

# Is the decline of industry due to the growth of services?

By [Sarah Guillou](#)

*On [Friday, April 8 2016](#), the Observatoire Français des Conjonctures Economiques (OFCE) began a series of quarterly seminars on the analysis of France's productive network. The purpose is to bring together researchers and discussion of the situation, the diversity and the heterogeneity of the companies making up France's production system. This discussion is now being fed by the increasing use of business data. We hope in this way to enrich the analysis of the strong and weak points in the country's production fabric, with a view to guiding the development of public policies aimed at strengthening it.* [\[1\]](#)

The first seminar took up the role of services in deindustrialization as measured by the decline of industrial employment as a share of total employment. Since 2000, the manufacturing industry in France has lost more than a quarter of its work force, i.e. more than 900,000 jobs. A recent note by the INSEE ([Insee Première, No 1592](#)) points out that manufacturing's weight in the economy has been halved from 1970 to today. Even though deindustrialization has aroused greater attention in France than elsewhere, probably because of the country's interventionist tradition and the challenges facing its labour market, it is taking place in all the developed economies. This raises questions about underlying structural trends common to all these countries.

However, the decline in industrial employment is being accompanied by net job creation in services. It also appears that the growth of services is being driven in part by changes

in industrial production methods. Products are incorporating an increasingly large component of services, and companies are expanding their portfolio of service products. The fragmentation of production processes – fuelled by the opportunities provided by globalization – is isolating low value-added manufacturing units from high value-added services units.

These changes in production methods need to be analysed to understand the extent of this phenomenon. It seems that the changes occurring within industry are just as much factors driving the decline of industry as the rise of services in employment. In other words, there is a question of how much deindustrialization finds a mirror image in the growth of services, or even its explanation.

Three contributions helped to provide some answers to the following questions: which manufacturers are producing services and with what impact on their performance? What is the role of services in the development of global value chains? Are flows of international services replacing flows of goods? Three main lessons emerge.

## **1 – “Servitization” and the decline in manufacturing jobs are clearly correlated**

Manufactured products are incorporating an increasingly significant amount of services. This can be seen both by the growing share of companies that produce services ([Crozet and Millet, 2015](#)) and export them ([Castor et al., 2016](#)) and by the rising content of services in exports (Miroudot, 2016) [\[2\]](#).

The growth in companies’ value-added “services” may well push all their jobs into the service sector, including what are strictly speaking manufacturing jobs, if the added value of the services becomes dominant. Today an average of 40% of manufacturing employment corresponds to service activities. Furthermore, the fragmentation of production processes is

intensifying, as is the distribution around the world of outsourced activities based on the comparative advantages of different locations. If the company maintains an anchor in the home country, it usually keeps only the higher value-added jobs there, in line with the cost of the related work and qualifications, meaning jobs often characterized as services.

Note that these changes in production methods clearly reflect a decrease in manufacturing functions in a product's added value, which translates into a decline of manufacturing in the sources of the wealth of nations. But it is important not to underestimate the impact of the fragmentation of production units. Thus, jobs in services, formerly attributed to manufacturing, are being reclassified as service jobs even though the underlying production task has not changed, and this is happening regardless of outsourcing abroad.

However, this reclassification is all the more likely as "servitization" accelerates and becomes a must for companies to remain competitive.

## **2 – The servitization of manufacturing is a competitive factor**

Servitization, which is associated with qualitative improvements in products and more generally the creation of value in manufacturing, is a factor in competitiveness.

As is shown by Crozet and Millet (2015), the production of services by manufacturing enterprises is a factor that enhances their performance. There are actually many French manufacturing companies that produce services, with 70% producing these for third parties (2007 data). The decision to produce services represents an important turning point, and clearly boosts performance. The authors' estimates thus show that taking this decision raises profitability, employment, total sales and sales of goods. Even though there are sectoral variations, the impact on performance is positive, whatever the industrial sector in question.

At the aggregate level, the share of imported services in the export of goods is also growing. In France's exports, the share of services ranges from 30% to 50%, depending on the sector. The fragmentation of production processes is leading to outsourcing certain service functions and to the provision of imported services. This dynamic goes hand in hand with the integration of economies in international trade, with the benefit of globalization opportunities and ultimately with the competitiveness of economies (see [De Backer and Miroudot, 2013](#)).

### **3 – The direct and indirect export of services will continue to make a positive contribution to the trade balance**

The developments described above directly affect the trade in services. It is indeed increasingly services that are the subject of trade in intermediate products, with the latter being estimated at nearly 80% of world trade. Digitalization, along with differentiation through services, is leading to the fragmentation of production with the inclusion of more and more services.

Trade in services in France has not experienced a decline since the crisis of 2007. Even though the trade balance in services has shrunk slightly since 2012, it has remained positive since the start of the 21st century, and the export of services has been rising faster than for goods. As the world's third largest exporter of services – especially because of tourism – France will see service exports increase as a share of its trade balance. Admittedly, for the moment, the volume of exported services has not offset the negative balance for goods, but the development of intra-firm trade in services and of intermediary services will eventually reverse their respective shares.

Trade in services is even more concentrated than trade in goods. It is mainly carried out by French or foreign multinational corporations, which account for more than 90% of

this trade. While just over half of trade takes place with the European Union (EU), this component is running a deficit, while non-EU trade is running a surplus. It is interesting to note that the balance is positive for companies that are part of a French group, but negative for companies belonging to a foreign group (Castor *et al.*, 2016).

## **In conclusion**

It seems that the dichotomy between industry and services is becoming increasingly inappropriate to describe the dynamics of employment and the productive specialization of economies. An approach in terms of productive functions that breaks down the job properly based on whether it involves manufacturing activities strictly speaking or other activities, such as transportation and logistics, administrative support or R&D services, would allow a better understanding of a country's skills and comparative advantages.

More generally, the growth of services and their increasing role in production and exports is giving them an increasingly central role in economic growth. Getting better statistics on the production and export of services and improving the methods of assessing productivity in services are prerequisites for a better understanding of the role of services in growth and of the levers to be activated to achieve this.

[\[1\]](#) A scientific committee responsible for the organization of the OFCE seminar on the Analysis of the Production System is composed of V. Aussilloux (France Stratégie), C. Cahn (Banque de France), V. Charlet (La Fabrique de l'Industrie), M. Crozet (Univ. Paris I, CEPII), S. Guillou (OFCE), E. Kremp (INSEE), F. Magnien (DGE), F. Mayneris (Univ. Louvain), L. Nesta (OFCE), X. Ragot (OFCE), R. Sampognaro (OFCE), and V. Touzé (OFCE).

[2] Miroudot, S. (forthcoming), “Global Value Chains and Trade in Value-Added: An Initial Assessment of the Impact on Jobs and Productivity”, *OECD Trade Policy Papers*, no. 190, OECD Publishing.

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# The tax credit to encourage competitiveness and jobs – what impact?

By [Mathieu Plane](#)

Following the submission to the Prime Minister of the [Gallois Report on the pact for encouraging the competitiveness of French industry](#), the government decided to establish the tax credit to encourage competitiveness and jobs (“the CICE”). Based on the rising trade deficit observed over the course of the last decade, the sharp deterioration in business margins since the onset of the crisis and growing unemployment, the government intends to use the CICE to restore the competitiveness of French business and to boost employment. According to our assessment, which was drawn up using the e-mod.fr model as described in an article in the [Revue de l’OFCE \(issue 126-2012\)](#), within five years the CICE should help to create about 150,000 jobs, bringing the unemployment rate down by 0.6 point and generating additional growth of 0.1 GDP point by 2018.

The CICE, which is open to all companies that are assessed on their actual earnings and are subject to corporation tax or income tax, will amount to 6% of the total wage bill for wages

below 2.5 times the minimum wage (SMIC), excluding employer contributions. It will come into force gradually, with a rate of 4% in 2013. The CICE's impact on corporate cash flow will be felt with a lag of one year from the base year, meaning that the CICE will give rise to a tax credit on corporate profits from 2014. On the other hand, some companies could benefit in 2013 from an advance on the CICE expected for 2014. The CICE should represent about 10 billion euros for the 2013 fiscal year, 15 billion in 2014 and 20 billion from 2015. As for the financing of the CICE, half will come from additional savings on public spending (10 billion), the details of which have not been spelled out, and half from tax revenue, *i.e.* an increase in the standard and intermediate VAT rate from 1 January 2014 (6.4 billion) and stronger environmental taxation.

This reform is similar in part to a fiscal devaluation and in some respects bears similarities to the mechanisms of the "quasi-social VAT" ([see Heyer, Plane, Timbeau \[2012\], "Economic impact of the quasi-social VAT" \[in French\]](#)) that was set up by the Fillon government but eliminated with the change of the parliamentary majority as part of the second supplementary budget bill in July 2012.

According to our calculations using 2010 DADS data, the CICE would lower average labour costs by 2.6% in the market sector. The sectors where labour costs would be most affected by the measure are construction (-3.0%), industry (-2.8%) and market services (-2.4%). The ultimate sectoral impact of the measure depends both on the reduction in labour costs and on the weight of wages in value added in a given sector. Overall, the CICE would represent 1.8% of the value added of industrial enterprises, 1.9% of the value added in construction and 1.3% in market services. In total, the CICE would represent 1.4% of the value added in market sector companies. According to our calculations, the total value of the CICE would be 20 billion euros: 4.4 billion in industry, 2.2 billion in construction

and 13.4 billion for market services. Industry would therefore recover 22% of the total spending, *i.e.* more than its share of value added, which is only 17%. While this measure is intended to revive French industry, this sector would nevertheless not be the primary beneficiary of the measure in absolute value, but, along with the construction sector, has the best exposure relatively speaking due to its wage structure. Furthermore, industry can benefit from knock-on effects related to reductions in the prices of inputs generated by the lowering of production costs in other sectors.

The expected effects of the CICE on growth and employment differ in the short and long term (see graphic). By giving rights in 2014 based on the 2013 fiscal year, the CICE will have positive effects in 2013, especially as the tax hikes and public spending cuts will not take effect until 2014. The result will be a positive impact on growth in 2013 (0.2%), although it will take longer to affect employment (+23,000 in 2013) due to the time it takes employment to adjust to activity and the gradual ramping-up of the measure.

On the other hand, the impact of the CICE will be slightly recessive from 2014 to 2016, as the loss in household purchasing power linked to higher taxes and the cuts in public spending (household consumption and public demand will contribute -0.2 GDP point in 2014 and then -0.4 point in 2015 and 2016) will prevail over lower prices and the recovery of business margins. Apart from the first year, the CICE's positive impact on growth related to income transfers will be slow to be seen, as gains in market share related to lower prices and to higher business margins are dependent on a medium / long-term supply-side mechanism, with demand-side impacts being felt more rapidly.

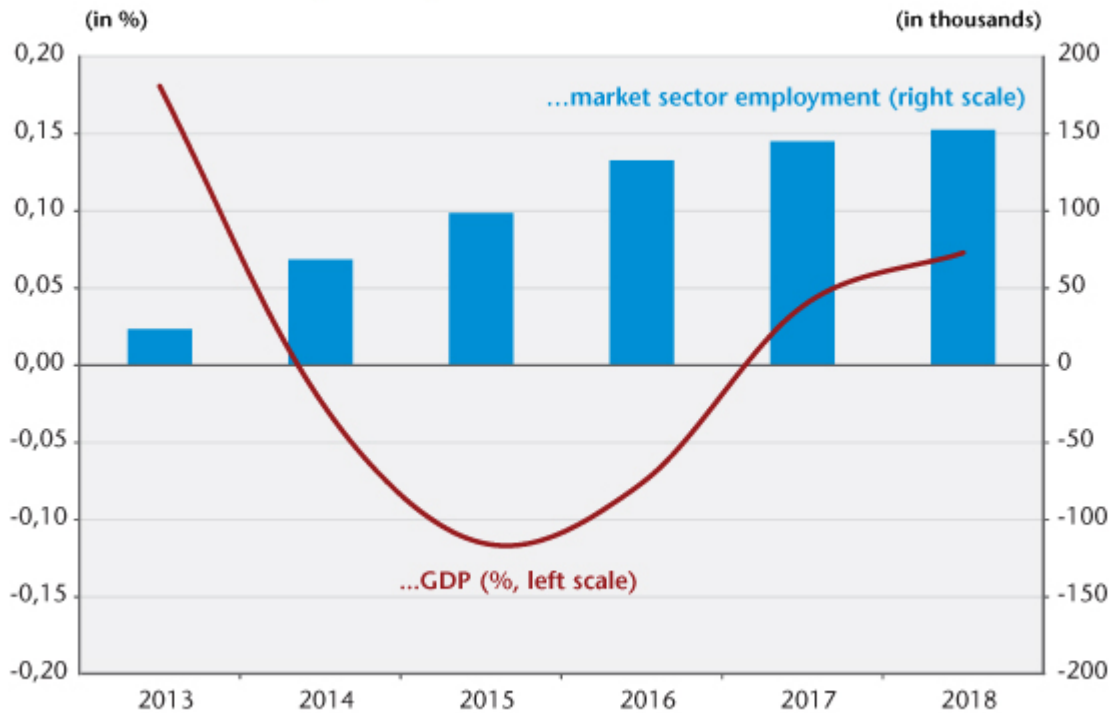
The implementation of the CICE will gradually generate gains in market share that will make a positive contribution to activity by improving the foreign trade balance (0.4 GDP point in 2015 and 2016), whether through increased exports or



reduced imports. From 2017, the external balance will not contribute as much to the economy (0.3 GDP point) due to the improved purchasing power of households, resulting in slowing the reduction in imports. Despite the higher margins and the improved profitability of capital, productive investment will fall off slightly due to the substitution effect between labour and capital and the negative accelerator effect related to the fall in demand.

With the decline in the cost of labour relative to the cost of capital, the substitution of labour for capital will gradually boost employment to the detriment of investment, which will lead to job-rich GDP improvements and to lower gains in productivity. This dynamic will result in steady gains in employment despite the slight fall-off in activity between 2014 and 2016. Due to the rise in employment and the fall in unemployment, but also to possible wage compensation measures in companies arising from the greater fiscal pressure on households, wages will regain part of their lost purchasing power based on an increase in real pay. This catch-up in purchasing power will help to generate growth, but will limit the impact on employment and productivity gains.

Graphic. Impact of the CICE tax credit on...



Source : e-mod.fr, OFCE calculations.

## “Buy French”: From the slogan to the reality

By [Jean-Luc Gaffard](#), [Sarah Guillou](#), [Lionel Nesta](#)

The current election campaign is lending weight to simplistic proposals like the slogan “buy French”, which evokes the need for France to re-industrialize. And to accomplish this, what could be simpler than to convince the population to buy native products designated with a special label? This is also more politically correct than advocating a straightforward return to protectionism. Employment is expected to benefit, along with the balance of trade. But if we look more closely, not only is it difficult to identify the geographical origin of products, but even if that were possible, any preference that these products might enjoy could well wind up in job losses.

This solution for dealing with the need for re-industrialization ultimately reflects a refusal to get to the bottom of the problem.

Can we really define what it means to “buy French”? Does it mean buying the products of French companies? What about buying products made in France by foreign companies instead of buying products made abroad by French companies? These simple questions show that it is not so easy to pin down what is “Made in France”. One major difficulty is that the final goods produced in a country usually incorporate intermediate goods manufactured abroad. It may even happen that the components of a final product are manufactured by a competitor in another country. The iPhone is emblematic of this [fragmentation](#). Should we refrain from purchasing intermediate goods from low-wage countries even though this makes it possible to produce final goods at a lower cost and boost exports by being more competitive on price? Those who think so should no longer be touting German industry as an example, since everyone knows about the growing share of imported inputs in the production of the final goods Germany exports (OECD, *Measuring Globalisation: OECD Economic Globalisation Indicators 2010*, p. 212).

Imagine, nevertheless, domestic consumers who are able to identify products with a high labour content and are ready to make sacrifices out of a spirit of economic patriotism. Don't the polls tell us that over two-thirds of consumers would be willing to pay more for French goods? While there are doubts about whether they would actually do this, it would be risky to ignore the opportunity cost of such a choice. Buying more expensive products simply because they are French reduces purchasing power. Other goods and services would not be purchased or would be bought for less abroad. The balance sheet for employment is far from certain.

Should this exercise in economic patriotism actually materialize, it would be a way that consumers form attachments

to certain types of products, in this case based on their place of manufacture, which would in turn reduce the intensity of competition. This could lead the companies concerned to cut back on their efforts to become more competitive on price and other factors. Why, indeed, should they shell out for expensive and risky investments when have a guaranteed customer base? It's a safe bet that they will not do this much, if at all. The national economy would then be locked in a low technology trap, doomed to slower growth, obviously with damaging consequences for employment in the medium and long term. This would also deprive the economy of the means to innovate and improve the competitiveness of its products.

Finally, it is likely that the willingness to buy French products would benefit products that replace goods made elsewhere in Europe rather than goods made in developing countries, either because the latter are no longer manufactured at all in France or because the price differences with French products would still be prohibitive. Ultimately it would not be possible to avoid further shifts in production to low-wage countries, with the consequent job losses. Furthermore, from a European perspective the non-cooperative character of this kind of measure could lead our European partners to adopt reciprocal measures, which would be detrimental to exports and employment.

The slogan "buy French" masks a refusal to see that the downturn is a global phenomenon which calls for a comprehensive response at the European level, and a refusal to consider a proactive industrial policy that takes into account the realities of supply as well as demand.

This is not just a matter of looking the other way. France is undergoing a deindustrialization process that threatens its capacity for growth. But who can deny that this phenomenon has accelerated with the crisis and that this acceleration is set to increase [as the general austerity measures and restrictions on bank credit further undermine domestic and European demand](#)

for consumer durables? Unless we are willing to accept that an entire segment of industry in France and elsewhere in Europe is destroyed, with no hope of ever returning, and with as a consequence still greater disparities between countries and sharper conflicts of interest, it is clearly urgent to support this kind of demand.

Is this kind of support “the solution”? Of course not: propping up demand will not be enough, as an industrial policy aimed at strengthening the supply side is also needed. The point is not to protect domestic production nor to promote the conquest of foreign markets through competition on taxation or social charges, but to stimulate investments designed to produce new goods and services, which is the only way to create stable jobs. Rather than try to rely on dubious slogans, the goal should be to consolidate production that has the advantage of being high quality in terms of design, safety and reliability, and which corresponds to what French and European consumers genuinely want.