OECD

ECONOMICS NEWSLETTER

ECONOMICS DEPARTMENT

January 2004, Issue 1

Focussing on structural issues

Welcome to the first issue of this newsletter, which will regularly provide the busy reader with summaries of empirical work carried out by the OECD Economics Department (ECO). This newsletter will address the rich set of issues that shape long-term economic performance. It will cover a wide variety of areas ranging from the sources of growth and economic resilience to the impact of product and labour market reforms as well as the long-run consequences of fiscal and social policies.

This focus on structural issues is well deserved. Because they are crucial to the success or failure of economic policies. As such, they have now reached the centre stage of the public policy debate in many countries. However, they are not always well understood. "Structural issues" is in itself a rather rebarbative and obscure label. It conveys a sense of complexity and high technicality that is indeed characteristic of much of the work in the field. The effectiveness of structural policies, which often takes time to materialise, is also doubted by large segments of public opinion.

It is therefore essential for economists to make this field more approachable and engaging to a wider audience. To this end, this newsletter will provide, several times a year, a non-technical but rigorous presentation of our most recent and important work on structural policies. I hope it will be of interest to experts as well as less expert readers. This inaugural issue of *Economics Newsletter* draws in particular on our ongoing work on the sources of growth. By doing so we hope to provide you with a better and more concrete sense of how successful economic reforms can actually influence long-term growth.

Jean-Philippe Cotis,
OECD Chief Economist

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The Sources of Growth

Why is economic growth diverging?

Economic performances have been diverging across OECD countries since the mid-1990s. A group of "high achievers" – North America, Australia, the United Kingdom and Nordic European countries among others – have enjoyed sustained and fast growth. By contrast, a group of "less impressive achievers" – such as Japan and large Continental European countries – have experienced disappointing growth. This divergence is partly a reflection of demographic trends, but more importantly it has also been driven by worrying developments in terms of GDP per capita.

Per capita GDP levels are decoupling…

For the first time since the end of WWII, GDP per capita among the "less impressive achievers" ceased to converge to US levels in the 80s and started to diverge in the 90s so that existing gaps in income levels have widened further. These changing fortunes have led to a renewed interest in the determinants of long-term growth. International comparisons suggest that what singles out North America and other "high achievers" is a rare ability to combine a high degree of labour utilisation with strong productivity. By contrast, Japan experiences low productivity and large European countries weak employment. To make sense of these international comparisons, it is crucial however to bear in mind that employment and productivity are interdependent. In Continental Europe, for instance, productivity figures may be too flattering, in a context where employment rates are low and a disproportionate number of low productivity persons are out of work.

This decoupling results from differences in trend growth rates across countries. To put it simply, GDP tends to grow in the long haul by about 3% in the U.S., 2% in the euro area and 1% in Japan. An important part of these differentials comes from largely exogenous demographic trends, which play in favour of the U.S. Nonetheless, GDP *per capita* also grow at different rates and the income gap between the United States and large Continental European countries and Japan is widening from its existing range (between 20% and 30%). Inside the European Union, economic performances also differ considerably across countries, with large continental economies (France, Germany and Italy) experiencing significantly slower growth than others. There is also a great disparity in convergence speeds among new OECD members.

… due to differences in labour utilisation…

In most European countries, the weakness of economic performance comes from the weak labour force utilisation (notably in Belgium, France, Germany, Italy and the Netherlands). The rate of employment is particularly low for people aged 55 and above. In addition, working hours tend to be shorter in Europe than in other parts of the OECD, and their trend is declining. These findings have prompted some European and American commentators to wonder whether the low rate of labour utilisation may not reflect a greater preference for leisure. In other words, Europeans would trade lower income levels against longer leisure time. Although this hypothesis should not be completely ruled out, it has to be said that low labour utilisation also reflects policy choices such as systematic subsidisation of early retirement and penalisation of continued work beyond the legal retirement age. Compulsory shortening of working hours may also have contributed to weaken labour utilisation. These various policies, which have a strong Malthusian flavour, were introduced in an attempt to reduce unemployment in Europe. They contributed instead to reducing employment rates and relative income levels. The policy challenge in Europe is therefore to re-establish more neutral tax and benefit systems in relation to work. Recent reforms of old-age pension schemes (France and Italy) and unemployment benefits (Germany) are good examples of the steps that are needed to re-establish progressively higher rates of labour utilisation.

… and productivity levels

Income gaps also reflect the relatively weak productivity level of a number of countries. Labour productivity looks relatively low in Oceania and Japan, and particularly so among new OECD member countries (such as transition economies). Empirical research largely relates weak productivity performance to a variety of potential determinants such as human capital and R&D, but it also attributes an important influence to competitive pressures. In the absence of competition, in particular in non-traded (services) industries, businesses may have little incentive to restructure, reorganise and incorporate new technologies to become more productive. Restrictions to FDI entry may also act as an impediment to competition and hamper productivity.

In large Continental European countries, by contrast, labour productivity appears high, sometimes even higher than in the United States – at least at first glance. This partly reflects the negative selection of workers through the pricing-out of low-skilled workers from the labour market. Adjusting for this, there appears to be ample room for raising productivity levels in Continental Europe, notably by fostering competition in product markets. The markets for utilities are a case in point: despite formal opening to competition, incumbents have in practice kept their market shares nearly intact and price falls have been modest.

The widening of gaps in income levels across countries did not happen by accident. Empirical research shows that policy settings – notably related to labour market and competition – have impacted on economic performances. With adequate structural reforms, there is no reason why "less impressive achievers" should not converge once again. This calls for particular attention to policy institutions and to business creation, as discussed in the next two articles.

Institutions and policies: Do they matter for growth?

Governments cannot fine tune productivity. But they can play an important role in establishing an environment conducive to higher productivity and growth. Good education, well designed incentives to R&D, highly competitive markets, open trade as well as low and stable inflation, there are indeed many levers governments can use to achieve stronger growth. What is most important, however, from a practical point of view, is trying to quantify their likely impact on economic activity. This is precisely what recent OECD research has tried to achieve. In the end, what it most strikingly shows is how large the "cost of inaction" is, i.e. how much growth is indeed foregone by not moving ahead with reforms and adopting best practices.

How do policies influence growth?

Economic analysis suggests unsurprisingly that public policies can influence growth through labour utilisation and productivity. Labour productivity itself depends on the accumulation of physical, human as well as knowledge capital. Accumulating capital is not enough, however. What matters too is how effectively it is used. In theory highly competitive markets are expected to provide the incentives and disciplines leading to high productivity growth. Putting numbers behind all these potential channels of influence requires however large-scale empirical investigations involving the careful handling of various datasets as well as proper econometric techniques.

Investing in human capital. Our research supports the view that improving skills has indeed a strong impact on per capita income. It was estimated that one additional year of education raises output in the long run by about 6 %. At present the representative worker in most OECD countries has benefited from 10 to 14 years of education, compared to 7 to 11 years in 1970. Longer education is therefore estimated to have increased GDP per capita from 10 to 20 %, bringing high returns to individuals and society. However, the length of education is not all that matters. Quality is also crucial and it varies markedly across the OECD. In some countries, for instance, secondary education does not operate effectively, resulting in low literacy and numeracy levels.

Investing in R&D. Empirical research has found a strong link between R&D and growth. It shows that increasing business-sector R&D pays very large benefits in terms of additional growth: on average an increase in R&D of 0.1 per cent of GDP should translate into a twelve-fold increase in economic activity! Public-sector research R&D has a more complex relationship with growth, because it is less directly oriented towards commercial applications, but can generate important basic knowledge that will then feed into private activities. Considerable international differences on R&D spending – Europe spends much less than the U.S. and Japan – have therefore obvious consequences for growth.

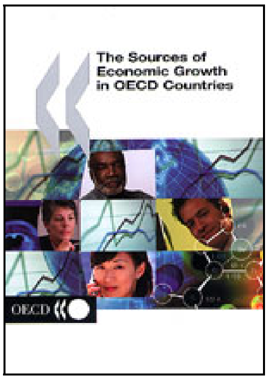
Pro-competitive product-market regulation is essential for growth

Pro-competitive product-market regulation helps growth in a variety of ways. Indeed, OECD evidence shows how restrictive product-market regulations make it particularly difficult for firms to catch up with the leaders in their field. Pro-competitive product-market regulations promote managerial efficiency and, ultimately, innovation, the adoption of new technologies and growth. Notably, one reason why many European countries are lagging behind in the development of the ICT industry is because stringent regulation has held them back. For example, it is estimated that if some OECD countries were to reform their regulatory stance, their lagging industries could reduce productivity gaps by as much as 10 %.

Promoting a stable inflation and an open economy

Let us now turn to a different sort of "public good", macroeconomic stability. Low and stable inflation was found to have an important impact on the accumulation of physical capital in the medium-term. Empirical research suggests that the reduction in the level of inflation between the 1980s and 1990s boosted GDP per capita by about 2 % by encouraging stronger investment. Also, the reduction in the volatility of inflation is estimated to have increased GDP per capita by about 1 to 1½ % by providing a secure framework to allocate resources. Opening national economies to the global environment also seems to be paying off: increased international trade is estimated to have brought about 4 % additional GDP per capita between the 1980s and 1990s.

These empirical findings send a clear message to governments: policies that promote educational achievements, private R&D activities, a stable inflation and an open economy matter for growth. But these policies cannot yield their full potential without highly competitive markets.



For further reading:

The Sources of Economic Growth in OECD Countries

Contents:

Ch.I	Economic Growth: the Aggregate Evidence
Ch.II	Policy Settings, Institutions and Aggregate Economic Growth: a Cross-country Analysis
Ch.III	What Drives Productivity Growth at the Industry Level?
Ch.IV	Firm Dynamics, Productivity and Policy Settings

How do businesses grow?

The life cycle of businesses has important consequences for productivity. The creation of new firms and the destruction of old ones are spectacular ways to increase the overall level of efficiency. But the regular expansion of existing firms – growth within the firms – is also accompanied by very large productivity gains that should not be underestimated. To find out more, the OECD co-ordinated a cross-country study based on firm-level data. Data were provided in a common framework and using similar methodologies by experts from 10 countries.

Growth comes within the firms

The study found that productivity mostly comes from within the firm: the expansion of existing firms contributes 50 to 85 % of the productivity increase process. It is indeed a major source of productivity increase in a typical OECD economy. By adding equipment, using new technologies, changing the organisation of work and other managerial decisions, existing businesses improve their productivity. Another form of productivity increase is the process of "creative destruction" – the departure of old firms from an industry and the arrival of new ones with higher productivity. This generally plays a secondary role, accounting for 20 to 40 % of productivity growth. And the third possible way of increasing productivity, that of high-productivity firms gaining market share over less productive companies, typically has a very small impact.

New small firms contribute more to productivity in the United States than in Europe

High-tech sectors differ however from other industries. Here it is the entry of new firms which significantly boost productivity growth. In this regard there are also differences between Europe and the United States. While overall rates of firm turnover are similar, start-ups in the United States tend to be smaller, and on average less productive than those in the European Union. But those that survive tend to grow much faster than in Europe. What appears to be happening is that low business set-up costs and relatively light labour market regulations in the United States encourage entrepreneurs to start on a small scale, because the opportunity cost is not too high and the business can be expanded or contracted quite easily. In contrast, higher entry and adjustment costs in Europe encourage more pre-entry evaluation of business plans, with consequently less market experimentation.

Easing entry regulations

The U.S. approach of greater hands-on experimentation by new firms seems to allow faster innovation and adoption of new technologies. The strong contribution to productivity growth by new firms in ICT-related industries appears to confirm this, and would suggest that easing regulations to stimulate firm-entry may have significant effects on productivity growth. New entrepreneurs can help boost technological advances. Countries that are disappointed by the slow pace of their technological progress may want to consider easing regulations to stimulate firm-entry. This would be beneficial to their productivity and medium-term growth.

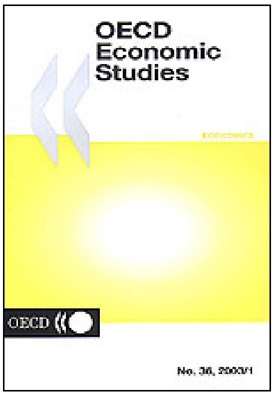
Various structural policies contribute to productivity lags

	United States	European Union[5]	Japan
GDP per person employed[1]	100	78	61
Education spending[2]	3.8	3.7	3.0
Private R&D activity[3]	2.0	1.3	2.3
Indicator of regulatory stance[4]	1.0	1.6	1.5

1. USA = 100, data for 2002 converted using 1995 PPP rates.
2. Total non-tertiary education in % of GDP. Source: *Education at Glance*.
3. In % of GDP, 2001.
4. The scale of indicators is 0-6 from least to most restrictive, 1998.
5. Weighted average, 1995. PPPs

Source: OECD.

Recent Publications



OECD Economic Studies No. 36, 2003/1

www.oecd.org/OECDEconomicStudies

- The influence of policies on trade and foreign direct investment
- Measures of restrictions on inward foreign direct investment for OECD countries
- The decline in private saving rates in the 1990s in OECD countries: how much can be explained by non-wealth determinants?
- Fiscal relations across government levels
- Tariff bindings, unused protection and agricultural trade liberalisation

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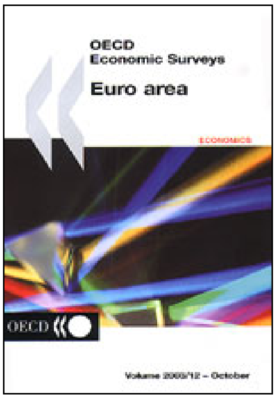

New Zealand	(Migration)
Japan	(Product market competition)
Chile	(Structural reforms)
Mexico	(Migration)
Austria	(Product market and macroeconomic performance)
Euro area	(Product market competition)
Luxembourg	(Migration)
Canada	(Migration)
Italy	(Product market competition and economic performance)
France	(Public expenditure management)
Ireland	(Enhancing the effectiveness of public expenditure management)
Denmark	(Migration)
Spain	(Migration)
Czech Republic	(Health policies)
Iceland	(Controlling spending)
Japan	(Structural policy)
Germany	(Issues in public sector spending reform)
Australia	(Migration)

Papers and articles of OECD Chief Economist

www.oecd.org/eco/speeches

Topics covered by Jean-Philippe Cotis at recent public events include: Europe's place in the world recovery, macroeconomic coordination within EMU, the new mix of monetary and fiscal policy in Japan, the reform of European labour markets, healthcare demand in Europe, tax reform in Mexico, pitfalls in evaluating potential output and the sources of divergence of growth in the OECD. Press articles include Financial Times Germany, Le Monde and Les Echos.

Recent Working Papers

OECD Economics Department Working Papers

www.oecd.org/eco/working_papers

No. 365: *Corporate Taxation of Foreign Direct Investment Income 1991-2001*, By K.Y. Yoo

No. 364 : *Indicator Models of Real GDP Growth in Selected OECD Countries*, By F. Sédillot and N. Pain

No. 363: *Post-crisis Changes in Banking and Corporate Landscapes – The Case of Thailand*, By M. Molnar

No. 362: *Post-crisis Changes in Banking and Corporate Landscapes in Dynamic Asia*, By M. Molnar

No. 361 : *After the Telecommunicatons Bubbles*, By P. Lenain and S. Paltridge

No. 360 : *Controlling Public Spending in Iceland*, By H. Suppanz

No. 359: *Policies and International Integration: Influences on Trade and Foreign Direct Investment*, By G. Nicoletti *et al.*

Corporate taxation of foreign direct investment income 1991-2001

This paper constructs indicators of tax burden on FDI in order to review their trends and cross-country patterns. Over the 1990s, the overall tax burden on inward FDI (measured by the effective marginal tax rates) fell by 8 percentage points, reflecting corporate tax reforms in some OECD countries. Nevertheless, a large variation across host countries still remains. It is also found that there is more variation in the tax burdens faced by a parent company operating in different host countries than in the tax burdens faced by subsidiaries from different home countries operating in the same host country.

Yoo, K-Y (2003), "Corporate taxation of foreign direct investment income 1991-2001", OECD Economics Department Working Paper No. 365

After the telecommunications bubble

Confidence is slowly returning to the telecommunications sector after the "boom and bust" years of the 1990s, says the study. And although the necessary restructuring now underway in the industry is painful, a new governments and regulators should resist the temptation to provide relief to companies by easing competition requirements or by providing financial help. The study says that the current state of the industry in OECD countries does not justify a major shift in telecommunications regulatory policy as a way of encouraging new investment. Indeed, competition is still hampered in some market segments, particularly high-speed internet access, which deprives consumers and businesses of some of the benefits of technological innovation.

Lenain P. and S. Paltridge (2003), "After the telecommunication bubble", Economics Department Working Paper No. 361

Global economic integration – the influence of policies on trade and FDI

This paper assesses the importance of border and non-border policies for global economic integration. The focus is on four widely-advocated policies: removing explicit restrictions to trade and FDI; promoting domestic competition; improving the adaptability of labour markets; and ensuring adequate levels of infrastructure capital. The analysis covers FDI and trade in both goods and services, thus aiming to account for the most important channels of globalisation and dealing with most modes of cross-border services supply. The paper finds that, despite extensive liberalisation over the past two decades, there is scope for further reducing policy barriers to integration of OECD markets. Remaining barriers have a significant impact on trade and FDI, with anticompetitive domestic regulations and restrictive labour market arrangements estimated to curb integration as much as explicit trade and FDI restrictions. Simulating the removal of such barriers could have a substantial impact on global integration.

Nicoletti, G. et al. (2003), "Policies and international integration: influences on trade and foreign direct investment", Economics Department Working Papers no. 359

Tax Incentives and house price volatility in the euro area

A problem associated with inflation differentials in monetary unions is that the "crowding-in" effect of lower real interest rates associated with high inflation will initially outweigh the loss of competitiveness (crowding out). The crowding-in effect may produce volatility in house prices, especially if tax regimes favour the occurrence of bubbles. This paper shows that this is the case notably in the smaller countries of the euro area, and this could explain the persistence of inflation differentials in the area to some extent.

Van den Noord, P. (2003), "Tax incentives and house price volatility in the euro area: theory and evidence", Economics Department Working Papers No. 356

Structural policy and growth

To tackle the widening gap in GDP per capita now emerging among the major OECD countries, many governments, particularly in Europe and Japan, need to change policies to boost both jobs and labour productivity, says this new study. GDP per capita in the European Union and Japan remains about 30 percent behind that of the United States, and the steady narrowing of this gap appears to have reversed during the 1990s. In Japan the gap is due to a lower level of productivity while the EU has fallen behind because of generally weak employment rates and the fact that, on average, employees work fewer hours than in the United States.

De Serres, A. (2003), "Structural policies and growth: a non-technical overview", Economics Department Working Papers No. 355

Macroeconomic policy and economic performance

This paper analyses the major changes in both monetary and fiscal policy that have taken place over the past two decades and evaluates the costs and benefits for the OECD economies. The general findings for monetary policy are that, while it was costly to lower inflation (in terms of output and employment), there are also benefits in terms of lower risk premiums, a more favourable investment climate and an improvement in economic efficiency. That said, the paper concludes that there is not much of a case for lowering inflation further from its already low level. The paper also says that, despite recent slippage, fiscal policy has contributed to a better macroeconomic environment. Existing fiscal frameworks may however not be sufficient to guarantee sustainability over the medium term in the face of projected rising demands from health care and ageing.

De Lima, P., A. de Serres and M. Kennedy (2003), "Macroeconomic policy and economic performance", Economics Department Working Papers No. 353

Regulation and investment

One commonly held view about the difference between continental European countries and other OECD countries, especially the United States, is that the heavy regulation of Europe reduces its growth. Using newly assembled data on regulation in several sectors of many OECD countries, the paper provides substantial and robust evidence that various measures of regulation in the product market, concerning in particular entry barriers, are negatively related to investment. The implications of the analysis are clear: regulatory reforms, especially those that liberalise entry, are very likely to spur investment.

Alesina A. et al. (2003), "Regulation and investment", Economics Department Working Papers No. 352

No. 358: *Enhancing the Effectiveness of Public Spending in Finland*,
By P. Hemmings *et al.*

No. 357: *Measures of Restrictions on Inward Foreign Direct Investment for OECD countries*,
By S. Golub

No. 356 : *Tax incentives and House Price Volatility in the Euro Area: Theory and Evidence*,
By P. van den Noord

No. 355 : *Structural Policies and Growth: A Non-technical Overview*,
By A. de Serres

No. 354: *Tax Reform in Belgium*,
By D. Carey

No. 353: *Macroeconomics Policy and Performance*,
By P. de Lima, A. de Serres and M. Kennedy

No. 352: *Regulation and Investment*,
By A. Alesina *et al.*

No. 351: *Discretionary Fiscal Policy and Elections: The Experience of the Early Years of EMU*,
By M. Buti and P. van den Noord

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The Economics Newsletter is published by the Economics Department of the OECD.

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Home pages of particular interest:

Agenda for growth (www.oecd.org/growth/agenda)

This is the home page of ECO's work on policy agenda for growth. Click and find:

- Background information on this work
- Links to publications which are free to download
- A set of data files that can be downloaded in Excel format
- Speeches by the OECD Chief Economist
- Links to the home page on the firm-level data project

Economic Outlook (www.oecd.org/OECDEconomicOutlook)

This is the home page of the OECD Economic Outlook. Click and find:

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- The detailed findings of cross-country empirical research on structural policies
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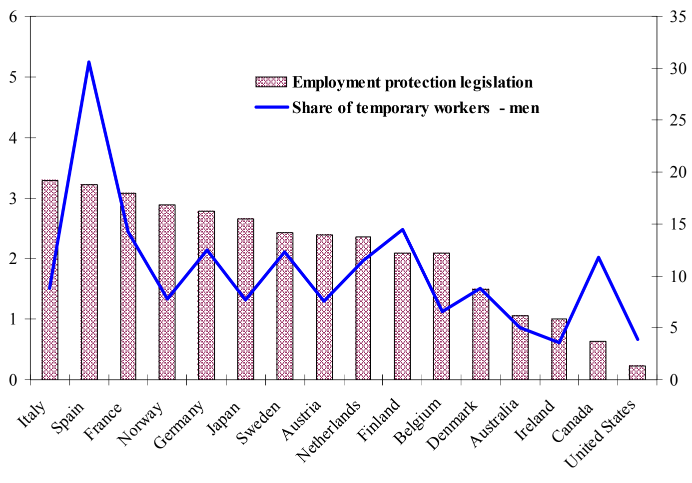
Spotlight on Recent Statistics

Strict employment protection legislation is associated with a high prevalence of temporary work in the OECD



Note:
The employment protection legislation indicator is drawn from Nicoletti et al. (1999), "Summary indicators of Product Market Regulation with an Extenstion to Employment Protection Legislation", *Economics Department Working Paper* No. 226. The scale of employment protection indicators is 0-6 from least to most restrictive.
The incidence of temporary employment among male workers represents the share of temporary workers in total dependant employment for 2000. It is based on Table 3.3 of OECD *Employment Outlook*, 2002 Edition.