

Going for Growth One Year On

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Welcome to the presentation of the second issue of **Going for Growth**, our new annual publication. Let me first remind you briefly of the *raison d'être* and nature of this work.

The OECD is perhaps best defined in two words, namely as a “convergence club”. That is, the place where member countries meet together to learn from each other and to emulate best practice. The objective, as stated in our founding Convention, is for all members to achieve vigorous and sustainable economic growth. And for those where living standards are lower to catch up.

Over the past two decades, however, we have not witnessed enough convergence within the club. Trend growth and resilience have improved in some OECD economies. But at the same time, Japan and large Continental European economies have tended to fall further behind the best performers over the past 15 years in terms of GDP per capita. With demographic ageing hurting Europe and Japan more than North America, the risk, looking forward, is one of accelerating divergence.

This lack of convergence holds policy lessons, which we try to draw out in the **Going for Growth** series. The first issue, released one year ago, inaugurated a new type of benchmarking surveillance, based on a set of policy indicators selected for their link to economic performance. We use these indicators, alongside the in-depth expertise of the OECD, to identify policy priorities and to derive policy recommendations for each OECD member.

What's the right metric?

Let me note upfront that the measure of performance that takes centre stage in this exercise is GDP per capita. A frequently-asked question is: how reliable a measure of overall welfare is GDP? This is a fair question. Indeed, our founding Convention also says that one of the key objectives of the OECD is to promote “social well-being”.

So, in this issue of **Going for Growth**, we surveyed a considerable number of alternative indicators of well- or ill-being. As an indicator of well-being, GDP suffers from many shortcomings. It does not incorporate environmental degradation, nor the value of leisure. Neither does it take into account the influence on well-being of income distribution. By using GDP per capita as an indicator of well-being, you always run the risk of adopting a reductionist approach.

We want to guard ourselves against such a bias. One way to do it is of course to criticise countries featuring lower levels of GDP per capita only in as much as it is also reflecting a policy deficiency as opposed to differences in societal choices. In our first issue of **Going for Growth** the low levels of employment achieved in some Continental countries were deplored because they reflect misguided Malthusian policies, where public funds are used to lure people into leaving the labour market prematurely. Had this low employment reflected a stronger preference for leisure, criticism would have been unwarranted. Economists have nothing to say about preferences, either personal or collective.

With this second issue of **Going for Growth**, we investigate further the relations between well-being and growth, by reviewing a considerable set of alternative indicators of well-being that range well beyond GDP per capita.

Moving beyond GDP and production, we look at income and consumption based indicators, which better capture living standards. These refinements do not much alter the picture already provided by GDP indicators however, nor does the examination of indicators net of capital depreciation. We also construct measures of GDP and income per capita adjusted for leisure time or aversion to income inequality. Although

valuing leisure does not modify markedly the hierarchy of GDP per capita across countries, an extremely strong degree of aversion to income inequality can flatten out the distribution of “adjusted GDP per capita”.

We then broaden the scope, looking at social indicators which fall under four main headlines: self-sufficiency, equity, health and social cohesion. More concretely, we look at indicators such as child poverty, income inequality, suicide rates, number of jobless households, years of schooling ...

With two questions in mind:

- What are the dimensions of well-being that go together with high GDP per capita?
- What are the other dimensions of well-being that need to be considered to complement and nuance the picture provided by GDP statistics?

Looking at simple correlations, it appears that self-sufficiency, equity and health are generally stronger in countries where GDP is high, while other features related to social cohesion such as suicide and victimisation rates seem uncorrelated to GDP. In addition, one can not discard the view that additional growth, starting from already high GDP levels, may yield somewhat diminishing returns in terms of improved well-being.

A tour d’horizon of welfare indicators would be incomplete without examining subjective measures of well-being. These measures do not always seem well correlated with each other nor with GDP per capita. A striking feature of the survey results is that most people in most OECD countries rate themselves as being fairly happy to very happy, irrespective of their income levels. There is a weak tendency for the richer countries to report higher levels of life satisfaction. But countries with the lowest level of happiness also have lower than average GDP per capita. A number of authors suggest that subjective measures may provide indicators of relative rather than absolute well-being.

All in all, social and subjective indicators clearly add valuable information to that conveyed by GDP. But many of them are narrow, capturing only one dimension of well-being. And all have practical drawbacks, including availability, measurement and cross-country comparability problems. Hence, in the end, we conclude that the least imperfect and most timely summary statistic of well-being remains GDP. But obviously, other dimensions of welfare should be borne in mind as well. These conclusions reinforce our choice to go beyond simple GDP per capita statistics and look carefully too at the quality of policies.

Moving beyond the remit of the present work, I would add that economic growth as conventionally measured may have negative side effects, notably on the environment - but richer societies can and typically do spend more on the mitigation of environmental stress. Also GDP growth may have positive political externalities: insofar as conflicting claims on resources are easier to solve in an expanding economy, growth may facilitate pluralism and democracy.

After these cautionary remarks, I would like to run you through the report and highlight some of the salient findings and novelties. Starting with the follow-up on last year’s recommendations, and then on to the broadening of the scope of surveillance.

Following up on last year’s recommendations

As mentioned, in the previous issue of **Going for Growth**, the focus was first and foremost on labour and product markets. Our diagnosis was centred on the need to boost labour productivity and on how to improve labour utilisation. Today’s report follows up on the progress made.

Consider first the efforts deployed to raise labour productivity:

- Barriers to entry and other regulations inhibiting competition are being eased in some countries. For example, in the Netherlands, where the administrative costs for start-ups are set to be slashed by one fourth. Or in Finland and Poland, where the privatisation of government-owned commercial companies has continued. At the EU level, efforts are underway with the Services Directive. But here there is great uncertainty about Europe’s capacity to keep up momentum.

- Concerning human capital formation, progress is being made in most countries where strengthening the education system was identified as a policy priority. Even if in some cases, reforms are still at an early stage.

Unfortunately, new initiatives to lift labour utilisation have been scarcer. In particular, too little has been done to reduce the implicit tax on work for the so-called ageing workers. That said, we do welcome the broad thrust of the measures announced in France to reduce hiring disincentives in the smaller firms. And, more recently, to boost the hiring of youth and the employment of older workers.

Extending surveillance to innovation

As announced initially, we are gradually expanding the scope of the indicators used to take into account other policy areas of relevance for economic performance.

Last year, we focused very much on labour and product markets, the areas in which we have worked most in the past. This year we are bringing innovation into the picture. Indeed, innovation is one of the main engines of long-run growth. And the OECD has long monitored quite a few of the relevant indicators. The policy indicators we use encompass the so-called framework conditions, for instance regulations affecting competition in product markets. But also more specific policies, notably R&D performed in public institutions (universities and government laboratories) or public support for private sector R&D. Performance is measured using input-oriented indicators such as business R&D intensity or more output-oriented ones such as patents.

What then determines R&D intensity empirically? What are the factors that drove investment in business R&D in the course of the 1990s.

Overall, our research suggests that factors such as capacity to absorb and exploit foreign knowledge, or broad financial and economic conditions have had the largest contribution to changes in R&D intensity. Changes in market regulations and the strength of intellectual property rights have also spurred R&D in all the countries we looked at. And substantially so in the star Nordic performers. The contribution from public R&D funding has generally been smaller, which is not surprising given that, in many countries, levels of public R&D funding have not changed substantially during the 1990s. Policy action in this area has focused instead on raising the effectiveness of measures or programmes to support innovation efforts.

Two caveats are in order at this stage. One is that some of the indicators are highly correlated. For example, among framework conditions, product market regulations and intellectual property right protection tend to display a negative correlation. This can raise questions when assessing their respective contributions.

The other and perhaps partly related caveat is that the interpretation of some of the indicators is somewhat ambivalent.

- Take R&D intensity: it measures inputs rather than the productivity and success of innovative activity.
- Or take patents: they can be a *sine qua non* for innovators to reap the benefits from their efforts, and therefore a powerful incentive to innovate. Alternatively, they can be filed to undermine potential competition or with a view to launch predatory lawsuits.

Tabling a new set of recommendations in the area of innovation

Let me now turn to our country-specific recommendations to boost innovation. We followed the same approach as for labour and product markets. Namely, reforms are presumed to be needed when weaknesses in the policy settings are coupled with sub-par innovation performance or weaknesses in the proximate determinants of innovation (such as skills or financial conditions). To take a concrete example, when innovation performance is below the OECD average while high regulatory barriers stifle competition, we see a *prima facie* case for product market reform and for a recommendation in this area.

We also want to ensure that we are not missing out on required policy action along dimensions that cannot - or are not yet - properly captured via indicators. Hence, drawing on our in-house country-specific expertise, additional policy recommendations are set out, which may or not be based on indicators.

In the process, four clusters of countries emerge:

- Leading innovators include the Nordics, the United States and Japan. Most of them enjoyed strong productivity growth over the past decade (Japan being an exception). And most exhibit high graduation rates from tertiary education. But several face the challenge to boost innovation in services calling for more open and competitive markets in this area.
- At the other end of the innovation performance spectrum, improvements in education are called for in Southern Europe, and stronger product market competition both in Central and Southern Europe.
- In the middle lie the non-US English speaking countries, where productivity performance has generally been good. A common challenge there is to strengthen the links between public research and industry.
- The remaining countries - notably France and Germany - tend to display above-average innovation performance, but need to strengthen tertiary education and the contribution of universities to research. Most of them can also improve the cost-effectiveness of the financial measures taken to support private sector R&D.

Exploring the links between financial markets and growth

This year's **Going for Growth** also ventures into another field: financial markets. Earlier OECD work had established the importance of well-developed and efficient banking systems and capital markets for economic growth - not least because they facilitate innovation. But for this diagnosis to gain policy content, it is necessary to better understand the determinants of financial development itself. In particular competition and investor protection.

In banking, indicators of competition display considerable differences across countries. And therefore suggest that sizeable gains could be reaped through heightened competition in many of them. Specifically, the dispersion of overhead costs and net interest margins shows that cost structures and pricing strategies vary a lot. Likewise, measures of cross-border competition span a wide range. What is particularly striking is how little foreign institutions have penetrated the loan market in euro area retail banking. Despite EU efforts to bolster financial integration.

To some extent, these cross-country disparities reflect regulatory differences. Barriers to competition in banking tend to inhibit financial sector development and thereby GDP growth. So does poor investor protection in stock and bond markets. Furthermore, sectors that are more dependent on external finance grow faster in countries where regulation is more conducive to financial development. Incidentally, sectors highly dependent on external finance - say, pharmaceuticals or ICT manufacturing- are often the ones that also spend a lot on R&D. Hence, regulation can affect both the overall rate of growth of the economy and its industrial structure.

All in all, our tentative quantitative analysis suggests that in the countries with the most restrictive banking regulation, reforms that would align it with the OECD average could for some time boost GDP growth by up to ½ percentage point. These findings confirm that we are pursuing a promising line of research. However, more work is needed to improve the OECD-wide database of indicators. What is needed is a better ability to capture the most relevant characteristics of financial systems. Only then will it be possible to use it to derive pointed policy recommendations.