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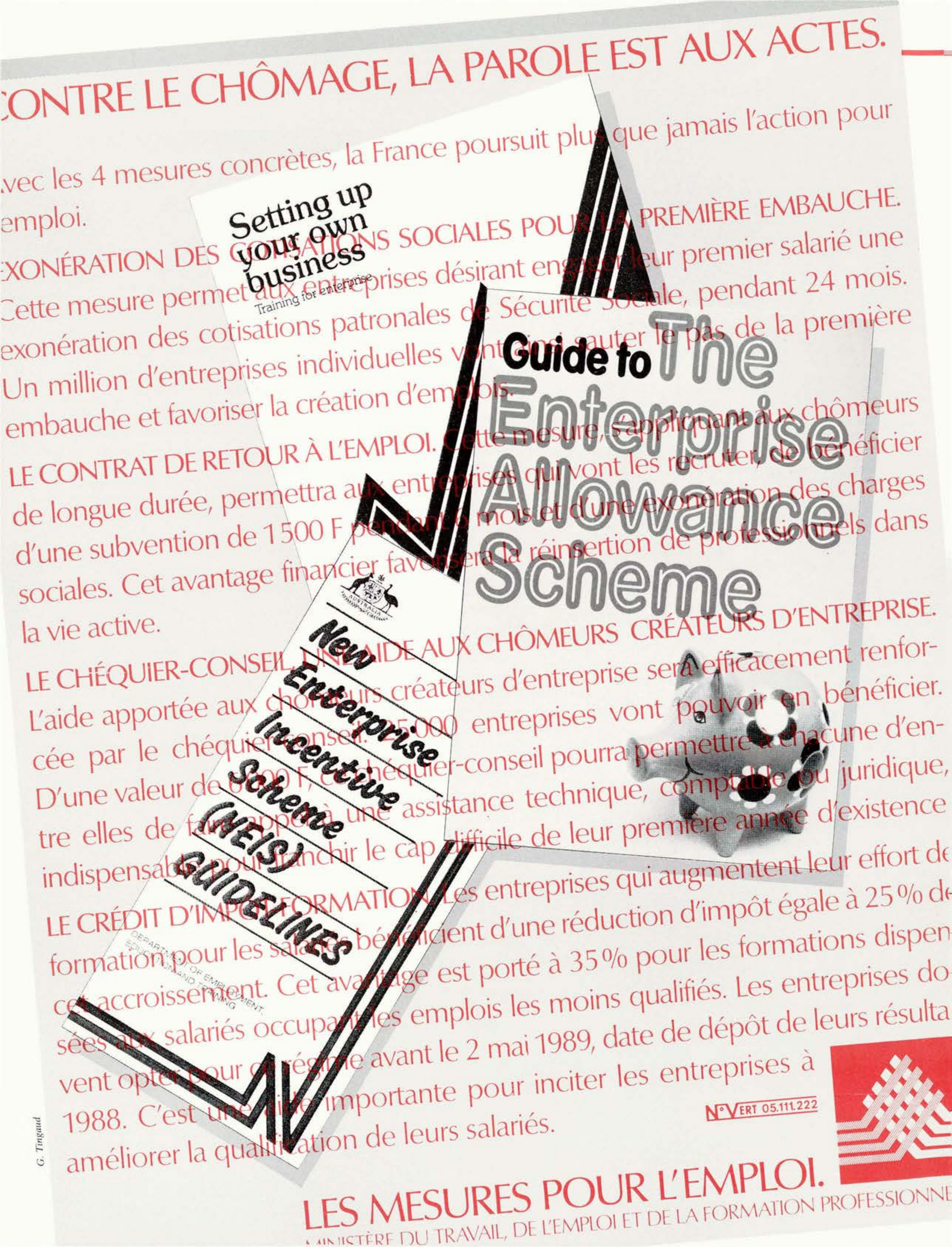
The marriage of local initiatives and national schemes that allow unemployed workers to opt for self-employment is stimulating the growth of new jobs in more and more OECD countries.


CONTRE LE CHÔMAGE, LA PAROLE EST AUX ACTES.
Avec les 4 mesures concrètes, la France poursuit plus que jamais l'action pour l'emploi.
EXONÉRATION DES COTISATIONS SOCIALES POUR LA PREMIÈRE EMBAUCHE.
Cette mesure permet aux entreprises désirant engager leur premier salarié une exonération des cotisations patronales de Sécurité Sociale, pendant 24 mois. Un million d'entreprises individuelles vont ainsi sauter le pas de la première embauche et favoriser la création d'emplois.
LE CONTRAT DE RETOUR À L'EMPLOI. Cette mesure, s'appliquant aux chômeurs de longue durée, permettra aux entreprises qui vont les recruter, de bénéficier d'une subvention de 1500 F pendant 6 mois et d'une exonération des charges sociales. Cet avantage financier favorisera la réinsertion de professionnels dans la vie active.
LE CHÉQUIER-CONSEIL, UNE AIDE AUX CHÔMEURS CRÉATEURS D'ENTREPRISE.
L'aide apportée aux chômeurs créateurs d'entreprise sera efficacement renforcée par le chéquier-conseil. entreprises vont pouvoir en bénéficier. D'une valeur de F, ce chéquier-conseil pourra permettre à chacune d'entre elles de faire appel à une assistance technique, comptable ou juridique, indispensable pour franchir le cap difficile de leur première année d'existence.
LE CRÉDIT D'IMPÔT FORMATION. Les entreprises qui augmentent leur effort de formation pour les salariés bénéficient d'une réduction d'impôt égale à 25% de cet accroissement. Cet avantage est porté à 35% pour les formations dispensées aux salariés occupant les emplois les moins qualifiés. Les entreprises doivent opter pour ce régime avant le 2 mai 1989, date de dépôt de leurs résultats 1988. C'est une aide importante pour inciter les entreprises à améliorer la qualification de leurs salariés.
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From Unemployed to Self-employed

Paul Barker

The promotion of the entrepreneurial capacity of the unemployed has received increasing attention among OECD countries. One way has been to encourage the jobless to start their own businesses while receiving state benefit, an approach which has given considerable impetus to the general trend towards self-employment.

It was France which developed the idea of giving the unemployed the opportunity of creating their own businesses by capitalising their unemployment insurance contributions in a lump-sum payment. Its pioneering 'Chômeurs Créateurs' scheme was started up nationally in 1979 after a period of limited application, and four years later the United Kingdom introduced its own version, the Enterprise Allowance Scheme. Since then, a total of 17 OECD member countries (including all the main European ones) have instituted similar schemes, and the United States and Austria are now considering following their example. Now well over 700,000 people have participated in the French and British schemes alone.

The programmes are generally incorporated within unemployment benefit/insurance regimes and, normally, people receiving or entitled to benefit are eligible. Basically, the self-employment schemes entail an exemption from the normal conditions governing the payment of financial assistance, since recipients of unemployment benefit are not usually permitted to engage in paid employment while supposedly seeking work. Unemployment compensation is a fixed cost much of which would be incurred anyway. So making a special exception for those who wish to use their financial entitlements as an income cushion to tide them over the start-up phase of business creation or, in some instances, as start-up capital, governments are encouraging the unemployed to exploit their entrepreneurial potential at little cost to the exchequer, since the additional costs of administering the schemes and providing advice and assistance to participants are relatively small.

Who Opts for Self-employment?

The funding of these schemes is strongly influenced by the nature of national unemployment benefit systems. In countries where unemployment benefit is an automatic entitlement to all those who lose their jobs, such as the United Kingdom, Australia, and Canada, income support continues to be provided in the form of periodic payments while the recipient establishes his or her enterprise. In countries where unemployment compensation takes the form of a nationwide insurance plan, such as France, recipients can opt to take a lump sum at the outset corresponding to the stream of payments they would have received during their period of joblessness. In both cases, it is up to the entrepreneurs to raise the rest of the seed capital they require to get their businesses off the ground, whether from personal or commercial sources. Would-be entrepreneurs may also benefit from other forms of financial assistance, such as exemption from social security contributions for a limited period, or supplementary loans and grants. Some governments offer guarantees for bank loans raised by participants in these schemes, but others have more general programmes for self-employment which can help them with finance.

An important element is the advice and support provided to participants to prepare them for self-employment and business management, which sometimes include a degree of training. While some countries impose conditions on the type of business that may be created, vetting procedures are usually kept to a minimum. That is partly due to the high cost of such procedures but it is also an acknowledgement of the likelihood that officials would exclude as many deserving ventures as they would approve. Rather than laying down strict conditions subject to rigorous vetting, some governments are now putting the

Paul Barker works in the Co-operative Action Programme on Local Initiatives for Employment Creation in the OECD Directorate for Social Affairs, Manpower and Education.

emphasis on the effective preparation of these budding entrepreneurs and backing that up with continuing support and advice, especially during the make-or-break early phase of sponsored enterprises.

The overall track record of these schemes is pretty good, with the survival rate of the businesses created–in the British scheme, for example–at about 65% two years after the government's financial support has ceased. And the new firms can represent a significant contribution to the rate of new business creation. In France, for instance, nearly a quarter of business start-ups and takeovers in 1985 had received assistance from the 'Chômeurs Créateurs' scheme. The types of business created are very varied, but are overwhelmingly concentrated in the service sector.

The sort of unemployed people that tend to take advantage of these business creation schemes are by no means typical of the unemployed as a whole. Only a relatively small proportion of the unemployed actually volunteer to take advantage of these schemes–2.5% in France and 4.5% in the United Kingdom. They are predominantly male, concentrated in the 25–50 age bracket, and tend to have been unemployed for a relatively short time. They have usually had work experience in the activity they choose to undertake, and in the United Kingdom at least a quarter of them have been self-employed before. Although women are represented on most schemes in about the same proportion as among self-employed women generally, they are under-represented when compared to the proportion of the total female unemployed and often fare less well when they do create their own businesses.

In general, the most disadvantaged amongst the unemployed–those who have been without a job longest and whose prospects of finding new employment are the poorest–are less likely to take the option of self-employment. But if the schemes were targeted specifically at such groups, they would lose much of their efficacy–and would be even less useful in reducing the numbers of unemployed by limiting the stock of new entrants and, accordingly, the number of new enterprises created. A more practical approach to improving the social equity of these schemes would be to make a point of reducing the barriers to entry to the schemes faced by the unemployed through any lack of the skills requisite for self-employment. Even so, it cannot be said with any certainty that this would be a better use of resources than other labour-market programmes aimed at the long-term unemployed and the hard-to-employ unskilled jobless, such as special training schemes or wage subsidies.

HOW THE SCHEMES WORK

***Chômeurs-Créateurs*, France**
A grant of between FF10,000 and FF43,000 is paid in a lump sum to unemployed people in receipt of benefit, or entitled to it (the grant varies according to the applicant's previous work references and length of enrolment at the employment office). Participants in the scheme are also exempt from a variety of obligations (sickness insurance, pension contributions, family allowances and industrial accident insurance, where normally required). Provisions exist, too, for workers who wish to take over existing firms. Prospective applicants are required to prepare a business plan. A management advice voucher for FF6,000 was recently introduced (FF4,000 is provided by public money, the rest being added by the recipient to become eligible for the voucher); it enables participants on the scheme to receive business advice, training and/or support. In 1987 there were 63,435 participants in the scheme.

***Capitalizacion de las prestaciones por desempleo*, Spain**
A grant not exceeding the equivalent of 24 months' unemployment insurance payments is paid in a lump sum to unemployed people who are entitled to such insurance. This payment averages a little under one million pesetas (approximately US$8,600) per person. In addition to the lump sum, participants in the scheme receive benefits to enable them to meet their commitments to the relevant social-security scheme. Provisions are made for co-operative working arrangements. The scheme began in 1985, and in 1987 had almost 76,000 participants.

***Enterprise Allowance Scheme*, United Kingdom**
A taxable £40 per week allowance is paid to unemployed people for one year in lieu of unemployment benefit. Participants are required to attend an introductory or 'awareness' day on the scheme and sources of small business advice. Three free business-counselling sessions are offered to scheme participants by the Small Firms Service or Scottish and Welsh Development Agencies. In 1987/88 there were 106,305 participants in the scheme.

Some Cons, Many Pros

Self-employment schemes have been criticised on the grounds that they give rise to little secondary employment and that a number of the small enterprises created fail. But these critics tend to miss the point about the fundamental objectives of these schemes. For one thing, a small percentage of the businesses that survive do create a significant number of jobs. For another, the schemes offer an additional choice to the unemployed for getting back to work, perhaps providing for some a stepping-stone back into salaried employment. Finally, the schemes represent a significant innovation in social policy, in that recipients of welfare benefits are provided with incentives to develop their own solutions to unemployment using resources that otherwise would have been spent on income maintenance.

That said, there are two effects which are thought to diminish the net cost-effectiveness and extent of job-creation of the schemes. First, there is a 'deadweight' element insofar as some of those assisted in the creation of new businesses would have done so in any case without state support. But any attempt to screen applicants to

Manpower Services Commission

Making it on your own—the Enterprise Allowance Scheme in the UK has helped many thousands of unemployed people into self-employment.

reduce the deadweight factor would reduce the efficacy of the schemes, might result in fewer firms being created and would hence diminish the supply-side effects in the labour market of increased entrepreneurship and innovation. Even those who say they would have gone into business anyway may be encouraged by the schemes to do so earlier than they would otherwise have done. Entrepreneurs can also gain in this way a valuable safety net that gives them a little longer to break even, so the number of failures during the start-up phase may be reduced. So, on balance, the schemes still have a positive result, since they do enlarge the entrepreneurial base and stimulate new business creation, which is particularly beneficial in its creation of new jobs.

Second, there is a 'displacement' effect associated with government assistance to new business creation to the extent that these new firms receiving assistance can undercut and take business away from existing enterprises. The apparent increase in output and employment brought about by new businesses is thus partially offset by losses elsewhere in the economy. Since a high proportion of start-ups are dependent upon the purchasing power in the local economy, especially new firms entering the crowded service sector, some observers claim that displacement rates are high and that the net gains are very limited. But little empirical research has been done to gauge the extent of displacement, and it is difficult to evaluate the net result of the negative effects of displacement in relation to the benefits of increased competition, improved service to the consumer, and so on.

As these schemes become more extensive and more firmly established, their contribution both to reducing unemployment and to encouraging entrepreneurship should grow. For instance, the 'role-model' they provide will influence other people considering self-employment. The survival rates of the new businesses they engender are much the same as those of start-ups in general, which may be a measure of the value of the support and advice provided to participants. In any case, there is still room for improvement.

□□

Although the self-employment schemes for the unemployed are still in their infancy in many countries, they appear to offer much potential. Their effect on supporting entrepreneurial initiatives by the unemployed should contribute to the process of job creation whilst simultaneously better enabling social-security systems to re-integrate welfare recipients into active social and economic life.

Demand for participation in these schemes is clearly high, especially in the United Kingdom, France and Spain, where unemployment rates are, or have been in recent years, higher than average. It seems that, not forgetting that the lack of data on the effects of the schemes prevents the formation of an overall record, they have nonetheless demonstrated that the entrepreneurial capacity of the unemployed can be put to work. ■

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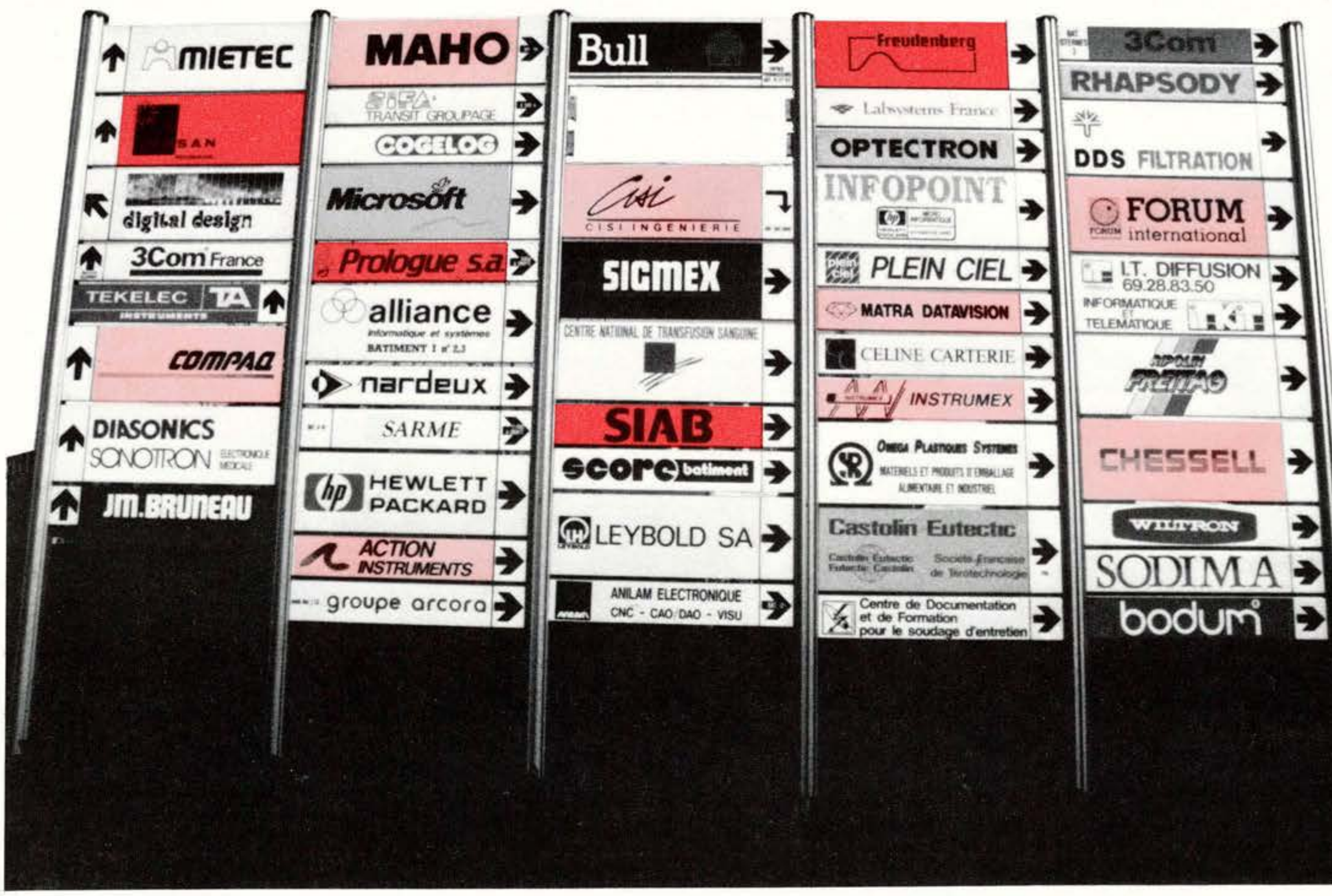
Local Initiatives for Enterprise

Jean-Pierre Pellegrin

It was the Austrian economist Joseph Schumpeter who described the 'gales of creative destruction' that lie at the heart of the process of growth and of stimulation of innovation and employment. Economic life is punctuated by the births and deaths of firms, especially small ones. The pace of this process of regeneration or turbulence is one of the main factors in the economic vitality of a community, and hence of a country. Policies for stimulating the creation of enterprises and jobs locally are in truth perfectly compatible with the objectives of national macro-economic policies, as an OECD report points out.[1]



J. Hilary/OECD

Small firms are the primary source of new jobs in OECD countries. In the United States, where 30 million net new jobs have been generated over the past 15 years, it is firms with under 100 employees, mostly young and expanding, that have accounted for fully 80% of all the new jobs created. These figures, though frequently quoted, are controversial, and could well be induced by the contraction of large firms at times of recession and restructuring. Nonetheless, the vital role of small and new firms in the economy, and especially in providing employment, is widely recognised. Encouraging their creation and expansion must therefore be one of the main planks of any employment strategy based on the economic activity of viable enterprises. But it is increasingly recognised that national policies to this end are inefficient because they are too uniform. Action is therefore required locally, in the places where new businesses are created and which bear the brunt of high employment.

Research in the United States has shown that an average of 8% of the urban job base disappears every year. So the challenge for any region or locality is to replace the jobs lost. The difference between more and less prosperous communities, in particular those affected by structural difficulties, is their ability to face up to this challenge and develop new employment–basically, to create and foster small firms.

The lynch-pin of any medium- or long-term employment strategy must be to determine what types of company start-up should be encouraged and what form any support for new business creation should take. It is very difficult on paper to determine which proposed ventures will succeed and which will not–even the professionals, such as private venture capitalists, find it hard to beat the odds and pick winners at the starting-gate. Such a strategy must also aim to encourage an enterprise culture among individuals and groups, to create a local environment favourable to the creation and development of business projects.

Care must be taken that jobs are not created at any cost. A question mark hangs, for example, over the quality of the millions of jobs created in recent years, particularly in the United States, as is borne out by the current lively debate on this issue. In the many small firms established during the 1980s the investment per job created has been below average, as have the rate of productivity and the wages paid. Yet such criticisms are valid only where there are other work opportunities (whether as employer or employee) for the people concerned. Moreover, some of these jobs do give less privileged groups the opportunity to enter the labour market.

Although the ability of the United States to generate new jobs has no equal anywhere else in the industrialised world, European countries are more on a par with the United States when it comes to the number of new businesses created annually. Although data are not strictly comparable, some idea of the orders of magnitude can be gained from the fact that in 1986 950,000 new firms started up in the United States against 270,000 in France, and over 300,000 new businesses were created in both Italy and Germany during 1987 as a whole.

TEN REQUIREMENTS FOR LOCAL ECONOMIC DEVELOPMENT

1. A thorough 'strategic audit' of the real strengths and weaknesses of the local economy as a basis for action.
2. The mobilisation of people for employment initiatives with the concerted support of local political, business and trade-union leaders, teaching establishments and voluntary bodies.
3. New forms of private investment, with local government acting as a catalyst, not a substitute, for private funding.
4. The enhancement of the local educational and RAD infrastructure.
5. Information and feedback mechanisms for monitoring market change and responding to it.
6. Improvement of the quality of life through environmental protection and the installation of good physical and recreational facilities.
7. A reinforced entrepreneurial climate through assistance centres, incubators and financing programmes for small businesses, and action to promote awareness of and training in business creation and management.
8. Easier access by entrepreneurs to risk and start-up capital, in the form of both equity and long-term debt.
9. An expanded market for new products and processes.
10. A strategic approach to local development, i.e., among other things, a clear and shared vision of the future.

The Dynamics of Turbulence

Companies rise and fall, expand and contract, so that a small firm today may be a medium-sized or even a large one tomorrow–or may have disappeared. The perpetually shifting sands of corporate life are a measure of the dynamism of an economy and its capacity for renewing its productive base. Stability is not a virtue in the life of an enterprise; for instance, companies that grow smoothly for the first five years of their existence can expect major problems later. Nonetheless, 85% of new businesses which survive remain very small, so that the pace of economic development depends largely on the dynamism of the other 15%.

Although it may be undesirable for firms to go out of business, bankruptcies are inevitable and are associated with a healthy process of experimenta-

Jean-Pierre Pellegrin specialises in development and employment policies within the programme on local initiatives for employment creation run by the OECD Directorate for Social Affairs, Manpower and Education.

1. **Implementing Change: Entrepreneurship and Local Initiatives**, OECD Publications, Paris, forthcoming 1989.

J. Hilary/OECD

'Incubators' offer shared facilities–secretaries, telephones, faxes, etc.–that can help small business blossom.

tion and learning. It is essential to enable as many viable new businesses as possible to be created and to see that aspiring entrepreneurs are not frustrated by unnecessary institutional, regulatory or financial barriers. Bankruptcies should perhaps also be seen not as a stigma or mark of ultimate failure but as a form of learning for future success. It is well known in the United States that the young Henry Ford was twice made bankrupt.

To make this 'propensity to enterprise' a reality, the would-be entrepreneur requires a commercially viable business proposition backed by a sound marketing strategy and some managerial ability. He also has to have the financial resources to get his venture off the ground and tide him over the loss-making launch phase. The lack of personal wealth and the unavailability of venture capital and seed money are a major constraint on the scale of entrepreneurial activity (although insufficient funds are rarely the principal cause of bankruptcy).

Public and private policies, increasingly in partnership, for local employment and economic development must provide for investments of seed capital and the provision of loan finance to start-ups, together with business training and other support services of help to those going into business on their own. The availability, in the initial phase, of low-rent premises and support services like those offered by small business 'incubator' buildings can be important in holding down fixed and operating costs.

Who Are the New Entrepreneurs?

'Qualified male engineer in his mid to late 30s starting a high-tech business backed by venture capital'–this type of technical or managerial self-starter certainly still exists, but there are many other variations on the theme: women, young people, the unemployed, groups of partners, people establishing businesses under franchise arrangements (especially common in the fast food, retailing and hotel industries), and both blue-collar and white-collar employees who become the owners of their companies by buying out existing shareholders.

To whichever group the new entrepreneurs belong, they are driven by equally varied motives. They may be inspired by some deep-seated desire to be their own master and/or to make money, or they may have a marketable idea or invention they wish to exploit, or they may simply want their own job and source of income. In some cases they may be acting in response to an upheaval in their working or private

lives (redundancy, divorce). Decentralisation of production methods in some cases leads former employees to become independent workers while retaining sub-contracting or commercial links with their old firm. Financial or other incentives (such as special leave for enterprise creation) offered by certain large companies can also be an important factor.

Whence the Finance?

Local communities have to find imaginative ways of financing and supporting small businesses. Would-be entrepreneurs who have no personal fortune and who do not enjoy the financial backing of family and friends, find seed capital and loan finance hard to wring out of commercial banks and private sector institutions. The existing pattern of savings supply and investment demand effectively excludes business start-ups from the financial markets, since most investors seek either low-risk or large-scale investments whereas new businesses require small amounts of high or medium risk capital. To overcome this barrier to the development of new businesses, some existing financial institutions have evolved original programmes for assisting business start-ups, while governments or regional authorities in some countries have set up development funds to finance new businesses and so fill the gaps in financial markets (box).

Instances of financial initiatives aimed at stimulating the development of local economies are the exception rather than the rule. There is general agreement throughout OECD countries that not enough is being done locally to provide business training for aspiring entrepreneurs, encourage co-operation or links among firms, involve institutional investors in the process of business creation, and promote the right local environment for economic development and job creation.

□□

There is sometimes thought to be a conflict between the objectives of national macro-economic policy and promoting the development of local economies. But this does not have to be the case. Although national policy-makers are concerned above all to contain inflationary pressures rather than to stimulate economic activity in order to create jobs, they are also anxious to exploit the talent, imagination and entrepreneurship of local communities. The development of local economies, furthermore, is a long-term strategy whose success is not counted in terms of immediate gains in jobs, business start-ups or output growth. Local communities must establish environments that encourage a dynamic process of economic renewal and instill a certain culture of innovation and enterprise. Such environments–and the dynamism and propensity to innovate of local businessmen–are decisive factors in the capacity of local firms and economies to adjust to the structural changes of recent years. ■

INITIATIVES FOR FINANCIAL INNOVATION

The NMB bank in Amsterdam offers an example of what can be done by the private sector. It has set up a network of so-called workshops that provide physical facilities to infant businesses on a shared basis, either free of charge or at a fee related to the state of the project. It also provides business start-up packages that include short- and longer-term loan finance and other facilities. In the United Kingdom, the Midland and National Westminster Banks both operate special loan schemes for new businesses. In Chicago, the South Shore Bank has mobilised local savings to rehabilitate run-down housing after feeling the effects on its own business of the social and economic decline of the neighbourhood it serves.

Finland's Regional Development Fund is a good example of how Nordic countries help small businesses. During the 1980s the Fund has helped about 3,500 firms in regional development areas to adapt themselves to structural change. While not providing equity capital, Scandinavian governments do advance loans and even grants to start-ups and young firms, with the support covering as much as 50 or even 75% of the total cost of highly innovative projects.

In the United States, the Michigan Strategic Fund is another illustration of a development finance agency whose objective is to facilitate structural change away from a declining manufacturing base and towards new service activities. It encompasses six programmes to encourage the creation and development of small and technically innovative businesses. It functions as a partnership between government and the private sector in Michigan and each dollar invested generates some $20–40 of private investment. In Italy, the Friuli-Venezia region has created a financial company to help with the creation of new firms, mostly in industry, with particular emphasis on research and development activities. In other countries regional capital markets have evolved that foster the creation of new businesses, such as the one in the Rhône-Alpes region in France.

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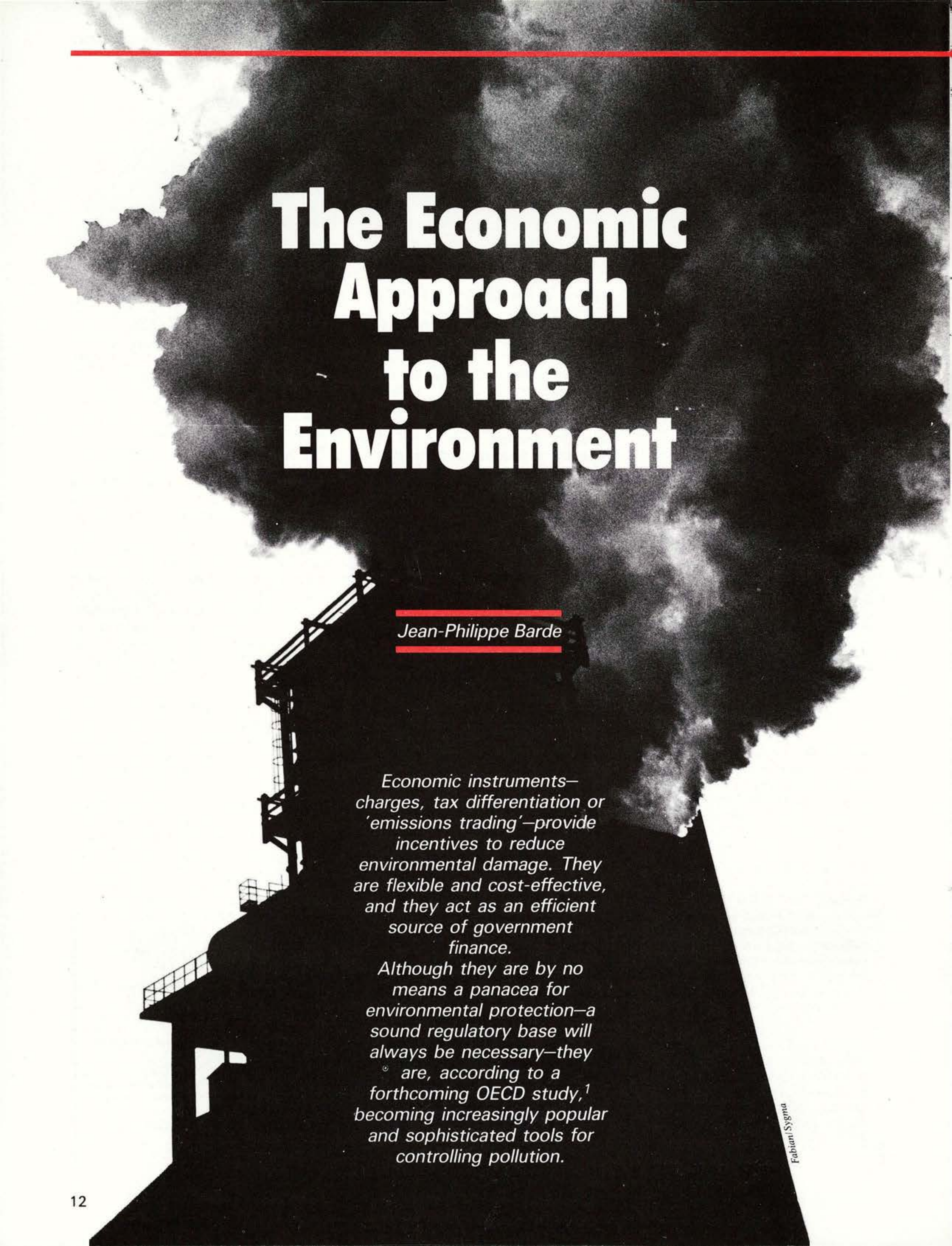

Fabian/Sygma

The Economic Approach to the Environment

Jean-Philippe Barde

Economic instruments—charges, tax differentiation or 'emissions trading'—provide incentives to reduce environmental damage. They are flexible and cost-effective, and they act as an efficient source of government finance.

Although they are by no means a panacea for environmental protection—a sound regulatory base will always be necessary—they are, according to a forthcoming OECD study,[1] becoming increasingly popular and sophisticated tools for controlling pollution.

In the early 1970s, when government intervention was extended to include environmental protection, the authorities in most industrial countries turned to regulatory controls as a matter of course–either to create new laws and regulations or to adapt existing legislation.

In some cases, they were pouring new wine into old bottles in using old methods to tackle new problems. But old isn't necessarily bad. Regulatory controls have the advantage of being a tested method founded on the experience acquired in other activities. They have considerably expanded over the past fifteen years in environmental protection: pollution control for air and water, waste management, noise abatement, and so on. And as new or neglected problems are addressed–development of new hazardous substances, new technology and products–the trend is continuing.

The Economic Approach

Alongside, a new approach to environmental policies has developed–the 'economic approach'.[2] It is directly derived from the economic theory of externalities: pollution and environmental damage arise from the fact that environmental resources are not priced. By pricing such resources, their users (including polluters), instead of wasting them on the grounds that they are 'free', can take suitable measures to limit consumption and deterioration. This new thinking has very soon led to experimentation, chiefly in water management.

The concept of an economic instrument broadly covers the idea of a signal in the form of a financial transfer (tax, charge) or modification of relative prices (taxation on certain products). Economic instruments operate as financial incentives to polluters, who select the most advantageous solution: polluting and paying, or investing in pollution control to avoid paying.

Jean-Philippe Barde is in charge of economic aspects of environmental policy in the OECD Environment Directorate.

In other words, they are intended to modify behaviour (to induce a switch from polluting to pollution control) merely through financial incentives and market forces. Financial incentives may consist either of making the polluter pay (by a charge) or paying him a given amount (through a subsidy).

The two are not entirely symmetrical. Financial aid may have perverse effects (over-equipment, disincentive to technical progress) and, above all, it is incompatible with the 'polluter-pays principle'. In terms of efficiency and incentive, financial aid, as applied in most OECD countries, does not show the advantages of the other economic instruments.

In fourteen countries studied by OECD,[3] there were over 150 instances of the application of economic instruments including systems of financial aid. They cover a wide range of situations both in the instruments used and in their application and role in environmental policy.

The most widely used instruments are charges, which represent the 'price of pollution' and oblige polluters to pay for the environmental 'services' they consume, for example, in disposing of waste in a river or other water course.

Charging the Polluters

Charges have two purposes. First, they act as incentives by encouraging polluters to reduce releases of waste to the extent that it is cheaper to treat them than to incur the charge.[4] And, second, they have a financial impact since the funds collected are mostly used for financing pollution control. In practice, charges are seldom high enough to offer much incentive, so that their financial function is usually more important.

Four main types of charges are generally acknowledged. The first, effluent charges, are payments on direct releases into the environment. They are often used in controlling water pollution (in Australia, France, Germany, Italy, Netherlands). In France (since 1964) and the Netherlands (since 1972), they form the backbone of water management systems. In Germany, they have been applied throughout the country since 1981. Effluent charges are also applied in waste management (Australia, Belgium, Denmark, Netherlands, United States) and in the abatement of noise from aircraft (France, Germany, Japan, Netherlands, Switzerland, United Kingdom).

In the control of air pollution, by contrast, direct regulations have always been the main tool of intervention, while effluent charges play a limited role, on two principal grounds: first, the calculation and implementation procedures are too cumbersome; and, second, there is no collective treatment body which could receive the revenue obtained.

Such charges are chiefly used for financing individual or collective systems of pollution control. In the Netherlands, the levels are so high that they constitute a strong incentive to clean up water pollution.

User charges, the second type, are payments for the cost of effluent discharge and treatment services. These are commonly used for the collection and treatment of solid waste and sewage water by local authorities, who regard them as the 'normal' price to be paid for such services. They rarely act

1. J. B. Opschoor and H. B. Vos (Free University of Amsterdam), **The Application of Economic Instruments for Environmental Protection in OECD Member Countries**, OECD Publications, Paris, 1989.

2. It began in 1932 with *The Economics of Welfare* by A. C. Pigou, which later led to the birth of a new branch of economics, environmental economics.

3. Six countries (France, Germany, Italy, the Netherlands, Sweden and the United States) were studied in depth. Information was also collected on Australia, Belgium, Canada, Denmark, Finland, Norway, Switzerland and the United Kingdom.

4. In technical terms, the polluter treats the discharges to the extent that the marginal cost of treatment becomes equal to the charge.

Almasy

as an economic incentive to pollute less.

Product charges, thirdly, are applied to the prices of products which create pollution either as they are manufactured, consumed or disposed of: for example, lubricants (France, Finland, Germany, Italy, Norway, Netherlands), sulphur in fuels (Netherlands, Norway), fertiliser (Norway, Sweden), mercury and cadmium batteries (Norway, Sweden), non-returnable containers (Finland, Norway, Sweden), base–i.e., 'feedstock'–chemicals (United States), pesticides (Norway, Sweden). Product charges are intended to modify the relative prices of the products and/or to finance collection and treatment systems.

Finally, administrative charges are chiefly aimed partly or totally, at funding systems of licensing and licence monitoring. Many countries apply them (Australia, Belgium, Denmark, Germany, Norway, the Netherlands, Sweden and the United Kingdom)–for example, in a charge on registering new chemical products (Norway), or for the cost of studying and authorising activity which will cause pollution (Sweden).

Pricing by Taxing

Tax differentiation modifies the relative prices of products by penalising those harmful to the environment. It is a practice that is spreading. In several countries (Finland, Germany, Netherlands, Norway, Sweden, Switzerland, United Kingdom), tax differentiation on petrol is aimed at encouraging the use of lead-free petrol. Its impact is probably limited, although in some countries the introduction of tax differentiation has coincided with the end of production of petrol that contains lead. This change seems chiefly because of government negotiations with the industry, although consumers were probably also influenced by the lower taxation of lead-free petrol.

Tax advantages for cars are effective: in Germany, for instance, sales of 'clean' cars have exceeded forecasts. Tax differentiation is fairly easy to set up and administer since it can be integrated in existing taxation systems.

Trading Emission Rights

Where a statutory ceiling on pollution has been reached in a given area, a polluting firm can set up or expand an activity only if its additional pollution emissions are nil, which is usually technically and/or economically impossible. The firm must therefore buy 'rights' to pollute from other firms already active in the area, which then are required by law to abate their emissions by an amount equal to the additional pollution emitted by the new activity.

The aim of emissions trading is therefore twofold: first, to minimise the cost of pollution control by reducing the highest emissions where they are the least expensive while tolerating higher emissions where treatment costs are higher; second, to reconcile economic development with environmental protection by allowing new firms to set up activity in a given area without increasing the total amount of polluting emissions within it.

The practice may also be implemented for other purposes, such as improving environmental quality by requiring that the transaction leads to a marked reduction in emissions (and not merely straight compensation). This innovatory approach was developed in the United States, mainly in the control of air pollution (but also lately in water pollution control). The results are highly promising compared with the usual approach of direct regulation alone and are leading to substantial savings, estimated at on average $1 million per transaction, with some

transactions topping $15 million.

Two further economic instruments that can be deployed are deposit-refund systems for containers or car hulks, and non-compliance fees, whereby polluters are required to pay as much as the profits they obtain by ignoring regulations.

Incentives and Efficiency

Economic instruments show a number of intrinsic advantages in addition to laws and regulations, which are sometimes too rigid and static and are difficult to apply and finance.

- They are more cost-effective. Effluent charges, at a suitable rate, for example, can minimise the total cost of pollution control (by making the marginal treatment costs equivalent to the charge). Emissions trading also leads to a lower overall cost.
- They offer a permanent incentive to reduce pollution for the period of time that a payment is made. It also leads to further encouragement for technical change through research and the development of non-polluting products or better and more effective processes of pollution control.
- They increase flexibility. For the authorities, it is easier to modify or adjust a charge than to modify legislation; for polluters, freedom of choice and adjustment is preserved.
- They provide a source of finance. In most cases, economic instruments play an important role in the collection of funds, which are usually re-allocated to pollution control (taxes and charges).

Instruments in the Future

Governments have been using regulation for a long time in spite of the inherent advantages of economic instruments since it has a direct and immediate impact on the behaviour of polluters. Over the past fifteen years, however, these instruments have attracted increasing interest. There are three main reasons:

- economic stagnation and budgetary constraints have led the authorities to consider more cost-effective approaches
- the direct regulation of social processes seems to have reached its maximum potential effectiveness, and there have been calls for deregulation or regulatory reform
- it is becoming increasingly difficult to finance steadily expanding policies, requiring the creation of special financial means.

The OECD has been advocating the use of economic instruments for some time and, in 1985, OECD Environment Ministers stated that they would 'seek to introduce more flexibility, efficiency and cost-effectiveness in the design and enforcement of pollution control measures in particular through a consistent application of the Polluter-Pays Principle and a more effective use of economic instruments in conjunction with regulations'.[5] These instruments seldom replace a framework of direct regulation; they supplement it in mixed systems which can be modulated. Their role is to raise the revenue necessary to finance measures that protect the environment, to encourage more effective application of direct regulation linked to them and to stimulate technical innovation. The increasing requirements for environmental protection in times of mounting pressures on national budgets suggest that the financing function will expand in future. Regulations will continue to be used because, provided they are effectively and strictly applied, they can control behaviour directly.

The place of economic instruments in environmental policy should be judged not only by the number of them deployed in any country or activity but also by their type. Many countries have used financial assistance but few have employed effluent charges and fewer still emissions trading. Some economic instruments have a limited effect (deposit refund systems, most product charges and charges on noise); others play an essential role (charges on water pollution in France and the Netherlands).

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Economic instruments could play a much more important role in the future, particularly since they reinforce the main current tendencies of environmental policy. They thus offer the possibility of integrating action on the environment with measures taken in other domains. Taxation, for example, could be adapted to protect the environment (taxes on airports as a function of aircraft noise, for example; and there is an 'environment tax' included in the price of transport fuels in the Netherlands).

Another important aspect points to the future: more reliance on economic instruments should incite polluters to take preventative rather than curative measures. They should, therefore, have more 'bite' than at present—their incentive effects should be strengthened considerably (by heavier charges, for example). New instruments can be devised, too, and existing ones used more efficiently. ■

5. 'Environment: Resource for the Future', declaration adopted by the governments of the OECD member countries at the OECD Environmental Committee meeting at ministerial level on 20 June 1985.

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Industrial Risk and the Right to Know

Henri Smets

For many years it was left entirely to the operators of hazardous installations to assess the risks for surrounding areas and to take any measures necessary to reduce them. But safety is too important to be left to their judgement alone and, little by little, they have been obliged to supply information on their activities to people who could be affected by them— to the point where there now exists an effective 'right to information' about the risks to which they are exposed.[1]

From the beginning of the twentieth century, operators of industrial plant in European countries were gradually required by law to inform the authorities of the nature of any potentially hazardous activities, harmful products they might use and any precautionary measures taken to prevent and deal with accidents. This information was intended exclusively for the so-called 'competent' authorities, who were often not entitled to reveal it to other public bodies, the aim being to protect industrial and trade secrets, and sometimes also to avoid alarming local communities, their elected representatives or the public at large. This preference for secrecy is now outmoded.

The next stages have already begun. In recent years, operators of hazardous plant have been required by law to supply information to people working there. At present, they must inform the local population and, where appropriate, certain authorities abroad. This gradual development was the main theme of a recent OECD Conference during which Ministers and senior officials from the 24 OECD member countries agreed that these various groups have a *right* to be informed. This agreement took the form of a Statement adopted by the Conference and two Decisions (or Acts) of the OECD Council[2] imposing legal obligations on OECD countries.

Since workers are usually the first victims of accidents, it is natural that they be informed of the risks to which they are particularly exposed. Another reason is that, if properly trained, they are well placed to take steps to prevent accidents. The OECD Conference also recognised that trade unions had a role to play, agreeing that 'two-way channels for communication of information on safety between management and workers should exist in hazardous installations'. The main reason for this observation is to avoid any intermediate-level obstacles to information from workers reaching company management.

Henri Smets is a specialist in the Management of Accidental Risks in the OECD Environment Directorate.

OECD member countries had already agreed, in 1979, in the framework of a Ministerial Statement, to provide the public with information about major risks, but the instruments adopted then were neither binding nor very detailed. An important step was taken in 1988, when the OECD Council adopted a legally binding Decision concerning the public directly exposed to the risks created by hazardous installations. This Decision recognises that 'the potentially affected public *has a right to be informed*'. The 24 member countries undertake to ensure that the public potentially affected 'is provided with general information on the nature, extent and potential off-site effects on

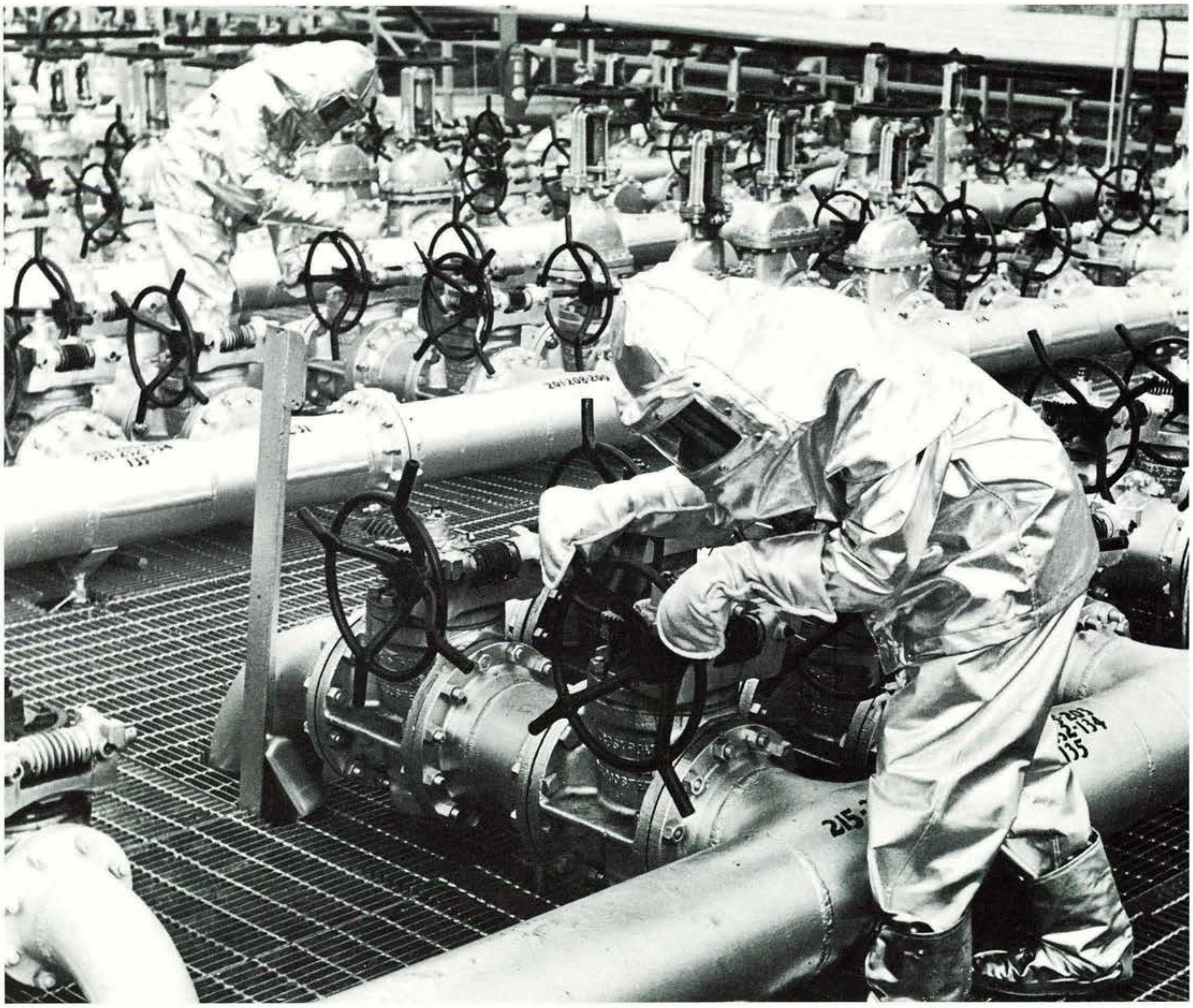
1. The right to information on risks has, over the last decade or so, become remarkably widespread in the United States (freedom of information, right-to-know, etc.) and is gaining ground in several other OECD member countries (access to administrative documents, access to information on the state of the environment, etc.). In December 1988, the Commission of the European Communities proposed a new Directive on freedom of information in environmental matters.

2. Concluding Statement of the OECD Conference on Accidents Involving Hazardous Substances, OECD, 1988.

Decision-Recommendation of the OECD Council concerning provision of information to the public and public participation in decision-making processes related to the prevention of, and response to, accidents involving hazardous substances, OECD, 1988.

Decision of the OECD Council on the exchange of information concerning accidents capable of causing transfrontier damage, OECD, 1988.

American Cultural Centre



Information can go two ways: workers have the right to know about any dangers they may encounter and are often best placed to inform the management about them.

human health or the environment, including property, of possible major accidents at a planned or existing hazardous installation'. This Decision is in accordance with current or proposed practice and policy in several other member countries, notably France, the United Kingdom and the United States.

The Decision does not specify who is responsible for informing the public–the authorities on the basis of information received from operators, or the operators themselves–but it states that the information should be 'comprehensible to the general public', provided in a timely fashion, re-issued periodically and updated.

This new right to information concerns the public potentially at risk from major accidents occurring in reputedly hazardous installations–essentially, those 'capable of giving rise to hazards sufficient to warrant the taking of precautions off-site'.[3] In the 12 member countries belonging also to the EEC, the OECD Decision applies to

the approximately 1,800 installations which have to be notified under the 'Seveso Directive'[4] since special emergency plans have to be prepared for them. To obtain a more realistic figure, account must also be taken of non-military installations for manufacturing and storing explosives and rocket fuel. In a country such as France, the number of installations to which the Decision applies could exceed 500, against 325 under the Seveso Directive.

While the precise nature of the general information to be provided to the potentially affected public is left to the discretion of each member country, the Act of the Council recommends in particular that the following information be provided for each hazardous installation: 'the common names or, if more appropriate, the generic names or the general danger classification of the substances involved at the installation which could give rise to an accident capable of causing serious off-site damage, with an indication of their principal harmful characteristics'. The Act further recommends that such information be given to the public potentially affected as a matter of course–that is, without any specific request being necessary.

The amount of information given to the public will vary according to the objective pursued. If all that is required is an understanding of the possible effects of an accident, information about hazardous substances and their effects will be sufficient. When the public is directly associated with the decision-making process, fuller information is required. Thus, in the United Kingdom, the public is involved in planning permission procedures and, in France, in the licensing of hazardous installations, whereas in the United States, the public is consulted about decisions on plans for community preparedness for emergencies. In such circumstances, the information to be supplied includes a general description of the activities carried on in the installation as well as all the information already made available to the public–construction permits, environmental impact studies, operating licences, safety studies and enquiry documents.

Not everything will be divulged–consideration has to be given 'to the protection of confidential information, as defined under domestic law, including both proprietary data and information protected for reasons of national security'. Some countries are reluctant to provide information which could possibly be used against the operator by competitors, opposition groups, political parties–even subversive groups.

The OECD Decision established the obligation for all member countries to

Six hundred metres away there was a gas reservoir. Did the neighbours know they were living dangerously?

Government of the State of Mexico

3. Except military installations and civilian nuclear installations, which are subject to other rules.

4. Directive of the Council of the European Communities of 24 June 1982 on the major accident hazards of certain industrial activities (the 'Seveso Directive').

ensure that the public potentially affected is provided directly with 'specific information on the appropriate behaviour and safety measures they should adopt in the event of an accident involving hazardous substances'. This principle conforms with the practices of some OECD countries, such as the United States[5] and the member states of the EEC.[6] The Act of the Council recommends that the potentially affected public be given, as a minimum, details of how they will be warned in the event of an accident, general information and advice on emergency measures to take, depending on the circumstances (evacuation, closing windows, etc.), and the sources of information after the accident (radio or television, for example).

Letting the Neighbours Know

The communication of information about risks–by operators to the authorities and the public–is governed by national law and, consequently, concerns only persons and authorities inside national borders. This is one reason that, for many years, neither the authorities nor the public in an adjoining country received any information about a hazardous installation even though they may have been very directly concerned.

Since such a situation is obviously not compatible with the right to information about major risks, the OECD Council felt that it was necessary 'to ensure that frontiers between member countries do not constitute an obstacle to the transmission of information needed in order to protect human health and the environment in the event of accidents capable of causing transfrontier damage'. This is the purpose of the 'Decision on the Exchange of Information concerning Accidents capable of causing Transfrontier Damage', which is binding on the 24 OECD member countries with respect to hazardous installations located near common frontiers.

What does the Decision stipulate? That the member countries concerned shall exchange information and consult among themselves if any country should request it, with the objective of preventing accidents capable of causing transfrontier damage, and of reducing damage should one occur. The objective of this consultation is to examine jointly the problems which might arise in connection with a proposed installation and co-ordinate emergency plans relating to it. These consultations are not intended to facilitate any sharing of responsibility for or jurisdiction over the construction or licensing of a hazardous installation.

The OECD Decision has the merit of introducing into an international legal framework the principles of information and consultation between member countries in the event of transfrontier pollution. But the principles apply only to particular hazardous installations containing a sizable quantity of specified inflammable, explosive, oxidising or toxic substances (for example, natural gas, petrol, ammonia, chlorine and phosgene). This is a 'minimum' list of hazardous substances and is to be reviewed in three years.

The Decision specifies that OECD countries should improve co-operation on emergency plans. Member countries have agreed that, in the event of an accident, they will–as a minimum–give a brief description of the accident location and circumstances, describe the immediate effects of the accident and give information about the emergency measures planned and action taken. In addition, they will specify the chemical identity, quantity and physical form of the hazardous substances which may affect an exposed country and will provide the data available for evaluating the probable impact of the accident in exposed countries.

Although the OECD Decision primarily concerns the transmission of information between the relevant authorities in neighbouring countries, it also contains some provisions for the information of the public in such countries. Thus the principle of non-discrimination has to be respected: people in a neighbouring country who might be affected by an accident in the country where an installation is sited must receive the same information as the people there.

□□

There is no doubt that the adoption of this Decision by the OECD is a step forward in international environmental law. Modelled on bilateral or international agreements relating to nuclear installations, it makes several principles on transfrontier pollution developed by the OECD in the years 1974–1978 legally binding. ■

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5. Emergency Planning and the Community Right to Know Act, SARA, Title III, 1986.

6. Under the Seveso Directive, member states must ensure that persons liable to be affected by a major accident as defined by the meaning of the Directive are informed in an appropriate manner of the safety measures and of the correct behaviour to adopt in the event of an accident. This provision has still to be implemented in nearly half the sites concerned. The second amendment to the Seveso Directive, one of the purposes of which is to transpose some OECD Decisions into Community law, was adopted in November 1988. It may be noted that OECD member countries which are also members of the Community are obliged to implement OECD Decisions whether or not there is a Community Directive on the same topic. The OECD Decision on accidents capable of causing transfrontier damage covers fewer activities than the Seveso Directive but goes beyond it when providing for the transmission to the authorities in countries exposed to risk of certain information not communicated to the public, consultations on emergency plans, warnings and the communication of information following an accident.

Who Gains from Predatory Pricing?

Bernard J. Phillips

Should shops and stores be free to price as low as they choose—even give goods away free—or is unrestrained price-cutting likely to hurt consumers' long-term interests? This question, long debated in competition policy circles, is becoming more urgent as Europe approaches 1992 and the goal of a truly

unified Common Market. One of the aims of 1992 is to make it easier for firms to compete across the European Community. But will long-standing laws against price-cutting blunt the competition which should otherwise occur? A new OECD study examines the conflict between competition and control.[1]

Rules against price-cutting take several forms. One kind of regulation, based on notions of 'unfair competition', generally sets a price floor for a merchant, usually the cost which the merchant paid for the item in question. Some laws go further and specify that the minimum price is cost plus tax, sometimes even plus some overhead. Exceptions are generally made for seasonal merchandise, obsolete goods, perishables and liquidation sales. An exception infrequently seen is for promotions by new entrants. Laws of this kind can be found in a number of OECD countries, including Austria, Belgium, France, Japan and Switzerland as well as in some States in the USA.

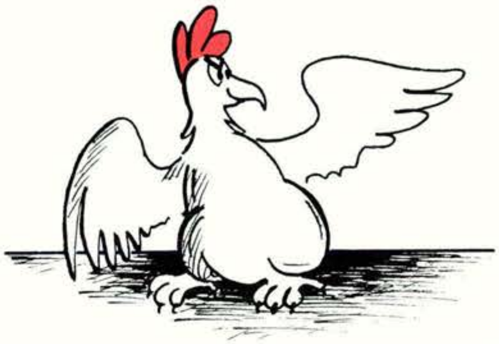
Another way in which price-cutting is regulated is through competition laws which control the abuse of the dominant position in a given market and attempts to create monopoly power. The concern here is that a large firm will cut prices in order to drive out competitors, and then raise prices later when few others are left.

Dissent on Predatory Pricing

This kind of conduct is called predatory pricing in competition-policy literature, and cases trying to control it have been brought by the authorities in many OECD countries, including Australia, Canada, Denmark, France, Germany, Japan, Norway, the United Kingdom, the United States and the European Community (many of these cases are discussed in the OECD report).

Although many competition policy officials have long considered the harm to consumers from predatory pricing to be self-evident—the name itself seems to justify the prohibition—a dissenting view has gained more and more adherents. Indeed, the dissenters now represent the conventional wisdom in some countries, especially in the United States, where the campaign of dissent began.

Bernard J. Phillips is a lawyer specialising in competition matters in the OECD Directorate for Financial, Fiscal and Enterprise Affairs.



Under this new thinking (which dates from the 1960s), predatory pricing does not make sense in most circumstances and should therefore be rare. Moreover, predation should be hard to identify, because it will look much like good, hard price competition. Because it should be both rare and hard to spot, trying to control it is likely to do more harm than good by inhibiting non-predatory firms from engaging in vigorous price competition.

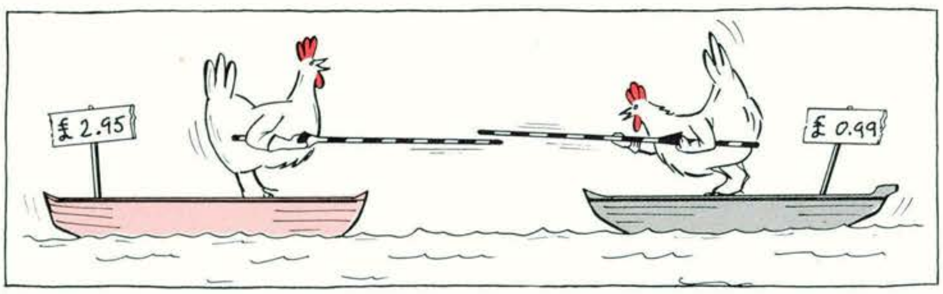
Why is predatory pricing thought to be so unlikely? One reason is that the practice is risky for the would-be predator. The firm voluntarily loses money (or gives up potential profits) in the hope that that sacrifice will be more than repaid in future monopoly profits. The difficulty is that those future profits are far from certain: the 'victim' simply may not leave and, even if it does, another firm may come in and take its place in the future, especially if the subsequent high prices by the predator make entry to the industry look inviting.

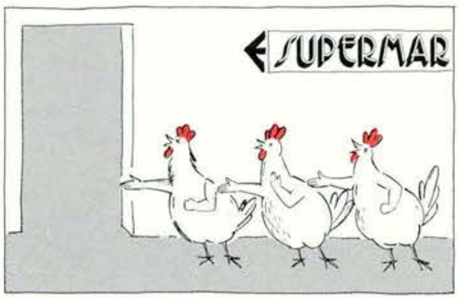
Even though most economists and competition policy officials would probably agree that predatory pricing should be rare, a measure of disagreement has been voiced. Some economists have applied game theory and, with certain assumptions about the information held by firms in the market, concluded that predation could still be a rational strategy. In particular, they have argued that when the victim of the predation is uncertain about the true costs of the predator, predation is more likely to be successful. Such a situation is more likely to occur when the predator produces more than one product or service, making it difficult to know whether a particular item is being sold predatorily at a loss. Unfortunately, this situation is equally difficult for competition officials to judge.

The risk that new firms will enter after the predatory period is one way to determine whether to worry about predation in the first place. If firms can enter a particular market without too much trouble, the predatory firm will have little ability to raise prices and exploit its monopoly position. Thus, even though the predator may have hurt its competitors, consumers will have benefited from the price war and will continue to benefit if the threat of entry by new firms keeps the predator from raising prices. In truth, this situation is very similar to one involving the displacement of one firm by a more efficient newcomer, a welcome event from the point of view of competition policy and consumer welfare.

Weeding Out the Least Efficient

Predatory pricing has been alleged to occur in a wide variety of industries—the new OECD report discusses cases



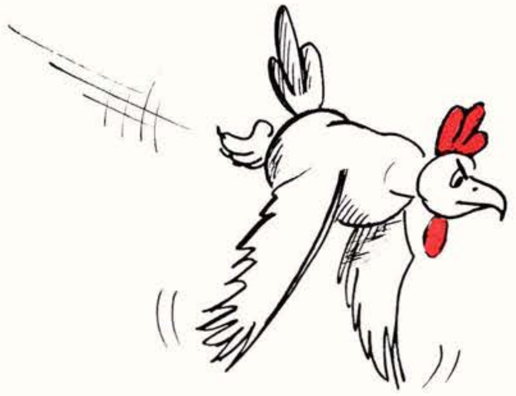


in items as diverse as bus services, flour additives, eggs, fertilisers, bread, coffee, beef-packing, home electronics, industrial gases and intravenous solutions—but it is probably more useful to focus on one activity. Grocery retailing is a good example. It has been argued that this sector has characteristics (at least in some countries) which make successful predation especially unlikely and which also make it very difficult to distinguish normal competition from predation.

For example, in the case of supermarket retailing in the United States, new discount supermarket chains have complained that conventional supermarkets have responded predatorily, pricing below cost, when confronted with the entry of a discount store in a local market. But pricing below cost may just be the natural competitive response in a market hit by excess capacity; a firm may lose *less* money be reselling goods below cost than by closing down and trying to re-open later. And if there is excess capacity, a period of loss-making is what weeds out the least efficient firm.

Further, structural characteristics should make grocery retailing an unlikely candidate for predation. For example, start-up costs are low, especially for 'no-frills' stores. Consumer loyalty is not a difficult barrier to overcome (their loyalty is more to the brands than to the store). Further, sunk costs (which cannot be recovered later) are lower than in other industries—for example, the inventory can be disposed of and the building sold or

1. **Predatory Pricing**, OECD Publications, Paris, 1989.



sub-leased. In view of these characteristics, any attempt by a predator to raise prices after inducing the exit of competitors is likely to induce new entry. So predation is less likely to be a profitable strategy in grocery retailing than in industries where entry is more difficult.[2]

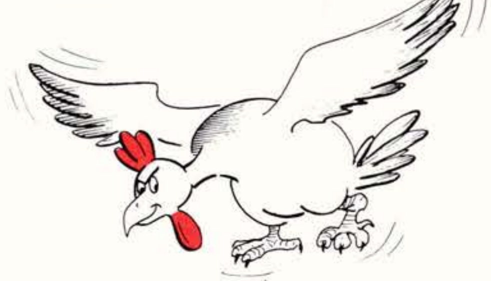
Loss-Leaders Stimulate Competition

The use of loss-leaders is a pricing practice which is common in grocery retailing in some countries but which would be considered to be predatory or unfair elsewhere. Loss-leaders involve, as the name implies, offering selected goods at a loss in order to lure customers into the store. Where loss-leaders are used, certain staple foods like bread, milk, coffee and chickens are frequently offered as the advertised 'specials'.

Under some laws, the use of loss-leaders violates sale-at-a-loss prohibitions. Yet some commentators argue that such sales are not necessarily at a loss—at least, not if one takes into account other purchases that consumers often make once inside a store.

Leaving aside questions of consumer protection (for example, are the loss-leaders really in stock?), it is hard to see why stores should not be able to use promotional devices like loss-leaders to generate business. Such practices seem both an aid to new entry and a stimulant to price competition in general.

When firms use loss-leader pricing, those prices are usually communicated through mass-media advertising, which should encourage competitors to respond with their own price advertisements. The result is an environment richer in price information, helping consumers to shop more easily and further stimulating price competition. Rules against price-cutting limit retailers' incentives to advertise prices—why spend money to advertise prices which are similar to your competitors'?



Loss-leading can also help the new entrant. A new firm in a local market has to induce consumers to break ingrained shopping habits. How does a firm accomplish that, especially when the goods it offers are the same as or similar to those in current stores? Here again, the firm may want to offer some goods at a loss to draw in potential customers to introduce them to the new store.

Who is protected by laws which set price floors? One obvious beneficiary is the small merchant, to the extent that such laws inhibit the ability of larger, more efficient firms to enter a market or gain market share. Existing large merchants should also gain, as their margins are protected by the suppression of price-competition.

Potentially aggressive new entrants, on the other hand, suffer to the extent that their ability to enter and grow in new markets is restrained. More important is the harm to consumers which can result, paradoxically, from efforts to protect them. Here, excessive concerns over the dangers of predation can deprive consumers of the vigorous (if sometimes bruising) competition which provides low prices and efficient distribution.

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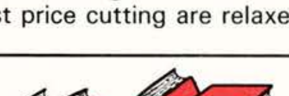
Where does this analysis leave the European Community after 1992? If the goal of a truly open and highly competitive internal market is to be realised, it seems that governments may have to take a more relaxed view about price-cutting than some do today (in a few OECD countries, the enforcement of sale-at-a-loss prohibitions has become *more* strict in recent years). If firms are to be encouraged to enter foreign markets, they should be able to price aggressively in order to gain business.

Moreover, the risk that real predation will occur seems less likely after 1992 than before. If barriers to cross-border trade and investment fall after 1992, the ability of a would-be predator to charge monopoly prices following a period of predation will be reduced: there will be a bigger risk that those high prices will attract an entrant from elsewhere in the Community.

Although it may be too soon to start counting discount chickens, consumers can hope that the next decade will see more and more vigorous price competition if government restraints against price cutting are relaxed. ■



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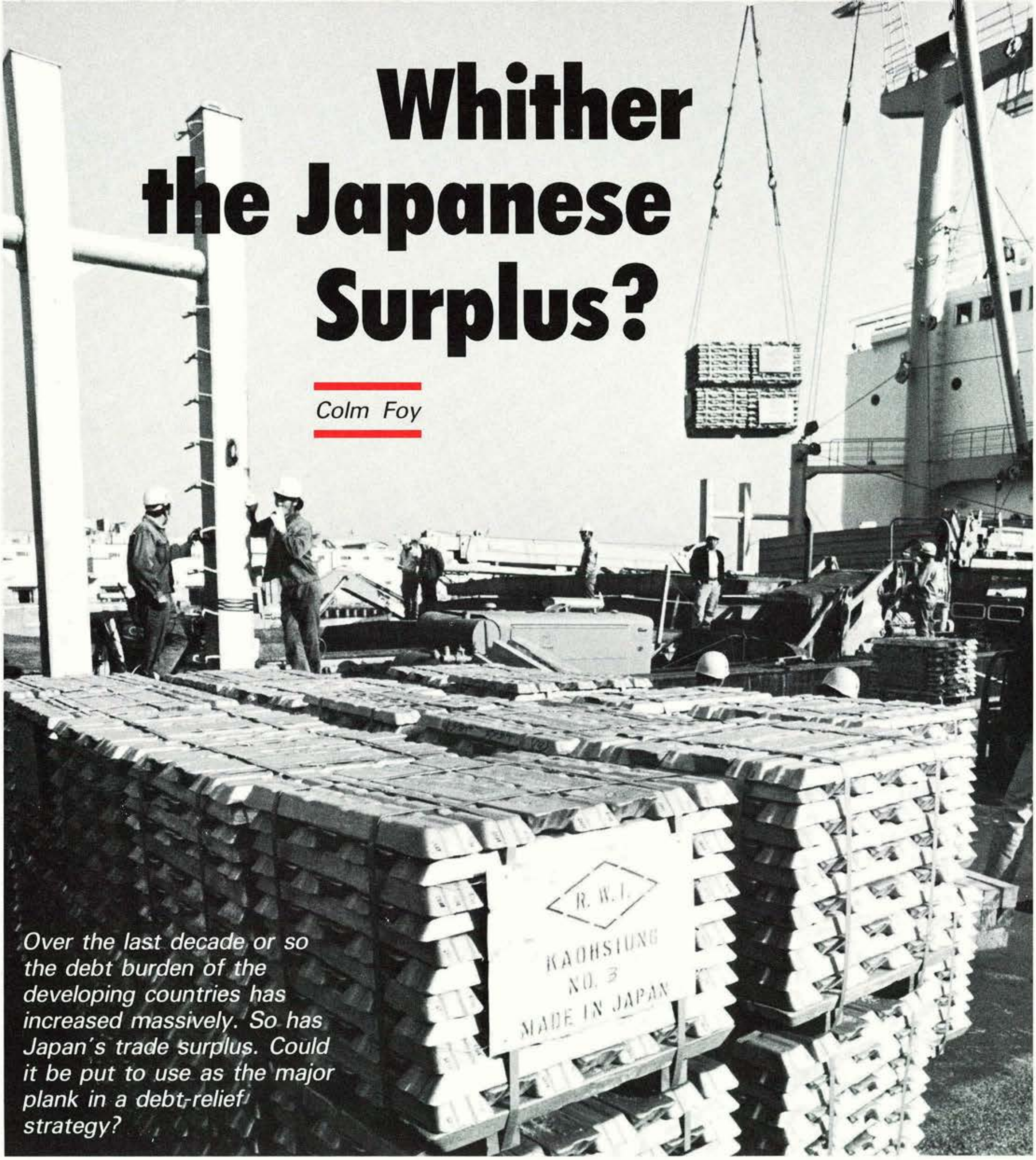
Whither the Japanese Surplus?

Colm Foy



J.P. Laffont/Sygma

Over the last decade or so the debt burden of the developing countries has increased massively. So has Japan's trade surplus. Could it be put to use as the major plank in a debt-relief strategy?

From 1980, when Japan was a debtor nation in pursuit of economic growth through exports, the country has become the world's largest creditor. Its trade surplus, running at some $100 billion per annum is the largest in history and its net assets abroad now total around $300 billion. This economic turnaround is seen as largely at the expense of Western economies–principally that of the United States. It has led to accusations that Japan is indulging in unfair competition, distorting trade and selfishly driving competitors in fellow OECD countries out of business. In addition, Japan has received criticism because of the relatively small proportion of Official Development Assistance (ODA) which it gives to the poorest countries of the world.

Indeed, Japan's trade pattern reflects a pre-occupation with the United States which is so pronounced that half the island nation's surplus is created out of the US deficit, while a substantial share of US borrowings are financed from Japanese loans. The US deficit, therefore, goes hand-in-hand with Japan's surplus.

Now that it has been recognised that Japan has built up surpluses, the question is what to do about them. One response would simply be to do nothing–in a world of free competition, the Japanese are as entitled as anyone else to keep the profits of their own hard work and innovation. One could argue, further, that they have achieved

Colm Foy is Head of the Publications and Information Unit of the OECD Development Centre.

K. Mizutani/OECD

A third of domestic saving in Japan is channelled through the Post Office.

their economic success without war or colonial domination and that the only markets they have exploited were those of the developed countries, which are as well-equipped as anybody to defend themselves against such competition.

This argument has much to recommend it on grounds of logic and equity. But the international community, and Japan's trading partners in particular, would prefer to see a more 'egalitarian' approach to the 'problem' of the surpluses. Especial concern has been expressed that Japan has not used its new-found wealth sufficiently to help the cash-starved countries of the Third World.

Japan to the Rescue?

This last aspect of Japanese financial activity has been explored in detail by Professor Terutomo Ozawa, of Colorado State University, in a recent publication for the OECD Development Centre.[1] Ozawa takes as his starting point three important reports which attempted to devise ways of channelling excess Japanese funds to developing countries: the 1977 Nakajima Report with its Global Infrastructure Fund (GIF), the World Institute for Development Economic Research (WIDER) Plan published a decade later, and the 1986–87 Maekawa Report. Though their solutions differ, each of these initiatives seeks both to deflect criticism of Japan's commercial policies and to find a way of stimulating economic growth in developing countries by transferring Japanese resources.

Since the preparation of the first of these reports, the plight of developing countries has worsened through the massive increases in their indebtedness. According to World Bank figures, the 17 'Highly Indebted Countries' have transferred $135 billion to their creditors and remain trapped in a marasmus of indebtedness. For the Third World, therefore, two questions have to be answered: how to reduce the debt burden to manageable volumes; and, concurrently, how to achieve sustained development which will avoid the generation of such gigantic debts in the future.

Japan is the natural candidate for consideration as major contributor to a debt-relief strategy for the developing countries. Its trade surplus has grown to such a magnitude that putting it at the disposal of such countries would appear to be not only desirable but also logical. But the form which such debt-relief assistance should take is another question. Indeed, the debate about whether the country's surpluses should be recycled internally or externally has itself yet to be satisfactorily resolved. It is worthy of note that, while Japan has been accused of aggressive penetration of markets traditionally the preserve of the West, it has also been criticised over domestic policies which lead to a high cost of living, dubious labour practices, and sub-standard living conditions.[2] Such criticisms have had their effects in Japan and the Maekawa Report was the official response of the policy-makers. This document, prepared by a former Governor of the Bank of Japan, Haruo Maekawa, for the Prime Minister's advisory committee, suggested:

- a drastic expansion of domestic demand through investment in urban development and housing
- industrial restructuring via overseas investment to reduce exports
- deregulation of imports
- the doubling of ODA grants over a period of five years.

Though the Prime Minister, Yasuhiro Nakasone, promised to implement these recommendations at the 1987 Economic Summit, he later was obliged to emphasise that they were still the recommendations of a private advisory group and not yet officially adopted measures. Nevertheless, Japan has been nudged to move along

1. Terutomo Ozawa, **Recycling Japan's Surpluses for Developing Countries**, Development Centre Studies, OECD Publications, Paris, 1989.

2. In, for example, Jomo (ed.), *The Sun Also Sets: Lessons in 'Looking East'*, INSAN, Kuala Lumpur, 1985, and Kamata Satoshi, *Japon : l'envers du miracle*, Maspéro, Paris, 1982. The first of these two titles is particularly interesting: it discusses Japanese overseas investment in Asia with a very critical eye.

the lines of the Maekawa Report under the relentless pressure of the high-valued yen.

Since there is domestic support in Japan for internal recycling based on private-sector initiatives, which would, in theory, aid developing countries by drawing in their exports, the tendency has been to place less emphasis on direct assistance to the Third World. The WIDER report was an effort to provide the framework in which such external recycling could take place. The ideas in the WIDER document draw heavily on the 1977 GIF proposal to recycle $25 billion annually over five years to developing countries. The GIF plan would involve, among other things, changing the legal status of the Japan Development Bank, which still receives as much as ¥ 1.1 trillion per year (approximately $8.9 billion) in public funds for domestic development projects. Domestic projects can now easily be financed with private-sector money, so that the Bank's resources and the public financing it receives could be redirected to projects in the Third World. This public money would, in fact, largely come from the Ministry of Finance's Trust Fund Bureau which collects funds mainly through what Ozawa calls 'The World's Largest Bank: the Japanese Postal Savings System'.

Aid can take many forms, not least training in the donor country, here in a Japanese greenhouse.

Japan International Co-operation Agency

Whence the Surplus?

Domestic savings account for the vast bulk of the Japanese surplus. The Postal Savings System captures almost one-third of these domestic savings, a sum amounting to some $714 billion. As Ozawa explains:

> The Postal Savings System is managed by the Ministry of Posts and Telecommunications. It has scores of attractions for small savers. To begin with, the system is part and parcel of the government, hence depositors have complete confidence in its solvency. Second, it offers convenience; people can open a savings account at their neighbourhood post office. Third, the account pays a high rate of interest, indeed higher than the market rate; in 1986, the statutory minimum was 6.05 per cent, while the discount rate was a mere 3.5 percent. Fourth, interest on the account up to $20,000 was, until 1988, tax-exempt.

This special status afforded to the system is partly to blame for the Japanese savings habit, which is itself responsible for the country's excessive surpluses. Accordingly, on 1 April 1988, the government reduced some of the advantages the system enjoyed, but the institution retains its allure.

The WIDER Report, one of the authors of which was former Japanese Foreign Minister Saburo Okita, sought ways in which these domestic savings could be mobilised for developing countries. Taking the same figure as the GIF–$25 billion–Dr Okita and his co-authors proposed redirecting this sum from Japan's annual $100 billion surplus towards developing countries and away from the developed economies, principally the United States. To do this, WIDER suggested raising capital in the country's private markets by way of interest subsidies and various forms of government-backed collateral. It suggested expanding the role of the Ex-Im Bank of Japan and a further tapping of 'the resources of the *Zaisei-Toyushi*, the government's Fiscal Investment and Loan Programme (FILP), including post office savings, government pension funds and other collections–which recently amounted to a total of $150 billion annually'.

This formula for using the surplus is particularly interesting. The emphasis since the 1988 reform is now turning to institutional savings which can be used by the government through the issue of special bonds for ODA financing. At the same time, and as part of its ODA, the Japanese government is to increase export credit guarantees (ECGs) for exports to specific least developed countries (LLDCs).

The Patterns of Assistance

If the WIDER recommendations were accepted in their entirety by the Japanese government, the effect would be to divide the country's trade surplus into three parts: stimulating domestic demand; promoting economic development in the Third World; and continued capital transfers to the developed countries to remedy their lack of savings.

Japanese official policy reaction to calls for a transfer of resources to the Third World has changed over the last

decade, as, indeed, has the pattern of Japanese economic assistance over the past forty years. In a paper delivered to the OECD Development Centre's 25th Anniversary Symposium,[3] Dr Okita divided his country's assistance programme into five periods:

- war reparation payments to Asian neighbours from 1954
- lending to promote trade from 1958
- economic assistance as part of diplomacy in Asia from 1965
- assistance as part of the country's responsibilities as a significant economic power in the 1970s
- contributing as a surplus country during the 1980s.

For part of this last period Professor Ozawa points out that Japan's ODA *declined* from approximately $6 billion in 1981 to only $3.5 billion in 1987. By then, international criticism of Japanese aid policies had begun to have an impact and the WIDER report was generating much discussion. In 1986, $10 billion was committed to special economic aid to redistribute Japan's trade surpluses and an additional $20 billion was pledged in the first half of the following year.

When Saburo Okita delivered his paper to the Development Centre Symposium, he was able to announce that 85% of the total $30 billion pledged in 1986 and 1987 had been committed. By then, however, a substantial proportion of this extra money had been soaked up by the significant appreciation of the yen–since 1986, the rate has gone from 200 to 125 yen to the dollar. Although Dr Okita maintains that this level of aid has widespread support in Japan, quoting a recent opinion poll which showed that 'approximately 80 per cent of Japanese people support further expansion of Japan's economic assistance', Professor Ozawa says that 'there is little domestic pressure' for overseas aid and points out that 'no foreign-aid legislation exists which clearly spells out the purpose and function of such aid'. As a result, he continues, Japan's 'aid policy has been taxed with being *ad hoc* and marked by expediency'. In spite of these criticisms, Japan is expected to become the world's largest donor of foreign aid as it overtakes the United States in 1989.

3. The Development Centre's 25th Anniversary Symposium, 'The Next Decade: Interdependence in a Multipolar and Two-Track World Economy', was held in Paris from 6-8 February 1989; it provided the basis for **One World or Several?**, edited by Louis Emmerij, Development Centre Seminars, OECD Publications, Paris, forthcoming Summer 1989.

But the Japanese surplus could be put to good use at home, too–in housing improvement, for example.


Jutaku-Shinpo-Sha

Transferring Technology

The structure of this aid is another matter. The increase in Japanese overseas assistance is short on outright grants and long on multilateral aid and on financing in collaboration with the private sector. As Professor Ozawa says, 'the structure of Japan's economic co-operation is pyramidal, with official flows at the top, quasi-market flows in the middle and market co-ordinated flows at the bottom. The economic resources that are transferred to the developing countries are much more significant in value and variety and are more conducive to development at the market-co-ordinated (private investment) level than at either the official or quasi-market level'. This structure encourages the transfer of technology and the industrial skills required for development, rather than the mere transfer of capital which has in the immediate past led to the 'debt trap' phenomenon. The effect of this (the Japanese form of aid to Asia) is the proof of the utility of this type of transfer which includes 'New Forms of Investment' (NFI: joint equity ventures and contractual interfirm co-operative arrangements) in which there is a division of risks and responsibilities.[4]

The use of NFI by Japan's private sector is itself tied to the spread of the Japanese financial institutions, principally banks, whose overseas operations are shown by Ozawa to be 'closely synchronised with the multinational advances of Japanese industry'.

4. See Charles Oman, 'Investing in Development' **The OECD Observer**, No. 157, April/May 1989.

Asian Development Bank

To date most Japanese aid has been directed toward Asia.

These banks are themselves moving towards what may be called 'new forms of lending', such as project financing and leasing which combine transfers of financial capital with finance-specific productive physical assets and which can open up new, alternative financing for debt-ridden countries. Recent developments in Japanese-style economic co-operation thus form part of the current global trend towards privatisation and represent a continuation of general Japanese economic philosophy.

The direction of Japanese aid is still not towards those countries which most urgently require the type of help which Japan has to offer. The first phase of Japanese overseas economic assistance–war reparations–involved Asian nations exclusively, and this trend, though slightly modified, has continued. Japanese banks have branches and representative offices in developing countries, but these are concentrated in Asia (56 branches and 91 representative offices); and in Africa there are no branches at all and only three representative offices. If the present pattern of assistance is to be continued, this uneven distribution of financial back-up will lead to a similarly uneven distribution of aid flows based on the private sector. While there has been a spectacular expansion of leasing operations, these too have been essentially in Asian developing countries. Although Prime Minister Noburu Takeshita told the Toronto Summit in June 1988 that Japan is prepared to extend grant aid to the least-developed countries in Africa, Professor Ozawa points out that a means must be found to create incentives in the world economic system that will encourage the use of Japan's huge surpluses for new forms of investment in the least-developed countries outside the Asia-Pacific rim region.

□□

It is clear that the only sound solution to the problems of the planet's heavily indebted countries will be in worldwide economic growth, based on a restructuring of international investment and a realignment of market forces. Japan is poised on its surpluses to become a catalyst in this transformation. But there will be a price to pay for this process and Japan, as a leading industrial power whose economy was long export-led and is now increasingly dependent on overseas investment, will have to pay its share. It may wish to do so by increasing its overseas aid along the lines suggested by Professor Ozawa, but it may decide instead to redirect more of its financial surpluses to the current restructuring of its own internal economy to encourage domestic demand and reduce the danger of retaliation by the industrialised countries against 'unfair' Japanese trade practices. The growth in Japanese interest in new forms of investment in developing countries may indicate that Japan may be heading for a position somewhere between the two. ■

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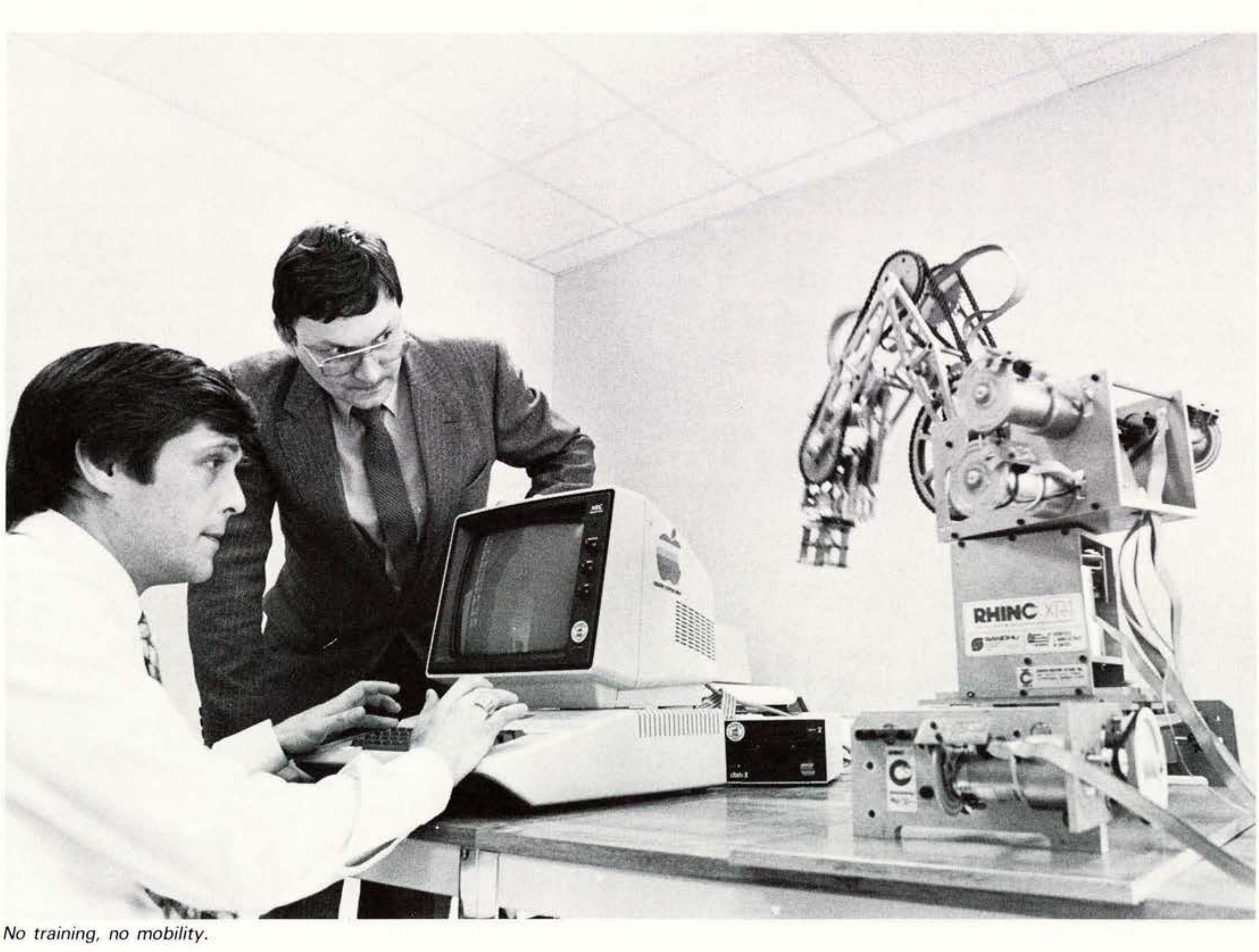
Economic Policy and the Move towards Markets

Hartmut Fest

What is the potential of policy change in enhancing the role of markets and improving economic performance? What are the key features of the micro-economic policies of OECD countries and what changes have occurred in them over the past four years or so? Which forces have stimulated this structural change–and has it been market-induced or policy-led? More generally, how should structural change, and the impact on it of policies, be considered in relation to aggregate economic performance such as employment and income? These are among the questions a recent OECD report has sought to answer.[1]



A. Nogues/Sygma

No training, no mobility.

Four main areas of the economy, all of central concern to policy-makers, have been regularly investigated since 1984 in the OECD country surveys:[2] financial markets, industrial adjustment, the labour market and public-sector finances. The last two have an immediate impact on the average household.

The experience of unemployment of the OECD countries can be divided into three broad groups:

- those whose unemployment rates have today been brought down almost to the levels obtained before the first oil shock (1973): these include the United States and Canada, where unemployment rose steeply at first but then declined, and also Japan and a few European countries (such as Austria, Norway and Switzerland) where unemployment has traditionally been low
- those where unemployment is still close to its peak rate: most European countries fall into this category
- Australia and New Zealand, where unemployment, though much higher than at the beginning of the 1970s, is not as high as in the second group of European countries.

But the difference in performance between countries appears even bigger when one considers that it is the countries where employment growth has been the most buoyant that have experienced the fastest increase in the supply of labour in the last fifteen years. In other words, the good performers in employment have not generally achieved this position through limiting, by design or otherwise, the growth in working population. Something more systematic must account for this difference.

Hartmut Fest is Deputy Director of the Country Studies and Prospects Branch of the OECD Economics and Statistics Department.

The traditional explanation has been that differing rates of unemployment reflect differing rates of growth of demand and, indeed, the two are highly correlated. But what is cause and what effect?

To answer this fundamental policy question the OECD report considers the distribution of unemployment among different groups of the labour force. In all countries, youth unemployment rose more steeply than aggregate employment: the higher the level of unemployment, the bigger was the excess of the youth unemployment rate over the aggregate unemployment rate. A similar relationship also holds for long-term and female unemployment. If demand were all that mattered, such relationships would not be observed.

Impediments to Efficient Labour Markets

One explanation for this disparate experience both between and within countries is the level of real wage costs (i.e., the level of wage costs to the firm relative to the prices firms receive for their product). This is based on the principle that the absence of profitable opportunities brought about by the prevailing cost/price ratios discourages both investment and employment. Indeed, there is evidence that those countries with relatively rigid real wages also suffered the steepest rise in unemployment between 1973 and 1987. More importantly, however, the focus on real wages returns the discussion about unemployment to the realm of market efficiency.

These impediments can be grouped under two broad headings: tax and social spending policies; and over-protective legislation.

OECD member governments have gradually come to realise that their tax and welfare policies may have exacerbated unemployment:

- higher payroll taxes, and in particular employers' social security contributions have, in some countries, driven a wedge between labour costs and gross wages: the larger the wedge, the lower the level of employment associated with a given level of wages, inducing employers, for instance, to rely more heavily on overtime rather than hire new workers; similarly, higher taxation of income and high social security contributions from employees have reduced take-home pay, so distorting the supply of labour
- tax subsidies to capital investment lower the cost of capital relative to labour and encourage labour-saving investment[3]
- unemployment benefits that represent a high proportion of the former wage subsidise a longer job-search and have the effect of raising the lowest wage level at which an individual is willing to accept a job offer.

All these distortions have encouraged the business sector, particularly in Europe, to give increasing priority to rationalisation, often at the expense of investment that would enlarge capac-

1. **Economies in Transition. Structural Adjustment Experience in OECD Countries**, OECD Publications, Paris, 1989.

2. The **OECD Economic Surveys** of OECD member countries, which are regularly prepared by the Secretariat of the Organisation have produced over the years a very valuable stock of data which appeared to warrant an overview. That is what **Economies in Transition** seeks to provide.

3. See Graham Vickery, 'Tax Reform: What Impact on Industry', **The OECD Observer**, No. 155, December 1988/January 1989.

ity. As a result, not only has unemployment risen but, as demand has increased, these countries have been arriving at full capacity utilisation well before unemployment has come down.

Improving Labour-Market Flexibility

These perverse effects have prompted governments to take a number of measures, including changing the tax treatment of labour, reducing unemployment benefits and linking entitlement to benefits more closely with willingness to work. Several countries have come to realise that legislation to protect employees can have adverse effects. As a result, they have eased hiring and firing practices, reduced the cost of dismissals, shortened fixed-term contracts and eased regulations governing temporary contracts.

Governments have thus sought to act on two fronts: wage flexibility and employment adaptability. Economies characterised by high real-wage flexibility can afford some rigidity in employment adjustment, since production can still be profitable without shedding labour because of the relative fall in wages (Figure 1). Japan and Austria are the most striking examples in this category. There are, on the other hand, countries where employment is highly adaptable, such as the United States and Canada. In the event of a supply shock, such as a change in the price of raw materials, there will be a quicker and larger rise in unemployment than in the first two countries, but it will also fall faster once recovery sets in. The worst of both worlds is one where real wages are inflexible and employment not very adaptable, as many European countries have found out.

Containing Government Expenditure

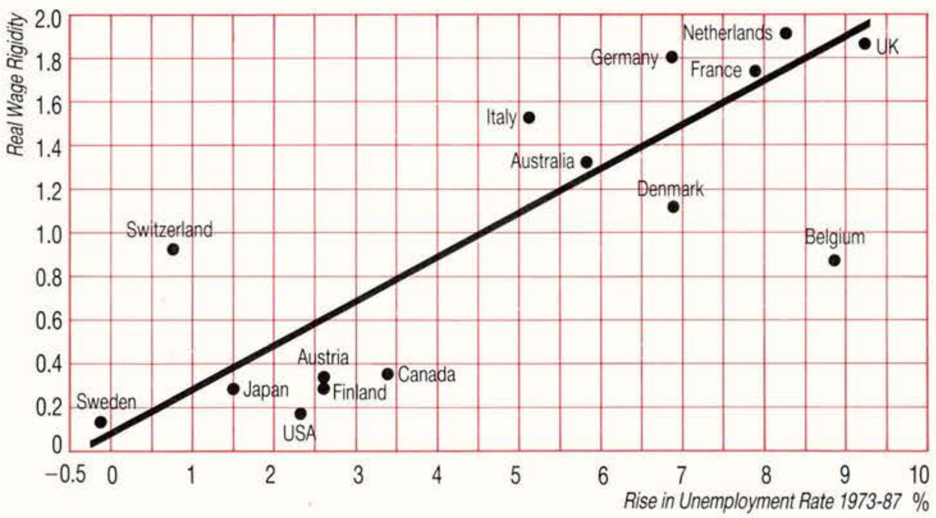
Recognising the importance of ensuring lasting and non-inflationary growth, the OECD countries have sought since the early 1980s to consolidate their public finances. Increasingly, financial self-discipline became the order of the day–or decade–as it was realised that higher taxes and budget deficits could distort the allocation of resources and erode the long-term potential for growth. Governments therefore decided to rein back public expenditure and stabilise their debt, while at the same time rationalising the structure of their tax systems.

The late 1970s saw a radical shift in thinking in the OECD countries. For many years, the civil service had expanded strongly, fuelled by optimism about the benefits to be derived from growing government involvement in the economy, if only to correct the market 'failure' that was assumed to be pervasive in capitalist economies. But as productivity growth declined and inflation accelerated, views about the role of the public sector began to change and the increasing concentration of resources in a sector not subject to the discipline of market forces came to be seen as harmful to efficiency. It is true that, in the two decades from 1960, the average share of government outlays in OECD GNP increased by a third, from just under 30% to 40%, and actually doubled in a number of countries (Figure 2).

Several ways were then sought to slow the growth in public spending, even to reduce it. Public investment was cut back, a brake was put on recruitment, and public-sector costs, particularly wages, were more closely controlled. Similarly, growth of transfer payments was curbed somewhat despite unfavourable demographic trends and the employment situation. Lastly, efforts were made to enhance the efficiency of the government sector: improved management techniques were introduced with the aim of promoting productivity gains, and increased involvement by the private sector in public projects was encouraged.

Apart from being designed to increase the role of the private sector in the management of national resources, the object of this policy was to stem the rapid growth of public debt, generated by persisting budget deficits.

Figure 1
REAL WAGE RIGIDITY AND UNEMPLOYMENT[1]



1. The index of real wage rigidity shows the responsiveness of wage costs (relative to prices) to the rate of unemployment. A low degree of real wage rigidity indicates that an increase in unemployment will lead to a relatively rapid decrease in wage costs.

Source: OECD.

Figure 2
TOTAL PUBLIC EXPENDITURE[1]
% of GDP/GNP

1. Total general government outlays, national accounts basis (i.e., excluding government lending operations).
Source: OECD.

With the gross public debt/GNP ratio rising by an average of 10 points in the 1970s, the OECD countries, with the exception of the United States, concluded that the long-term costs of a heavier debt burden were particularly high. Budget deficits either are inflationary or they oblige countries to borrow on the credit market to finance them. This immediately increases competition on that market, affecting capital accumulation and pushing up interest rates, particularly since, to convince lenders to finance their deficits in a non-inflationary manner (the lesson of the 1970s cannot be ignored), public authorities–as well as other borrowers–are obliged to pay extremely high real rates.

A majority of governments have thus adopted some form of medium-term financial planning in order to control the growth of indebtedness. This tighter stance has succeeded in reducing the average share of public expenditure in OECD GNP (Figure 2), and the general government deficit today averages 2% of GNP as against 4% in 1982. Indeed, the overall general government deficit has often moved into surplus when debt interest payments have been excluded.

The problem is that public debt and interest payments are still increasing, relative to GNP, in many countries, preventing governments from easing tax pressure despite their efforts to establish a more neutral and rational tax system.

A More Neutral Tax System

The tax reforms introduced in recent years were rooted in fears that high marginal tax rates constituted a disincentive to work, save and invest, and exacerbated tax avoidance and evasion. There was also the realisation that the proliferation of tax concessions had made tax systems unduly complicated and unfair, by the same token distorting household consumption and savings decisions and also the pattern of corporate investment and financing strategies.

The reforms were thus aimed at minimising the impact of the tax system on the behaviour of 'economic agents'–buyers and sellers, savers and investors, employers and employees, and so on–as well as limiting tax pressure to the utmost, since governments had come to realise that the marginal costs of raising extra revenue were out of all proportion to the marginal benefits of extra public spending.

Initially, governments attempted to improve the existing system. With tax revenues from personal income tax rising strongly because of high inflation and the progressive nature of tax schedules, they indexed schedules to inflation. They then turned their attention to the proliferation of exemptions which were eroding the tax base and causing growing unfairness, since tax liabilities for those with similar incomes had come to vary with the ability to find loopholes. The best way of correcting these distortions appeared to be global reform, three objectives generally being sought:

- changes in personal income tax systems–the tax base has been broadened by doing away with a large number of exemptions and deductions and, at the same time, the number of marginal rates has been cut and top rates lowered; in some countries there have also been moves to integrate income and social security taxes
- a rationalising and broadening of the expenditure tax base, on the grounds that it is best to tax income at the point where it is spent. New consumption taxes have been created in some countries, while in others the base has been broadened and the number of rates reduced; a number of countries have introduced a general consumption tax, usually a value-added tax (VAT)[4]
- more uniformity in company tax revenues–in many OECD countries, after-tax rates of return differ widely between various assets; the aim, here

Figure 3
GROSS PUBLIC DEBT[1]
% of GDP/GNP

1. General government.
Source: OECD.

4. See Kenneth Messere and John Nørregaard, 'Taxing Consumption', **The OECD Observer**, No. 156, February/March 1989.

Central Office of Information, London

Datapost–the UK's overnight delivery service–may be state-owned but it is exposed to competition.

again, has been to make tax treatment more neutral by eliminating various exemptions and reducing the tax rate.

The increased neutrality of the tax system has been achieved without any loss in revenue. Even had governments wished to reduce receipts, they would have been unable to do so because of the sheer burden of servicing public debt in many member countries.

Problems in Managing Public Debt

The debt/GNP ratio is continuing to rise in many countries, and even where it has stabilised (Figure 3), demographic trends, notably the aging of the population, could increase pressure on budgets because of the deficits on social security accounts.

High real interest rates, exacerbating the debt service burden, have compounded the problems of public debt management. Although as a result of restrictive policies, the budgets of OECD member countries, excluding debt interest payments, are on the whole reasonably well balanced as a result of pursuing restrictive policies, the situation of many countries is still delicate. Unless the budget deficit/GNP ratio diminishes or interest rates fall, the share of interest payments in total expenditure will continue to expand. The room for manœuvre that countries have in setting interest rates is limited because of the internationalisation of financial markets, so that all they can do is to adopt restrictive fiscal policies and achieve increasingly large 'primary surpluses', i.e., excluding interest payments. But there are social and political limits to budget austerity, and such policies make it impossible for a budget to underpin demand. It thus appears difficult to arrest the dynamics of debt and avoid the vicious circle of borrowing to service the debt, with the attendant risk of an indefinitely rising debt/GNP ratio. These factors have in turn served to increase the concern about the efficiency of government programmes.

□□

Although it is too early to grasp their full impact, the micro-economic adjustment policies pursued over the past decade have very often enhanced the flexibility of labour markets and brought public finance under more effective control. They have also helped to highlight the interplay between the different components of economic life–between employment and taxation, or between the budget deficit and interest rates, for example. Similarly, economists have increasingly rediscovered the linkages between micro-economic policy measures and macro-economic performance. Rather than seeking to impose administrative measures to achieve policy objectives, the importance of strengthening market mechanisms is increasingly recognised. This constitutes a major reorientation in thinking which arguably is not yet complete. In many areas, the OECD economies are still in transition. ■

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Spotlight on

Sweden

Swedish economic performance since the early 1980s has been remarkable: the unemployment rate has been one of the lowest in the OECD area, public budgets have been improved and are now in surplus, and there is approximate external balance.

The most important problems of the Swedish economy are not rooted in the short term; they are, rather, of a structural nature, affecting both the demand and the supply side of the economy.

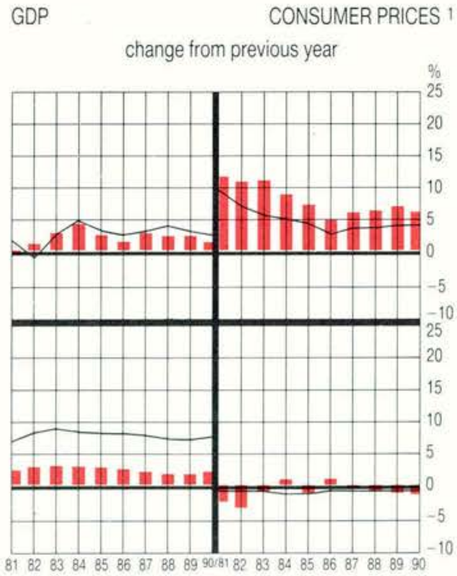
Domestic Wages Out of Step

It has been a matter of concern for the Swedish authorities that wages have continuously risen faster than wages abroad. It is evident that a political commitment to maintain full employment is compatible with the policy of keeping the exchange rate stable only if wage costs develop in step with costs in competitor countries, or if supply-side improvements to the structure of the economy allow them to rise. The evidence from the last two decades seems to point to the ability to reconcile low unemployment with moderate inflation. This is a significant achievement in comparison with other countries but, seen in the light of Sweden's high ambitions and of very low actual unemployment levels and reported manpower shortages, it may not be sufficient.

A principal reason for the rise in labour remuneration in recent periods appears to be the move away from centralised wage bargaining. Another is continuing expectations that, if Swedish cost competitiveness became seriously impaired, the authorities would not allow open unemployment to rise and would sacrifice the policy of stable exchange rates. In view of the clearly expressed determination of the Swedish authorities not to soften this policy, such speculation seems to be singularly unfounded. The most recent proof of their attachment to it was the announcement that the remaining exchange restrictions would be phased out.

Wage leadership, moreover, has passed from the exposed sector to the sheltered sector of the economy, thus breaking with the so-called 'Scandinavian model' of wage determination, where the scope for wage increases in the economy is determined by the competitive position of the exposed sector. This development may have been accelerated by distortions of market forces as a result of excessive government intervention, preferential tax treatment for various sectors and activities and special subsidies. The main problem with wages in the public sector would appear to be their particularly compressed structure rather than their level.

INDICATORS



1. Private consumption deflators.
2. National definitions.

Rigidities in the Labour Market

The original aim of the so-called 'solidaristic wage policy' was not a general narrowing of differentials between different category of skills but equalisation of wages across different sectors of the economy for a given skill category. This interpretation has the merit of facilitating structural change by encouraging movement of labour out of declining sectors and into more productive ones. But the focus on more general pay equalisation may have obscured the allocative function of wages. General pay compression seems to have led to several unwelcome developments: the persistent lack of certain types of labour; a tendency in periods of slack demand for relatively higher unemployment among exposed groups in the labour market—for example, youth unemployment in the early 1980s; and probably, to some extent, higher wage drift and hence higher total wage increases.

The supply-side constraints on economic growth affect both growth of factor inputs and productivity. In the

Swedish Institute

Less tax, fewer deductions, broader base–Sweden sails away from fiscal distortion.

past two to three decades, the input of fixed capital has gradually slowed down and the input of labour, measured in hours worked, is currently at the level of the mid-1960s; growth of productivity has also become weaker. Given the strategy of high employment, labour supply–particularly skilled labour–is the principal limiting factor, possibly to the extent that its relative scarcity may have discouraged investment in new capacity. Nevertheless, there may still be some room, if limited, for mobilising labour reserves, especially among people now working part-time and among the elderly and pensioners who have retired early. Labour may also be misallocated to some extent because of inadequate wage differentials which also discourage the acquisition of higher skills.

The input of capital seems to have been discouraged by the double taxation of distributed profits and the encouragement of self-financing of investment, which have apparently been detrimental to the creation of new enterprises. The dominance in the Swedish industrial sector of large firms in traditional branches appears to bear witness to this tendency.

Because of the stagnation of growth in the population and labour force, the main contribution to economic growth in the longer term will no doubt reside in higher levels of investment and stronger productivity growth. But productivity growth has been relatively weak. One of the causes may have been the lack of competition through subsidisation and protection in certain sectors. The Swedish authorities, aware of this problem, have recently announced the abolition of restrictions on textile imports–although not before 1991, when the present multi-fibre arrangement expires–and a change in agricultural support policy. But it should be emphasised that the gains from more productive use of the factors now employed in these sectors will come about only if these factors, and in particular labour, are not prevented from moving freely elsewhere–which may conflict with current regional policy.

Other sectors that could benefit from increased foreign competition are financial services and construction. The recent boom in construction, which has led to overheating in the building sector–and has caused wages to accelerate–is indicative of the distorting effects of subsidies and tax breaks, and these call for correction.

Removing Fiscal Imperfections

The comprehensive tax reform announced for 1991 appears to be aimed at correcting many, if not all, the impediments to sustained growth. Many of its details have yet to be defined but, generally speaking, it will aim at removing the major imperfections in the Swedish tax system: very high marginal tax rates, relatively narrow bases for most revenues, and a host of specific exemptions and allowances.

A major feature of the reform will be the lowering of high marginal income-tax rates, coupled with the abolition of

certain tax exemptions. Apart from providing added incentives to work and thus giving a boost to the supply of the labour, the lowering of marginal income taxes would help reduce future wage inflation, as the gap between before- and after-tax wage increases would diminish, provided the trade unions did not put too much emphasis on relative after-tax wages, since an attempt to narrow the new net wage differentials would again lead to higher wage inflation. It might thus be advisable to review the system of taxing the labour income of retired persons and state pensioners, as well as the rules for entitlement to pensions.

The automatic reduction of public transfers when other revenues rise does not seem to make sense from a labour-market point of view, nor help create incentives for savings. Last but not least, a sizable reduction of marginal income-tax rates should make it possible to eliminate or at least weaken one of the main causes of low private net savings–the deductibility of up to 50% of interest payments on household debt.

By abolishing obstacles to the distribution of profits and other tax devices that tend to lock capital in the large, mature industries, additional savings could be mobilised to finance new and potentially more productive ventures.

Because of the complexity of the Swedish tax system as it has evolved over the years–and the heavy burden of taxation in relation to GDP–a comprehensive reform that aims at removing structural impediments to sustained growth, whilst continuing to observe a specific concern for social justice, will be a formidable undertaking. There is no doubt that over the medium term the achievements of Sweden can be defended successfully only if the necessary structural reforms are carried out and the procedures of wage formation yield outcomes more in line with the requirements of sustained international competitiveness.■

Source: **OECD Economic Surveys: Sweden,** OECD Publications, Paris, 1989.

Austria

Austrian economic performance has been much better than expected a year ago. Total output grew at a healthy rate of around 4%; employment picked up, increasing by more than the labour force for the first time since 1979; inflation, measured by the rise in the GDP deflator, came down further, to below 2%; and the current external account remained in broad equilibrium.

The favourable international environment has played a vital role, as did a number of other factors which, in large measure, will not re-occur. First, because of its export structure, Austria benefitted at an early stage from the increased strength of world trade since the second half of 1987. Second, the remarkable resilience of financial and foreign-exchange markets to the stock-market crash in October 1987 had beneficial effects on business and consumer confidence. Third, clement weather early in the year boosted building and related activities. And finally, the speedy and early voting of the 1989 Tax Reform, apart from inducing business to advance investment projects, seems also to have helped build confidence in the Austrian economy.

In view of the much-improved business climate in Austria and her major trading partner countries, the outlook for the coming year or two remains satisfactory, although, with less favourable shifts in the structure of demand and less idle capacity, the growth of output may fall to 2–3% per annum. Exports should remain the most dynamic growth component. With monetary policy continuing to be accommodating and the cyclically adjusted budget deficit projected to rise slightly in 1989, the expansion of private domestic demand can also be expected to hold up relatively well, in particular in the event of a further drop of the personal saving ratio as assumed in the OECD projection.

On these trends, and with productivity growth likely to remain strong, employment growth may be only moderate, allowing little further reduction in unemployment. Yet strong productivity growth in conjunction with projected wage developments and maintenance of a stable Schilling/Deutschmark relation should keep inflationary pressures at bay. With no further terms-of-trade gains expected, the current external balance is unlikely to change much over the projection period.

Tax and Industry Reformed

During its first two years in office the present Government has implemented two important reform projects: a major income-tax reform and a comprehensive restructuring of nationalised industries, including partial privatisation, with the government maintaining majority share-holdings. Concurrently, steps were taken to reverse the previous trend deterioration in the Federal financial position. Beneficial supply-side effects can be expected to result from each of these initiatives. The first encouraging results are already apparent but it will take a few more years before the full impact can be assessed.

The restructuring of the state-owned holding company, the Österreichisches Industrielverwaltung Aktiengesellschaft (ÖIAG), has nearly been completed. The production capacity and the labour force in structurally weak sectors, such as steel, have been further slimmed. Management independence has been strengthened and the most obvious operating inefficiencies have been removed. The ÖIAG is now expected to break even in its current operations two years earlier than initially planned.

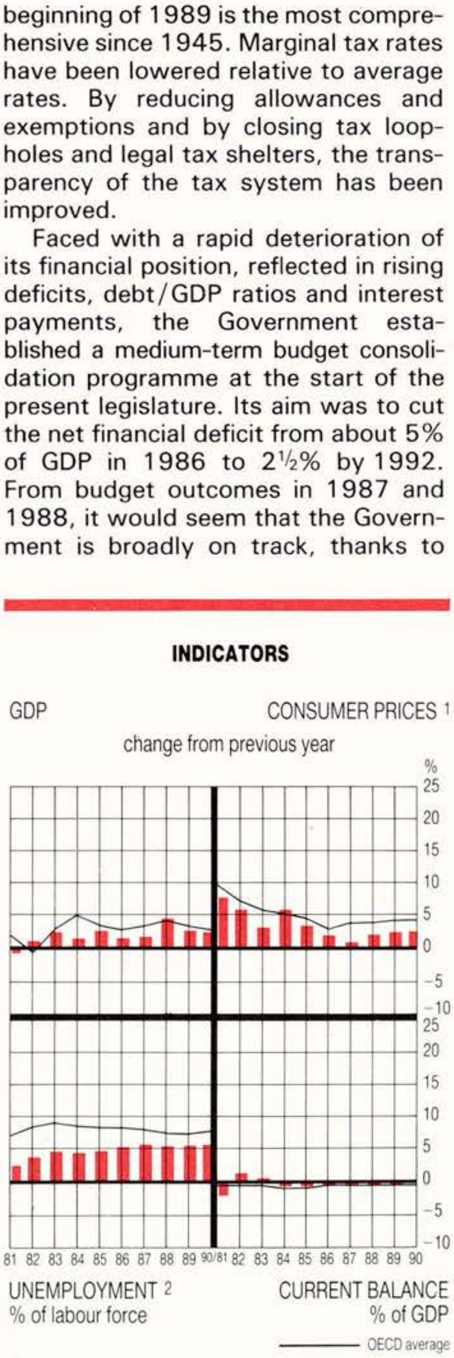
To allow more room for financial manœuvre, sizable asset sales have been made over the past two years and further selling is envisaged in the future. It is important that firms that are still largely state-owned be subject to the same financial discipline and regulatory conditions as competing private enterprises, and equally important

that markets in which these enterprises operate are, or are made, competitive.

The tax reform introduced at the beginning of 1989 is the most comprehensive since 1945. Marginal tax rates have been lowered relative to average rates. By reducing allowances and exemptions and by closing tax loopholes and legal tax shelters, the transparency of the tax system has been improved.

Faced with a rapid deterioration of its financial position, reflected in rising deficits, debt/GDP ratios and interest payments, the Government established a medium-term budget consolidation programme at the start of the present legislature. Its aim was to cut the net financial deficit from about 5% of GDP in 1986 to 2½% by 1992. From budget outcomes in 1987 and 1988, it would seem that the Government is broadly on track, thanks to

INDICATORS



1. Private consumption deflators.
2. National definitions.

appreciable expenditure restraint in public-sector consumption and investment. In limiting the net borrowing requirement to 4.7% of GDP in 1987 and to an estimated 4.2% in 1988, the Government was much aided by the unexpected strength of the economy.

But there are limits to further investment cutbacks and continued asset sales. Designed to be revenue-neutral over the medium term, the tax reform will nonetheless entail revenue losses in 1989 and the early 1990s. The first-year shortfall of Sch. 10 billion (about half of which is carried by the Federal government) will be more than offset by a stepping-up of asset sales and a transfer of built-up reserves from 1988–both non-recurrent sources of finance.

Supply-side improvements as a result of the tax reform may raise the growth potential of the Austrian economy, especially if accompanied by further reductions of regulation and subsidy. A number of beneficial steps have already been taken, but the scope for further measures remains large. The budget balance should eventually also benefit from the recent and prospective progress in putting the nationalised sector of the economy on a sounder footing, enabling public enterprises to acquire external finance in the capital market on equal terms with private companies. For some more years to come, nonetheless, the Federal budget will still be burdened with losses previously incurred by state-owned enterprises.

Social Security, Financial Fragility

Apart from unemployment benefits, the rapid rise in social expenditure has been mainly due to steadily increasing pension outlays, in turn a combination of several factors:

- a growing tendency towards early retirement
- extension of eligibility for social security coverage
- a rise in average pensions relative to wages.

Labor Pfeifer, Vienna

Business confidence, reduced regulation and fewer subsi increased growth.

In addition, the financial burden on the Federal government has been exacerbated by a narrowing of the contribution base entailed by a continuing shift of employment towards the public sector and, since the early 1980s, the rise in unemployment. The steady increase in social-security contribution rates, now among the highest in the OECD area, has by itself been insufficient to check the rise in federal transfers to the pension insurance system.

The problems of funding contribution-related pensions partially out of general tax revenue will be further aggravated by the aging of the population. The available options for social security finance are a matter of simple arithmetic, involving price and/or quality adjustments. On plausible assumptions about fertility rates and life-expectancy, the implicit old-age contribution rate required to meet all pension obligations even if there were no change to pension entitlements would have to rise by about 50% over the next four decades. But if contribution rates remained unchanged and government transfers to the old-age pension system were frozen at present real levels, average pensions relative to the compensation of employees would have to decline by about 25%. In the absence of any adjustment of contribution rates and benefit entitlements, federal transfers to the old-age pension insurance would have to double in real terms. Numerous combinations of these three solutions exist.

dies could put the Austrian economy on the path to

There are, of course, also other measures which could be taken to ease the financing problem–for example:

- prolongation of working life
- full dependence of pensions on lifetime income and contributions
- widening of the social-security tax base
- harmonisation of benefit levels of different pension schemes.

Immigration could also affect the picture. The package of measures eventually to be chosen will obviously be a political question. None of the various solutions can clearly be favoured on its own merits, although a simultaneous easing and equitable sharing of future transfer burdens between the active and the inactive part of the population would seem to be the most reasonable outcome. Moreover, future pensioners could be encouraged to participate more actively in building up wealth earlier, including claims on private insurance.

Progress has been made in many areas of policy, both in micro-economic reform and reducing macro-economic imbalances. It is important to keep up momentum in efforts to improve supply conditions for output and employment. The dividend from sustained growth would much facilitate the task of budget consolidation and help solve the inter-generational transfer problem arising from the aging population. ■

Source: **OECD Economic Surveys: Austria**, OECD Publications, Paris, 1989.

New Zealand

During the second half of the 1970s, the importance of making OECD economies more flexible and responsive to change was increasingly recognised as an indispensable element of policies designed to restore prosperity after the oil shocks and the associated worldwide recession. In New Zealand, up to 1984, policies had often moved in the opposite direction, and the degree of trade protection and extent of government intervention that resulted was unusual for a developed economy. The underlying malaise required far-reaching micro- and macro-economic reform. Macro-economic policy sought a steady, but large, reduction in the budget deficit and to keep monetary policy sufficiently tight to put downward pressure on deeply entrenched inflation expectations. The micro-economic leg of the strategy adopted was to reform a variety of controls and regulations to enhance productivity growth and to restore New Zealand as a competitive, market-oriented economy. The reorientation of micro-economic policies during the last four years has been an outstanding achievement (box, p. 38).

Four years of extensive reform have put the New Zealand economy in a better position to achieve sustainable, non-inflationary growth than at any time for decades. For the first time for fifteen years (excluding periods of price and wage freezes), inflation is down to the OECD average. The current external deficit has been reduced by around 7% of GDP. Moreover, with a large array of government controls on the economy now unwound, New Zealand is well placed to make good use of the strong world economy and buoyant international commodity prices.

Structural Achievement

But the speed and degree of policy change has varied between sectors. The export sector was quickly exposed to world prices as export and agricultural subsidies were rapidly phased out. Adjustment in the import-competing sector has been slower, but still substantial, and the authorities have announced a timetable for further significant reductions in tariffs, which are still high by OECD standards.

The exposure of the non-tradable sector to increased competition started more recently: the commercialisation ('corporatisation') of various economic activities carried out by government departments has been an important step. The authorities intend to continue these reforms. Telecommunications, electricity generation and postal services are being opened to new competition. Smaller–but still privileged–sectors will not be immune: in particular, restrictive practices in professional services (for instance, lawyers' monopoly on conveyancing) are to be abolished.

Reform in factor markets has also been rather uneven. Financial markets

INDICATORS

1. Private consumption deflators.
2. National definitions.

were freed rapidly, and the boom in the financial sector that resulted was an important factor behind the resilience of economic activity. But adjustment in the labour market has been slow, and further reform is required. Wages, largely determined by national awards, still tend to rise at similar rates in different sectors irrespective of market conditions. Wage bargaining should be sensitive to the risk of worsening unemployment which is already high; and wage agreements must maintain international competitiveness. Wage moderation is essential for securing lower inflation and a significant and durable increase in employment. International experience suggests that those countries with flexible and responsive wages manage to cope with structural change and disinflation with a smaller increase in unemployment than those countries where wages are rigid.[1]

The experience of other OECD countries also suggests that dealing with high and rising unemployment requires action over a broad area. As in many other countries, bargaining outcomes are often adversely affected by institutional and legal frameworks, and progress towards improving them is desirable. For example, work practices that protect those in employment but discriminate against others seeking jobs should be discouraged. Furthermore, it would seem important to review how tax-and-benefit systems affect labour-market behaviour. Better training and educational reform will help to reduce the mis-matches of skill that will arise as the economic recovery progresses.


Something to shout about? New Zealand has undertaken

THE RE-ORIENTATION OF NEW ZEALAND MICRO-ECONOMIC POLICIES SINCE 1984

Wage and Price Controls
- Abolished in 1984
- No government involvement in private wage negotiations
- Rents and energy prices deregulated between 1985 and 1987

Labour Market Regulations
- Labour Relations Act 1987 to encourage decentralised bargaining and union amalgamation
- Compulsory unionism remains and national award agreements still dominate
- State Sector Act 1988 puts public-sector employment on a comparable basis to private sector

International Trade
- Export subsidies for agriculture and industry rapidly phased out from 1985
- Import quotas and licensing phased out in mid-l988 for industries outside industry plans
- Phasing out of quotas for trade-sensitive industries by the early 1990s
- Rapid bilateral removal of tariffs with Australia by 1990
- Phased unilateral tariff reductions with third countries
- Effective rates of industry assistance fell from 37% in 1985 to 26% in 1987/88

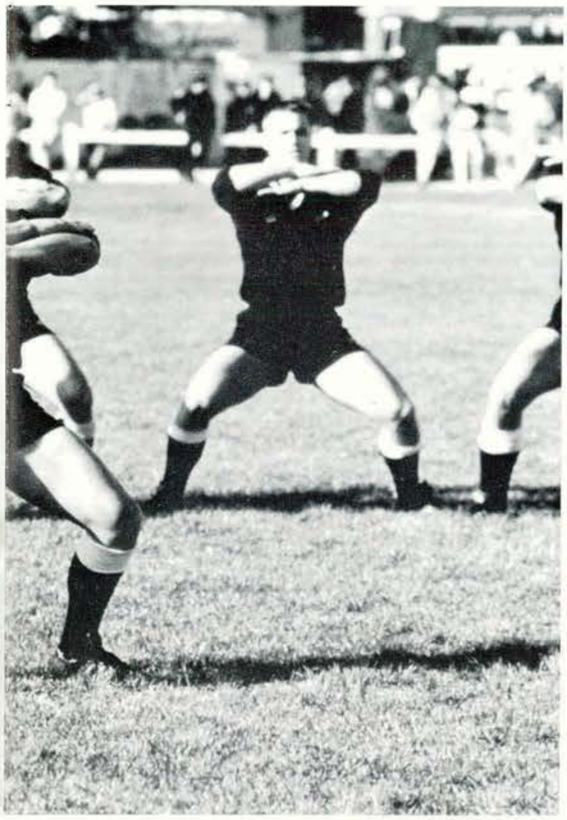
Financial Markets
- Removal of controls on international capital flows and domestic credit in 1984
- Removal of barriers to entry into banking in 1987

Other Private Services
- Deregulation of road haulage in 1983 and partial deregulation of airlines in 1987
- Deregulation of telecommunications in 1987

Public Sector Reforms
- Tax and transfer reform, establishing the least distortive tax system among OECD countries
- Corporatisation of government departments providing commercial services
- Privatisation to reduce public debt by one-third by 1992
- Reform of the government sector: emphasis on outputs
- Opening government procurement to private competition
- Introduction of increased local autonomy and accountability for hospital and education boards and for local authorities
- Adoption of full cost recovery pricing and users' cost principles for government services.

Reforming Government

Government services constitute one of the largest non-tradable sectors in most modern economies, and the potential gains from reform are large. As in many other countries, the provision of government services in New Zealand had been insulated from



Presse-Sports

a vigorous programme of micro-economic reform.

changes in economic conditions: civil servants, teachers and others enjoyed almost unconditional security of employment; pay was determined on fixed scales with little or no differentiation for performance, the scarcity of skills and so on; government departments were frequently obliged to purchase goods or services only from other government departments; and managers within the government sector had little scope to make the changes required to improve the efficiency of their services. Public expenditure control took the form of restrictions on inputs. Moreover, consumers had little say in the quality or nature of services provided them by the state sector.

The authorities are enacting major changes here. Much more effort will be put into measuring the output of services provided. The recruitment of senior civil servants will be broadened and appointees given contracts of up to five years. Contracts will define what 'outputs' Ministers expect their department to achieve in as explicit and measurable way as possible. As the input-based form of public expenditure control will be gradually phased out, new-style chief executives will have much more freedom to determine pay and employment and to purchase goods and services from the private sector.

But such a radical change will take time to introduce, and there will almost inevitably be teething problems. During a transitional period it would seem particularly important to keep in place mechanisms designed to prevent cost overruns. Given the importance of achieving a budget surplus and of exploiting fully the potential gains in efficiency from tax reform, as much of the required fiscal adjustment as possible should take the form of cuts in lower-priority expenditure.

In sum, maintaining the momentum of micro-economic reform by further reductions in import protection and by a continued attack on restrictive practices in the non-tradable sector and in the labour market would enhance New Zealand's economic prospects. The OECD's assessment is that strong growth in export markets, terms-of-trade gains and lower inflation should provide a significant stimulus to growth: annual GDP growth is projected at about 2% in 1989 and 1990. For the first time in many years, growth would come from activities where New Zealand is competitive on world markets and could therefore be sustained. Further progress towards government budget surpluses and maintaining downward pressure on inflation would do much to build confidence. Similar persistence with adjustment policies in a number of other OECD countries was rewarded by a steady decline in long-term interest rates and a strong rise in investment. ■

1. See pp. 28–32.

Source: **OECD Economic Surveys: New Zealand**, OECD Publications, Paris, 1989.

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