

OUTSOURCING, OFFSHORING

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OUTSOURCING, OFFSHORING

SERVICES OFFSHORING: BANE OR BOON AND WHAT TO DO?

LAEL BRAINARD* AND
ROBERT E. LITAN**

Services offshoring is without a doubt the newest chapter in the American globalization debate. Americans are worried that the economy is permanently shedding jobs and compressing wages, not just in blue-collar manufacturing but also now in the white-collar services sector, once thought to be immune to foreign competition.

Public anxiety centers on low-wage countries such as India, China, and to a lesser extent Russia and Southeast Asia, where American companies are outsourcing services jobs, ranging from routine call center and clerical jobs to higher-value software programming, medical diagnosis, and even research and analytical jobs. The digitization of information and expanded bandwidth abroad are for the first time bringing international wage competition to a sector that economists used to describe as “nontradable.”

Coming on the heels of an economic recovery with record-low job creation, the offshoring debate hits at a time when anxieties about job losses and insecurity about trade are at fever pitch. Concern runs across political and demographic lines, with political leaders at all levels of government calling for measures to slow down or even halt offshoring.

The nation still has much to learn about offshoring, and existing data is not adequate to the task. Economic theory and past economic performance suggest that, on balance, although offshoring provides overall economic gains, it also is redistributive,

with affected workers facing the prospect of job loss and wage pressures. The challenge for policymakers is to make sure Americans have the skills they need to compete successfully in the global economy, America remains the most attractive location in the world for high value services and manufacturing, and the economic playing field does not artificially induce U.S. firms to go abroad, while doing a much better job of addressing the serious challenges faced by permanently displaced workers.

Services offshoring: How much, how fast?

Despite all the headlines, we know surprisingly little about how many jobs have moved offshore in the recent past, let alone how many are likely to do so in the future. One of the first priorities in the offshoring debate should be to improve the data that the government collects.

Goldman Sachs has estimated that offshoring has accounted for roughly half a million layoffs in the past three years. Looking forward, perhaps the best-known projection is by Forrester, an information technology consulting firm, which expects the number of U.S. jobs outsourced to grow from about 400,000 in 2004 today to 3.3 million by 2015. If this estimate turns out to be accurate, then offshoring could result in roughly 250,000 layoffs a year. How should we think about that number? It is small relative to total U.S. employment of 137 million, and accounts for less than 2 percent of the roughly 15 million Americans who involuntarily lose their jobs each year. But to workers who lose their jobs, and to the far larger number of workers who worry that they will lose theirs, the foreign outsourcing total, whatever it is, resonates powerfully. Indeed, a recent study by Ashok Deo Bardhan and Cynthia A. Kroll suggests that up to 14 million Americans now work in occupations that could reasonably be considered “at risk.”

Gathering more accurate official data about the extent of offshoring may be difficult. The data on services collected by the Bureau of Economic



Offshoring could result in 250,000 layoffs a year, less than 2 percent of total unemployment

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Analysis, for example, do not seem to be capturing any noticeable upticks in imports in the services where outsourcing is believed to be prevalent – a finding that raises questions about the accuracy of those numbers. Meanwhile, the Labor Department surveys employers, asking if they have had significant layoffs attributable to moving offshore. But firms are reluctant to offer such information, and without extensive (and expensive) verification of their survey responses, Washington is unlikely to get a good handle on the real numbers any time soon.

The economic theory of offshoring

What does economic theory have to say about the likely economic impact of offshoring? Economic principles point to two quite robust conclusions. Overall, offshoring will offer economic gains. But, with equal certainty, some American workers, companies, and possibly communities will lose out in the process. Let's examine each conclusion in turn.

Offshoring is closely related to technological advance: both are driven by competitive pressures to reduce costs and result in displacement of existing jobs. Both productivity gains and the displacement of existing jobs associated with technological advance have been features of the U.S. economy since its inception. Indeed, manufacturing productivity has been increasing roughly 4 percent a year for several decades now, which helps explain why the share of U.S. workers engaged in producing "things" has declined significantly, although the pace has been very uneven.

International trade works much the same way. Economists who point to the overall benefits of offshoring to the U.S. economy – such as Catherine Mann of the Institute for International Economics and, more recently, economists at the President's Council of Economic Advisers – typically argue that it helps lower costs and prices. A recent McKinsey study estimates that the net cost savings of moving some jobs offshore is about 50 percent – far lower than the sometimes 80 percent to 90 percent wage differential between U.S. and foreign workers (because of costs incurred for coordination and telecommunications), but still sizable. In turn, lower inflation and higher productivity allow the Federal Reserve to run a more accommodative monetary policy, meaning that overall and over time the economy will grow faster, creating the conditions for higher overall employment.

Catherine Mann has estimated that GDP growth would have been lower by 0.3 percent a year between 1995 and 2002 without foreign outsourcing of jobs in information technology.

Foreign outsourcing may also accelerate the formation of innovative products and services – an effect that has thus far been unmeasured but may be important. Some new and young firms, especially those reliant on information technology, are using highly trained foreign technicians (principally in India and China) to build prototypes of new products and services. In this way, U.S. based firms – that ultimately employ highly trained U.S. employees to bring new products and services to market – can develop those products and services at far lower cost, and often more quickly, than if the "proof of concept" stage activities were conducted solely in this country.

But if fewer people are needed in existing jobs and occupations, then won't total employment fall over time? Historically, the number of jobs has closely followed the growth of the labor force, despite major increases in foreign trade and the advent of a host of new job-displacing technologies, such as voicemail, word processors, and optical scanners. Indeed, despite a surge in openness, the U.S. economy since 1985 has added 30 million workers to its payrolls, even taking account of the recent recession and the jobless recovery. At the same time, median family income has jumped 20 percent. Structural changes, including trade and technology, influence where the jobs are, not their total number.

The policy challenge arises from the second sure bet from economic theory and practice. Offshoring, like trade and technology, is a process of creative destruction whereby workers in affected industries face the very real possibility of losing not only their jobs but also their health care. Even worse, some workers fall down the economic ladder when they have no choice but to take new jobs at lower pay and thus face the prospect of lower lifetime earnings.

This concern is particularly acute because it comes at a moment when anxieties about jobs and wages are at fever pitch. Against the backdrop of a breathtaking acceleration in manufacturing job losses over the past few years, the jobs picture remains bleak two years into recovery. Stephen Roach of Morgan Stanley estimates that the current "jobless" recovery is short 2.4 million jobs compared with the previous

Impact: general gain, but individual pain

“jobless” recovery of the early 1990s, and Laura Tyson, Dean of the London Business School, estimates that even those Americans that have jobs are short about \$350 billion in “missing income.” In such an economic climate, it is easy to understand why many Americans lack interest in parsing out how much dislocation is due to offshoring and how much to other causes and instead simply want to put on the brakes.

Just how redistributive is offshoring likely to be? Here, both the theory and the evidence only give partial answers. Let’s take an illustration from the McKinsey study, which estimates that for every dollar of U.S. services activity offshored, there is a global gain of \$1.44, suggesting a net gain of 47 cents. In their analysis, India captures 33 cents of the total, leaving the United States with the remaining \$1.12. How is this \$1.12 distributed? “Reemployed” workers get 45 cents – a substantial reduction – additional exports account for a relatively modest 5 cents, and shareholders of the firms doing the offshoring

Figure 2



gain the other 62 cents. U.S. shareholders, it appears, win while U.S. workers lose.

Indeed, the experience since the end of the 2001 recession is very negative, although current data is not adequate to determine how big a role offshoring has played. Figure 1 shows that the profit share has grown much more strongly in the current recovery than in the recovery of 1992–93, while worker compensation has suffered a more pronounced decline than in any previous recovery in the last four decades, a point also highlighted by Jared Bernstein of the Economic Policy Institute.

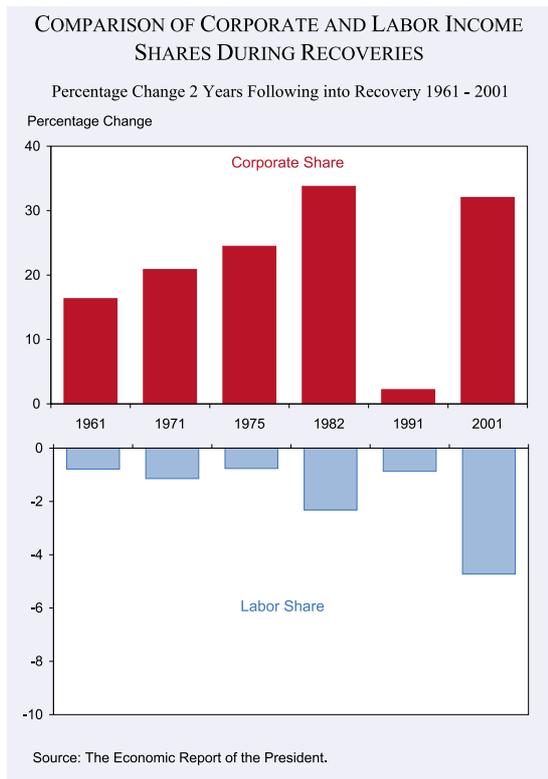
But this new allocation may be only temporary. Over the longer run, competition among firms should drive down profits, and consumers should benefit from lower prices. Historically, as shown in figure 2, there does not appear to be a long-term trend in the share of income going to profits relative to labor compensation.

Even so, these averages conceal what is happening to individual workers. Solid economic research now documents that the wages of low-skilled workers – those in the bottom of our income distribution – were pushed down in the 1980s and early 1990s by a combination of foreign trade, immigration and a drop in demand caused by changes in technology that favor greater skills. This downward pressure increased income inequality during this period, until the mid-1990s, when the rising tide of the overall economy lifted all boats.

Now that college-educated, white-collar American workers will increasingly be in competition with

Low-skilled workers, but increasingly also college-educated workers will lose

Figure 1



highly qualified workers in the developing world whose wages are a fraction of their own, won't they be subject to the same pressures? In a forthcoming book, *Business Week's* chief economist Michael Mandel worries that the answer to this question is "yes," and he may well be right. If so, then the "skills premium" that educated workers earned in the past may be pushed down in the future, thus reversing a decades long trend. At the same time, however, wages within sectors may diverge. In services, for example, some workers whose jobs are vulnerable to offshoring will suffer an erosion of their wages while others in supervisory positions see compensation gains. With all these possible changes, it is no wonder that fears about foreign outsourcing resonate across a broad spectrum of society.

Policy agenda

One thing is clear. Unless policymakers get out ahead of this debate, they will find themselves reacting to a host of band-aid proposals that do more harm than good. They should act proactively by taking five important steps.

First, they should ensure that America remains the most attractive location in the world for high-value services and manufacturing. That means taking a hard look at distortions in the tax code that may artificially encourage offshoring. It also means reducing reliance on an employer-based system of health insurance that adds to costs of U.S. firms, as well as strengthening government support for R&D in some areas.

Second, much must be done to make sure American workers have the knowledge and skills they need to compete in the global economy. That means strengthening the K through 12 curriculum, investing in science and engineering higher education, and restoring funding to community colleges and retraining programs that have suffered large cuts in recent years. Designing policies to strengthen the skills of the American workforce is particularly critical because the American economy is likely to confront a skill shortage of growing dimensions fast on the heels of the offshoring debate. In separate reports, Anthony Carnevale and Donna M. Derochers of ETS and David Ellwood of Harvard University forecast a "skilled worker gap" of 5.3 million workers by 2010 and 14 million by 2020. This is attributable both to the aging of the American workforce and to the

expectation that the increases in average educational attainment achieved over the past two decades will flatten out over the next two decades. Meanwhile, the demand for skills will continue growing at a rapid pace.

Third, policymakers must do more on trade, not less. They must make sure trade agreements are being enforced and must also regain the market-opening momentum lost in recent years. Ultimately it will not be feasible to sustain political support for the relative openness of U.S. services markets while countries such as India maintain high barriers on entry into their own services markets.

Fourth, while refraining from blunt, potentially counterproductive approaches, policymakers must pay attention to legitimate regulatory issues – notably, the need for oversight of consumer privacy, cyber security, and consumer protection when services (especially dealing with sensitive medical and financial information) are produced in jurisdictions with different regulations and professional credentials. Moreover, consumers have a right to know in services no less than in manufacturing, where country of origin labeling is mandated by law.

Finally, and most immediately, leaders must address the dislocation faced by workers in the services sector. Although Congress made far-reaching reforms to the Trade Adjustment Assistance program in 2002 – including adding a health care benefit – it ultimately rejected efforts by Senators Max Baucus, Jeff Bingaman, Tom Daschle, and others to extend its reach to services workers. Software programmers are now suing the Department of Labor to gain access to the same extended unemployment insurance and retraining benefits long guaranteed to trade-impacted manufacturing workers. Congress could make the suit moot by making clear that service workers are covered by Trade Adjustment Assistance.

"Wage insurance" should also be a central part of the safety net for displaced services workers. In 2002, Congress added to the Trade Promotional Authority Act a program providing wage insurance to workers older than 50 who can prove that trade is a "major cause" of their displacement. The goals of the wage insurance program were not only to ease the economic dislocations associated with trade-induced displacement, but also to encourage affected workers to search for and accept new jobs quickly.

Education, open markets, consumer protection and safety net for dislocated workers are urgent policy issues

Payments start when workers take new jobs and stop two years from the date they were laid off.

Workers who qualify receive, temporarily, half the earnings they lose when taking a new job, up to an annual ceiling of \$10,000. Clearly, therefore, one ready way to address worker displacement by offshoring would be to make such workers eligible for wage insurance, albeit with some qualifications: lowering or eliminating the age requirement and possibly raising the compensation limit to reflect the likely higher income of many dislocated services workers.

Of course, limiting the kinds of benefits available under Trade Adjustment Assistance to workers displaced by trade and offshoring more generally raises fundamental questions of fairness – in addition to the difficulties of identifying the cause of displacement. Why should those protections not also be available to workers who are permanently displaced for other reasons, notably improvements in technology and shifts in consumer demand? Because there is no satisfactory answer to this question – other than one of cost to the federal government – one author of this brief (Litan) proposed three years ago, with Professor Lori Kletzer of the University of California at Santa Cruz, to offer wage insurance to all permanently displaced workers regardless of age. The proposed insurance would be identical to that in the TPA program except that it would also provide a federal subsidy for up to six months of health insurance coverage. Had both programs been in place in 1997 for example, when the national unemployment rate was 4.9 percent, the annual total cost would have been \$3.6 billion. With today's 5.6 percent unemployment rate, and the likelihood that average wage losses suffered by displaced workers have increased since 1997, a reasonable estimate is that the two programs would now cost roughly \$4.5–5 billion.

When the wage insurance proposal was first made, amidst worries over what to do with a looming multi-trillion dollar budget surplus, \$4–5 billion annually seemed like a lot of money. Now, paradoxically, with a federal deficit exceeding \$500 billion for this year alone, \$4–5 billion a year seems eminently reasonable. After all, if the nation can afford \$87 billion in one year to rebuild Iraq and roughly \$400 billion over the next decade to cut taxes for Americans in the top income bracket, a program with a ten-year price tag in the neighborhood of \$50 billion to address losses from permanent job displacement,

whatever its source, seems not only affordable, but the only fair thing to do. And it could be paid for with a barely noticeable rate increase in the upper income tax bracket, which also seems fair. After all, people in this group, directly or indirectly, own most of the corporate stock in the country and thus will benefit from any short-run gains in profits from offshoring.

The nation still has much to learn about offshoring, and existing data is not adequate to the task. Economic theory and past economic performance suggest that, on balance, although outsourcing provides net benefits to the economy, it also is disruptive and worsens the anxiety that workers already feel during the current jobless recovery. The challenge for policymakers is to make sure Americans have the skills they need to compete successfully in the global economy, America remains the most attractive location in the world for high value services and manufacturing, and that the economic playing field does not artificially induce U.S. firms to go abroad, while doing a much better job of addressing the serious challenges faced by permanently displaced workers.

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One proposal: wage insurance offered to all permanently displaced workers



ADJUSTMENT OF EUROPE'S INDUSTRIES IN A COMPETITIVE WORLD

ERKKI LIIKANEN*

Europe's industry is confronted with challenges that reflect partly technological shocks and partly the advancing process of globalization. In recent months, concerns have been expressed about possible loss of manufacturing jobs to overseas locations while the threat of competition from China is raising intense anxieties not just in Europe; the debate is equally vigorous in the U.S. where thousands of jobs are rumoured to be in the process or to have already migrated abroad.

Uncertainty inevitably increases during periods of structural change. The period since the mid-1990s can, of course, be characterized as one such period of vigorous structural change caused primarily by technological shocks.

At least three factors have contributed to this. First, the technological revolution associated with the deployment of ICT technologies and the concomitant enterprise re-organization; secondly, the on-going process of trade and capital account liberalization has reduced barriers in international trade and investment and has expanded possibilities for locating production in areas different from the market where a product is sold as well as opportunities to act pre-emptively and position oneself in growing markets to exploit first-comer advantages; and, third, international and domestic competition has intensified, leading to various adjustments and economic strategies on the part of enterprises to cope with a changing business environment. The outcome of these has been rapid productivity growth, the pace of innovation has accelerated and new business opportunities have emerged. This process has also been accompanied

by employment losses. Historically, such employment losses in declining sectors have been offset by employment growth in other segments of the economy so that overall employment has grown over time even though during this transitional phase jobs have come under threat or have been lost. No wonder that employees and entrepreneurs find today's business environment hostile and insecure.

The competitiveness challenge the EU is currently facing is twofold; first, there is one emanating from advanced nations, a challenge determined by relative innovation and productivity performance; and, secondly, one emanating from developing nations and from the new Member States based on relatively low cost and standardized technology that makes possible product imitation. It is certain that the EU will benefit most by meeting the first challenge; meeting the second may not even be feasible in a liberalized international trade and investment environment.

The present article, which might be taken as a response to the concerns about the future of Europe's industries, addresses some of these issues. Section II discusses developments in productivity growth in Europe's industries in recent years; section III reviews the changing pattern of specialization of the European manufacturing industry using some key international trade data; section IV discusses the issues of deindustrialization and delocalization and the likely threat they pose for Europe's industries; finally, section V concludes.

Productivity growth and competitiveness of European enterprises in recent years

Productivity growth is a key ingredient of competitiveness. Enterprises are competitive when they experience high and sustained total factor and labour productivity growth that make possible reductions in costs per unit of output compared to other enterprises domestically or internationally. Such productivity growth provides the resources to

The EU is facing two challenges: Competition from advanced nations (productivity) and from accession countries (cost).

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finance the firms' expansion plans, it enlarges the market for their products by changing relative prices and it raises the real wages of employees and ultimately real incomes. As the productivity-enhancing practices of successful enterprises are diffused throughout the economy, overall productivity and real incomes increase. Improving productivity growth is tantamount to strengthening competitiveness.

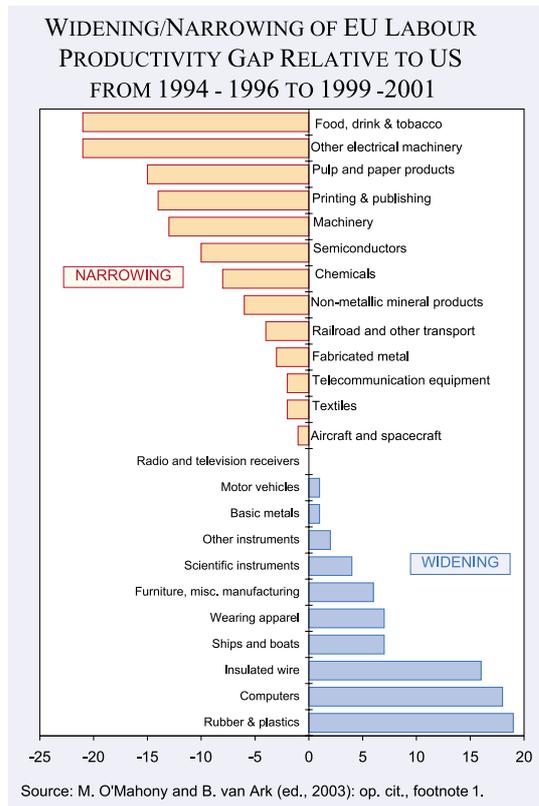
Europe's weak productivity performance since 1995, symptomatic undoubtedly of deteriorating competitiveness, is in sharp contrast with the galloping productivity growth recorded in the U.S.

Hourly productivity growth in EU manufacturing eased from an average of 3.4 percent in the period 1979–1990 to 2.3 percent in 1995–2001 but in the U.S., over the same periods, it rose from 3.4 percent to 3.8 percent. However, it is in the service sectors (especially distributive trades and financial services) where a remarkable acceleration in US productivity growth has taken place that has not been matched in the EU, although EU productivity growth in the communications sector has outstripped that of the U.S. by a considerable margin.¹

The widening productivity differential in both the manufacturing and in the services sectors is a worrying development. Manufacturing accounts for around 20 percent of value added in the EU and poor productivity growth in this sector will inevitably affect aggregate measures of productivity but even more so for the service sectors which represent around 70 percent of value added in the EU.

Clearly, understanding productivity developments in the largest sector of the economy should be the key to explaining differential productivity growth across the Member States in the EU and against the U.S. Future research should, therefore, investigate the determinants of productivity growth across services within the EU and against the U.S. Work by the McKinsey Global Institute has already documented that a dominant part of the aggregate productivity differentials across nations reflects productivity differentials in the service sectors.²

Figure 1



The U.S. productivity growth advantage over the EU concerns around 50 percent of industries – mainly market services and high-tech manufacturing – and only a limited number of industries account for the rapid US productivity growth – electronic valves and tubes, wholesale and retail trade and office machinery. In the EU, productivity growth the communications sector, in ICT intensive business services and in computer-related activities as well as in banking and in electronic valves and tubes in the latter part of the 1990s has outstripped that of the U.S.³

For the manufacturing sector, Figure 1 shows that it is some high-tech sectors (scientific instruments, insulated wire, computers) that have contributed considerably to increasing the EU productivity differential relative to the U.S. while lower-tech sectors (such as food, drink and tobacco and pulp and paper) have contributed to narrowing the differential over the period 1999–2001 compared to the period 1994–1996.

Overall, the data suggest that the EU has a productivity advantage in scale-intensive industries

The EU has a productivity advantage in scale-intensive industries and science-based manufacturing

¹ See M. O'Mahony and B. van Ark (ed., 2003).

² See W. Lewis (2004). Lewis brings together material from individual country studies that the McKinsey Global Institute has conducted over a number of years.

³ See O'Mahony and B. van Ark, op. cit., for details.

and in science-based manufacturing but it has a disadvantage in key service sectors such as supplier-dominated services and client-led services. The latter are important findings not least because they lend support to Lewis' proposition that it is consumer demand that drives productivity through improving service to customers, better prices and better products rather than industry-led initiatives.⁴

Information and communication technologies (ICT) have been credited for the remarkable productivity acceleration experienced by the U.S. since 1995. There is also concern that the productivity slowdown in the EU reflects failure to undertake technological modernization and to invest in the organizational capital that should accompany the introduction and diffusion of ICT.

Here, it is important to distinguish between ICT producing sectors and sectors intensively using ICT as well as non-ICT users. It is the potential these technologies have to improve productivity performance due to its penetration and diffusion in non-producing sectors that clearly matters most.

Table 1 shows that in both the U.S. and the EU the ICT producing group experienced very high rates of productivity growth, especially manufacturing. ICT producing services (communications, computer software) is the only group that shows a pattern of accelerating growth in the EU and decelerating in the U.S., but this group has a small value added and employment share.

In ICT using sectors, productivity growth in the EU has been relatively stable across time in contrast to a

very large acceleration in the U.S., mostly in services sectors where a growth rate of 5.3 percent was recorded in the period 1995–2001. This, together with the larger share in the U.S., is a clear indication that the U.S. is ahead in the productive application of ICT outside the ICT producing sector itself. This evidence again indicates that the service sectors are crucial in the determination of aggregate, economy-wide, productivity growth.

Finally, note that in non-ICT industries the EU has a productivity advantage compared to the U.S. but this has been eroding during the latter part of the 1990s. This group, whose share in value added is quite substantial (64 percent in the EU), is performing below the productivity growth of the total economy, suggesting that this group of industries will not likely be the engine of growth and wealth creation in the EU's future.

Europe's specialization in international trade

Europe's weak productivity growth in the period since the mid-1990s will have undoubtedly affected the performance of European industries and enterprises in international trade. Such performance is closely linked to the problem of deindustrialization discussed in the next section. This section follows up on the discussion of the contribution of different sectors to narrowing or widening of the EU productivity differential against the U.S. noted previously. It discusses developments in the trade performance of EU manufacturing but not of services since, despite their growing importance, the necessary data are not available.

The discussion is based on two measures of Revealed Comparative Advantage (RCA) called

The U.S. is ahead in the productive application of ICT outside the ICT producing sector

⁴ See W. Lewis, op. cit.

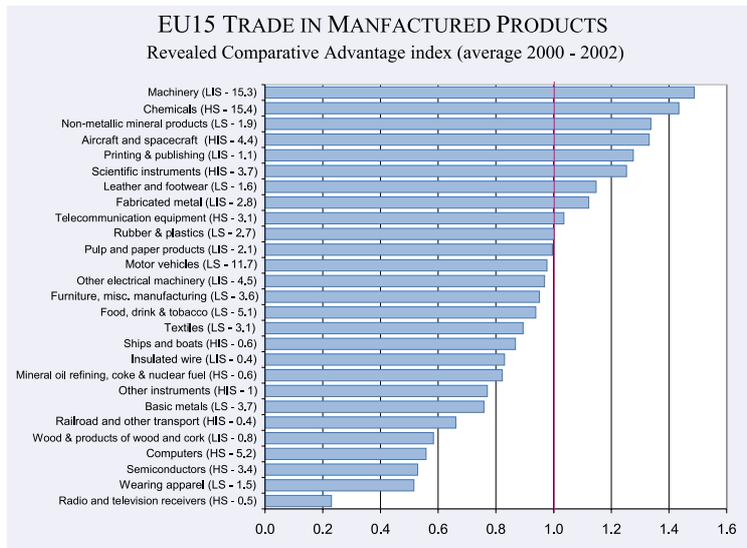
Table 1

Labour productivity growth and value added

	1990–1995		1995–2001		Value added (1999)	
	EU	US	EU	US	EU	US
Total economy	2.3	1.1	1.7	2.2	100	100
ICT producing industries	5.9	8.1	7.5	10.0	6.2	7.7
ICT producing manufacturing	8.4	16.1	11.9	23.7	1.3	2.7
ICT producing services	4.8	2.4	5.9	1.8	4.9	5.0
ICT using industries	2.0	1.2	1.9	4.7	30.2	34.6
ICT using manufacturing	2.4	-0.6	1.8	0.4	6.9	5.1
ICT using services	1.8	1.6	1.8	5.3	23.3	29.5
Non-ICT industries	2.1	0.3	1.0	-0.2	63.6	57.7
Non-ICT manufacturing	3.6	2.7	1.6	0.3	13.6	10.6
Non-ICT services	1.2	-0.5	0.5	-0.3	38.3	36.5
Non-ICT other	3.2	1.2	2.1	0.7	11.7	10.6

Source: Calculations based on M. O'Mahony and B. van Ark (ed., 2003): op. cit., footnote 1.

Figure 2



RCA1 and RCA2.⁵ The former shows estimates of averages for the period 2000–2002, the latter the change between 1989 and 2002. These measures assume that good international trade performance in a particular industry reveals comparative advantage⁶; they are based on 27 groups of EU manufactured products. RCA1 is based on EU-15 trade with 90 countries, which account for about 97 percent of total world trade in manufactures and RCA2 is based on EU-15 trade in manufactures with the rest of the non-EU-15 world.⁷

Figure 2 ranks industries according to the value of RCA1 but it also provides information on the skill intensity of the industry⁸ and the share of the industry in EU exports, respectively, in parentheses on the vertical axis.

The data show that in one third of the 27 industries the EU has a revealed comparative advantage. But these industries represent 49.3 percent of EU exports. The data suggest a strong comparative advantage in mechanical engineering products followed by chemicals, which together represent 31 percent of EU exports of manufactures. In diminishing rank follow

⁵ The indexes are defined as follows:

$$RCA1 = \frac{X_{EU,j}}{\sum X_{EU}} \quad \text{and} \quad RCA2_j = \frac{(X_j - M_j)}{(X_j + M_j)}$$

$$\frac{X_j}{\sum X_W}$$

where X is the value of exports, M is the value of imports, W is world, EU is the European Union and j is the good index.

aircraft and spacecraft (export share 4.4 percent), printing (1.1 percent), scientific instruments (3.7 percent), leather products (1.6 percent) metal products (2.8 percent) and telecommunications equipment (3.1 percent). This group of industries employs 43.9 percent of employees in manufacturing.

Five industries rank in a neutral region of no evident comparative advantage or disadvantage. These, which in total represent 24.6 percent of EU exports, range from paper products (share of 2.1 percent) to motor vehicles (11.7 percent). This

group employs 23.9 percent of employees in manufacturing. Thus, 67.8 percent of EU manufacturing employment is in industries whose performance in international trade is good.

The EU shows a weaker performance in the remaining 13 industries which represent globally 26.3 percent of EU exports of manufactures. These industries employ around 32 percent of employees in manufacturing. Among these only six industries, representing 8.7 percent of manufacturing output (in 2001), have characteristics that might be associated with deindustrialization.⁹

Ranking export performance according to skill intensity shows that there is considerable diversity across EU-15 industries. Among the 27 industries, eleven are classified by O' Mahony and van Ark (2003) as either high-skill-(six) or high-intermediate-skill intensive.¹⁰ There is some evidence that the trade performance in manufactured goods of the EU-15 is concentrated in this category. Indeed, four of the nine industries where the EU has a revealed comparative advantage are high- or high-intermedi-

⁶ It should be stressed, however, that actual trade performance reflects also the effect of trade policy measures (quotas, tariffs).

⁷ Data for RCA1 are from the UN database COMTRADE and for RCA2 Eurostat's COMEXT.

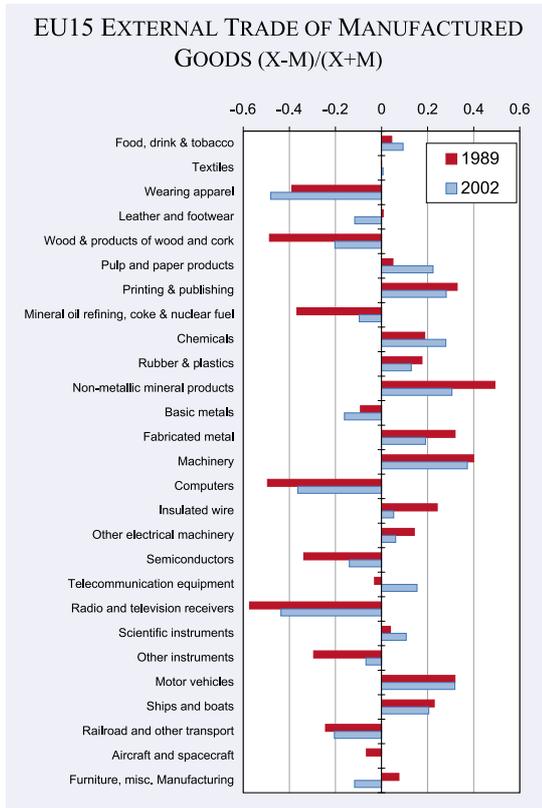
⁸ The skill taxonomy is obtained from M. O'Mahony and B. van Ark, op. cit. Note that the skill taxonomy applies to final goods and it is likely that high-skill intermediate goods are used in the production of low-skill final goods. This information from input-output tables has not been used here.

⁹ These are textiles and clothing, leather and footwear, mining and quarrying, mineral oil refining, coke and nuclear fuels; these have seen declines in employment and value added (in constant prices) in the period since 1979. The data are from M. O'Mahony and B. van Ark (ed., 2003): op. cit., footnote 1.

¹⁰ See M. O'Mahony and B. van Ark, op. cit.

In one third of the 27 industries, the EU has a revealed comparative advantage

Figure 3



ate-skill industries. These are chemicals, aircraft and spacecraft, telecommunications equipment and scientific instruments. The remaining are either low- or low-intermediate-skill industries.

Strong productivity growth and improved trade performance are positively correlated

Among the remaining thirteen industries of weak comparative advantage there are seven that are high- or high-intermediate-skill industries (oil refining, other instruments, railroad equipment, office machinery, electronic equipment and radio receivers). Finally, the intermediate group of no advantage or disadvantage consists of low- or low-intermediate-skill industries.

Figure 3 shows the change in the index of revealed comparative advantage between 1989 and 2002, thus putting the evidence of Figure 2 into perspective. An interesting finding is that the sectors recording a deteriorating comparative advantage employ low and low-intermediate-skilled labour. These 11 industries employ less than 9 percent of manufacturing employment in 2001. As argued in the next section, these may be vulnerable to international competition.

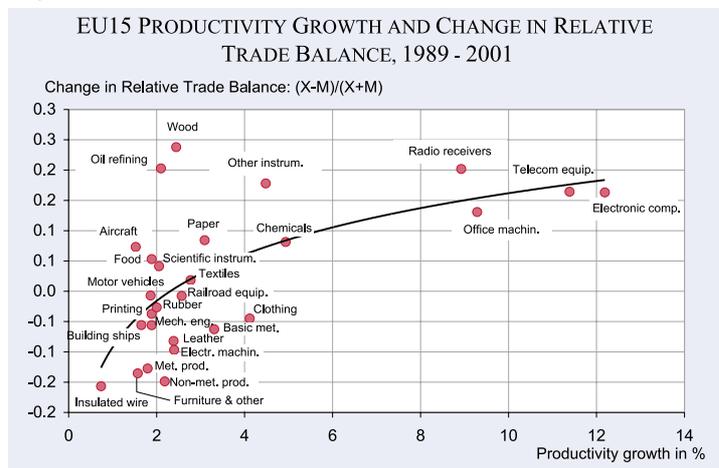
The poor performance of clothing products has worsened. Europe has a poor competitive advantage in this group of products even if in segments European designers dominate. There have been, however, improvements in the performance of the other products, particularly wood but also office machines and radio receivers, and there has been a modest improvement in railroad equipment. Also electronic components and other instruments have improved dramatically their performance between 1989 and 2002.

Is there evidence supporting the notion that those industries that have recorded strong productivity growth have also improved their performance in international trade?

Figure 4 plots on the horizontal axis the annual average of (hourly) productivity growth and on the vertical axis the average change in the index of revealed comparative advantage (RCA2)/relative trade balance for 27 industries over the three years 2000, 2001 and 2002 against the average of the three years 1989, 1990 and 1991. It is clear that, with the exception of some outliers (wood products, oil refining and other instruments), the data generally cluster along a positive path suggesting that productivity growth and improvements in the international trade performance of these EU industrial sectors are positively correlated; the correlation coefficient is 0.58 and highly significant (p-value = 0.0015). Further evidence supporting the link between productivity growth and international competitiveness comes from the fact that 8 out of the 10 industries with poor productivity performance vis-à-vis the U.S. shown in Figure 1 are also recording weak international competitiveness (see Figure 3).¹¹

¹¹ The evidence though is not unequivocal since it might be industries with productivity improvements, but performing relatively bad compared to the U.S.

Figure 4



Deindustrialization and offshoring

What do these developments in Europe's competitiveness and trade tell us about the threat of deindustrialization and offshoring? Clearly, products and industries that are experiencing declining market shares and declining employment and productivity growth are more vulnerable to shocks that give rise to these phenomena.

Deindustrialization episodes are not new. Both the UK and the U.S. suffered an intense deindustrialization¹² process in the early 1980s. The decline in the relative – and absolute – manufacturing employment in Europe over time is indicative that deindustrialization has been under way throughout the post-war II period.¹³ What has in fact been under way is a process of structural transformation of the economy with a growing share of services in national income.

All modern industrial economies have seen the share of manufacturing decline over time. A *stylized fact* of economic history is that employment in manufacturing follows an inverted U-curve: as income per capita rises manufacturing employment rises and after a peak it begins to decline. In the EU, the share of manufacturing in value added has declined from 30 percent in 1979 to around 20 percent in 2002; the share of manufacturing employment has also declined from 28 percent in 1979 to 18 percent in 2001. The rising share of services in national income is a historical inevitability.¹⁴

The current debate reflects two concerns. First, the experience of the UK and US during the 1980s shows that, while job losses occurred in the steel and other labour-intensive and “rust belt” sectors, both coun-

tries ultimately saw rising employment in more skilled and high-tech activities. The current economic slowdown in the EU does not guarantee that new jobs will be created to replace those lost. Secondly, deindustrialization is often accompanied by offshoring of some jobs as activities are transferred abroad; however, this time part of the offshoring process includes high-tech and research-intensive jobs as opposed to the blue-collar job migration that has been traditionally easier to accept. That could well have serious implications for Europe's future competitiveness.

There are two issues that may be raised here.

• Competitiveness and the potential scale of deindustrialization

First, taking into consideration the structure of the EU's international trade what is the potential scale of the deindustrialization problem? To answer this, it is necessary to recall that the dominant part of the international trade of advanced industrial economies in manufactured goods takes place between industries, a reflection of product differentiation and of scale economies.¹⁵ Data suggest that as much as

Structural change:
Employment in
manufacturing
follows an inverted
U-curve

¹³ Several factors contribute to and/or can trigger a deindustrialization process: liberalization of international trade and competition from low-wage countries which will affect low-skilled jobs and labour-intensive industries- the potential shock of China's entry in world trade can have significant implications; the same can be said for outsourcing towards the new Member States in the EU; changes in expenditure patterns where a combination of high productivity growth and gently or steeply rising Engel curves explain much of the falling (rising) share of manufacturing (services) in national income; and differences in productivity (higher in manufacturing than in services) that are reflected in relative price changes. A sustained appreciation of the real exchange rate could also contribute to the deindustrialization process. Offshoring can be caused by improvement in international communications, the computerization of business services as well as the availability of an educated labour force that is prepared to perform the same work for less pay. This has been typically the case with English-speaking countries such as India. Clearly, when feasible, offshoring presents attractive opportunities for enterprises and confers benefits to consumers; see B. Bernanke (2004), for a discussion.

¹⁴ See R. McGurkin (2004), for a discussion of the broader trends internationally and the issue of recent US job losses.

¹⁵ See, for example, the discussion in OECD (2002): “Intra-Industry and Intra-Firm Trade and the Internationalization of Production”, *OECD Economic Outlook* no. 71, June available in <http://www.oecd.org/dataoecd/6/18/2752923.pdf>.

¹² For the concept of deindustrialization see “Some Key Issues in Europe's Competitiveness – Towards an Integrated Approach”, Communication from the Commission to the Council and the European Parliament, COM (2003) 704 final, 21.11.2003.

Table 2

World trade matrix in manufacturing products
Origin and destination by income level of countries – 2001

	EU15	High non-EU15	Upper medium	Low medium	Low	Total
EU15	28.7	9.5	3.1	3.6	0.6	45.6
High non-EU15	7.1	16.4	4.1	3.8	0.7	32.1
Upper medium	2.4	4.8	0.6	0.9	0.1	8.9
Low medium	2.8	5.9	1.0	1.4	0.5	11.6
Low	0.5	1.0	0.1	0.2	0.1	1.9
Total	41.5	37.7	8.9	9.9	2.0	100

Source: Calculations based on data from the UN databank COMTRADE.

62 percent of world trade in manufactures takes place between EU-15 and high-income countries; if upper-medium income countries are included, this percentage increases to 76.7 percent¹⁶, as can be seen in Table 2. Therefore, competitive threats, among which deindustrialization, clearly emanate from competition with countries producing similar products as the EU and to a far lesser extent from low-income countries.

In fact, even if there are specific product categories in which the EU (and the rest of the industrial world) compete with labour abundant countries, the dominant part of our trade performance is determined less by relative factor abundance than by productivity and innovation, as Figure 5, which shows the size of EU trade by the level of income of its partners, confirms.¹⁷ As was shown previously, industries intensive in low and low-intermediate skills that are recording deteriorating comparative advantage employ less than 9 percent of total manufacturing employees. Thus, the competitiveness

challenge comes primarily from advanced industrial nations like the EU.

There is, however, some evidence that China is already competing in some *prima facie* surprising products categories with the EU. According to the European Competitiveness Report, exports from China to the EU in 2002 originating in high-skill industries amounted to more than 20 percent of total exports from China, surpassing those from the new Member States; exports originating in medium-skill/white-collar industries were almost 30 percent again surpassing those from the new Member States; exports from medium-skill/blue-collar industries have remained stable at around 20 percent while exports from low-skill industries have declined, amounting to around 30 percent.¹⁸ These developments reflect a growing competitive challenge in human-capital intensive industries such as the delivery of ICT products.

Thus, the challenge posed by trade conducted with low-wage nations cannot be disregarded. This risk is particularly evident in those regions and those industries in the EU which compete directly with those exporters. To facilitate adjustment, it is essential to have a strategy to respond to this challenge within the enlarged Europe. Elements of such a strategy were presented in a recent Commission Communication.¹⁹

• Do we benefit from structural change?

Second, since deindustrialization and, to some extent, offshoring are predominantly a reflection of structural change that all economies will undergo as their incomes rise and as globalization expands, what are some of their implications?²⁰

Clearly, there can be significant employment losses in the short

Competitive challenge comes primarily from advanced countries producing similar goods

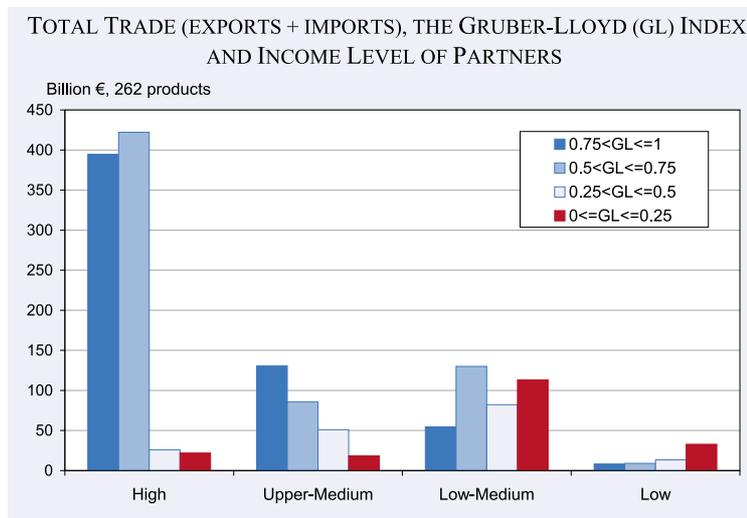
¹⁶ The data for the world trade matrix are obtained from the United Nations COMTRADE data bank.

¹⁷ The index in Figure 5 is the Grubel-Lloyd (GL) index defined as

$$GL_i = 1 - \frac{|X_i - M_i|}{X_i + M_i}.$$

The values of the index range from 0 (no intra-industry trade) to 1 (all trade is intra-industry). The index is sensitive to the level of aggregation of the products: it increases with the level of aggregation, without necessarily implying trade in *similar* products. The index is useful for comparisons across products and over time but it can over-state the size of IIT trade and fail to reveal different levels of intra-industry trade within a given group of products. For the calculation of the GL index and the distribution of trade, a total of 262 products (4 digit of the Classification of Products by Activity nomenclature) have been used.

Figure 5



¹⁸ See European Commission (2004): *European Competitiveness Report*, forthcoming.

¹⁹ See "Fostering Structural Change: An Industrial Policy for an Enlarged Europe", Communication from the Commission to the Council and the European Parliament, COM (2004) 274 final, 20.04.2004.

²⁰ William Poole notes succinctly that "(M)uch of what is happening today is an unavoidable consequence of new technology. Rather than complaining about the consequences of new technology, or trying to roll back its effects, we need to adapt and use technology in innovative and constructive ways"; see W. Poole (2004).

term associated with structural adjustment. These will be especially severe in local labour markets and those characterized by low labour mobility. However, over the medium term the economy will be more efficient and will be using its resources more rationally. Employment will also increase albeit in different sectors than those experiencing decline.²¹ But even during the transitional period domestically produced goods and services will absorb some part of employment lost. Besides, a high proportion of jobs are in sectors that cannot easily be moved abroad.

Offshoring can be a source of benefits since the process also creates value for the home country through several channels: through cost saving for the companies that move abroad; through imports of goods and services from the home country by the providers abroad; through repatriated earnings; and indirectly through redeployed labour (with high average wages). According to the McKinsey Global Institute, for every US\$ offshored to India a net gain of 12 to 14 cents is generated.²²

Catherine Mann estimates that outsourcing of IT hardware has reduced prices in the U.S. by 10–30 percent or more, it has promoted the diffusion of IT investment and use, it has added at least \$ 230 billion to GDP and has contributed to the acceleration of productivity growth.²³ Finally, Mann notes that those service sectors investing more in information technologies (IT) and employing more IT workers post a trade surplus despite slow growth and closed markets abroad.

Concluding remarks

Is Europe experiencing deindustrialization? There has been no generalized decline in output and in employment, simultaneously, in European manufacturing. High productivity growth has contributed to raising industrial output without concomitant changes in employment. However, the data suggest that there are some sectors that are vulnerable. If

deindustrialization occurs in these sectors this would be a “local” problem. In part this problem arises from competition from low-wage countries, especially in technologically standardized products with little scope for additional productivity gains. But despite the “localized” job losses, deindustrialization due to international competition brings higher profits for firms that might choose to offshore activities, leading to lower prices for consumers and long-run benefits for the economy.

This is not to say we should not worry. Adjustment policies aimed at easing the transition to the evolving structural change in our economies are necessary. It is essential that the EU has a domestic strategy that facilitates adjustment within the large internal market.²⁴ A special problem arises when delocalization and offshoring threaten technologically advanced manufacturing industries and services. This might signal trouble for Europe ahead unless we strengthen our competitiveness and innovation in high-value products to create new jobs.

The dominant part of trade of advanced industrial economies is intra-industry; this means that it will be easier to adapt to structural change through resource shifts within industries and within firms in the same industry rather than across sectors. Europe’s competitiveness challenge emanates primarily from advanced industrial countries producing similar goods. These producers compete on the basis of innovation and productivity performance using as a springboard their factor endowments rather than using static factor abundance to determine the nature of their international trade. A better understanding of productivity growth in the service sectors is essential.

Productivity growth is a critical determinant of international trade performance. Data from industries with strong competitive performance correlate well with strong productivity growth. The slowdown in productivity growth in the EU in the more dynamic industrial sectors especially when compared to the U.S. is a serious challenge that raises doubts about the prospects for improving Europe’s competitiveness. Innovation is the principal source of high value added products and R&D and innovation are closely related. Europe must improve its innovation performance and raise its R&D efforts significantly.

Deindustrialization and offshoring are a reflection of structural change and bring long-term benefits for the economy

²¹ There is already evidence from European data that this is under way. Egger and Egger (2003) report that the fall of the Iron Curtain led Austrian manufacturing to resort to outsourcing motivated by low wages. The removal of trade barriers strengthened this outsourcing process. The authors estimate that a 1 percent increase in outsourcing to Eastern countries relative to gross production shifts relative employment by 0.1 percent in favor of high-skill jobs. Outsourcing, they note, accounts for around a quarter of the change in relative employment in favor of high-skilled jobs over the 1990s, a phenomenon likely to gain in importance with enlargement; see H. Egger and P. Egger (2003).

²² See V. Agrawal and D. Farrell (2003).

²³ See C. Mann (2004) and C. Mann (2003).

²⁴ Some of these issues were addressed in COM (2004).

Despite its decreasing prominence, the manufacturing sector remains a significant channel for innovation and application of new technologies. New capital vintages embody the latest technologies whose successful economic application ultimately raises contributes to improving productivity performance and competitiveness. Public policy ought to remove barriers to technology diffusion, in particular ICT, and to encourage the growth of innovative enterprises. Moreover, policies for market access abroad are an essential ingredient of an international strategy supporting the manufacturing (but, clearly, not only) sector. A vigorous manufacturing sector depends on and supports a strong service economy.

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OUTSOURCING AND OFFSHORING

BRUCE CRONIN, LESLEY CATCHPOWLE AND DAVID HALL*

The recent overseas outsourcing of a number of business services, such as call centres and accounts processing, has raised concerns about the future of an area of business activity in which the UK has been deemed to hold a competitive advantage. While the future direction of UK manufacturing may have been questionable, the abundance of skilled service workers has long been thought to provide the basis for a strong alternative range of businesses. But ICT developments have reduced the dependence of many tasks from any particular location and made possible the relocation of many service jobs from industrialized to developing countries that provide a suitable infrastructure, high skills labour market and labour cost benefits.

The great majority of work which is being offshored is in information technology (IT) and business process or call centre work (BPO). The providers of IT/BPO services include UK specialists, multinationals, and an emerging group of Indian companies. Interestingly, the Indian IT/BPO have not remained as local offshore providers but are becoming competitive multinationals in their own right, winning contracts directly in the UK and opening offices in the UK to supplement their Indian operations (Global News Wire 2002). Offshore capacity is also being developed in countries other than India, notably China, South Africa, Eastern Europe, Malaysia and the Philippines. IT/BPO service companies may rely on partnership arrangements, especially for BPO capacity in India (Air Transport Intelligence, 22 October 2003).

Nonetheless, the issues are not simply about saving costs. The emergence of the global knowledge company is said to have the potential to re-shape the relationship between the employer and employee in

the service sector in much the same way as manufacturing was altered in the mid-1980s (Sedley and White 2003). For developing countries, the benefits of accumulating competencies in relatively high-skilled work have been widely hailed, although a gender gap between male-dominated high-skill software jobs and female-dominated low-skill call centre work is evident and amidst rising wages for skilled work, India is being replaced by other third world countries as low cost destination (ILO 2001).

The promise

A useful starting point in discussing the potential of outsourcing and offshoring of business services is to consider why firms undertake activities locally and in-house at all. Nike epitomises such a standpoint, outsourcing its entire output to 900 contract manufacturers worldwide.¹ But even Nike still directly employs 23,000 staff and the case for directly administering core business activities is strong, centring on strategic and collaborative advantages.

The major motivation for in-house activities is to protect core product and process innovations. Locating core activities deep in-house can avoid encroachment from competitors, with proximity allowing for collaboration, closer monitoring and easy access to specialised resources and infrastructure (Marshall 1890, Richardson 1978, Krugman 1991, Saloner et al. 2002).

Against the benefits of in-housing, outsourcing offers the potential for reduced labour costs, efficiency through specialisation, and reduced agency costs:

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¹ Nike draws revenues of \$10.697 billion, directly employing 23,000 staff compared to an outsourced workforce of 660,000. Nike Inc., *Annual Report For the fiscal year ended May 31, 2003*.



- Because services are labour-intensive and staffing usually accounts for 65 percent of the cost of running IT departments and data centres (Simons 2003), the relocation of business processes to low labour cost centres is attractive. However, the interaction skills of providers are crucial to the quality of service provision.²
- Specialisation obtained through offshoring can increase efficiency beyond domestic outsourcing through economies of scale and learning gained from large volumes in international markets.³ However, the distinctiveness of each provision of a service reduces the scope for economies of scale and learning compared to those available in the more standardisable production of goods.
- Agency costs arise because it can be difficult to precisely identify the costs of activities carried out within the firm and to eliminate inefficiencies. Outsourcing can be attractive because the cost is clearly identified by the external contract (Besanko, Dranove, Shanley, and Schaefer 2004). However, it is difficult to measure the value of services in advance of provision and thus contract effectively for these.

Outsourcing offers the potential for reduced labour costs, efficiency through specialisation, and reduced agency costs

Each of these benefits is potentially enhanced by offshoring rather than domestic outsourcing. There are greater opportunities for lower-cost labour offshore, typically 20 percent of UK levels (Shennan and Bain 2003). The greater volumes in international markets increase the economies of scale of offshore providers. And the greater number of international competitors is likely to provide a greater variety of services available to be outsourced. Offshoring firms have cited total cost savings of as much as 65 percent (M2PressWire 2003).

Nevertheless, evidence shows that gains in enterprise performance only occur when new technology is combined with changes in work organisation – semi-autonomous, task-orientated teams with controls over quality and performance, plus greater flexibility

Table 1

Typology of offshoring and outsourcing

	<i>UK</i>	<i>Abroad</i>	<i>Mixed</i>
<i>Internal</i>	Insourcing	Inhouse ('Captive') offshoring	Locally Integrated Offshoring
<i>External</i>	Outsourcing	Outsourced offshoring	

in work patterns (World Employment Report, 2001). There are limitations here. Problems are encountered with flexibility and speed of delivery, due to practical implications of language, time difference, cultural subtleties, and the level of face to face interaction so often required to solve complex problems (Electronics Weekly, 17 September 2003).

Differing benefits

We found it useful to differentiate the potential benefits of outsourcing and offshoring in terms of the location and degree of control involved. Despite the often interchangeable usage of these terms, outsourcing and offshoring are two different dimensions. Firms may decide to offshore work that remains within the core company – this is sometimes known as “captive” offshoring. In other cases work is outsourced to a contractor and the contractor may carry out the work within the UK or offshore.

Some large companies have transferred business services from in-house UK operations to in-house operations offshore in India or elsewhere. GE Capital, part of the US multinational General Electric, set up its own in-house Business Process Outsourcing (BPO) division in India in 1993, which employs 12,000. In 1996, BA transferred 600 jobs from the UK to a newly created Indian subsidiary in India, World Network Services (WNS). HSBC is in the process of transferring 4,000 jobs from UK call centres to its Global Service Centres in India, China and Malaysia. In-house offshoring is likely to be more attractive where the issues of control and confidentiality matter and also where companies have existing operations in the chosen region, as is the case with HSBC.⁴ Most companies, however, use outsourced agents who then carry out all or part of the work offshore.

² Weak human resource management capabilities among out-sourcers has had a detrimental impact on service provision in NHS contracts. See Grinshaw, Vincent, and Wilmott (2002) pp. 475–502.

³ According to Adam Smith, the limit of specialisation is market demand. Firms will only develop specialist expertise and capacity when market demand for the specialist is sufficient to cover the cost of the investment. Thus, specialisation tends to deepen over time with market growth and as the cost of specialisation lowers, as with developments in information technology.

⁴ Even for companies setting up inhouse options, there are intermediate support agencies, such as venture capital firm Ariadne Capital which offers advice on “creating offshore subsidiaries”. http://www.ariadnecapital.com/journal/v3e1/portfolio_news_outsource.htm.

Yet UK companies are not faced with the simple alternatives of outsourcing to a purely Indian service company, or to a purely UK service company, what we call “locally integrated offshoring”. Most IT/BPO out-sourcers can offer a locational mix of capacity in both the UK and India (or elsewhere), which can combine the cost advantages of cheaper labour costs in India (or elsewhere) with the control advantages of a UK presence to interface with the client: “leveraging the cost effectiveness of our Indian delivery capability whilst providing clients with strong local support [in the UK]” (Xansa 2003). The mix offered on any specific contract is influenced or specified by the client. Three-quarters of the clients for IT services now request an offshore element, but public sector clients usually exclude any offshore component, considerations related to public concerns about the impact on employment and the role of public sector employment in regional development.

In these terms, different combinations of internal and external outsourcing and offshoring provide different sets of benefits. Firms seeking to enhance collaboration and customised offerings but still reduce costs are likely to retain much of their outsourcing and offshoring in-house. Firms more focused on general cost-cutting are likely to make more widespread use of external agents.

Our survey of 93 randomly selected large UK firms found 73 percent outsourcing significant components of their internal business services, and 20 percent offshoring these. Distinct results were found among outsourcers and offshorers. Offshoring is concentrated in precision manufacturing, computing, utilities and financial services. Research and Development and business research is a more frequent subject of offshoring than might be suggested from the business press. Further, this is often moved to high income, rather than low income locations, presumably in search of specific competences and productivity, rather than simply lowest cost.

While offshorers share with outsourcing firms an emphasis on price, innovation and investment in their business strategies, offshoring was more likely to emerge from established product and process offerings. Staff cost was a major motivator for offshoring but control, quality and efficiency are also significant considerations. Offshorers generally reported improvement in each area.

The costs of outsourcing and offshoring

Even with the major developments in ICT, coordinating geographically distributed activities is not without difficulty. Alongside more generalised concerns about job losses in developed countries, much of the controversy and uncertainty about current trends in offshoring concerns these coordination and related costs.

Drawing from established literature, our research identified five significant areas of cost in outsourcing and offshoring, including search costs, transition costs, coordination costs, exchange costs and capability losses.

- **Search costs** comprise the time and effort to discover the range of prices in the market. These costs are highest when price alone is insufficient to judge utility, as when product offerings are not standardised (Douma and Schreuder 1998). Since services cannot be standardised, only processes, they are particularly susceptible to these costs. Furthermore, the heterogeneous nature of service levels means transactions are uncertain. A rule of thumb for search costs in IT is between 1 and 10 percent of contract value (Overby 2003).⁵

⁵ Costs include documenting requirements, sending out RFPs and evaluating the responses, and negotiating a contract, and initial travel and hospitality. The process can take 6 months with due diligence.

Costs include those of search, transition, co-ordination, exchange, and strategic capabilities

Table 2

Differential benefits of outsourcing and offshoring

	<i>Local</i>	<i>Offshore</i>	<i>Local integrated offshore</i>
<i>Internal outsourcing</i>	Agency cost reduction Protection of proprietary information Collaboration Customised offering	Agency cost reduction Protection of proprietary information Labour cost reduction Customised offering	Agency cost reduction Protection of proprietary information Labour cost reduction Customised offering
<i>External outsourcing</i>	Agency cost reduction Specialisation efficiency	Agency cost reduction Specialisation efficiency	Agency cost reduction Specialisation efficiency Labour cost reduction Customised offering

Table 3

Differential costs of outsourcing and offshoring

	<i>Local</i>	<i>Offshore</i>	<i>Local integrated offshore</i>
<i>In-sourcing</i>	Option Loss +	Search Costs Transition Costs Coordination Costs Exchange Costs Proprietary Information Risk Reputation Risk Specific Asset Risk Infrastructure Loss Option Loss +	Search Costs Transition Costs Coordination Costs Exchange Costs Proprietary Information Risk Reputation Risk Specific Asset Risk Infrastructure Loss Option Loss +
<i>Out-sourcing</i>	Search Costs + Transition Costs + Coordination Costs + Exchange Costs + Proprietary Information Risk + Reputation Risk + Specific Asset Risk + Infrastructure Loss + Option Loss +	Search Costs ++ Transition Costs ++ Coordination Costs ++ Exchange Costs ++ Proprietary Information Risk ++ Reputation Risk ++ Specific Asset Risk ++ Infrastructure Loss + Option Loss +	Search Costs + Transition Costs Coordination Costs + Exchange Costs + Proprietary Information Risk + reputation risk Specific Asset Risk + Infrastructure Loss + Option Loss +

+ represent greater cost.

- **Transition** can also incur costs. Because the quality of service is important, the training and integration of the new providers is crucial, especially as costs are likely to be greater when encompassing different national business environments and national cultures. Furthermore, redundancy, reorganisation, retraining may have detrimental impacts on the remaining capabilities of the firm (Overby 2003). A rule of thumb in IT is that the costs of familiarising outsourcers with existing operations can cost 2 to 3 percent of contract costs, while redundancies and associated costs can add another 3 to 5 percent. Additionally, initial productivity shortfalls of 20 percent in the first two years of contracts have been experienced in IT (Overby 2003).
- **Co-ordinating** and integrating outsourced activities is also a cost, although the risk of disruption can be reduced by insuring against interruptions in supply, but this too is a cost. One Indian specialist offshore provider, Wipro Technologies, cites the cost of a sufficient telecommunications link for effective communication between a UK firm and an Indian operation at £70,000 per year (The Guardian, 25 September 2003, p. 18). Ongoing costs in specifying operational requirements of projects for IT outsourcers can account for 1 to 10 percent of contract price (Overby 2003).
- **Exchange** also poses a further cost. Enforcing the terms of exchange is particularly difficult in international transactions where international contract specifications are complex, or where the time between product despatch and delivery is long and the process often ambiguous (Hill 2003). In IT, ongoing contract management can account for 6 to 10 percent of the total offshore contract price (Overby 2003).
- **Strategic capabilities** are the final set of costs. These include: the risk of *loss of proprietary information* to competitors – although the risk of loss can be reduced through detailed (and costly) contract specification; *dependence on specialised assets* specific to that transaction – there are costs or asset devaluation if these assets are used for other purposes (Williamson 1985), for example specific training and communication media associated with offshoring is not directly transferable to other processes; a *reduced infrastructural capacity* – for example once a business activity is outsourced, the technical expertise, infrastructure and knowledge to carry out that activity in house is eliminated or significantly reduced; and finally a firm has reduced options once having outsourced a business process. Retaining it in-house provides a degree of flexibility and protection in responding to future events (Johnstone 2002).

As with benefits, the impact of these costs will vary with location and degree of control involved. Many of these costs arise from the act of outsourcing, although search costs, transition costs and specific asset risk are likely to be particularly difficult for services because of ensuring quality of provision. Coordination costs are likely to be greatest for business processes that are more critical to other operations of the firm, whilst the options loss is universal.

Our survey found the management of offshoring involving a wider range of tasks than domestic outsourcing, with quite different priorities. For firms,

As with benefits, the effect of costs differ with location and degree of control

offshoring services, management of expatriate activities, infrastructure provision, transition and labour relations issues are of major concern. The costs of these management activities are significantly greater for firms offshoring than outsourcing services, particularly monitoring and transition costs. Offshoring firms encounter a much greater range of difficulties than outsourcing or in-housing firms, with government relations, contract negotiation and intellectual property rights being most problematic.

Conclusion

Our study of offshoring by UK firms found a much more limited and considered uptake of the practice than could be expected from media coverage of the issue.

This highlights the persistent theme evident in earlier work on ICT adoption in general. Only a small group of UK firms appear to have the capacity to tackle the potential of the new technologies to effectively utilise the creative competences of their workforce. Offshoring predominantly involves firms seeking to tap geographically distributed competences and are prepared to invest in the transition, monitoring and coordination necessary to do this.

Outside this group, few firms appear to have a vision of the strategic potential available from this route, with discussion focusing simply on the possibility to reduce operating costs. It is not surprising, then, that, when faced with some of the operating difficulties involved in offshoring, most firms are reluctant to explore this.

This underpins the emerging form of offshoring that we have labelled “locally integrated offshoring”. Firms are able to vary the domestic/offshore mix through external agents according to short-term contingencies. While this is an ideal option for a cost-minimisation focus, it provides only limited ability to build internal synergies and develop distributed competencies. As with IT in general, UK firms are clearly still grappling with a limited understanding of the business potential of the new technologies.

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OFFSHORE OUTSOURCING – MUCH ADO ABOUT WHAT?

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“Benedict Arnolds”¹, “Unpatriotic”² or contributors to a multi-billion dollar export boom?³ Companies (or governments) engaging in offshore outsourcing have many names in 2004 and arouse much passion. This paper will not, however, attempt another numerical pin-down of the extent of offshore outsourcing and associated job losses. Instead, after a short introduction, the degree of uncertainty regarding international trade data in areas affiliated with offshore outsourcing will be illustrated. Then data indicating a minor direct impact of offshore outsourcing relative to other labor market factors implicated in large-scale job losses will be presented before a short conclusion.

What is offshore outsourcing, and what drives it?

Initially it is useful to distinguish between two different terms frequently used interchangeably in the debate:

- *Outsourcing* refers to companies (or governments) purchasing services from outside specialist providers at arms length. This may include a wide range of services, such as cleaning, catering, security, building maintenance, as well as business services

such as IT support, consulting, advertising, payroll management, accounting or specialist design. Inherently many of these types of services must be acquired from suppliers located in the local area, as they require a continuous physical presence – you want someone to clean and guard the office every night.⁴ This type of activity is as old as at least the industrial revolution, and basically refers to companies specializing in what they do best and leaving the rest to others.⁵ It is a crucial process in which companies engage to remain cost-competitive and raise productivity, but is not the focus of this paper.

- *Offshore outsourcing (offshoring)* refers to purchases by companies (or governments) of services from foreign providers at arms-length, or the transfer of particular tasks within the organization to a foreign location. This generally occurs through the use of information technology, either in the form of cross-border data transmissions (any task that can be digitized, sometimes known as IT enabled services, or ITES) or cross-border voice-transactions (for instance direct phone-based customer support and other call-center functions). While the scope of offshore outsourcing, due to distance, cannot be as broad as for outsourcing itself, the technical possibilities for it should not be underestimated. Increasingly diverse tasks, such as tax accounting, medical scans or claims processing can today be digitized and therefore potentially sourced from any distance. However, technical capability does not necessarily mean that the offshore outsourcing of a given task will be profitable (or legally possible) for an organization to engage in.

Hence, while outsourcing has occurred for many years, offshore outsourcing is a relatively recent phenomenon. Only in 1996 did India’s exports of software and IT-enabled services breach the \$1 billion mark⁶, but have since risen to more than \$12 billion.

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¹ US Democratic Party presidential candidate John F. Kerry’s label for companies and CEOs that move jobs and operations overseas to avoid paying US taxes. Benedict Arnold was an American traitor from the War of Independence, who in 1780 plotted to surrender the fort he commanded to the British forces.

² German Chancellor Schroeder’s characterization of German companies considering relocating jobs abroad. The remark came in response to suggestions from Georg Ludwig Braun, President of the German Chamber of Industry and Commerce, that German companies “not wait for better policies”, but act to take advantage of the opportunities offered by EU enlargement.

³ Indian IT industry association NASSCOM estimates that Indian exports of software and IT services in the fiscal year April 2003 to March 2004 reached \$12.5bn. “Indian Software and Services Exports”, NASSCOM Press Release June 3, 2004. Available at http://www.nasscom.org/artdisplay.asp?Art_id=2707, accessed June 16, 2004.

⁴ Note that this does not mean that for instance cleaning or security cannot be handled by a multinational company, only that such a multinational must have a local presence.

⁵ To use Ronald Coase’s terms, companies perform only those tasks, whose marketing/transactions costs in the market are higher than the cost of producing them in-house.

⁶ NASSCOM estimates of Indian software and IT services exports. Please see below for the reason to rely on this source.

Offshoring differs from outsourcing in that foreign providers or locations are involved

At least four factors have driven the recent rapid rise in offshore outsourcing:

- *Technological innovation:* This has enabled large price declines in, and accompanying diffusion of, information technology, as well as a rapid decline in telecommunication connection prices since the late 1990s.⁷ This has permitted many new suppliers and customers to enter the market, and will likely continue in the coming years.
- *Free trade:* The sector has so far not been affected by any significant regulatory barriers to growth in the form of duties or other trade barriers. Sector growth has thus been entirely market determined. However, this fortunate situation may not last. A recent white-paper from US Senator Liebermann's Office (Liebermann 2004) lists no less than 13 different US federal legislation proposals aimed, in different ways, at limiting the scope for offshore outsourcing, and points out that 33 US states have introduced similar types of legislation since May 2003. While none has yet been implemented, the danger is evident. Other developed countries have so far resisted similar legislative initiatives. This is fortunate, as such measures will further complicate global trade negotiations⁸ and are unlikely to preserve many jobs in developed countries.
- *Possible cost savings:* Surveys of companies demanding offshore outsourcing services indicate that they seek cost savings in existing operations. A survey of different estimates and experiences reveal a 30 to 60 percent range in typical cost savings.⁹ Yet, some caution is warranted in interpreting such numbers. Estimates will vary between different types of tasks and different suppliers of services, but more importantly it may be difficult to measure the all-in costs to a company of offshore outsourcing. Labor costs are frequently the most important aspect, especially in labor intensive call-center type tasks, but such immediate savings may

be offset in the longer term by additional costs arising from less operational control of output (for instance in IT support), or reputational risk from customers withdrawing business.¹⁰

- *Access to a large pool of skilled English speaking labor outside the home country:* Several countries, particularly India and the Philippines, but also higher-wage countries, such as Canada, Australia or Israel have provided plentiful skilled English-speaking labor. The importance of English in facilitating seamless, continuous interaction between business units from different countries in multinational companies is crucial. Countries lacking English speakers are less likely to host facilities servicing other parts of multinational companies. English is furthermore the spoken language in the United States, which makes good command of it imperative for suppliers of "call-center-type direct interaction with customers" services to this, by far the biggest and most mature offshore outsourcing market in the world.

Offshore outsourcing is growing – but how do we measure it?

Many industry specialists have published estimates of the size of the global offshore outsourcing market. These vary wildly in levels (from tens to hundreds of billions of dollars¹¹), but all agree that growth is rapid, that it will continue, that US clients form the largest customer base and that India is emerging as the dominant supplier.

Instead of now offering another, but less informed guesstimate of the true scope of offshore outsourcing, I will point to a related issue of increasing importance – how does offshore outsourcing show up in international trade statistics? Obviously it is of interest to account properly for cross-border trade flows that may soon (or already) account for hundreds of billions of dollars in value. But offshore outsourcing represents an additional challenge in that it falls in the middle of two traditional "grey areas" of international trade statistics, namely accounting for trade in services (as opposed to goods), and accounting for trade involving multinational companies. First a little background information on both "grey areas":

⁷ McKinsey Global Institute estimates that cost of an international 2Mbps fiber leased line in India have declined by up to 80 percent from 1997–2001, with similar magnitude declines seen in the Philippines and other developing countries. McKinsey Global Institute (2003b).

⁸ Former Indian Minister of Commerce Arun Jaitley several times in talks with US officials and the press indicated a direct link between Indian interest in a successful Doha agreement and anti-offshoring legislation. The position of the new Indian Congress-led government cannot yet be gauged, but is unlikely to differ from the outgoing Indian government.

⁹ There are many such surveys and estimates, as well as industry executive interviews. I shall list just a few of the largest and most cited here: Deloitte Research (2003), Gartner Research (2003) McKinsey Global Institute (2003a), Evaluserve (2003), Forrester Research (2002, 2004a, 2004b), UNCTAD/Roland Berger (2004), A&A (2004), BusinessWeek February 3, 2003 "The New Global Job Shift", The Economist, July 17, 2003, *The New Geography of the IT Industry*, and Financial Times, July 2, 2003 IT Review *Looking for Savings on Distant Horizons*.

¹⁰ A recent survey in Britain indicated that one in seven Briton, who knowingly came into contact with a call center overseas, took their business elsewhere. Financial Times June 2, 2004 Special Report: Risk Management, Move to Reduce Costs Can Also Lose Customers.

¹¹ Please refer to footnote 9 for a number of such estimates.

Offshoring is driven by technological change, free trade, cost savings and skilled English speaking labor abroad

*Statistics on International Trade in Services*¹²

Measurement of trade in services is inherently more difficult than measurement of trade in goods. Individual services are frequently intricate to define, and may constitute abstract concepts rather than a physical attribute or function. International trade in services requires, unlike trade in goods, no physical package to cross borders, frequently has no description of content, or information on quantity, origin or destination, and critically has no administrative system based on customs duty collection measuring it.

Correct data on services trade require a common understanding of concepts from both statistical agencies as well as data providers, i.e. suppliers and customers of internationally traded services. International services trade data, as opposed to goods trade data which rely predominantly on customs duty declarations, are collected through both business accounting and recordkeeping systems, administrative sources, regular surveys of businesses as well as numerical estimations by statistical agencies.

Practical considerations of data secrecy (companies wanting to protect proprietary data of potential value to competitors), respondent burden (there are limits to how many surveys businesses can be expected to fill out) and maintaining common standards need to be weighted against the demand from users for more data detail and validity. As such, despite recent progress with the agreement on a set of common international standards in the “Manual on Statistics in International Trade in Services”, it is reasonable to declare that data on international trade in services remain frequently inexact, in some cases for certain purposes outright misleading.

An example may illustrate this point: For many years, the United States has had a deficit in telecommunications services. This sector is measured by an idiosyncratic accounting system. As described in the ITC Annual Report on Trends in US Services Trade (US ITC 2003, chapter 11, pp. 11 ff.), cross-border trade in telecommunications is determined by a system of bilaterally negotiated accounting rates for carrying international calls measured in minutes. Calls are billed in the originating country, so a carrier whose outbound calling minutes exceed its inbound calling minutes makes a net payment to its

foreign counter part “delivering the calls.” Net settlement payments by US carriers to foreign carriers are subsequently recorded as imports, while net settlement receipts from foreign carriers to US carriers are recorded as exports. The high level of international calls originating in the U.S. caused a chronic US telecommunications trade deficit until 2002, but Federal Communications Commission (FCC) mandated reductions in the accounting rates in the five years from 1997¹³ and technological innovations such as internet protocol telephony have served to improve the sectoral balance. The question then becomes what trade data in this category mean – is it trade, or accounting? This data certainly does not reflect anything about the relative competitive position of the US telecommunications industry.

Statistics on Trade in Services Involving Multinational Companies

Many services differ from goods in that they are non-transportable and require the immediate physical proximity of supplier and customer to be traded – if you want your hair cut, both you and the hairdresser need to be present. This is reflected in the last three of the four modes of supply of services in the GATS agreement. The four modes are: (1) cross-border supply (traditional trade of services between two countries); (2) consumption abroad (the consumer moves cross-border to the country of the supplier); (3) commercial presence (the supplier establishes a permanent legal/physical cross-border presence in the country of the consumer); and (4) presence of natural persons (the supplier moves temporarily cross-border to the country of the consumer). Mode 3, commercial presence, refers directly to multinational service providers. Above, we have already discussed the difficulties in measuring traditional trade in services delivered cross-border (mode 1). This is now compounded by the requirement to measure the quantity of services delivered through commercial presence (mode 3, also known as foreign affiliates’ trade in services (FATS)) on a parallel basis.¹⁴ And the numbers involved are big. The US Bureau of Economic Analysis estimates that US total cross-border exports (mode 1) of services in 2001 was \$276 billion. Yet, sales of services by US

¹³ 1997 FCC Benchmark Order *Benchmark Order*, 12 FCC Rcd 19,806 (1997) demanded a reduction in settlement rates within five years to \$.15/minute for upper income countries, \$.19/minute for middle income countries and \$.23/minute for lower income countries.

¹⁴ Exhaustive measurement of services trade would obviously require measuring also mode 2 and 4, but for the purposes of offshore outsourcing predominantly mode 3 (and to a lesser degree mode 4) is relevant.

¹² This section is based on UN, European Commission, IMF, OECD, UNCTAD and WTO 2002.

Statistics on trade in services remain at best inexact, at worst misleading

multinationals in foreign markets through foreign affiliates (mode 3) were \$432 billion.¹⁵ In other words, mode 3 sales of services are easily 50 percent larger than total cross-border sales, but they are frequently unrecorded. Unfortunately, but perhaps not surprisingly, recalling the above-mentioned practical considerations, international data collection of mode 3 services sales is very limited. Interested readers may refer to the OECD report (OECD 2001) for an indication of the relative paucity of data in this area, even from the world's most advanced economies.

A statistical black hole?

But do two overlapping grey areas make for a statistical black hole? An example may shed some light on the issue. Much has been written about the surge in US imports of IT services and software from India in recent years and not least about the projected annual double-digit increases in the years to come. Accordingly, it is relevant to consider just what the official trade data says about the extent of this bilateral trade. The US Department of Commerce/Bureau of Economic Analysis (BEA) has what is arguably the world's most extensive program for collection of international services trade data, and publishes detailed bilateral trade data for the relevant import categories of services.¹⁶ India publishes export data for Computer Software/IT Services.¹⁷ Data for recent years is presented in Table 1.

Table 1
US-India Bilateral Computer and Information Services Trade Data,
all data in \$US million

	Total Cross-border US Imports From India (Mode 1)		Source: BEA
1998	100		
1999	135		
2000	135		
2001	104		
2002	80		
	Total Indian Exports to the US and Canada (Mode 1 and 3)		Source: IndiaStat
1998 ^a	1,966		
1999	2,780		
2000	3,904		
2001	5,171		
2002	6,402		
	Mode of Trade	Total US Imports of Computer and Information Services	Source: BEA, Survey of Current Business
1998	Unaffiliated (Mode 1)	1,100	
	Affiliated (Mode 3)	900	
1999	Unaffiliated (Mode 1)	1,500	
	Affiliated (Mode 3)	3,000	
2000	Unaffiliated (Mode 1)	1,600	
	Affiliated (Mode 3)	2,600	
2001	Unaffiliated (Mode 1)	1,700	
	Affiliated (Mode 3)	2,800	
2002	Unaffiliated (Mode 1)	1,300	
	Affiliated (Mode 3)	2,900	

^a IndiaStat data refers to fiscal years, so that period shown as 1998 relates to April 1998 to March 1999.

A comparison of US and Indian trade data on ITC trade illustrates the problem of statistics

According to the BEA, US unaffiliated imports of Computer and Information Services from India, for instance a US company purchasing such services from an Indian provider such as Infosys or Wipro in India, is quite limited, and indeed some may be surprised to note that the US imported only \$80 million worth of such Computer and Information Services in 2002.

Looking instead at the reciprocal Indian export data, a somewhat different magnitude of trade emerges, with North America importing almost \$6.5 billion worth of Computer Software And Services in 2002. It may be that Canada imported many times more than the U.S. of such services, but most plausibly other issues are at play here. First of all, the US bilateral data includes only unaffiliated (mode 1) imports, whereas Indian bilateral data concerns total exports,

¹⁵ The opposite numbers for the US are similar. Total US cross-border imports of services in 2001 was \$202bn, yet services sales by foreign multinationals in the US was \$367bn. (*Survey of Current Business* October 2003, p.58).

¹⁶ U.S. International Services: Table 7: Business, professional, and technical services, unaffiliated, 1986-2002, available at <http://www.bea.doc.gov/bea/di/1001serv/1003serv/Tab7.xls>; and BEA(2003).

¹⁷ Available at <http://www.indiastat.com/india/ShowData.asp?secid=208159&ptid=18089&level=4>.

Other estimates of Indian Software and IT Services exports are available from the Indian IT industry association NASSCOM at http://www.nasscom.org/artdisplay.asp?cat_id=314. They are very similar to the official Indian estimates at approximately 85-90 percent of official data. Accessed June 15 2004.

i.e. also includes the output of Indian-located affiliates of multinationals.¹⁸ This means that in theory, say Accenture India selling services to Accenture in the U.S. is not calculated in the US import data, but is part of Indian export data. Unfortunately, bilateral intra-firm (affiliated trade, or mode 3) trade data is not available between the U.S. and India, but as can be seen in the lower section of Table 1, total US affiliated and unaffiliated imports of Computer and Information Services in 2002 stood at \$4.2 billion. Thus even if 100 percent of US affiliated imports originated in India – a wholly implausible scenario, considering that only a tiny amount of the total stock of US FDI is in India – only about $\frac{2}{3}$ of Indian exports of these services would be accounted for. Yet, it is clear from Table 1 that affiliated (mode 3) trade in Computer and Information Services is several times larger than unaffiliated (mode 1) trade, indicating that the total US bilateral trade deficit in Computer and Information Services with India may be significantly larger than the unaffiliated trade data reveals.

Other statistical quirks also cloud the issue of comparing official US and Indian trade data in these services. The US definition of Computer and Information Services may not be completely overlapping the Indian definition of Computer Software and Services, although it would seem unlikely that any definitional discrepancy could explain the order of magnitude difference in bilateral import and export data. Nonetheless, it is particularly relevant with respect to software. The BEA does not count imports of general-use software, packaged and physically shipped to the U.S., as services trade, but rather as goods trade. Similarly is the value of software pre-installed on computer equipment and peripherals counted in the value of this hardware rather than as services trade. Yet, the limited value of US imports from India of the relevant goods,¹⁹ worth less than \$140 million in 2002, seem unable to explain the sizeable difference in bilateral trade data.

Another issue is that of trade vs. compensation. In accordance with OECD standards, the BEA does not count “Indian IT workers working temporarily for Indian companies in the U.S.” as services trade,

but records this only as compensation of employees in the US International Transactions Tables.²⁰ Yet, total compensation for all such employees from all Asian and African countries (excluding Australia and Japan) was only \$726 million in 2002, and Indians were issued only a little over 20,000 US Intra-company Transferee L-1 visas in the fiscal year 2002 (Department of Homeland Security 2002, Table 27), so even if the Indian statistical agency does include such remuneration as exports, it is still not enough to explain the difference in the data values above.

Of much more importance is possibly the source of these trade data. The BEA relies largely on surveys for its services trade data (whether mode 1 or 3), and therefore may risk losing a large number of possibly new imports of Computer and Information Services simply due to the fact that such surveys do not cover the importers – especially as these may very well be in new sectors outside the well-covered Computer and Information Services producing industries, which have until recently not conducted this type of transactions with an overseas transactor, say an American airline offshore outsourcing ticketing administration to an Indian company. While the extent of such possible misses in BEA surveys cannot be gauged, and can only be speculated about, it is important to realize that surveying of exporters of Computer and Information Services is logistically much simpler as their number is much smaller. The NASSCOM membership in India by March 2004 stood at 860 companies, covering by their own admission almost 95 percent of revenues in the Indian software and IT services industry, whereas the (unknown) number of U.S. based importers of Computer and Information Services easily could be imagined to run into the tens of thousands. Hence one would expect that corresponding Indian survey data of Computer and Software Services exporters have a higher coverage than US data of importers²¹, and therefore be much closer to the true value. The fact that NASSCOM membership includes many multinationals would seem to strengthen the validity of Indian estimates, as also mode 3 services trade would likely be extensively covered.

Bottom-line: Data on offshore outsourcing of services may not quite represent a statistical black hole, but nonetheless exhibit differences in comparable

NASSCOM data are superior to US BEA survey data

¹⁸ According to the NASSCOM MNC Forum approximately a quarter of Indian exports of IT services comes from multinational companies operating in India. See NASSCOM website at <http://www.nasscom.org/artdisplay>.

¹⁹ US Census end-use categories (21300) Computers (21301), Computer accessories, peripherals and parts (41220), and Records, tapes, and disks, available at <http://www.census.gov/foreign-trade/statistics/product/enduse/imports/c5330.html>.

²⁰ Table 1, line 34 available at <http://www.bea.doc.gov/bea/international/bp>.

²¹ The closeness of official Indian and industry estimates of exports supports this.

bilateral values measured in the orders of magnitude. Needless to say, this warrants caution when interpreting such data.

What is the employment impact of offshore outsourcing in developed countries?

An inescapable part of discussing offshore outsourcing is its presumed disastrous impact on developed world employment. Everybody's job seems suddenly at risk. As with predicting the scope of offshore outsourcing, many industry specialists have published estimates of the number of jobs that may be shifted from developed countries to lower wage countries in the developing world. These, too, vary wildly from the tens of thousands to millions over the next decade.²² Others have published esti-

mates based on detailed official US labor market data (Kirkegaard 2004, Mann 2003, Bardhan and Kroll 2003) and reached more nuanced conclusions, pointing out that many jobs lost are low-wage and that the relative scope of job losses is limited.²³ Indeed, a recent survey of the Scottish call-center industry (Tailor and Bain 2003) found that a third of Scottish call-centers predicted increased employment by 2006, although it did also find that growth since 2000 had slowed.

²² Please refer to footnote 9 for such estimates.

²³ Multinational companies are frequently at the forefront of utilizing offshore outsourcing opportunities, but it is important to note that two recent broad surveys of large North-American (Forrester 2004b) and European firms (UNCTAD/Roland Berger 2004) reveal that about half of the companies are neither currently using nor planning to use offshore outsourcing in the future. This indicates that many even large businesses and their employees will not be directly affected by offshore outsourcing in the foreseeable future.

Table 2

Reason for Mass Layoffs in the United States 1996–2003, share of total

	1996	1997	1998	1999	2000	2001	2002	2003(p)
Total separations, all reasons	1,184,355	1,146,115	1,227,573	1,149,267	1,170,427	1,751,368	1,546,976	1,502,825
Automation	0.5%	0.2%	0.1%	0.0%	0.1%	0.1%	0.1%	0.1%
Bankruptcy	1.8%	1.9%	2.0%	4.3%	4.7%	7.7%	5.0%	4.0%
Business ownership change	4.1%	2.2%	3.0%	5.0%	2.8%	3.2%	2.8%	2.2%
Contract cancellation	1.6%	1.0%	1.0%	1.2%	1.2%	1.8%	2.3%	2.4%
Contract completed	11.0%	16.4%	11.7%	10.5%	10.4%	7.2%	9.2%	10.1%
Domestic relocation	1.0%	1.3%	1.3%	0.9%	1.0%	1.1%	1.3%	1.0%
Financial difficulty	4.8%	3.6%	2.8%	4.3%	5.3%	8.8%	6.9%	5.9%
Import competition	1.2%	1.1%	1.5%	2.3%	1.1%	1.6%	1.0%	1.6%
Labor dispute	1.2%	1.4%	5.3%	1.3%	1.5%	0.4%	0.3%	1.2%
Material shortage	0.2%	0.1%	1.7%	0.2%	0.1%	0.1%	0.1%	0.1%
Model changeover	0.6%	0.6%	1.1%	0.2%	0.2%	0.3%	0.1%	0.3%
Overseas relocation	0.4%	0.9%	0.7%	0.5%	0.8%	0.9%	1.1%	0.9%
Plant or machine repair	0.4%	0.2%	0.6%	0.1%	0.3%	0.2%	0.2%	0.2%
Product line discontinued	0.5%	0.9%	0.5%	0.5%	0.4%	0.6%	0.3%	0.4%
Reorganization within company	10.0%	7.1%	7.6%	8.3%	8.8%	8.9%	10.3%	9.1%
Seasonal work	41.8%	44.9%	36.7%	42.8%	43.7%	28.5%	36.2%	35.6%
Slack work	9.9%	8.2%	12.2%	7.0%	8.5%	18.6%	13.8%	9.2%
Vacation period	1.0%	1.2%	2.0%	2.4%	1.2%	1.4%	1.7%	1.7%
Weather-related	0.9%	0.8%	1.1%	1.2%	0.5%	0.3%	0.3%	0.5%
Other	5.1%	3.8%	6.0%	3.4%	2.9%	5.4%	2.5%	2.4%
Not reported	2.1%	2.1%	2.6%	3.8%	4.4%	2.9%	4.4%	11.2%

(p) = provisional.

Source: BLS Mass Layoff Statistics.

Many jobs lost to offshoring are low wage, and the relative scope is limited

It is outside the scope of this paper to offer a new “jobs-lost-to-outsourcing-number”, but I will point to some data evidence that indicates that relative to other factors affecting developed country labor markets, the direct impact of offshore outsourcing is limited. Data is available both for the United States and for European countries, although both sources have their own severe limitations.

The US Experience

The US Bureau of Labor Statistics collects data in what is called the Mass Layoff Statistics (MLS) program. Among other things, this covers all cases where employers indicate that 50 or more workers were separated from their jobs for at least 31 days, and employers are asked to identify the reason for the mass lay-off. Obviously this gives rise to at least two major shortcomings. First of all, establishments with fewer than 50 employees and laying off less than 50 people are not included. Secondly, employers are asked to “self-identify”, and it does not take much imagination to suspect that, in the current political climate in the U.S., employers would be hesitant to identify themselves as laying off because of offshore outsourcing. Results from the MLS program are presented in Table 2.

Two things jump out from Table 2:

- Mass layoffs due to offshore outsourcing, which would be captured in the category “overseas relocation”, are extremely small and have been relatively stable since 2000.
- The number of separations, where the reason is “not reported” has jumped significantly in 2003. This may indicate the emergence of the employer self-identification problem.

Offshore outsourcing may obviously also be captured by other categories, such as “reorganization within company”, but even so the picture of a small direct impact of offshore outsourcing remains.²⁴

²⁴ This is confirmed for Q1 of 2004 by new BLS statistics published on June 10 2004, available at <http://www.bls.gov/news.release/pdf/reloc.pdf>.

Table 3
Job-losses Associated With Major European Company Restructurings, January 2002 to present

Type of restructuring	# Planned job reductions	% Planned job reductions	# of Cases	% of Cases
Internal restructuring	560,557	75.8%	860	64.5%
Bankruptcy / Closure	100,666	13.6%	296	22.2%
Relocation	36,513	4.9%	91	6.8%
Merger / Acquisition	22,884	3.1%	48	3.6%
Outsourcing	18,335	2.5%	13	1.0%
Other	820	0.1%	26	2.0%
Total	739,775	100%	1,334	100%

Source: European Restructuring Monitor.

The European Experience

The European Monitoring Centre on Change (EMCC) publishes the European Restructuring Monitor (ERM), which has published data for major European company restructurings since the beginning of 2002. These data include restructurings that affect at least one EU country and entail an announced or actual reduction of at least 100 jobs. Cases are identified through a press review of daily newspapers and business press in the 15 old EU Member States. As with the US data, the threshold of inclusion in the data set (100 jobs lost) will inevitably leave out smaller cases of offshore outsourcing, just as cases may not be reported in the European press. Furthermore, ERM does not distinguish between outsourcing and offshore outsourcing. Results from January 2002 – June 2004 are presented in Table 3.

As is the case in the U.S., offshore outsourcing is directly responsible for only a very minor part of large-scale job losses in European countries, although like in the U.S., offshore outsourcing may be included in other categories such as “internal restructuring” or “relocation”.

Considering the extent of political tension regarding offshore outsourcing, it is remarkable that these data – with their significant caveats and limitations – indicate that the phenomenon has a relatively small effect on both the US and European labor markets, relative to other sources of job losses.

Conclusion

Of the four factors that have combined to drive offshore outsourcing, technological innovation, free

In Europe as in the U.S. only a minor part of mass layoffs is due to offshore outsourcing

trade, potential cost savings and large numbers of skilled competitively priced English speakers, only free trade may be in immediate danger of abating. However, so far US lawmakers have resisted the temptation to legally restrict the trend.

Massive uncertainty surrounds the official statistics capturing offshore outsourcing. Comparable export and import numbers may be hundreds of percent apart, which warrants caution in interpreting this type of data. Most likely, export data gathered from a limited number of suppliers will be more precise than import data from a much more dispersed group of customers.

Data from both the U.S. and European countries indicate that the direct effect of offshore outsourcing on job losses is muted, compared to other factors in the labor market. The significance and implications of this finding may, however, be restricted by serious data deficiencies. Nonetheless, the finding indicates that the political storm from offshore outsourcing has little to do with the sheer number of job losses. Instead, it points to the fact that general uncertainty about the scope of the phenomenon (could my job be next?), combined with a very limited number of resourceful, politically articulate people affected (such as software programmers) has succeeded in capturing the political agenda.

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Rather than the number of job losses, it is the uncertainty about the scope of the phenomenon that captures the political agenda

THE IFO INSTITUTE'S MODEL FOR REDUCING VAT FRAUD: PAYMENT FIRST, REFUND LATER

HANS-WERNER SINN,
ANDREA GEBAUER AND
RÜDIGER PARSCHE

In 2003, the tax authorities lost almost €18 billion¹ in value added tax (VAT) revenue due to fraud and bankruptcies. This figure was calculated by the Ifo Institute by comparing actual revenues with those that would theoretically accrue on the basis of information by the Federal Statistical Office on private consumption and non-taxable items (see Dziakowski et al. 2002).

As far as fraud is concerned, the calculated losses can be traced to activities in the underground economy as well as various versions of open tax fraud, where invoices are drawn up. This includes primarily input tax fraud including the so-called carousel deals. This paper deals with ways to prevent revenue losses due to tax fraud and bankruptcies.²

If VAT losses could be prevented, the authorities would receive estimated additional revenue of €6.5 billion. This would constitute a non-negligible contribution to a reduction of the fiscal problems of the various levels of government. In fact, the figure is twice the revenue from the inheritance tax and exceeds by half the potential revenue from a wealth tax, assuming the same conditions as in 1996, the last year in which this tax was levied. Germany would also be in a better position to meet the debt ceiling of the EU Stability and Growth Pact. The share of net borrowing in gross domestic product would fall by more than 0.3 percentage points.

What explains the revenue losses?

One of the major causes of the revenue losses is input tax deduction. In the present system, the seller presents the buyer with a bill showing the VAT, and the buyer can deduct the VAT from his tax liabilities if he is eligible for input tax deduction. This may even lead to net refunds if input tax entitlements exceed the VAT owed on one's own sales. The refund

of the input tax is independent of whether and when the bill is paid and also independent of whether the seller has paid over the VAT shown in the bill to the tax authorities. It further does not matter whether or not the buyer has received sales revenue that is subject to VAT and must therefore pay VAT himself. Since investments are VAT free, the refund of the input tax that is independent of one's own tax payment is an essential element of the VAT.

This procedure leads to an undesired loss of revenue if the buyer demands the refund of the input tax by presenting a bill, but fails to pay the bill because of bankruptcy. Tax losses also occur when the seller fails to pay over the VAT, which the buyer has already paid as part of the total sum billed, either because he himself goes bankrupt or because he does not declare the revenue subject to VAT on his tax statement.

Tax defrauders have thought of a multitude of tricks for taking advantage of loopholes in the system. Especially profitable are carousel deals. These are deals in which a good is actually or at least on paper shifted several times between several firms in order to qualify for fraudulent input tax refunds. Cross-border transactions frequently play a role in this because they make tax-free imports or exports possible and make controls by the tax authorities more difficult.

For example, mobile phones are imported from abroad and sold to a domestic commercial firm which ships them back to the initial shipper. The importer may buy the mobiles tax-free according to the present country of destination principle. By selling them to the domestic commercial firm, he includes the VAT in the invoice but does not pay it over to the tax authorities. The commercial firm receives the input tax refund and sells the mobiles tax-free to an importer in a foreign country. From there the good may be sent again to Germany and the carousel keeps going round and round. By the time the tax authorities detect the scam and try to collect the VAT from the importer, the participating firms have, as a rule, dissolved and the owners cannot be found.

¹ This figure is subject to considerable uncertainty at the present time, as it is based entirely on estimates of the Ifo Institute. In addition, tax losses due to recent decisions of the European Court of Justice, which may amount to €1.5 billion, have not been included.

² Underground economy activities are not considered here. Measures to fight moonlighting range from a change of the welfare system (see Sinn et al. 2002), which withdraws labour from the underground economy, to radical tax cuts (see Sinn et al. 1999), which generally lowers the attractiveness of moonlighting.

In order to contain the abuse, the law to reduce tax deficiency was passed in 2002 which among other things provides for the buyer's liability for the seller's culpable failure to pay over the VAT.

Neither did the new law achieve the expected additional tax revenue of €2.5 billion, nor did it effectively prevent carousel deals.

This is firstly due to the fact that to date a buyer is only liable for the seller's culpable failure to pay over the VAT if he knew of the latter's intention to cheat at the time the deal was struck, which is, of course, difficult to prove. Secondly, the law remains ineffective if not only the seller but also the buyer fails to pay over the tax.

Among the measures included in the law is one that demands collateral of newly established firms, because in a large number of cases firms were only established for the purpose of VAT fraud. This measure, too, proved ineffective because the people reacted swiftly by "stocking up" on newly established firms. In addition, such firms are increasingly abused for carousel deals that had been in the market inconspicuously for years in order to give the tax authorities the impression of orderly management. Only the VAT follow-up, i.e. unannounced tax audits, seem to have achieved some success in reducing tax fraud. According to the estimates of the Ifo Institute, tax losses due to fraudulent carousel deals and bankruptcies amounted to €5 billion in 2003, despite the law to reduce tax deficiency.

A solution proposed by the Ifo Institute

In order to solve the problem, the Ifo Institute proposes a modified value added tax procedure, which legally remains as close as possible to the present system, but prevents fraud effectively. It makes sure, firstly, that the buyer does not receive an input tax refund that had not been previously paid as VAT to the tax authorities, and secondly, that the VAT included in a bill is indeed paid over to the tax authorities when the bill is paid by the buyer. The buyer of a product may only claim the input tax deduction if he can prove that the seller has already paid over the VAT to the tax authorities, and the seller must pay over the VAT to the tax authorities at the same time at which he collects the VAT with payment of the bill. In this way, some frauds which are possible in the present system, and especially the carousel deals, are prevented.

In addition, possible tax losses resulting from bankruptcies are also largely prevented. Thus, the seller can no longer escape passing on the VAT collected in the case of bankruptcy, and it is impossible for the buyer to have the input tax refunded as a liquidity reserve without ever paying his bill.

Two procedures may be used to achieve these effects, depending on whether the sale is in cash or non-cash.

1. Non-cash payment (trust account)

If a bill is paid by bank transfer or by credit card, the amount of VAT, which is shown separately when payment is made, is directly passed on to the tax authorities. Toward this end, the bank involved acts as a trustee for the tax authorities. In detail the payment process can be explained as follows:

- (1) As part of his business, the seller sells a good or a service to the buyer.
- (2) He ships or presents the good. If it is not paid immediately, the good is accompanied by a bill of sale that includes the seller's tax number and the number of the bill of sale.
- (3) The seller charges the buyer the agreed price plus VAT and notes the number of the bill and, as the case may be, the number of the bill of sales and his tax number.
- (4) The buyer pays his bill plus VAT by bank transfer or credit card with the number of the bill, the tax number of the seller and his own tax number.
- (5) The amount paid is always transferred by way of an intermediate account, from which not only the VAT is paid over to the tax authorities but also the net amount of the bill is credited to the seller. This special account, the VAT trust account, is administered by the seller's bank as trustee to make sure that the VAT is paid over to the tax authorities.
- (6) In non-cash transactions, the seller hands over to the buyer a receipt for the gross amount received and, in addition, a receipt for the VAT paid over. In credit card transactions, the corresponding information is printed out on the buyer's record. In bank transfers, the bank makes out a record of transfer that contains all the necessary information.
- (7) With the record of VAT paid the buyer can now claim the input tax from the tax authorities in the same way as it is done today. If fraud is suspected, the tax authorities can check with the

help of the printed tax numbers of the parties to the transaction and the number of the bill whether the VAT payment has actually been made.

2. Cash payment (tax stamp system)

To also make sure in the case of cash payments that the tax authorities receive the VAT due on the purchase price, a prepayment of VAT by the seller is planned. For this there are two possibilities:

- a) The seller has a machine with which he stamps the receipt with the amount of VAT in question. This machine, which is connected to the telephone line, works like the well-known postage machines of the Postal Service and contains a kind of account, which the seller has "filled" in advance with payments to the tax authorities and against which the stamped VAT amounts can be debited. The tax credit in the machine account can be granted by telephone as in the case of postage machines.
- b) For the few sellers who will not have a VAT machine and in special cases, a tax stamp system is planned. The seller buys tax stamps in advance directly from his tax authority, the printed amounts on the stamps being graduated like the amounts on notes and coins. This way any amount can be affixed. This is the system followed by tobacco stamps.

In detail, the cash payment system works as follows:

- (1) As part of his business, the seller sells the buyer a good or service.
- (2) The buyer pays the sales price plus VAT.
- (3) The seller gives the buyer a receipt which contains the receipt number, the seller's tax number as well as a printed or affixed VAT receipt.
- (4) If entitled, the buyer claims his input tax refund with the help of the VAT amount contained in the receipt.
- (5) If he is not entitled to an input tax refund, he must still take the receipt. He must have the receipt on him when leaving the store.

The payment model can be considered an extension of the Italian Scontrino model. In Italy, no buyer may leave a store without a receipt. As a rule, the receipt is printed in standardised form by the automatic cash register, owned by even the smallest

stores. The Scontrino System registers only the VAT to be paid, however, without implying an advance payment.

By connecting the cash register to an account of the tax authorities, from which the virtual VAT stamps can be downloaded, a VAT system for cash transactions is created that prevents input tax deduction without prior VAT payment as well as non-payment of the collected VAT to the tax authorities by the seller. The new cash payment system has the additional advantage that it generally makes transactions in the underground economy more difficult.

As shown by the Italian example, it is easily and effectively possible to check whether someone has a receipt or a bill of sales when leaving a store. In this way, a greater measure of discipline in cash transactions in stores may be generated. Italy has always had much greater problems of collecting taxes than the German tax authorities (see Nam et al. 2001). Therefore that country has felt the need to fight VAT fraud much earlier. The Italian experiences can and should be utilised.

Why the Ifo proposal is better than the reverse-charge procedure

A long discussed alternative to the present system, which is to prevent the present VAT losses, is the so-called reverse-charge procedure (see Ministry of Finance 2003). With this procedure the tax liability is transferred to the buyer, and his input tax claim is directly balanced against his VAT liability. As the result, the shipment between two firms remains tax-free. The entitled buyers are assigned a special identification and entitlement number, the so-called R-number.³ An electronic system is supposed to let the seller check the R-number online in order to make sure that the shift of the tax liability and balancing takes place only if the buyer is firm entitled to claim the input tax refund. To be sure, the R-number may only be used for purposes that do not preclude an input tax deduction. Furthermore, the reverse-charge system is not applied to negligible transactions, for example up to €1,000, and probably not to cash transactions.

³ The concept of an R-number is used in recent publications on the reverse-charge system.

The seller must report the concluded sales online and must also itemize his receipts in the annex to the advance value-added tax return, according to whether they are from entitled or not entitled buyers. The buyer must keep a record of the use of his R-number.

Like the Ifo model, the reverse-charge system also largely prevents carousel deals and tax losses due to bankruptcy that are based on claiming input tax refunds from the tax authorities without ever having paid the tax. However, the reverse-charge system has at least four important disadvantages compared to the Ifo proposal.

Firstly, the reverse-charge system promotes the crime of shifting private expenditures to the business. Carrying private expenditures on the books of the business is already a widely practiced fraud at present. But at least he who wants to get input taxes refunded must actively file a claim with the tax authorities. With the reverse-charge system purchases of consumer goods may be assigned to the business from the start and in this way be exempted from VAT. This greatly facilitates fraud.

Secondly, the reverse-charge procedure increases the probability of VAT fraud in transactions with final consumers. For example, a firm which is in financial trouble may buy goods at net prices and sell them at gross prices, i.e. including VAT, to final consumers without paying over the VAT. Via an excessive volume of transactions, it can generate liquidity in this way without involving the tax authorities and raising their suspicion. In case of flight, the VAT collected is as a rule lost to the tax authorities.

In the Ifo procedure, this risk is small. In order to generate liquidity in the same way, the final consumers and the tax authorities must be party to the fraud. The former would have to do without a bill, as payment per bill requires paying over the VAT. The latter would have to refund the input tax without becoming suspicious of the excessive transaction volume. Fulfilling both conditions at the same time should be most difficult.

A milder form of this disadvantage of the reverse-charge system occurs in the case of simple bankruptcy that is not preceded by an excessive transaction volume and is absent a fraudulent intention. If the firm supplying the final consumer goes bankrupt immediately after the sale of the goods, the tax

authorities as a rule lose the entire VAT collected at the final sale. In the Ifo procedure, this possibility is at least precluded if the consumers are honest and buy only with a receipt. The firm can claim the input tax refund from the tax authorities, but it cannot sell to the consumers in a regular way without at the same time paying over the VAT on the value of the goods.

Thirdly, the introduction of the reverse-charge system could imply parallel systems, as the seller would have to differentiate his buyers according to whether they are entitled to an input tax refund or not. In contrast to the present system and the Ifo proposal, the seller would have to know the status of his customers and could no longer ask for the payment of VAT on each sale. The negligibility rule and the exclusion of cash sales, which are important characteristics of the reverse-charge procedure, also add complications.

Fourthly, before the reverse-charge system can be introduced, considerable resistance on the EU level will have to be overcome. In view of the similarity of the Ifo procedure to the present system, the required approval by the European Commission of such a modification of the system may be expected much rather than that of a reverse-charge system.

Concluding remarks

The value added tax replaced the cumulative all-stage turnover tax in the 1960s. While it has many theoretical advantages, its collection has proven more difficult over time than expected. Especially the present practice of input tax refunding is highly problematic. It has invited fraud. The volume of fraud charges has reached such an extent that the state must act without delay in order to stop a further erosion of one of its major taxes. This contribution shows a way to prevent VAT fraud and to safeguard the tax revenues of the state. In times of scarce financial resources, the state should not hesitate to implement the proposal presented here for an improvement of the value added tax system.

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ACTIVATION VERSUS OTHER EMPLOYMENT POLICIES – LESSONS FOR GERMANY

LARS CALMFORS*

In the last two years, Germany has embarked on a path of labour market reforms to fight its high and persistent unemployment. The reforms have come in two rounds. The first set of reforms, based on the report of the Hartz Commission (2002), aimed mainly at increasing the efficiency of the federal employment service. The second round of reforms, the Agenda 2010, went further and involved also reforms of the unemployment benefit system.¹

The reforms to raise the efficiency of the employment services have involved a number of measures: the establishment of integrated job centres, attempts to extend the access of the unemployed to various training programmes (for young people in particular), subsidised employment for elderly unemployed, and the creation of temp work agencies. Other ingredients are “activation measures” in the form of increased requirements on the unemployed regarding active job search, availability for work, and acceptance of work conditions in new jobs, as well as stronger sanctions if these requirements are violated. One way of characterising these reforms is as an attempt to adopt active labour market policies of the type used in the Scandinavian countries, where these policies have been employed on a large scale.

This article discusses what contribution to lower unemployment such active labour market policies can give. This is done against the background of experiences from other countries, mainly Sweden. Based on this, I give an outsider’s evaluation of Germany’s labour market reforms and draw conclusions on which other policies are required if unemployment is to be permanently reduced.

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¹ See e.g. EEAG (2003, 2004) for brief accounts of the reforms. More detailed accounts are given in e.g. Collier (2004) and Siebert (2004).

² The figures refer to 2000 or 2001 and are from the *OECD Employment Outlook* (2003).

³ This literature originated with Layard et al. (1991). The most important of these studies are listed in Calmfors et al. (2001, 2004) and EEAG (2004, Ch. 3).

The conventional wisdom on active labour market policy

There appears to be a broad consensus that the major part of unemployment in Germany is structural, reflecting a high rate of equilibrium unemployment (see, for example, Sinn, 2003; or EEAG, 2003, 2004). Although the current recession has certainly added a substantial cyclical element, the fact that unemployment in Germany has over the last three decades ratcheted up from recession to recession must be interpreted as a successive rise in equilibrium unemployment.

It has for many years been a standard recommendation from international organisations, such as the OECD and the European Commission, that in such a situation there are large gains from re-allocating resources from passive unemployment benefits to active labour market policies. This recommendation has to some extent been followed in many countries. The average EU country today spends nearly 1 percent of GDP on active labour market programmes. Germany spends even more, around 1.2 percent, although this is a smaller fraction of total expenditures on the unemployed (39 percent) than in the average EU country (42 percent).²

The recommendation to channel more resources to active labour market policies is underpinned by a large empirical research literature, which has tried to explain differences among countries and over time in equilibrium unemployment with differences in *labour market institutions*: a standard result in these studies is that higher expenditure on active labour market policies tends to reduce unemployment.³

However, there are reasons to be sceptical about these results since they only measure the effects of active labour market policies on *open unemployment*: it is not surprising that open (registered) unemployment falls when openly unemployed persons are enrolled in various labour market programmes of long duration (training programmes, public-sector job-creation programmes, and subsidised employment in the private sector) and are then no longer counted as unemployed. It also turns out that if one recalculates the results in the studies it is no longer clear whether or not active labour market programmes reduce unemployment in total (that is if we add *open unemployment* and *programme participation*). According to some studies they do, according to others they do not (Calmfors et

al. 2001, 2004).⁴ The flip side of this is that it is also unclear whether or not programmes increase *regular employment*.

The Swedish experience with active labour market policies

One can probably learn more about the effects of active labour market policies from the experiences of individual countries than from the aggregate studies using data from many OECD countries that have been undertaken. The experiences from Sweden are particularly illuminating.

Sweden has a long tradition of active labour market policy with large placements of unemployed in various training, practice or subsidised employment programmes (usually of about half-a-year length). These labour market programmes were gradually expanded in the post-war period. They reached a peak during the Swedish unemployment crisis in the first half of the 1990s. In that period, Sweden spent more on active labour market policies than any other OECD country, almost 2 percent of GDP. At a time, nearly 5.5 percent of the labour force participated in various training or subsidised employment programmes. Subsequently, programme volumes were reduced to 2 to 3 percent of the labour force.

The Swedish active labour market policies in the 1990s can be seen as a giant experiment. Afterwards, the policies were subjected to a large number of rigorous evaluation studies.⁵ One can summarise the results as follows:

- Looking at the outcomes for individuals participating in various training programmes, results are very disappointing: training programmes appear either to have had *no effect* at all on future employment opportunities or a *negative effect*.
- In contrast, some types of subsidised employment seem to have increased employment probabilities of participants substantially also after programme completion: not very surprisingly the results are the better the closer such a programme has been to regular employment.

⁴ In the studies the size of labour market programmes is measured in terms of expenditures and not in terms of the number of persons enrolled. This means that a number of assumptions have to be made in order to calculate the effect of an increase in the number of programme participants on total unemployment (the sum of open unemployment and programme participation).

⁵ See Calmfors et al. (2001, 2004) for an overview of the evaluation studies performed.

- But, unfortunately, subsidised employment seems also to cause a large displacement of ordinary jobs: estimated crowding-out effects on regular employment are often of the order of magnitude of 60 to 70 percent.
- As expected, training programmes do not seem to be associated with displacement of ordinary jobs.
- The results are particularly bad for youth programmes. It is unclear whether such programmes have increased the employment prospects of participants. At the same time, the subsidised employment schemes for young people seem to have caused particularly large crowding-out effects.
- Both training and subsidised employment programmes seem to have reduced rather than increased labour mobility.⁶

These results are indeed very dismal. Some types of subsidised employment have been good for the individual, but have had a high price in terms of reducing regular employment. Training programmes have not suffered from such crowding-out problems, but have been inefficient or even damaging to the individual participants.

Is there nothing good to say about Swedish active labour market policies in the 1990s? It is possible that policies – by keeping the long-term unemployed attached to the labour market – helped maintain labour force participation. There are studies indicating this, but we do not know to what extent it was *effective* labour supply that was maintained or just the measured labour supply, because programme placements were to a large extent used to re-qualify the unemployed for unemployment benefits. Programmes may also have kept the unemployed “happier” than would otherwise have been the case: survey results indicate that the experienced welfare of programme participants was significantly higher than the experienced welfare of openly unemployed (Korpi, 1997).

Lessons to learn from the experiences of Sweden and other countries

A first lesson to learn from the Swedish experience has to do with the scale of programmes. With such large programme volumes as undertaken in Sweden, huge inefficiencies are bound to arise. Especially

⁶ See Fredriksson and Johansson (2003) in addition to the studies surveyed in Calmfors et al. (2001, 2004).

training and practice schemes tend to become of low quality.⁷ The same happens with various schemes of public job creation and subsidised private-sector employment if one tries to regulate them in such a way that they only encompass “tasks that would not otherwise have been carried out”, which one is in effect forced to do with large volumes in order to reduce crowding-out effects.

Equally serious – but often not realised – is that large placements in long-duration programmes of the Swedish type have very negative effects on the core matching activities of the public employment services. The task of matching unemployed and vacancies in as efficient a way as possible is to a large extent crowded out by the administration of large programme placements.

The obvious conclusion is that programme placements should be carefully targeted. This will automatically reduce programme volumes and increase efficiency. If one can target subsidised employment programmes on those that are, or run the largest risks of becoming, long-term unemployed, displacement of ordinary jobs is much less of a problem: to the extent that such displacement is the result of increased competition for jobs for “insiders” in the labour market from “outsiders” supported by labour market policies, there will be downward pressure on wages that generates a net employment creation effect.

At the same time, there are limits to the extent to which programmes should be targeted. The reason is the risk of “stigmatisation”: if programme participation is reserved only for those with the largest difficulties in the labour market, programme participation may come to serve as a negative screening device for employers. So there is a delicate balance between targeting too little and targeting too much.

One conclusion that has been drawn in Sweden, and many other countries, is that the focus of active labour market policy should shift from placement in various training and subsidised employment programmes of long duration to *activation measures* designed to directly improve the matching process.

⁷ It is interesting to note that the labour market outcomes for participants in training programmes appear to be considerably more favourable in the new EU states than in the old, according to a number of studies (Leetmaa and Vörk, 2003). A possible explanation is that the programmes in the new EU states have been of very limited size. It also appears that training programmes in the U.S., which have also been much smaller than the Swedish programmes, show more favourable results, even though they are not better than those for programmes of subsidised employment (Blank, 2003).

Such measures include intensified counselling, more frequent contacts between employment offices and job seekers, higher demands on job-search activity, individual action plans for the unemployed, tougher requirements on which jobs to accept, more benefit sanctions when job offers are not accepted, and “workfare” requirements for receiving long-term income support instead of passive benefits.

Several countries have moved in this direction; for example, Australia, Denmark, Ireland, the UK, the Netherlands, and Sweden. Changes of this type are also part of the German reforms.⁸ According to studies, such measures can increase outflow rates from unemployment substantially (say in the range of 15 to 30 percent).⁹ This has led to quite some optimism on what can be achieved through activation policies.

Although I share this judgement to some extent, one should, however, also be aware of the risk that the positive effects may be overrated. This seems to be a risk that active labour market policy is constantly exposed to.¹⁰ Improved matching can increase unemployment in two ways. First, labour demand increases if hiring costs of employers fall. Second, there is less wage pressure to the extent that employers can fill their vacancies more quickly. But it is difficult to believe that any of these effects is large in a situation with very high unemployment. As vacancies then tend to be filled quickly anyway, both employers’ hiring costs and wage pressure are already low.

To the extent that activation has been limited to particular groups, better labour market outcomes for these groups have probably come at the expense of other groups, so that one cannot generalise the results to the whole labour market. And where activation measures have been claimed to have positive aggregate effects – such as in Denmark, Ireland, the Netherlands, and the UK – it has often been difficult to disentangle these effects from the effects of other institutional changes in the labour market (Grubb and Martin, 2001).

A general problem is that successful activation policies are quite resource-demanding on the part of the labour market administration. This problem is, of course, most serious when unemployment is high.

⁸ See e.g. EEAG (2003, 2004).

⁹ See e.g. Grubb and Martin (2001).

¹⁰ See e.g. Calmfors (1995) and Saint-Paul (1996).

Indeed, *multiple equilibria* are likely to exist. If unemployment is low, as it was in Sweden in the 1970s and the 1980s, close monitoring of the unemployed can help maintain such an equilibrium. But when unemployment is high, close monitoring is no longer possible. In such a situation, monitoring efforts also often tend to focus on formal search methods, like the number of written job applications, rather than on more informal and probably more efficient methods. Also, in high-unemployment situations, caseworkers may shun applying sanctions against unemployed with low search intensity if the sanctions are regarded as too harsh.

My overall conclusion is that we cannot expect too much from active labour market policy. It is probably most effective as a complement to other measures. Activation measures are likely to work best when vacancies increase and unemployment is falling anyway. Activation efforts can reinforce such a process. This may be what happened in countries like Denmark, Ireland, the Netherlands, Sweden, and the UK in the 1990s (Grubb and Martin, 2001).

At the same time, it is clear that the efficiency of active labour market policies and activation measures can be raised in various ways:

- Proper evaluations of various programmes are crucial. This is so not least because active labour market policy is one of the areas with the highest turnover of policies: new programmes are invented all the time and old ones are constantly being disguised under new names.¹¹ This process usually takes place based on far too little evaluation. This is a strong argument for institutionalising evaluation procedures, for example, by setting up an independent national evaluation body that can accumulate both institutional knowledge about policies and apply academic evaluation techniques. This was done in Sweden in the late 1990s when the Office for Labour Market Policy Evaluation (IFAU) was established: the office has produced a number of qualified evaluation studies, which have been quite important in influencing policies.
- Statistical methods for the ex-post evaluation of programmes can also be used to obtain better ex-ante criteria for programme selection for individuals. These methods can be used either for predicting at an early stage which individuals run the

greatest risk of becoming long-term unemployed (profiling) or for estimating which programmes are likely to give the largest improvement in future labour market outcomes per resources invested for a given individual (targeting).¹²

- It is very important to avoid confusing various objectives of labour market programmes. A certain recipe for bad results is to confound objectives of income support and activation. The Swedish experience is that when the same programmes are used both to provide income support and to activate the unemployed, the former objective has a strong tendency to take over and weaken the incentives for using the programmes in an efficient way for enhancing the future employment prospects of participants.¹³ This is a strong argument for keeping activation and “workfare” programmes apart.
- There may also be a lot to be gained from introducing more incentive schemes (incentive pay linked to performance) in the public employment service and to open it up for competition, or at least “quasi-competition”, among different providers of employment services (job brokering, activation measures, training etc.). Australia provides an interesting example of how this can be done (Grubb and Martin, 2001), but overall it is very hard to assess the potential gains from such a system without much more experimenting. It is clear though that any such system must be backed up by solid evaluations, so as to counter any incentives for employment officers to select programme participants from groups with very favourable employment prospects from the start in order to show good results.¹⁴

General knowledge of labour market reforms

Even if efficiency can be increased substantially, active labour market policies and activation measures can only be one ingredient of many in a successful employment policy. It may even be very harmful to expect too much of active labour market policies, because too much of a focus on them may weaken the incentives to pursue other policies. There is always a risk that active labour market policies are

¹¹ See e.g. Calmfors (1995), Saint-Paul (1996), and Calmfors et al. (2001, 2004).

¹² See e.g. Fröhlich et al. (2003).

¹³ See Calmfors et al. (2001, 2004) and Forslund et al. (2004).

¹⁴ For example, in Sweden it has been found that training programmes with a high degree of goal achievement in terms of subsequent employment have a lower share of participants with unfavourable labour market characteristics than other programmes: there are lower shares of immigrants, low-educated, long-term unemployed etc. (Martinsson and Lundin, 2003).

used as an excuse for not taking other more efficient – but politically also more controversial – policy action.

The consistent lesson from the large research literature trying to explain differences in unemployment both across OECD countries and over time within them is that there are a number of important determinants of structural unemployment (besides active labour market policy): these include unemployment benefit levels, the duration of benefits, the requirements for obtaining benefits, the way wage setting occurs (which is determined by such factors as the degree of unionisation, the coverage of collective bargaining, and the extent of co-ordination in collective bargaining), and possibly also tax levels and the degree of employment protection.¹⁵

In general, we seem to have good knowledge of which factors work in which direction, but rather insufficient knowledge about the magnitude of the exact effects of individual factors. There is, however, a general presumption that the more factors (“labour market institutions”) are changed in an employment-friendly direction, the greater is the chance that unemployment is reduced. This has recently been illustrated by Nickell (2003), who showed that there is indeed quite some correlation across the OECD countries between the (net) number of labour market institutions changed in an employment-friendly direction and reductions in unemployment between the 1980s and the late 1990s: with an excess of employment-friendly movements in countries that succeeded in reducing their unemployment rates substantially, such as the Netherlands, Ireland, Denmark, and the UK, but with little change or an excess of employment-hostile movements in less successful countries like France, Italy, and Germany.

German labour market reforms

Against the background of the above discussion, how should one look upon the current labour market reforms in Germany? These are my reactions as an outsider to the German debate.

As to active labour market policy and activation measures, the attempts to move in the Scandinavian

direction by increasing the efficiency of the employment services through various reforms are steps in the right direction. However, in view of the very limited success of, for example, Swedish active labour market policy, one should not expect very large effects from these measures alone. To put it rudely and only with a slight exaggeration, Germany may be moving from *very bad* active labour market policies to *bad* such policies. If so, it is an improvement, but not a very impressive one.

The limitations of active labour market policies and activation measures imply that much greater reliance must be put on other labour market reforms. According to both microeconomic studies of the unemployment spells of individuals and macroeconomic studies of aggregate unemployment, the generosity of unemployment benefits is a crucial determinant of unemployment. Against this background, it is difficult to avoid the conclusion that if labour market reforms are to achieve a significant reduction in unemployment, they must involve substantial reforms of unemployment benefits. Such reforms are now being implemented in Germany, involving a reduction in the duration of unemployment insurance benefits for elderly workers and some reductions in the level of unemployment assistance benefits for long-term unemployed (with unemployment assistance being merged with social assistance).¹⁶ But the changes are rather limited and may not be enough to have a major impact on unemployment.

If reductions in benefit generosity are to make a maximum contribution to employment generation, they must be translated into lower real wage costs as efficiently as possible. It is therefore a step in the right direction that the unemployed may now have to accept jobs that pay less than the jobs they had before. But the current stipulation that unemployed workers are not required to take jobs at wages below the prevailing ones in the local market means in effect a support for collectively bargained wage levels, which reduces pay flexibility. For this reason, it is

¹⁵ Recent such studies are Nickell and Layard (1999), Blanchard and Wolfers (2000), Belot and van Ours (2001), and Nickell et al. (2003). See also EEAG (2004, Ch. 3) for a more complete list of relevant studies.

¹⁶ Unemployment insurance benefits (*Arbeitslosengeld I*) are 67 percent of the previous net income after tax (for an unemployed with at least one child). Before 2003, the duration of benefits was up to 32 months for those older than 44. From 2003, the maximum duration is 12 months except for those older than 55, for whom it is 18 months. Earlier, unemployment assistance benefits (*Arbeitslosenhilfe*) was 57 percent of the earlier net wage for unemployed with at least one child. Unemployment assistance for new recipients is as of 2005 decoupled from the previous income and aligned with social assistance (*Arbeitslosengeld II*), which in most cases means some reduction. Social assistance levels are not, however, reduced. See e.g. EEAG (2003, 2004) for brief accounts of the reforms. More detailed accounts are given in e.g. Collier (2004) and Siebert (2004).

important that the plans to remove this stipulation for the long-term unemployed next year are indeed carried through.

If labour market reforms are to succeed in reducing real wage levels, it is also necessary for the pay-setting system to be responsive enough. Existing research does suggest that the present pay-setting system in Germany, with a high coverage of collective agreements and where the main locus of collective bargaining is the sectoral level, is not conducive to real wage moderation and relative wage flexibility (EEAG, 2004: Ch. 3). Instead, it appears that the systems most conducive to low unemployment are either those with a high degree of co-ordination of wage bargaining at the national level (producing very substantial aggregate wage moderation) – like in Ireland, the Netherlands, and Sweden – or those with very decentralised bargaining at the level of the firm and low coverage of collective agreements (producing a combination of aggregate wage moderation and substantial wage differentials among skill groups) – as in the U.S., the UK and most of the new EU member states.

Highly co-ordinated wage bargaining at the national level in order to achieve real wage moderation does not seem to be a feasible option for Germany. Nor is such a system likely to achieve larger relative wage flexibility, for which there is a great need in Germany in view of the compressed wage structure and the concentration of unemployment among the low-skilled and in east Germany.¹⁷ More decentralisation of pay setting to the level of the firm would seem necessary in order to create larger possibilities to adjust wages to the local employment situation. This could be achieved through more liberal opening clauses in sectoral collective agreements and possibly, as has occurred in Sweden, also through collective agreements that leave the determination of the margin for wage increases entirely to the local level (EEAG, 2004: Ch. 3).

There is also great merit in moving towards the Anglo-Saxon approach of restrictive unemployment benefits combined with generous tax credits for income from employment for low-wage earners. Such a shift provides social protection at the same time as it strengthens the incentives for employment and facilitates a downward adjustment of real wage levels. This can be done through general employ-

ment income tax rebates for all low-wage earners as in the U.S. (*Earned Income Tax Credit*) and the UK (*Working Family Tax Credit*).¹⁸ Alternatively, such tax rebates can be limited to the long-term unemployed or earlier welfare recipients (similar to what was tried with the *Self-Sufficiency Project* in Canada).¹⁹ An advantage of employment income tax rebates as compared with employment subsidies to employers within the framework of traditional active labour market policy is that the employment support can be given directly to the targeted group without involvement of the employer. As a consequence, the risk of “stigmatisation” is much smaller than when employers are induced to hire long-term unemployed with extra wage subsidies that identify the unemployed as problem cases.

An “internal devaluation”

Finally, one must not forget about demand policies. Because nominal wage levels are sticky downwards (it is even difficult to reduce annual nominal wage *growth* below 1 to 2 percent), it will take time for any labour market reforms that put downward pressure on real wage levels to produce results in a situation with low product demand and low inflation. This is a strong argument for speeding up the adjustment process through policies increasing aggregate demand. Without EMU, such a demand increase would in all likelihood have been achieved through a devaluation of the D-mark relative to the other European currencies and a more expansionary monetary policy in Germany than in the rest of Europe. Or put differently, the real exchange rate depreciation (relative price reduction for German products) necessary for creating the demand to match the increase in equilibrium output associated with labour market reforms would have been achieved through a nominal currency devaluation.

With EMU, there is no longer any D-mark to devalue. Then there is only one option left to achieve a fast reduction of real labour costs and a real exchange rate depreciation boosting Germany's international competitiveness. That is a radical cut in payroll taxes (social security contributions) paid by employers (say by 10 percentage points). If such a

¹⁷ See e.g. the German Council of Economic Experts (2002), EEAG (2004, Ch. 3) or Siebert (2004).

¹⁸ See Ochel (2001) or Blank (2003) for discussions of the US system. Sinn et al. (2003) develop such a proposal for Germany.

¹⁹ See e.g. Lyndon and Walker (2004). Germany has taken a small step in this direction by allowing recipients of *Arbeitslosengeld II* to retain a fraction of the unemployment assistance benefit (15 to 30 percent) if they find a market job (see Siebert, 2004).

tax cut is not to increase the budget deficit, it must be fully financed. To the extent that this cannot be done through reductions in government expenditures, taxes paid by employees would have to be raised. This could be the VAT, social security contributions paid by employees or income taxes. Such a tax shift – or *internal devaluation* as it is sometimes labelled – is a policy measure that has been used in the Nordic countries as a substitute for nominal exchange rate devaluations.²⁰

The point of an internal devaluation is to achieve the same adjustment of the real labour cost and the real exchange rate as with a nominal exchange rate devaluation in a situation with an own currency. The theory is that the equilibrium real labour cost (and real exchange rate) is determined by the fundamental labour market institutions, but that a rapid adjustment to the equilibrium levels is prevented by downward money wage rigidity. Just as nominal exchange rate devaluation can speed up adjustment to equilibrium in such a situation, so could a tax shift from employers to employees. Under some assumptions, the effects of such a tax shift and a nominal exchange rate devaluation are equivalent.²¹

Concluding remarks

As an outsider, I am surprised that the option of speeding up real wage adjustments and boosting aggregate demand through an internal devaluation does not seem to have played any role in the German economic-policy discussion. To me, such a tax shift would seem an obvious complement to labour market reforms. As far as I can judge, such reforms need to go much further than they have done so far, involving more substantial cuts in unemployment benefits, reforms of the pay-setting system, and an introduction of generous employment income tax credits. A two-handed approach, combining demand policy with thorough labour market reforms, seems to be required to lift Germany out of its present stagnation. In such a policy package, there is a place for active labour market policy and activation measures for the unemployed. But experiences from other countries, especially Sweden, suggest that such policies can only play a limited role. They can be a complement – but not more – to other policy measures.

²⁰ See, for example, Calmfors et al. (1997), Calmfors (2003a,b), or EEAG (2003).

²¹ The argument is elaborated in Calmfors (1993) and Calmfors (1998).

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CESIFO INTERNATIONAL SPRING CONFERENCE

“PROSPECTS FOR THE EUROPEAN ECONOMY”

AT THE BRITISH EMBASSY, BERLIN

ON 18–19 MARCH 2004

Hans-Werner Sinn, President of the Ifo Institute for Economic Research, gave an introductory presentation on the global economic situation.

John Lewellyn, Lehman Brothers, New York, gave his view on the “Outlook and Major Issues in the Global Economy.” He saw positive cyclical forces in all three principal regions – the U.S., Europe and Asia. The likely outcome is that the US economy, still the world engine, will progress at only a trend-line pace. On that basis, the euro area and Japan will pick up only moderately, so that the world output gap, the largest in ten years, will steady or narrow, but not close. Since output gaps are unlikely to narrow markedly in 2004, wage pressure will remain muted and pricing power subdued. Only China seems to be seeing an increase in goods and services inflation. Some commodity prices have been spiking. In terms of SDR, the CRB index of commodity prices (which does not include oil) has risen by some 15 percent over the past two years, suggesting a buoyant world recovery, but not an inflationary boom.

There is a caveat in this, however. This recovery starts with unusually large sectoral imbalances, both within economies (principally the U.S.) and between economies (principally between the U.S. and the rest of the world). The US private sector has not reduced its deficit, and the US government started the recovery with a huge deficit. This means that the U.S. had a record counterpart current account deficit – minus 5 percent of GDP – at the start of this recovery. As a consequence, the dollar has been on a downward trend since mid-2002. A further fall in the dollar is projected to 1.35 euros and 100 yen by the end of 2004. In the medium term he considers the downside risk to be greater than other analysts.

Jim O’Neill, Goldman Sachs, New York, followed this up with his own comments on “US deficits and exchange rates.” He discussed the underlying problems facing the dollar, in particular the twin deficit problem posed by the current account and fiscal imbalances. He emphasized the greater complexity of the problem today compared to similar challenges in the 1980s, as the U.S. now has a more diverse set

of important trading partners, including developing countries, especially in Asia. The large current account deficit is more sustainable today than in the 1980s. He considers the dollar not significantly over-valued, as the dollar equilibrium has risen due to gains in US productivity. Still, the dollar needs to decline further.

Torbjörn Fredriksson, UNCTAD, Geneva, spoke on “FDI in emerging economies: The role of corporate strategies.” In recent years, the share of global FDI going to emerging economies has increased. However, the patterns of investment differ considerably between countries and regions. Based on an analysis of recent shifts in international trade and FDI, he identified locations that have been especially successful in attracting efficiency-seeking, export-oriented FDI. In particular, selected countries in East Asia, Central and Eastern Europe as well as in Latin America emerge in the winner group – but the nature of their gains differs. Whereas East Asian economies, and especially China, are developing global supply capacity, selected countries in Central and Eastern Europe and in Latin America have become regional supply bases. Corporate restructuring – in response to changes in policy, technology and increased competition – is instrumental in shaping a new geography of international production, which increasingly involves the internationalization not only of manufacturing but services too. Understanding the driving forces behind the current restructuring is key to designing and implementing adequate policy responses.

Willem H. Buiter of the European Bank for Reconstruction and Development (EBRD), London, also took up the issue of FDI in the context of Central and Eastern Europe. In his presentation on “Central and Eastern Europe – Patterns of investment and FDI”, he discussed the above-average growth performance of the region but also the significant remaining risks – global as well as national such as fiscal pressures, stabilisation and institution building challenges. Better business environments and expanding markets are attracting more capital, especially in the form of private flows. Most inflows are

FDI into the more advanced reform countries. In conclusion, he referred to the reform benefits being reaped by the transition economies (greater stability and growth; better balance between risk/return for investors; increased access to private international capital), but also mentioned the remaining challenges, especially those of intensified competition and fiscal pressures as a result of accession to the EU.

Sonja Opper, an economics professor of the University of Tübingen, gave a presentation on “Inward investment and Chinese financial markets: The impact on Asia”. She started out by stating that China’s economic role in the Asian and global economy has changed dramatically during the last decade. Particularly China’s ongoing integration into the world’s financial system is entailing a huge reallocation of financial assets across Asia. China not only receives the largest part of the world’s FDI, it is meanwhile also home of one of the largest stock trading locations in Asia, likely to surpass the Tokyo market by 2010. There is a host of systemic risks in China’s financial market, however. They may be subsumed under the headings of regulatory issues, property rights, accounting standards, and company liabilities.

She sees a trend of increasing confidence in Chinese stocks, with great interest in recent IPOs. The new confidence of investors is not backed up by a maturing institutional environment, however, and an increasing amount of financial assets is redistributed from direct control (FDI) to portfolio investment in a politicised market. She therefore warns of the risk of a new bubble and financial instability as a result of China’s politicised capitalism.

Karl F. Cordewener, Deputy Secretary General of the Basel Committee on Banking Supervision, opened the second day of the conference with a presentation on “Rating under the New Basel Capital Accord – Opportunities and Challenges”. In June 1999, the Committee issued its first proposal for a new Capital Adequacy Framework (Basel II) to replace the 1988 accord (Basel I). Based on the results of public consultations, the Committee issued two subsequent revisions to the proposals. Karl Cordewener outlined the basic framework of the New Accord and provided an update on its time schedule. He focused on the New Accord’s first pillar, the minimum capital requirements (the other two pillars being the supervisory review of a bank’s

internal assessment process and market discipline) and discussed external ratings in the context of the standardised approach and the use of banks’ internal ratings under the internal ratings-based approach. He highlighted the advantages of a framework that is more risk sensitive but also discussed its challenges.

Jochen Flach of the Deutsche Bundesbank gave a German view of Basel II. He represents the German central bank in the working groups on credit risk mitigation techniques of the Basel Committee and the European Commission. He focused on the “Impact of Basel II on corporate loans”. Under Basel II, banks will be allowed for the first time to use (external or internal) ratings to calculate supervisory capital requirements. Whereas some German banks intend to use the Standardised Approach that is based on external credit assessments, a large number of banks plan to apply the Internal Ratings-based Approach and have therefore begun to develop new internal rating models or to refine their existing methods to be used in an objective and standardised internal rating process. He gave an overview on the activities of the German banking industry with regard to the implementation of the Internal Ratings-based Approach under Basel II and discussed possible effects of the new rules on the capital requirements for SME loans.

Dieter Glüder, of the German Kreditanstalt für Wiederaufbau (KfW), was the third speaker on the topic of Basel II with a banker’s view. The envisaged new Basel accord will more closely align management practice and economic capital requirements in banks with regulatory requirements. The result of this and the different treatment of banks in the basic three approaches (Standard, IRB Standard, IRB Advanced) is a huge potential reallocation of capital among banks. This trend is already visible. Smaller banks in advanced countries are confronted with burdensome investments to fulfill regulatory requirements, which may result in increased merger activity. Besides the impact on the banking industry, there will also be an impact on banking products (more retail business and repriced loans to SMEs) and on the business cycle (less credit supply in recessions).

The afternoon session of the second conference day was devoted to analyses of major branches of European industry.

Simon Hallam of Cambridge Econometrics gave an overview of European manufacturing industries under the title “European Manufacturing Prospects”. Although financial and business services are expected to benefit more than other sectors of the European economy from the global recovery, manufacturing should also begin to recover during 2004. The strongest growth is expected in electronics (3.6 percent), although the rate of growth is likely to be well below that of the mid-to-late 1990s. Roll-out of new technology should restore rapid output growth in “new economy” sectors (3G mobile telephony, broadband and digital broadcasting). Strong growth is also expected in pharmaceuticals (3.5 percent) which are less sensitive to cyclical fluctuations. Producers of motor vehicles (2.75 percent) will await the next upturn in export markets. Machinery and equipment, electrical goods, other transport equipment will have low growth rates of 1.5 percent or less in 2004–05. Growth will be especially weak in textiles, clothing and footwear with more relocation of production to lower-cost non-European nations.

Vittorio Maglia is chief economist of Federchimica, the Italian Federation of the Chemical Industry. The European chemical industry plays a major role in European manufacturing. With sales of over €500 billion and a share of 32 percent, it is the world’s biggest chemical industry. Its output covers a wide range of products, and it generates large and increasing trade surpluses. In the last three years, the chemical industry in all the advanced countries has stagnated, but there has been strong growth in emerging countries, especially in Asia and China. There the market has proved stronger due to impressive growth in infrastructure and many traditional sectors which are extremely material, thus having high chemical content.

Chemical output in Europe (and the U.S.) will thus grow much less than in the Far East, probably at 2 percent in 2004 and 2.7 percent in 2005. This compares with 7.7 percent and 6.7 percent respectively in the Far East. Prices will rise strongly due to high oil prices, strong demand in Asia, and high US gas prices.

Ralph Wiechers, chief economist of the German Engineering Association (VDMA), discussed the outlook for the European mechanical engineering industry. Since end-users of capital goods are cycle sensitive, the engineering industry is doubly cycle sensitive. The level of investment and the euro

directly impact on the prospects of the industry. The European mechanical engineering industry is the biggest producer of machinery in the world and holds a 43 percent share in world machinery trade. Following a 2 percent decline in output in 2003, growth in 2004 is expected to come in at also 2 percent. This compares to 4 percent in Japan and 1 percent in the U.S.

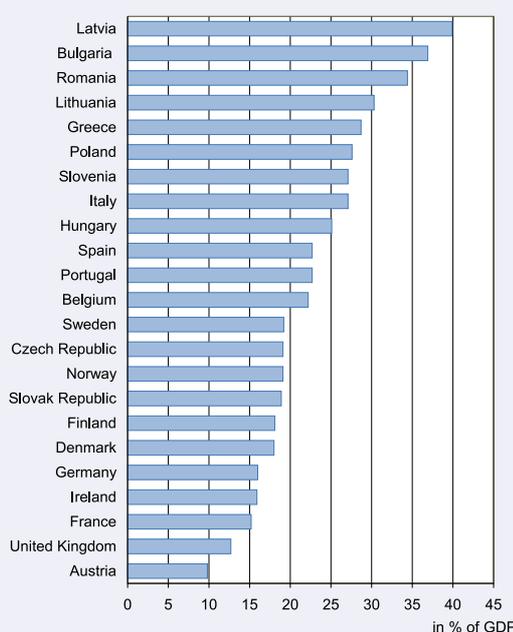
Paul Nieuwenhuis is Assistant Director of the Centre for Automotive Industry Research (CAIR) at Cardiff University. His presentation on the automotive industry started with identifying a number of underlying trends coming to prominence in the next ten years that could dramatically affect the future of the world automotive sector. Among these is the chronic and structural lack of profitability as a result of some fundamental technology choices made decades ago. He discussed the emergence of new technologies, new and unfamiliar to car makers, as well as the increasing challenge of meeting the sustainability agenda, particularly the agreement on CO₂ emissions and the ELV directive. As a result, there will be more downsizing meaning lower margins. Cars will become smaller, lighter, cleaner, more electronics intensive and more expensive, but also more tailored to customer needs.

ACCESSION COUNTRIES IN THE SHADOWS

The subject of the shadow or informal economy is still quite controversial; there are disagreements on the definition, the estimation methods and policy aspects. There is agreement, however, on the importance of the shadow economy for tax revenue and social security contributions collected and other effects on the official economy. Unfortunately, it is very difficult to get accurate information on the size of the shadow economy, as the actors involved are not eager to discuss their illegal or unreported activities. In a recent paper, F. Schneider and R. Klinglmaier (February 2004) presented estimates on the size of the shadow economy in 110 countries. According to their findings, the shadow economy represents a greater share of total output in poor countries, but it exists in rich places too. And it is growing.

In several EU accession countries the shadow economy is much larger than in Western Europe. This is not surprising, considering the difficult times faced by many people after the breakdown of their Communist regimes. Many who had worked in the run-down state-owned enterprises became unemployed with no new jobs in sight. The lack of social security benefits left only the way into the shadow economy.

SIZE OF THE SHADOW ECONOMY 1999/2000



Source: Schneider/Klinglmaier 2004.

Still, big differences exist between the accession countries in this respect too. Whereas the shadow economies in the Czech and Slovak Republics amounted to only 19 percent of GDP in 1999/2000 and thus less than in Italy or Greece, it was 40 percent in Latvia.

There is little mystery about why the shadow economy exists. Besides the special problems of the people between Riga and Sofia, there are a lot of advantages to operating in the shadows. Avoiding income and value added taxes as well as social security contributions, which often drive a big wedge between take-home pay and employers' wage bills, cuts labour costs and leaves more in the pay packets. People can also save costs by ignoring safety, environmental and health rules, not to mention intellectual property rights. Thus taxes, especially the marginal tax rate, and the density of regulation are the major driving factors.

While operating in the shadow economy has advantages for the individual employee or firm, it has big disadvantages for the economy as a whole.

By leading to reduced tax revenues, growth in the shadow economy reduces the quantity and quality of public goods and services. Ultimately this can result in an increase of tax rates for firms and individuals in the official economy. And a large shadow economy also has the price of leading to much lower productivity (McKinsey Quarterly 2004, no. 3). Informal firms tend to be small lest they come to the attention of the authorities. However, their small scale limits their ability to make use of new technology and business practices.

Those countries will have smaller shadow economies that have higher tax revenues achieved at lower tax rates, fewer laws and regulations and less bribery and corruption.

Transition countries have higher levels of regulation leading to a significantly higher incidence of bribery; they have higher effective tax rates and a large discretionary framework of regulation and hence a larger shadow economy. Broadening the tax base, cutting rates and improving enforcement would help.

H.C.S.

LABOUR UNIONS : FAILING TO COPE WITH STRUCTURAL CHANGE

Globalisation, structural change, individualism as well as new information and communication technologies have fundamentally changed the environment for labour unions. Teleworkers, part-timers and service workers in general are not as easily unionised as were the coal miners or steel workers. Are labour unions doomed to go the way of the dinosaur? Union membership is declining almost everywhere, their influence is waning. In many countries, unions are organising more retirees and unemployed than active workers.

The degree of unionisation (union membership as a percentage of the total labour force) has declined in many countries. It has halved, since the 1960s, in Germany to 29.1 percent, in France to 10.5 percent, in the United States to 14.8 percent and in the Netherlands to 24.5 percent (see Hagen Lesch, "Gewerkschaftlicher Organisationsgrad im internationalen Vergleich," *iw-trends* 2/2004).

Not everywhere is the situation so dismal. In several countries the degree of unionisation has even increased, so in Sweden from 66.4 percent to 85.9 percent, in Finland from 40 percent to 77.2 percent, in Denmark from 61.3 percent to 76.6 percent, in Belgium from 40.6 percent to 53.1 percent, and in

Canada from 27 percent to 31.8 percent. These countries have been able to induce women, white collar workers and part-timers to join the classic male blue-collar union members.

But structural change has hit all countries. Since the 1970s, the share of industry employees in total employment has declined, by 15 percentage points in Switzerland, by nearly 12 percentage points in France and the Netherlands, by 9 percentage points in Germany and 3 percentage points in Japan. And to almost the same extent did union membership decline. Resistant to structural change were only the so-called Gent countries: Belgium, Denmark, Finland, Norway and Sweden. In these countries unionisation increased despite the general decline in the share of industry. There are two reasons:

- *Institutional factors.* Whereas in most OECD countries unemployment insurance was introduced before World War II, a group of countries left this to the labour unions. Denmark, Finland and Sweden have maintained this to this very day. Belgium, where in 1901 the first voluntary, union organised unemployment insurance had been introduced (hence the Gent countries), has a mixed system. Membership is mandatory, but unions are involved in the organisation.

Unemployment insurance induces people to join a labour union. Firstly, unions can make eligibility for unemployment compensation difficult for non-members. And secondly, unions decide about reasonableness criteria, i.e. which jobs an unemployed person may reject without losing his claim to unemployment compensation. Thus it makes sense to combine voluntary unemployment insurance with union membership.

- *Service workers.* In the Gent countries, the unions have found strong support in the service sector. Thus in Sweden three out of four full-time employees in the service sector are unionised; in Norway the figure is still 60 percent. In Germany, in contrast, only 10 percent of the employees of such classic service industries like commerce or banking are unionised. The strong standing of the unions in the Scandinavian service industry may be due to the fact that white collar workers are increasingly interested in the unemployment insurance that is organised by the unions. Thus in Scandinavia, an above average share of women and part-time workers is unionised. At 86 percent, net unionisation of women in Sweden is even higher than that of men at 79 percent. In comparison, in Germany the figures are 18 and 31 percent respectively. And whereas, at 70 percent, as many part-time workers are unionised as men in Sweden, in Germany, less than 10 percent of part-timers have a union card.

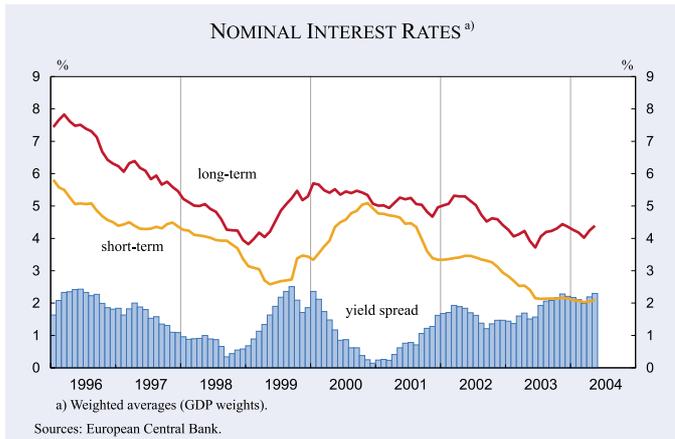
H.C.S.

BUT UNIONISATION INCREASES
IN THE GENT COUNTRIES
Change from 1971-1980 to 1991-2000

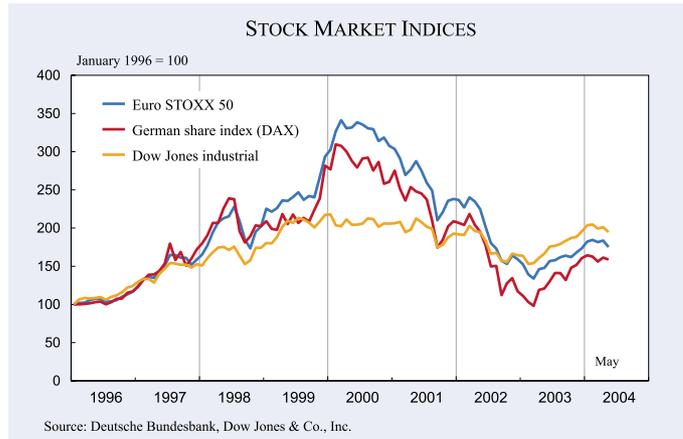


Source: Cologne Institute of Business Research.

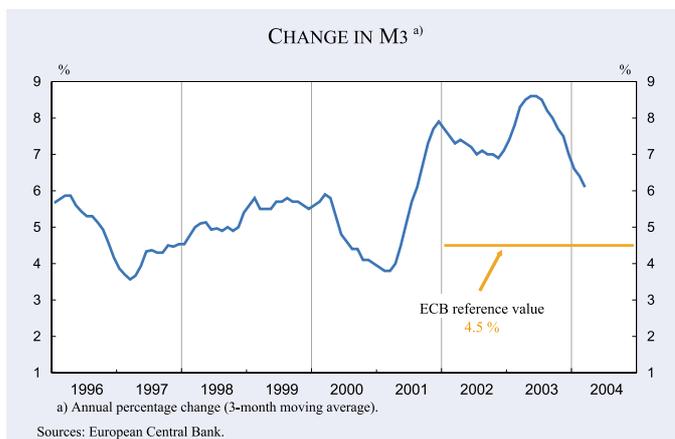
FINANCIAL CONDITIONS IN THE EURO AREA



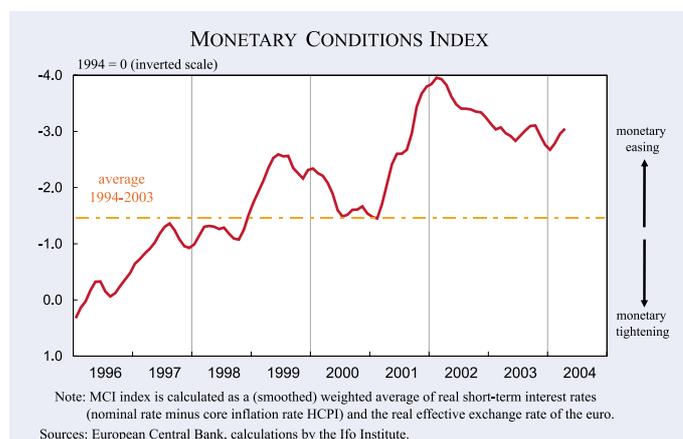
The European Central Bank has left its key interest rates unchanged. The rate on main refinancing operations has stood at 2% since early June 2003. Ten-year government bond yields, however, did turn up again after their all-time low of 4.02% in March, averaging 4.39% in May. The yield spread thus widened.



The stock markets, which had recovered until February 2004, have moved sideways since then. The broad Euro STOXX index lost a bit more in May than the Dow Jones Industrial and the German DAX.

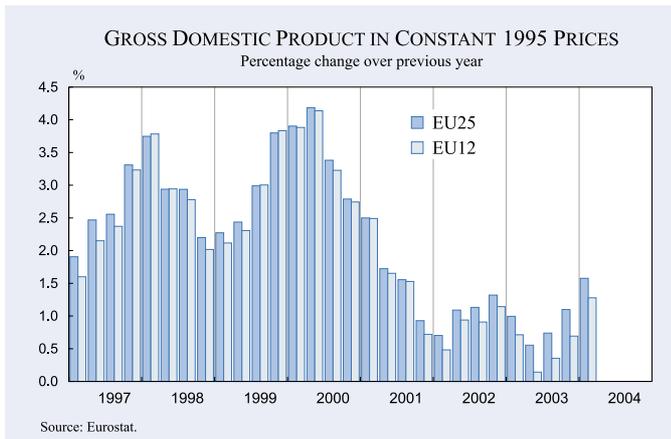


The annual rate of growth of the broad monetary aggregate M3 continued its downward trend, reflecting an ongoing normalisation of portfolio behaviour of money holders, involving a cautious shift towards long-term financial assets. The annual rate of growth of M3 declined to 5.6% in April, pushing the three-month moving average down to 6.1% for the period February – April 2004 from 6.4% in the period January – March 2004.

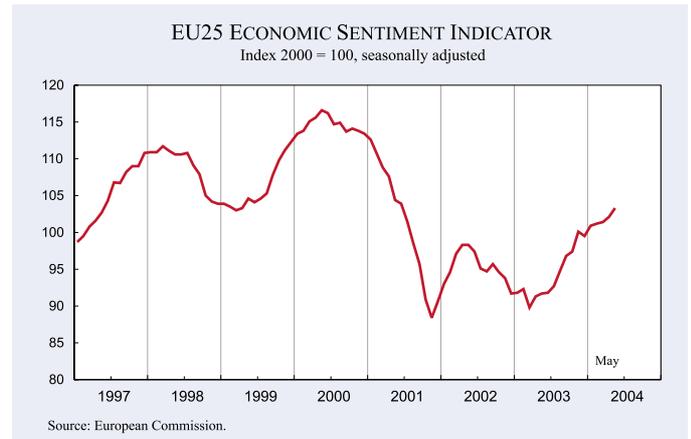


The monetary conditions index continued the upward trend established at the beginning of the year, indicating further monetary easing. A slight decline of real interest rates and a rise in the real effective exchange rate of the euro caused this development.

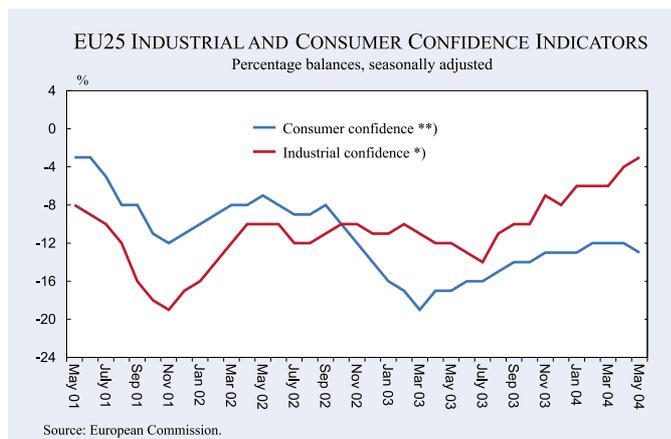
EU SURVEY RESULTS



Euro-zone and EU25 real GDP both grew by 0.6% in the first quarter of 2004, compared to the previous quarter, according to first estimates of Eurostat. Compared to the first quarter of 2003, GDP grew by 1.3% in the euro-zone and by 1.6% in the EU25, after 0.7% and 1.1% respectively in the previous quarter. Private consumption and exports accelerated, whereas investment and imports slowed down.



The economic sentiment indicator for the EU rose by 1.2 points in May, reaching a level of 103.3. This improvement reflects primarily mounting confidence in the industry and services sector, which more than offset a slight dip in consumer sentiment. Economic sentiment improved strongly in the Czech Republic, Estonia, Latvia, Luxembourg, the Netherlands, Portugal, Sweden and the UK, while it dropped noticeably in Denmark, Greece, Ireland, Lithuania, Hungary and the Slovak Republic.

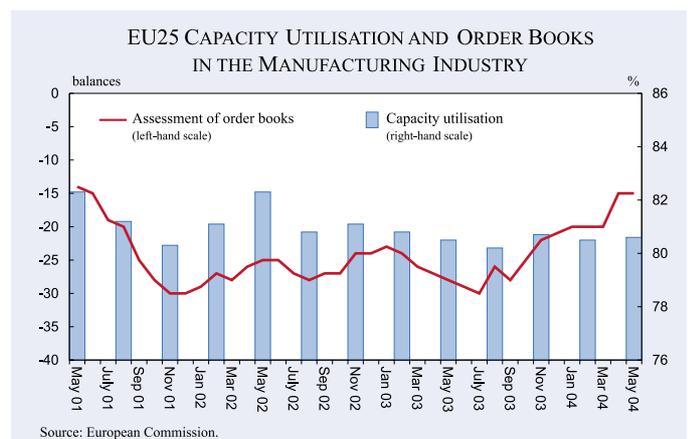


* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).

** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

Industrial confidence in the EU continued its upward trend that had started in mid-2003, increasing by 1 point to a level of -3. Behind the increase was a strong improvement in the assessment of stocks of finished goods. Luxembourg and the UK showed double-digit increases, whereas Hungary saw the most pronounced fall.

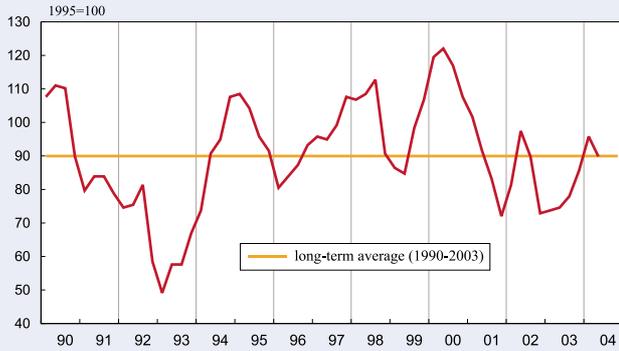
Consumer confidence for the EU dipped slightly to -13 after having remained unchanged at -12 in the previous three months. Large improvements in consumer confidence were recorded in the Czech Republic, Hungary and Poland, whereas Estonia experienced a big drop.



The assessment of order books had improved noticeably in April and remained unchanged in May (as did production expectations). Capacity utilisation increased marginally in the second quarter, from 80.5 to 80.6%.

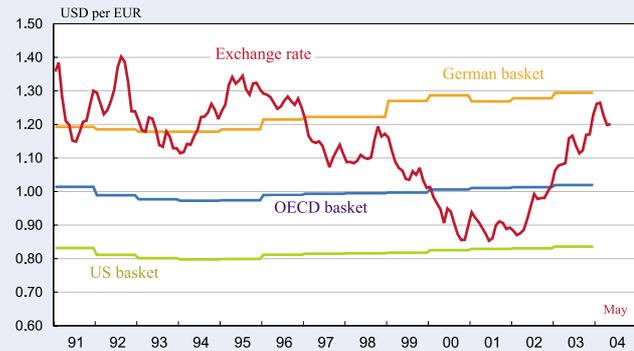
EURO AREA INDICATORS

IFO ECONOMIC CLIMATE FOR THE EURO AREA



The economic climate indicator for the euro area fell slightly in April after having risen five times in succession. Both, the assessments of the current situation and the outlook for the next six months contributed to the worsening. Nevertheless, the experts surveyed expect the economy of the euro area to grow by 1.7% in 2004 after a mere 0.4% in 2003.

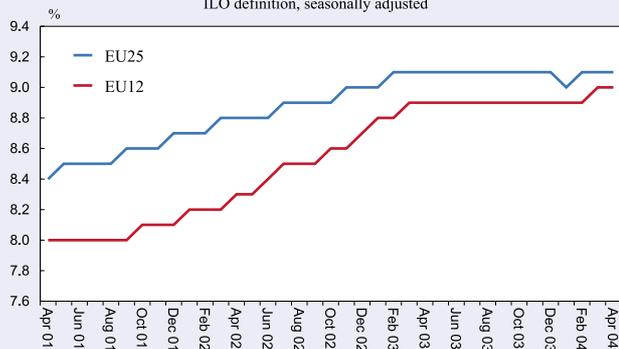
EXCHANGE RATE OF THE EURO AND PPPS



The euro was subject to relatively wide oscillations against the US dollar in May and early June. The euro initially appreciated against the dollar before depreciating rather sharply in the second week of May. In the second half of May and early June, however, following US data releases showing a further widening of the current account deficit in March, the euro more than regained its earlier losses. On 22 June it stood at \$1.22.

UNEMPLOYMENT RATE

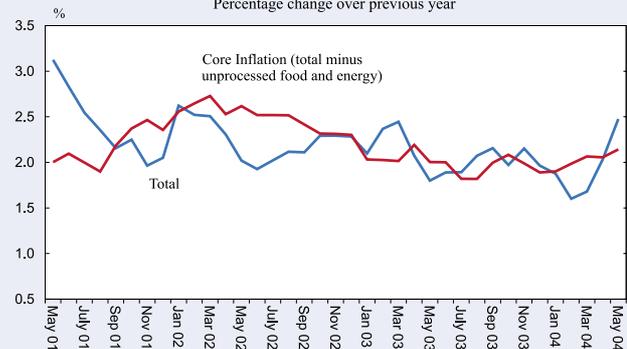
ILO definition, seasonally adjusted



Euro-zone seasonally adjusted unemployment stood at 9% in April 2004, unchanged compared to March. It was 8.9% in April 2003. In April 2004, the lowest rates were registered in Luxembourg (4.2%), Ireland and Austria (4.5%) and the Netherlands (4.7% in March). The unemployment rate was highest in Spain (11.2%), followed by Germany (9.8%), France (9.4%) and Italy (8.5% in January).

INFLATION RATE (HICP)

Percentage change over previous year



The Harmonised Index of Consumer Prices continued to rise in May 2004, to 2.5% from 2% in April. The continued rise in energy prices (prices of processed food remaining roughly stable) meant that core inflation rose only modestly from April to May.

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