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TRADE AND STRUCTURAL ADJUSTMENT

This document contains Part II and Part III following Part I which is contained in TD/TC(2005)2/CHAP1/FINAL.

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TABLE OF CONTENTS

PART II: THE DOMESTIC POLICY FRAMEWORK: THE EXPERIENCE OF OECD MEMBER COUNTRIES 3

Structural adjustment and its driving forces 3
Countries' capacities to adjust differ 8
Policies to facilitate structural adjustments and assist displaced workers 11

PART III: TRADE AND STRUCTURAL ADJUSTMENT: TOWARDS GOOD PRACTICE 24

1. National Policy Making 24
2. Bilateral and Regional Cooperation 43
3. Multilateral Cooperation 44

PART II: THE DOMESTIC POLICY FRAMEWORK: THE EXPERIENCE OF OECD MEMBER COUNTRIES

Structural adjustment and its driving forces

1. Part I has shown that structural change is pervasive. This Part will consider structural adjustment in OECD member countries in more detail, including possible policy responses. The following material draws on OECD members' experience. The policy implications, however, are also relevant for all but the poorest developing countries. For the latter, the focus should rather be on capacity and institution building, as discussed later.

2. Trade and investment liberalisation and international competition are important drivers of changes in the structure of output and employment. As international integration advances, demand, production and employment are shifted across industries within each country in line with their comparative advantages, while international competition encourages restructuring within firms and industries by spurring innovation and productivity, as the case studies in Part III will demonstrate. A number of other factors – notably technological progress and international mobility of capital and labour – interact with trade as drivers of structural change, partly by opening up domestic markets to international competition and offshoring possibilities. Trade-related adjustments are, in this respect, part of a wider process of structural change and creative destruction. Disentangling the role of trade from this wider process of change is difficult because of the many possible interactions. The main policy challenges appear, however, to be the same – regardless of the ultimate source of the structural change: i) to create the general conditions in order to facilitate a smooth transfer of resources from declining to expanding activities; while ii) providing adequate assistance to those who experience adjustment costs as a result of structural change.

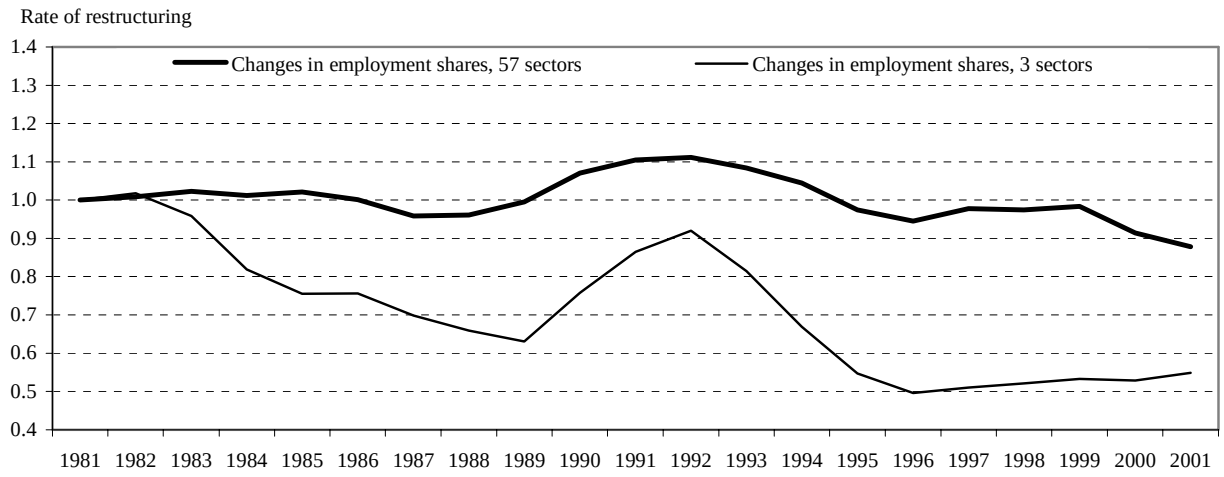
3. As discussed in Part I, the sectoral composition of OECD economies has changed substantially over time, with services playing an increasingly important role. The transfer of resources from declining to expanding industries is, in this respect, not a new challenge. In fact, the rate of change in employment shares of broad industries (*i.e.* agriculture, manufacturing and services) seems to have declined in most OECD countries over the past decades (Box 1). The continuing re-allocation of labour resources is, however, still quite strong, in particular across more narrowly-defined industries. This reflects, in part, changing trade patterns. For example, employment declines have often been quite sharp in those manufacturing industries where import penetration has risen most strongly (Figure 1, Panel A). The recent strong expansion of intra-industry trade – including international sourcing of intermediate inputs – suggests that trade is also stimulating a significant amount of labour re-allocation within industries. These changes in the job mix also tend to reduce (relative) labour demand for the least educated workers (Figure 1, Panel B).

Box 1. The rate of structural change has not increased

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

The rate of change in sectoral employment patterns[1]

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



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

Notes

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

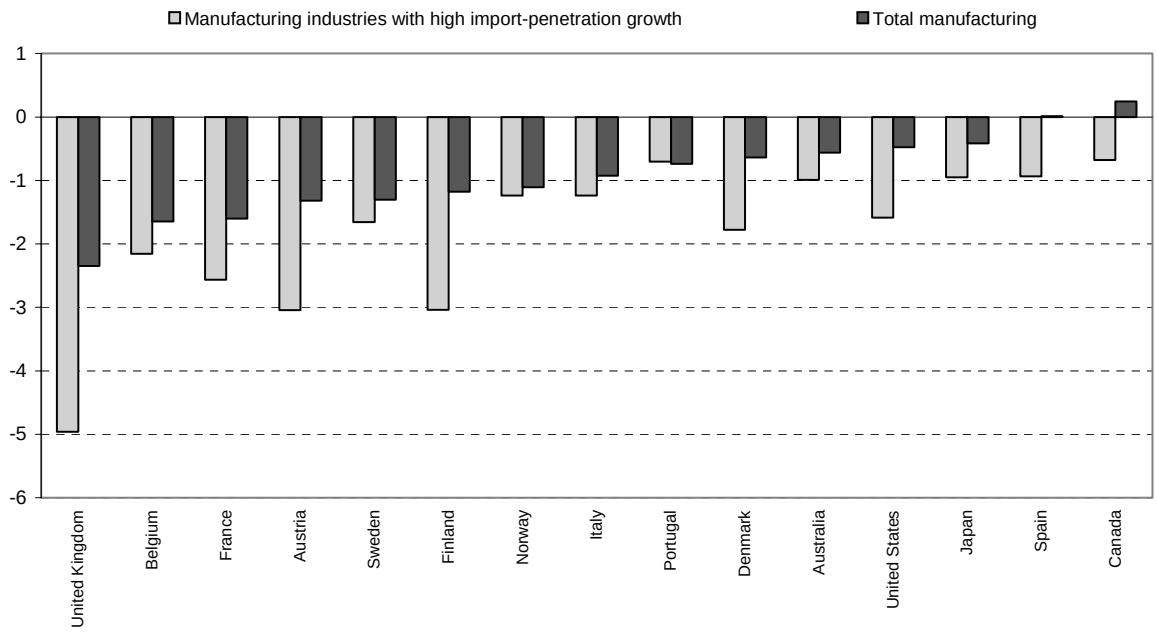
Simple average of 20 OECD countries.

Source: The OECD Stan Database for Industrial Analysis and Groningen Growth and Development Centre Database.

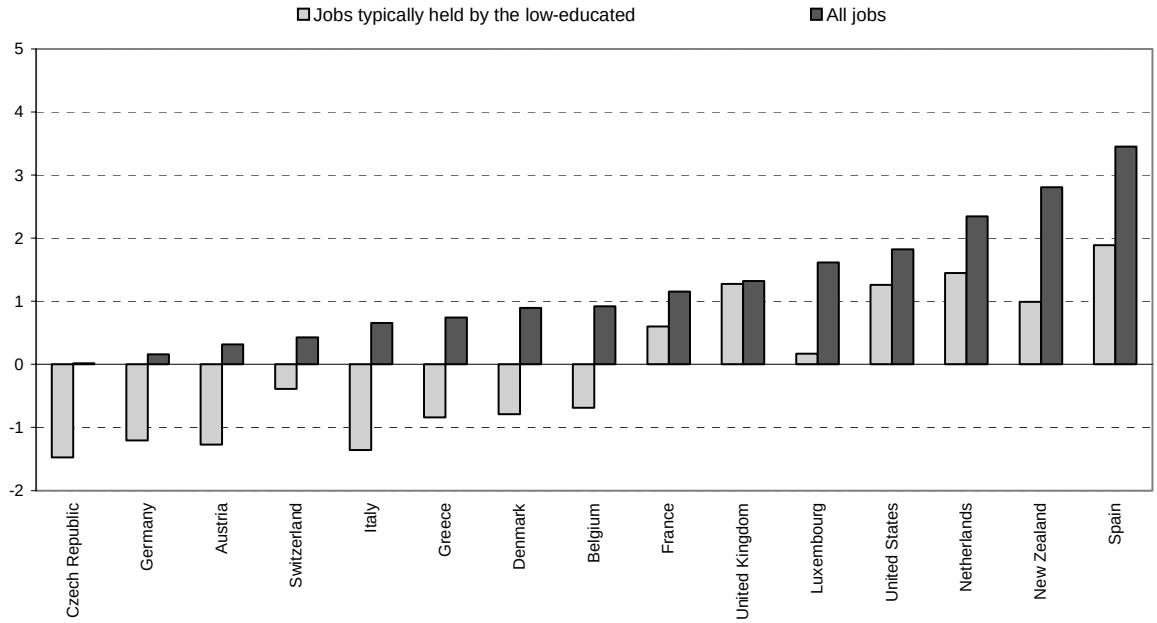
1. Such simple indicators are, however, subject to certain limitations. They are, for instance, sensitive to the chosen aggregation level, and pick up relative expansion and contraction of sectors over the business cycle.

Figure 1. **Trade, structural change and declining employment opportunities for low-educated workers**[1]

Panel A. Import competition and employment growth in manufacturing (annual percentage growth rate, 1980-2000)



Panel B. Changes in job mix and the demand for low-educated workers (annual percentage growth in employment, 1993-2002)



1) Industries with high import-penetration growth (see Panel A) are those manufacturing industries where the import-penetration ratio rose most strongly during 1980-2000, whereas jobs typically held by the low-educated (see Panel B) correspond to industry-occupation cells with a high share of workers with less than upper secondary education in 1993.
Source: OECD STAN Database; OECD Employment Outlook, 2004, Chapter 4.

4. To a large extent, structural adjustments take place through *voluntary* job transfers, either directly from one job to another or through the replacement of old cohorts of workers with younger ones. This is

accompanied by capital adjustments as fixed investments are reallocated towards expanding firms and industries. These developments have involved relatively low adjustment costs for individuals and spurred growth as resources are moved towards activities providing higher returns.

5. Firm closure and involuntary job displacements are, however, an inevitable and particularly challenging part of the adjustment process. Although the available evidence is limited, it suggests that 3 to 5% of the workforce experience an involuntary layoff in any given year, with about a third of these displacements corresponding to firm closings and other mass layoffs (Table 1). This can be painful for the individuals, families and communities involved, while costs for society as a whole can be large in terms of lost human capital and production. Indeed, involuntary displacement of workers is often associated with long spells of unemployment, or recourse to early retirement or disability benefits, in particular for high-tenure workers displaced from declining manufacturing industries. Re-employed workers may also experience a significant and persistent loss in earnings compared to their previous employment, particularly if they have to change industry and, thus, cannot capitalise on accumulated sector-specific skills. For example, a recent study found that two-thirds of US workers displaced from jobs in manufacturing and becoming re-employed earned less in their new job than they did in their previous one, and one-quarter experienced earnings losses in excess of 30% (Kletzer, 2001). An OECD analysis for 14 European countries also concludes that a significant minority of displaced manufacturing workers experience large earnings losses, although this is more often due to long-term unemployment or premature withdrawal from the labour force, than wage cuts on the new job (OECD, 2005).

Table 1. **Estimates of displacement incidence and costs for selected OECD countries**

		Incidence rate (annual)[a]	Probablity of still being jobless after		Displacement-induced percentage wage changes	
			6 months	12 months	Total tenure	Tenure more than 10 years
A. Total layoffs						
Canada	1995	4.9	0.47 (Men) 0.68 (Women)	0.30 (Men) 0.41(Women)	-1 (Men) -2 (Women)	-11 (Men) -7 (Women)
Japan	1995	3.5	0.23 (Men) 0.25 (Women)	0.14 (Men) 0.11 (Women)	-4 (Men) 0 (Women)	. .
Netherlands	1993-95	4.1	0.46[e]	0.28[e]	. .	. .
United Kingdom	1990-96	4.7	0.2	0.12[f]	-4	-6[h]
United States	1993-95	4.9	0.33[g]	0.24[g]	0	-19
B. Mass layoffs only[b]						
Belgium	1983	2.1	0.72 (Men)[d]	..	-6[d]	-6[i]
Denmark	1988	1.6	0.37 (Men)[d]	..	-1[d]	..
France[c]	1984-90	0.5 (Men)	0.62 (Men)[e]	0.45 (Men)[e]	..	10
Germany[c]	1984-90	1.1 (Men)	0.52 (Men)[e]	0.40 (Men)[e]	..	2

. . Data not available.

a) Workers displaced in a year as a percentage of total employment.

b) Workers separating from dying firms (Belgium and France) or dying plants (Denmark and Germany).

c) Workers 25 to 50 years of age with a minimum of 4 years tenure.

d) Workers with a minimum of 3 years tenure.

e) Conditional on a positive spell of joblessness.

f) After 10 months.

g) Workers with a minimum of 1 year of tenure.

h) Workers with a minimum of 5 years of tenure.

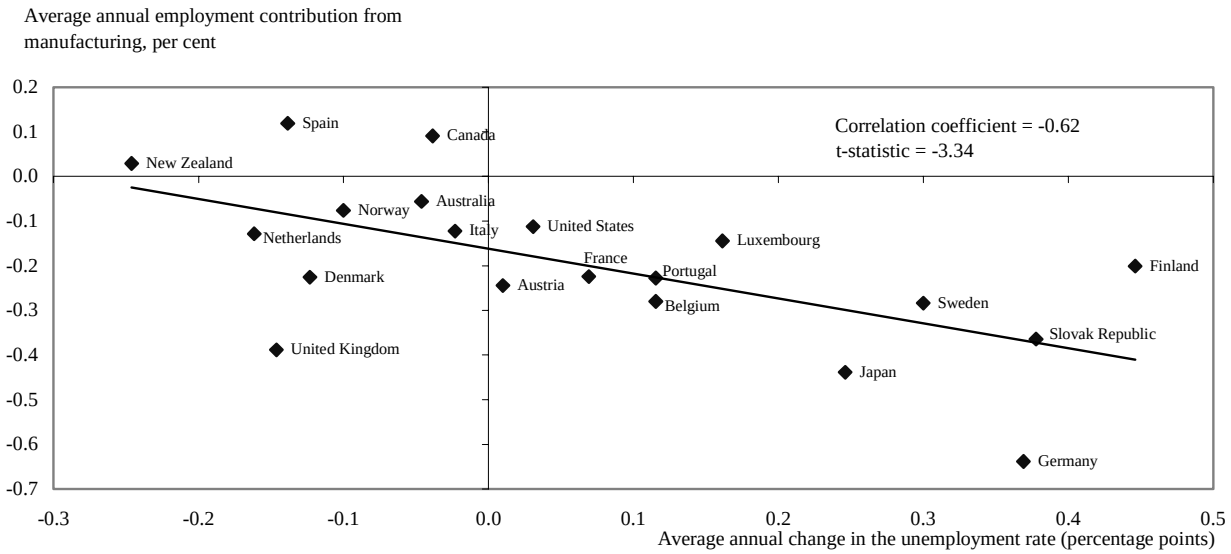
i) Workers with a minimum of 6 years of tenure.

Source: Kuhn (2002)

6. The adjustment costs resulting from job displacement and premature scrapping of capital reduce the overall short-term gains from structural changes and place the burden on a narrow segment of the population, raising equity concerns and potentially eroding political support for trade liberalisation and, more generally, efficiency-enhancing structural change. Recent OECD experiences indicate that the adverse effects could be significant at the macro level. Declining manufacturing employment, for whatever reason, has, for example, been accompanied by higher unemployment (Figure 2), although with important exceptions (notably the United Kingdom).

Figure 2. **Declining manufacturing employment, unemployment**

A. Manufacturing employment and unemployment, 1990-2003



Source: The OECD STAN Database for Industrial analysis, OECD Labour force statistics.

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

Countries' capacities to adjust differ

8. The capacity of countries to manage structural adjustments, including those which are directly trade-related, is reflected in broad indicators of performance like GDP, productivity, employment and unemployment. It is also revealing to examine *labour market mobility* – indeed, other things being equal, higher mobility is likely to speed adjustment to structural change and lower the associated costs. A number of indicators point to substantial cross-country differences in the mobility of labour resources (Figure 3):

- Countries' capacity to re-employ displaced labour resources varies considerably, as measured by the incidence of long-term unemployment (Panel A).

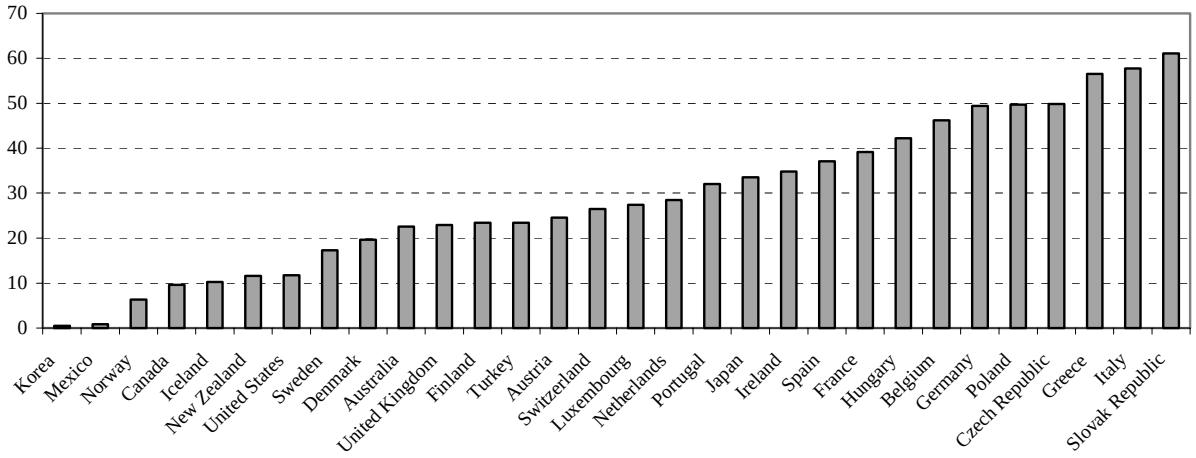
- Labour mobility between employers differs widely, as measured by the average job tenure of workers (Panel B). Shorter job tenure – if accounted for by voluntary job changes – may facilitate the adjustment process by providing a higher flow of vacancies.

- Finally, regional labour mobility is important to handle structural change that has uneven geographical impact. Again, huge country differences seem to exist, as measured by the incidence of internal migration (Panel C).

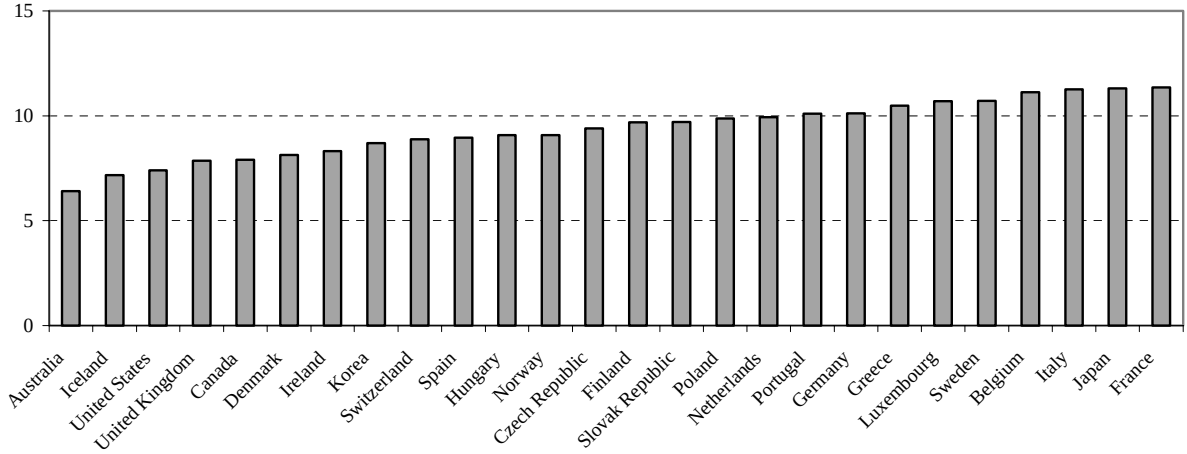
These mobility indicators should be interpreted with caution. Some labour turnover may be unproductive "churning" and country disparities in re-allocative turnover could reflect differences in the magnitude of structural shocks, rather than differences in adaptive capacity. Nonetheless, a certain country grouping emerges from the above indicators. First, some countries are characterised by relatively high labour mobility along all the dimensions discussed above and appear to have well-developed adjustment capacities (including Australia, Canada, Denmark, New Zealand, Norway, the United Kingdom and the United States). On the other end of the spectrum, a number of countries have below-average mobility, which may be symptomatic of particular problems in coping with labour market adjustments (including Belgium, the Czech Republic, France, Germany, Greece and Italy).

Figure 3. Indicators of labour mobility

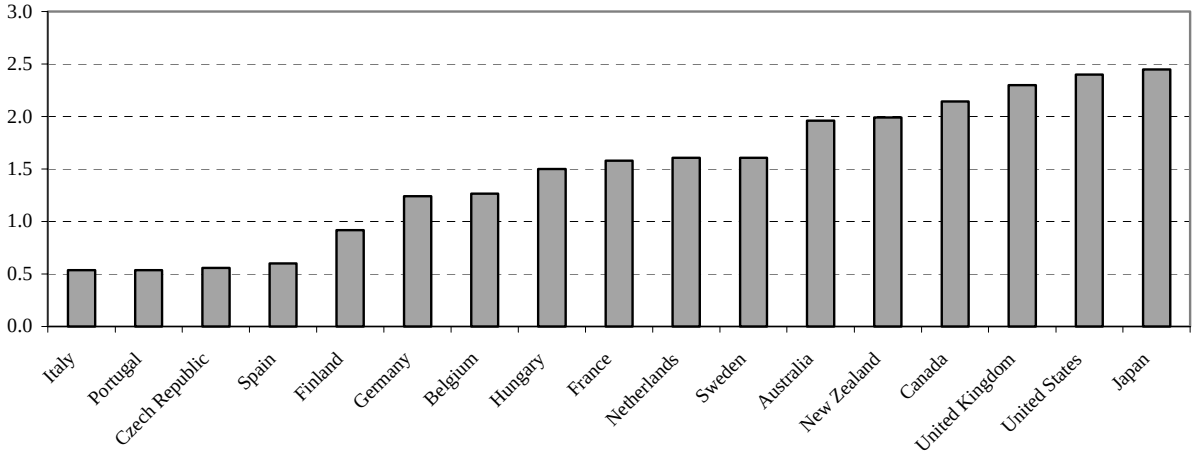
A. Incidence of long-term unemployment[1], 2003



B. Average job tenure (years), 2003[2]



C. Internal migration in the mid-1990s (ratio of gross flows to population)



1. Defined as those unemployed continously for 12 months or more as percentage of total employment.
2. Or latest year available.
Source: OECD.

Policies to facilitate structural adjustments and assist displaced workers

9. A number of policies may impact on the capacity of countries to adjust in the face of structural shocks. Reintegrating displaced workers is particularly challenging and involves policies to ensure sufficient work and hiring incentives, as well as employability. In addition, regulations and related policies should favour a mobile labour force and a business environment supportive of growth and job creation. The overriding advice to countries is to aim for good general policies to handle the costs of structural adjustment, although targeted policies could be useful in certain circumstances.

Unemployment benefit, early retirement and disability schemes

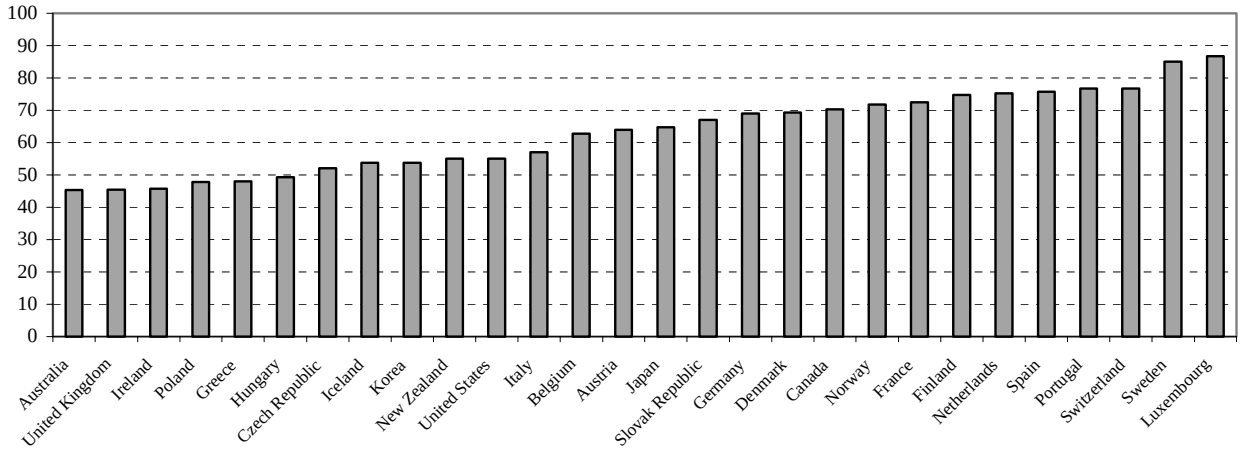
10. Countries' benefit systems play an important role in the reintegration of displaced workers. Unemployment benefits help cushion the cost of adjustment for the affected individuals and subsidise productive job search, but overly high replacement rates also lower the economic incentives for re-employment (Figure 4). Work incentives can be especially poor for displaced workers who have to change industry as unemployment benefits based on past earnings can be very high relative to potential post-displacement wages. There are two main reasons for this. First, workers that have to change industry to find new employment may no longer capitalise on accumulated firm and sector-specific skills, reducing their productivity and potential earning in a future job. Second, different industries tend to pay very different wages to workers with roughly similar skills and other characteristics, possibly reflecting rents originating in weak product market competition and workers' bargaining power in different industries. In general, displaced workers from declining industries could easily face replacement rates close to or above 90% relative to their potential earning in expanding destination sectors when differences in the sectoral wage premia are taken into account.

11. Re-employment of older workers represents a particular challenge, partly because long-tenured workers often experience the largest wage losses when displaced. Unemployment benefits for older workers are often also of longer duration and can be subject to fewer job-search requirements, while early-retirement and disability pension schemes may provide alternative attractive routes out of the labour force. In practice, job displacement of older workers is often associated with long spells of unemployment and a high risk of permanent withdrawal from the labour force.

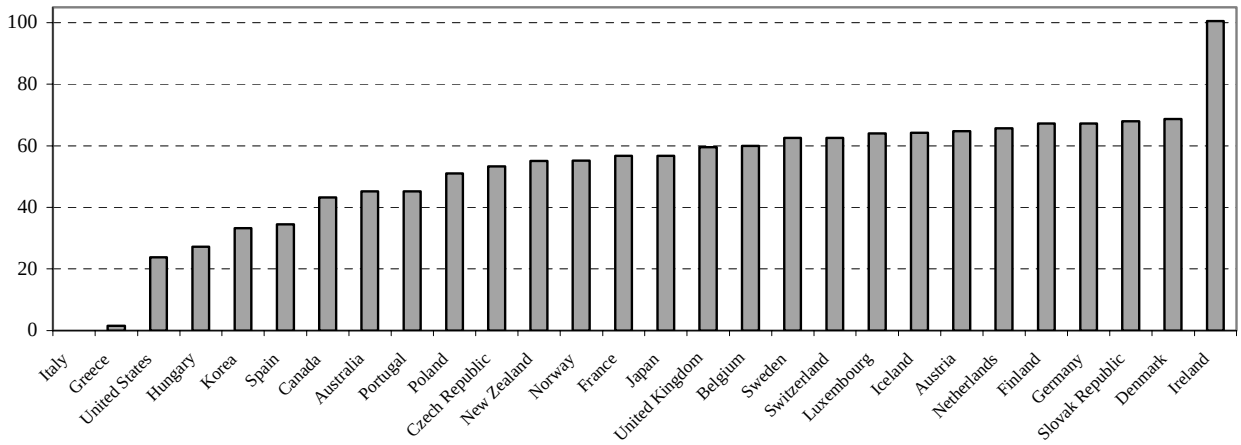
Figure 4. **Net replacement rates in unemployment benefit schemes**

Relative to previous earnings[1], per cent, 2002

A. Initial replacement rate for workers earning 100% of the average production worker



B. Long-term replacement rate for workers earning 100% of the average production worker



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

Source: Benefits and Wages, OECD Indicators.

12. In view of their high replacement rates, many continental European countries face a particular challenge in ensuring that benefits do not excessively delay the labour re-allocation process. These countries face the choice of increasing the emphasis on activation as a means of providing effective re-employment services, ensuring work-availability and willingness-to-work, and/or reducing benefit levels or benefit duration. In the context of peer-reviews in the OECD, several countries have been recommended to take such actions (including Austria, Canada, Denmark, Finland, France, Germany, Luxembourg, the Netherlands, Norway, Poland, Spain and Switzerland). A number of countries have also received a recommendation to curtail early retirement through either special schemes or the disability benefit system (including Australia, Japan, Norway, Switzerland and most EU member countries). Acting on such recommendations would limit the risk that quits or layoffs would result in long spells of unemployment or withdrawals from the labour market.

13. The structure of unemployment benefits might also be modified in the case of displaced workers, so as to increase the financial incentives to become re-employed promptly or to provide some compensation for long-term reductions in earnings potential. Re-employment bonuses may help shorten unemployment spells by paying awards to job seekers who find and accept employment within a specified period of time. Wage insurance is another possible means to encourage displaced workers to become re-employed promptly, even if they are not able to find a job that pays as well as previously. These schemes pay a temporary earnings supplement to displaced workers who accept new jobs at lower wages, with the amount of the supplement increasing with the magnitude of the reduction in wage between the old and new job. Wage insurance is similar is some ways to the in-work benefits that have been used as part of a "make work pay" strategy in a number of OECD member countries. However, wage insurance differs insofar as the benefit is based on the decline in wages between the current and prior job, rather than on the wage in the current job being low in an absolute sense. While interesting, the approaches discussed in this paragraph are still experimental in nature and no firm conclusions can yet be drawn as to whether their benefits outweigh the potentially high budgetary costs (see Box 2). Finally, targeted employment subsidies represent an alternative fiscal mechanism encouraging re-employment (see the discussion of active labour market programmes) which may be superior in some cases.

Box 2. Examples of innovative forms of unemployment benefits

Re-employment bonus: The United States, Japan, Sweden, France and Korea have used re-employment bonuses in an attempt to shorten post-displacement jobless spells. Re-employment bonuses are awards paid to job seekers who find and accept employment within a specified time period. The size of the bonus can be a fixed-sum payment or based on a percentage of the total unemployment benefit for which the worker is eligible. In Sweden and France, for example, workers receive 65% of their remaining entitlement if they accept a job within ten months. In Japan, the bonus equals between a third and two-thirds of the remaining entitlement while a pilot scheme in the state of Illinois in the United States compensated job seekers with a lump-sum payment of $500 for re-employment within an 11-week period. Evaluation results are somewhat promising, suggesting that re-employment bonuses can reduce average durations of unemployment, but it is not clear whether this effect is also present for displaced workers experiencing a significant reduction in earnings potential.

Wage insurance (three recent schemes):

A wage insurance scheme for older trade-displaced workers was recently introduced in the United States. Since August 2003, workers of at least 50 years of age eligible for Trade Adjustment Assistance (TAA) may choose Alternative Trade Adjustment Assistance (ATAA) instead. This programme offers a wage subsidy to trade-displaced workers who obtain a different, full-time job within 26 weeks of separation and who are paid wages below those in the previous, adversely affected employment. Provided that the worker does not earn more than $50,000 per year in the new employment, a payment (*i.e.* an employment subsidy) of 50% of the difference between the new salary and the old salary is paid, up to a maximum of $10,000 over two years. The German government has recently introduced a similar programme for older job losers, albeit without limiting eligibility to workers affected by trade-related job displacement. In France, *Article R. 322-6 du code du travail Arrêté du 26 mai 2004* provides for a system of wage insurance known as *conventions d'allocations temporaires dégressives*. Under this programme, workers displaced in a mass layoff who are reemployed on a permanent contract at a lower wage are eligible to receive a subsidy covering 50 to 70% of the difference in earnings, but of not more than 153 Euros per month, for a period of two years. Neither of these schemes has been in place long enough to assess how well they are functioning.

Active labour market policies

14. Active labour market programmes (ALMPs) – including job-search assistance, counselling, training, moving allowances and other re-employment services – are the policy instrument that serves most directly to enhance the re-employment prospects of displaced workers. For example, the re-integration of displaced workers possessing obsolete skills can be facilitated if adequate re-training programmes can qualify these workers for new jobs at a reasonable cost. To the extent that such interventions are effective, they can both reduce the efficiency costs resulting from structural adjustment, while also addressing equity concerns. However, the role of ALMPs goes beyond reducing the adjustment costs borne by workers displaced by structural change, encompassing also assistance to labour market entrants (especially those from disadvantaged groups), improving the overall matching efficiency of the labour market and complementing income replacement benefits with "activation" schemes that minimise adverse labour supply responses and long-term benefit dependency. In OECD peer reviews, several countries have been advised to put greater emphasis on ALMPs relative to passive measures and/or enhance the effectiveness of available programmes (Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Japan, New Zealand, Norway, Poland, Portugal and Spain).

15. A general principle in best practice for ALMPs is that each person should receive a comprehensive package of treatments that corresponds to his or her specific needs. This raises the question of whether workers displaced by trade (or other forms of structural change) tend to require a different mix of treatments than other clients of ALMPs and, if so, whether the services that they receive are suitably tailored to their specific situation on the labour market. Recent experience supports the following observations:

- Workers displaced from jobs in declining import-competing sectors are likely to possess obsolete skills for which little demand exists in expanding industries. This means that job-search assistance may need to be complemented by training, to update skills or provide new ones that can be marketed in a changing economy, or targeted employment subsidies more often (or more intensively) than is the case for the average person receiving unemployment benefits. Nonetheless, it should not be assumed that retraining or employment subsidies are appropriate in most cases. Even in declining industries, there is considerable hiring as some part of natural attrition must be replaced. Hence, older workers whose skills are highly specialised and linked to those required in their previous industry should sometimes be assisted to locate vacancies in their prior industry, where their productivity and earnings will be higher.

- In cases where trade-related structural change has suppressed local demand for labour, employment services may need to maintain a broad geographic scope to include areas where employment is more buoyant. Also, relocation grants and mobility assistance may be required to facilitate moving or simply to permit travel for interviews, although it is also necessary to assure that rigidities in the housing market do not impede migration (see below).

- Some countries have emphasised proactive measures in anticipation of mass layoffs, which often can be predicted (at least to some extent). Rigorous evaluations of such early-warning schemes are scarce, but it appears that co-operation between the firm, worker representatives (when present) and the public employment service to prepare for imminent job losses can ease adjustment and, in some cases, avoid job loss altogether.

16. The information is lacking to assess whether the mix of services being offered to displaced workers by ALMPs generally is well-tailored to their specific needs. The importance of providing the right

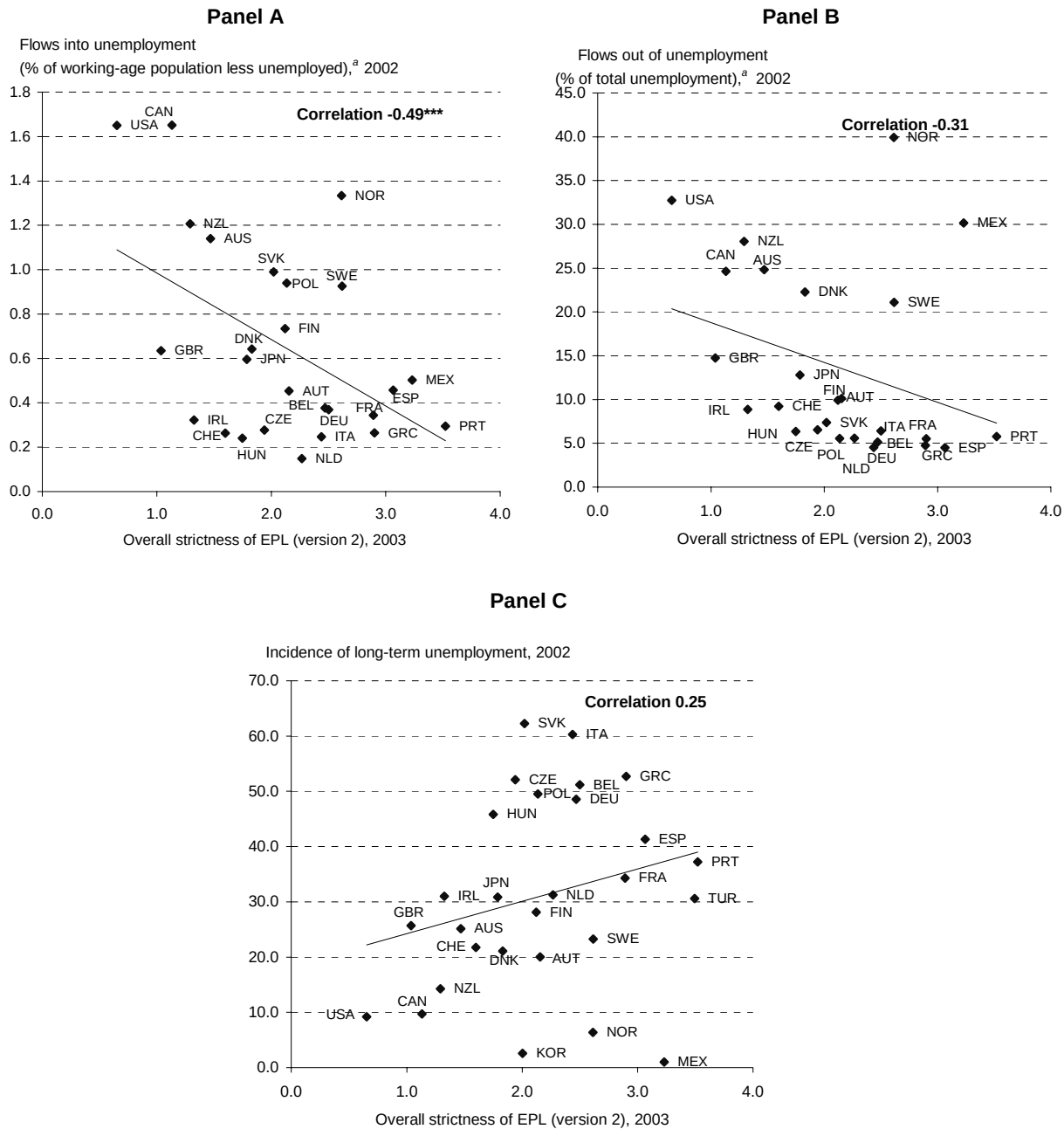
services to the right workers is underlined by evaluations results for ALMPs which are quite variable, depending on what types of service are being provided to what types of workers, and frequently have been disappointing, particularly for more intensive (and expensive) forms such as in-depth training. This is a policy area where an "evaluation culture" is especially important for constantly monitoring what is working well and what should be changed.

Employment protection policies

17. Employment protection that is relatively strict or implemented in a manner that creates significant uncertainties for employers may slow down the adjustment process by constraining firms' ability to cope with a rapidly changing environment (Figure 5). Since firms' hiring, as well as firing, practices are likely to be affected by the restrictiveness of employment protection, both the inflow to and outflow from unemployment tend to be reduced. Strict employment protection may thus imply lower re-employment probabilities and longer unemployment spells for those experiencing unemployment.

18. Moreover, workers' incentives to change employer are likely to be negatively affected by the existence of strict employment protection, resulting in lower voluntary labour flows. This is because workers usually have to stay with the same employer for a certain time (*e.g.* three or five years) before being eligible to full employment protection, including the rights to severance pay in case of dismissal. Widespread use of temporary contracts in several countries divide the labour market into segments providing different levels of protection, further reducing the incentives for workers on permanent contracts to change employer (although it may ease the adverse impact on firms' hiring practices). For the inactive population, recent evidence also suggests that strict employment protection can impede work possibilities of youth and prime age women.

Figure 5. **Simple correlations between EPL, labour market dynamics, and the incidence of long-term unemployment**



*, **, *** means statistically significant at 10%, 5% and 1% levels respectively.

a) The unemployment inflow rate is defined as persons unemployed for less than one month as a percentage of the source population (the working-age population less the unemployed) and the outflow rate as the percentage of the unemployed moving to employment or out of the labour force in an average month.

Source : OECD Employment Outlook 2004.

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

20. In general, employment protection regulations need to find a balance that provides workers with adequate protection and fosters a co-operative approach to lessening adjustment costs, without hampering business dynamism and job creation. A better balance can be achieved when adequate unemployment benefits and effective active labour market programmes are in place to assist job losers. An easing of employment protection regulations has been recommended for many OECD countries, including Japan, Korea, Mexico, Norway, Turkey and several European member countries (including Austria, Belgium, the Czech Republic, France, Germany, Greece, Italy, the Netherlands, Poland, Portugal, the Slovak Republic, Spain and Sweden).

Wage-setting flexibility and pension portability

21. Flexible wage-setting systems can facilitate structural adjustment by helping to keep labour resources fully utilised and providing signals to workers in respect of moving to the employment where their productivity is highest and improving their human capital. The capacity of various bargaining systems to provide efficient wage structures across occupations, industries and regions may, however, differ, with centralised systems sometimes being associated with more rigid relative wage structures than more decentralised ones. Displaced low-skilled workers could be particularly affected by insufficient wage flexibility as too high wage floors, either established in bargaining or by statute, may prevent them from finding new employment.

22. Non-portability of pension rights may further discourage workers from changing employer. Sometimes, workers may lose all their pension rights if, for example, they leave the employer within 3 or 5 years of appointment. Defined-benefit schemes are also frequently back-loaded, *i.e.* with disproportionately large employer contributions in later years of employment. This implies that workers who are leaving prior to retirement may give up a large share of their potential pension benefit, this acting as a barrier to job mobility. Indeed, the value of pension benefit is sometimes substantially lower for someone who has changed employer, interrupted his/her working life or moved country.

23. Recent OECD peer-reviews have advised a number of OECD countries to increase wage flexibility so as to better align wages with evolving labour market conditions (including Austria, Belgium, Germany, Italy, Japan, Korea and Spain). In particular, countries have been advised to relax existing practices of administrative extensions of collective wage agreements (including the Czech Republic, Finland, Germany, Italy, the Slovak republic and Spain) and to reassess the level of minimum wages (including Australia, France and New Zealand). Measures to improve the portability of pension rights have recently been recommended for Japan and the Euro area.

Housing market policies

24. High transaction costs on property and rigidities in the rented housing sector can seriously impede regional labour mobility. For owner-occupiers, the tax on property transactions is, for example, reported at 11 to 13% of house prices in Greece and 10 to 12.5% in Belgium (ECB, 2003). Both these

countries are characterised by relatively low regional labour mobility. In comparison, the tax on property transactions is 1 to 4% in the United Kingdom and in the range of 1 to 3% in the Scandinavian countries. Changing residence is usually associated with much lower transaction costs for tenants than for owner-occupiers. The mobility of tenants may, however, be hampered by other market inefficiencies. For instance, long waiting lists for locally-provided social housing or rent controls for certain accommodations create a segmented market in some countries. Social housing represents roughly half or more of the rental sector in countries like Austria, Ireland, France, the Netherlands, Sweden and the United Kingdom, while private segments sometimes are subject to regulations on rents in the Czech Republic, Denmark and Sweden). Tenants with housing costs far below the market price may have few incentives to move, even when work opportunities are considerably better in other regions.

25. Inefficiencies in the rental market may also impede the mobility of owner-occupiers by making it more difficult, and possibly more costly, to accept temporary work in another region. The incentives for home owners to use the rental market for temporary moves can be further hampered by the tax system, sometimes requiring the owner to live in the house to be eligible for certain tax preferences (including Finland, France, Greece and Italy). In effect, even temporary job moves for home owners may require a process of house selling and purchasing, making such moves more cumbersome and costly.

26. A number of OECD countries have recently been advised to improve the functioning of the housing market in order to stimulate regional labour mobility. The functioning of the rental market should be improved by reducing remaining regulations, as has been explicitly recommended for Denmark, the Czech Republic, the Slovak Republic and Sweden. Measures to reduce the implicit subsidy to home owners could further help to create a more efficient rental market, and has been recommended for several countries, . Moreover, to ensure a more responsive housing supply, and thus allow a net inflow of labour resources to expanding areas, some countries have been advised to ease residential zoning and planning restrictions or to take other measures to improve housing infrastructure (including the Netherlands, Poland, Spain, Sweden, Switzerland and the United Kingdom).

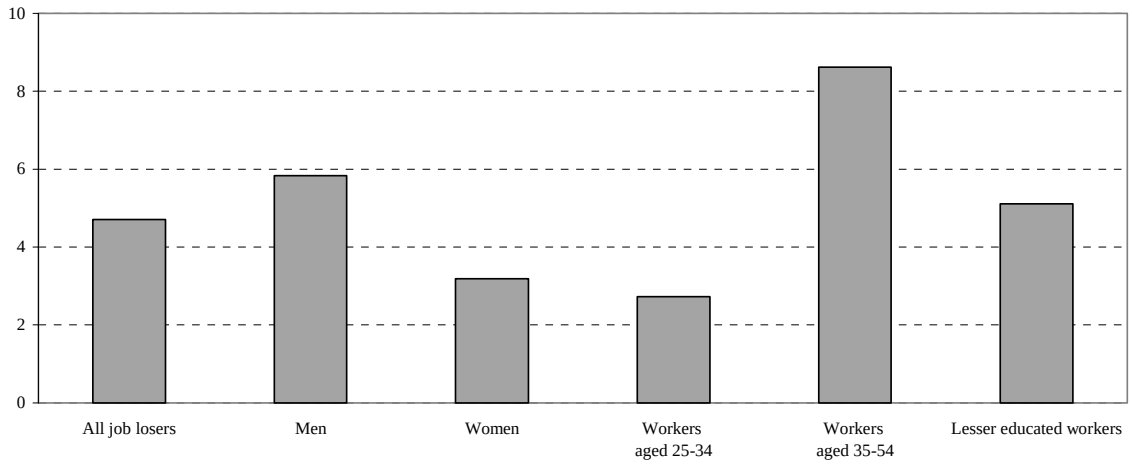
Education and training

27. Ensuring a work force with adequate and adaptable skills is key to facilitating structural adjustments and, in the longer run, will support growth in productivity and real earnings. This is particularly true since changes in the job mix and production technologies both imply rising skill requirements. High-skilled workers tend to have relatively high job-to-job transition rates, and are more mobile across occupations, industries and regions. Highly-educated workers and workers receiving in-house vocational training also face less risk of lay-off than their lower-educated and non-trained counterparts. Even when they lose their job, educated and trained workers enjoy a relatively high probability of re-employment.

28. Enhancing the incentives to invest in workers' skills is especially important in the face of structural change that requires greater labour mobility. Recent OECD analysis illustrates how workers who receive training are in a better position in the event of layoff (Figure 6). For all job losers, the probability of finding a new job within two years after layoff is estimated to be a little over 4 percentage points greater if he/she took some training in the year before job loss. This difference widens to 8 percentage points for workers aged 35-54, who typically have greater difficulty following layoffs than do younger workers. The employability advantage from training appears to be somewhat lower for women than for men. This is consistent with research suggesting that employers more often organise and finance training for male employees than female employees. It appears that the training that women organise for themselves is less valued by prospective employers and that this difference could disadvantage women in periods characterised by high rates of structural change if their access to employer-sponsored training does not improve.

Figure 6. Training increases the probability of re-employment after job loss

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



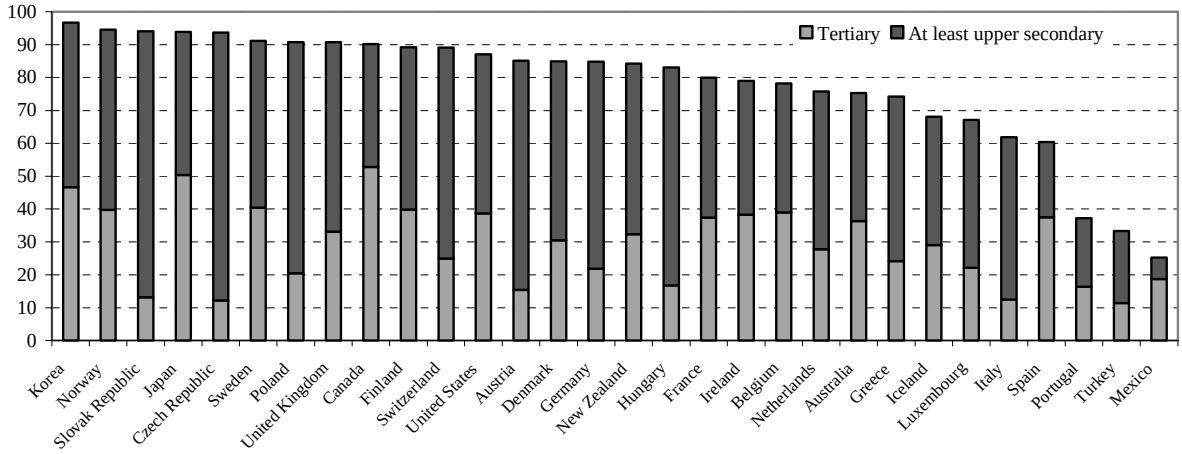
1) OECD calculations based on the European Community Household Panel, waves 1 to 7 (1994-2000) for Austria, Belgium, Denmark, Finland, Germany, Italy, Ireland, the Netherlands, Portugal and Spain.

Source: OECD Employment Outlook, 2004.

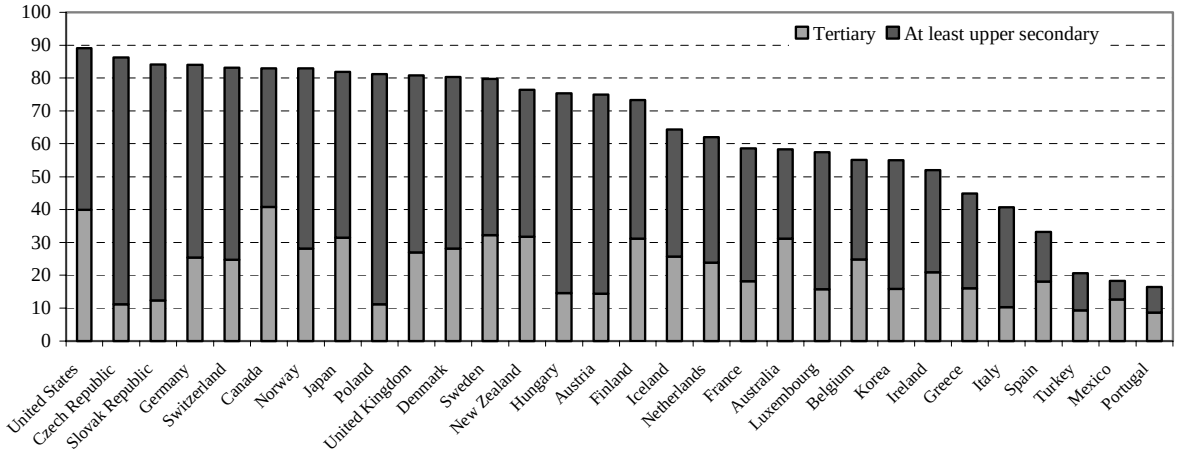
29. Educational attainment rates and the incidence of in-work training differ significantly between OECD countries (Figure 7), indicating a substantial scope for improvements in some countries. Recent OECD peer-reviews have recommended that several countries improve enrolment rates in upper secondary education (including Australia, Canada, Iceland, Italy, Mexico, Portugal and the United Kingdom) and tertiary education (including Austria, Germany, Italy, Korea, Poland and the Slovak Republic). Moreover, a widening of public support for adult learning has been recommended for some countries, although a cautious approach has been envisaged (including Australia, Finland, Greece, Italy, Japan, Korea, Mexico, Portugal, the Slovak Republic and Switzerland). More generally, a majority of OECD countries have been recommended to take measures to ensure that labour skills meet evolving needs of the labour market. In this respect, providing appropriate incentives for employers and employees to invest more in training and increasing the scope for competition in higher education could contribute to more effective human capital accumulation.

Figure 7. **Indicators of education and in-work training**

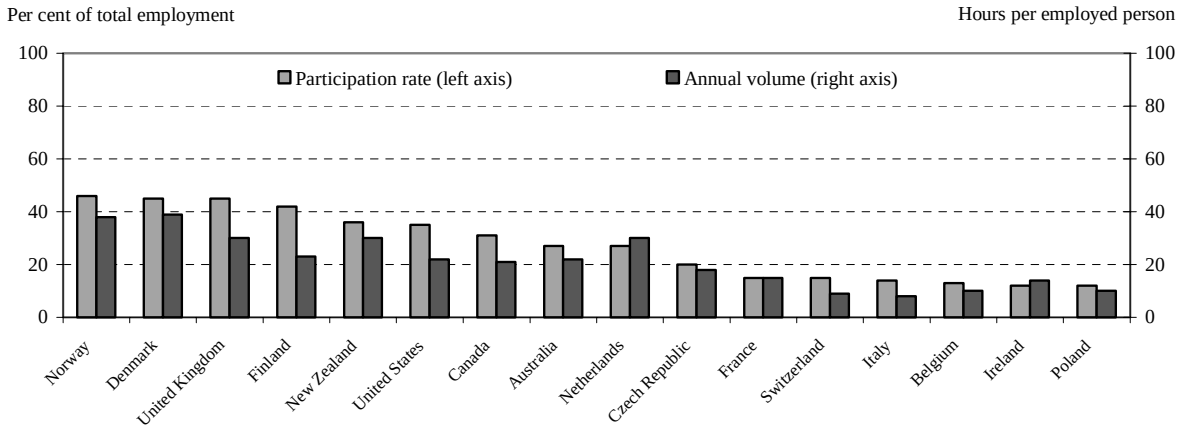
A. Percentage of 25 to 34 years old that have attained a certain level of education, 2003[1]



B. Percentage of 45 to 54 years old that have attained a certain level of education, 2003[1]



C. Employer-sponsored education and training[2], mid 1990s



1. 2002 for Denmark, Greece, Iceland, Italy, Japan, Luxembourg, Netherlands, Norway and Switzerland.
2. Data refer to job-related education and training that employers provided (or partially paid) to their workers (26-65 years).
Source: OECD, Education Database and OECD Employment Outlook 2003, Chapter 5.

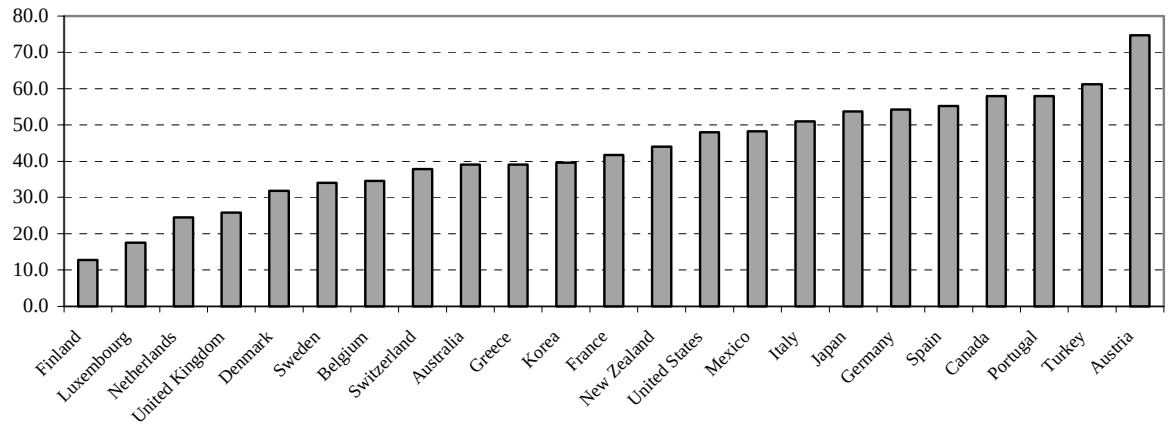
Product market competition

30. Exposing domestic markets to increased competition can in itself encourage restructuring, thus leading to possible job displacements or reduced asset values. The accompanying worker adjustments can be particularly difficult if workers in deregulated sectors have enjoyed large rent elements in wages. However, reduced barriers to competition, entrepreneurship and growth are also instrumental in strengthening the economy's capacity to adjust and to absorb displaced resources. In particular, product market deregulation may unleash the considerable potential of the service sector as a source of job creation.

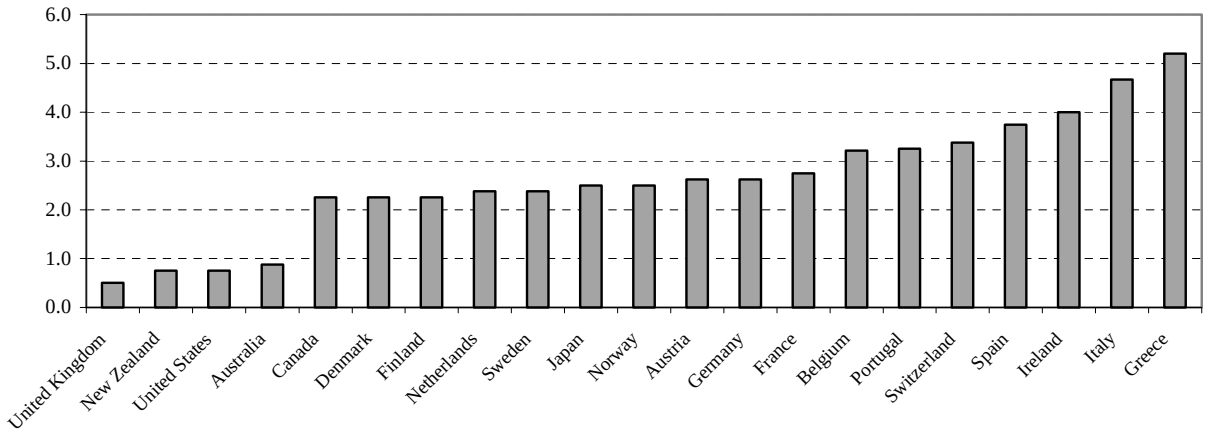
31. Employment and growth in several service industries are potentially obstructed by regulatory hurdles in many OECD countries (Figure 8). Cumbersome labour and product market regulations may have particularly detrimental effects on industries characterised by a large share of relatively small firms or by high entry and exit rates, like the business service sector. Inefficiencies in financial markets and distortions created by the tax code may reinforce such obstacles by raising capital costs for such firms. Several service industries, such as transport, professional services and retail trade, are also subject to heavy sector-specific regulations in many OECD countries, with potentially detrimental effects on employment and productivity.

Figure 8. Anti-competitive regulations in selected service sectors [1]

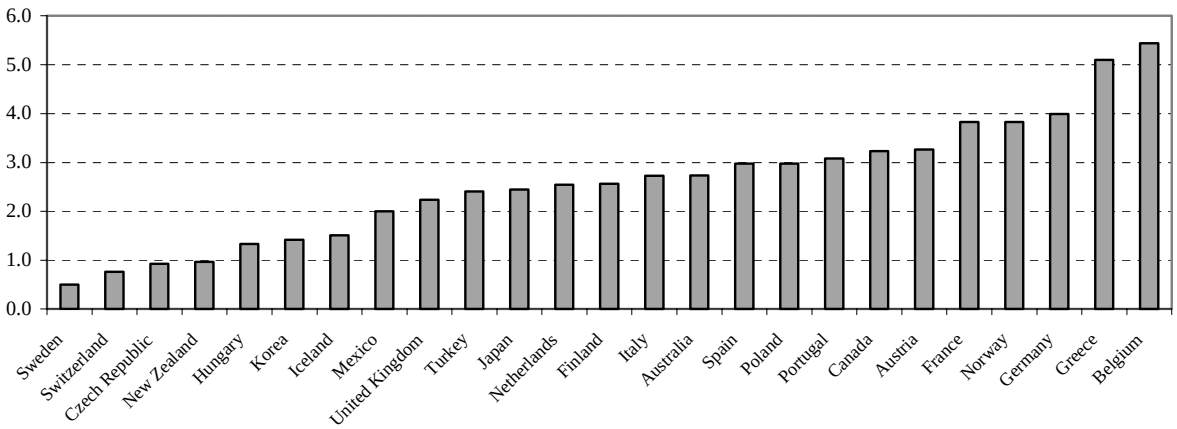
A. Professional services[2], 2003



B. Transport[3], 1998



C. Retail trade, 2003



1. Index 0-6 scale from least to most restrictive.
2. Simple average of indicators for legal work, architectural work, accountancy and engineering.
3. Simple average of air, rail and road transport.

Source: OECD Product Market Regulation Database.

32. A number of country recommendations for regulatory reforms have been identified in the context of OECD peer reviews. Several countries have been recommended to reduce regulatory barriers to business start-ups and firm entry (including Austria, the Czech Republic, Denmark, France, Germany, Greece, Hungary, Iceland, Japan, Mexico, Netherlands, Portugal, the Slovak Republic, Spain, Switzerland and Turkey). High compliance costs for firms due to unnecessarily cumbersome regulations have also been seen as a potential obstacle to business dynamism in several countries (including Belgium, Ireland, Mexico, Netherlands, Norway, New Zealand, Portugal, Switzerland and Turkey). Furthermore, liberalising service trade and reducing restrictions on foreign ownership may help create a more dynamic and international service sector. Steps in this direction have been recommended for most OECD countries.

PART III: TRADE AND STRUCTURAL ADJUSTMENT: TOWARDS GOOD PRACTICE

33. We seek here to identify elements of good practice drawn from the annexed case studies ranging over the eight selected sectors. Specific attention will be devoted to the development dimensions of structural adjustment. The identification of good practice needs to be approached with care. It cannot be assumed that an approach which has worked in one sector will *necessarily* work in another, or that good practice for one country or group of countries will *necessarily* translate into good practice elsewhere. The adjustment challenge faced by developing countries differs in both its nature and extent from that faced by the advanced industrialized economies. So therefore does the required policy mix and the ability to implement policies. Nevertheless, underlying principles of good practice permeate through all the sectors. And while the nature of the adjustment challenge may differ from country to country, the principles of good practice tend to be widely applicable across countries albeit with differing degrees of emphasis. For the OECD economies, the policy challenge relates in particular to reforms in structural policies affecting the functioning of labour and product markets while also providing effective income support and re-employment services to job losers. For poorer developing countries, particular attention will need to be devoted to building sound institutions, fostering an appropriate macroeconomic framework, improving access to finance, developing human capital, strengthening infrastructure services and reducing often high impediments to trade. Above all, for the poorest countries concerted efforts will be needed to improve supply-side capacities, to diversify economic activity and to build sound institutions in order that these countries can begin to avail themselves of the full range of policy options identified in this study, some of which, such as certain labour market policies, are currently beyond their reach.

34. Policies implemented at the national level are at the heart of successful structural adjustment. However, such policies can be complemented by bilateral or regional initiatives and through multilateral cooperation. These three elements will be considered in turn.

1. National Policy Making

35. **Reliance on generally available measures to address adjustment costs.** Advice to governments is, wherever possible, to rely on generally available adjustment measures, including through the social security and tax system, in order to treat individuals in similar circumstances equally, provide assistance to people in genuine need, and avoid compounding distortions in the economy. This said, such measures cannot cover all situations and targeted adjustment measures can be useful in some cases, such as when structural decline in a particular sector causes geographically concentrated job loss beyond that with which existing labour market programmes can cope. This bears on the political economy of structural adjustment: while the benefits are usually dispersed throughout the community, adjustment pressures are typically concentrated on a relatively small group. Targeted programmes may be the price one has to pay to get reforms enacted.

36. In almost all of the eight sectors examined in this study there are examples of sector–specific measures being used, sometimes successfully, to help the adjustment process. In many cases, assistance has been given to address market failure, such as that associated with the under-supply of investment in new technology, because of fears that resulting innovations will be appropriated by new entrants.

37. Targeted measures – whether to facilitate entry or exit – have involved:

- Transitional budget support to encourage innovation and investment to help textiles and clothing producers in Australia be competitive in a low-tariff environment;
- Subsidies for the decommissioning of Danish fishing vessels to help address problems of overcapacity (though the public cost has been high and underlying structural problems have persisted)
- Transitional budget support to encourage new investment in the motor vehicle industry to meet more stringent environmental standards;
- Financial assistance for Australian dairy farmers to compensate for an adjustment-related fall in the value of farm assets - on condition that assistance was time-bound and decoupled from production (for further discussion **see Box 1**).

Box 1: Two cases of targeted policies

Below, two cases in which targeted policies appear to have played a significant and positive role are analysed. In the case of the Australian dairy industry, transitional support decoupled from production ameliorated the impact of an overnight phase out of price support for milk products. The case of the EU shipbuilding industry reflects a set of policies designed both to dampen a concentrated sectoral impact and facilitate restructuring in that sector.

The Australian dairy industry

The Australian dairy case reflects a set of targeted measures designed to strike a balance between equity versus efficiency considerations over a credible transition period. The price support mechanism for fluid milk prices in the Australian economy was dismantled in July 2000 thus allowing for synchronisation of domestic and world fluid milk prices and more efficient resource allocation within the domestic economy. This change not only marked a significant re-instrumenting of support for fluid milk producers, but has provided a vehicle for reductions on a time-bound and self-financing basis.

To allow producers time to prepare for adjustment, the removal of the price support mechanism was announced nine months prior to its implementation. Accompanying this change was a transitional assistance package designed to address the impact that removal of price support (averaging 20-25 per cent) would have on producers. Developed in 1999, the *Dairy Structural Adjustment Package* (DSAP) was implemented to provide producers with assistance totalling AUD 1.63 billion in the form of payments decoupled from production. The DSAP provides 32 quarterly grants over eight years based on milk production in 1998-99.

To address concerns about the extent of decline in fluid milk prices by late 2000, the Government announced an AUD 100 million *Supplementary Dairy Assistance* (SDA) package in May 2001. During the first three years of this programme, 2 234 farms or 17 per cent of the industry left the sector. Both the DSAP and SDA are funded by the *Dairy Adjustment Levy* imposed on domestic drinking milk which is scheduled to end in 2010, or two years after the end of programme payments in 2008.

The European Union shipbuilding industry

Structural adjustment within the EU shipbuilding industry is marked by a long-term and steady decline in its world market share from over 60 per cent in 1960 to less than 15 per cent in 2000. The concentrated impact and non-market considerations influencing policy approaches towards the shipbuilding industry can only be partially appreciated based on the 70 per cent decline in the work force (to 126 761 employees) between 1975 and 2003. Targeted policies formed two categories including Community-wide subsidy disciplines to reduce distortions in production and assistance to facilitate restructuring for competitiveness.

Policy response at the Community-wide level on shipbuilding emerged in 1970 and by the 1990s, three consistent approaches to disciplining subsidies for shipbuilding had emerged. First, the maximum allowable "contract-related production aid" was progressively reduced from 28 per cent in 1987 to 9 per cent in 1993. Second, "investment aid" to restructure shipyards was not allowed to result in the addition of overall capacity, and if it did so, capacity had to be

equally reduced elsewhere. Finally, “closure aid” was allowed only to finance unemployment assistance for retrenched workers (not closure of the shipyards themselves) and capacity reductions had to be irreversible.

To enhance the competitiveness of the EU shipbuilding industry, selective “investment aid for innovation” was made available in addition to R&D aid that was generally available for the overall industry. “Aid for modernisation/upgrading” was also allowed in the form of regional investment aid on the condition that it was not used for financing the restructuring of shipyards.

38. A particular form of targeted assistance is that designed to help workers displaced by structural adjustment. Examples from our case studies include specific training schemes and regional development programmes to help redeploy displaced steel workers in Europe; and “closure aid” for shipbuilding workers made redundant - - but for workers, not for yards, and on condition that capacity reduction was irreversible.

39. These schemes, which will be discussed in more detail below under labour market policies, appear to have had rather mixed success. Indeed, the problem, more broadly, with targeting is that market failure can be hard to identify and sector-specific trade-related assistance or compensation fraught with difficulties:

- *Creating precedents*: The introduction of an adjustment programme may be seen as creating a precedent that the Government is prepared to compensate people who lose as a consequence of changes in Government policy. Given that governments are unlikely to have the resources to be able to compensate all the possible losers from all possible changes in Government policy, there is a risk that the creation of a compensatory package will trigger others to lobby for similar compensation for a wide range of other shocks.

- *Incentive effects:* Enhancing opportunities for workers to move to expanding sectors and areas with better employment opportunities is nearly always a key to successful adjustment. Approaches that are targeted on "declining" sectors and areas risk perpetuating the structural problem. .

- *Institutional inertia:* Once started, compensatory programmes are politically extremely difficult to stop.

- *Equity:* People suffer negative consequences from many types of economic (and other) shocks; trade adjustment assistance only compensates for the costs resulting from one kind of shock. Many may regard this as unfair - creating internal tensions. Trade displacement *per se* confers no special entitlement to preferential treatment. Moreover, it may be difficult to determine whether trade, as opposed to changing global tastes or firms' poor productivity, in fact accounted for any specific job loss. It is this consideration, among others, that makes it difficult to give practical application to the principle of welfare economies that it is theoretically possible for the gains from trade liberalisation to be such that the gainers can compensate the losers, without anyone being worse off.

- *Efficiency of public expenditure and revenue*: Governments have a responsibility to ensure the most efficient use of public funds. If a Government’s objective is to provide assistance to overcome a trade shock or some other form of structural adjustment arising from such a shock then it needs to be clear that the introduction of a trade compensation programme will be more effective than any other use of public funds. International experience (including from the OECD Jobs Study) suggests that this is highly unlikely since the workers affected by trade reform are often better off than other workers (though this is country-specific). Increased expenditure for adjustment programmes must be paid out of increased revenue, the collection of which through taxation creates additional distortions. For instance, assume that the economic costs of raising an

additional USD 1 of government revenue ranges from USD 1.17 to USD 1.56 (based on econometric work undertaken in the US by Ballard, Shoven and Whalley, 1985 - there is a net efficiency loss in the range of 17% to 56%. Consequently, a public project must produce marginal benefits of more than USD 1.17 per dollar of cost if it is to be welfare improving.

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

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

41. **A sound macroeconomic framework**. At the broadest level, structural adjustment will be facilitated where government policies create an enabling environment through the promotion of macroeconomic stability and growth. As shown in the OECD *Growth Study*, macroeconomic stability contributes to a dynamic economy, which in turn is likely to make adjustment easier and swifter. Macroeconomic disequilibria, such as excessive inflation and high budget deficits, have in the past come at the cost of lower economic growth. Several case studies highlight the complementarity between macroeconomic and trade policy and the crucial role of government in creating an enabling environment for successful adjustment, notably the case study on reform of New Zealand agriculture. Indeed, all of our agriculture case studies point to the crucial role of government in creating an enabling environment for successful structural adjustment, while at the same time pointing to the need to reduce the direct role of government in the production, marketing and pricing of farm products.

42. In the case of developing countries, as borne out in the case studies, the impact of the overall macroeconomic framework is often more important to the performance of particular sectors than the impact of any sector-specific policy measure. Indeed, with the exception of Kenya[1], the sectors concerned here have evolved in a context of strong overall economic growth. This highlights the importance of creating an enabling policy framework as a prerequisite for successful structural adjustment. Securing macroeconomic stability, removing an anti-export bias and adopting an appropriate exchange rate policy played a key role in developing countries' initial efforts to put their economies onto outward-oriented growth paths and restructure their economies. Complementary policy measures were also implemented to improve domestic conditions for international business development and to encourage long-term investment in non-traditional export sectors. The complementarity of a sound macroeconomic framework and trade policy reform is seen to be particularly important in the case of developing and transition economies, not least via the role of tax policy in compensating for tariff revenue loss resulting from trade liberalisation **(see Box 2** on Macroeconomic stability and trade liberalisation).

43. A sound macroeconomic framework also helps foster well functioning financial markets and access to credits by firms, particularly small and medium-sized enterprises. The developing countries case studies show that the availability of short- and long-term finance is a key element for entrepreneurs. In Mauritius, for instance, the Development Bank of Mauritius played a key role in providing preferential credit to certain sectors, setting up a foreign exchange risk scheme and supporting SMEs. In other African countries, various efforts have also been made in the financial market, but access to finance remains a serious bottleneck to flexible responses in the area of trade.

Box 2: Macroeconomic Stability and Trade Liberalisation: important complements

The case studies examined below support the proposition that macroeconomic reform is an important complement to market opening. In particular, tax reform to offset declines in government revenue resulting from tariff reductions and the rationalisation of exchange rate regimes are seen to be important steps along with or prior to the implementation of trade liberalisation. The question of tax reform to offset revenue loss is discussed in more detail in the section dealing with multilateral cooperation.

Chile agro-food industry

The Chilean case study illustrates the relationship between sound macroeconomic policymaking, structural adjustment and benefits from increasing trade liberalisation. The initial period of policy reform beginning in 1979 led to macroeconomic imbalances which stymied sustainable structural adjustment. In contrast, reforms following the economic crisis of 1982 have proven effective to date. Pre-1982 macroeconomic reforms in Chile were characterised by tight fiscal policy, consisting of significant reductions in government subsidies, high interest rates and eventually exchange rate appreciation. Trade policies saw the implementation of a 10 per cent uniform tariff (down from an average of 94 per cent) and the removal of most non-tariff barriers (NTBs). These policies led to an import surge while high interest rates and exchange rate appreciation reduced incentives for the domestic industry including agriculture to adjust from subsidised inward looking towards outward looking export orientations.

Adjustments to macroeconomic and trade policymaking following the crisis in 1982 led to a sustained recovery and growth trajectory beginning by 1984. On the macroeconomic level, significant exchange rate devaluation was accompanied by fiscal reform designed to replace government revenue once garnered from higher tariff rates. Trade policy reflected a temporary lifting of uniform tariffs to 35 per cent by 1984 and graduated reduction down to 11 per cent by 1991. It is significant that trade policy neither derogated from the principle of non-discrimination nor receded back into use of NTBs throughout this period thus minimising price distortions and allowing for efficient reallocation of resources in support of adjustment and growth. Extensions of credit lines also assisted efforts by the agricultural sector to adjust to a more liberal trade regime while rationalisation of the exchange rate supported the competitiveness of its exports.

Bangladesh textiles

The challenge of managing a sound macroeconomic policy in tandem with economic liberalisation is clear in the case of Bangladesh textiles. For a developing economy highly dependent on tariffs as a source of government revenue, sound macroeconomic policy has helped to maintain fiscal discipline in the face of declining tariff revenues resulting from trade liberalisation. Trade liberalisation was marked by a decline in the average effective rate of protection from 75.7 to 28.6 per cent between the periods 1990-91 and 1997-99. The process of trade liberalisation which continued today is notable as the government continues to rely on import tariffs for half of total tax revenues.

The apparent success of the macroeconomic framework to address structural adjustment was reliant on reform of the domestic tax regime to compensate for revenue loss from tariff reductions. Indeed, the fiscal discipline enabling reduction of the budget deficit from 5.1 to 3.5 per cent of GDP between FY2001-03 was likely a key factor allowing for the float of the exchange rate without major difficulties in May 2003; an achievement in the process of exchange rate liberalisation begun in 1994. In short, a dynamic framework of macroeconomic policies was important to meeting structural adjustments entailed by trade liberalisation, while maintaining the fiscal discipline necessary to support exchange rate liberalisation.

Mauritius textiles

The case of Mauritius demonstrates another approach to macroeconomic management of economic liberalisation and structural adjustment, through a dual sector approach allowing for both gradual liberalisation in an import substitution sector and implementation of a liberalised export sector. In the 1960s, export processing zones (EPZs) were established in designated areas although most of the economy remained under the protected sector of the economy characterized by a continuation of import substitution policies. Economic activities conducted in EPZs had immediate access to duty free imports, cheap labour, public investment in infrastructure, as well as tax incentives to attract both domestic and international investment. The overall economy also benefited from a gradual programme of trade liberalisation completed in the early 1980s. A number of exogenous economic shocks led to further economic reforms including the introduction of a flexible exchange rate and removal of a number of quantitative import restrictions and price controls. By the mid-1990s, Mauritius witnessed economic recovery and had one of the most liberal economic regimes in Africa. However, the economic situation has worsened since 2000 with a growing fiscal deficit, sluggish exports and declining income growth.

Poland autos

Macroeconomic policymaking in Poland is coloured by the application of "shock therapy" at the start of 1990 and preparations for accession to the EU soon afterwards. Shock therapy consisted of economic policies designed to reanimate the market mechanism and spanned: freeing of prices, elimination of rationing, liberalisation of foreign exchange, fiscal discipline as well as the termination of various subsidies to state owned enterprises and their privatisations. Structural adjustment resulting from shock therapy including both liberalisation of the exchange rate and overall reductions of tariffs in preparation for EU accession, facilitated integration of the Polish into the international economy. Further structural adjustments resulting from removal of barriers to trade and investment *vis-à-vis* the EU resulting from accession remain in progress, but the liberal macroeconomic framework implemented since 1990 has proven supple to date.

Australia's experience

Australia's experience gives strong support to the need for appropriate exchange rate policy (not dissimilar from Chilean example). The floating of the $A in 1983 (and the subsequent depreciation) arguably had two effects: it exposed the need for real depreciation and the policy reforms to achieve this; it also cushioned adjustments in the traded goods sector following general reductions in protection which commenced in 1988.

Contrast this with the experience in 1973 when tariffs were cut across the board by 25% - this measure was taken to avoid further revaluation of the $A which would have blunted somewhat the minerals export boom. In other words, exchange rates were not allowed to reflect their market level. The manufacturing sector, which was already being squeezed by the 'Dutch disease' effects of that boom, was then faced with a substantial cut in protection. The tariff cut created strong opposition which manifested itself in a subsequent shift to quota protection in key manufacturing industries (e.g. TCF and cars), and which proved very difficult to remove later.

44. **Labour market policies**. Just as domestic policy making at the national level lies at the heart of the structural adjustment process so labour market conditions lie at the heart of the national policy framework. More particularly, it is often the relationship between labour market conditions and the trade regime that determines whether or not adjustment is successful.

45. As noted in Part II, a guiding principle in seeking to determine good practice in structural adjustment is that successful countries would not necessarily be characterised by stable sectoral patterns of production and employment or by the presence of particular industries. Instead, they would be characterised by their capacity to manage structural change without experiencing long-lasting increases in unemployment among working-age persons, while at the same time improving living standards as resources move into new and expanding areas. In short, this is a question of worker mobility and its contribution, along with other policies such as regulatory reform, to the entry and exit of firms. Recent analysis suggests that entry and exit accounted, respectively, for 25 and 50 percent of UK manufacturing productivity growth during the 1980s and 1990s[2]. Moreover, there is strong evidence that while trade liberalisation is positively linked to growth, it is associated with a lower standard of living in economies that heavily regulate new entry or impose high costs on exiting or downsizing[3]. The link between trade policy and labour market conditions is amply demonstrated in our case studies on the international sourcing of IT and business process services. It is pointed out there that while such sourcing is expected to affect fewer workers in the EU than in the United States, the European worker is generally more likely to have difficulties finding a new job because of higher unemployment and lower re-employment rates.

46. Part II identified a number of labour market-related policies which are central to the adjustment process.

47. *Unemployment benefit, early retirement and disability* schemes play an important role in the reintegration of displaced workers, though there is a danger that overly high replacement rates will lower economic incentives for re-employment. This danger can be lessened by use of re-employment bonuses or wage insurance.

48. *Active labour market programmes* (ALMPs) – including job-search assistance, counselling, training, moving allowances, and proactive measures in anticipation of mass layoffs – are found to be the most effective policy instrument to improve the re-employment prospects of displaced workers.

49. As touched on in Part II and earlier in this section, a question arising in the discussion of the labour market – and of ALMPs in particular – is that of targeted assistance for displaced workers. Our case studies and other examples point to three different ways to target assistance to workers, including nation-wide labour market programmes targeted at workers affected by foreign competition and administered by governments; targeted labour market programmes designed by both the private and the public sector; and corporate initiatives establishing adjustment programmes. Short case studies are presented in Box 3 for each of the three types of programmes to illustrate some experiences in OECD countries. In all cases, success seems to be mixed.

50. There are clearly examples where displaced workers have been successfully brought back into the workforce. And some targeted schemes appear to have been successful in building public support for trade liberalisation. However, in many cases participation rates have been low and success appears to have been dependent on prevailing economic conditions and labour market buoyancy as much as on specific measures adopted. Moreover, the targeted policies have all been susceptible to the broad targeting pitfalls identified earlier in terms of both equity and efficiency. In addition to the broad pointers to good practice outlined there, our case studies suggest that targeted measures to help displaced workers, and indeed ALMPs more generally, are more likely to succeed where:

- Policies are based on active tripartite cooperation between management, workers' representatives and government;
- Labour market opportunities for displaced workers are realistically assessed;
- External specialists are used in the case of large-scale layoffs.
- Programmes are neither too short, incapable of providing real support, nor too long, encouraging complacency;
- Active measures are combined with income-replacement benefits, and
- Broad-based policies seek to promote economic growth and opportunity. (**See Box 3** on Active labour Market Policies)

Box 3: Active Labour Market Policies

I. Targeted nation-wide labour market programmes

Adopted in 1962, the **United States Trade Adjustment Assistance (TAA)** legislation complements general unemployment assistance and ALMPs by providing temporary assistance to workers losing their jobs as a result of trade liberalisation. The economic rationale for this policy remains controversial, since it is not evident that trade-displaced workers should receive more adjustment assistance than other job losers encountering similar difficulties and, in any case, it has proven difficult to differentiate between the two groups of job losers. Nonetheless, the TAA programme has been a source of innovative practices related to the provision of earnings-replacement benefits (e.g. the wage insurance programme introduced in 2003) and training for displaced workers (e.g. voucher programmes operating through state community college systems).

On the other hand, TAA seems to respond well to political economy considerations, in particular by consolidating public support for trade liberalisation. TAA has been significant in the area of textiles which accounted for 35 per cent of all TAA certifications between 1995-2000. The Trade Act of 2002, which established the current system of Trade Promotion Authority (TPA) that facilitates acceptance of trade liberalisation by the US by restricting the power of Congress to alter trade agreements negotiated by the President, also contains substantial enhancements to existing TAA for workers displaced as a result of international trade agreements.

The **Australian Structural Adjustment Assistance programme**, initiated in 1973 following significant tariff cuts, was targeted specifically to trade-displaced workers. The programme, which focussed on income assistance rather than active measures, was terminated in 1976 after only three years. Its termination came on the heels of a government evaluation which concluded that the provision of special benefits to designated displaced workers reduced worker mobility. Other reasons for ending the programme included pressures on government to provide similar benefits to other displaced workers and the arbitrariness of the determination that recipients are unemployed as a result of government policies. The programme was similar to the early TAA programme in the United States in its emphasis on passive measures and disappointing evaluation results.

II. Targeted labour market programmes involving both the private and public sector

The resilience of communities heavily dependent on single industries can be assisted by measures taken in cooperation between the public and private sectors to facilitate transition. When **British Steel** closed a plant in Corby located in South-East England, total employment in Corby was reduced from 23,300 to 15,900 between 1979 and 1981. Implemented in response were a combination of measures including: early retirement schemes, programmes for workers re-training and the designation of new land for developing manufacturing industries under regional development programmes. By 1984, total employment in Corby had recovered to 19,700.

In the late 1980s, privatisation of the underperforming **Austrian steel industry** led to significant layoffs in this sector. As part of a social plan to help cope with the negative aspects of structural reform, management and the works council negotiations brought about the creation of the Austrian Steel Foundation. The Foundation's shared responsibility for labour market adjustment is reflected in its executive board, which consists of three works council members and three steel firm managers. The Foundation provides services tailored to individual worker needs and includes vocational orientation, small business start-up assistance, rigorous and extensive training or formal education (sometimes for several years) and job-search assistance. Retraining programmes are concentrated on re-qualification and occupational reorientation rather than on marginal skill upgrades. The Foundation is financed by the steel firms and programme participants themselves, as well as by the government (in the form of unemployment benefits) and remaining employees who pay a solidarity levy of 0.25% of gross wages toward the Foundation.

Evaluations have suggested positive results. One rigorous evaluation suggests that, in the five years following completion of the Foundation's programme, employment prospects were significantly higher for participants than non-participants. Younger participants and low-wage workers also achieved significant wage gains compared to the control group. There is little in the way of evidence, however, to suggest whether the positive results associated with this employment foundation are the result of unique characteristics of this effort or whether its structure could be duplicated or generalised. Also, participation rates among eligible workers have been relatively low.

III. Targeted labour market programmes designed by companies

In 2001-2003, approximately 12,600 workers were affected by layoff announcements in **Östergötland** – a Swedish county with 415,000 inhabitants. One third of these workers had been employed by affiliates of large industrial groups that offered voluntary adjustment programmes that went beyond corporate obligations. The programmes were tailor-made by companies that laid off significant numbers of workers (on average 350 workers in this case) and offered support in addition to the assistance required by laws and collective agreements. The costs were borne by the companies and the programmes were offered during a limited period of time. The perceived value covered all parties involved: first, individuals benefited from early action, longer terms of notice, retraining support and access to external

job agents that search markets for unannounced jobs; second, companies benefited from improved public relations, reduced costs to manage downsizing, improved relations with unions, and improved reputation as responsible employers; and third, the public sector benefited from reduced pressure on job centres and lower unemployment insurance payments, reduced numbers of workers on long-term sick leave, higher tax payments, and smoother channelling of idle labour to expanding industries.

Based on Östergötland's experiences, crucial components of adjustment programmes include support activities that can lead to new jobs, support for re-education, and coordinated policies for people on long-term sick leave. Training for job search and the application process has proved useful and job search initiatives on the "hidden" labour market have been successful. Support for workers who opt for education is particularly important since many workers that are laid-off have skill sets for which demand is decreasing.

External specialists are preferably hired to manage adjustment programmes in situations of large layoffs with short notice – and conversely, internal organisations are more useful in small scale layoffs with longer notice. The core group that establishes the programme should include people with considerable knowledge of both the private sector and different public actors to facilitate the working of the programme.

The timing of the programme is critical. First, affected workers need time to mentally adjust between the layoff announcement and the successful implementation of the adjustment programme. Second, programmes too short in duration tend to be perceived as quick fixes incapable of providing real support while programmes that are too long often produce lock-in effects where individuals become complacent and start their job search activities late. The programme should also be located outside the work place. In addition, workers with high previous salaries are often unwilling to initially take up new lower paying jobs. This unwillingness can be bridged with a time limited offer by the retrenching company to pay the difference in salary between the old and the prospective new job.

In the year ending March 2002, **Ericsson** reduced its Swedish workforce by 6,300 employees and adjustment programmes were negotiated between the company and local affected parties. Laid-off workers were offered 12 months of support, with guaranteed remuneration and benefits, to find new jobs or retraining alternatives. Ericsson also turned to external job support agencies to help affected workers and in separate instances, white-collar workers were offered retirement packages or direct payments to leave the company. The support programmes included the establishment of teams of 15-20 individuals with an advisor with the task to find individual solutions for each worker, including through re-education, company visits, internships, seminars, and advice in the job search process. Workers who found new jobs were guaranteed their previous levels of salary and benefits for six months. Co-operation was sought from local labour market agencies, and special committees were established, including local authorities, representatives from the Social Insurance Office, unions etc.

Almost 4,000 of the 6,300 affected Ericsson workers were at some stage involved in a support programme. 45% of these people had found a solution by March 2002 although most programmes were still running. In light of the severe problems faced, the Swedish Government Agency was highly satisfied with the outcome and responsibility taken by Ericsson. While the corporate adjustment programmes were fairly coherent across subsidiaries, the effects of the adjustment process varied between towns:

In Linköping (133,000 inhabitants, 1,170 layoffs) the adjustment process was smoothed by a timely expansion in both the public and private sector. Of the 430 workers who completed the adjustment programme, more than 200 people found new jobs, 180 people enrolled in education programmes while some started new companies and others were on long-term sick leave or actively looking for jobs. In Kumla (19,000 inhabitants, 1,500 layoffs) the adjustment process was fairly successful due to larger surrounding towns that absorbed some of the idle labour. Many of the retrenched workers were commuters from neighbouring districts and the proximity to external labour markets helped to divert pressure from the local labour market. 65% of the people who joined an adjustment programme had found a new job or joined an education programme seven months after its initiation.

In Gävle (91,000 inhabitants, 500 layoffs) and Hudiksvall (37,000 inhabitants, 145 layoffs) the layoffs added pressure to weak labour markets with the former region already suffering from adjustment. There were no signs of an imminent improvement in terms of labour demand.

Sources : Kletzer and Rosen (2004); Länsstyrelsen Östergötland (2004); Karlsson (2002); Winter-Ebmer (2003); Evans-Klock *et al* (1998); Leigh (1990).

51. *Employment protection policies* can foster a cooperative approach to lessening adjustment costs but care is need that they do not restrict business dynamism and job creation.

52. The effective functioning of the labour market is also seen to depend importantly on flexible *wage setting systems, pension portability* and reduced rigidities in the *housing market*.

53. And there is a crucial role for *education systems* that help build human capital and ensure that labour skills meet evolving needs in the labour market.

54. In the developing country cases studied here it is found that when the industries first started to grow, they all had access to a pool of relatively well-educated and cheap labour. Literacy and primary education levels were all relatively high. As the industries developed, they were confronted with shortages of skilled labour and rising wage levels. Human resource development has thus become a major challenge for them to improve productivity and climb up the value-chain ladder, in the face of rising competition and market demands. (See, for example, Bangladeshi and Colombian textiles case studies). Governments can help overcome this challenge by investing in secondary and tertiary education as well as vocational training.

55. **Enhancing product market competition, regulatory reform and institution building**. Successful structural adjustment needs to be implemented in a sound macroeconomic context and within the framework of a well-functioning labour market. It also needs to be complemented by a sound regulatory and competition environment which enables firms to respond flexibly to changing circumstances whether through mergers or shifts in corporate culture. While private and public sectors must work closely together the ultimate responsibility for effective adjustment rests with firms. **(See Box 4).**

Box 4: The role of firms

Firms are the conduit between the forces of structural adjustment and the impact on the domestic economy. Two ways in which this is manifested are via mergers and changes in corporate culture.

In the case of EU steel, mergers facilitated the rationalisation of capacity, uptake of new technologies and promotion efficiency at the EU level. The case of Renault-Nissan alliance illustrates how a strategic relationship between a domestic and foreign firm enabled a deep transformation of corporate culture in support of a business turnaround. It also highlights how the manner in which firms respond to structural adjustment may affect the domestic economy more widely.

Mergers: the EU steel industry

Mergers create space to increase productivity, rationalise production and introduce new technologies to increase efficiency. In the case of EU steel, these factors have been present during capacity reductions totalling 13 million tons within the EU 15 between 1998 and 2002. Between the mid-1990s and 2002, seven EU based steel producers merged into three. Presently, four EU steel producers rank among the ten largest in the world. These mergers are linked to rationalisations of production and productivity averaging 601 tonnes per employee year achieved in 2002. Closures of inefficient capacity have facilitated the expanding use of new technologies such as energy-efficient continuous-casting technology and electric arc furnaces throughout the EU steel industry. Uptake of new technologies has supported productivity gains and higher rates of capacity utilisation. Between 2003 and 2005, the closure of an additional 8 to 10 million tons of capacity paralleled by continuing concentration of steel production in the most efficient plants throughout the EU is expected to support a further projected increase in productivity to 645 tonnes per employee by the year 2005.

Transforming corporate culture: Renault-Nissan alliance in Japanese motor vehicles

Structural adjustment generally impacts firms along a continuum ranging from forcing closure to stimulating efficiency. In the case of the Renault-Nissan alliance, the introduction of foreign management practices into a Japanese firm transformed corporate culture that had prevented the deep restructuring upon which the survival of Nissan depended. The difficulty of this transformation lay not only in the perception by the Japanese public (including Nissan employees) that Japanese corporate culture was an inalienable component of a unique national culture and heritage, but because Japanese corporate culture had itself been considered (domestically and internationally) as the bedrock upon which rapid post-war recovery and a half century of prosperity had been built. Transforming corporate culture enabled Nissan to de-link itself from traditional but unsustainable external relationships with former *kiretsu* partners, as well as inefficient internal practices such as career advancement based on seniority as opposed to merit. Considered radical by the Japanese corporate practice—if not cultural norms—of the time, these changes represented the flexibility

needed to turn Nissan back to profitability. Pressures for structural adjustment may facilitate the introduction of new ideas and approaches to deeply ingrained corporate culture, and influence perceptions of culture at the national level.

56. Flexible and competitive product markets have been found to facilitate structural adjustment by encouraging efficiency, innovation and job creation. Regulation is an essential part of a well-functioning economy. An efficient regulatory framework, that achieves stated objectives, keeps regulatory burdens on enterprises to the necessary minimum, fosters competition and ensures genuine market openness, will enable firms to engage effectively in the process of structural adjustment, whether through transformation within firms or industries or through entry and exit across sectors. The case studies underline the importance of the regulatory environment, whether via the reduction of regulatory diversity in Mexican avocado production, the deregulation of the agro –food sector in Chile, or reduced barriers to private capital participation in Japan's health sector.

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

58. A sound regulatory environment can be established and maintained with the help of practices that improve regulatory design (regulatory impact analyses, the use of regulatory or non-regulatory alternatives, administrative simplification, transparency) and regulatory implementation (administrative justice, judicial review, measures to develop better compliance). The efficient, transparent and accountable design and functioning of institutions involved in the making and implementation of regulations (regulators, regulatory oversight bodies, parliaments, etc.) is also crucial.

59. OECD work in the area of regulatory reform has enabled the OECD Trade Committee to identify six principles seen to provide policy orientations for the creation of an efficient regulatory framework from a market openness perspective, while respecting diversity in national preferences and regulatory objectives:

- **Transparency of regulations and openness of regulatory decision-making** contributes to a regulatory framework that supports understanding, compliance and equivalence of competitive opportunities among economic actors. Relevant practices are: systematic publication of rules, public consultation, use of the internet to disseminate information, the establishment of enquiry points, and clear, open and effective appeals procedures.

- **Non-discrimination** in the treatment of economic actors aims to provide equivalent competitive opportunities for like goods and services irrespective of their country of origin. A liberal investment regime also helps reduce discriminatory effects.

- **Unnecessary trade restrictiveness of regulations can be reduced** through careful design and implementation of regulations. Relevant approaches are: regulatory impact analysis (RIA), simplification of administrative and customs procedures, consideration of regulatory alternatives and use of performance based regulations.

- **The use of internationally harmonized measures or standards** as the basis of domestic regulations, along with systematic procedures for giving consideration to such use, can be effective for reducing unnecessary regulatory diversity and the costs it engenders.

- **Streamlined conformity assessment procedures** and the recognition of the equivalence of results of assessments performed elsewhere help avoid the duplication of procedures for firms operating in more than one country and thus facilitate trade.

- **Vigorous application of competition principles,** including open and accessible complaint procedures and enforceable remedies**,** is crucial for foreign and domestic players alike, in providing the appropriate conditions for successful entry and competition in the market.

60. The regulatory environment is particularly important for the development of needed infrastructure. This is demonstrably the case in developing countries. International transport facilities and other physical infrastructure also play a crucial role in particular for perishable products such as fresh fruit and cut flowers. All the developing countries case studies seem to indicate that adequate infrastructure facilities and services were already in place at the time of industry growth, though further investments were undertaken by the government, alongside deregulation of infrastructure services. In the Mauritian case, the Development Bank of Mauritius was directly involved in building and managing the industrial estates for the EPZ sector. In the case of Kenyan cut flowers, the industry was able to take advantage of the international air traffic created by tourism and early horticultural exports. In Thailand, companies co-operated to negotiate lower international freight costs. In Lesotho, the Lesotho National Development Corporation provided factory space and utility services to investors, even though the recent rapid growth of the clothing industry has created a shortage of facilities.

61. A particularly sensitive aspect of the regulatory dimension of the adjustment process relates to heightened societal concerns about environmental damage that may ensue from increased exports, and production. In the developing country case studies considered here the expansion of the examined industries has sometimes caused harmful environmental effects, such as water pollution, depletion of fish stocks and destruction of mangrove ecosystems, which have in turn raised concerns regarding the sustainability of some of these industries (shrimp farming in Thailand is a case in point). Buyers and consumers in importing countries are now adding pressures on producers to comply with a wide range of health, environmental and social standards. To deal with these issues, the governments in the surveyed countries are required to develop legislation, formulate good regulatory practices and put in place appropriate quality control systems in co-operation with the private sector and eventually with the support of external aid. [4]

62. The institutional and governance process of structural adjustment in enhancing public understanding and in anticipating challenges is also seen to be of particular importance. Australian experience highlights three elements **(see Box 7):**

- Effective policy evaluation, including analysis of whether a proposed structural reform is in the overall interests of the community.

- Independent review processes, operating at arms length from government, to enhance public understanding that benefits will outweigh costs.

- Ex-post evaluation to help reassure the community that unanticipated adjustment difficulties will be addressed.

63. Establishing a well-functioning consultative process between the government and the private sector is considered to be a key requirement for effective policy formulation, which is needed to manage and sustain an effective structural adjustment process (OECD, 2002a; Bonaglia and Fukasaku 2002; Rodrik, 2004). For the consultative process to work, it must involve active and vocal business organisations. A variety of such organisations exists in all five developing countries reviewed; sometimes they have emerged with direct government support. These organisations play an important role both in promoting business interests to the government and in providing business services to members. Relevant sector-specific organisations include, for example, the Kenya Flower Council, the Lesotho Textile Exporters' Association, and the Thai Frozen Food Association. There is also a range of more general industry organisations and chambers of commerce that represent and support the private sector. In addition to the associations, networks of private service and input providers have developed as well.[5]

64. The developing country case studies also point to the importance of sound public institutions and governance structures for managing the services and incentives provided to investors and exporters, such as the EPZ in Mauritius and the investment incentives in Chile. However, the problem of defining "sound institutions" remains (see Rodrik, 2003). Governance indicators available in the public domain highlight Chile's good performance yet indicated that Lesotho and Kenya are lagging far behind. In the case of Kenya, the cut flower industry has prospered in what seems to be an adverse governance environment, which has been an important factor behind the country's disappointing overall economic performance.

65. The question of institution building in a sound regulatory environment also bears on the question of policy sequencing. While the interdependence of market openness and regulatory reform would suggest the need for parallel action on both fronts, there may be a case for establishing appropriate regulatory institutions and mechanisms *before* technical regulatory decisions are decided upon and implemented.

66. There is much debate on the sequencing of reforms. In general, measures to eliminate market distortions should be taken before reforming market regulations, in order to increase benefits from reform and reduce the pain of transition. For instance, state monopolies may need to be restructured prior to deregulation, in order to establish conditions for competition and avoid high market concentration and abuses of dominant position in post-deregulation markets.

67. Reform in one policy area can also make the costs of inefficient regulations in other areas more visible and painful. This is particularly true with respect to the trade liberalisation of sectors suffering from domestic regulatory inefficiencies. Even when tariffs and quotas no longer significantly limit the export potential of domestic industry, enterprises will have little success in domestic and foreign markets if they are held back by unnecessarily heavy or divergent regulatory burdens.

68. The optimal sequencing from an economic point of view will reduce transition costs and help achieve benefits quickly. However, as noted earlier, there is no blue print – appropriate sequencing needs to be determined case by case. Optimal sequencing may not always be possible from a political perspective, where political momentum for reform would need to be achieved. Most countries have approached sequencing very pragmatically, since waiting for the optimal sequence of reforms can delay reform for a long time.

69. **Trade and trade policies**. In all of the eight sectors examined in this study, trade policy emerges as a key element of structural adjustment, for developed and developing countries alike. As a general rule, barriers to trade are not effective in facilitating the adjustment process, or in obviating the need for adjustment. Take agriculture as an example. There are deep-seated structural factors that cause the importance of agriculture in overall economic activity to decline as growth and development occur, notably, income elasticity of demand for food tends to be less than for other commodities, and technical innovation in agriculture is labour saving. Efforts to resist trade liberalisation will not change these

underlying realities, but they will impede adjustment. Put differently, and positively, a liberal trade environment, *backed by supportive action in other policy areas*, is found to complement the adjustment process. At the broadest level, it will do this by contributing to economic growth and so helping create an environment where the movement of factors of production from declining to expanding areas of activity is facilitated. Insofar as growth through trade helps the adjustment process in developing countries and contributes to increased returns to labour in those countries, it will also help ease the pressures arising from international migration. Our Infosys case study points out, for example, that in the Indian IT sector, remuneration grew by 17 per cent in 2004 and salaries have grown by approximately 13 per cent annually over the last five years. The influence of trade on returns to labour is also evident in the Kenya cut flowers and Mauritius textiles case studies. As noted earlier, recent papers by Winters (2004) and by Duncan and Quang (2002), collectively review a large body of empirical work aimed at quantifying the trade/growth link. The general conclusion that emerges is that while not wholly conclusive, the evidence justifies, as Winters puts it, "… the strong presumption that trade liberalisation contributes positively to economic performance". As our case studies show, the particular channels by which trade (both imports and exports) and foreign direct investment help adjustment include by:

- fostering competitiveness and innovation,
- improving access to essential inputs, whether raw materials, capital goods or services; and
- stimulating exports, by offering enlarged market opportunities or encouraging synergies between countries with different areas of comparative advantage (**See Box 5**).

Box 5: Trade and Trade Policies: Helping Adjustment

Fostering competitiveness and innovation: Infosys Technologies Ltd

The case of Infosys demonstrates how openness in trade and trade policies can stimulate competitiveness and innovation. In 1991, India initiated a reform agenda to open its economy to increased trade and investment. As a result, companies such as British Airways and General Electric established IT centres and back offices in India to service English speaking markets on a global basis. Transfer of technology to establish these operations left India with a pool of IT talent which provided a basis for investment and further knowledge transfers by ethnic Indian IT professionals, particularly from the US. Established under such circumstances, Infosys stands out among the innovative, competitive and independent companies based in India and servicing clientele around the world.

Recording 800 per cent growth over the last five years, Infosys now manages projects and provides services from a variety of locations throughout the world. Its success was assisted by three factors signalling the benefits of a liberal trade environment and supportive policies in ancillary sectors. First, the development of Infosys was aided by the easing of the legacy of protectionism and state planning characteristic of the Indian regulatory environment. Second, developing without a domestic client base meant that Infosys, as measured by its competitiveness *vis-à-vis* established foreign providers in foreign markets, had to be efficient from the onset by adopting an innovative delivery model based on new IT technologies. Finally, the large pool of skilled labour in India and the fact that IT services companies rely disproportionately on a well educated work force, rather than physical infrastructure, provided natural synergies between needs and resources.

Improving access to essential inputs: South African autos

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

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

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

Stimulating exports: Australian shipbuilding

The system of government support to the Australian shipbuilding industry, dating back to 1940, consisted of "bounties" in the form of subsidies provided to offset the higher cost of domestic ship production when compared to that in the United Kingdom. Applicable only to ships bound for domestic use, this system discouraged investment, innovation and diversification of production away from large steel hulled vessels, which were increasingly being produced with more technological sophistication and at a lower cost by European and East Asian shipbuilders in the 1970s. Thereafter, a series of reforms to the Australian shipbuilding subsidy regime resulted in its complete removal by 2003. The effect was a reduction in the number of people employed in the Australian shipbuilding industry by nearly half (to 7434) between 1985 and 1996, and a three-fold increase in the output of the domestic shipbuilding industry over the same period. The vast majority of current production is now destined for export.

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

70. Although in the context of the Doha Development Agenda (see below), trade liberalisation will need to occur across all sectors, in order to ensure that a balance of interests is maintained, specific benefits are likely to result from the liberalisation of trade in services. In a framework of structural adjustment, there are three reasons for this:

- First, the potential welfare gains – and therefore the breathing space in which to adjust – are expected to be much greater from services liberalisation than in the case of goods liberalisation; on some estimates by a factor of five. This is of particular relevance to developing countries who on average have more restrictive barriers than developed countries and who are expected, in the long run, to gain most from services liberalisation (see Nielson and Taglioni, 2004).

- Second, given the dynamism of the service sector, the adjustment strains of liberalisation are likely to be more easily accommodated than those associated with goods liberalisation.

- Third, the liberalisation of services inputs to agricultural and manufacturing production is likely to ease any adjustment strains which those sectors might be facing. Ongoing analysis at OECD finds that if account is taken of services barriers, the effective rate of protection for some agricultural and manufacturing sectors actually turns negative, meaning that services barriers contribute to effective taxation, rather than protection, of these industries. (see Figure 1)

Figure 1. Impact of Services Barriers (SB) on Effective Rates of Protection (ERP) in Manufacturing
Effective Rates of Protection (ERP) results

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

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

71. As noted earlier, restrictions on trade are unlikely to affect the underlying structural forces that determine the role of different sectors in overall economic activity. However, in some specific cases, where serious injury is caused by large and unforeseen surges in imports, it may be felt that targeted safeguard action is warranted as part of the adjustment process. The question that needs to be answered is whether the potential benefits of safeguards in providing breathing space for – and greater public acceptance of – structural adjustment justifies the cost they entail (**see box 6**).

Box 6: Harley Davidson: trade safeguards and adjustment

In 2003, Harley-Davidson Motor Company marked its 100th anniversary by announcing record revenues and earnings for an 18th consecutive year. The company increased its market share of heavyweight motorcycles in North America to 48 percent and worldwide sales reached almost 300,000 units of which 22 percent were exports. Today's strong position stands in stark contrast to the company's precarious condition two decades earlier.

Between 1973 and 1980, Harley-Davidson's market share in North America plunged from 75 percent to less than 25 percent for heavyweight motorcycles. Japanese companies had already captured 98 percent of the North American market for lightweight motorcycles and these companies were now turning their attention to the heavyweight motorcycle market. In 1978, the United States International Trade Commission (USITC) had rejected an antidumping petition brought against imports of Japanese lightweight motorcycles. Although the USITC did find dumping, it reasoned that Harley-Davidson, a subsidiary of NY-based conglomerate AMF, was not injured by the imports, and no action was taken. However, four years later and with an additional 30 percent decline in the company's market share, the United States' last remaining domestically-owned motorcycle manufacturer, having been spun off recently in a leveraged buy-out by its corporate parent, was on the verge of collapse as it continued to lose ground to lower-cost, higher-quality Japanese heavyweight motorcycles.

At this point, the newly independent Harley-Davidson was seeking to turn around the business by reducing idle capacity, introducing a new organisation and implementing new quality control measures and production systems. But the U.S. was in the midst of the deepest recession since the Great Depression, interest rates were extraordinarily high, demand was falling, imports were accelerating and Japanese inventories were at unprecedented high levels. Against this backdrop, the highly leveraged Harley-Davidson filed for relief under Section 201 of the Trade Act of 1974 (incorporating the escape clause principle embodied in GATT Article XIX:1(a)).

In short, Harley-Davidson asserted that the company was already taking the necessary action for a turnaround, that the Japanese manufacturers had amassed high levels of inventories which they would need to sell at heavy discounts, and that the company needed some time to complete its adjustment to these changes. The USITC evaluated four main issues to determine if Harley-Davidson met the statutory requirements for relief. These were: 1) whether the domestic industry produced articles like or directly competitive with the imported articles in question; 2) whether imports of the article in question had increased; 3) whether the domestic industry was seriously injured or threatened with serious injury; and 4) whether the increased imports were a substantial cause of the injury or threat thereof.

The three Commissioners all agreed that the first three requirements had been met. However, concerning the fourth issue, one of the Commissioners did not conclude that increased imports were a substantial cause of the injury but rather that the decline in demand resulted from the recession. This Commissioner also noted that two Japanese motorcycles producers that manufactured motorcycles within the United States were doing relatively better than Harley-Davidson. The USITC thus found (by two votes to one) that relief was warranted on the basis of a threatened injury and the U.S. President subsequently accepted the USITC's recommendation to increase the 4.4 percent *ad valorem* tariff on heavyweight motorcycles to 45 percent for the first year, 35 percent the second, 20 percent the third, 15 percent the fourth and finally 10 percent during the fifth year.

The new tariff led to a fall of the import share in the U.S. motorcycle market from 60-70 percent in the early 1980s to 31 percent by 1984. Japanese manufacturers Kawasaki and Honda responded by increasing their production within the United States.

In the meantime, Harley-Davidson made noteworthy efforts during the period of relief to adjust to import competition. It introduced new computer-aided technologies, limited production costs, and improved product quality. It achieved significant improvements in manufacturing methods and productivity through the introduction of a just-in-time inventory system and statistical process control. It also improved its marketing and retail financing and strengthened its dealer network.

Following the introduction of the tariff and in combination with the reorganisation and efficiency drive, Harley Davidson enjoyed increased employment and output in the mid 80's together with a rise in its domestic market share. While it was argued by some critics that the success came at an estimated cost to US consumers of USD 400-600 per motorcycle and, in 1984, USD 150 000 per job saved in the motorcycle industry, the swift change in the fortunes of Harley-Davidson led the company to ask the US administration to remove the protective tariffs one year ahead of schedule.

Sources: USITC (1987); Appleyard and Field (2001); Baltzan and Tate (1995); Hufbauer, Berliner and Elliott (1986).

72. While trade reform is part and parcel of the requirements for successful structural adjustment, it is worth noting that the developing countries under review in this study have taken different approaches. In the early stage of reform, Mauritius undertook a policy of partial opening, by instituting an export processing zone (EPZ) in the protected domestic economy. Similarly, the Thai economy has been liberalised only gradually. Among the five countries, Chile is the only case in which the government pursued a policy of full import liberalisation. This policy, together with a range of other measures that further opened up the economy and promoted exports, contributed to the development of fresh fruit, wine and other agro-food export industries. Meanwhile, the government adopted a set of corrective regulatory measures in both product and factor markets (see Box in the case study of Chile in the annex) in order to put the economy onto an outward-oriented development path. Developing country experience suggests that gradual trade-related structural adjustment may be warranted where time is needed to strengthen the

institutional framework. The danger, however, with gradualism is the signal it may send about the credibility of reform and the opportunity it may present for back-tracking or specific exceptions.

73. Like many other developing economies, the five countries under study introduced various forms of export incentives, such as duty-drawback schemes (reimbursement of import levies charged on parts and components used for export production), tax holidays and other fiscal measures provided for export firms in EPZs. It is worth emphasising that export incentive packages need to be managed by well-functioning public institutions, in order to avoid delays and other inefficiencies. In addition, these incentive packages must be part of an overall export and investment promotion strategy of the government, such as the EPZ in Mauritius. The absence of such overall strategies may explain the difficulty of establishing successful EPZs in other Sub-Saharan countries (Bost 2001). Inefficiencies in the protected sector may also weaken the linkages with the dynamic export sector. Lesotho is a case in point, as the country faces a major challenge to strengthen linkages between the mostly foreign-owned clothing sector and the rest of the economy.

74. The links between trade and investment are often crucial, not least in developing countries. While much investment capital originated from *domestic* sources in all the developing country sectors under study, FDI has played an important role. In Lesotho, for example, the clothing sector is mainly in the hands of foreign investors. It is noteworthy that capital often came from the export sectors that had been built up previously, such as the sugar sector in Mauritius, the agro-industry corporations in Thailand, and the horticulture industry in Kenya. In particular, the Mauritian experience highlights (for African governments) how important it is not to kill the "cash cow" and allow domestic sources of risk capital to appear (Subramanian and Roy, 2001).

75. While domestic investments dominated in terms of quantity, foreign investments seem to have made an important "qualitative" contribution. FDI and expatriate expertise provided capital, managerial, and technological know-how, as well as access to foreign markets and buyers. The Dutch and Israelis helped to develop cut flower expertise in Kenya, East Asians the clothing industry in Mauritius and Lesotho, Americans fruit packaging techniques in Chile and Japanese shrimp farming in Thailand. The governments also assisted in attracting FDI with fairly open and non-discriminatory investment regimes put in place in the 1980s.

76. **Reliance on broad-based policy approaches**. Undertaking reforms across different policy areas in a complementary way can both reduce resistance to change, because those adversely affected by one reform might benefit from another, while also creating cross-policy synergies. The combined effect of complementary policies will be greater than the sum of the parts, not least by creating an environment conducive to innovation and technology diffusion – enabling countries to move up the value chain. The overriding advice to government is thus to aim for good general measures over a range of policy areas to handle structural adjustment. Comprehensive reform programmes are likely to be more effective than piece-meal strategies. For example, policies that improve labour market flexibility would help reduce adjustment costs in terms of lost production, while promoting growth by facilitating resource transfers to expanding activities. However, if accompanied by measures that ease regulatory barriers to competition and growth in domestic markets, the overall benefits for society may well be reaped earlier and the ultimate gains higher. Broad-based reforms can also reduce resistance to change and make it harder for individual industries to argue for exemption **(see Box 7)**.

Box 7: Structural adjustment insights from Australia's experience with broad-based reforms

Over the past two decades, Australia has implemented an extensive range of structural reforms –involving trade, exchange rate and financial sector liberalization, more flexible labour market regulation, reform of the public sector monopolies that dominated the supply of basic infrastructure services, as well as the systematic review and reform of anti-competitive regulation through a comprehensive 'national competition policy'.

The reforms have generated a range of benefits across the economy. They have also often put adjustment pressures on particular firms, workers and regions. While these pressures have typically been concentrated on a relatively small group and evident from the outset, the benefits have usually been dissipated throughout the community and have taken time to accrue. This highlights the perennial difficulty in achieving support for worthwhile reform.

Australian experience affirms the importance of macroeconomic stability to engender an environment conducive to structural change and successful policy reform. However, it also shows the importance of addressing adjustment issues and implementing appropriate adjustment policies. Some key lessons from the Australian experience are the following.

Effective policy evaluation processes are fundamental. Decision makers need information and analysis on whether a proposed structural reform is in the overall interest of the community, having regard to its expected benefits and costs and any significant distributional consequences. Where appropriate, different implementation strategies need to be examined and the basis for particular policy choices made clear.

Independent review processes can facilitate acceptance of the need for reform.
Governments and communities need to understand the rationales and consequences of different policy choices. Review bodies that operate at arms length from government and sectional interest groups and whose processes provide for extensive consultation and public scrutiny, can help governments 'sell' reform and enhance community understanding that the benefits will outweigh the costs.

Broad-based reforms can reduce adjustment costs. Notwithstanding the substantial challenges involved, concurrently undertaking reforms across different policy areas can reduce resistance to change. This is because those adversely affected by one reform may receive offsetting benefits from others. For example, modelling undertaken by Australia's Industry Commission (the predecessor of the Productivity Commission) of tariff, electricity, telecommunications and public sector reforms demonstrated that, although trade liberalization would reduce manufacturing employment by 0.3 per cent, the net effect of all four reforms would be to increase employment in that sector by about 1.2 per cent. A broad-based reform programme also made it harder for individual industries to argue for exemption.

Rely on generally available adjustment measures, wherever feasible. General social safety nets – such as the social security/tax transfer system, job search assistance and training programmes – have the advantages that they: treat individuals in similar circumstances equally; target assistance to people in genuine need; and support people rather than particular industries or activities. Even so, such measures cannot handle all contingences and additional measures may be needed. There are, however, few hard and fast rules for determining when additional assistance might be warranted and what will work best.

Other industry-specific adjustment assistance needs case-by-case evaluation. Special assistance packages have been used to ease the transition to lower levels of assistance for Australia's dairy, passenger motor vehicle, and textile clothing and footwear industries. Specific adjustment measures should facilitate rather than hinder change, be targeted to adjustment problems, be cost effective and compatible with general safety net arrangements, involve an equitable sharing of their financing costs and be transparent with clear lines of accountability. The risks with special industry 'deals' are that they can create incentives to hold out for compensation (thereby slowing adjustment) and encourage other firms and workers to seek favourable treatment.

Incremental reform can facilitate adjustment. One implementation strategy which can ease adjustment pressures is the phasing of reform. It has distinct advantages where gradual, sequential changes would smooth the transition path by allowing affected parties times to adapt to a new policy environment and where there is limited information on the adjustment capacity of different groups of workers and firms. For example, phasing has been used in Australia's programmes of reform for tariffs, subsidies and public utility pricing. The graduated introduction of reforms can delay receipt of the benefits, however, and in some cases may increase the scope for policy reversal.

Ex-post evaluation can help keep reforms on track. The ability of policy makers to identify and address possible adjustment or distributional problems in advance is often limited. Difficulties associated with a reform might only emerge during its implementation. Consequently, there is a role for ex-post assessment and, where appropriate, associated modification to reforms. This can help reassure the community that unanticipated adjustment difficulties will be addressed. The Productivity Commission's 1999 review of the impact of national competition policy reforms on regional Australia not only found scope to fine-tune arrangements, but also identified some key drivers of change in regional communities –such as changes in technology, terms of trade, consumer tastes and social trends – for which national competition policy was being made the 'scapegoat'.

Source: Australian Productivity Commission

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

2. Bilateral and Regional Cooperation

78. Action taken at the national level can often be complemented by cooperation between countries on a bilateral or regional basis. At its best, such cooperation can constitute a laboratory for change where trade-related adjustment can be undertaken among neighbours, as a transition, or complement, to wider multilateral commitments. Our case studies demonstrate how regulatory cooperation between countries can be fostered through regional or bilateral initiatives, whether through cooperation between SPS regulatory authorities or via provisions for the portability of healthcare insurance. **(See Box 8).**

Box 8. Bilateral and Regional Regulatory Cooperation

Bilateral and regional trading arrangements (RTAs) can sometimes provide an effective framework for addressing difficulties posed to developing economies when exporting to developed markets, such as meeting sanitary and phyto-sanitary (SPS) requirements. They can also help facilitate trade in healthcare services.

Mexico-US avocados

Under NAFTA, Mexican growers have benefited from trade liberalisation on avocado exports to the United States market, but actually accessing these benefits has depended on the NAFTA institutional framework, which facilitated cooperation between SPS regulatory authorities in the two countries to meet SPS standards in the US. Beginning in 1990, bi-national meetings between the USDA Animal Plant Health Inspection Service (APHIS) and Mexico's Ministry of Agriculture and local phytosanitary control boards (JLSVs) resulted in APHIS inspectors overseeing programmes implemented by JLSVs to build the capacity of Mexican farmers to meet high SPS standards. Culminating in 1997 with APHIS certifying four Mexican municipalities as pest free, this programme of regulatory cooperation provided access for Mexican avocado exports into the US while addressing the risk of infestation over which California growers had raised concerns. NAFTA had foreseen a programme of bilateral meetings between national SPS regulatory authorities, providing a mechanism for resolution that would otherwise have been much more difficult to attain.

Japan-Thailand/Philippines health

By 2020, the ratio of working aged adults to senior citizens in Japan will drop from the current 4:1 to nearly 2:1 thus shrinking the tax base financing public services while increasing demands on the healthcare system. Ageing in Japan is the primary driver of structural change in the Japanese healthcare sector; policymakers are seeking to address it, in part, through RTAs that facilitate trade in health services. RTAs may foster trade in healthcare services by allowing better bilateral coordination of regulatory institutions to allow for mode 4 trade in healthcare services *e.g.* by developing mutual recognition systems enabling healthcare providers to provide services in foreign healthcare systems. RTAs can also represent an innovative approach to implementing policies to enhance liberalisation *e.g.* via portability of healthcare insurance which currently restricts mode 2 trade or movement of patients to healthcare providers abroad.

The potential for Japanese senior citizens to receive retirement home care in destinations including the Philippines and Thailand (thus reducing strains on the domestic system) is generally beyond reach in the absence of liberalisation enhancing policy such portability of healthcare insurance, which may be more accessible as a component within a set of commitments embodied in an RTA.

3. Multilateral Cooperation

79. Action taken to foster successful structural adjustment nationally or regionally is often strengthened by multilateral initiatives or disciplines. Indeed, in some cases, effective action, where opportunities are fully realised, can only be taken on the basis of multilateral cooperation.

80. **The Doha Development Agenda**. Full realisation of the gains from trade will require multilateral action via the WTO and effective implementation of the Doha Development Agenda, with balanced and concrete progress across all the core areas of negotiation: agriculture, non-agricultural market access, services, rules and trade facilitation. The 2004 WTO World Trade Report (WTO, 2004a) reminds us that some fifty years ago, Harry Johnson demonstrated how countries could cooperate by avoiding mutually destructive trade policy retaliation. Commitments entered into in the WTO are also important in helping to lock-in domestic reform as well as in addressing particular concerns of developing countries, not least those associated with preference erosion and revenue loss.

81. *Preference erosion*. As noted in Part I, some developing countries have become reliant on trade preferences and therefore may be vulnerable as preferences erode. Where trade develops in response to preferences in a manner consistent with a country's underlying comparative advantage, such measures may assist in helping the beneficiary to catch up economically without undue structural distortions. However, this is not always the case. Preferences may promote development in sectors where a particular beneficiary country will remain dependent on preferential access and never become fully competitive. If preference margins under an existing scheme are subsequently reduced (*e.g.* as a consequence of reductions in MFN tariffs resulting from multilateral negotiations), then adjustment pressures will arise, even in competitive sectors. These pressures will be particularly strong for sectors where a beneficiary country is relatively uncompetitive. In some cases, the adjustment may prove costly and painful to address. Consequently, some WTO member countries have raised the issue of preference erosion as a concern in the Doha Development Agenda negotiations.

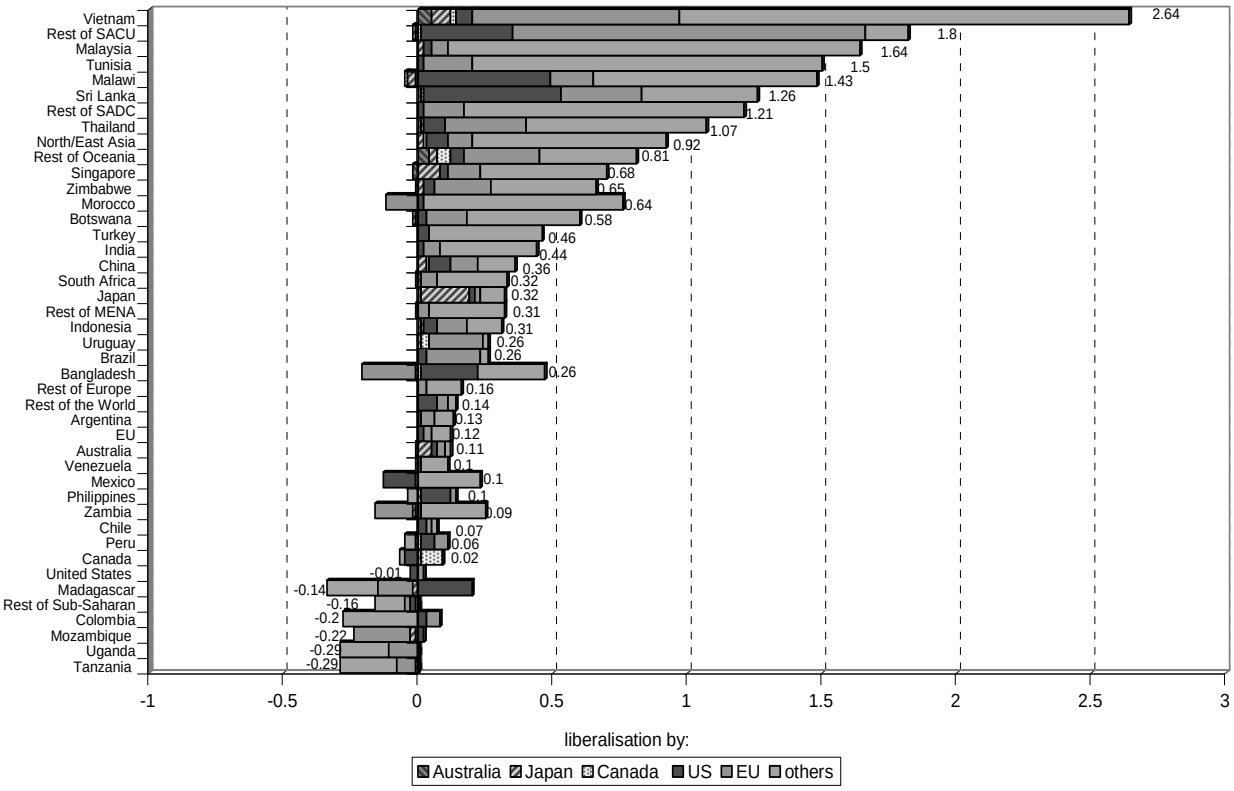
82. Although the main beneficiaries of preferences have often been developing countries with relatively high income levels and pre-existing supply capacity (*e.g.* Brazil or Thailand), some small or poor countries have also succeeded in expanding preferential exports. Some have become reliant on preferences and therefore risk dislocations as preferences erode. Two industries of particular concern are textiles and clothing, where the market access of large suppliers has been constrained in the past by quantitative restrictions and where some developing countries have had preferential access to developed country markets. Countries such as Bangladesh, the Dominican Republic, Haiti, Honduras and Lesotho, among others, all export substantial volumes of products in these sectors under preferential schemes and are especially reliant on preferences (OECD, 2004c). In the case of Lesotho, for example, the IMF lists as one of the "daunting medium-term problems", "the growth of the textile industry [which] is driven by preferential treatment under AGOA [the African Growth and Opportunities Act] and may not be sustainable as trade preferences by the US are phased out" (IMF, 2004a). Another sector of concern is agriculture, where some developing country exporters receive high income transfers because of their privileged access to developed country markets that are otherwise protected by high barriers. Mauritius, for example, exports a large amount of sugar under EU preferences. A recent World Bank study on trade preferences in agriculture (Brenton and Takako, 2005) notes that whereas agricultural preferences have provided large transfers to a small number of countries, they have failed to stimulate exports for a broader range of products. The authors note that reform is needed to enhance the effectiveness of agricultural

preference schemes (e.g. through complementary domestic policies in developing countries and improvements in the provisions for market access), while taking care to avoid interference with the prod-development process of multilateral trade liberalisation.

83. A full assessment of preference erosion and adjustment costs from multilateral tariff reductions must balance these negatives against the potential gains. While preferential exports may decrease as a consequence of erosion, there will also be new opportunities from MFN tariff reductions that may well offset the negatives. Matusz and Tarr (1999) review more than 50 studies on adjustment and trade liberalisation (not necessarily preference erosion). They note that virtually all of the studies find adjustment costs to be very small relative to the benefits of trade liberalisation, in part because adjustment costs are typically short-term and welfare gains from trade liberalisation are long-term.

84. Economic models permit an evaluation of the economy-wide welfare implications of the tariff reform in a multi-country, multi-sector framework. In this framework, changes in market access conditions for a given product category are linked to developments in other sectors through goods and factors markets. Similarly, the effects of a simultaneous liberalisation in multiple destination markets are assessed. Such an integrated approach enables assessment of the effects of preference erosion taking into account the WTO approach to tariff reduction (*i.e.* covering simultaneously multiple markets, tariff lines and product categories). While production in some preference-eligible sectors may be affected negatively, the resources that are freed from a sector that loses its preferential treatment can be employed in other sectors where they may be used more productively. Similarly, the negative effects of preference erosion that may be observed in one destination market may well be outweighed by positive effects resulting from a better market access to other destination markets.

Figure 2. Per capita welfare gains[1] from a simultaneous 50% reduction in tariffs by all regions



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

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

85. Figure 2 presents the results of a tariff liberalisation modelling exercise involving a 50 percent reduction of *ad valorem* measures of protection across all regions. Such a scenario would entail substantial preference erosion. The chart presents the overall welfare change and the geographic sources of the welfare change with respect to markets for trade. Overall, the model indicates that most developing countries would gain from such a liberalisation, with positive net variation in welfare arising as a consequence of the combined changes in the terms of trade and the allocation of resources. In most cases, the gains from trade liberalisation would outweigh the losses from the associated preference erosion. However, in a few regions – primarily in Africa – there may be net losses in welfare, a risk that will pose a challenge for policymakers contemplating the effects of preference erosion. As stated in a recent IMF article (Alexandraki, 2005), "The problem is concentrated on a small number of countries dependent on an even smaller number of products".

86. Where a preference-reliant developing country faces an erosion of benefits, the best policy responses may well be similar to those recommended for most other situations of trade liberalisation. That is, the response should seek to capitalise on the new opportunities while facilitating adjustment. To accomplish this, trade policy reform must be accompanied by complementary policies in such areas as promotion of macroeconomic stability and development of a social safety net. To the extent that the sector in question may be potentially competitive internationally, policy may seek to reinforce that competitiveness through support for an upgrading of infrastructure or human resources (*e.g.* through training). Where new opportunities arise, a focus on facilitating adjustment, redeployment of resources

and promotion of entrepreneurship may be appropriate. In terms of trade policy, Matusz and Tarr (1999) note that a uniform tariff policy can help to minimise incentives to special interest groups to seek protection which can impede adjustment.

87. In addition to such domestic policy measures, (Hoekman, Michalopolos and Winters, 2003) call for a range of international measures to ensure that MFN liberalisation is an effective development tool (one superior to preferences). These complementary steps would include such elements as a strengthening of WTO rules, recognition that resource constraints in small and low income countries may require temporary exemptions from multilateral rules, and greater efforts to tie trade-related assistance to national development priorities. Donors can indeed also have a role in the adjustment process; *e.g.* the EU has made development assistance available to finance sectoral restructuring in some ACP countries in light of the impact of preference erosion in number of sectors. Where a particular sector is vulnerable, the IMF and WB (2002) highlight the importance of early identification of adjustment needs followed by an appropriate policy response. For example, trade liberalisation across a broad range of industries may help compensate for losses in some nations in the textile and clothing sector. Similarly, a recent World Bank study on *Global Economic Prospects: Trade, Regionalism and Development: 2005* underscores the importance of multilateral liberalisation in assisting most developing countries to improve their market access and reduce the discrimination they face from the prevailing web of regional trade agreements. At the same time, the report acknowledges that for some, generally smaller, developing countries there are risks of net losses from preference erosion. This does not mean that preferences should be maintained. Rather, the reports points to evidence that appropriately designed development assistance measures can provide a less distorting and more cost-effective alternative to preferences (e.g. by supporting reforms that will help sustain growth).

88. *Revenue loss*. As also noted in Part I, a particular trade-related adjustment concern of developing countries relates to the revenue effect of tariff liberalisation. Tariff revenue concerns have emerged as an important issue in the framework of multilateral trade negotiations under the Doha Development Agenda (DDA). The July 2004 framework agreement explicitly identified the tariff revenue issue as a challenge for countries dependent on revenues from import tariffs and instructed the Negotiating Group on Non-agricultural Market Access (NAMA) to take into account the particular needs that may arise for the Members concerned.

89. Developing countries that currently maintain higher and more dispersed tariffs are particularly well positioned to benefit from a non-discriminatory tariff reform. The empirical estimates from recent studies indicate that the potential gains from dismantling remaining tariffs are significant and that developing countries stand to capture the largest gains relative to their GDPs.[6] Reducing tariffs brings welfare gains, net of any losses in tariff revenues and these gains are the ultimate motivation for tariff reform. However, potential revenue shortfalls can undermine macroeconomic stabilisation and development programmes and may cause a reversal of the trade reform itself.

90. While the removal of quantitative restrictions and/or their replacement with tariffs has the advantage of preserving or in some cases increasing government revenue, the same cannot be said about tariff reduction. Unless offset by increased demand for imports, a reduction in tariffs will lead to a reduction in tariff revenues and could thus affect governments' ability to mobilise resources. This is of concern to developing countries that depend heavily on revenues from trade taxes. It can also be a particularly serious problem for countries with a small domestic tax base and an inefficient tax regime.

91. The recent policy advice in the area of fiscal implications of trade liberalisation stresses the use of income, sales or value added taxes as compensating measures [WTO (2003a) and (2003b)]. Several developing countries have already made significant progress in reducing their reliance on import duties as a source of tax revenue (*e.g.* 20 percentage points reduction in Tunisia, 17 in Jordan, 16 in Pakistan, 14 in Mauritius and Congo over the period 1994-2001). Yet, the average share of tariff revenues in low income

countries remains at around 18 per cent. According to UNECA, in the Least Developed Countries (LDCs) in Africa, import duties represented on average 34 per cent of total government revenues over the period 1999-2001, and exceeded 50 per cent in a number of countries.

92. Reliance on import duties as a source of government revenue differs considerably from country to country and so will the adjustment requirements associated with replacement of import duties with other revenues. Table 1 contains basic data on tariff levels and reliance on import duties in a sample of selected developing countries. It also presents the results of a simulation of multilateral tariff liberalisation according to a non-linear formula.[7] The considerable cross-country differences in trade, welfare and revenue impacts are largely a reflection of varying initial tariff levels and differences between bound and applied rates (binding overhangs). A comparable simulation where tariff revenue losses are replaced with consumption tax indicates that there is significant scope for obtaining positive welfare gains from a joint package of tariff and tax reform without compromising public revenue. Thailand, for example, could benefit from a permanent annual welfare gain of 1.3 per cent while keeping overall government revenue intact.

93. Overall, past experiences point to both successful and failed attempts at co-ordinating tariff and domestic tax reforms. The mixed evidence calls for a forward looking approach to addressing the adjustment costs that may be associated with tariff cuts agreed in the DDA negotiations. Such an approach should involve both an advance analytical assessment of which countries may be particularly vulnerable as well as an integration of revenue concerns into SDT provisions be it in the form of extended implementation periods or coordinated financial assistance provided to disadvantaged developing countries to help them overcome financial, technical or capacity constraints associated with a tariff-cum-tax reform.

94. It is clear that overcoming financial, technical or capacity constraints associated with a tariff-cum-tax reform in disadvantaged developing countries will require coordinated action by the international community. To that effect, the Executive Heads of the IMF and the World Bank have expressed their commitment to work with the WTO to address problems that some developing countries may have in adjusting to trade liberalisation agreed in the Doha round.[8] It is also worth noting however that while the costs associated with the design and implementation of an appropriate (compensating) tax are temporary, the gains they induce through an improved allocation of resources are permanent. Therefore, from an economic point of view, these costs are seen not as an obstacle to liberalisation but rather as necessary investments that would pave the way for the realisation of long-term gains.

Table 1. Tariff profiles, dependence on import duties and simulated welfare and revenue impacts

	Fiscal indicators		Average tariff [a]		Simulation of tariff reduction according to Swiss formula[b]		
						% changes	
	Import duties (% of tax revenue)	Taxes on international trade (% of current revenue) [c]	Applied	Bound	Per capita welfare gains relative to base	Tariff revenue	Volume of imports
Argentina	*4*	*4*	*7.3*	*32.2*	*0.6*	*-15.3*	*2.9*
Bangladesh[1]	*30*	*23*	*27.4*	*158.3*	*0.3*	*-42.0*	*16.1*
Brazil	*3*	*3*	*8.9*	*34.3*	*0.3*	*-24.4*	*2.8*
Chile	..	*5*	*6.6*	*25.1*	*-0.1*	*-0.6*	*-0.2*
China	*7*	*10*	*9.2*	*6.9*	*0.2*	*-47.1*	*10.2*
Colombia	*9*	*7*	*8.2*	*57.3*	*-0.1*	*-11.3*	*0.8*
India	*24*	*18*	*31.1*	*46.2*	*0.4*	*-58.7*	*29.9*
Indonesia	*5*	*3*	*4.6*	*38.2*	*0.5*	*-12.6*	*0.9*
Madagascar[1]	*54*	*52*	*3.8*	*26.3*	*0.1*	*-4.5*	*0.5*
Malawi[12]	..	..	*10.5*	*105.9*	*0.7*	*-16.6*	*0.8*
Malaysia	..	..	*5.0*	*6.7*	*1.3*	*-42.6*	*1.3*
Morocco	*19*	*16*	*29.1*	*48.9*	*0.8*	*-55.4*	*25.0*
Mozambique[1]	..	..	*8.9*	*99.9*	*0.2*	*-11.8*	*1.6*
Peru	*11*	*9*	*12.4*	*32.4*	*0.1*	*-30.0*	*6.5*
Philippines	*20*	*17*	*2.8*	*11.1*	*0.2*	*-8.0*	*0.3*
Sri Lanka	*13*	*11*	*7.3*	*20.4*	*0.7*	*-27.1*	*2.3*
Tanzania	..	..	*14.8*	*84.2*	*-0.3*	*-37.0*	*9.2*
Thailand	*12*	*10*	*15.8*	*19.0*	*1.5*	*-47.0*	*4.9*
Uganda[12]	*50*	*50*	*6.1*	*66.5*	*-0.2*	*-10.8*	*1.4*
Uruguay	*3*	*3*	*5.5*	*32.0*	*0.6*	*-1.8*	*-0.2*
Venezuela	*12*	*7*	*6.7*	*33.7*	*0.0*	*-19.5*	*1.0*
Vietnam	*23*	*20*	*17.8*	*43.5*	*1.6*	*-34.1*	*6.8*
Zambia[12]	..	..	*9.3*	*42.7*	*0.7*	*-17.5*	*1.6*
Zimbabwe [2]	..	..	*30.8*	*75.9*	*0.7*	*-43.6*	*5.5*

a Trade-weighted averages in 2001.

b Bound rates are reduced worldwide according to the Swiss formula with a coefficient of 10. Applied rates are reduced only in cases where the resulting bound rates fall below the level of initial applied rate.

c Taxes on international trade include import duties, export duties, profits of export or import monopolies, exchange profits, and exchange taxes. Current revenue includes all revenue from taxes and nonrepayable receipts (other than grants) from the sale of land, intangible assets, government stocks, or fixed capital assets, or from capital transfers from nongovernmental sources. It also includes fines, fees, recoveries, inheritance taxes, and nonrecurrent levies on capital. Data refer to central government only. The reference year is 2001 with exception of Bangladesh, China, Colombia, Morocco (1999), Brazil (1998), Madagascar (2000), Vietnam (2002)

[1]Denotes LDCs and [2] denotes landlocked countries.

Source: WB World Development Indicators based on IMF Government Finance Statistics, GTAP and WITS databases and OECD Secretariat's model simulations using GTAP model.

95. **Good practices and efforts in trade capacity building[9].** The international community can support the adjustment process in developing countries, *inter-alia* by encouraging the development of sustainable trade-related capacities of these countries.

96. **Good practices**: The OECD Development Assistance Committee (DAC) recommends in its 2001 *Guidelines on Strengthening Trade Capacity for Development* to target assistance to the strengthening of an effective, participatory and sustainable trade policy process and framework in the developing countries, building on existing endogenous human and institutional capacities.

97. Supporting an effective trade policy process and framework is a complex task. It requires developing country efforts and donor support in a wide range of areas, including among others capacity development for (1) economic analysis, diagnosis and (ex-ante) policy evaluation; (2) the design and execution of a comprehensive trade strategy (see below); (3) the establishment institutionalized consultation mechanisms amongst different Ministries, and with the private sector and civil society; (4) effective "voice" of the different (state and non-state) stakeholders; and (5) independent monitoring and review.

98. Ultimately, partner and donor efforts should aim to enhance the ability of policy-makers, enterprises and civil society in developing countries to:

- *Formulate and implement a coherent trade strategy* (and related action plans) that cuts across all relevant trade-related policy areas. Hence a comprehensive trade strategy should aim at supporting participation in and compliance with the institutions, negotiations and processes that shape national trade policy and the rules and practices of international trade (including standard-setting bodies); promote export competitiveness (see below) and facilitate trade (e.g. by streamlining customs procedures and administrations). The trade strategy should be closely integrated with the country's overall development strategy;

- *Increase the volume, value-added and diversification of exports.* This implies enhanced production and export capacities to help enterprises take better advantage of new opportunities arising from globalization (*e.g.* through enhanced trade promotion and market analysis and development capacities, as well as strengthened business support services).

- *Enhance infrastructure facilities* which are critical for international trade.

99. Donors' trade-related technical assistance and capacity building (TRTA/CB) efforts should be targeted at the wide range of relevant state and non-state actors involved in, and affected by trade, for example government agencies and officials, enterprises and industry associations, labour unions, private and public trade support organizations, research institutes etc.

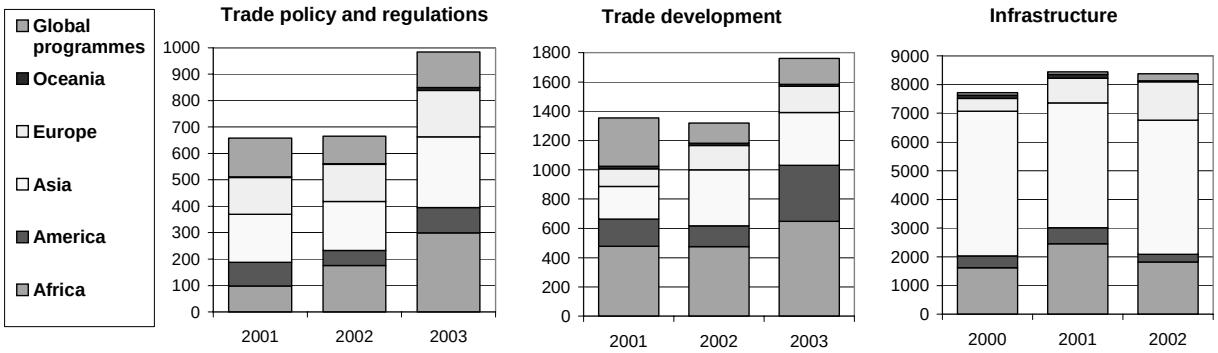
100. In order to maximize aid effectiveness, it is important to (1) support strong local ownership and high-level leadership in the design and execution of trade and poverty reduction strategies; (2) align donor assistance programmes with developing country priorities - as identified in the national trade strategy and development and poverty reduction strategies- and take into account the national context (e.g. political, institutional, cultural and business environment); (3) use, where possible, developing country systems; (4) harmonize (administrative) donor procedures and practices; (5) better co-ordinate assistance programmes and increase donor complementarity (maximizing logical sequencing, continuity and synergies amongst different assistance programmes) in order to ensure a comprehensive approach and integrated delivery of trade capacity building support; and (6) adopt a results-based management of national strategies and related assistance programmes (including regular and objective monitoring and evaluation on the part of the beneficiaries and the donors).

101. **Current efforts**: In November 2002, the WTO and OECD Secretariats set up the Doha Development Agenda Trade Capacity Building Database (TCBDB) to monitor the implementation of commitments included in the Doha Declaration and enhance information-sharing and co-ordination of bilateral donors' and multilateral agencies' TRTA/CB efforts.

102. The most recent TCBDB data, as shown in Figure 3 below, shows a significant increase in TRTA/CB in 2003, after being static between 2001 and 2002. Commitments for assistance in *trade policy and regulations*[10], which amounted in 2001 and 2002 to some USD 660 million per year, increased by 48% to reach almost USD 1 billion in 2003. Similarly, commitments for assistance in *trade development*[11], which amounted to some USD 1.35 billion per year in 2001 and 2002, increased by 34% to reach almost USD 1.8 billion in 2003. In addition to these TRTA/CB activities, donors and multilateral agencies committed over USD 8 billion in 2002 to support economic *infrastructure* –transport and storage, energy and telecommunications– which is essential to international trade. Commitments in this sector did not vary significantly between 2000 and 2002.

103. The share of TRTA/CB in total aid commitments also progressed, from 3.6% in 2002 to 4.2% in 2003.[12]

Figure 3 - Distribution of Trade-Related Technical Assistance and Capacity Building and infrastructure by region and main category – USD million



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

104. These amounts cannot be summed to give an overall value for TRTA/CB. Assistance to *trade policy and regulations* is often delivered through training sessions and workshops, at a relatively low cost but with a potentially high payback in terms of institutional capacity building. In contrast, general assistance to the business sector and agricultural or industrial trade-related projects is greater in value, but only part of the project may build trade capacity. Assistance to *infrastructure* is "capital intensive" and so high cost.

105. Aid to *trade policy and regulations* increased in all developing regions, but particularly in Africa, where it tripled between 2001 and 2003. The sharp increase in 2003 is explained by the rise of commitments for assistance with mainstreaming trade in PRSPs, understanding and complying with SPS and TBT and implementing trade facilitation procedures. Examples of broad activities committed in 2003 include a regional trade facilitation programme of the United Kingdom that aims to increase trading opportunities for small scale farmers and traders through the development of common standards across goods and services and the streamlining of customs procedures in Southern Africa. Another example is France's regional programme that aims to develop "fair trade" in Africa.

106. In 2003, the volume of commitments to *trade development* activities increased in Africa and America, mainly through *regional programmes*, e.g. an IDA loan to assist the development of power exports between southern African countries, or an EC's multisector SME development project in South America. The sharp increase in 2003 is accounted for by the important surge in the volume of activities to support trade promotion, particularly in the agricultural and industrial sectors, and to a smaller extent to the increase of aid for market development, particularly in the industrial and services sectors.

107. As for *economic infrastructure*, Asia remains by far the largest recipient region – due to the number of populous countries in the region. In 2002, Africa's share in infrastructure diminished, reflecting a tendency of donors to focus more on social sectors and less on infrastructure in the region, while Europe's share has increased since 2001, mainly due to the post-war reconstruction in Serbia and Montenegro.

108. **International co-operation in regulatory reform issues**. The OECD is an example of an international organization that undertakes work to promote understanding of the benefits and practice of regulatory reform. It adopted in 1997 a set of principles of good regulation, which have recently been updated. The OECD has also reviewed regulatory practices in 20 member countries so far. The reviews follow a multi-disciplinary approach and focus on the government's capacity to manage regulatory reform, on competition policy, on market openness and on the regulatory framework of specific sectors.

109. The OECD is co-operating with APEC in a joint project in this area. The *APEC-OECD Cooperative Initiative on Regulatory Reform* provides a forum for discussions and aims to facilitate the implementation of similar principles on regulatory reform in their respective member economies.

110. Under the initiative, an *APEC-OECD Integrated Checklist* has been elaborated to serve as a tool for guidance and for self-assessment on regulatory reform policies and their implementation. The checklist proposes to view regulations from whole-of government perspective. When designing and implementing regulations governments should be aware of the complementarity and the interrelations between regulatory, competition and trade polices. Concerning the trade perspective, it is suggested to integrate market openness considerations into regulatory decision-making through the creation of appropriate intra-governmental consultation mechanisms between regulatory, trade and competition authorities, through better training for regulators, and through coordination between regulatory and trade officials in the context of negotiating trade agreements.

111. **Export Credits**. As a consequence of their key role when supporting international contracts for the sale of capital goods and projects, governments' officially supported export credits provided in accordance with various agreements negotiated and agreed in the OECD can contribute to structural adjustment by facilitating access to infrastructure projects, by helping maintain flows of trade finance and by imposing disciplines on the provision of official support. **(see Box 9)**

Box 9. Officially Supported Export Credits and structural adjustment

OECD Members provide official export credit support through Export Credit Agencies (ECAs) in order to finance national exports or to insure/guarantee export credits provided by banks against the risk of non-payment. Historically, the provision of officially supported export credits has been targeted by OECD countries to maximise trade benefits; in addition, aid credits, focused on development purposes, have been channelled via public aid agencies and enjoyed more generous financial conditions than commercial export credits. Statistics show, however, that over the last ten years, more than two thirds of officially supported export credits were related to exports to developing countries.

The disciplines in this field, *i.e.* the *Arrangement on Officially Supported Export Credits,* encompass rules that apply to export credits (export loans issued by a private bank with cover from an ECA against the non-repayment risk) and disciplines applying to aid credits (*e.g.* soft loans), in particular to tied aid credits.

Export credits but also aid credits may impact quantitatively on structural adjustment policies in several respects:

- The active role of ECAs tends to reinforce the inflow of long-term infrastructure projects in recipient countries, supporting in particular sectors such as telecommunications, mining, manufacturing, oil and gas, transportation. Typically, the presence of ECAs in a big multi-sourced project can facilitate the selection of a recipient country having little access to international finance markets for efficient equipment and up-to-date capital goods.
- In case of financial crisis, the presence of ECAs may also help recipient markets to overcome short-term liquidity problems by contributing to the maintenance of a minimum flow of trade finance.

- OECD Members also use aid credits to support projects that the market would otherwise not finance, when such projects are non-commercially viable (*e.g.* schools, hospitals, isolated infrastructure projects) and which could not be serviced in a normal repayment period – typically 10 years.

- However, official support may not be granted at any cost. The conditions set out in the *Arrangement on Officially Supported Export Credits* include, in particular, the obligation to charge a risk-premium fee commensurate with the risk covered. As well, OECD Members' own cover policies (including ceilings of cover/finance) tend to limit in practice the capacity of the borrower to increase its debt. In this connection, the level of the risk-premium fee to be paid by the borrower is a function of the buyer country's payment performance in servicing its external debt and, therefore, reflects its capacity to serve its debt whilst managing new infrastructure projects.

- As an example of such limitations, the OECD Members have adopted guidance relating to official support to Heavily Indebted Poor Countries (HIPCs). OECD Members have agreed to a Statement of Principles designed to discourage the provision of officially supported export credits for "unproductive" expenditures in the HIPCs. This agreement complements the World Bank-led Debt Initiative for the HIPCs which seeks to provide debt relief in order to foster sustainable development.

112. **Corporate responsibility**. In dealing with the strains, as well as the opportunities, of the adjustment process, it is important to foster an atmosphere of trust between management and workers. The **OECD Guidelines for Multinational Enterprises** make an important contribution to this objective by strengthening the basis of mutual confidence between enterprises and the societies in which they operate, including through the provision that in the context of bona fide negotiations with representatives of employees on conditions of employment, companies should not threaten to transfer the activities from the country concerned in other countries in order to influence unfairly those negotiations. **(See Box 10 and Annex).**

Box 10. OECD Guidelines for Multinational Enterprises

The governments adhering to the Guidelines represent countries that are home to most multinational enterprises and the source of most global trade and international investment. Adhering countries comprise all 30 OECD member countries, and to date eight non-Member countries (Argentina, Brazil, Chile, Estonia, Israel, Latvia, Lithuania and Slovenia). The Guidelines have been reviewed in 2000 to ensure their continued relevance and effectiveness in the rapidly changing global economy.

The OECD Guidelines provide voluntary principles and standards for responsible business conduct consistent with applicable law, in such areas as labour relations, human rights, disclosure of information, anti-corruption, taxation, environment and consumer protection. They apply to the global operations of multinational enterprises based in adhering governments. Governments adhering to the Guidelines should not use them for protectionist purposes.

The Preface to the Guidelines points out that competition in the global economy is intense and multinational enterprises face a variety of legal, social and regulatory settings and in this context, some enterprises may be tempted to neglect appropriate standards and principles of conduct in an attempt to gain undue competitive advantage. The Guidelines both complement and reinforce corporate initiatives to define and implement responsible business conduct.

The Guidelines are backed by unique government-sponsored follow-up mechanisms. While observance of the Guidelines is voluntary for companies, the adhering governments are committed to actively promote them. The most visible sign of this commitment are the “National Contact Points (NCPs)”, which are government offices (sometimes tripartite in structure) charged with promoting observance of the Guidelines by multinational enterprises operating in or from the national territory. The NCPs are responsible *inter alia* for the "specific instance" procedure which allows any interested party to ask an NCP to engage in dialogue with an individual company regarding observance of the Guidelines in specific business situations. As of June 2004, a total of 80 specific instances have been brought to National Contact Points' attention since the 2000 Review of the Guidelines. The majority of them concern observance of the provisions of the Employment and Industrial Relations chapter of the Guidelines, which cover all internationally recognised core labour standards (see annex). Many deal with managing social adjustment arising from corporate decisions to close or relocate production or service provision sites.

The main strength of Guidelines implementation is that the NCPs allow general principles for business conduct to be promoted in ways that account for different national institutions and circumstances. NCPs have significant flexibility in determining how they go about this. However, they engage in annual peer reviews of their activities and publish an annual report. The 2004 Annual Report on the OECD Guidelines for Multinational Enterprises describes NCPs’ handling of specific instances and on-going efforts by adhering countries to enhance the effectiveness, transparency and timeliness of the Guidelines procedures.

The Guidelines are part of a broader and balanced instrument of rights and commitments – the OECD Declaration on International Investment and Multinational Enterprises. In addition to the Guidelines, the Declaration provides guidance for governments in the areas of national treatment, avoiding imposing conflicting requirements on international investors and investment incentives and disincentives.

Annex . Chapter IV of the OECD Guidelines for Multinational Enterprises: Employment and Industrial Relations

Enterprises should, within the framework of applicable law, regulations and prevailing labour relations and employment practices:

1. a) Respect the right of their employees to be represented by trade unions and other bona fide representatives of employees, and engage in constructive negotiations, either individually or through employers' associations, with such representatives with a view to reaching agreements on employment conditions;

   b) Contribute to the effective abolition of child labour;

   c) Contribute to the elimination of all forms of forced or compulsory labour;

   d) Not discriminate against their employees with respect to employment or occupation on such grounds as race, colour, sex, religion, political opinion, national extraction or social origin, unless selectivity concerning employee characteristics furthers established governmental policies which specifically promote greater equality of employment opportunity or relates to the inherent requirements of a job.

2. a) Provide facilities to employee representatives as may be necessary to assist in the development of effective collective agreements;

   b) Provide information to employee representatives which is needed for meaningful negotiations on conditions of employment;

   c) Promote consultation and co-operation between employers and employees and their representatives on matters of mutual concern.

3. Provide information to employees and their representatives which enables them to obtain a true and fair view of the performance of the entity or, where appropriate, the enterprise as a whole.

4. a) Observe standards of employment and industrial relations not less favourable than those observed by comparable employers in the host country;

   b) Take adequate steps to ensure occupational health and safety in their operations.

5. In their operations, to the greatest extent practicable, employ local personnel and provide training with a view to improving skill levels, in co-operation with employee representatives and, where appropriate, relevant governmental authorities.

6. In considering changes in their operations which would have major effects upon the livelihood of their employees, in particular in the case of the closure of an entity involving collective lay-offs or dismissals, provide reasonable notice of such changes to representatives of their employees, and, where appropriate, to the relevant governmental authorities, and co-operate with the employee representatives and appropriate governmental authorities so as to mitigate to the maximum extent practicable adverse effects. In light of the specific circumstances of each case, it would be appropriate if management were able to give such notice prior to the final decision being taken. Other means may also be employed to provide meaningful co-operation to mitigate the effects of such decisions.

7. In the context of bona fide negotiations with representatives of employees on conditions of employment, or while employees are exercising a right to organise, not threaten to transfer the whole or part of an operating unit from the country concerned nor transfer employees from the enterprises' component entities in other countries in order to influence unfairly those negotiations or to hinder the exercise of a right to organise.

8. Enable authorised representatives of their employees to negotiate on collective bargaining or labour-management relations issues and allow the parties to consult on matters of mutual concern with representatives of management who are authorised to take decisions on these matters.

113. As a separate OECD initiative related to corporate responsibility, in recent years, OECD governments and their Export Credit Agencies (ECAs) have increasingly conditioned their **official support for export credits** to a series of new guidelines, criteria and procedures relating to "corporate social governance". In this regard, Governments have both increased their accountability *vis à vis* societal concerns and engaged in dialogue with importing countries, in particular in the following areas:

- Environmental impact of projects: An OECD recommendation was adopted in December 2003, which establishes detailed environmental review procedures and exchange of information – including with the public – together with the use of common environmental standards when considering support for projects.

- Fight against bribery in international business transactions: OECD Members have also agreed an Action Statement to detect and deter bribery in officially supported export credits. This Statement supplements the OECD Bribery Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. ECAs are committed to taking concrete, co-ordinated measures to deter bribery in the export deals they support.

114. **ILO: Core Labour Standards**. As identified at the outset, one of the underlying forces of structural adjustment comes from shifts in comparative advantage and the emergence of new sources of international competitive pressures. This has led to concerns that countries will - and do - disregard internationally agreed core labour standards in order to gain a competitive edge – so promoting a race-to-the-bottom in labour conditions. The emergence of China and the growth of Export Processing Zones are at the centre of these concerns.

115. An earlier study by OECD (OECD, 2000b) found no evidence of a race-to-the-bottom. More recent analysis tends to support this finding. In one study[13] it is found that while labour costs are some five times lower in the typical firm in Central Europe than in high wage countries like Belgium and Germany, labour productivity is more than five times lower in Central Europe. The study finds no evidence that employment substitution between high wages and low wage locations takes place in response to changes in wages and concludes that for most companies the main driving force for investing in Central and Eastern Europe is not the low wage costs, but rather the attainment of first mover advantages and the opportunity to get access to a growing market.

116. The case study of IBM prepared for this project also puts the importance of wage costs in a broader context. IBM experience suggests that location decisions depend primarily on the availability of skills, and on quality and cost factors, which in turn vary with the activity in question, *e.g.* commoditised activities are generally more price sensitive. Although for some of these activities labour cost differentials between high income countries and emerging market countries can be significant, operational risks tend to be higher and any cost-benefit analysis must consider the total costs of processes beyond just labour expense.

117. Earlier OECD analysis also found that countries do not gain a sustained improvement in competitiveness by disregarding core labour standards. Indeed, quite to the contrary, improved working conditions are found to contribute importantly to growth and development –a point also made by the ILO's World Commission on the Social Dimension of Globalisation. The study therefore stressed the need for stronger compliance with - and implementation of - ILO core labour standards. The OECD Guidelines for Multinational Enterprises, as noted earlier, promote observance of core labour standards. This issue is also a principal focus of the work of the ILO. And there is agreement that the ILO should remain the main institution to set and monitor core labour standards.

1 The apparent Kenyan "exception" can be explained in part by the early-mover advantages enjoyed by the sector in question (cut flowers). Moreover, unless the broad policy framework is improved in Kenya, the continued success of this industry cannot be assured.

2 Criscuolo, Haskel and Martin cited in Hoekman and Javorcik (2004). In other recent work it is suggested that in Europe new firms typically make a positive contribution to overall productivity growth. By contrast, entries make a negative contribution in the United States for most industries and a stronger than average contribution tends to come from the exit of low productivity firms. See Bartelsman, Haltwanger and Scarpetta (2004).

3 Bolaky and Freund (2004).

4 Numerous donor agencies and regional bodies have already funded workshops to provide information on the SPS and TBT regulations in place in OECD countries, as well as advice on traceability, residue testing, food safety risk/conformity assessments and certification techniques.

5 A case in point is the experience of Singapore in the mid-1980s when the economy suffered two years' recession (1985-86). With contributions from a wide range of stakeholders, including employers, labour, public agencies and private companies, the Economic Committee appointed by the Government prepared a report (Report of the Economic Committee, 1986) which represented a broad consensus view of the best way forward for the Singapore economy. The report recommended a set of specific cost-cutting measures to restore business confidence and international competitiveness. These measures included, among other things, a reduction in employers' contribution to the Central Provident Fund (CPF) and wage restraints that the report considered unpalatable but inevitable.

6 OECD (2003b) provides an overview of existing estimates of welfare gains associated with tariff reduction.

7 Results extracted from an ongoing OECD Secretariat's project [see TD/TC/WP(2004)29/REV1].

8 Paragraph 27 of the Draft Cancun Ministerial (24 August 2003).

9 This section is based on (1) the DAC Guidelines for Strenghtening Trade Capacity for Development (2001); (2) the 2004 WTO/OECD Report on Trade Related Technical Assistance and Capacity Building (December 2004); and (3) the Draft Report on Aid Effectiveness for the Second High-Level Forum, prepared by the DAC Working Party on Aid Effectiveness and Donor Practices (December 2004).

10 Trade policy and regulations: covers support to aid recipients' effective participation in multilateral trade negotiations, analysis and implementation of multilateral trade agreements; mainstreaming of trade issues into development plans/PRSPs; strengthening of the trade policy process; understanding and complying with technical standards –SPS and TBT; simplification of trade facilitation procedures; simplification of tariff structures and customs regimes; support to regional trade arrangements and human resources development in trade.

11 Trade development: cover assistance related to business development and activities aimed at improving the business climate, access to trade finance, and trade promotion and market development in the productive sectors (agriculture, forestry, fishing, industry, mining, tourism, services), including at the institutional and enterprise level.

12 OECD estimate, calculated on the basis of sector-allocable ODA commitments.

13 Konings (2004).