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The role of product market regulations in the process of structural change

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Abstract

The sectoral allocation of labor differs considerably across developed economies, even in the presence of similar patterns of structural change. A general equilibrium model that captures the stylized facts of structural change is presented. In this framework, economy-wide product market regulations hinder the development of dynamic sectors such as service industries. This is consistent with the negative cross-country relationship between product market regulations and the service employment share, discussed in the paper. Additionally, the model suggests that higher service prices and rents in regulated economies reduce labor supply, providing a rationale for the negative association between product market regulations and the employment rate previously found in the literature.

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1. Introduction

Service industries have absorbed a continuously increasing share of the labour force during the last century in developed countries, while agricultural activities have

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lost weight dramatically. This process of structural change has led researchers to establish the positive (negative) association between the service (agricultural) employment share and GDP per capita as a stylized fact of modern economic growth.[1] However, remarkable differences in the sectoral distribution of employment can still be observed across countries at a similar stage of development. For instance, some European countries such as Austria, Italy and Germany have service employment shares barely exceeding 60%, 10 percentage points lower than in Australia, Canada and the US. In the light of these differences, it is not surprising then that the lack of dynamism in the service sector in Europe has often been blamed by policy makers as one of the key elements in explaining the poor employment performance vis a vis the US. Similarly, Rogerson (2004a) claims that the fundamental difference between the European and US labour market performance is found in employment rather than unemployment, and this difference is intimately related to the lack of dynamism of the service sector in Europe.

Echevarría (1997) and Kongsamut et al. (2001) develop general equilibrium models consistent with the long-run patterns of structural change. They rely on demand (non-homothetic preferences) and supply (differences in the rate of productivity growth across sectors) forces to explain the long-run patterns in the sectoral allocation of resources. This paper considers these two forces as engines of sectoral reallocation, but focuses on their interaction with product market regulations in explaining persistent cross-country differences in the sectoral structure.

Recent studies focus on the effects of different aspects of product market regulations in labour market outcomes. The stringency of product market regulations and start-up costs appears negatively associated with employment rates (Nicoletti et al., 2001) and entrepreneurial activity (Fonseca et al., 2001). Regarding service industry jobs, Bertrand and Kramarz (2002) found that entry regulation hinders job creation in the French retail sector, and Lopez-García (2003) found that the interaction of macroeconomic shocks with higher start-up costs is associated with lower service employment to population shares across OECD countries.

This paper aims at linking these two branches of literature. It provides a simple general equilibrium model of unbalanced growth that spells out the channels through which product market regulations interact with the forces of structural change determining the sectoral allocation of labour and other labour market outcomes. The main implications of the model regarding service employment are contrasted with the data, examining the determinants of the service employment share across OECD countries.

The model described herein captures the long-term patterns of structural change: (1) an increase (reduction) in the services (agricultural) sectoral employment share along the growth process; (2) a similar pattern with regard to nominal GDP shares; (3) a less marked increase in the real GDP share of the service sector; (4) a decline of the employment rate associated with the secular fall of employment engaged in

[1] Clark (1957) and Kuznets (1966) study the relationship between sectoral structure and economic growth. For a recent review of the empirical regularities in the growth of service employment see OECD (2000).