



Economic Survey of Germany, 2008

How can high economic growth be made more enduring?

What can be done to improve the fiscal framework?

Can growth be made more labour intensive?

How can education outcomes be improved?

Which reforms in network industries would help to increase competition?

What can be done to make healthcare more cost-efficient?

For further information

For further reading

Where to contact us?

Summary

Following a prolonged period of stagnation, Germany has been enjoying a vigorous recovery. Business and government finances are robust, laying a solid foundation for a continuation of the upswing provided that headwinds from the global financial market turmoil do not become overwhelming. Nevertheless, for high economic growth to last beyond the cyclical upswing, it will be necessary to raise the growth rate of potential output. Past reforms, especially in the labour market, have helped to raise the potential growth rate recently, but there is still much scope to increase hours worked per capita and to increase productivity, notably in certain network industries. Improving education outcomes, including by reducing the impact of socio-economic background on outcomes, will be important for sustaining high economic growth in the long run.

Past achievements in fiscal consolidation need to be preserved. With the structural budget now in balance, the challenge is to avoid pro-cyclical policies and to deal with the long-term fiscal challenges of ageing. Replacing the current fiscal rule, which has proved to be ineffective, with the requirement of a structural budget balance in line with the Stability and Growth Pact should be considered. In addition, securing future tax revenues requires shifting more of the tax burden from mobile to immobile tax bases. The lowering of corporate tax rates is a step in the right direction but more could be done. Finally, the tax collection process should be made more efficient.

Reform momentum in the labour market needs to be maintained to achieve lasting improvements. The focus should be on increasing the low number of hours worked per person employed, notably of women. This could be achieved by lowering financial disincentives for second-earners to work longer and increasing the supply of childcare to allow more mothers to work. Long-term unemployment also remains a problem and while the increase in work incentives implemented with the Hartz IV reform has been a first step to improve labour supply of this group, more could be done. On the labour demand side, lowering the strict employment protection legislation for regular job contracts and avoiding too high minimum wages are important challenges. Plans to further phase out early retirement options are welcome in order to raise employment rates for older workers and should be implemented soon.

This Policy Brief presents the assessment and recommendations of the 2008 OECD Economic Survey of Germany. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed 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.

Further reforms in education are needed to raise education achievement and attainment and reduce the impact of socio-economic background on outcomes. To improve education achievement and reduce the large impact of socio-economic and/or immigrant backgrounds on outcomes, the authorities should expand participation in pre-school education, improve teaching quality, and reduce stratification in the education system. Giving universities more flexibility over their funding by allowing them to charge students tuition fees, accompanied by loans with income-contingent repayments, would help to enhance the quality of university education, making it more attractive in *Länder* where these policies have not yet been implemented.

Product market competition needs to be strengthened, notably in network industries. Both the energy and railways sectors are dominated by large vertically integrated companies operating networks. Productivity could be increased and consumer prices reduced by lowering entry barriers, including the option of stronger forms of vertical separation. Also, concentration at the wholesale level needs to be reduced. Privatisation in the railway sector should focus on a strong separation between track ownership and operation, on the one hand, and transport services on the other.

Healthcare reforms should help to increase efficiency but need to be taken further. The government plans to reduce the impact of healthcare costs on non-wage labour costs by increasing budget contributions, but needs to decide quickly on how to finance them. To strengthen price signals in the reformed healthcare system, the government should remove income limits on the surcharge that less efficient insurers charge their members and directly compensate the higher burden for low-income earners. Private insurers should be included in the new financing system to make risk pooling more efficient and to enhance equity. ■

How can high economic growth be made more enduring?

Germany has been experiencing a strong economic recovery after a prolonged period of stagnation in the early years of the current decade. With corporate balance sheets and profitability robust and the government structural budget near balance, solid foundations have been laid for the continuation of the upswing. Nevertheless, for high economic growth to be more enduring, as intended by the authorities, it will be necessary to raise the growth rate of potential output. Past reforms, notably in the labour market have helped to lift growth in potential output recently, but there is still considerable scope to increase hours worked per capita, despite the progress made during the current upswing, and to improve productivity, notably in certain network industries. In the long run, improving education outcomes, including by reducing the impact of socio-economic background on outcomes, will be central to sustaining high economic growth and social cohesion.

A factor that aggravated the downturn in Germany that preceded the current recovery is that it was necessary to consolidate the government budget during the downturn, structural public finances having deteriorated during the preceding upswing. Avoiding such pro-cyclicality would contribute to making economic growth more stable; it could also help to raise productivity by reducing investment risk. As in other OECD countries, the overarching objective of fiscal policy is to ensure that public finances are on a sustainable path. Despite major pension reforms in recent years, some further budget consolidation may still be needed to pre-fund future budget pressures related to population ageing. Germany also shares with other OECD countries the challenge of containing and financing long-run growth in healthcare expenditures not related to population ageing.

Following the traditional business cycle pattern in Germany, the current upswing began in the export sector. Exports have grown strongly since 2004, underpinned by high growth in Germany's export markets and its specialisation in capital and intermediate goods (demand for which is sensitive to the global business cycle). So far, appreciation of the euro has not had much effect because exporters make their supply decisions on the basis of their assessment of sustainable exchange rate levels, absorbing exchange rate fluctuations via margin compression, and because real unit labour costs have been declining. Investment expenditure turned around next, following the slump in such expenditure that occurred in the early years of the decade. In contrast to previous recoveries, private consumption expenditure is lagging the recovery. This performance is attributable to unusually weak growth in household incomes, despite much higher growth in total hours worked than in previous upturns, reflecting low growth in real wage rates, which has lagged far behind productivity growth. The upside of these developments for the continuation of the economic upswing is that companies are well placed to continue to invest and expand employment, albeit at a slower pace than in recent years owing to the headwinds coming from the global credit crunch and rising commodity prices. The OECD projects that the economic growth rate will slow from 2½ per cent in 2007 to 1½ per cent in 2009, which is around the estimated potential growth rate. Such growth would see a small positive output gap from 2008 onwards. ■

What can be done to improve the fiscal framework?

While the favourable cyclical development has helped to improve government finances, the largest contribution came from expenditure restraint. The revenue share has been broadly stable, despite the increase in the VAT rate in 2007 and strong growth in direct taxation, owing to lower social security

contributions. Going forward, past achievements in fiscal policy should be preserved and pro-cyclical policy during the upswing avoided. International comparisons show that sensibly designed fiscal rules can be helpful in this regard. The current fiscal rule arrangement enshrined in the German constitution, which follows a golden rule methodology, states that the deficit should not be higher than investment in a given year, but has not proved to be effective. It has prevented neither a rise in the debt level nor pro-cyclical policies. *It should thus be replaced by the requirement of a balanced budget in cyclically-adjusted terms, in line with the regulations of the Stability and Growth Pact. This rule could be made more effective by making the underlying expenditure path public and binding. This should also be applied to sub-national levels which might require strengthening the tax autonomy of the Länder. Allowing them to levy a surcharge to the income tax which would not be taken into account in the fiscal equalisation scheme would be one option.*

As population ageing requires further budget consolidation, efforts also need to be stepped up to safeguard future tax revenues in a globalised world with mobile tax bases. Lowering corporate tax rates and broadening the tax base from 2008 onwards is a step in the right direction as it addresses the problem of outward profit shifting. But it may not be enough over the long run to secure the corporate tax base, as statutory tax rates after the reform will be higher than in a number of other countries and as global tax competition will induce other countries to lower their rates, too. *Thus, shifting more of the tax burden from mobile to immobile tax bases should be considered. Options would be to lower the local business tax and to increase property taxes at the municipal level. Also, pressures to abolish inheritance taxes should be resisted. Additional tax revenue might also be gained by improving the tax collection process, for example by centralizing corporate tax collection at the federal level. This would help to circumvent a potential loss of revenue induced by the lack of incentives for states to levy the tax rigorously. Alternatively, the fiscal equalisation scheme could be reformed so that transfers are computed on the basis of tax capacity rather than actual tax revenue. Furthermore, the current application of the reduced VAT rate should be reconsidered for products for which a reduction is no longer justified.* ■

Can growth be made more labour intensive?

With relatively low economic growth over the past decade, potential GDP per capita (converted to dollars at PPP exchange rates) has slipped from 78% of the United States level in 1995 to 73% in 2006 (the United States is typically taken as the benchmark as it is the global productivity leader in most sectors). This divergence of potential GDP per capita levels is attributable to lower growth in both hours worked per capita and labour productivity in Germany than in the United States. Focusing on the current gap in potential GDP per capita, the main factor accounting for this shortfall is lower hours worked per capita in Germany, despite the progress that Germany has made in increasing labour utilisation in recent years. An examination of productivity data by sector suggests that there is substantial scope to raise productivity in the energy and transport sectors. These are sectors in which the quality of regulation can have a large impact on competitive pressures and hence on productivity and prices charged to clients.

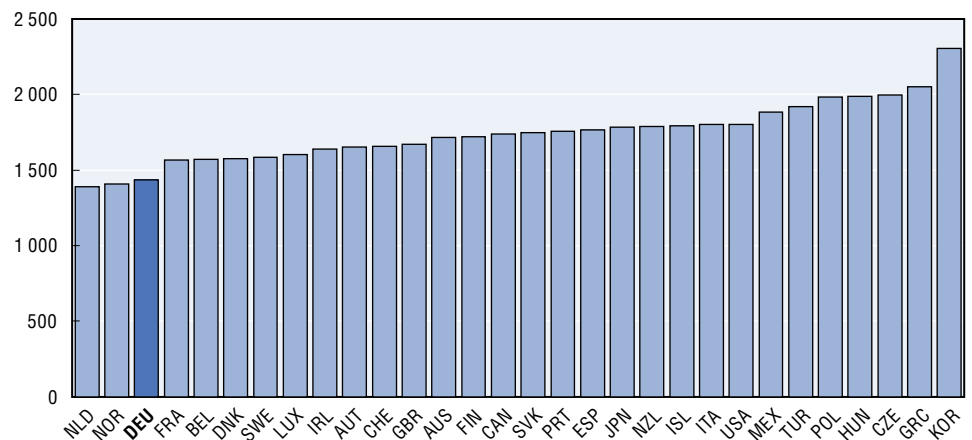
Compared with other OECD countries, the number of hours worked per person employed remains low. This is mainly due to the low number of average hours worked by women, while hours worked by male workers compare more favourably with other reference countries. One reason for this outcome is the fiscal disincentive for second-earners to work longer

hours. In particular, the joint taxation system as well as the free healthcare coverage for non-working spouses leads many women to work in part-time jobs with a low number of hours which are not liable for taxes or social security (*mini-jobs*). Consideration should thus be given to moving towards a system of individual taxation and to phase out the free healthcare coverage. In order to satisfy constitutional constraints, individual taxation could be combined with the option to shift the personal allowance from the non-working to the working partner. Corresponding social concerns about the availability of health care for non working spouses are taken care by the current health insurance reform, which introduces obligatory health care insurance and compensates insurance funds for non-contributing members from the budget (see below).

A further reason for low labour input by women is the lack of childcare provision. This is evident by the fact that fewer mothers with small children are employed in Germany than in other countries and those who work, do so for fewer hours. While childcare is cheaper in Germany than in many other countries, relatively little of it is available. The government plan to significantly expand the number of places until 2013 is thus important. The government should consider introducing a voucher system for childcare while resisting pressures to also subsidise parents who keep their children at home. Experiments have shown that such subsidisation can actually reduce attendance rates in childcare facilities, in particular of those children who would benefit most. To encourage greater private supply, the government should also consider easing regulations for the set-up of childcare facilities.

While the cyclical upswing is also increasingly affecting the long-term unemployed, their share in the total number of unemployed remains very high by international standards. A step in the right direction has been taken with the past Hartz IV reform of the labour market, which has significantly increased the work incentives by lowering unemployment benefit replacement rates and shortening their duration. Those reforms should not be rolled back as international evidence clearly suggests that they will have beneficial effects on labour supply and should lower the structural unemployment rate by around one half of a percentage point. While the supplementary benefit layer paid to

Figure 1.
AVERAGE ANNUAL HOURS
WORKED PER PERSON
IN EMPLOYMENT



Note: Data refer to total employment for 2006 or 2005 and are from national accounts, or where these are not available, labour force surveys.

Source: OECD Hours Worked Database.

former recipients of unemployment insurance benefits when they move into the new unemployment benefit II scheme smoothes the reduction in benefits it may also weaken work incentives. *Consideration should be given to phasing out supplementary benefits in order to further strengthen work incentives.*

In contrast to the reforms on the labour supply side, more needs to be done to raise labour demand, notably by tackling employment protection legislation (EPL). The past liberalisation of temporary work contracts has resulted in a sharp pick-up of temporary agency work contracts in the current upturn. While this has helped to increase the flexibility of companies and has also helped to keep labour costs down, it risks creating a dual labour market over the longer run where some jobs are more protected than others, leading to well-known insider-outsider problems. *The government should thus consider easing employment protection legislation for regular job contracts, which is strict by international standards, in order to use the current upswing to create as many regular job contracts as possible. One option would be to replace the court route for dismissals for economic reasons with a formula-based severance payment, making the process more transparent and less uncertain.*

The government's decision to introduce minimum wages in the postal sector by legal extension of wage agreements is unfortunate, as it effectively means that those companies who are not part of the original wage agreement in the sector are forced to accept the wage costs of other companies in the sector, reducing competition. Moreover, there are discussions about establishing minimum wages in other sectors. *If a minimum wage is deemed necessary to counter the negative effects of monopsonistic labour demand in certain areas, it should be applied on a nation-wide basis at a sufficiently low level that will not lead to job losses, i.e. below the level that would prevail in a market characterised by perfect competition. Based on experience in other countries, decisions on a general minimum wage level should be made by an independent commission of experts so as to avoid politicising these decisions, reducing the risk of the minimum wage being set at a level that harms employment.*

One of the most visible successes of past reforms is the increase in the employment rate of older workers, by over ten percentage points since 2003. While employment rates are still below the OECD average, a considerable part of the gap has been closed. This reflects foremost efforts by the government to reduce the attractiveness of early retirement, for example by shortening the unemployment benefit duration for older workers and gradually increasing the age at which early retirement is possible. However, the recent decision to lengthen unemployment benefit duration for older workers might put some of the gains witnessed in older worker employment in jeopardy, even though the planned voucher scheme might alleviate the adverse effects. *The current upswing should be used to further raise work incentives for older workers, for example by ending the subsidisation of the part-time employment scheme for persons above 55 years of age (Altersteilzeit) earlier than 2010 as is currently envisaged. This would also avoid ending this scheme during a potential downturn. ■*

How can education outcomes be improved?

Improving education outcomes would enhance productivity and employment prospects and, if distributed more evenly, reduce income inequality. The authorities have implemented wide ranging reforms in recent years to improve education outcomes and further reforms are planned. These reforms concern the whole spectrum of education, from early childhood education

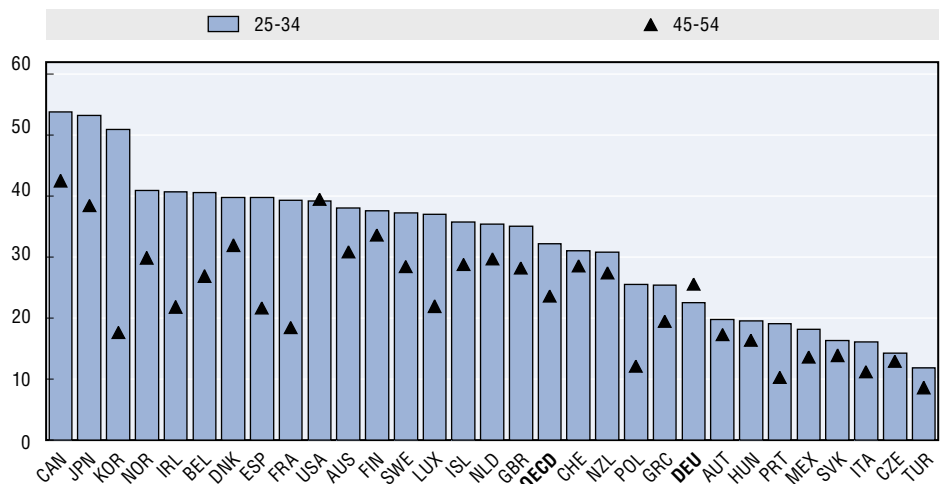
and care to continuing education. Nevertheless, there remains considerable scope for further improvements in education outcomes:

- The main problem to overcome in student achievement is that socio-economic and/or immigrant backgrounds have a large impact on outcomes. While average education achievement is satisfactory – scores in the 2006 PISA study were above average in science (Germany ranked 8th among OECD countries), and average in reading and mathematics (ranked 14th in both subjects) – there is no reason why Germany should not aim higher, especially in the subjects where performance is average.
- Tertiary attainment is low among younger generations – it is 22% for the 25-34 age group, compared with an OECD average of 32%; post-secondary non-tertiary graduation rates are, however, approximately 8 percentage points higher than the OECD average. While the increase in tertiary graduation rates in recent years will lead to future increases in tertiary attainment, the rise in graduation rates in most other countries has been greater, suggesting that tertiary attainment in Germany will fall even further behind the levels in most other OECD countries.

The areas of education policy that most directly impact on these problems concern early childhood education and care, teaching quality, school structure, and tertiary education. While vocational education and continuing education are also important for human capital development, they are not taken up in this Survey as they are less closely related to the specific achievement and attainment issues identified above and have been or will be reviewed in other OECD publications.

International evidence shows that early childhood education and care has a significant effect on learning in subsequent stages of education, especially for children from lower socio-economic backgrounds. In recognition of these effects, the authorities have embarked on reforms to improve its quality. Integrated education programmes for children aged 0-6 have been or are being implemented. Measures are also being taken to identify children with inadequate German language skills, most of whom are immigrants, and provide them with intensive language training so that there is less of a risk

Figure 2.
TERTIARY EDUCATION
ATTAINMENT BY
AGE-GROUP, 2005



Source: OECD (2007), *Education at a Glance: OECD Indicators*, OECD, Paris.

of poor language skills being an impediment to learning when children start primary school. These policies would be more effective if more children from lower socio-economic backgrounds attended kindergarten and did so earlier. As fees are generally waived for children from poorer households, the lack of participation is unlikely to reflect affordability issues. *The authorities should find out more about why parents with low levels of education put less weight on participation in early childhood education and care than do other parents so that effective strategies can be identified for raising participation of these children in kindergarten from three years of age onwards.*

Most current research also suggests that teacher quality is very important in determining student achievement. The difficulty in raising teacher quality is that it does not appear to be related to most common measurable teacher characteristics. In view of this difficulty, the most effective approach to raising teaching quality would appear to be to give schools autonomy to decide how to achieve education goals and to hold educators responsible for outcomes. Such an approach enables school leaders to identify and promote high quality teaching.

- It is important to make educators more accountable for delivering high quality education to every child and to put in place the structures needed to support this development. Germany has recently made considerable progress in clearly establishing high achievement goals for students. The *Kultusministerkonferenz* agreed national education standards in 2004, which have already been implemented in all *Länder*, and evaluation instruments for ensuring compliance with these standards in 2006. Accountability of individual schools and teaching staff is being strengthened through greater use of external exit exams centralised in each Land. Such exams will have been introduced in all *Länder* but one that did not have them by 2008. In view of the relatively poor achievement of weaker students by international comparison, *it will be important to hold individual schools and teachers more accountable for the progress of all students and to provide individualised support to weaker students to bring them up to the required level quickly, as occurs in Finland. Greater use of financial incentives for good teaching based on adequate evaluation of performance could also help to raise teaching quality.*
- School leadership has an important effect on student learning. Traditionally, school principals in Germany have not played a very significant management role. While this is starting to change – new laws give schools greater autonomy and responsibility in the areas of school development, quality assurance and evaluation – *there is still scope to strengthen selection and development of school principals as effective leaders.*

International empirical studies also tend to find that socio-economic background has a larger impact on education outcomes in countries, such as Germany, that have highly stratified education systems. There is also some evidence that early tracking is associated with a greater impact of socio-economic background on education achievement across German *Länder*. *To reduce this impact, Länder should consider delaying the first tracking decision to beyond age 10, the age at which this decision currently occurs in most Länder. This could help to reduce the influence of socio-economic background on tracking decisions. Permeability between education tracks should also be increased so that tracking decisions that do not reflect a child's subsequently revealed academic ability can be more easily corrected. Länder that have not already done so should also consider offering the track leading to the *Hauptschule* leaving certificate, which generally caters*

to the least academically able students, together with the track leading to the Realschule certificate, which generally caters to the middle ability group of students, in one school type. This could help to reduce the impact of socio-economic background on outcomes by reducing social segregation between schools and avoiding the risk of very weak students being grouped together in a school type (*Hauptschule*) with low achievement expectations.

According to a recent OECD study, the low tertiary graduation rate in Germany appears to reflect low internal rates of return on university education and limited university autonomy concerning input and output decisions, amongst other things.

- The low rates of return found in this study are attributable to low gross wage premiums per year of tertiary education and to a relatively progressive income tax system. The move to the two-tier (Bachelors/Masters degree) Bologna system, which now covers about 60% of university programmes and should cover almost all of them by 2010, should help to increase internal rates of return on university education by shortening programmes, focusing them more on occupational qualification, and reducing dropout rates, which are currently high, albeit slightly below the OECD average. *The impact of the progressiveness of the income tax system on incentives to acquire tertiary qualifications should be taken into account, amongst other factors, when making future decisions about the appropriate degree of progressivity in the tax system.*
- Autonomy over inputs is being increased in some *Länder* by giving universities the right to select students; this measure should also contribute to reducing dropout rates, raising expected internal rates of return on university education. In addition, universities in some *Länder* have recently been given the right to set low tuition fees (€ 300-500 per semester) accompanied by student loans. *The Länder that have not already increased their universities' input flexibility should consider doing so.*
- Output flexibility is being increased by the introduction of shorter courses in the context of the Bologna system, and by further easing *numerus clausus* restrictions. To assist the *Länder* to reduce the *numerus clausus* restrictions, the federal government has entered into the "Higher Education Pact 2020" with them in order to finance an expansion in the number of study places. A constraint on there being an adequate number of university places in Germany is that there is the free-rider problem that the *Land* that finances a graduate's university education is not necessarily the one that receives taxes on his/her subsequent earnings. *A solution to this problem that should be considered is for universities to charge notional tuition fees on a cost recovery basis that are repaid out of tax receipts in the Land where the graduate subsequently works.*

The federal government together with the *Länder* also finance a variety of programmes to improve access to university studies of persons from less favourable socio-economic backgrounds. While these measures are helpful, the most effective approach to improving access of such persons to university studies is to reduce the impact of socio-economic background on achievement at earlier stages of education, as discussed above. ■

Which reforms in network industries would help to increase competition?

Strengthening competition in *network industries* could help Germany to raise productivity in these sectors and beyond, since they produce important services for other parts of the economy. It would also help bring down prices, which are high by international comparison in the energy sector. Both the

energy and railways sectors are dominated by large vertically integrated incumbent companies which operate the networks, giving these companies considerable scope to make market entry for their competitors cumbersome and costly. Unbundling requirements exist in both sectors, but they are weak as the network access provider is not completely vertically separated from the dominant market incumbent. The Federal Network Agency has the task of guaranteeing network access on fair conditions. However, strengthening the separation between network access provision and potentially competitive services will be critical to making these markets more competitive.

In the *energy sector*, Germany has opted against full ownership unbundling, partly because market incumbents are privately owned and forcing them to sell their network assets could involve thorny legal problems. However, recent experience has shown how difficult it is to enforce operational and informational unbundling between affiliates that share an interest in maximising joint profits. *Against this background, Germany should consider stronger forms of vertical separation, including the option of full ownership unbundling and establishment of an independent system operator that operates the network without ownership of the assets themselves.* The gas market in particular is currently much segmented with market areas delineated along network property lines. This increases possibilities for network owners to discriminate against competitors and makes market entry cumbersome and costly for newcomers. *The authorities should consider integrating market areas across the networks of different owners.* This could lead to an independent system operator, because different owners would have to join forces for network operation, making it more neutral. *In addition, it will be necessary to reduce concentration at the wholesale level by fostering market integration with neighbouring countries and market entry of newcomers.*

In the railway sector, the choice of model of the envisaged privatisation of the market incumbent, Deutsche Bahn AG (DB AG), will be important for the development of competition going forward. In light of the difficulties in enforcing sufficient independence of network operation in a market with private vertically integrated companies, Germany should choose a privatisation model with a strong separation between track ownership and operation, on the one hand, and transport services on the other. Retaining full ownership of the tracks would allow the government to sell its full stake in transport services, thus disentangling its conflicting roles as a shareholder of DB AG, a regulator and a buyer of transport services. In addition, there are indications that tenders have significantly brought down the associated costs for state governments and the government should further strengthen competition by accelerating the process of mandatory tendering lines that are dependent on subsidies. ■

What can be done to make healthcare more cost-efficient?

In the face of considerable spending pressures stemming from technological and demographic change, Germany needs to reform healthcare financing to make it efficient and limit the negative impact on employment and growth. The envisaged gradual increases in budget contributions to the social health insurance system will help reduce non-wage labour costs, if and when they materialise, as general taxes draw on a larger base than labour-income-dependent social insurance contributions which are the main financing source of the social health insurance system now. *The government should reach an agreement on how to finance increasing budget contributions, soon, to avoid putting this important reform at risk.*

Germany also needs to exploit untapped efficiency potential to limit spending increases to the degree which is necessary to ensure access to high-quality care for all. It has chosen enhanced competition as the main tool to reach this goal. The new financing system for the social health insurance system linked to an improved risk structure adjustment between insurers could reduce the incentives for risk selection and improve the chances for competition between insurers to lead to higher cost-effectiveness, but to avoid distortions some aspects of the design will have to be corrected before the system is introduced in 2009. The largest part of the system's costs will continue to be financed by labour-income dependent contributions, protecting lower income earners, while the price signal will come from a surcharge that those insurers that otherwise cannot cover their costs will have to levy on their members. However, the surcharge will be both weak and distorted as it is limited to 1% of members' income subject to contributions, reducing incentives to switch, in particular for lower income members. Moreover, the associated redistribution will be financed within surcharging insurers' memberships, putting insurers with a large share of low income earners at a competitive disadvantage, because they will have to levy higher surcharges on higher income members. *The government should consider making the surcharge flat, without limits in terms of its share of members' incomes, while increasing its contributions to a larger share of the system's total costs, to strengthen the price signal and decouple healthcare financing from labour costs a bit more. To the extent that additional subsidies for low-income earners would then be needed, they should be financed via general taxes to avoid distorting competition.*

The current segmentation of the health insurance system will be maintained, raising equity and efficiency concerns. Private health insurance members are both healthier and wealthier on average than social insurance members and segmentation leads to less efficient risk pooling, leading to higher social contributions and ultimately to lower employment and economic growth with negative effects for society at large. In addition, it raises equity concerns to exempt private health insurance members from contributing to the financing of the various re-distributive tasks performed within the social insurance system, such as free co-insurance of family members without own income. *Private health insurers should be included in the new financing system.*

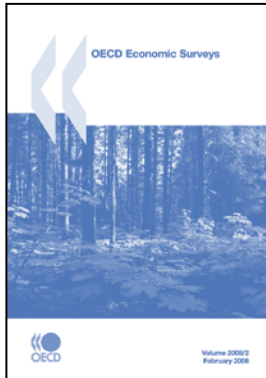
The government has also introduced greater freedom for insurers in their contractual relations with providers and pharmaceutical companies to allow them to distinguish themselves on the basis of their products and enhance competition in the insurance, provider and pharmaceutical markets. This is a logical move as the government aims at improving cost-effectiveness through enhanced competition. However, establishing competition in the healthcare system is a challenging task in view of numerous market failures, equity-efficiency trade-offs and consumers who do not pay directly. *The government should monitor closely whether enhanced competition results in the desired outcomes and correct the rules of the game if necessary. ■*

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