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## **Demand-side issues of the service economy**

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**Abstract.** – This paper examines the relevance of the demand-side approach to the development of a service economy. It starts by addressing some concerns about the possibility of creating a growth regime based on services. Discussion has mainly focused on the increasing share of services in consumer spending; but equally important is the fact that most products – goods and services alike – integrate a significant service-to-the-client dimension. The paper considers the costs incurred by strategies that aim to create value for the client and that require the existence of a purchasing power likely to validate them.

## 1. Introduction

Since the 1980s, most interpretations of the economic difficulties encountered by the developed countries have highlighted supply-side problems posed by globalisation. A number of European countries have suffered from persistent unemployment that is widely attributed to obstacles that hinder the adaptability of enterprises in the face of increased international competition. Less attention has been paid to demand-side problems: few economists nowadays defend the necessity of Keynesian remedies. This article explores the issue of demand in the current environment. The aim is not to provide a classical justification for Keynesian policies in Europe today. The arguments in favour of such policies are already well-known (although they have been too rarely put forward). The removal of supply-side constraints on European growth in the 1980s has proved in the 1990s to have been too successful in certain respects: liberalisation policies have had the effect of suppressing demand and thereby excessively curbing growth (Fitoussi, 1993). This conventional analysis favours more flexible monetary policies and, in the longer term, the organisation of concerted budgetary stimulation in Europe.

Without contradicting this analysis, the present paper suggests that the relevant demand-side issues today arise out of the structural transformations of our economy, and that the focus of attention should be on the possibility of a shift to a growth regime based on services. This analysis is somewhat unconventional. Indeed, the defenders of demand-side policies rarely establish a connection with the structural transformations of our economies and even less with the shift to a service economy – even if some of the Post-Keynesian literature has considered the implications of structural change (see, for example, Pasinetti, 1993). Conversely, those who do acknowledge this shift to a service economy tend either to point out the limits of "tertiary-based growth" or to encourage a clearer understanding of the nature of services and then to identify the obstacles that need to be removed to allow their development. In both these cases, the focus is not on demand-side problems per se.

Our approach to the question of demand is intended to complement the research which has highlighted the specific nature of services and its implications for a tertiary growth regime. It actually constitutes an extension of that work. Accordingly, our first step will be to examine the conditions likely to favour a service-based growth regime. However, our second step will be to adopt the analysis that the services sector could lead to reorganising all our economies further still. This being the case, the questions of demand will become the major questions to be dealt with. This analysis is to be considered as a new path to explore, bearing in mind moreover, that it is examined in its French context, both from the viewpoint of the lines of the analyses considered and from the field of applicability.

## 1. Towards a Growth Regime Based on Services

The idea of a growth regime based on services has been a source of concern for some economists. It is thus necessary to address those worries and to start by reviewing the analyses which demonstrate that services are not, in themselves, insusceptible of increases in the efficiency of their production; rather, services have distinct characteristics that require a different outlook on certain categories of economic analysis (such as productivity). These analyses suggest a number of institutional reforms to promote the development of the service sector.

### *1.1. The Possibility of Tertiary Growth*

Not all economists view the development of services as favourable to economic growth. Some argue that, as these activities are not highly productive, "tertiary growth" (Petit, 1986) tends to be slower than when manufacturing prevails, and can be maintained only at the cost of rising class tensions, in particular by the emergence of a low-wage workforce in the service sector. Kaldor (1966) had already developed this argument when he attempted to explain the slow rate of economic growth in the United Kingdom relative to other industrialised countries from 1953 to 1964. In the 1980s, the debate over the quality of jobs created by the American "job machine" was a central element in discussions of the tertiary economy (Meisenheimer, 1998).

By what seems to be a paradox, this development of services drew attention to the importance of industry (Cohen & Zysman, 1987) inasmuch as that sector would be more than ever obliged to create value for the rest of the economy. This line of argument has been challenged by some "defenders" of the service sector, who contend that the apparent weak productivity gains in services may be due not to any intrinsic insusceptibility of services to productivity growth, but rather to the difficulties of measuring efficiency improvements in the production of services (Gadrey, 1988). Inasmuch as the product of a service rendered lacks the objective visibility of the production of a good, the measurement of a service frequently involves methods that amount to assimilating the service considered as a process to the service considered as a product: the product is identified by the resources used to create it. It is therefore not surprising that the productivity calculated is nil.

In the question of productivity, one characteristic that prevails in the provision of services arises from the overlap between the latter and quality. The transaction conditions governing services differ in a significant way from transactions involving manufactured goods. A transaction relating to a service does not result in a transfer of property rights: the aim of the transaction is not to acquire a tangible object which has been manufactured and displayed on the market before changing hands. The purpose of the transaction is a promise, an undertaking to achieve a result which the contracting parties have more or less precisely defined but which, in the extreme case, may never become a reality (1). The quality of the product is not immediately apparent and the product may not be delivered in completed form. The outcome depends on the process required for the provision of the service. Productivity and quality are closely related issues in that the quest for greater productivity may have an

adverse effect on the quality of the product, if cost-saving measures prevent the service provider from giving the product all its defining attributes.

One of the particular characteristics of services is that the quality of the product depends not only on the provider but on the degree of co-operation (or level of involvement and competence) forthcoming from the purchaser. The quality of the product will result not only from the skills of the service provider but also from the quality of what is termed the service relationship (Gadrey, 1988) between the provider and the beneficiary. A service constitutes a very specific activity with its own production conditions and constraints which are not always properly captured by statistical methods which were designed primarily to measure the output of tangible objects. The question of quality, which is difficult to dissociate from the efficiency of the service rendered, is very inadequately addressed. Purely quantitative indicators, when they are conceivable (such as recording the number of transactions in banks) supply no information on the differences in the quality of the service rendered (for example, the presence or the absence of a financial advisor).

This point is made by some economists in order to explain that expansion of the service sector per se need not impede economic growth: as shall be stressed in section 2.3., the problem may rather be that 'wealth of nations' is more and more a matter of quality and of the service rendered by commodities, and not of the mere volume of the latter. Though the productivity and output of services are still poorly measured we cannot conclude that services are incompatible with growth (2). Moreover these economists also argue that the same specificities may also impede service activities in their development. This could prevent them from expanding even more and, as a consequence, from exerting bandwagon effects on the whole productive-system growth.

### *1.2. The Need to Structure Certain Service Markets*

One fundamental issue is that uncertainty as to product and productivity –that is the relation of quality to price– may hinder the development of markets for certain services. This uncertainty is due to the fact that the product does not exist when a contract is signed, in such a way that failures comparable to those set out in the economics of information (Akerlof, 1970; Stiglitz, 1987) can occur in the functioning of the markets. The lack of transparency of the market can prevent potential buyers from expressing their demand. Furthermore, since this uncertainty makes comparisons between offers difficult, there is limited scope for competition and price cuts.

From this point of view, the uncertainty factor means that services cannot, at this stage, exert all the positive effects on economic growth that could be expected of them. These effects stem from the fact that services fulfil needs that are expected to increase. These needs arise firstly from the complexity of contemporary societies and economies: from the diversity and increasing technical complexity of the products among which consumers may choose; and from complex production systems and corporate environment (highly developed and sophisticated legal systems, constant innovation, economic globalisation), resulting in needs for related services such as assistance, counsel, maintenance, repair work. A second reason

for this explosion is the unpredictability and risk factors in everyday life, both for companies and for individuals, resulting in a need for services geared to risk-prevention, risk-reduction and insurance.

Such needs triggered a rise in demand for services, arise that started during the Fordist growth period following the Second World War. A second wave of increased demand for services began in the early 1980s. It paved the way for a significant development of supply which counterbalanced, to some extent, job losses in industry. Nevertheless, the persistent high level of unemployment in most European countries reflects insufficient job creations. Some economists, reasoning that industry no longer drives employment, advocate a thorough review of the obstacles which limit the development of service markets; the focus has been on supply-side obstacles relating to particular characteristics of services, notably the uncertainty factors (du Tertre, 1999).

This approach has much in common with New Keynesian Economics. Some policy recommendations point to the need for safety devices to regulate the terms of service contracts (for example, collective measures providing for quality certification). Others deal with the provision, either directly or through financial assistance, of services such as child care and elder care, the need for which has grown significantly in the past several decades.

### *1.3. An Intangible Growth Regime?*

The point of view just described is based on the idea that economic growth and job creation could be stimulated by the development of services. The main impediments to growth along this line are problems of organisation of the service markets. But once these obstacles have been overcome, we might witness the emergence of a new growth regime, which would fully benefit from the opportunities provided by the needs for services (du Tertre, 1995); this new growth regime would replace the Fordist regime that prevailed in the 1950s and 1960s (Boyer, 1994). The latter regime was characterised by production methods that generated high productivity gains, the benefits of which were in turn allocated in a broadly equitable manner among employers and employees through collective bargaining. A virtuous circle of economic growth emerged in which the production methods allowed firms to produce goods on a large scale in response to a demand resulting from high wages. Under the Regulation Theory associated with Boyer and du Tertre, among others, the current crisis is a structural crisis expressing the limits of this Fordist growth regime.

When a growth regime is in crisis, not only do the main institutions undergo a reorganisation, but shifts occur in certain sectors of activity. In the current crisis, the automobile industry, which was one of the main focuses of economic growth and a key player in the Fordist compromise, is in relative decline. The services sector could take the place of such sectors; in other words, it could constitute the core of a new consumer standard.

However, the expansion of services is subject to particular constraints that need to be explained. Services may be classified either as time saving (the provider carries out a task that the beneficiary could have carried out himself) or as time consuming (for example, training

courses) (Gadrey, 1992). The latter category includes services in which the relationship between provider and purchaser is particularly important; in a sense such services are co-produced since the beneficiary is obliged to find time to take part in the production of the service.

There are two theoretical models of the links among services: social organisation of time and economic growth (Ughetto, 1998). On the one hand, the services sector may develop if one part of the population, pressed for time due to hyper-activity, has recourse to time-saving services offered by the other part of the population. This model implies a considerable degree of income inequality between the two portions of the population since the first group will find it worthwhile to consume time-saving services only if they cost less than what these persons can earn by devoting time to the generation of income. This model partly corresponds to the American job machine described in the 1980s.

The other model requires the development of time-consuming services. It supposes that the beneficiaries can find time to take part in the production of the service. It therefore requires an extensive reorganisation of social time and working hours to provide time for activities such as meetings with financial advisors in banks, training courses for employees, interaction between the providers and the representatives of the company benefiting from the service, etc.

More than the first model, the second model raises the question of the obstacles to the reorganisation of markets. In view of the involvement of the beneficiary in the co-production of the service, *ex ante* uncertainty as to the product is more likely to constitute a major characteristic of the services on which economic growth would be based. In this case, the analysis points to the need for an institutional reorganisation of markets, whereas the first model would focus on the difference between the income levels.

In view of the focus of the present paper, it is interesting to note that, if this second model is to deal with demand issues, it will be through market-organisation issues. This brings us back to the question of making demand solvent through shared financing mechanisms and through drops in relative prices in more transparent markets. However, as demand is limited by the time necessary to co-produce the service, any growth in demand would require that periods of time be made available prior to using certain services. This requirement raises the question of reducing and reorganising working hours within the framework of renewed collective bargaining agreements and a new wage compromise with a view to encouraging economic growth (du Tertre, 1995). Such reforms would no doubt require active governmental intervention. By contrast, in the model based on time-saving services, no intervention seems necessary as the demand for these services depends mainly on the difference in income levels and a *laissez faire* policy can generally be counted upon to preserve or exacerbate income inequalities.

In sum, current analysis of service-oriented economics suggests that the full development of a growth regime based on services would be limited by obstacles preventing services from 'structuring' the consumption standard. Services therefore would not yet be able to play the full role that was played by standardized goods in the Fordist regime; such

standardized goods were at the centre of the articulation of the production standard and the consumption standard, and, as such, sustained growth. However, the literature has mainly focused on the organisation of markets, leaving open the question of the *level* of global demand in the economy. Here we shall argue that this question can only be solved by defining the characteristics of the consumer standard that could provide the basis for a new growth regime. From this point of view, what matters is not just that services account for a larger share of consumer spending, but more precisely that most products – goods or services alike – integrate a significant service-to-the-client dimension. From this point of view, expansion of the service dimension within consumption and production standards may still remain at a stage at which a logic of standardized production is simply amended by quality strategies providing limited tailored aspects. This would not be sufficient – notably in Europe – to produce durable effects of self-sustaining economic growth.

## **2. Service to Client as a New Consumer Standard**

### *2.1 From Services to the Service Model*

Services are not just sectors occupying a central position in a new potential growth regime; they also imply that a productive model extends to most sectors of the economy. More and more producers view their business as rendering a service, even in industry. This means that the products tend to become tailor-made solutions for the client given their conditions of use.

This tendency is of course expressed in different forms in different sectors and can be more limited in manufacturing. However in all industries can there be a shift towards an increased service to client dimension, due to the producer's growing awareness that the consumer is not just buying a good but more precisely its condition of use.

From this point of view, theory was ahead of reality when Lancaster (1966, 1975) suggested a new approach to the neoclassical theory of consumer choice by arguing that the level of demand for a good is based on all of its characteristics, and when Gershuny (1983) suggested that consumers, concerned primarily with a need or function to be fulfilled, choose between self-service and external provision of services. Supply strategies no longer limit themselves to the production of a type of good but now take into consideration the needs and the uses expressed by the consumer for that good. The role of the service provider is then to provide a global solution to the problems relating to the conditions of the use of the good rather than of merely providing the good and letting the customer solve the problems.

For example, computer manufacturers no longer simply manufacture computer hardware but try to offer a package of services: they start by assessing the client's specific needs; then they propose reorganisational solutions; finally, they evaluate the material needs of the client. The field of industrial cleaning provides another example. Certain service providers do not simply "clean up" after their client: they consult the client about how to limit the volume of dirt, thereby improving the quality of their service. This is a sector, which, by developing new strategies, has increased the service aspect of its activity: it takes into



consideration the use of the product and the situation of the client. However, in such cases the "service model" (Veltz, 1996) implies the existence of a significant relational dimension. The service is not rendered in an abstract context, which disregards the relationship between the service provider and a client who has specific problems and conditions of use.

This service model could structure the production and consumption standards in most sectors of the economy and, as such, be the basis of a growth regime. However, the model has significant demand-side consequences in view of the resources that it requires for the production process and which have to be paid for by the client.

## *2.2. Neither Extensive nor Intensive Growth*

As stated, the emergence of the service dimension implies taking client needs and concerns into consideration. As a result, creating value requires that producers adopt the client's point of view. This is what current management theories refer to when they define value in terms of the attributes or the functions of the product for which the consumer is prepared to pay the price necessary to obtain the product (Porter, 1985). The price, when paid, validates the costs incurred to use the product. These theories actually rediscover the Marxist concept of value realisation (Marx, 1867, Vol. II, Chap. I); that is, the fact that a sale implies the validation (and the risk of non-validation) of the costs incurred to create a certain value.

In the new supply strategies the products' use value becomes significant. In the case where production is standardised (or simply differentiated) and aims at certain categories of consumers considered as a whole and not as individuals, the prevailing logic is to rationalise production, that is, to manufacture a good without taking into account the individual characteristics of the consumer and then to launch it on the market. The aim is to increase the chances of selling it in a given market segment by reducing production costs in order to cut the price of the good (3). Conversely, in the case of products implying a significant relational dimension, the cost-cutting aspect, while not disappearing, will only become relevant once the question of creation of value for the client has been solved. The chances of selling the product are first increased by creating a value, which, by arousing the clients' interest, is likely to be realised.

Indeed, the priority is to capture a demand that tends to play one producer against another. When consumers endeavour to obtain high quality products and at low prices, offering services to a client means offering more and more product attributes while forging a more personal relationship with the client. Such a relationship tends to restore the balance between the producer and the client to the advantage of the producer. Indeed, by offering his services to the client (thereby appearing to be the subordinate party in the relationship), the producer in fact "captures" the client who becomes the dependent party (4). This aspect of competition, described by Chamberlin (1933), is consistent with the adoption of strategies that tend first to create useful effects for the client and relegate cost-cutting measures to a position of secondary importance.

Consequently, the increase in the service component of the products offered requires not only an increase in the cost of production, but also additional investment expenditures, without which the new value-enhancing attributes to the product cannot be created: value creation requires investment. An international comparison of large-scale retail distribution systems will illustrate the point (Gadrey et al., 2001). Statistics appear to indicate that retail trade in the United States and Japan is less productive than in France. This is a puzzle, since French retailers have access to the same technology and practices as American and Japanese retailers. The puzzle is solved by considering that the quality of the services rendered varies significantly from one country to another. The products are not the same: in the United States and Japan the services rendered include sales advice, a wide variety of goods, fresh food counters, free product samples, long opening hours. In France, retailers favour strategies based on price competition and therefore seeks to avoid costs. But American and Japanese retailers do not hesitate to incur costs (notably in terms of personnel) in order to provide a high level of service and increase the value of the product to the client. This has a negative effect on the productivity statistics (inasmuch as they are unsuited to measure the differences in product quality) but not on profitability which is higher in the US and Japan than in France.

From a historical point of view, a growth regime based on the generalisation of the service model would be rather original. Contrary to what the productivity statistics lead us to believe, we can conclude that it is difficult to qualify the corresponding accumulation as extensive – that is to say growth would arise from using an increasing volume of the labour force. Such productions use higher volumes of labour force not because they are not efficient (or unlikely to be rationalized) per se – and as a consequence not because they would necessarily correspond to an extensive growth. Rather it is because they use more employees (than in a strict intensive growth) to improve the quality of the service rendered, these employees being at the origin of an outcome that is for some part intangible as regards output and productivity statistics.

### *2.3. Price, Income Distribution and Demand*

Now that we have examined the costs issues at the heart of potential new supply strategies, we can address the issue of a new growth regime from the point of view of Keynesian or Kaleckian macroeconomics. For Keynes and Kalecki, aggregate output, the price level and growth are determined primarily by the level of spending of entrepreneurs or capitalists. Within the economic circular flow, the decision made by different categories of agents to spend is triggered by the decision of entrepreneurs to invest (spend in investment goods), thereby exerting considerable influence on the level of effective demand.

We propose to examine the spending behaviour of producers in the context of new supply strategies corresponding to new production methods and a new consumer standard. From this point of view, the typically Keynesian issue of how spending supports aggregate economic activity should be addressed in connection with structural changes in production and consumer standards due to the emergence of a service model throughout the economy.

Service-intensive production processes are indeed production processes with high value-added, incurring costs, which means that they will be highly priced productions. In order to create value for the client these processes incur costs exceeding those incurred for standard products. These costs increase the exchange value of the product as well as its use value. The question arises as to who will meet these costs. There seem to be three possibilities. The first is that the company will bear this cost by accepting relatively low margins. If we discard this possibility (5), the costs will have to be borne by the firm's clients and employees. If the clients are unwilling to pay a high price to validate the costs incurred in the creation of value the costs are borne by the employees. Inasmuch as the additional service rendered to the client is the result of additional working hours the firm will have a strong incentive to control labour costs. Gadrey, Jany-Catrice and Ribault (2001) show that this method is partly used in Japan and the United States to manage the costs of value-added products in retail trade. Although Japanese distributors bear staff costs 35 to 40% higher than in France for a comparable range of products, the hourly wage and the social security contributions are lower, which means that for the same amount of staff costs more working hours can be hired.

Hence, the balance of power among firms, clients and employees determines the allocation of the costs of producing high-value products. If the market situation is such that producers are obliged to differentiate themselves from their competitors and the requirements of consumers are such that the producers cannot hope to base their strategies on the price issue alone, then it is likely that the effects of client pressure will be transferred to those firms whose activities add to costs. In a context where the purchasing power is limited, so that consumers are not able to pay the full cost of the service offered, the supply strategies for service-intensive products can be justified only if the producers can control the price by reducing the related costs. The costs needed to pay the employees – notably to provide an additional service – would have to be reduced. While these cost-controlling strategies may be individually justified, in the aggregate such behaviour can have negative repercussions on the level of effective demand. The decline in consumption demand would discourage business investment.

Without any outside intervention the market cannot be expected to end the crisis – all the more so at a time of structural change (Driver, 1996). State intervention is required. In Europe, a common initiative to adopt a demand policy (Drèze & Malinvaud, 1993) would help entrepreneurs to reverse the trend of negative expectations which hinders the development of service-intensive production and consumer standards. However such standards require that purchasing power be fuelled by sources more powerful and permanent than public spending, which raises the question of wages. What is required is something analogous to the Fordist wage compromise – not the re-establishment of this compromise *per se*, but the recognition of the legitimacy of workers' claims on a portion of the gains from productivity growth, within the context of new supply strategies. This is an even trickier question than that of concerted Keynesian action taken at the level of the European Union. The European governments and central banks share the same analysis of the crisis centred on the issue of firms' competitiveness, in which there is an implicit consensus that having corporate policies of high wages is unnecessary either to buttress demand or to control

inflation. Demand-side issues of the service economy state new justifications for the macroeconomic effects of such policies.

### **Conclusion**

Although largely neglected, demand-side issues are particularly relevant today in view of the structural changes that have taken place in the global economy – in particular the emergence of a significant service dimension in consumer and production standards. The proliferation of service-intensive products may have macroeconomic repercussions, partly because of the investment expenditure required to provide high-cost services leading to self-sustained growth (either directly or as auxiliaries to other products or services).

Keynesian policies and a new wage compromise may be required to sustain the demand for such services. Such issues should be investigated in more detail than they are presently: this requires from Keynesian economists to deepen their concern for structural change and from service economics not to focus too exclusively on market-organisation issues.

**Footnotes**

(1) In the field of services, the intangible nature of the product is not due to the fact that once the service has been rendered there is no objective result (this is not usually the case) but to the fact that the finished product cannot be displayed at the time of the signing of the contract. The intangibility is ex ante and not ex post.

(2) Baumol (1967)'s argument that it will always take four musicians to play a string quartet is too restrictive to infer any more general conclusion about services. It refers to a peculiar type of 'product', namely art, which is definitively non reducible to a commodity. Services per se are not incompatible with some sort of rationalization: for instance, in medicine, professionals draw from experience knowledge and methods making them more efficient without damaging the quality of their acts.

(3) This does not exclude the possibility of seeking profits through monopolistic positions or product differentiation, which would justify higher prices. However, in the current competition conditions, the cost-cutting measures prevail.

(4) Consider the relationship between a patient and his physician: the more the relationship becomes personal (acquaintance, trust) the more difficult and costly it is for the patient to go to a new physician.

(5) Let us suppose that efforts to promote service strategies tend to be provided by producers preferably in order to gain high margins.

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