Uncertainties about countries' application of consumption taxes have been seen as a potential impediment to developments in international service markets, in particular for producer services (OECD, 2004h).¹² While the principle that goods should be effectively zero-rated at export and taxed in the country of import is well established internationally, no accepted standard for taxation of service deliveries across borders exists. Some countries use the origin principle as the main rule, while others use the destination principle. In both cases, many exceptions typically exist. International service deliveries may thus risk double taxation or unintentional non-taxation, creating uncertainties and unnecessarily high compliance costs.

12. This includes the development of international markets for financial lease and so-called global contracts, where one firm provides services for another firm in many countries, sometimes via subcontracting.

- Barriers to international e-commerce – including time delays and high handling charges because of cumbersome tax declaration – may obstruct the entry of foreign providers in domestic retail markets. Handling charges are relatively high in some OECD member countries, including the Nordic ones (OECD, 2004i), significantly reducing the incentives for cross-border deliveries.

Figure 3.14. **Barriers to foreign trade and investment**
Regulation in 2003¹



Note: 1. Index 0-6 scale from least to most restrictive.

Source: OECD Product Market Regulation Database.

Enhancing the efficiency of social services

Social service activities – including core government administration, education and health – are characterised by heavy regulation and substantial direct public involvement in all OECD member countries. Many social services are thus provided in a non-competitive environment and are often free of charge for the user at the point of delivery. The absence of a price mechanism implies that it is difficult to gauge demand, and thus to assess if the optimal level of social services are provided in each country. However, more can be said regarding the efficiency in the provision of social services. In particular, policies to encourage competition and strengthen the role of market mechanisms have been seen as instrumental in enhancing efficiency in social services, although there are limits to their use.

Allowing users a choice among alternative providers of publicly funded services can strengthen competitive pressures, stimulate innovation and result in services which respond better to citizens' needs (Journard, *et al.*, 2003). Introducing free choice can be particularly useful where there are difficulties in assessing the actual quality of publicly funded services, as it then imposes a market test on providers. One important condition for competitive pressures to be effective is the implementation of the money-follows-the-user principle, allowing successful providers to expand their activity. User

choice may, however, also have some unwanted effects by, for instance, opening up for more social segmentation.¹³

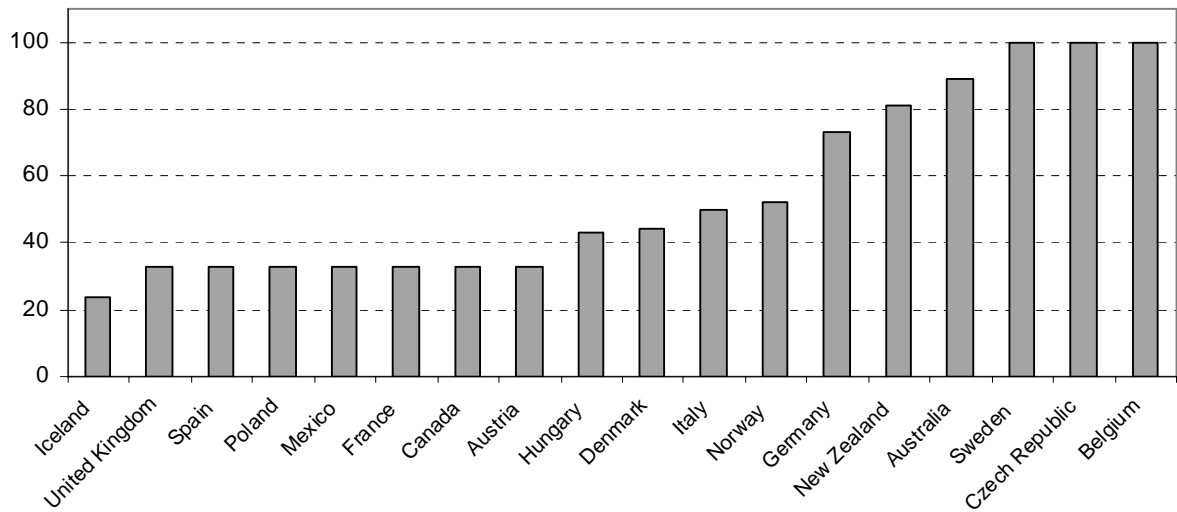
Providing information to consumers and providers on quality and cost is an alternative means to impose competitive pressures on social services providers. By allowing comparisons to be made across providers of similar services, benchmarking can put consumers, providers and the government in a better position to make informed decisions. It can also create incentives for providers to improve their performance, in particular if combined with free user choice and supportive funding arrangements (*i.e.* money-follows-the-user principle or performance-based funding). But publication of results may have some drawbacks. In the case of school results, for example, it may lead privileged families to shun schools with a “worse” intake by making parents more aware of the variations in the social and academic profiles of students. Moreover, as valid performance measures are not easy to design, providing performance information may risk guiding providers to focus efforts for improvement only on those aspects that can be easily measured.

While a clear case may exist for the government to ensure equal access to key social services, this does not require the government to be the only provider of these services. Relaxing entry restrictions for private providers may help strengthen competition, in particular when combined with free user choice and non-discriminatory funding arrangements. Several studies have documented positive effects of user choice and competition on performance in primary and secondary education, childcare and long-term care (Lundsgaard, 2002). The performance of public schools has, for instance, been found to improve when exposed to competition, while a positive impact in terms of greater flexibility and lower costs have been identified in long-term care. However, to be effective, funding arrangements need to provide for variations in delivery costs across user groups. This could also reduce the scope for “cream-skimming”, *i.e.* that some providers are able to make a profit or provide higher service standards by attracting individuals that are less costly.

Subcontracting and competitive tendering may further enhance efficiency in the provision of social services, and in particular the production of intermediate inputs, by exploiting economies of scale and specialisation. Indeed, empirical studies generally find that competitive tendering results in lower costs than under uncontested public provision. Contracting out, however, also implies costs, especially when the output being purchased is complex and may entail the risk of cost overruns, which may be borne by the public sector, if the contractor fails to deliver or threatens to go into bankruptcy.

Measuring the extent of competition and efficiency in social service industries are fraught with problems. Available information suggests, however, significant cross-country variations. The extent of free user choice seems, for instance, to vary considerably among countries (see Figure 3.15), despite being an important policy objective in a number of countries over the past decade.¹⁴

-
13. In countries with a private and competitive market in employment services (including Australia and the Netherlands), the degree of free choice is often limited for the unemployed. This is to alleviate the risk that the unemployed choose providers that impose few requirements on *e.g.* job search. Service providers may also have stronger incentives to provide adequate training to clients if they stay long term with the same provider (Grubb, 2003).
 14. Benchmarking has been frequently used in all OECD member countries to identify best practices and inefficiencies in a wide range of social services, including hospitals, education institutions, employment services and prisons. However, no cross-country information about their overall application is easily available.

Figure 3.15. The extent of free choice of government-financed services¹

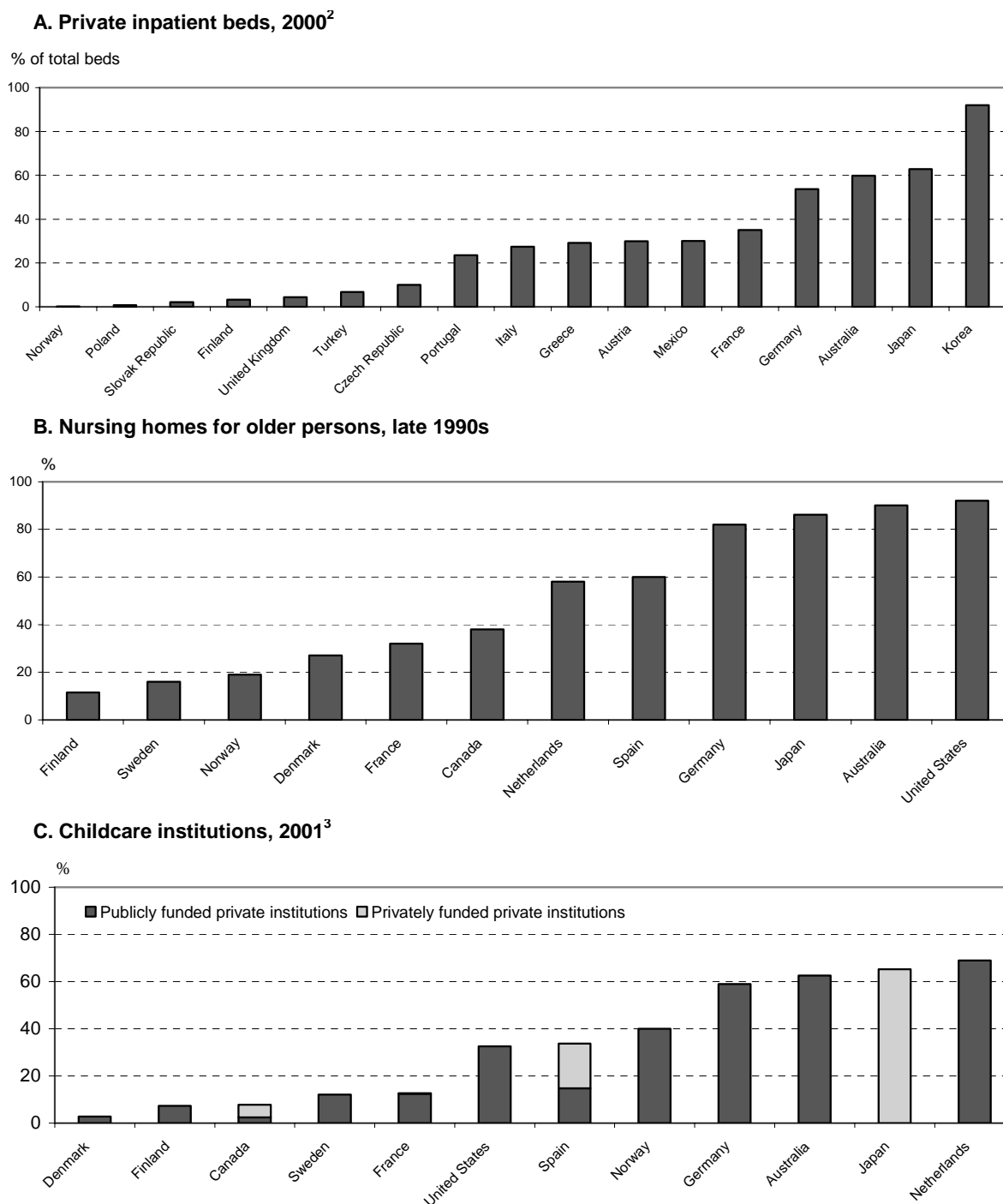
Note: 1. The index shows a relative scale where the countries with the most freedom of choice have index=100; this does not mean that they have free choice for all services. The index reflects the extent of free choice in hospitals, dentists, general practitioners, nursing homes, kindergartens and home help, as reported in questionnaires by consumer authorities in the various countries.

Source: OECD (2005), *OECD Economic Surveys: Denmark*, OECD, Paris.

Similarly, the market share of private providers varies considerably in important social service markets:

- In hospital care, the share of private inpatient beds varies from close to zero in Norway and Poland to 60% in Australia and Japan and more than 90% in Korea (see Figure 3.16, Panel A).
- In elderly care, OECD member countries are found all along the spectrum from predominantly private providers in countries like Australia, Germany, Japan and the United States to predominantly public providers in the Nordic countries (see Figure 3.16, Panel B).
- In childcare, the share of private institutions range from less than 5% in Denmark and 10% in Finland to more than 60% in Australia, Japan and the Netherlands (see Figure 3.16, Panel C). Independent private institutions – *i.e.* private institutions that are financed mainly by household payments – are, however, rare except in Japan and Spain.
- In upper secondary education, the share of students enrolled in private institutions varies from a few percent in Ireland, Sweden and Turkey to close to 75% in the United Kingdom and more than 90% in the Netherlands (see Figure 3.16, Panel D). Independent private institutions are mainly found in Japan, Mexico, Portugal and Spain.

Figure 3.16. Private providers: market shares in selected services¹

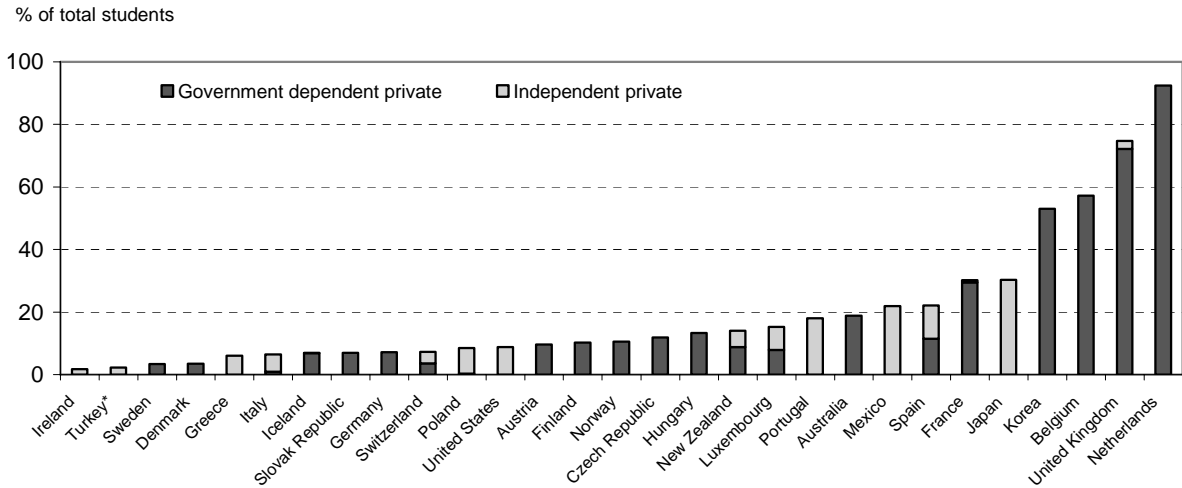


Notes: 1. Private institutions include both non-profit institutions and private firms.
 2. 1999 in the case of Australia, Greece, Italy, Portugal and the United Kingdom.
 3. Includes pre-primary education and organised centre-based programmes designed to foster learning and emotional and social development in children from three years to compulsory school age. For Australia, Germany and Norway some of the private institutions may be predominantly privately funded, but the available data cannot determine the exact share of private and public funding for private institutions.

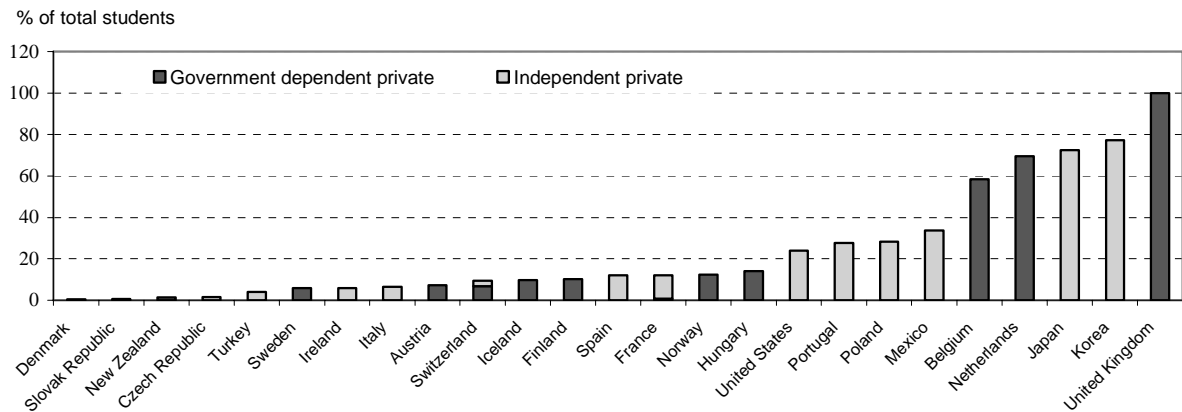
Source: OECD Health Database, 2002; OECD Education Database, 2004; OECD (2004), *OECD Economic Surveys: Finland*, OECD, Paris.

Figure 3.16. **Private providers: market shares in selected services¹** (continued)

D. Students enrolled in private institutions: upper secondary education, 2002



E. Students enrolled in private institutions: tertiary education, 2002²



- Notes:
1. Based on the number of users in each type of institution. Private institutions include both non-profit institutions and private firms.
 2. Includes largely theory-based programmes that are designed to provide sufficient qualifications for entry to advanced research programmes and professions with high-skill requirements, such as medicine, dentistry or architecture. Usually includes both Bachelor and Masters degrees and their equivalents.

Source: OECD Health Database, 2002; OECD Education Database, 2004; OECD (2004), *OECD Economic Surveys: Finland*, OECD, Paris.

- In tertiary education, the share of students enrolled in private institutions ranges from close to zero in Denmark and the Slovak Republic to close to 80% in Korea and 100% in the United Kingdom (see Figure 3.16, Panel E). Independent private institutions are in general more common in tertiary education than in childcare and upper-secondary education, and represent a particularly large share of the market in Japan and Korea.
- In core employment services, Australia and the Netherlands established a fully private market in the late 1990s (Grubb, 2003). In many other countries, core employment services are delivered by a sole public provider.

- The extent of subcontracting and competitive tendering in public procurement differs also widely across countries. Within the European Union, the share of public procurement openly advertised for tender varied from around 3% in Germany to 12% in Greece in 2002 (OECD, 2005b).

The significant cross-country variations documented above, even among countries that share similar social norms and preferences, suggest that these differences do not reflect equity or other legitimate concerns but to a larger extent is rooted in history. In this respect, the findings above suggest a significant scope for more experimentation in the use of market mechanisms and competition in social services in several OECD member countries.

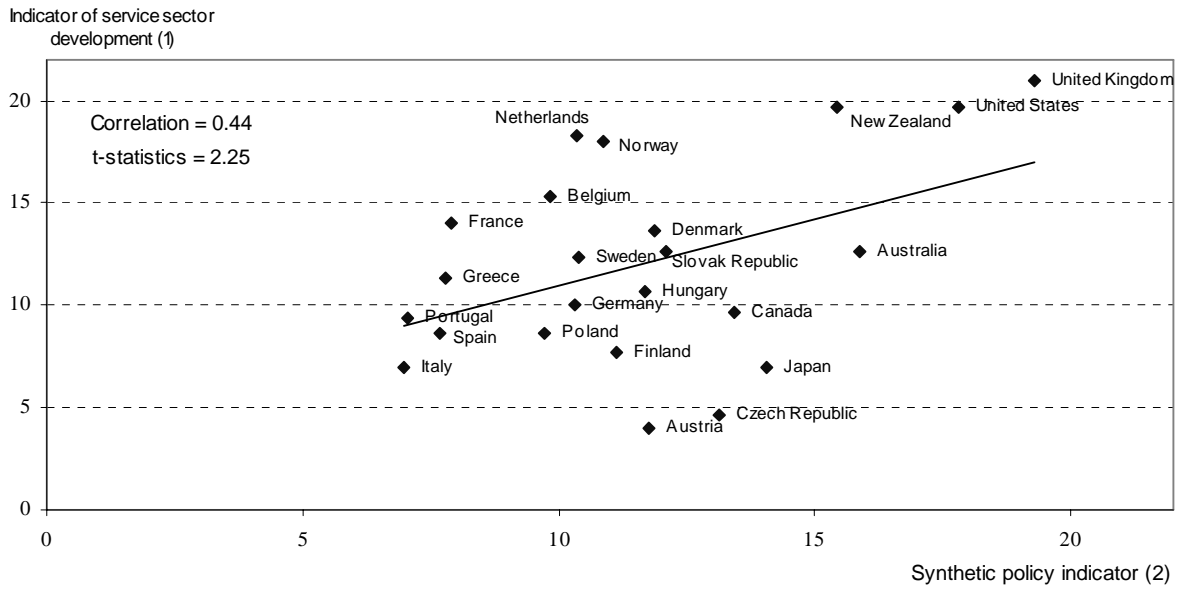
Policy settings and performance: concluding remarks

The section on sectoral reallocation, economic performance and cross-country adjustment capacities earlier in this chapter developed a set of indicators for the capacity of countries to foster the service sector. Based on these indicators, a simple cross-country summary indicator can be constructed by taking the average country rank of the individual indicators. Countries' policy settings can in a similar way be summarised as the average country rank on the policy indicators presented in the section on policies to facilitate adjustment in labour markets and the section on removing barriers to competition and growth in service markets. The following eight policy areas are included: replacement rates in unemployment benefit systems, employment protection legislation, wage-setting systems, education and training indicators, labour taxes, anti-competitive regulations in services and barriers to trade and investment.¹⁵ However, as noted in section on sectoral reallocation, economic performance and cross-country adjustment capacities, such summary indicators are imperfect and need to be interpreted with caution. They are all based on an element of judgement and are constrained by data availability, implying that important aspects might be missing. Moreover, they are all calculated as a simple average of countries' rankings based on a number of sub-indicators, *i.e.* with no attempt to weight their relative importance.

A positive association can be identified between the policy indicator and the indicator for service sector developments (see Figure 3.17). A few countries with a policy setting supposed to be favourable to structural change stand-out with comparatively large income-adjusted service sectors (including New Zealand, the United Kingdom and the United States). At the other end of the spectrum, some countries with a relatively poor ranking on the policy indicator tend to have a less developed service sector (Italy, Portugal and Spain). However, significant differences exist between countries with roughly similar overall policy settings.

15. See Kongsrud and Wanner (2005) for more details on the construction of the synthetic policy indicator.

Figure 3.17. Policy settings and countries' capacities to foster the service sector
Average country score



- Notes:
1. A high value indicates a relatively large service sector.
 2. A high value indicates a policy setting seen as favourable to structural change.

Source: Kongsrud and Wanner (2005), "The Impact of Structural Policies on Trade-Related Adjustments and the Shift to Services", *Economics Department Working Papers*, No. 427, OECD, Paris.

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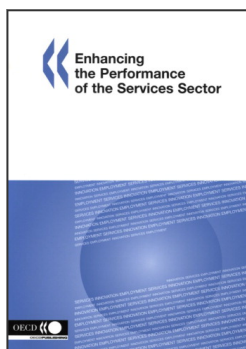
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