

Meeting of the OECD Council at Ministerial Level

2007

Key Information



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Les questions clés

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Preface

Dear Minister,

This year's OECD Ministerial Council Meeting (MCM) will be held under the chairmanship of Pedro Solbes, Deputy Prime Minister of Spain, with the overarching theme of "Innovation: Advancing the OECD Agenda for Growth and Equity".

The swift pace of globalisation has been pushed by an extraordinary rate of technological innovation. This globalisation has created extraordinary wealth; but growing inequalities remind us that not everyone has access to these fruits. Innovation, in both the technological and policy contexts, is fundamental to correcting this disparity.

The information in this brochure provides a background for the main topics that ministers will address, namely: i) globalisation, growth and equity; ii) current situation and prospects for the world economy; iii) innovation and growth; iv) political economy of reform; v) OECD enlargement and enhanced engagement; and vi) future challenges for an open global trading system.

In today's interdependent world, the OECD is increasingly a "hub of permanent dialogue on globalisation issues". This is why a number of important emerging economies have been invited to join the ministerial meeting.

At the same time, I would strongly encourage you to participate in the OECD Forum 2007, which takes place in Paris on 14-15 May. The OECD Forum is a "multi-stakeholder" summit which brings together business and labour representatives, civil society personalities, government ministers and leaders of international organisations to discuss key aspects on the MCM agenda.

This is my first opportunity as Secretary-General to welcome you to the OECD MCM. I look forward to working closely with you and enabling you and your government to make the most of the OECD as a strategic partner in the political economy of reform.



Angel Gurría

World Economy

ECONOMIC SITUATION AND PROSPECTS

Global rebalancing is under way

The US expansion has shifted into lower gear and the robustness of the recovery in Continental Europe has been confirmed. Meanwhile, growth in much of Asia is holding up well. Oil prices have remained jittery but are down from the peaks reached in the third quarter of 2006, contributing to easing inflationary pressures. On the whole, financial conditions are still favourable.

The expansion has slowed in the United States...

US growth has stayed somewhat below potential since mid-2006. Household consumption has been supported by high levels of wealth and lower oil prices but shrinking residential investment has been dragging down real GDP growth by over one percentage point. Exports have increased faster than imports, making for a substantial positive contribution from the external sector. Growth is projected to remain sub-par over the near term, weighed down by the ongoing adjustment in the housing sector but supported by the sustained job creation witnessed to date and by export market buoyancy.

... while picking up in Europe...

Activity in the euro area has outpaced that in the United States in recent quarters, with growth above potential and largely driven by domestic demand. The German recovery has been particularly vigorous and the Italian economy has picked up. Euro-area growth is likely to have moderated somewhat in the first quarter of this year, partly on account of the value-added-tax hike in Germany, but should remain solid. Business sentiment continues to be upbeat overall, and faster job creation should support household incomes and consumption. In the United Kingdom, growth has been stable around trend and is projected to remain so.

... and remaining on track in Japan

The Japanese expansion – the longest albeit not the strongest in half a century – is on track, notwithstanding the volatility and sizeable revisions of the statistics. Growth is driven by business investment, based on high corporate profits, and exports, which have been boosted by a very weak exchange rate. Japan's growth pattern remains unbalanced, however, with household consumption still lacklustre, reflecting muted wage developments, despite relatively low unemployment.

Growth is set to be robust in the BRICs

Growth should remain robust in China, India and Russia, while picking up in Brazil. It is likely to remain in or close to double digits in China, with continued subdued inflation but a very large current account surplus. The Indian economy has accelerated in recent years to expand at a pace of over 9% per annum and is now displaying some overheating symptoms, not least owing to infrastructure bottlenecks. As in China, the monetary stance has been tightened somewhat and growth is expected to ease a bit. Growth in Russia has been hovering between 6% and 7% and is foreseen to stay in that range. In Brazil, growth has been more subdued in recent years but is projected to gather strength.

Tensions and risks

Some of the forces that have fuelled overall growth until recently are no longer doing so or may cease going forward. Housing markets are already in the midst of a major correction in the United States and are cooling in a number of other countries. Long-term interest rates remain low and might rise more than currently expected, accentuating or triggering housing market weakness. At the same time, current account imbalances have reached unprecedented magnitudes, notwithstanding the recent stabilisation of the US external deficit. There are other uncertainties, in particular as regards energy prices. In addition, new obstacles to foreign takeovers related to heightened concerns about security or other national interests could affect the business climate.

Inflation and monetary policy

In the United States, where monetary policy has been on hold since mid-2006, headline inflation has eased as energy prices changed course, but core inflation has persisted on the high side. Growth is set to remain subdued in the near term, which should help dampen inflationary pressures, but labour market conditions are fairly tight. In the euro area, accommodation has been largely withdrawn, consistent with higher-than-expected growth, and inflation is expected to continue hovering around the 2% mark. In Japan, gradual monetary tightening has begun but a decisive exit from deflation seems to be some way off.

Fiscal challenges in the face of ageing populations

Fiscal outcomes have generally been more favourable than budgeted in 2006, thanks to the abundant revenues stemming from buoyant activity and/or asset prices. Compared with previous such episodes, more of the corresponding windfalls appears to have been reflected in consolidation. In most countries, however, additional efforts – notably on the spending side – are required to restore fiscal margins of manoeuvre. In particular, in the face of rapidly ageing populations, pension and healthcare system reforms are a matter of urgency.

GLOBALISATION AND INFLATION

Globalisation is affecting inflation in OECD countries through a number of channels. On balance, it tends to reduce it, but monetary policy is presented with new challenges.

Trade with emerging economies eases inflationary pressures in OECD countries

Low-priced imports, especially from the Asian emerging economies, and most conspicuously from China, make up an increasing share of domestic demand in OECD countries, thereby exerting a damping effect on consumer price inflation. At the same time, competition from low-cost foreign suppliers heightens the pressure on local firms to reduce the mark-ups of prices on costs, also keeping a lid on inflation. Working in the opposite direction, however, strong GDP growth in non-OECD countries has been pushing up energy and other commodity prices.

OECD research indicates that, on balance, globalisation has reduced inflationary pressures in major OECD economies by up to $\frac{1}{4}$ percentage point per year since the turn of the millennium. This estimate may be on the low side as it ignores the restraining effects globalisation also has on domestic labour and capital costs.

New challenges for monetary policy

From a monetary policy perspective, globalisation complicates the identification of underlying trends in the price level because it entails large shifts in relative prices. In particular, core inflation measures, which aim to remove the noise from headline inflation measures by excluding a number of volatile items such as food and energy, may have become less useful. Indeed, they suffer from the shortcoming that they reflect the systematic downward impact of globalisation on manufactured goods prices but not the possibly systematic, though volatile, upward impact on commodity prices.

Moreover, the shape of the relationship between inflation and activity facing central banks may be changing. Inflation seems to have become less responsive to domestic demand pressures. This is partly a result of improvements in monetary policy frameworks, which have helped to better anchor inflation expectations. But it may also be related to globalisation, not least insofar as increased international labour and capital mobility serves to relieve labour market tensions. Globalisation therefore should help central banks meet their inflation targets at higher levels of resource utilisation. However, lower sensitivity of inflation to domestic conditions would also mean that, should inflation get above desirable levels, bringing it back down will be more costly in terms of foregone output. In sum, the distribution of risks facing policymakers may no longer be the same.

MEASURING THE PROGRESS OF SOCIETIES

Economic and political theory demonstrates the importance that information plays in increasing social welfare. Information, from the Internet and elsewhere, is more readily available to more people than ever. And the ideal of a “fully informed decision maker” is perhaps achievable. Unfortunately, this is far from the case: people today are overwhelmed by the amount of information available. This is a key issue for our democracies. The better an electorate is able to hold its policymakers accountable, through evidence of their performance, the greater the incentive for better policy-making.

Looking beyond GDP

Meanwhile, citizens are increasingly concerned with their quality of life. A consensus is growing around the need to develop a more comprehensive view of progress – one that takes into account social, environmental and economic concerns – rather than focusing mainly on economic indicators like Gross Domestic Product which, while an important measure of economic activity, was not developed to be the sole measure of a nation’s progress.

Internationally, the UN Millennium Declaration paved the way to monitor the Millennium Development Goals (MDGs) through a set of indicators. Meanwhile, governments, international organisations and NGOs have developed indicator systems to monitor economic, social and environmental trends.

In 2006, the OECD launched a Global Project on “Measuring the Progress of Societies”. The OECD has a rich history in developing international statistical concepts and standards and is well placed to lead the development of new approaches to measure societal progress. The Project aims to catalyse a global conversation about what progress means. It tackles one of the most important issues of our time: how to improve the nexus between evidence, decision-making and public discourse. The project is about improving democratic dialogue in the information age. It is open to all sectors of society and is organised by the OECD and other institutions, including the European Commission, the Organisation of the Islamic Conference, the United Nations and the World Bank.

Project goals

The Project will achieve its mission with three key goals: fostering a global conversation about what progress actually means; galvanising people and institutions to actions aimed to measure progress; and improving the effectiveness of indicator work and their use for decision-making. To achieve these goals, the Global Project will work in four areas: statistical research; development of new ICT tools to help users transform statistics into knowledge; advocacy; and institution building. The project also aims to make a key contribution to the international discussion in the run-up to 2015 when the set of existing MDG indicators will be reviewed.

The Project will be launched during the second OECD World Forum on “Statistics, Knowledge and Policy” (Istanbul, 27-30 June 2007). The event, focusing on “Measuring and Fostering the Progress of Societies”, will involve well over 200 world class speakers (political leaders, experts from academia, NGOs, media, etc.). Some 900 people from around the world will attend with thousands more following via live webcast in seven languages. See www.oecd.org/oecdworldforum.

POLITICAL ECONOMY OF REFORM

Even when the reforms to boost economic performance and living standards are well-identified, they are often difficult to translate into action. Indeed, reforms often entail highly visible costs for some groups whereas the benefits, while greater, tend to come later. The benefits are also more uncertain and diffuse, and may materialise later for some groups than for others. Furthermore, it is never the best time to reform. History shows that reforms have often been initiated in face of crises, when the unsustainability of the *status quo* becomes plain, weakening opposition to change. In times of economic recovery, reforms are easier to implement but then the sense of urgency has waned. There are further complications. The political cycle matters, as does political stability. Population ageing may facilitate product market reform, insofar as retirees' incomes are particularly affected by the rate of return on their savings, but may hamper pension or health system reform. Country size is potentially relevant: smaller countries, which are more open to trade, experience greater competitive pressures conducive to reform.

The role of macroeconomic policies

Sound macroeconomic policy helps. If households and firms recognise that monetary policy is designed to keep aggregate demand close to potential output, structural reforms are easier. On the fiscal side, healthy public finances create the wherewithal to launch structural reforms, by bolstering confidence and freeing up room for manoeuvre. Where fiscal positions are weak, the necessary consolidation uses up political capital which otherwise could have been spent on structural reform implementation.

Sequencing

Reforms of trade, foreign direct investment and financial markets have often preceded domestic product market reforms, which themselves have often paved the way for labour market reforms. This is in part because the former facilitate the latter, since they contribute to shifting part of foreign and capital incomes to wage earners. In practice, however, the luxury of deciding on sequencing is not always available. Moreover, some product market reforms (such as the privatisation of state monopolies in network industries) are hard to carry out precisely because of the related labour market dimension.

International co-ordination

Internationally co-ordinated approaches to product market reform at or inside borders have been successful historically at generating momentum for further reforms. Opportunities to pursue this route today include the reanimation of the Doha Round and a rapid and effective implementation of the internal EU market for services. Further opening of borders and more extensive product market liberalisation within countries may also facilitate labour market reforms.

The importance of communication

Last but not least, proper communication is an essential ingredient of successful reform. The various stakeholders should have a clear understanding of the problems and solutions, costs and benefits. To this end, outside expertise – such as that built up at the OECD – plays an important role.

THE OECD'S GLOBAL RELATIONS

The OECD Convention mandates the Organisation to promote policies to contribute to the sound economic expansion in economies outside its membership, as well as within it.

Many countries and economies outside the OECD have become major players in the global economy; excluding them from our work would seriously hamper the effectiveness of policy initiatives agreed within the OECD framework.

The OECD has evolved into a hub for global economic international co-operation. Its engagement with over 70 non-members (“global relations”) has become an integral and increasingly important part of its regular programme of work. It helps foster a common understanding on policy principles amongst a worldwide network of policymakers, promoting policy convergence and a global level playing field.

How does the OECD engage with non-members?

The OECD provides a forum in which best practices, guidelines, principles and other “rules of the game” are developed. These can provide the building blocks for formal treaties and other binding international agreements.

The sequence of the OECD’s consensus-building process is usually: 1) a shared analysis of the issues and mutual understanding of other countries’ positions; 2) formulating a common market-based response to the issues, often in the form of guidelines, principles and agreed best practices; 3) monitoring follow-up given through a “peer review” process.

Important non-member economies have shown a remarkable willingness to work with the OECD as a result of its methods. For example, countries who objected to the inclusion of the “Singapore issues” in the WTO negotiations at Cancún have been willing to discuss these issues within the context of the OECD’s Global Forums and other global relations programmes.

OECD work with non-members, including through regional or country-targeted initiatives, promote the world-wide application of OECD principles, guidelines and best practices, such as the Convention to Combat Bribery in International Business Transactions, the OECD Principles of Corporate Governance and the OECD’s National Treatment Instrument and its Guidelines for Multinational Enterprises (a voluntary code for good corporate conduct).

The dialogue with non-members encompasses policies to enhance the investment climate, improve public and corporate governance, build stronger national institutions for trade policy and, more generally, encourage the range of domestic reforms required to reap the benefits of globalisation. The OECD works closely with other international organisations to avoid duplication, and to ensure greater impact and efficiency.

With which non-members does the OECD engage?

Work with non-OECD economies is organised in regional approaches, through individual country programmes and global forums.

Regional initiatives include Europe, the Caucasus and Central Asia, Asia, Latin America, Middle East and North Africa and Africa in support of the New Partnership for Africa’s Development. A programme in south-eastern Europe supports the aims of the Stability

Pact for that sub-region. In 2006, co-operation has been deepened with South-East Asia in co-operation with ASEAN.

Co-operation with Brazil, China and Russia is carried out through individual country programmes focusing on specific policy areas. Co-operation with India is developing, including a first ever *OECD Economic Survey*.

Ten OECD Global Forums provide a framework for dialogue on issues that cannot be resolved by a single country or region. Topics include sustainable development, knowledge economy (biotechnology and e-commerce), governance, trade, international investment, international taxation, agriculture, competition, education and development.

More information on OECD work with non-members is available at www.oecd.org/ccnm.

Innovation, Equity and Globalisation

INNOVATION AND GROWTH

Innovation's impact on growth is reinforced by globalisation and advances in new technologies...

Much of the rise in living standards is driven by innovation – this has been the case since the Industrial Revolution. Today, innovation performance is a crucial determinant of competitiveness and national progress. Moreover, innovation is important to help address global challenges, such as climate change and sustainable development. Investment in knowledge and intellectual assets is rapidly becoming key to value creation. More recently, the role of innovation has been reinforced both by globalisation and by rapid advances in new technologies, notably ICT, which have spurred competition and opened new markets for the creation and delivery of innovative products and services. Globalisation has also increased the pressure on OECD countries to move up the value chain and engage in a continuous process of adjustment and innovation. Countries such as China and India are no longer simply low value-added producers but are adding their weight to the creation and commercialisation of innovative products, processes and services.

... but many OECD countries face difficulties in strengthening innovation

Despite the importance of innovation for economic growth and sustainable development, many OECD countries face difficulties in strengthening innovation performance. For example, progress along these lines under the aegis of the Lisbon strategy of the European Union has been slow. Moreover, many OECD countries have seen little improvement in productivity performance in recent years despite the new opportunities offered by globalisation and new technologies, especially ICT.

Intellectual property rights pose a particularly important challenge

Globalisation and the spread of ICT have facilitated diffusion, copying and imitation, leading inventors to increase their reliance on intellectual property rights (IPR) to protect new knowledge. The key question remains how to strike an appropriate balance between providing incentives and rewards to innovators and providing access to new knowledge for users. Changes in IPR policies over the past decades have increased the scope and duration of protection (*e.g.* for software and genetic material), and higher damages have been awarded by courts to IPR holders. At the same time, the innovation process itself has become more open: ideas and knowledge for innovation are now drawn from many, often global, sources; linkages and co-operation are of growing importance for successful innovation and key sources of knowledge lie in the public domain.

Product and labour market reform would promote innovation...

Policy reforms are needed to strengthen innovation and productivity. Improving the business environment for innovation is especially important, as business is the main driver of innovation. Further liberalisation of the services sector and of network industries could encourage innovation in these activities. More innovation-friendly regulatory regimes, combined with lower barriers to trade and FDI, would enhance competition and foster the flow of technology and knowledge across borders. Reform of labour markets, notably of strict employment protection legislation, would help firms adjust and allow them to draw greater benefits from their investment in innovation and technology.

... as would reform of financial markets...

Reform of financial markets can also boost innovation and growth, including by helping to reduce the financing gaps faced by some innovative small firms. Investment in innovation would be encouraged by deeper and more efficient venture capital markets and easier access to external finance. Improving disclosure of intangible assets could also make for a better allocation of capital.

... and education systems

Innovation relies heavily on the creation of basic knowledge, through both education and science. A well-performing and broadly accessible education system facilitates the adoption and diffusion of innovation. Creating and developing innovations requires strong science and technology skills, as well as both soft and entrepreneurial skills.

Public funding of scientific research should focus on excellence and relevance

Public investment in science and basic research can play an important role in developing ICT and other general-purpose technologies and, hence, in enabling further innovation. Reform of the steering and funding of higher education and science institutions, by providing incentives that focus on excellence and relevance, can help strengthen the contribution of public investment to scientific progress and innovation. In addition, more can be done to link science to business, including by enhancing the climate for innovative entrepreneurship.

Public support for business innovation can be made more effective

All OECD countries provide public support to promote innovative activity in the private sector. The effectiveness of such support can often be improved, through an appropriate mix of direct and indirect instruments such as tax credits, direct support and well-designed public-private partnerships, support for innovative clusters and rigorous evaluation of public support.

Flanking IPR regimes with pro-competitive policies also fosters innovation

In view of the changing environment for innovation, it is important to consider whether the current system of IPR rules and practices continues to stimulate innovation while allowing access to knowledge. In certain cases the degree of control with which IPR owners are endowed could hamper competition, fair use and the diffusion of technology. Flanking IPR rules with practices, tools and networks that promote competition and access to knowledge offers a way forward. So would the clarification of the use of IPR, *e.g.* as regards research exemptions and rules on fair use. Greater efforts are also called for to promote a growth-enhancing use of IPR, for example through good licensing practices, cross-licensing and patent pools.

Counterfeiting and piracy need to be addressed

Regardless of issues related to the flexibility of the IPR system, stronger efforts are needed to combat counterfeiting and piracy, which are a serious and growing problem. Given the role of IPR in promoting investment in innovation and in future competitiveness, such infringement needs to be deterred. Rules and legislation must be adequate, penalties sufficient to deter, enforcement pursued vigorously and international co-operation strengthened, in particular with emerging economies.

Innovation can help address environmental challenges

Innovation can also contribute to resolving environmental challenges, such as climate change, when the right incentives are given. The use of flexible instruments applied according to national circumstances, including environmentally-related taxes, emissions trading and technology-neutral performance standards should encourage innovation and enhance the international diffusion of clean technologies.

Implementing the reforms will require strong political leadership

Implementing reforms to foster innovation may prove difficult. Some of the required reforms may affect vested interests, such as in universities and scientific institutions, as well as in businesses sheltered from competition or benefiting from public support, or confronted by technology-induced structural change. Strong political leadership and efforts to develop a clear understanding by the various stakeholders of the problems and the solutions – including the costs they involve – can all help to communicate the need for reform and facilitate acceptance.

An Innovation Strategy at the OECD

As a catalyst for globalisation and innovation, ICTs (notably, the Internet) have become a fundamental component of the global economic infrastructure. The future of the Internet as a positive agent for economic and social outcomes is the focus of OECD work as well as a ministerial meeting in June 2008.

With the growing importance of innovation for future growth and for addressing global challenges such as climate change and sustainable development, the OECD could make an important contribution to policy-making in member and non-member economies by developing an OECD Innovation Strategy. This could draw on OECD work on innovation, entrepreneurship and the broader business environment, as well as on existing cross-cutting work on environmental innovation, globalisation of innovation, innovation in the software sector, evaluation of innovation policies and country-specific analysis of innovation policies. The OECD could also examine the functioning of the current IPR system in the context of the new, more open, business environment for innovation and propose ways to ensure an adequate balance between stimulating innovation and providing access to knowledge.

An OECD Innovation Strategy would add to the existing body of OECD work on innovation by providing a cross-disciplinary mutually-reinforcing package of policy elements and recommendations to boost innovation performance, including non-technological innovation, both generally applicable and country-specific. This would include the identification of good policy practices, and where appropriate, policy guidelines. It would provide a framework that could be used to monitor and review the innovation environment and the performance of the innovation system. It would also enhance existing mechanisms and forums for international discussion and co-operation, including strengthened dialogue, especially with emerging economies and other important stakeholders. Moreover, it would provide analysis clarifying the links between the policy domains of a comprehensive strategy, such as those between innovation and entrepreneurship and how innovation contributes towards economic, social and environmental goals and develop better metrics to identify and benchmark innovation performance and the factors and policies influencing it.

GLOBALISATION, GROWTH AND EQUITY

Openness is a major engine of economic growth...

As economic history amply demonstrates, freer trade and investment holds the promise of higher economic growth. More open economies tend to enjoy higher living standards than less open ones. The OECD Growth Study estimated that a 10 percentage point increase in trade openness translates over time into an increase of around 4% in the level of per capita income in the OECD area.

The recent expansion enjoyed in the OECD area as a whole has benefited considerably from efforts by emerging countries to integrate into the world economy and to proceed with domestic liberalisation, in a context of rapidly falling trade, travel and communication costs. Globalisation has helped these countries lift living standards and reduce poverty. In the OECD economies, it has supported growth, not least because openness and more competition encourage firms to adopt new technology and to innovate, thereby enhancing productivity.

... with countries specialising in line with comparative advantage...

Freer trade and investment ensures countries specialise in the production of goods and services for which they have a comparative advantage. This allows more goods and services to reach consumers at lower prices, translating into higher real incomes. Open markets also improve living standards by expanding the variety of products available to consumers.

... and reaping efficiency and welfare gains

Globalisation improves well-being through other channels as well. In particular, open trade and foreign direct investment (FDI) heighten product market competition, which reduces rents and places greater pressure on firms to innovate and raise productivity. Trade and FDI also play an important role in the diffusion of best-practice technologies – including to developing countries – while allowing scale economies to be more fully realised.

Increased international migration is providing gains to both sending and receiving countries

Yet another major channel is international migration, which helps alleviate labour shortages in OECD countries and provides hard currency to emigration countries, via remittances (which often exceed official development assistance flows). Migration has increased in recent years, including for higher-skilled workers, resulting in a rise in the share of migrants in the workforce in most OECD countries.

While globalisation is positive overall, it also entails some job losses...

Reaping the gains stemming from globalisation, however, requires reallocations in domestic capital and labour resources out of sectors where jobs are no longer viable into growing ones. Indeed, like other sources of economic change, globalisation involves substantial job shifts across sectors. Overall economic well-being is enhanced and empirical evidence suggests that aggregate employment performance is not undermined. However, the economic situation of individual job losers and their communities may

worsen in the short run, especially in economies where the regulatory environment inhibits their swift redeployment. While so far most dislocations have occurred in manufacturing, they are spreading to services, where most of the jobs are, as advances in information and communications technology have broadened the range of tasks which can be outsourced – the so-called “great economic unbundling”. Even so, it must be borne in mind that only a fraction of job losses in OECD countries are likely to be directly attributable to trade and investment liberalisation.

... and is occurring against the backdrop of rising earnings and income inequalities, and declining wage shares...

There is also concern about the impact of globalisation on wage and income distribution, as it is proceeding in a context of wider inequalities. In 16 of the 19 OECD countries for which data are available, the earnings of workers at the top of the wage distribution have risen relative to those of workers at the bottom since the mid-1990s. However, the distribution across households of market income has generally not widened much over that period, even if it did become more unequal during the preceding decade, i.e. before China and India’s accelerated inroads into world markets. The same holds for the distribution across households of disposable income, i.e. taking into account the redistributive impact of tax and benefit systems. Another stylised fact is that wage shares in national income have tended to edge down – and profit shares to rise – fuelling worries that globalisation might erode the ability of employees to fully share the gains it generates.

... which, though often unrelated to globalisation, may erode support for freer trade

It is not easy to isolate the specific effect of freer trade and investment on labour income, but most empirical evidence suggests that they have only modestly contributed to increased earnings inequality, while new technology and institutional factors have played a much larger role. Nevertheless, persistence of high and/or growing inequalities – alongside the risk of job loss – is an economic and social problem which may also weaken support for globalisation. Indeed, public opinion polls tend to convey rather sobering perceptions of the impact of globalisation on living standards and job security.

Domestic policies play a crucial role in shaping the effects of globalisation

The quality of policies and institutions affect the actual impact of globalisation. Countries with similar trade and FDI liberalisation patterns – even members of a common market – have widely different unemployment rates and wage/income disparities. Indeed, good economic policies can enhance the adjustment capacity of the economy, increasing the gains in overall living standards gleaned from globalisation, while also making it easier for displaced workers to move into new jobs. The restated OECD *Jobs Strategy* provides an important benchmark against which to judge countries’ policy stances.

Low barriers to firm creation and expansion help...

Resorting to trade and investment protectionism is not the right response. Instead, a good policy response involves, first, competitive product markets. Reducing barriers to business start-ups and growth improves the economy’s capacity to seize the new opportunities arising from globalisation, and helps re-employ displaced resources in those firms and sectors where they can contribute most. Cumbersome product market

regulations may be particularly detrimental for the development of small firms, where there is a large job creation potential. Several service industries, such as transport, professional services and retail trade, are also subject to heavy sector-specific regulations in many OECD countries, which are a brake on their dynamism and hiring.

... as does enhancing workers' mobility, upgrading skills and providing adequate income support in order to minimise adjustment costs

Second, it is essential to pay attention to adjustment costs. Globalisation increases the need for mobility, making it more urgent to reform employment regulations when they inhibit change; to allow wages to adapt to the new economic patterns; and to facilitate geographic mobility and prevent adjustment difficulties from concentrating in particular areas.

Globalisation also raises the issue of supporting job losers adequately. As highlighted in the restated *Jobs Strategy*, some countries have succeeded in providing adequate welfare benefits while at the same time promoting a more rapid return to employment through flexible labour markets and strong job-search obligations.

Providing sufficient training opportunities tied to labour market needs so as to ensure that all workers have adequate skills is also key to reducing adjustment costs. Some of these measures can be costly for the public purse so it is vital to evaluate them and eliminate those that fail cost-effectiveness tests. However, by assisting the losers from globalisation rapidly to regain their footing, effective compensation *cum* adjustment measures, if necessary, enable further progress towards equity and efficiency goals. Putting such measures into place can also help sustain political support for globalisation.

STARTING STRONG

A recent OECD report on early childhood policy, *Starting Strong II* (September 2006), shows that more countries are making early childhood education and care a priority, with greater attention paid to service quality. Among the factors driving governmental attention are the needs to: increase women's labour market participation; reconcile work and family responsibilities on a more equitable basis for women; confront the demographic challenge of falling fertility rates in many countries; and address child poverty and educational disadvantage. Increasingly, the early years are viewed as the first step in lifelong learning and a key to successful social, family and education policies.

The returns to early education

A review of longitudinal analyses shows that investment in early childhood more than repays the society in both economic and social terms. The differential gains in a child's long term cognitive and personal development are combined with social benefits of reduced cost of remedial social programmes, higher earnings and employment ratios, greater labour force participation of women and more equitable performance in terms of educational outcomes.

Managing education policy

With the need for education, labour market and social policies to work well together, there is a trend towards integrating early childhood policy and administration under one ministry, often education. Another trend is of a wider sharing of responsibilities between national and local governments leading to greater decentralisation, which has often widened differences in access and quality between regions. This can be addressed by combining a national approach to goal setting, legislation and regulation, financing, staffing criteria and programme standards needs with devolved resources and responsibilities to local authorities.

Recommendations for a strong start

Among other recommendations, the publication notes: stronger links between early childhood centres and schools; greater use of national curricular frameworks in the early childhood sector; the provision of at least two years of kindergarten before children enter compulsory schooling; more participatory approaches to quality improvement, based on wide consultation of stakeholders and the engagement of professional staff in documentation and research; and clearer ideas at government level of the qualifications needed by staff to engage with rapidly changing social and family conditions.

INNOVATION TO ADDRESS ENVIRONMENTAL CHALLENGES

Innovation can contribute to addressing environmental challenges, such as air and water pollution and climate change. While this requires an appropriate innovation policy framework in general, the **environmental** policy framework also influences technological innovation that can provide solutions to environmental problems.

Establishing policy frameworks

The **stringency** of the environmental policies should be sufficient to send strong signals to ‘direct’ innovation efforts toward environmental technologies. Businesses need a predictable policy framework within which to establish their own long-term business plans.

Establishing **stable** environmental policy conditions is important to allow potential innovators to foresee returns on their investment. Recent OECD work on renewable energy has shown how important policy measures such as minimum obligations and quotas, tradable renewable energy certificates, differentiated tariffs, taxes and subsidies, can be in encouraging innovation (www.oecd.org/env/cpe/firms).

Encouraging policy innovation

Policy instrument choice matters too. More “**flexible**” policy instruments – such as environmentally related taxes, tradable permits, and technology-neutral performance standards – generate more market opportunities for innovations and enhance the international diffusion of clean technologies than more “prescriptive” technology-based regulations.

OECD work has also demonstrated the positive role of flexible environmental policy measures in encouraging investment in both environmental R&D and “clean” production among manufacturing facilities (www.oecd.org/env/cpe/innovation).

FOSTERING INNOVATIVE AND HIGH GROWTH SMEs

Governments are increasingly aware that programmes to support small and medium-sized enterprises (SMEs) can not contribute to national growth and support the development of lagging regions without a vibrant entrepreneurial sector which is able to take risks and grow rapidly.

The importance of high-growth SMEs

High growth SMEs (HGSME) – in particular “Gazelles”, the new entrepreneurial firms exhibiting extraordinary growth – are of crucial importance to most economies in the framework of globalisation. They are essential for new job creation and diffusion of innovation because they introduce product, process, or business model innovations; develop new markets and change the rules of the game in their industries. In those processes, the knowledge embodied in intellectual assets is exploited, which is likely to have important spill-over effects affecting the operations of other companies and industries and the lives of individuals around the world. However, firm-level innovation is a product of how management utilises its intellectual assets.

The need to address high growth and innovative SMEs

While governments recognise that there are financing gaps in the HGSME sector and have instituted a broad range of policies and programmes to address this shortfall, policymakers still need to learn more about which obstacles to address and how to evaluate the effectiveness of their programmes. Also of specific importance to high growth SMEs are bankruptcy laws and legal rules about the separation of personal and business liability which affect the willingness of entrepreneurs to seek expansion capital. In addition, labour market regulations that reduce the costs of job changes (for instance, as concerns the portability of pension benefits) can encourage the development of high growth SMEs. In terms of building intellectual assets for expansion, tax treatment of investments in intellectual assets, as well as accounting regulations that better account for investments in intellectual assets, are important to high growth SMEs.

The role of clusters

Local environment is also a strong influence on the development of high growth SMEs. Indeed, innovation activity is highly concentrated, although the pattern of innovation would be expected to hold constant if performance were explained solely by national innovation assets and framework conditions. The strong spatial variations observed in innovation reflect both local differences in the capabilities of enterprises, research organisations and individuals and differences in the local innovation systems within which SMEs, as well as large firms and other agents, operate. There are many market, government and systems failures affecting these innovation capabilities and systems at local level that if corrected could facilitate the development of high growth SMEs. Policies that help include for instance: building clusters, strengthening local science-industry linkages, training technicians and technologists to fill local skill gaps.

Trade, Investment and Development

DOHA AND THE FUTURE OF MULTILATERAL TRADE

Policies that impede trade continue to hold back the world economy. The process of global integration is far from complete and substantial gains from international specialisation remain untapped. Overcoming the barriers that currently prevent countries and their citizens from fully and equitably reaping the benefits of a globalised economy remains a major challenge for the future of international economic relations.

Trade liberalisation works for the benefit of all

It is widely recognised that countries benefit economically by liberalising trade and moving to capitalise on their respective areas of comparative advantage. If they do, their use of resources – land, labour and capital – can be focused on what they do best.

Among other advantages, liberalised trade can help to lower prices, broaden the range of quality goods and services available to firms and consumers, and allow companies to diversify risks and channel resources to where returns are highest. Conversely, where governments maintain inward-looking and protectionist policies that undermine the working of the principle of comparative advantage, they risk inefficiencies and weakened economic performance.

Through the WTO's Doha Development Agenda (DDA) trade negotiations, we have within our grasp the possibility to avoid this pitfall. We now know a lot about the potential for the DDA to deliver tangible economic benefits to both developing and developed countries through a process of trade liberalisation.

Six years into the Doha Round, legions of analysts and negotiators have considered various formulations and dimensions of a possible accord. It is clearly possible to deliver win-win scenarios that both increase global wealth and assist those who need help to adjust to a more liberal economic environment. Moreover, the DDA negotiations can deliver **multilateral** trade liberalisation, offering the prospect of globally inclusive and generalised benefits that go beyond the scope of any individual regional trade accord.

Agriculture has been at the centre of the deadlock in the DDA negotiations, with extensive discussion of the trade-offs in reductions demanded across the three key elements: market access, export competition and domestic support. However, two things must be kept in mind. First, many existing farm policies do not perform well; clear alternatives exist that would enable governments to achieve their domestic objectives more effectively, without negative impacts on world markets. Second, the negotiations are about a package that covers the far larger economic sectors of services and non-agricultural goods, as well as a variety of other trade-related issues. The broad scope of the potential package means more trade-offs are possible, as well as larger potential gains overall and gains for a greater number of countries, regions and households.

OECD contributes to progress

Analytical work and discussions in the OECD have made a major contribution in helping to clarify the economic stakes involved as well as available options. In some cases this work has served as direct contributions to the work of Negotiating Groups in the DDA (trade in services, trade facilitation, trade and environment). In other cases it has served to inform the negotiations by providing a deeper understanding of the benefits and costs of

trade liberalisation in the range of area under negotiation. Particularly significant have been the analyses covering the role of developing countries, including issues such as special and differential treatment, preference erosion, government revenue and aid for trade. In agriculture, the OECD provides key benchmarking indicators that inform the negotiations. OECD work on issues such as the multifunctional role of agriculture and decoupling farm support from production has improved understanding of the policy issues involved, and work on a positive agenda for agricultural policy reform has drawn attention to policy options that improve the domestic performance of policies while simultaneously reducing distortions of international trade. The work and discussions in the OECD have covered most important aspects of the DDA and have been conducted in close consultation with governments and other international institutions.

Political obstacles can be cleared

Charting the path at this stage to a breakthrough in the Doha negotiations is not primarily a matter of finding solutions to complex technical issues. It is above all a matter of clearing the political obstacles and acting on the information we already have. Often, these obstacles come in the form of entrenched ideas about the supposed advantages of certain trade-inhibiting policies and the domestic interests that may benefit. Yet, many of these ideas are plainly erroneous. Greater efforts are needed to explain the potential of the DDA to their constituencies, address legitimate concerns related to adjustment challenges and provide the needed political leadership to ensure a positive outcome from the Doha Round.

The reasons to strive for a successful conclusion to the DDA go well beyond the simple economics of trade liberalisation. A positive conclusion to the Doha round will represent an endorsement of the multilateral trading system, continued international engagement and dialogue on trade and development issues, and an approach to global economic governance centred on mutually-agreed rules and concerted action instead of conflict. A positive conclusion to the Doha round will be a major step towards improving the conditions for international exchanges in the broad range of economic activities that today are traded in the globalised economy, and it will thus enable the international community to address evolving challenges, ensuring that trade can continue to serve as a strong engine of growth around the world.

MEETING AID TARGETS

The OECD's preliminary data on aid flows in 2006 show that net official development assistance (ODA) from its main donors fell by 5.1% in real terms to USD 103.9 billion. While most countries met their 2006 aid targets, this was largely due to exceptional debt relief not foreseen when the targets were set. Excluding debt relief, ODA fell 1.8% in real terms in 2006.

The next aid target, set in 2005 by the G-8 and Millennium+5 Summits, is to increase aid by USD 50 billion in real terms between 2004 and 2010, doubling aid to Africa over the same period. Substantial increases are required in 2007 and 2008 to meet these targets in a planned and manageable way.

Performance against ODA targets

At the 2002 Monterrey International Conference on Financing for Development, donors promised substantial increases in aid by 2006. Most donors met these pledges, helped by exceptional debt relief for Iraq and Nigeria, with humanitarian aid also rising following the Indian Ocean tsunami. Neither increase was foreseen at Monterrey. Apart from debt relief and humanitarian aid, ODA increased by 4% per year in real terms between 2002-2006.

Debt relief and humanitarian aid will decline towards their historical averages between now and 2010, the date for achievement of the next aid pledges. This means that the yearly growth rate of other forms of aid must triple to 12% to fulfil the 2010 pledges.

Similarly, aid to Africa, excluding debt relief and humanitarian aid, has barely increased since 2004. Donors must accelerate scaling up of aid to Africa to maintain the credibility of their promises to double it by 2010.

Clarifying donors' spending plans

The OECD's Development Assistance Committee (DAC) will survey donors' forward spending plans during the second half of 2007, focusing on core aid available for allocation at country level. This should improve the predictability of aid 3-4 years ahead, support developing countries in their medium-term planning, and facilitate scaling up and aid allocation work in aid agencies. The DAC High Level Meeting in April welcomed the survey, noting it would also help identify aid orphans and structure discussions on aid allocations to fragile states.

The emergence of new development financing mechanisms

The year 2006 saw progress in implementing new development financing mechanisms. Initially supported by six European countries, the International Finance Facility for Immunisation (IFFIm) will issue government-backed bonds to finance a rapid increase in vaccination coverage, averting hundreds of thousands of infant deaths. About 20 countries, including several developing economies, have introduced air ticket levies to fund development activities. And Canada, Italy and the United Kingdom have become the first countries to make Advance Market Commitments to provide incentives to develop new vaccines.

TACKLING CLIMATE CHANGE

The OECD helps governments develop least-cost policies to reduce greenhouse gas emissions, and suggests ways to integrate the adaptation to climate change into all policy areas (www.oecd.org/env/cc). Together with the IEA, the OECD provides analysis of key issues on the negotiation agenda of the Climate Change Convention, including on greenhouse gas emissions trading schemes, the Clean Development Mechanism (CDM), technology development and diffusion, and deforestation.

Adapting to climate change

A recent OECD study has shown that climate change is already affecting the European Alps, winter tourism is particularly vulnerable, and the industry is already adapting to climate change. Climate change does not yet feature prominently within the environmental or economic policy agendas of many developing countries.

The developing country response

Yet evidence shows that these countries might be particularly vulnerable to climate change impacts, and that climate change will likely affect the development potential for these countries. In April 2006, OECD environment and development ministers met and adopted the OECD “Declaration on Integrating Climate Change Adaptation in Development Co-operation”. As follow-up, the OECD is co-ordinating the sharing of best practices on integrating adaptation into development planning and assistance, and is starting new work on the economics of adaptation.

INTERNATIONAL MIGRATION AND DEVELOPMENT

International migration into OECD countries has been increasing and currently stands at some 3.5 to 4 million persons per year, less than a quarter of which consists of labour migrants. The rest are essentially family and humanitarian migrants. If unauthorised migrants (who generally move into lower skilled jobs) were counted, the numbers would be at least one million higher. Many of these movements are due to difficult economic conditions in origin countries, continuing high wage differences between OECD countries and the developing world, and increasing opportunities in destination countries.

Renewed, though largely unfounded, concerns about the “brain drain”

When this rising trend in immigration in OECD countries is combined with a growing demand for highly skilled immigrants, the spectre of a “brain drain” from origin countries is raised, threatening their future growth and development prospects. OECD evidence suggests that, in most cases, these fears are overblown. However, some developing countries in Africa and in the Caribbean have indeed suffered large losses of their most educated people.

Remittances have put international migration in a new light

Meanwhile, rapid increases in remittances from migrants to their families in origin countries have become a valuable source of hard currency, outstripping official development assistance and turning migration into an anti-poverty measure and a motor of economic development. Remittances contribute to reducing poverty in recipient households and, to the extent that they are spent on health and education, help to support human capital and economic development in origin countries.

OECD countries need immigrants

In destination countries the picture has been mixed, with uneven integration outcomes among some immigrant groups but a growing need for highly skilled immigrants in some occupations. These needs are expected to grow as populations age. However, highly educated migrants arriving as family members or refugees are experiencing difficulties finding employment commensurate with their formal qualifications and experience in some countries. On the other hand, labour shortages are beginning to appear in less-skilled occupations and jobs which the native-born population does not want. In some countries, these requirements have been met through hirings of unauthorised immigrants, who are subsequently regularised.

Better management of international migration is necessary

Needs in OECD countries will most likely continue to grow. Consequently, formal recruitment channels will need to be developed for lower skilled migration and movements managed in a more orderly fashion if both origin and destination countries are to reap benefits from international migration. Governments must pay closer attention to facilitating return migration and tapping diasporas to support economic development in home countries. Goals include redirecting irregular movements into legal channels, meeting labour needs in OECD countries, avoiding downstream integration problems and respecting the development prospects of origin countries. These challenges can be addressed through appropriate and more coherent policies, aimed at ensuring a positive contribution of migration to growth and development.

PROMOTING CROSS-BORDER SERVICES: THE TAX PERSPECTIVE

Tax has the potential to become the last barrier to cross-border trade and investment. Discriminatory tax treatment of taxpayers, inconsistent tax rules, uncertainty in the application of the rules, and lack of effective mechanisms to resolve tax disputes can have the potential to create serious impediments to cross-border activities. At the same time, tax has the potential to distort decisions as to where to locate investments and where to carry out service activities. The OECD has tried to address these issues by:

Developing a global consensus on international tax arrangements

The OECD's Model Tax Convention and its Transfer Pricing Guidelines are the basis upon which member and an increasing number of non-member countries have developed their international tax arrangements. These instruments are continually updated to reflect new business models (e.g. e-commerce).

Monitoring the application of these standards

Developing an international consensus on what the international rules should be is, in itself, insufficient. We need to ensure that there is a consistent application of these rules by peer reviews either of specific issues or of countries. While there has been some increase in the frequency of these reviews, the OECD needs to make a greater effort in this respect.

Engaging non-OECD economies in this dialogue

To gain a global acceptance of these rules requires that non-OECD economies be involved in the process of setting the rules and monitoring their implementation. One means for this is through the OECD's annual Global Forum on Taxation, which is the premier event on international taxation for senior government officials (attended by over 300 officials from 90 countries in 2006). The OECD also presents more than 60 events a year in its worldwide network of tax centres and country-based programmes which enable a common understanding of the tax issues facing governments. The recently created Forum on Tax Administration plays a key role in this process, regularly bringing together Commissioners from over 40 leading economies around the world. In addition, the OECD has provided a mechanism for non-OECD economies to set forth their positions on the OECD Model Tax Convention, and more than 25 countries have now done so.

Providing effective tax dispute settlement mechanisms

Despite the OECD's efforts to develop common international standards and monitor their implementation, disputes between national revenue bodies will arise. If these cannot be resolved in an effective and principled manner double taxation and uncertainty will arise, which in turn will act as a barrier to the development of the global economy. In February 2007, the OECD issued recommendations to improve the existing mechanism under tax treaties for the resolution of cross-border tax disputes (i.e. the mutual agreement procedure) and put in place a framework within which countries may, if they wish, enter into mandatory binding arbitration agreements on a bilateral basis. The OECD will monitor the implementation of these new agreements.

AFRICA IN GLOBALISATION: FROM PASSIVE TO ACTIVE INTEGRATION

The OECD Development Centre's *African Economic Outlook*, published in partnership with the African Development Bank, expects solid growth in Africa over the medium term, but cautions that the continent's policymakers need to take decisive measures to facilitate integration in the global economy and to support domestically driven growth.

The emerging economies in Asia, in particular China, are contributing to demand for Africa's commodities (oil, metals and precious stones) while good growing conditions are helping agriculture in most countries. Economic activity in Africa is as a result estimated to have risen by nearly 5.5% in 2006, the fourth straight year of good growth. The prospects for 2007 and 2008 are considered promising.

To consolidate the acceleration, improved policy design and implementation are essential

Further acceleration is essential. Mineral exporters are faced with the challenge of using windfall profits for investment in infrastructure and human capital development to enhance the prospects for diversification in anticipation of the end of the boom. African agriculture remains hampered by physical and institutional constraints, such as poor rural infrastructure, access to inputs, vague property rights and difficult contract enforcement. Services, including tourism, need better supporting infrastructures to flourish.

These critical deficits are locking Africa into a marginal and passive role in the globalisation process. To share fully in its benefits – improved growth and development through access to resources, markets and knowledge, exposure to best practices, and increased competition – African decision-makers need determined and imaginative measures that are nonetheless within their grasp. They need to integrate and improve the coherence of their trade, growth and poverty reduction strategies, and pay greater attention to fostering the stable business environment that is a precondition for the effective mobilisation of internal and foreign investment. Co-operating with partners to facilitate the expansion of domestic and regional markets is essential too.

Aid must be used more strategically as a catalyst to encourage investment-climate reform, infrastructure investment and financial-sector reform.

By exploiting its unique opportunities, Africa can become a full player in the global economy

Achieving these several objectives is possible with co-ordination between the agents of change in a context of efficient sequencing and combinations of policies. Co-operative dialogue between African policymakers, development partners, business and civil society organisations is therefore essential if this complexity is to be overcome and Africa transformed into a more active player, integrated into the global economy.

INVESTING IN INFRASTRUCTURE FOR SUSTAINED GROWTH

The longer-term future performance of OECD economies, and indeed of the global economy, will depend to an important extent on the availability of adequate infrastructures to sustain growth and social development. This is a huge challenge for governments and businesses around the globe. Through to 2030, annual infrastructure investment requirements for energy, road and rail transport, telecommunications and water are likely to average around 3.5% of world GDP.

What is driving such massive needs?

A large share of the investments will be undertaken in the developing world, where countries such as China, India and Brazil will be spending billions of dollars on infrastructures to underpin their booming economies and satisfy the growing aspirations of their populations. However, despite their significantly lower economic growth rates over the next few decades, OECD countries too will be required to invest heavily to maintain, upgrade or replace existing (and often ageing) infrastructures, and to preserve their international competitiveness. In particular for OECD countries, infrastructure investment will be challenged by a range of fundamental long-term trends. These include *inter alia* growing pressures on public finances as a result of population ageing, the demands of expanding international trade, the consequences of climate change, and rising expectations with respect to the quality of the environment. Concerns around reliability and security are also likely to loom larger in the future. While there is growing convergence and interdependence among the different infrastructure domains – with telecommunications playing a particularly important role in the management of infrastructures and related services in electricity, transport and water – increasing interdependence also brings greater vulnerability to technical failures, congestion, and security breaches .

How to meet these infrastructure needs?

The implications of these trends for the ways that infrastructures are built and operated today are likely to be far-reaching. For example, more innovative approaches to private sector finance will be needed, including diverse forms of public/private partnerships and greater recourse to pension funds and other large institutional investors. Moreover, the role of pricing is set to become increasingly critical in all these infrastructure sectors, be it to combat congestion, better manage demand, or raise the required funding for investments. Public sector infrastructures that today depend heavily on taxes and appropriations (for example in road transport) will need to place more reliance on other perhaps new sources of funding (*e.g.* user charges). And governments will have to step up international co-operation to improve the efficiency, reliability and security of flows of goods, services and information across trans-border infrastructures. If infrastructures are to continue to provide the underpinnings of sound and sustainable economic performance, then their planning, development and financing need to be seen and addressed in a long-term policy perspective.

Good Governance

CITIES AND GLOBALISATION

Cities as the engines of national growth

As globalisation progresses, cities around the world compete with one another to attract investment and high wage jobs, and policymakers are increasingly aware that national economic success depends on having cities that are internationally competitive. As a result, many OECD member countries are rethinking their policies towards major cities and are looking for more effective ways to support the actions of the cities themselves.

Striking a balance between growth and quality of life

A number of strategic choices or dilemmas emerge that are important for both national and regional policymakers as they review policy options. For example, the balance between sustaining economic dynamism and ensuring a liveable urban environment is one of the common dilemmas that cities face. Concentration of population generates agglomeration economies and ultimately drives growth, but it also leads to congestion, poor environment, housing shortages and the formation of ghettos. Is there a necessary trade-off between economic dynamism and having a sustainable city? Some cities appear to have found such a balance, while others struggling to reconcile these two dimensions are engaged in reversing mistakes made over the past decades.

Making the most of cities' assets

Cities must play to their strengths. The clustering of large companies alongside competitors, dynamic smaller companies and research institutions represents a tangible advantage when innovating and competing in global markets. This is the comparative advantage that large cities have over other regions. Initiatives to better link regional research institutions with industry are one example of how governments can use “soft” instruments to reinforce the competitiveness of a regional economy. But hard infrastructure is also important. Careful planning of transport infrastructure makes the difference between managing growth and being the victim of growth. Many cities have road and commuter rail systems that have been poorly maintained. Reversing this underinvestment and dealing with congestion and pollution represent expensive challenges. Examples from megacities like Istanbul, Mexico City or Seoul show that more coherence between urban land use and transport infrastructure development can make a crucial difference to the daily lives of citizens. But decisions are often still taken from a narrow sectoral perspective that misses essential linkages.

Metropolitan governance for competitive cities

A region-wide strategic vision is required to reconcile increasingly complex and interdependent policy challenges. Flexible metropolitan governance emerges as a key mechanism by which to co-ordinate and build consensus for managing urban growth and for the implementation of policy actions and strategies. Yet, creating such institutions and getting both municipal and central levels to assign responsibilities and resources to them is a difficult task in many countries.

OECD work – reviewing policy responses in metropolitan regions and exploring key cross-cutting policy themes – emphasises the innovative instruments and institutional arrangements that member countries have introduced to reinforce their urban policies.

PROMOTING GOOD CORPORATE GOVERNANCE

The *OECD Principles of Corporate Governance* continue to serve as the global benchmark for countries wanting to improve their corporate governance standards. They facilitate comparison of national standards and serve as a guide when addressing current policy concerns such as executive remuneration, new forms of shareholder activism and the functioning of the market for corporate control.

OECD recently issued a new tool – the *Assessment Methodology* – that will help countries weigh up the merits of different approaches to implementing the *OECD Principles* and the tradeoffs that may be involved when reforming corporate governance policies and practices. The *Methodology* is also an important resource for emerging markets where the OECD actively promotes implementation of the *Principles* through regional roundtables.

Private equity and hedge funds

The emergence of private equity and certain hedge funds as proactive owners has stirred controversy among market participants and policymakers. The strategy of these investors is typically to increase the value of their investment through active engagement with individual companies. Engagement may include demands for changes in management, the composition of the board, the company's capital structure and long-term strategy. Considering the increased importance of private equity firms and activist hedge funds, the OECD has initiated a discussion about their role in facilitating good corporate governance based on the *OECD Principles*.

Corporate governance of state-owned enterprises

As the transparency and disclosure standards continue to improve in the private sector, there is also increasing demand for improved transparency in state-owned enterprises as advocated by the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*. To support reform, the OECD is therefore developing a *Guide on Transparency and Accountability for State-Owned Enterprises*, which will also help governments set objectives and monitor performance. As privatisation remains an important priority in a number of countries, the OECD is also examining best practices that can assist governments to prepare and implement privatisation policies.

FIGHTING CORRUPTION

The OECD is a global leader in the fight against corruption in business, taxation, export credits, development aid and governance. The keystone of this work is the *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*.

Combating bribery of foreign public officials

Since its adoption in 1997, the Anti-Bribery Convention has catalysed important progress. Governments have passed laws to outlaw bribes to foreign public officials to secure business deals. Multinational companies on every continent have changed the way they do business. Civil society has mobilised unprecedented transparency and public scrutiny.

Monitoring countries' performance

The Anti-Bribery Convention's rigorous peer review mechanism distinguishes it from other anti-corruption tools. The OECD has established the "gold standard" of monitoring and evaluation to ensure that countries stick to their international commitments.

Country evaluations testify to several positive developments in States Parties' work to fight foreign bribery – improvements in prevention, detection and investigation; centralised anti-corruption agencies; non-tax deductibility of bribes; awareness-raising among public servants and private-sector leaders; and co-operation among law enforcement officials nationally and internationally.

Countries still face important challenges in taking a systematically proactive approach to investigating and prosecuting foreign bribery, and ensuring effective, proportionate and dissuasive sanctions for both individuals and companies. Guaranteeing the independence of foreign bribery investigations from the influence of national interests, potential diplomatic repercussions, or involvement of high-profile individuals or companies remains another major challenge.

While the signatories of the Anti-Bribery Convention are reporting a growing number of investigations, prosecutions and convictions of foreign bribery, there are still relatively few cases. Some countries have yet to secure a conviction, or in some cases, open an investigation.

Growth and future development

All 30 OECD countries are signatories of the Anti-Bribery Convention, along with 6 non-member countries. The OECD is also building partnerships to bring major emerging economies closer to its anti-corruption policies and standards. In 2006, officials from China attended a meeting of Convention signatories at OECD headquarters for the first time. Steps have been taken for South Africa to become a Party to the Convention.

Careful design of an efficient and effective future monitoring mechanism – "Phase 3" – is underway. Analysis of the first two rounds of monitoring identified key issues that should be assessed even more closely, including bribes through intermediaries, bribes that benefit third parties, facilitation payments, corporate liability, jurisdiction and mutual legal assistance.

The OECD is also working to ensure that its anti-bribery instruments remain at the cutting edge of international legal tools to fight foreign bribery by reviewing the *Revised Recommendation of the Council on Combating Bribery in International Business Transactions*, also known as the 1997 Revised Recommendation.

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