TRADE AND STRUCTURAL ADJUSTMENT

OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Executive Summary

International competition, accelerating technological change and shifting societal concerns are important drivers of structural change, both within and across firms, industries and regions. As well as bringing undoubted opportunities, structural adjustment raises acute challenges. This must be acknowledged in making the case for open markets.

This brochure aims to identify, for both developed and developing countries, the requirements for successful trade-related structural adjustment via the reallocation of labour and capital to more efficient uses, while limiting adjustment costs for individuals, communities and society as a whole. It draws on a longer study incorporating detailed sectoral case studies.

The adjustment challenge is highly differentiated. For example, strong impacts on individuals may translate into modest economy-wide effects. The frequently cited 55 000 jobs estimated to be lost quarterly in the United States because of the international sourcing of services is small in comparison to the more than 7 million jobs destroyed on average every quarter as a result of the normal functioning of the US labour market. Moreover, while structural change in employment patterns within the OECD service sector has been stable over the past two decades, labour adjustments between agriculture, manufacturing and services have actually declined in OECD economies.

The adjustment challenge faced by developing countries differs both in nature and extent from that faced by the advanced industrialised economies. So therefore does the required policy mix and the ability to implement policies. This differentiation is important. It does not deny, however, that key elements of the policy framework are found to be broadly applicable across countries, albeit with differing degrees of emphasis. This means adopting:

- Macroeconomic policies that promote stability and growth.
- Labour market policies that help develop workers' skills and facilitate labour mobility across occupations, firms, industries and regions while providing adequate assistance to those who experience adjustment costs as a result of structural change.
- An efficient framework of regulation that achieves regulatory objectives while keeping regulatory burdens on enterprises to the necessary minimum, fosters competition and helps ensure genuine market openness.
- An institutional and governance framework that will favour structural reform, while enhancing social dialogue and public understanding and acceptance of reform measures.
- Liberal trade and investment policies that support structural adjustment by contributing to growth, innovation and competitiveness and are implemented gradually enough to enable affected parties to adapt and quickly enough to avoid policy reversal. Because of downstream linkages, particular benefits are likely to arise from the liberalisation of trade in services; if account is taken of services barriers, the effective rate of protection

for some agricultural and manufacturing industries actually turns negative, meaning that services barriers contribute to effective taxation, rather than protection, of these industries.

Within this broad menu, this will mean, for the poorest countries in particular, building sound institutions, fostering an appropriate macroeconomic framework and removing any anti-export bias, improving firms' access to finance and infrastructure, enforcing core workers' rights and developing human capital and reducing their own, often high, barriers to trade. Opportunities may be sought for a joint package of tariff and tax reform which does not compromise government revenue.

Governments are strongly encouraged to pursue reform across different policy areas in a complementary way: to promote acceptance of change, by helping ensure that those disadvantaged by one reform benefit from another, and to foster synergies between policies. The key to successful structural adjustment lies less in individual policies themselves than in the way policies interact; the benefits of a liberal trade regime, for example, will only be fully realised in an economy with appropriate macroeconomic policies, efficient labour markets and a regulatory environment so as to facilitate the entry and exit of firms, and an education system that enables skills to match evolving needs. While this will mean pursuing policy reforms in parallel, there may be occasions when a particular sequence of reforms is called for. However, there is no blueprint for sequencing.

Governments are also encouraged to rely, as much as possible, on generally applicable measures to address adjustment costs, including through the tax and social security system, for reasons both of equity and efficiency. In some cases, however, targeted measures may prove effective for addressing certain aspects of the adjustment process, for example to correct for market failure or to address political economy concerns; but when used, these measures should be transparent, cost-effective and compatible with general safety net arrangements. Should it be considered necessary, for example, to use safeguard measures, it should be on the basis that their potential benefit in providing breathing space for – and public acceptance of – structural adjustment exceeds the costs they entail.

While appropriate policies adopted at the national level are, for all countries, at the heart of a successful adjustment process, bilateral, regional and multilateral co-operation play an important complementary role. Multilateral action is of particular importance in promoting the mutual interests of trade liberalisation, locking in domestic reform and building mutual confidence between enterprises and the societies in which they operate. Multilateral efforts – including through the Doha Development Agenda, the work of the international financial institutions, donor co-ordination and greater efforts to improve compliance with ILO core labour standards – are also an essential ingredient in addressing the multiple adjustment challenges facing developing countries, particularly the most vulnerable among them. Careful attention needs to be devoted to those, relatively few, countries for which preference erosion causes a net welfare loss (ranging up to –0.4% on a per capita basis) from trade liberalisation. Continuing concerted efforts will be needed to improve the supply-side capacities of the poorest countries, to diversify their economic activity and to build sound institutions so that they can begin to avail themselves of the full range of policy options identified in this study, some of which, such as certain labour market policies, are currently beyond their reach.

Introduction: an Evolving Context

The aim of this study is to identify the requirements for successful adjustment

This brochure aims to identify, for both developed and developing countries, the requirements for successful trade-related structural adjustment via the reallocation of labour and capital to more efficient uses, while limiting adjustment costs for individuals, communities and society as a whole. It is based on a longer study which incorporates detailed sectoral case studies.

With the emergence of new competitors in international markets, accelerating technological change and shifting societal concerns – *the drivers of structural adjustment* – the global context is radically different from that of over a quarter of a century ago when OECD Ministers stressed the need to promote "adjustment to new conditions, relying as much as possible on market forces to encourage mobility of labour and capital to their most productive uses" ("Policies for Adjustment: Some General Orientations" [Council Communiqué of 15 June 1978]). While open markets are seen to be a vital complement to effective adjustment (see Box 1), the intensification of public concerns about globalisation, including the effects on the environment, means that making the case for freer trade now requires greater attention to the costs that liberalisation may entail, costs that may be more acute for workers than for the firms or industries in which they work.

Box 1. **Trade and the adjustment process**

The relationship between trade and the adjustment process has many dimensions. While trade policy can be a trigger for adjustment – as the phase-out of the Multi-Fibre Arrangement (MFA) undoubtedly is – it can also be a brake on adjustment: as we see the persistence of trade policy distortions in agriculture or with restrictive rules of origin in sensitive sectors such as motor vehicles. But trade and trade capacity building can also be an integral part of the adjustment process, itself. We see this, for example, in the way in which the international sourcing of IT and business process services offers significant labour cost arbitrage, enabling companies in international maturing markets to pursue cost-cutting strategies. Most importantly, open and competitive markets make the economy more resilient to shocks and encourage job creation.

Freer trade and investment can lead to firm closures and job losses in some sectors, while creating new opportunities in others. The adjustment costs resulting from job displacement reduce the short-term efficiency gains from structural changes and place the burden on a narrow segment of the population, raising equity concerns and potentially eroding political support for trade liberalisation and, more generally, efficiency-enhancing structural change.

Nonetheless, the process of transferring resources to more productive uses has been an important driver of sustained growth and higher living standards. The policy challenge is therefore to facilitate reallocation so as to take advantage of new possibilities, while at the same time limiting adjustment costs for individuals, communities and society as a whole. By this standard, successful countries would not necessarily be characterised by stable sectoral patterns of production and employment or by the presence of particular industries. Instead, they would be characterised by their capacity to manage structural change without experiencing long-lasting increases in unemployment and/or inactivity rates among working-age persons, while at the same time improving living standards as resources move into new and expanding areas.

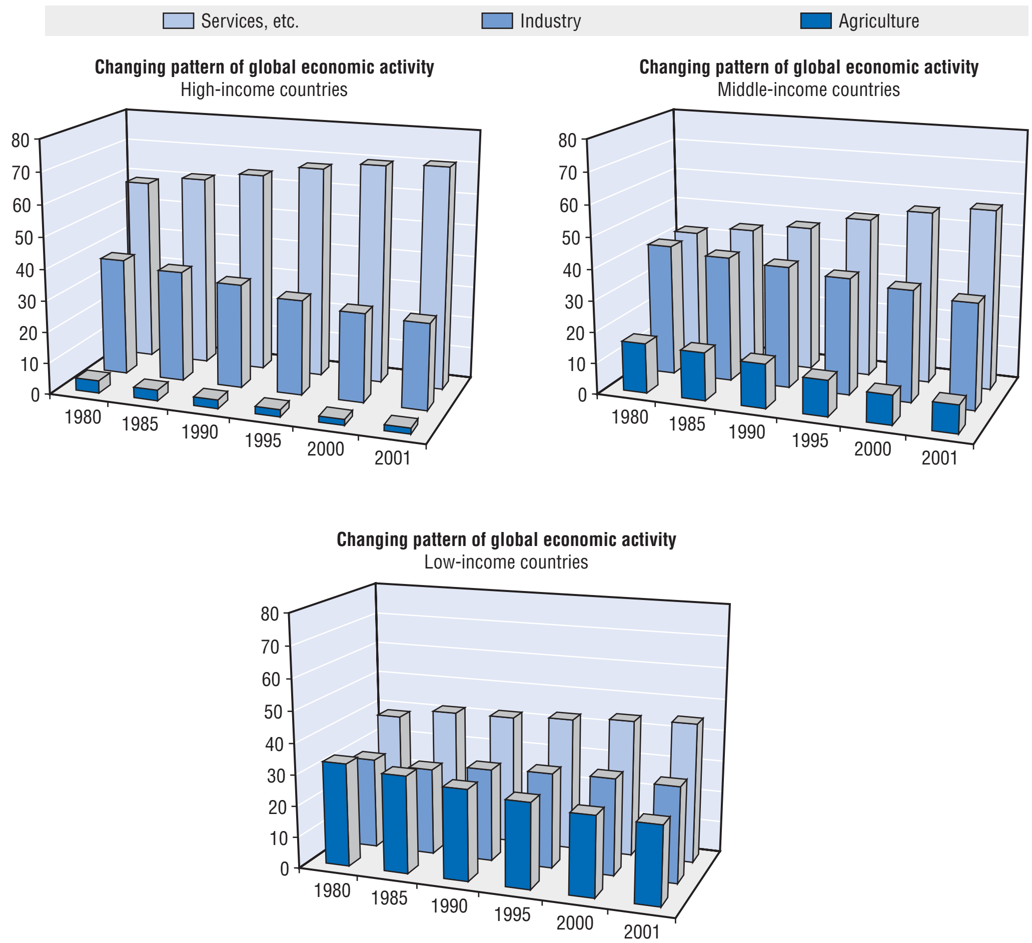
The transfer of resources to more productive uses has been an important driver behind sustained growth and increased living standards

One clear pattern over time, and an important frame of reference for this study, is the marked shift in the structure of global economic activity that has occurred in the past 20 years.

There has been a marked shift in the structure of economic activity to services for all country groupings

Figure 1. **The changing pattern of global economic activity**

% of GDP



Source: World Bank (2004), *World Development Indicators*.

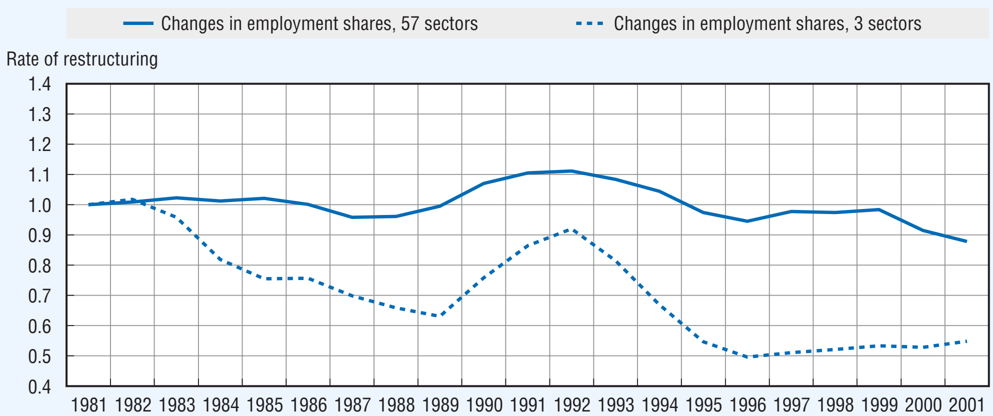
As Figure 1 shows, services have assumed increased importance in all country groupings, accounting for very large shares of GDP in high-income OECD countries (71%), middle-income (57%) and low-income countries (45%). In high-income and middle-income countries, the rise in the share of services has been achieved at the expense of both agriculture and industry. In low-income countries too agriculture's share of GDP has fallen, though industry's share has risen slightly. Exposing domestic service providers to foreign competition tends to contribute to a deepening of service intensity in the economy. At the same time, as service industries in OECD economies become more exposed to international competition, the trend whereby the transfer of resources is less from manufacturing to services than from one service activity to another, such that the overall rate of structural change is not increased, is likely to strengthen (see Box 2). While the growth in service activity is clear, there is, as pointed out in the Ministerial paper on *Growth in Services – Fostering Employment, Productivity and Innovation*, scope for services to make an even greater contribution.

Box 2. **The rate of structural change has not increased**

The rate of structural change cannot be easily measured, as it involves changes within as well as between firms, industries and regions. Available indicators suggest, however, that the rate of change has not increased in the OECD area. Developments in sectoral employment shares suggest, for instance, that the rate of change has been fairly stable over the past two decades (see figure below). At the same time, labour adjustments between agriculture (and other primary industries), manufacturing and services have declined. This indicates that structural changes in employment patterns take place to an increasing extent between broad industries within the service sector, as shifts of employment from goods-producing sectors to services have tapered off. As new service industries and categories of employees become exposed to international competition, this pattern is likely to persist.

The rate of change in sectoral employment patterns[1]

OECD average, three-year moving average, index 1981 = 1



Notes: The rate of restructuring is calculated as: 0.5 i (Ni, t – Ni, t – 1), where Ni, t denotes the share of sector i in total employment at time t. An unchanged employment pattern returns an indicator value of zero. The indicator is calculated for three sectors (primary, secondary and tertiary industries) and 57 sectors (dividing services into 55 sectors).

Simple average of 20 OECD countries.

1. Such simple indicators are, however, subject to certain limitations. They are, for instance, sensitive to the chosen aggregation level, and pick up the relative expansion and contraction of sectors over the business cycle.

Source: The OECD STAN database for Industrial analysis and Groningen Growth and Development Centre Database.

The adjustment challenge differs across industries, worker groups and countries

The nature of the adjustment challenge is highly differentiated:

- It differs from one sector to another, for example between agriculture, where employment is declining, and health services, where it is expanding and where the demographics of ageing create a particularly acute adjustment challenge.
- It differs between different groups in society: producers, consumers and taxpayers are likely to have diverging short-term interests as they may be affected differently by the adjustment process. And, as for the international sourcing of services, strong impacts on individuals may translate into modest economy-wide effects (see Box 3).

Box 3. **Globalisation of services and job losses in the service sector**

Even though there are no official statistics measuring the extent of international sourcing of services, 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 an increased supply of highly skilled workers in several developing countries. In principle, the range of services that can potentially be traded 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.

Current estimates, which are subject to significant uncertainty, indicate that international sourcing 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, 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 Germany, France and Italy are experiencing even more moderate movements of service jobs abroad.
- Although some job displacement will occur owing to international sourcing, the net impact on employment possibilities and real wages may 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 international sourcing are repositioned within the firm. Moreover, by raising productivity and profitability, international sourcing of certain tasks can secure other domestic jobs.
- Jobs are also moving in both directions, as firms in developing countries invest in the OECD area, although not necessarily for production of intermediate input for export. Significant international sourcing of services also takes place within the OECD area. As a consequence, several OECD countries have actually experienced a net inflow of service jobs in recent years.

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

- The nature of the adjustment challenge may differ between countries, depending on their levels of development. Two specific trade-related adjustment challenges facing developing countries are preference erosion and revenue loss. Underlying these and other concerns is a broader vulnerability which may arise because of formerly high levels of protection and low levels of productivity and technological sophistication. Limited fiscal capacities, poor safety nets, inadequate infrastructure, weak intellectual property rights, and poor governance often compound these challenges.

Promoting Good Practice

A common set of underlying principles of good practice is widely applicable

Notwithstanding the differentiated nature of the adjustment challenge, the sectoral case studies and peer reviews on which this brochure is based suggest that a common set of underlying principles of good practice permeate all sectors and tend to be widely applicable across countries, albeit with differing degrees of emphasis. For OECD economies, the policy challenge relates in particular to reforms in structural policies affecting the functioning of labour and product markets, while also providing effective income support and re-employment services to job losers. For poorer developing countries, the policy mix will need to direct particular attention to fostering an appropriate macroeconomic framework, improving access to finance, developing human capital, strengthening infrastructure services and reducing their own often high barriers to trade. Above all, the poorest countries will require concerted efforts to improve supply-side capacities, to diversify economic activity and to build sound institutions so that these countries can begin to avail themselves of the full range of policy options identified here, some of which, like those related to active labour market programmes, may presently be beyond their reach.

Reliance on generally available measures to address adjustment costs

Generally available adjustment measures should be preferred

A major policy message is that reliance on generally available measures, including through the social security and tax system, can help improve the benefits from openness while reducing adjustment strains. Targeted adjustment measures can, however, be useful in some cases, such as when structural decline in a particular sector causes geographically concentrated job losses beyond what existing labour market programmes can handle. Targeted programmes can be motivated either by economic efficiency arguments or by political economy considerations; they may be the price to pay for getting reforms enacted, as the benefits of structural change are usually dispersed throughout the community while adjustment pressures are typically concentrated on a relatively small group.

Identifying market failure can be hard, and potential gains must be weighed against the costs of targeted programmes

Targeted sector – specific measures are common, whether to help textiles and clothing producers in Australia to be competitive in a low-tariff environment or to cope with mass layoffs in Sweden's Östergötland county. In many cases, assistance has been given to address market failure, such as that associated with the undersupply of investment in R&D, because of fears that resulting innovations will be appropriated by new entrants. Overall, however, targeted schemes appear to have had rather mixed success in facilitating adjustment. Indeed, the problem with targeting, more broadly, is that market failure can be hard to identify and sector-specific trade-related assistance or compensation is fraught with difficulties:

- *Creating precedents:* The introduction of an adjustment programme may be seen as creating a precedent that will trigger others to lobby for similar compensation for a wide range of other shocks.
- *Incentive effects:* Enhancing opportunities for workers to move to expanding sectors and areas with better employment opportunities is nearly always a key to successful adjustment. Approaches that are targeted on "declining" sectors and areas risk perpetuating the adjustment problem.
- *Institutional inertia:* Once started, compensatory programmes are politically extremely difficult to stop.
- *Equity:* Trade displacement *per se* confers no special claim to preferential treatment. Moreover, it may be difficult to determine whether trade, as opposed to changing global tastes or firms' poor productivity, for example, in fact accounted for specific job losses.
- *Efficiency of public expenditure and revenue:* It needs to be clear that the introduction of a trade compensation programme will be more effective than any other use of public funds. Increased expenditure for adjustment programmes must be paid out of increased revenue, the collection of which through taxation creates additional distortions.

With care, problems of targeted assistance can be minimised

Should governments consider it necessary to target assistance in particular cases, experience suggests that problems of both equity and efficiency will be minimised to the extent that such assistance is:

- Time-bound, with a clear exit strategy.
- Decoupled from production.
- Aimed at re-employing displaced workers.
- Compatible with general safety net arrangements.
- Cost-effective.
- Transparent and accountable.

The enabling environment: A sound macroeconomic framework

Promoting macroeconomic stability can foster an adjustment-enabling environment

At the broadest level, structural adjustment will be facilitated if government policies create an enabling environment through the promotion of macroeconomic stability and growth. As shown in the OECD *Growth Study*, macroeconomic stability contributes to a dynamic economy, which in turn is likely to make adjustment easier and swifter. Macroeconomic disequilibria, such as excessive inflation and high budget deficits, have in the past come at the cost of lower economic growth. In the present project, several case studies highlight the importance of complementarity between macroeconomic policy and trade policy and the crucial role of government in creating an enabling environment for successful structural adjustment, notably illustrated by the case study on reform of New Zealand agriculture. In line with this insight, most OECD countries have adopted stability-oriented macroeconomic policies over the past couple of decades.

For many developing countries, securing macroeconomic stability through sound fiscal and monetary policies, removing an anti-export bias and adopting an appropriate exchange rate policy played a key role in their initial efforts to take an outward-oriented growth path and restructure their economies. In particular, a sound macroeconomic framework helped foster well-functioning financial markets and access to credit by firms, particularly small and medium-sized enterprises, though in many African countries access to finance remains a serious bottleneck to flexible responses in the area of trade. The complementarity of a sound macroeconomic framework and trade policy reform is illustrated by the use of tax policy in compensating for tariff revenue loss resulting from trade liberalisation.

Sound labour market policies – insights from the experience of OECD member countries

The labour market is key to the adjustment process

Ensuring a smooth transfer of labour resources across occupations, firms, sectors and regions is a particularly challenging part of the structural adjustment process. OECD countries have had mixed success in the past and periods of intense structural change sometimes have resulted in long-lasting increases in unemployment or large-scale recourse to early retirement. In other cases, workers displaced from declining sectors have had to accept large wage losses in order to become re-employed. However, the size of the adjustment costs borne by adversely affected workers – and the efficiency with which labour is reallocated more generally – depend, to a large extent, on the functioning of the labour market. A number of policies can enhance the adjustment capacity of labour markets.

Unemployment benefit systems should promote work incentives while providing adequate income support

Unemployment benefits help cushion the cost of adjustment for the affected individuals and subsidise productive job search, but they should be structured in a way that fosters re-employment. A number of strategies are available in this respect, although the tension between providing adequate benefits and encouraging rapid re-employment cannot be totally escaped. In particular, excessively high benefit levels should be avoided and effective measures should be in place to "activate" benefit recipients, for example, by requiring the unemployed to collaborate with case managers in developing a reintegration plan. Re-employment bonuses and wage insurance are being experimented in some countries to increase the financial incentives to find a new job promptly or to provide some compensation for long-term reductions in earnings. Finally, targeted employment subsidies represent an alternative fiscal mechanism encouraging re-employment.

Active labour market programmes can facilitate re-employment

Active labour market programmes (ALMPs) – including job-search assistance, counselling, training, moving allowances and other re-employment services – are the policy instrument that can serve most directly to support re-employment of displaced workers. For example, reintegration can be facilitated if job-search counsellors help job losers to make a realistic assessment of their labour market opportunities or steer displaced workers possessing obsolete skills into retraining programmes. Similarly, where trade-related structural change has suppressed local demand for labour, employment services with a broad geographic scope can help to match job losers with vacancies in areas where employment is more buoyant. In organising effective responses to large-scale layoffs, tripartite co-operation between management, workers' representatives and government have also proven useful (where consistent with national practice). To the extent that such interventions are effective, they can both reduce the efficiency costs resulting from structural adjustment and also address adjustment costs for affected individuals. It is, however, essential to monitor and evaluate these policies in order to ensure that they are effective. ALMPs should not be used as a substitute for general labour-market reforms.

A general principle in best practice for ALMPs is that programmes should respond to individuals' needs. This raises the question of whether workers displaced by trade require a different mix of treatments than other clients of ALMPs. Recent experience suggests that workers displaced from jobs in declining import-competing sectors are likely to possess obsolete skills for which little demand exists in expanding industries. This means that job-search assistance may need to be complemented by training or targeted employment subsidies more often than is necessary for the average unemployed person. Nonetheless, it should not be assumed that retraining or employment subsidies are appropriate in most cases. Even in declining industries, there can be considerable hiring. Hence, older workers whose skills are highly specialised and linked to those required in their previous industry should sometimes be assisted to locate vacancies in their prior industry, where their productivity and earnings will be higher.

Employment protection should not hamper firms' ability to adjust and workers' incentives to change employer

Overly strict employment protection legislation (EPL) may slow down the adjustment process by constraining firms' ability to cope with a rapidly changing environment. OECD research has also shown that too-strict employment protection may impede firm creation and the ability of successful start-ups to expand rapidly, applying a brake to the types of entrepreneurial response that appear to be essential to realising the full benefits from structural change. Moreover, strict EPL may slow adjustments to imbalances in the labour market since incentives for workers to change employer are likely to be negatively affected. For displaced and unemployed workers, strict EPL may imply a lower likelihood of re-employment and longer unemployment spells as firms' hiring incentives are reduced.

However, a certain degree of employment protection, like advance notification of plant closure or other large-scale layoffs, may reduce adjustment costs by providing all interested parties with time to plan and implement the necessary adjustments. Reasonable advance notice is often a prerequisite for social dialogue and co-operation between the firm, its workers and public employment services in preparing for imminent job losses. It is also possible to ensure workers' compensation against dismissal, while at the same time reducing some of the drawbacks of traditional severance pay systems. For instance, Austria has recently replaced its traditional dismissal compensation system with individual severance accounts that workers can carry with them in the event of changing jobs – thus facilitating the mobility that is so important in the face of structural change.

Wage-setting systems need to be sufficiently flexible

Flexibility in relative wages is necessary to provide adequate price signals during periods of structural change. The capacity of various bargaining systems to provide efficient wage structures across occupations, industries and regions may differ, however, with centralised systems sometimes associated with more rigid relative wage structures than decentralised ones. Firms' wage-setting practices and non-portability of pension rights may also discourage workers from changing employer. In some countries, the wage formula includes the number of years worked in the firm, thus significantly reducing the incentives for long-tenured workers to move. Similarly, defined-benefit pension schemes are not always fully portable from one employer to another, thereby inhibiting mobility. Sometimes, workers may lose all their pension rights if they leave the employer.

Housing policies should not hamper regional mobility

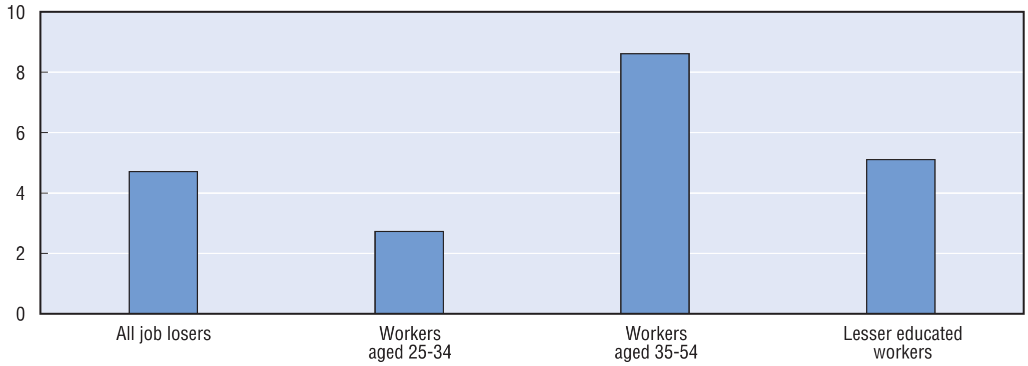
High transaction costs on property and rigidities in the rental housing sector can seriously impede labour mobility. For owner-occupiers, in some countries, the incentive for regional mobility is distorted by high transaction costs, sometimes amounting to more than 10% of the property value, and tax privileges that are only available after lengthy residence periods. Changing residence is usually associated with much lower transaction costs for tenants than for owner-occupiers. The mobility of tenants may, however, be hampered by other market inefficiencies. For instance, long waiting lists for locally provided social housing or rent controls for certain accommodations create a segmented market in some countries. Tenants with housing costs far below the market price may have few incentives to move, even when work opportunities are considerably better in other regions. Inefficiencies in the rental market may also impede the mobility of owner-occupiers by making it more cumbersome, and possibly more costly, to accept temporary work in another region.

Education and training systems should facilitate labour mobility and meet evolving skill needs

Ensuring a workforce with adequate and adaptable skills is key to facilitating structural adjustments and, in the longer run, will support growth in productivity and real earnings. This is particularly true since changes in the job mix and production technologies both imply rising skill requirements. Highly skilled workers also tend to have relatively high job-to-job transition rates, and are more mobile across occupations, industries and regions. Moreover, highly educated workers and workers receiving in-house vocational training face less risk of layoff than their less educated and non-trained counterparts, probably because they have a greater capacity to take on new tasks. In the event of a layoff, workers who received training on their prior job also find a new job more quickly (Figure 2). To ensure that labour skills meet the evolving needs of the labour market, appropriate incentives should be provided for employers and employees to invest more in training, while the scope for competition in higher education could be increased.

Figure 2. **Training increases the probability of re-employment after job loss**

Changes in the probability of re-employment as a result of training received prior to being laid off[1] (percentage points)



1. OECD calculations based on the European Community Household Panel, waves 1 to 7 (1994-2000) for Austria, Belgium, Denmark, Finland, Germany, Italy, Ireland, the Netherlands, Portugal and Spain.

Source: OECD *Employment Outlook*, 2004.

Enhancing product market competition, regulatory reform and institution building

Enhancing product market competition strengthens an economy's capacity to adjust

Flexible and competitive product markets have been found to facilitate structural adjustment by encouraging efficiency, innovation and job creation. In particular, efficient regulation that achieves stated objectives, keeps regulatory burdens on enterprises to the necessary minimum, fosters competition and ensures genuine market openness will enable firms to engage effectively in the process of structural adjustment, whether through transformation within industries or through entry and exit across sectors. The case studies underline the importance of the regulatory environment, such as the reduction of regulatory diversity in Mexican avocado production, the regulatory reform of the agro-food sector in Chile, or reduced barriers to private capital participation in Japan's health sector.

More generally, anti-competitive product market regulations may effectively hold back countries' capacity to take advantage of new possibilities, arising, for example, from trade liberalisation or technological advances, to create more jobs and raise overall welfare. As in the case of labour markets, product market regulation that is overly complicated or unnecessarily restrictive comes with significant economic costs in terms of higher prices, lower employment and less innovation. This may be particularly felt in industries characterised by small firms or high entry and exit rates, like the business services sector. Inefficiencies in financial markets and distortions created by tax codes may reinforce obstacles to entry and growth by raising capital costs for such firms. Service industries, such as transport, professional services and retail trade, are also subject to heavy sector-specific regulations in many OECD countries, with potentially detrimental effects on productivity and employment.

In this light, OECD governments have been reviewing and updating their regulatory environment to ensure that regulations achieve their objectives without putting unnecessary constraints on competition. It remains a serious challenge to reduce the core set of regulations which in most countries unduly stifle product market competition.

A sound regulatory environment calls for practices that improve regulatory design and implementation (transparency, regulatory impact analyses, consideration of alternatives, administrative simplification, administrative and judicial review). The efficient functioning of institutions involved in the making and implementation of regulations is also crucial.

Efficient regulation can foster market openness

OECD work has identified six principles of efficient regulation which respect the diversity of national preferences and regulatory objectives while fostering market openness: transparency of regulations and openness of regulatory decision making; non-discrimination; avoidance of unnecessary trade restrictiveness of regulations; use of internationally harmonised measures or standards; streamlined conformity assessment procedures; and vigorous application of competition principles.

The institutional and governance process of structural adjustment is equally important

The institutional and governance process of structural adjustment is also of particular importance and includes:

- Effective policy evaluation, including analysis of whether a proposed structural reform is in the overall interests of the community.
- Independent review processes to enhance public understanding that benefits will outweigh costs.
- *Ex post* evaluation to help reassure the community that unanticipated adjustment difficulties will be addressed.

Liberal trade policies

Barriers to trade do not facilitate the adjustment process or eliminate the need for adjustment

Trade policy is another key element of structural adjustment, for developed and developing countries alike. As a general rule, barriers to trade are not effective in facilitating the adjustment process, or in obviating the need for adjustment. In agriculture, for example, there are deep-seated structural factors that cause the importance of agriculture in overall economic activity to decline as growth and development occur. Notably, income elasticity of demand for food tends to be less than for other commodities, and technical innovation in agriculture is labour-saving. Efforts to resist trade liberalisation will not change these underlying realities, but they will impede adjustment. Put differently, and positively, a liberal trade environment, backed by supportive action in other policy areas, is found to complement the adjustment process. At the broadest level, it does so by contributing to economic growth and thus helping to create an environment where the movement of factors of production from declining to expanding areas of activity is facilitated. Insofar as growth through trade helps the adjustment process in developing countries and contributes to increased returns to labour in those countries, it will also help ease the pressures arising from international migration.

As the case studies – which range from information technology in India, to motor vehicles in South Africa or shipbuilding in Australia (see Box 4) – make clear, the particular channels by which trade (both imports and exports) and foreign direct investment help adjustment include:.

- Fostering competitiveness and innovation.

Box 4. **Trade and trade policies: helping adjustment**

Fostering competitiveness and innovation: the Indian IT services industry

India demonstrates how openness in trade and trade policies can stimulate competitiveness and innovation. In 1991, India initiated a reform agenda to open its economy to increased trade and investment. As a result, several American and British multinationals established IT centres and back offices in India to service English-speaking markets on a global basis. Transfer of technology to establish these operations left India with a pool of IT talent which provided a basis for investment and further knowledge transfers by ethnic Indian IT professionals, particularly from the United States.

The success of the Indian IT services industry was helped by three factors that show the benefits of a liberal trade environment and supportive policies in ancillary sectors. First, the development of the industry was aided by the easing of the legacy of protectionism and state planning characteristic of the Indian regulatory environment. Second, developing without a domestic client base meant that Indian IT companies were measured by their competitiveness *vis-à-vis* established foreign providers in foreign markets and had to be efficient from the outset by adopting an innovative delivery model based on new IT technologies. Finally, the large pool of skilled labour in India and the fact that IT services companies rely disproportionately on a well-educated workforce, rather than physical infrastructure, provided natural synergies between needs and resources.

Improving access to essential inputs: South African autos

Trade policy in relation to the automobile industry in South Africa has evolved over time, moving from simple protectionism in the 1920s, to import substitution characterised by local content requirements beginning in the 1960s, and to two periods of reform and liberalisation since the 1980s.

In 1989, South African trade policy applicable to the auto industry was reformed to enhance international competition through trade liberalisation and increased access to essential inputs. The new policy of "import-export complementation" was designed to create incentives for competitiveness while removing anti-export biases created by measures originally designed to protect the domestic auto industry. The new trade policy regime did away with mandated local content requirements and substituted a system allowing auto producers to receive credits for auto components and vehicle exports that could be applied against duties on imported auto components.

These reforms enabled the auto industry to specialise in producing auto components and vehicles that were internationally competitive by facilitating the incorporation of key auto components that could not be efficiently produced domestically. Significantly, these reforms also stimulated foreign investment in domestic auto component manufacturing, which further increased the competitiveness of both the domestic auto component and vehicle industries.

Stimulating exports: Australian shipbuilding

The system of government support to the Australian shipbuilding industry, dating back to 1940, consisted of "bounties" in the form of subsidies provided to offset the higher cost of domestic ship production when compared to the cost in the United Kingdom. Applicable only to ships for domestic use, this system discouraged investment, innovation and diversification of production away from large steel-hulled vessels, which were increasingly being produced with greater technological sophistication and at a lower cost by European and East Asian shipbuilders in the 1970s. Thereafter, a series of reforms to the Australian shipbuilding subsidy regime resulted in its complete removal by 2003. The effect was a reduction in the number of people employed in the Australian shipbuilding industry by nearly half (to 7 434) between 1985 and 1996, and a three-fold increase in the output of the domestic shipbuilding industry over the same period. The vast majority of current production is now destined for export.

Box 4. **Trade and trade policies: helping adjustment** *(cont.)*

First revamped in the 1970s, the system of subsidies applied to the shipbuilding industry was recalibrated to support structural adjustment for long-term growth, export competitiveness and thus eventual phase-out. Moving away from a cost-based approach to calculating subsidy amounts, to remove disincentives for efficiency and innovation, the nominal rate of assistance was also gradually tapered down from 27.5% to 0% between the early 1980s and 2003. Building on efficiency and technological advances as criteria for receiving benefits under the new scheme and allowing exported vessels to receive benefits in 1984 focused the domestic shipbuilding industry on developing a niche in which it would be internationally competitive. The result of these polices was conversion of the domestic shipbuilding industry from one based on large steel-hulled ships, already produced more efficiently by international competitors, to technologically cutting-edge fast ferries for which there were few viable international competitors.

- Improving access to essential inputs, whether raw materials, capital goods or services.
- Stimulating exports, by offering enlarged market opportunities or encouraging synergies between countries with different areas of comparative advantage

Benefits are likely to result from the liberalisation of trade in services

In the context of the Doha Development Agenda, trade liberalisation will need to occur across all sectors, in order to maintain a balance of interests, but specific benefits are likely to result from the liberalisation of trade in services. In a framework of structural adjustment, there are three reasons for this:

- First, the potential welfare gains – and therefore the breathing space in which to adjust – are expected to be much greater from services liberalisation than from goods liberalisation, on some estimates by a factor of five.
- Second, given the dynamism of the service sector, the adjustment strains of liberalisation are likely to be more easily accommodated than those associated with liberalisation of goods.
- Third, the liberalisation of services inputs to agricultural and manufacturing production is likely to ease any adjustment strains which those sectors might face. Ongoing analysis at the OECD finds that if account is taken of services barriers, the effective rate of protection for some agricultural and manufacturing sectors actually turns negative, meaning that services barriers contribute to effective taxation, rather than protection, of these industries (Table 1).

The benefits of trade safeguards must be greater than the costs

As noted earlier, restrictions on trade are unlikely to affect the underlying structural forces that determine the role of different sectors in overall economic activity. However, in some specific cases, where serious injury is caused by large or unforeseen surges in imports, it may be felt that targeted safeguard action is warranted as part of the adjustment process. The question that needs to be answered is whether the potential benefits of safeguards in providing breathing space for – and greater public acceptance of – structural adjustment justifies the cost they entail.

Table 1. **Impact of services barriers (SB) on effective rates of protection (ERP) in manufacturing**
ERP results

	Brazil		Morocco		Romania		Thailand	
	Without SB	With SB	Without SB	With SB	Without SB	With SB	Without SB	With SB
Forestry and wood products	**(+)**	**(–)**	(+)	(+)	(–)	(–)	(+)	(+)
Chemical, rubber, plastic products	(+)	(+)	(–)	(–)	**(+)**	**(–)**	(–)	(–)
Mineral product nec	**(+)**	**(–)**	(+)	(+)	(–)	(–)	**(+)**	**(–)**
Base metals and metals	(+)	(+)	(+)	(+)	(–)	(–)	(–)	(–)
Motor vehicles	**(+)**	**(–)**	(+)	(+)	(–)	(–)	(–)	(–)
Transport equipment	(+)	(+)	(–)	(–)	(–)	(–)	(–)	(–)
Manufactures nec	(+)	(+)	**(+)**	**(–)**	**(+)**	**(–)**	(+)	(+)

nec = Not elsewhere classified.
The ERP is a measure of the protection provided to an industry by the entire structure of tariffs, taking into account the effects of tariffs on inputs as well as on outputs. These results show the increase or decrease in value added per unit in an economic activity that is made possible by the tariff structure relative to the situation in the absence of tariffs. The difference between ERPs that are calculated without considering services barriers and ERPs that take into account services barriers could be interpreted as an indication of the additional cost imposed by inefficient services barriers. In terms of services protection, the most recent estimates of barriers in telecommunications, banking, distribution, electricity, professional services and air and maritime transport were employed.
(+) refers to positive ERPs.
(–) refers to negative ERPs.

There is no hard and fast rule for the pace of trade reform. Gradual trade-related structural adjustment may be warranted when time is needed to strengthen the institutional framework. The danger with gradualism, however, is the signal it may send about the credibility of reform and the opportunity it may present for back-tracking or specific exceptions.

The links between trade, investment and adjustment are often crucial, not least in developing countries. Domestic investments dominate in terms of quantity, with export sectors often providing an important source of risk capital. However, foreign investments have made an important "qualitative" contribution. FDI and expatriate expertise provide capital, managerial and technological know-how, as well as access to foreign markets and buyers. The Dutch and Israelis helped to develop cut flower expertise in Kenya, East Asians the clothing industry in Mauritius and Lesotho, the Americans fruit packaging techniques in Chile and the Japanese shrimp farming in Thailand. But the domestic policy framework is also important; the governments concerned helped to attract FDI by putting in place fairly open and non-discriminatory investment regimes in the 1980s.

Reliance on broad-based policy approaches

Policy reforms should be complementary

Undertaking reforms across different policy areas in a complementary way can reduce resistance to change, because those adversely affected by one reform might benefit from another; it can also create cross-policy synergies. The mutual reinforcement of policies is also emphasised in the Ministerial paper on *Growth in Services – Fostering Employment, Productivity and Innovation*. The combined effect of complementary policies will be greater than the sum of the parts, not least by creating an environment conducive to innovation and technology diffusion and enabling countries to move up the value chain.

The overriding advice to governments is thus to aim for good general measures over a range of policy areas to handle structural adjustment. Comprehensive reform programmes are likely to be more effective than piecemeal strategies. For example, policies that improve the functioning of labour markets while providing adequate income support can help reduce adjustment costs in terms of lost production, while promoting growth by facilitating resource transfers to expanding activities. However, if accompanied by measures that ease regulatory barriers to competition and growth in domestic markets, the overall benefits for society may well be reaped earlier and the ultimate gains may be higher. Moreover, there is evidence that while trade liberalisation generally has been positively linked to growth, it sometimes has been associated with a lower standard of living in economies that heavily regulate new entry or impose high costs on exiting or downsizing. Broad-based reforms can also reduce resistance to change and make it harder for individual industries to argue for exemption.

There is no blueprint for sequencing

It follows that governments should seek, to the greatest extent feasible, to pursue policy reforms in parallel. There may, however, be circumstances when a particular sequence of reform is called for, although no blueprint exists. Many policy initiatives can be advanced as *the* essential prerequisite of structural adjustment: trade liberalisation, to ensure resources do not migrate to protected sectors; investment liberalisation, to ensure a macroeconomic multiplier effect; industrial relations reform, to ensure prior labour market preparedness; competition policy reform to avoid abuses of dominant position in post-deregulation markets. In fact, the actual sequence of these and other policies will finally depend on what is politically feasible in the country concerned.

Multilateral co-operation

To fully realise the gains from trade, multilateral action and implementation of the Doha Development Agenda are needed

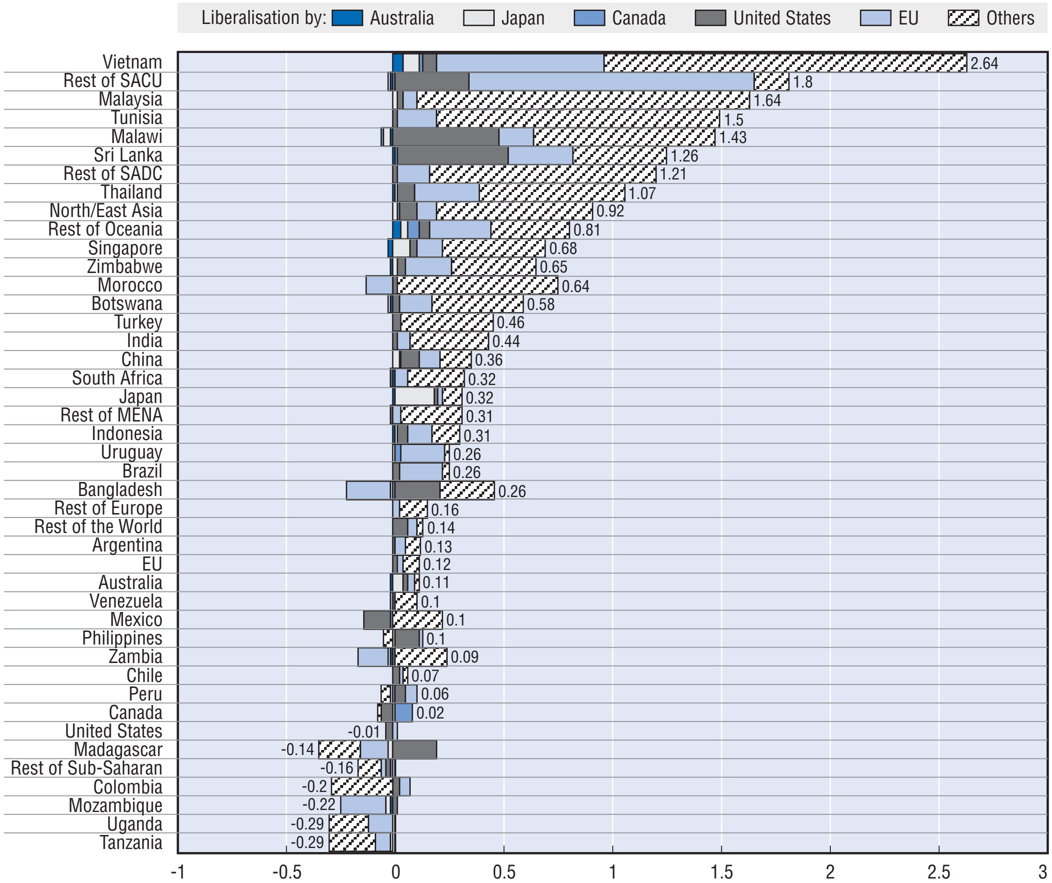
Full realisation of the gains from trade will require multilateral action via the WTO and effective implementation of the Doha Development Agenda, with balanced and concrete progress across all the core areas of negotiation: agriculture, non-agricultural market access, services, rules and trade facilitation. The WTO framework enables countries to co-operate by avoiding mutually destructive trade policy retaliation. Commitments entered into in the WTO are also important in helping to lock in domestic reform. And the WTO – in conjunction with complementary development assistance efforts – has a role in addressing particular concerns of developing countries, not least those associated with preference erosion and revenue loss.

In the face of preference erosion, it is important to seek to capitalise on new opportunities while facilitating adjustment

Figure 3 presents the results of a 50% reduction of *ad valorem* tariffs across all regions. While such a scenario would entail substantial preference erosion, most developing countries would gain from such liberalisation. In most cases, the gains from trade liberalisation would outweigh the losses from the associated preference erosion. While production in some preference-eligible sectors may fall, the resources freed can be used more productively elsewhere. Similarly, the negative effects of preference erosion that may be observed in

Figure 3. **Per capita welfare gains[1] from a simultaneous 50% reduction in tariffs by all regions**

Percentage change in per capita welfare



1. Welfare gains from trade liberalisation can be broken down into two components: *i)* the change in efficiency with which countries utilise their resources; and *ii)* the change in its terms of trade.

Source: OECD Study on Trade Preference Erosion (2004).

one market may well be outweighed by positive effects from better access to other markets. However, in a few regions – primarily in Africa – there may be net losses in welfare.

A comprehensive policy response will aim to capitalise on new opportunities associated with trade liberalisation while facilitating adjustment. Elements of the policy package will include trade policy reform accompanied by complementary policies intended to promote macroeconomic stability, encourage entrepreneurship and develop an appropriate social safety net. In some cases, special and differential treatment under the multilateral trading system may help manage the transition to a more liberal trading regime together with development assistance to strengthen supply-side capacities and export diversification. As a recent World Bank study points out, there is a need to enhance the effectiveness of agricultural preference schemes, while taking care to avoid interference with the pro-development process of multilateral trade liberalisation.

Revenue loss is a concern in some developing countries

Some developing countries have expressed particular concern about effects on government revenue of further multilateral tariff liberalisation such as might be achieved under the Doha Development Agenda. Notwithstanding any such revenue losses, empirical estimates in recent studies indicate that the potential welfare gains from tariff reductions are significant and that developing countries stand to capture the largest gains relative to GDP. Developing countries that currently maintain higher and more dispersed tariffs are particularly well positioned to benefit from a non-discriminatory tariff reform. However, in some cases, potential revenue shortfalls could undermine macroeconomic stabilisation (including fiscal sustainability) and development programmes and may cause a reversal of trade reform itself.

Positive welfare gains can be achieved from a joint package of tariff and tax reform

The degree of reliance on import duties as a source of government revenue differs considerably among countries and so will the adjustment requirements. A recent OECD study demonstrates that where tariff revenue losses are replaced with a consumption tax, there is significant scope for obtaining positive welfare gains from a joint package of tariff and tax reform without compromising government revenue. Where particular adjustment costs arise in the implementation of such a package, it may be appropriate to take this into account multilaterally through special and differential treatment that facilitates the shift away from reliance on tariff revenue.

The international community can help developing countries build trade capacity

The international community is helping support the adjustment process in developing countries and lessen the eventual costs of the process through several types of (trade-related) assistance and capacity-building programmes. The OECD Development Assistance Committee (DAC) recommends targeting assistance to:

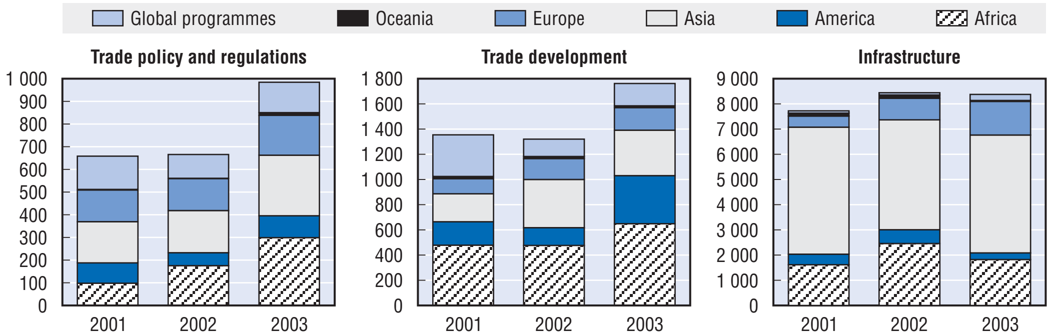
- *Policy making and institution building,* encompassing assistance with *ex ante* policy and strategy assessments, monitoring and evaluation of reforms, strengthening of government entities and supporting effective consultation mechanisms across different ministries, as well as with business and workers' representatives.
- *Production and export capacities,* including support for improved competitiveness in existing export sectors and for product and market diversification as well as support for complying with technical, sanitary and phytosanitary standards.
- *Infrastructure and trade facilitation* (including assistance for simplifying and streamlining importing and exporting regulations and customs procedures and administration), in light of the numerous "behind-the-border" constraints facing developing country firms.

Figure 4 shows the sharp increase in bilateral donors' and multilateral agencies' assistance for trade policy making and trade development.

In addition, international financial institutions can support the multilateral trade liberalisation process and help ease adjustment costs by providing financial assistance to alleviate temporary balance-of-payments shortfalls, including when these are due to preference erosion. An example is the IMF Trade Integration Mechanism.

Figure 4. **Distribution of trade-related technical assistance and capacity building and infrastructure**

By region and main category, USD millions



Source: WTO/OECD Doha Development Agenda Trade Capacity Building Database.

Officially supported export credits can also contribute to structural adjustment

Owing to their key role in supporting international contracts for the sale of capital goods and projects, governments' officially supported export credits, provided in accordance with various agreements negotiated and agreed in the OECD, can contribute to structural adjustment by facilitating access to infrastructure projects, by helping maintain flows of trade finance and by imposing disciplines on the provision of official support.

Corporate responsibility plays an important role in the adjustment process

In dealing with the strains, as well as the opportunities, of the adjustment process, it is important to foster an atmosphere of trust between management and workers. The OECD Guidelines for Multinational Enterprises make an important contribution to meeting this objective by strengthening the basis of mutual confidence between enterprises and the societies in which they operate, including through the provision according to which, in the context of *bona fide* negotiations with representatives of employees on conditions of employment, companies should not threaten to transfer the activities from the country concerned in order to influence unfairly those negotiations.

As a separate OECD initiative related to corporate responsibility, in recent years, OECD governments and their export credit agencies (ECAs) have increasingly conditioned their official support for export credits on a series of new guidelines, criteria and procedures relating to "corporate social governance". Governments have both increased their accountability *vis-à-vis* societal concerns and engaged in dialogue with importing countries, in particular in respect of the environmental impact of projects and the fight against bribery in international business transactions.

Concerns have arisen about core labour standards

The emergence of new sources of international competitive pressures has led to concerns that countries are disregarding internationally agreed core labour standards in order to gain a competitive edge, thereby promoting, it is feared, a race to the bottom in labour conditions. The emergence of China and the growth of export processing zones are at the centre of these concerns. However, an earlier study by OECD found no evidence of a race to the bottom. More recent analysis tends to support this finding.

Countries do not gain sustained improvement in competitiveness by disregarding core labour standards. Indeed, to the contrary, improved working conditions are found to contribute importantly to growth and development, a point made in the final report by the ILO's World Commission on the Social Dimension of Globalisation. There is therefore a compelling need for stronger compliance with, and implementation of, ILO core labour standards, and the ILO should remain the main institution to set and monitor these standards.

Countries do not gain lasting improvement in competitiveness by disregarding core labour standards

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