

## Economic Survey of Mexico, 2007

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### Summary

Over the past decade, Mexico has made significant progress towards macroeconomic stability and has launched important structural reforms to further open the economy to trade and investment and improve the functioning of markets for goods and services as well as to develop the financial sector. These efforts have yielded relatively good performance. After a strong 2006, output growth is expected to be close to potential, between 3½ and 4% over the next two years. Potential GDP growth, however, is much too low to bridge the wide gap in living standards with wealthier OECD countries and tackle the still widespread poverty. To move the economy onto a higher and sustainable growth path, a renewed effort at reform on a broad front is required.

### *Strengthening public finances remains a priority*

The fiscal position is good, and the 2006 Budget and Fiscal Responsibility Law has contributed to further strengthening the fiscal framework. However, the underlying situation of public finances is not yet comfortable given the heavy reliance of the budget on uncertain oil revenue. Measures aimed at increasing public spending efficiency are necessary. But a far-reaching tax reform also remains a priority to increase resources for supporting essential spending needs. Moreover, fiscal relations across levels of government should be reviewed to strengthen sub-national governments' accountability. The Mexican Government recently submitted to Congress a comprehensive public finance reform which would imply significant progress if approved.

### *Further international trade and investment liberalisation together with regulatory reforms are required*

Mexico has undertaken substantial trade reforms, including regional trade agreements with many countries, and tariffs vis-à-vis other countries have

*This Policy Brief presents the executive summary of the 2007 OECD Economic Survey of Mexico. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, discussed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

been reduced although they remain above levels prevailing in the OECD. Further tariff reduction would likely bring substantial gains since it would create new opportunities for firms to access competitive inputs and much-needed technologies. It is also important to reduce non-tariff barriers, including inefficient customs procedures and irksome technical requirements, which hamper trade flows. Likewise, there is scope to ease restrictions on foreign direct investment, in particular in telecommunications, domestic land transport, coastal shipping and airports.

***Mexico also needs stronger competition and better regulation to boost productivity and growth***

Significant progress has already been made, but there is scope to improve regulations and the enforcement of competition policy. Competition in postal services, natural gas and electricity is still hampered by unduly restrictive regulations. In airports, railways and telecommunications, adequate regulations for access pricing to key facilities are required to encourage the entry of new participants and enhance their ability to compete. The sector regulators do not always have sufficient authority to be effective. Finally, the enforcement of competition policy and sector regulations is often hindered by time-consuming litigation.

***Labour market and social policies have an important role to play***

Open unemployment is low, but many workers are engaged in low-productivity and unrewarding jobs. A review of the tax-benefit package is required, in particular to improve the efficiency and reliability of social security services. This would contribute to strengthening incentives to work in the formal economy, especially for low-paid workers. A better balance should also be found between labour market flexibility and worker protection in case of job loss. Moreover, stronger coordination between labour and social policies, as well as greater efforts to enhance human capital, are needed to effectively assist the most vulnerable individuals and pull people out of the poverty trap. ■

## What are the main challenges?

Mexico has implemented a wide range of reforms to liberalise the economy and open it to foreign trade and investment, starting in the late 1980s. Its macroeconomic performance has improved significantly and GDP growth averaged 3.6% per year since the 1995 peso crisis. In 2006, growth reached a robust rate of 4.8%, underpinned by buoyant exports and strong investment. However, activity is expected to slow this year and next, with GDP growth around its potential rate, estimated to be between 3½ and 4%. This growth rate, given population growth of around 1.3% per year, is too low to allow convergence of Mexico's income per capita towards the living standards of the more advanced OECD countries. In 2005, the average income of the Mexican population was still one of the lowest in the OECD and only about one-fourth that of the United States (in purchasing power parity). While labour utilisation is not far from the OECD average, labour productivity has grown at too slow a pace to catch up from its initial low level.

Sound monetary and fiscal policies have contributed to macroeconomic stability. On the monetary policy front, the Bank of Mexico has achieved a high degree of credibility and inflation expectations have converged towards the Bank's target. However, a series of supply shocks since the middle of 2006 have led to an upturn in inflation. Headline consumer price inflation has been hovering at just over 4% (year-on-year) since September, above the central bank's target of 3% and at the top of its variability interval of plus or minus 1 percentage point. Core inflation also increased, while inflation expectations remained broadly unchanged at 3½ per cent. The bank responded with a pre-emptive move by raising its interest rate in April, in order to prevent the upturn in inflation from feeding into inflation expectations. The projected slowdown in activity is likely to ease inflationary pressures. Until this occurs, a tight monetary stance should be maintained. On the fiscal policy front, Mexico has achieved a good track record in attaining budget targets for many years. Higher oil-related revenues since 2002 helped bring the public sector borrowing requirement to below 1% of GDP in 2006. Moreover, the Budget and Fiscal Responsibility Law, which came into effect in 2006, has contributed to further strengthening the fiscal framework. However, the underlying situation of public finances is not yet comfortable because of the heavy reliance of the budget on oil revenue, part of which is volatile and uncertain. At the same time, the budget is exposed to growing demands for essential spending in education, health, poverty alleviation and infrastructure.

Mexico can count on several assets to boost productivity and output growth: a relatively young population; geographical proximity to – and a free trade agreement with – the largest market in the OECD; a solid macroeconomic policy framework; and a healthy financial system. However, a number of structural weaknesses have to be addressed, in particular, the low level of human capital, a large informal sector, and widespread poverty. Furthermore, poor physical infrastructures (including transport, telecommunications, energy and water), restrictive regulations and insufficient competition in some sectors are hindering productivity growth. Large firms are likely to find a way around costly administrative burdens and manage to overcome infrastructure lags. But many smaller firms face severe constraints to investment and expansion. The benefits that the economy at large can draw from trade openness and spill-over

effects from foreign direct investment (FDI) can be further enhanced. *The reform process, which slowed in recent years, should be stepped up, in particular by further opening the economy to reap the full benefits from international integration and taking complementary measures that enhance infrastructure, improve the business environment and improve the prospects for workers to move to more productive jobs.*

In its agenda for structural reform, the new administration has identified ensuring fiscal sustainability and strengthening economic growth as priorities. Indeed, the underlying weakness of public finances requires a broad strategy with corrective actions on both the spending and tax sides. Boosting Mexico's growth potential is also a challenging task that requires taking action in all areas of public policy, including education, which was covered in the special chapter of the 2005 Economic Survey. Stronger economic growth will help reduce poverty, but targeted programmes for poverty alleviation are also needed to pull people out of the poverty trap. This report focuses on four main challenges that Mexico needs to address in order to lift per capita GDP growth, raise living standards and reduce poverty faster:

- Strengthening public finances.
- Maximising the gains from integration in the world economy.
- Strengthening competition and improving infrastructure.
- Enhancing the adaptability of the labour market while providing effective social protection.

These policy priorities are among those identified as key drivers of growth across OECD countries in the *Going for Growth* exercise. ■

### Why is a public finance reform needed?

Mexico has gained a solid reputation for fiscal rectitude, and the new fiscal responsibility law is expected to facilitate prudent fiscal management. It establishes strict budget rules and defines new guidelines for allocating excess revenue and drawing from the various stabilisation funds (the States Revenue Stabilization Fund, PEMEX Investment Stabilization Fund and the Oil Stabilization Fund). Also important to improving the soundness of public finances has been the reform of the federal government employees' pension system (ISSSTE), on which the government managed to build a consensus and which was approved in March 2007. The reform substantially reduces the government's pension liabilities and allows portability of pension rights between the government and the private sector. *Building on it, the government should now reform the other social security sub-systems of government agencies and state-owned companies. Other key reforms are needed to reduce the dependence of the budget on oil revenue and address fundamental weaknesses in public finances.* Aware that the current fiscal settings fall short of what is needed to support the growth process, the government submitted to Congress in June 2007 a wide-ranging public finance reform. The reform package includes four main pillars:

- Improving tax administration in order to facilitate tax compliance and to fight tax avoidance and evasion more effectively.
- Establishing an institutional structure that guarantees more efficient and transparent spending at the three levels of government.

- Redefining fiscal federalism by providing states and municipalities with better tools and incentives and promoting responsibility and accountability at all levels of government.
- Setting the foundations for a tax system that allows the substitution of oil revenues with more stable sources of income.

*If approved, this reform would represent a significant step forward. It would lay the ground for additional measures that may be required in the longer run to further strengthen public finances.*

Despite recent improvements, tax compliance remains relatively cumbersome and costly, especially for self-employed professionals and small and medium-size enterprises. Moreover tax evasion remains high. Measures have been proposed to facilitate voluntary compliance with tax obligations and tackle evasion, smuggling and informality. *Moving in this area is important for the success of the overall public finance reform, as it would raise the perception of fairness in taxation and make the reform package more effective.*

As part of its reform package, the government is proposing to strengthen the system of performance evaluation for public programmes. Building on progress achieved over the years in budgeting and public management, the plan is to introduce mechanisms for a more systematic and objective evaluation of the impact of government programmes, combined with measures to modernise public management and rationalise public services. *Achieving efficiency gains in public spending at all levels of the public sector would go some way to limiting new funding needs. It would also contribute to improving the quality of public services, while enhancing the fiscal position.* Two areas for reform on the spending side can illustrate this point. First, in education, *a larger share of spending should be allocated to non-wage items that are important for the quality of education services, while teachers' training and selection need to be strengthened. Rebalancing the allocation of spending and ensuring that the financial incentive scheme in place for teachers serves its purpose are some of the options to improve education outcomes.* Second, *subsidies which prevail in many areas (such as water, electricity and gasoline) should be reduced. They are costly for public finances, tend to be regressive and distort incentives. Removing subsidies and using part of the savings for direct cash transfers to the neediest would achieve several policy goals simultaneously: i) encouraging investment in areas of vital importance for growth and living standards (e.g. water); ii) improving income distribution by increasing the progressivity of public spending; and iii) increasing incentives for consumers to be more efficient.*

Fiscal relations across levels of government are another area where there is scope to improve the efficiency of public spending. The devolution of spending responsibilities to states and municipalities has been rapid, the process intensifying in recent years as states received a proportion of higher-than-budgeted revenue for investment. Generous adjustments in federal transfers have reduced sub-national governments' incentives to use their taxing powers and raise their own revenue. *In line with recommendations made in the OECD Economic Survey of Mexico, 2005, the reform proposal seeks to modify the formulas for the allocation of federal transfers to sub-national governments to better reflect objective needs and outcome evaluation. Furthermore, sub-national governments would*

be given more room to raise their own taxes. This last point is fundamental to increase states' accountability. Improving the quality of information on spending and outcomes at the sub-national levels of government, as included in the proposal, would also help promote accountability by increasing the transparency of spending.

To strengthen public finances and improve the stability of revenue, there is a need to restrict the numerous exemptions or special regimes and broaden the overall tax base. The government's proposal envisages introducing a minimum general income tax on firms and professional activities, which would tackle the exemptions, tax deductions and preferential regimes that currently create uneven incentives and complicate the administration of the income tax. Together, the proposed tax administration measures and tax reform are expected to generate additional revenues of close to 3% of GDP by 2012. In the longer run, consideration should be given to further broadening the tax base on the VAT side, which is plagued by exemptions and a large proportion of zero-rated goods and services. This would reduce the distortions on the economy and bring in additional tax revenue while also simplifying administration. As part of the VAT reform, measures may have to be taken to provide some compensation to low-income households. Measures will also be needed to raise the very low proceeds from the real estate tax (administered by municipalities) to levels observed in other OECD countries. Such a move would contribute to raising overall tax revenues in a fair way and it would increase taxing powers of sub-national governments. ■

### How should PEMEX be modernised?

To ensure the best returns from Mexico's oil resources and production stability in the medium-term requires improvements in the efficiency and financial performance of PEMEX, as well as adequate investment decisions and operation. Mexico should reform the corporate governance of PEMEX to strengthen the incentives and accountability for maximising the company's efficiency. Future oil production largely depends on the development of new projects requiring major investment. A new fiscal regime was introduced in 2006, so that PEMEX would have additional resources. It will be important to assess whether these resources are sufficient for the company to undertake adequate oil-field maintenance and development. *Many improvements could be made even within the current constitutional framework. Government's interference in management of the company should be minimised. The company's own social security regime should be reformed to bring it in line with that of the private sector (and the new civil servants regime).* Finally, the existing public works contracts that engage the private sector in production projects appear to be insufficient for PEMEX to access the technology it needs and to help manage risk exposure better. In this context, and while recognizing that more fundamental reforms are not on the agenda, legal changes will likely be required – sooner or later – to allow joint ventures with private companies in exploration and production from deep water oil reserves. ■

### What can be done to get more out of globalisation?

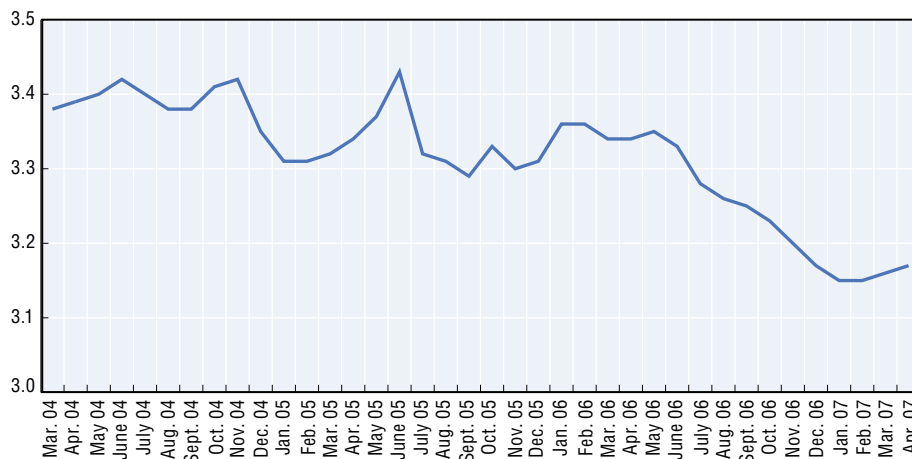
Over the past twenty years, Mexico's development strategy has been to open the economy to foreign trade and investment. The process has led to some structural changes in the production sector and a gradual shift in the economy's trade specialisation towards medium and high-technology products. The presence of foreign firms, through spill-overs and modern management practices, has brought substantial benefits, mostly in manufacturing, but

also in services such as banking. The example of several fast-growing OECD countries shows that Mexico could gain even more by combining competition-enhancing reforms with greater trade integration and FDI inflows. A reduction of remaining barriers to trade and FDI would encourage a more efficient allocation of resources, give access to lower-price, higher-quality, inputs for domestic firms and increase competition in the domestic market, thereby raising productivity and long-term growth.

Mexico has reduced its most favoured nation (MFN) tariff barriers over the past years and has concluded twelve regional trade agreements. However, average MFN tariffs remain well above levels prevailing in the OECD and many non-OECD middle-income countries. *Although many tariff lines were reduced in September 2006, there is scope for further action.* Potential gains for Mexico's productive sector would be substantial, since the tariff reduction would create new opportunities for firms to access cost-competitive inputs. By limiting the scope for corruption and fraud at borders, it would reduce private sector transaction costs. *It is also important to reduce non-tariff barriers, including complex customs procedures and burdensome technical requirements which hamper Mexico's trade.* At the same time, there may be a need to introduce measures to help labour market adjustments. In particular, time-limited, targeted policies may be considered to ensure that the most vulnerable population groups do not bear too high costs. However, the most promising option is to improve the functioning of the labour market more generally (see below).

Mexico has made significant progress in lifting restrictions to foreign direct investment (FDI), and gross FDI inflows, after peaking in the early 2000s, have stabilised at a solid level – close to 2% of GDP – over the past few years. However, *there is scope to further ease restrictions, particularly in some services and infrastructure sectors, including telecommunications, domestic land transport, coastal shipping and airports.* Lifting ownership restrictions on foreign investment in these sectors would help to increase FDI inflows and boost productivity by

**Figure 1.**  
**OIL PRODUCTION**  
Barrels per day (millions)<sup>1</sup>



1. Three-month moving average.

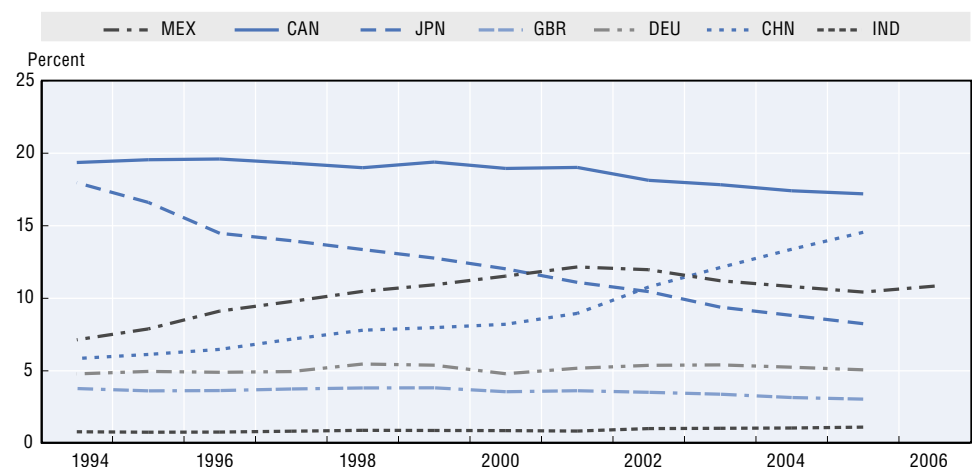
Source: PEMEX.

promoting technological spill-overs. To maximise benefits from higher FDI, broad policy measures are required to improve the business environment, including for smaller firms, and to upgrade human capital. Such moves would help linkages between foreign firms and suppliers to develop more deeply into the domestic economy, thereby maximising technological spill-over effects. Higher foreign investment in services and infrastructure sectors, such as transport, telecommunications and the energy sector, would contribute to improving the quality and price of services used as inputs by Mexico’s business sector, thereby helping their competitiveness and making the country even more attractive to FDI. More generally, further strengthening of the rule of law would create a better environment for domestic and foreign firms alike. ■

**How to remedy the shortfalls in infrastructure?**

Mexico has also made much progress in enhancing competition domestically; by creating pressure on firms to innovate, this will be a major source for economic growth. But in many areas, in particular network industries, more competition is needed. To this end, a number of broad issues related to competition policy and the regulatory framework should be addressed. Competition in some key sectors – such as postal services, natural gas and electricity – is still hampered by unduly restrictive regulations. Moreover, there are sectors where competition-enhancing regulations are not effective or enforceable. In airports, railways and telecommunications, for instance, adequate regulations for access pricing to key facilities are required to encourage the entry of new participants or give them the ability to compete. The sector regulators do not always have sufficient authority to obtain from industry participants the information they need in order to be effective. Finally, the enforcement of competition policy and sector regulation is often hindered by time-consuming litigation (*amparos*). Improving regulations and the enforcement of competition policy is a priority. The Federal Competition Commission (CFC) should be provided with more adequate resources and cooperation between sectoral regulations, the government and the CFC should be strengthened. Furthermore, *amparo* rights should be reviewed and specialised courts with economic expertise should be created.

**Figure 2.**  
**MARKET SHARE OF SELECTED COUNTRIES IN USA MANUFACTURED IMPORTS**



Source: US Department of Commerce.

The government is considering undertaking a review of existing laws and regulations to eliminate unnecessary restraints of competition. The experience of other countries, such as the broad competition policy review conducted in Australia over a period of several years, suggests that such a comprehensive review is an important step to promote competition, a key driver of economic growth. The OECD *Competition Assessment Toolkit* can provide a framework for this exercise.

The efficiency, quality and price of transportation are important factors influencing the cost-competitiveness of Mexican firms, the attractiveness of the country to foreign investors, and consequently Mexico's productivity growth. The road network and trucking are plagued by inefficiencies and there are border issues that need to be addressed. The government is committed to further developing road infrastructure through public-private partnerships and concessions for toll roads. *Clarifying long-term government plans would help private sector involvement. Scarce public resources should be invested in areas that are less attractive to private investors, but may be economically justifiable to facilitate inter- and intra-state commerce, as well as better integrate remote rural areas.* To further promote trade with the large US market, *an agreement for a pilot project on the US-Mexico cross-border trucking was signed in February 2007, and it needs to be implemented.* In railways, past privatisation has led to productivity gains, lower prices and quality increases, but disputes between private concession holders over trackage rights have prevented the nationwide development of traffic and interlinear transport across the whole network. *Stronger regulations are required for setting trackage and interconnection prices. Measures to improve port efficiency are also needed as this would bring large benefits in terms of trade flow increases.*

There is scope to impose effective competition in the telecommunication networks with a view to further reduce prices and improve the quality of services. Despite large reductions in telephone charges, Mexico remains one of the OECD countries with the highest charges, especially for business use. In the mobile telephone market, in particular, the dominant firm is using its market power to squeeze out other players. The government is committed to increasing effective competition. *Essential measures include improving mandatory access to the local loop (which is important for broadband development), regulating fixed-to-mobile termination charges and introducing mandatory roaming for smaller mobile companies to use the largest firm's network at a regulated price. The sectoral regulator, COFETEL, needs greater independence from leading companies in the sector. It should be given by law the power to set access prices to the local loop and other key network facilities. COFETEL should be held accountable to the government for the design and implementation of access pricing rules that are pro-competition.* Clarity in the law and regulations is of prime importance to reduce the scope for excessive use of *amparo* proceedings, which have frequently inhibited enforcement.

It would be appropriate to engage in a process of restructuring of the electricity sector, to improve its efficiency and the competitiveness of the economy as a whole, while at the same time strengthening incentives for generation and transmission investment so as to keep pace with projected demand over the medium term. The objective is to provide businesses with an increasing and reliable supply of lower-cost energy. Some useful steps can be taken to promote

efficiency in the state-owned companies within the current constitutional constraints. *In particular, clear separation of the generation from the transmission company should be carried-out. An electricity market should be set up and it should be run by a system operator working as an independent entity from the dominant state-owned company, CFE. To further improve investment incentives and efficiency, consideration will have to be given to changing the legislation at some point to allow private investors to sell power directly in the wholesale market.* ■

## What about jobs?

A well functioning labour market and effective social policies are also essential to promote stronger and more equitable growth. Open unemployment is low, but there is a high incidence of informal and low-productivity jobs. Promoting the creation of more – and especially more productive – jobs requires action on a broad front, including human capital formation and improvements in the business environment, as well as reforms in labour market and social policies. *First, there is a need to improve the prospects for workers to move to more productive jobs by upgrading skills and competences. Second, greater labour market flexibility coupled with effective protection in case of job loss (for instance through individual savings accounts) would enhance labour market efficiency. Third, a range of actions is required to fight exclusion and widespread poverty.*

The education system can play a vital role in helping Mexico's modernisation and enhancing its capacity to meet the rising and changing demand for skills in the new global environment. Poor education outcomes do not result from a lack of spending but from the sector's low efficiency. *Educational resources need to be better allocated; incentives for teachers to perform well should be strengthened. Furthermore, measures to improve the education system's performance have to be complemented by renewed efforts to upgrade the workforce competences through adult training.* Policy makers should focus on promoting privately-provided training and financial support should continue to go to trainees or firms to stimulate the demand for training, rather than financing training providers.

Tackling the problem of informality also requires labour market measures to strengthen the incentives for formal employment. Two reforms undertaken in the beginning of 2007 are expected to improve the functioning of the formal labour market. First, the reform of the public sector pension system (ISSSTE), by allowing portability of pensions across sectors, will facilitate labour mobility. Second, the pension savings account reform (SAR), which aims at reducing fund managers charges, is expected to enhance the net returns on private pension funds, thereby helping to make formal sector employment more attractive. But more has to be done. Because policies are inter-related, a comprehensive reform strategy is essential to increase incentives for formal sector employment. *Priorities include:*

- *Reviewing the tax-benefit package, in particular to improve the efficiency and reliability of social security services, as this would enhance incentives to formal sector employment, especially for low-paid workers.*
- *Increasing labour market flexibility, by broadening the legal ground for dismissal, while improving the effective protection of workers. To facilitate mobility in the formal sector, consideration should be given to replacing severance payments with a system of individual savings accounts. This would reduce transaction costs while increasing income security.*

- *Broadening the scope for temporary contracts and part-time work – this would help the creation of jobs in the formal labour market and promote female participation in particular.*
- *Strengthening control over compliance with tax and social security obligations, although this can only be a part of the strategy.* ■

### How to improve social protection and fight poverty?

A reduction in poverty levels has been achieved over the past few years. But poverty remains widespread and social policies are not always effective. On the one hand, there is a contributory social security system which covers only about half of the population. It is neither equitable nor efficient. Because benefits delivered exceed contributions, it has been subsidised by general contributions. On the other hand, the population which is not covered by social security has access to poor quality state health services. The basic health insurance, *Seguro Popular*, was created to extend the coverage of health insurance and reduce the risk of catastrophic out-of pocket health care spending for the uninsured. In the long-term, moving towards a unified system integrating state health services and the social security system would be appropriate to improve efficiency and equity. In the short-term, strong action is required both in the social security system and for the more vulnerable uncovered population. *In the contributory health systems, measures should be taken to improve efficiency in service delivery and ensure financial soundness. For the non-uninsured population, further widening of Seguro Popular is appropriate, as done for instance with the recent creation of the health insurance for the youngest generation, provided reliable budget funding is available.* Beyond health care provision, as the budget constraint is eased, more measures will have to be introduced to ensure that the most vulnerable population groups have access to adequate nutrition and basic education services. *Income support for targeted families through the conditional cash transfers programme Oportunidades has shown good results and it should continue. The programme's effectiveness should be further enhanced by increasing the quality of basic health and education services.* Small-scale social programmes were created in 2007, but it is unclear whether the financial resources will be available on a steady basis. More generally, *it would be appropriate to rationalise social programmes in place, based on systematic evaluation, and to improve the cost-effectiveness of social assistance as a whole, while ensuring that programmes preserve incentives to work.* ■

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