

Meeting of the OECD Council at Ministerial Level

2004

Key Information



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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- to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

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Preface

Dear Minister,

The OECD's annual ministerial gathering is special this year because for the first time, alongside the regular meeting, we are welcoming health ministers. The Council at Ministerial level will be held under the chairmanship of Luis Ernesto Derbez Bautista, Secretary of Foreign Affairs of Mexico; the meeting of health ministers will be chaired by Julio Frenk, Secretary of Health of Mexico.

I hope and expect that the discussions and outcomes of both these meetings will be useful to ministers as they grapple with their domestic economic and social agendas as well as with issues in the world economy. Economic recovery is now broadening. Impressive recoveries are under way in the US, the UK and Japan. But economic growth in some of the largest euro area economies remains anæmic and unemployment continues to be a serious issue for many countries. Financial scandals involving important companies have demonstrated the need to strengthen systems of corporate governance – a reason why the OECD's Principles of Corporate Governance have recently been revised.

Ministers will also address the longer term challenge of strengthening growth in an era of demographic change. Without changes in existing policies, population ageing will cause a marked slowdown in economic growth in most OECD countries and a marked deterioration of public finances. The challenge is to design and implement labour market and social policies that will increase employment and preserve the long-run sustainability both of public finances and, in particular, pensions.

International trade and investment must also continue to be a source of prosperity for all nations. At the meeting, ministers both from OECD countries and a number of emerging and developing countries will endeavour to inject momentum in the Doha Development Agenda, notably by addressing developing country concerns.

The meeting of OECD health ministers will consider the results of the OECD's three-year health project "Towards High-Performing Health Systems". Over the last three decades, the share of health spending in total national spending in the OECD area has doubled. This is set to rise even further as the growing numbers of older people in our populations increase the demand for healthcare. OECD analysis indicates however that there is considerable room to improve the efficiency of our health systems as a contribution to meeting the challenge of rising health costs.

Ministers of health and of finance and economics will also have the opportunity to discuss jointly the challenge of ensuring the financial stability of our health systems.

In association with these ministerial meetings, the OECD is organising the fifth edition of its OECD Forum, "Health of Nations". The Forum will provide the opportunity to discuss these same issues in an open public event involving business and labour leaders, and civil society personalities, along with government ministers and leaders of international organisations.

The health of nations depends on the health of our citizens, the health of our economies and the health of multilateral co-operation. I look forward to welcoming you to the OECD Ministerial and to the Forum where together we will seek the ways to strengthen all these elements for the health of our nations.

A handwritten signature in black ink, appearing to read 'Donald J. Johnston', written in a cursive style.

Donald J. Johnston

Economic Outlook and Agenda for Growth

WORLD ECONOMIC PROSPECTS

The global economy has gained considerable strength since mid-2003. The recovery is led by the United States, as often in the past, but also benefits from a rebound of Japan and the United Kingdom. By contrast, output growth has been weak until now in the euro area, in particular in large countries where consumer sentiment is depressed. The *OECD Economic Outlook* projects an expansion that broadens progressively, with growth exceeding 3% this year and next. The recovery will reduce much of the OECD output gap by late 2005. Even though vulnerabilities persist, downside risks have abated and the upturn is expected to be sustained.

Recovery has considerable momentum in US

In the United States, the expansion has gathered considerable momentum. Household spending continues to be robust, thanks to the support from low interest rates, income tax rebates and rising housing wealth. Business investment is rebounding in an environment of increasing corporate earnings and easy financial conditions. Exports benefit from world trade expansion and a weaker exchange rate. Looking ahead, output should continue to grow somewhat above potential in the near future, helping to close the output gap next year.

The projected reduction in resource slack makes desirable an early withdrawal of policy stimulus. Nominal short-term interest rates have long remained at or near historical lows and a gradual move towards a more neutral monetary policy stance would be consistent with the narrowing of the output gap. As well, medium-term fiscal consolidation would be advisable. Despite the recovery, the fiscal imbalance remains very large and is not expected to improve decisively on current trends, which could contribute over time to a rise in long-term interest rates.

Genuine upturn seems to be unfolding in Japan

In Japan a genuine, if somewhat irregular, recovery seems to be in train and is projected to continue. In contrast to the past two upturns, the current expansion is unfolding without the benefit of a large fiscal stimulus. Private demand has regained strength, in particular business investment which has been boosted by higher profitability. Exports are growing at double-digit rates thanks to strong intra-Asian trade, in particular with China.

Nonetheless, several underlying fragilities remain, including weaknesses in the financial sector, and monetary policy needs to continue to focus on ending deflation. The monetary policy strategy of quantitative easing has helped in this respect and should continue until the risk of deflation has become negligible. On the fiscal side, the expected decline in the budget deficit this year and next is welcome. As well, the time seems ripe to plan a more ambitious medium-term consolidation. This would help to re-establish confidence and slow the increase in public debt.

Prospects more uneven in euro area

In contrast to other regions, activity remains weak in the euro area, particularly in Germany and Italy where growth has been anæmic. While exports benefit from strong world trade expansion, consumer sentiment remains depressed, savings rates are high and rising and private consumption is sluggish. Nonetheless, a recovery is projected to unfold in the euro area later this year and next, as the buoyant international environment continues to support exports and eventually exerts traction on domestic demand. In the course of next year, real gross domestic product (GDP) growth should have built sufficient momentum to start reducing the output gap. This outlook is consistent with further disinflation and some loosening of monetary conditions.

By contrast, with a growing number of European countries experiencing large structural public deficits, vigorous fiscal retrenchment seems necessary and should start as soon as economic activity has achieved enough momentum. There is generally neither scope nor need for fiscal stimulus.

Risks arise from persistence of large current account imbalances

Even though a sustained expansion seems likely, vulnerabilities may materialise and cloud the outlook. An issue of concern in the international economy is the very large current account imbalances prevailing in several countries, particularly in the United States, and the international effects of their possible adjustment. Contrary to past experience, the US current account deficit did not recede during the downturn and is unlikely to materially decline at the 2005 horizon. Given the magnitude of the imbalance, various scenarios may well materialise that would involve significant effects. A sharp unwinding of the current account deficit could have a negative impact on economic activity outside the United States, although such effects depend on circumstances and policies.

Risks arise from possible adverse bond market reaction

Another possible source of fragility is the unusually low levels of risk premia, especially on corporate bond and emerging debt markets. While they have played an important role in supporting the recovery, low risk premia could revert rapidly towards historical averages, implying triggering sudden bond or equity market reactions. There is also the possibility of a sharp increase in long-term interest rates, which would negatively affect borrowers, including highly-leveraged households, possibly offsetting positive housing wealth effects. This highlights the importance of starting fiscal consolidation sooner rather than later, especially where public finances display large borrowing requirements. Rising debt and deficit positions imply that embarking on a credible course of fiscal consolidation would help in bringing about a lasting and robust recovery.

Employment prospects would benefit from labour market reforms

So far, the global recovery has created fewer jobs than usual, including in the United States. Even though job creation is likely to revive over time, a variety of factors could slow the increase of employment levels and hinder the retreat of unemployment. The public debate has focused on the potential role of “offshoring” in weak employment creation, but the relocation of jobs abroad appears too modest in magnitude to be a major determinant. The risk that labour market prospects remain sluggish underscores the important role that structural policies could play to stimulate job creation. Employment prospects could benefit from various reforms adapted to circumstances, including enhanced labour market flexibility, improved incentives to participate in the labour force and increased adaptability of the workforce, as discussed in the next chapter of this brochure.

PREPARING FOR AN ERA OF DEMOGRAPHIC CHANGES

How to adapt to population ageing is now a major challenge for most OECD countries. Ageing is a source of concern because, in the absence of further reforms, it could undermine long-term growth and the sustainability of public finances. But it is also an opportunity to contribute more to society because, with the continuous increase in longevity, we are living younger longer. Indeed, life expectancy without incapacity has increased by two and a half years per decade over the past century.

Without further reforms, ageing will undermine growth

Without changes in existing policies, ageing could cause a marked slowdown in economic growth in most OECD countries and result in a sharp deterioration of public finances. Based on current rules governing retirement and early retirement, the labour force will increase less rapidly, or even decline. Furthermore, additional resources will be needed to cover increased pension expenditure, irrespective of institutional arrangements (public or private pensions). In countries with pay-as-you-go public schemes, a vicious circle could develop. Rising public pension payments could put upward pressure on taxes, which in turn could tend to reduce the number of people at work and, hence, undermine growth. These adverse prospects might very well be exacerbated by rising public health expenditure and the associated taxes.

One way to mitigate this vicious circle would be to implement, early on, tighter fiscal policies aimed at reducing public debt. This would lower future interest payments and create “room” for increased ageing-related spending. Public debt is, however, currently increasing nearly everywhere, following the recent deterioration in public budgets throughout the OECD area. This raises questions about the political feasibility of a strategy aimed at paying off debt to prepare for the consequences of ageing.

Increased labour force participation is required

The diffusion of new technologies is certainly an important source of growth, but it is difficult to programme its effects with public policies. More importantly, the benefits of technological progress do not show up only in higher wages but also, later in life, in better pensions so that net transfers to inactive people are not reduced.

Immigration is sometimes seen as another way to meet the ageing challenge. And in the shorter term, an increased number of well-integrated young immigrants may boost the workforce. But immigrants also grow old and eventually will have to be catered for by those at work.

Raising labour market participation of older workers

The challenge is therefore to design and implement labour market and social policies that preserve the long-run sustainability of public finances and, more importantly, support economic growth. Policies encouraging higher employment rates of older workers would go a long way towards mitigating the consequences of ageing. After all, most people face longer and healthier life expectancies, which make them able to remain active longer than their parents. This positive development runs counter, however, to the numerous incentives and institutional arrangements encouraging premature withdrawals from active life. People remain active for a smaller and smaller part of their lives, in large part because institutions and policies are ill-adapted to increasing longevity. Statutory retirement ages or strong incentives built into public pension schemes mean that working beyond 60 or, *a fortiori*, 65 is discouraged, even though people live for a longer and longer period afterwards. And in many countries, invalidity, unemployment benefit and dedicated early retirement schemes give healthy and work-ready persons strong incentives to retire long before they qualify for an old-age pension.

Recent OECD research suggests that if incentives for retirement were made neutral, labour-force participation of persons in the 55-65 age-group could rise by up to 20 percentage points in the long run, or even more in a few countries. Hence, governments are considering reforming their pension schemes so as to avoid discouraging longer active lives. Such reforms would have positive effects not only on participation rates, but also on contributions to public budgets through income tax receipts. Most importantly, employers' attitudes toward older workers will also need to change, if these persons are to stay successfully in the workforce. In this context, public policies to strengthen the attractiveness of older workers may be helpful.

Higher participation of female and young workers also matters

Other policies that keep people away from work need to be reconsidered. For instance, female participation is low in some countries because tax and family policies discourage women from entering the labour market. Over-regulation also inflates the cost of services caring for children and the elderly, thus discouraging women from engaging in active lives. Likewise, people could be induced to enter the labour force at a younger age, without undermining their necessary investment in human capital. Broadly speaking, removing existing obstacles to labour market participation of all groups of workers would make important contributions to economic growth and the sustainability of public finances.

Can greater reliance on private pension schemes help?

Even if these policies to activate a higher proportion of persons were successful, they are likely to be insufficient to safeguard public budget positions in a number of countries. In such cases, less generous increases in public pensions may be necessary, even if that raises issues of inter-generational fairness. These adjustments might be facilitated by a set of measures encouraging future pensioners to accumulate private savings in order to supplement their future pension income. Positive side-effects can be expected from the accumulation of private savings, including higher investment, stronger potential growth and financial market development.

But there are several inherent difficulties with private pension schemes. Tax breaks are often provided to induce such saving, but such tax breaks may be more effective in triggering a reallocation of saving that would have taken place anyway rather than in stimulating new saving. At the same time, these tax breaks tend to benefit the well-off and the cost to public budgets is significant. OECD estimates suggest that the fiscal cost of such tax incentives ranges from 0% to 2% of gross domestic product (GDP). As well, administration costs of private schemes are often substantial. Finally, existing private pension schemes increasingly tend to be based on defined contributions, rather than pre-specified benefits. This implies that the individual saver carries the bulk of the financial risk, without necessarily being the best placed to do so.

OECD STATISTICS REFORM

The OECD Secretariat requires a wide range of comparable statistics for both the analytical work underpinning the development of policy recommendations and for its ongoing work monitoring developments in member countries and in key non-member economies. The OECD also disseminates a substantial amount of statistics to external users. Although the OECD has a high reputation for both the quality of its analytical work and for the statistics that support that work, new challenges have emerged over the past few years. To face these challenges, in 2001 the Organisation launched a new Statistics Strategy, based on the development of the **OECD statistical information system**, the completion of the first version of the **Quality Framework for OECD Statistics** and the launch of **new statistical projects** and **new publications**.

Thanks to the results achieved during the first phase of the Statistics Strategy, the OECD is now in a better position to address the new challenges faced by both the Organisation and the international statistical community at large. In this context, at the beginning of 2004 the OECD Council agreed on the establishment of a **Committee on Statistics**, which will oversee all the statistical activities carried out by the Organisation and will play a crucial role in improving the overall quality of OECD statistics and reinforcing the key role of the Organisation in the world of international statistics.

New research projects

At the OECD level, growing demand for internationally comparable statistics covering various economic, social and environmental subject matter, is putting particular pressure on statisticians and analysts working in the secretariat. At the international level, the revision of the **System of National Accounts (SNA)** and of the **Manual on Balance of Payments**, as well as the development of the new classification of **industrial activities**, are processes that will have a major impact on all economic statistics. The OECD is the focal point for the development of the new SNA. In addition, a new project on general government national accounts aims to disseminate timely and detailed data, enhance the comparability of the major aggregate results for general government (such as general government deficit/surplus and/or general government debt) and draft a special new chapter in the forthcoming SNA.

The OECD is engaged in other research activities devoted to establishing standards for the measurement of various economic, social and environmental phenomena, as well as the integration between the three dimensions. A tangible signal of this stronger integration of OECD statistics will be the publication of the first *OECD Statistical Yearbook*, which will bring together data related to various topics.

Especially important in 2004 will be work to prepare new **handbooks** and **manuals** in the following domains: education statistics, purchasing power parities, producer prices

for services, hedonic prices, globalisation statistics, data and metadata presentation. Methodological recommendations will be issued or reviewed in the areas of national accounts, quantitative and qualitative short-term economic statistics, foreign direct investment statistics, creditor reporting systems, ICT statistics, working time measurement and small and medium enterprises statistics (in the context of the 2004 Istanbul Ministerial Conference on small and medium enterprises).

New **datasets** and **publications** will be disseminated on general government accounts and financial accounts, while significant extensions have been made to already existing databases on business tendency and consumer surveys. A web site containing data and methodological papers has been created on **productivity measures and analysis**.

Finally, is it worth mentioning the initiative undertaken by the OECD to organise a **Forum on “Statistics, Knowledge and Policy”**. Policymakers and civil society are demanding integrated views of various phenomena to make decisions and to evaluate the overall situation of a country, a region or a local community. The OECD has therefore decided to provide a catalyst to sustain and promote a global community of practice on how to develop indicator systems for democratic political units on major areas of interest. The first Forum will be organised in Italy, in November 2004, as the “kick-off” event of a medium-term initiative in this field.

The Multilateral Trading System

INTERNATIONAL TRADE AND INVESTMENT: STRENGTHENING THE MULTILATERAL TRADING SYSTEM AND MOVING AHEAD IN THE DDA

OECD members recognise the importance of creating momentum in the Doha Development Agenda (DDA) by moving forward on issues of substance and by addressing developing country concerns. They are committed to strengthening the multilateral trading system and related policy areas in an effort to increase the benefits of globalisation and enhance human welfare in all countries.

Market access

In order to ensure a successful conclusion of the DDA, it is important to make concrete progress in the negotiations as quickly as possible. Along with agriculture (see *Agricultural Trade* chapter, page 23), negotiations regarding market access for goods and services are a major pillar of the DDA, and a key component for success will be finding ways to provide enhanced special and differential treatment for countries that need it most.

Tariffs

Recent OECD research shows that the potential welfare gains from dismantling tariff barriers are substantial for all regions of the world: up to USD 100 billion globally, with up to 70% of those gains going to developing countries. While developing countries have much potential benefit from improved access to the developed country markets, a substantial share of their potential gains is associated with the liberalisation of their own tariff regimes.

A number of developing countries have expressed concerns that multilateral tariff reductions may in some cases have negative economic impacts associated with declining tariff revenues and shrinking preference margins. The OECD is responding to these concerns with two studies that will assess each issue empirically. The aim is to examine these issues in the broader economic context and, where appropriate, to consider possible policy responses to address developing countries' genuine concerns while promoting access to the larger benefits of trade liberalisation.

Non-tariff barriers

In addition to tariffs, DDA negotiations in the area of market access for non-agricultural products also include the reduction or elimination of non-tariff barriers (NTBs). Intergovernmental discussions have made clear that the issue is not only traditional non-tariff measures at the border, such as import licensing, quotas and prohibitions, but also difficulties arising from behind-the-border policies in importing countries. World Trade Organization (WTO) members have started to provide notifications of non-tariff barriers but have yet to decide on the modalities for dealing with such measures. Given the wide

spectrum of NTBs and the difficulty governments have in obtaining good data, discussions on NTBs lag somewhat behind tariff negotiations.

To support and facilitate the NTB discussions, the OECD has taken stock of the range of non-tariff measures that are of concern to traders, and is currently pursuing a more detailed examination of the use and trade impact of individual types of border and behind-the-border measures.

Trade in services

A key challenge in the negotiations on trade in services is to ensure that all countries actively participate in the negotiations. OECD work provides analysis on issues and challenges for DDA negotiations on services and tools to assist governments in managing those negotiations. Recent OECD work on *Services Trade Liberalisation: Identifying Opportunities and Gains* has identified concrete examples of developing country services exports and presented the latest economic research quantifying the gains from liberalisation. Another important challenge in current negotiations relates to the potential impact of services liberalisation on countries' regulatory frameworks. The OECD is participating in concrete capacity-building in co-operation with the United Nations Conference on Trade and Development (UNCTAD) by producing practical checklists designed to strengthen negotiators' understanding of the issues involved in liberalisation, including benefits and regulatory challenges and how the WTO takes these into account. In addition to a generic negotiating checklist, sector-specific checklists have been developed for insurance and energy services, with legal, environmental and construction services under way.

The movement of people as service suppliers is among the most difficult issues in the services negotiations, and is particularly important for ensuring that developing countries fully reap the benefits of liberalisation. To inform this important debate, the OECD has recently produced a study on mutual recognition agreements. The temporary movement of services personnel was also the focus of a recent joint OECD/World Bank/International Organization for Migration seminar with non-members on trade and migration, as part of the annual series of OECD-World Bank meetings of services experts.

Trade facilitation

International trade has grown rapidly in recent years, and with it the relative importance of border procedures such as customs requirements, adding to the transaction costs for governments, businesses, and ultimately the customer. Surveys suggest that in some cases border-related costs could total as much as 15% of the value of the goods being traded. This is why trading nations have been seeking ways to make the whole process simpler and smoother, an endeavour now commonly called trade facilitation. Since 1996, trade facilitation has also been one of the topics under discussion in the WTO.

The OECD has carried out extensive analysis of this topic to help better understand the potential gains from international co-operation in the area of trade facilitation, as well as to identify possible approaches for putting any agreement into practice at the national level. Analysis has focused on assessing the costs of introducing and implementing trade facilitation measures, as well as the benefits of such measures to businesses, particularly small and medium enterprises (SMEs), and to governments, particularly in developing countries. The OECD has also analysed country practices aimed at harmonising and simplifying applicable border procedures, highlighting their strengths and weaknesses, and discussed possible approaches to trade facilitation reforms and related technical assistance and capacity building.

Trade and structural adjustment

A healthy multilateral trading system is one of the essential conditions – linked with sound macroeconomic, structural and social policies and good governance – for reaping the benefits of globalisation. Based on a Swedish proposal at the Ministerial Council Meeting in 2003, the OECD is presently examining the nature of these policy interlinkages and the gains they promise through enhanced human welfare – for developing and developed countries alike. The multidisciplinary project on trade and structural adjustment centres on sector-focused and forward-looking analysis, supported by country-specific case studies. The first part of the study will identify challenges in eight selected sectors (agriculture, fisheries, textiles and clothing, steel, shipbuilding, motor vehicles, health services, and outsourced business process services). The second part will discuss domestic structural policies that facilitate adjustment, drawing on the *OECD Growth Study*, *Jobs Strategy* and stocktaking of structural reforms. The third part will include case studies of national experience in dealing with structural adjustment in the eight areas identified earlier and the policy implications that might be drawn. The goal is to complete the project in time for the Ministerial Council Meeting in 2005.

Export credits

It is necessary to regularly update and maintain the international disciplines on officially supported export credits established and managed in the OECD, in particular the Arrangement on Export Credits. This need arises in the context of new emerging markets offering competing export credit products. The OECD has continued to review and improve disciplines for officially supported export credits, taking account of the need for more transparency and accountability. In this context, the OECD has achieved consensus and delivered concrete outputs over recent months: an improved text of the Arrangement on Export Credits which gives better access for non-participants wishing to know and possibly apply its disciplines, and an OECD Recommendation on Export Credits and the Environment which provides for a high level of due diligence with regard to the environmental impact of projects supported by export credit agencies.

Trade and investment, and trade and competition

In the context of the ongoing Doha mandate for WTO negotiations, a number of sensitive issues continue to present stumbling blocks. In view of the setback at the WTO ministerial meeting in Cancún and uncertainty since then at the WTO about the possibility of continuing previous work in Geneva on the “Singapore Issues”, including trade and investment and trade and competition, OECD members have generally been eager to keep analysis and dialogue alive on these important trade-related subjects through OECD committees and various outreach events.

An important new initiative on Investment for Development is under way at the OECD to help promote investment in developing countries. This new initiative involves three dimensions: drawing lessons on the use of official development assistance (ODA) in support of countries’ efforts to mobilise investment for development; sharing the OECD’s experience with investment policy peer reviews as capacity-building mechanisms; and developing a Policy Framework for Investment conceived as an operational guide on good practices for improving the investment environment. Other analytical work under way on trade and investment focuses on regional trade agreements and the impact on foreign direct investment (FDI) flows of commitments under the WTO General Agreement on Trade in Services (GATS).

OECD work on trade and competition continues to address concerns of developing countries. Before the Cancún ministerial, the OECD studied the perceived needs of developing countries for flexibility and progressivity in assuming possible multilateral obligations on competition policy. Post-Cancún, further analysis and advocacy work on trade and competition centre on two broad categories: addressing developing country concerns, including through trade and competition advocacy and outreach programmes; and analysis of frameworks and modalities for multilateral co-operation, which includes monitoring developments in negotiations at the WTO. The current work is based on the analysis of case studies on how anticompetitive behaviour affects the performance and competitiveness of firms in developing countries and transition economies. These case studies aim to increase appreciation of how strong competition policies complement liberalised trade policies in making export sectors in developing countries more competitive, thereby fostering economic growth and development.

AGRICULTURAL TRADE

The food and agriculture sector in many OECD countries continues to be characterised by high levels of support and protection. Ongoing monitoring and evaluation of agriculture policies by the OECD shows that support from consumers and taxpayers represents almost one-third of each dollar earned by producers, with just two-thirds coming from the marketplace. Much of this support is provided through high domestic prices that can only be maintained behind high tariffs and, when domestic production exceeds consumption, through the use of export subsidies. Over the past decade and a half, as measured by the OECD Producer Support Estimate (PSE), there has been some reduction in the level of support, a more significant but still modest improvement in the composition of support and some narrowing of differences in support levels between commodities.

Policy reform

OECD work clearly shows that further domestic and trade policy reforms are desirable. Policy reform can improve the efficiency of domestic policies in achieving their stated objectives, improve equity in the way policies impact on various sizes and types of producers, improve environmental quality, lower associated costs to consumers and taxpayers, and reduce distortions on world markets and the related costs that must otherwise be borne by less developed countries outside the OECD area.

There is a growing awareness of the positive and negative effects of agricultural production, and governments are increasingly looking for ways to ensure that these effects correspond to society's expectations. OECD work on multifunctionality, and the related "non-trade concerns" expressed by some countries, attempts to guide policymakers to the best possible decisions on whether government intervention is required and, if so, what the nature of that intervention should be. Related work on decoupling helps to clarify further the conditions under which alternative policies can be expected to have only minimally trade-distorting effects.

The OECD is also examining whether stringent environmental regulations in one country can penalise the competitiveness of its farmers, compared to countries with less stringent regulations. Such a situation might lead to demands for trade restrictions. Studies of this issue in the pig, dairy and arable crops sectors have been completed or are under way. Available evidence suggests that any concern is exaggerated: the extra costs of such regulations are a small fraction of overall production costs and, in some cases, products meeting rigorous environmental standards can command a price premium in the market. Of course, societal preferences vary greatly across countries.

Less is known about the impact of OECD policies on non-OECD countries, and about the impact of non-OECD country agricultural policies on their own agricultural and overall economic growth and development. This is an increasing priority for the OECD, and a

major new initiative is under way to examine agricultural policies and their impacts in Brazil, China, South Africa, and possibly India (i.e. the four founding members of the G20 group of developing countries). These analyses will help inform further dialogue on desired future policy directions amongst these countries and with OECD members.

Market access and export competition

Recent studies by the OECD have evaluated the results of implementing the Uruguay Round Agreement on Agriculture (URAA), and have also looked ahead to examine the likely impact of an extension of the market access and export subsidy commitments of the URAA. The URAA marked an historic point in the reform of the agricultural trade system, in that agriculture became part of a multilateral framework within which trade-distorting policies could be addressed and their (further) reform negotiated. The immediate quantitative effects of the agreement on trade and protection levels are modest, but ongoing negotiations provide an opportunity for further progress.

In the area of market access, even after full implementation of URAA commitments by developed countries, agricultural import tariffs for many products remain prohibitive and are, on average, 10 times higher than tariffs for industrial products. Tariff rate quotas, intended to facilitate market access for sensitive products, are often under-filled and, in general, have not been as effective as expected in opening markets. OECD analysis shows that simply reducing tariffs to the same degree as under the URAA, without addressing issues of tariff rate quota administration, tariff peaks and tariff escalation, would not result in significant additional trade flows.

Non-reciprocal preferential trading arrangements are intended to facilitate market access by developing countries, but there is uncertainty about the degree to which these agreements are effective. Nevertheless, many less developed countries are concerned that trade reform will reduce the preferential margins currently available to them, with negative consequences (at least in the short term) to their economies. Further empirical research and analysis is ongoing to clarify the size and distribution of the economic impact of existing preferences, and possible changes to the current systems.

Concerning export competition, the URAA bound the volume and expenditure of export subsidies, but did not discipline other export competition measures, such as export credits. OECD analysis confirms the importance of addressing all forms of export competition that could provide one country with government-sponsored advantages over another in export markets. At the same time, this analysis shows that the subsidy element in export credits is relatively small – less than 4% of the credit amount – compared with traditional export subsidies. Additional analysis is under way to allow the comparison of a wider set of measures that might distort export competition – export subsidies, officially supported export credits, elements of some food aid programmes, organisations with special authority in export markets (including state trading enterprises), domestic price discrimination and payments based on output – with respect to their relative subsidy elements and the impacts on markets.

Trade reform and adjustment

Research by the OECD has also examined the impact of OECD trade liberalisation on poverty and on food security. A general observation is that trade liberalisation alone cannot deliver the desired outcomes, and that trade reform creates both winners and losers. Ongoing work is aimed at expanding our understanding of the effects of policy reform. In

this respect, a major effort is under way to analyse and trace the impact of trade policy reform from the global scale to the household level, so that adjustment policies can be designed to contribute most effectively to sustainable economic development and poverty reduction. In addition, an important collaborative activity is under way with the UN Food and Agriculture Organization (FAO) to improve our collective understanding of the impact of trade reform on a larger group of developing countries.

GLOBAL VALUE CHAINS, OUTSOURCING AND EMPLOYMENT

Increased outsourcing of industrial production – often outside the OECD area – is of growing concern. Although this trend has existed for many years, it seems to have accelerated and extended beyond the manufacturing sector to services and higher-value activities. The process is driven by competitive pressure on companies to enhance productivity and reduce costs, which provides the long-term basis for rising living standards. But against a background of sluggish job growth, it presents the spectre of accelerated de-industrialisation and raises questions about the future of manufacturing in advanced economies.

Effects of outsourcing

Solid facts to underpin policy responses are lacking. A wide range of anecdotal and often contradictory evidence is quoted in the public debate. The lack of an empirical foundation for understanding current economic trends is partly due to their complex nature, as well as to differences in statistical classification systems. Nevertheless, OECD data exist which can help shed some light on the effects of outsourcing.

For example, while outsourcing to developing countries has captured headlines, this is only part of the wider phenomenon of the globalisation of production and rising cross-border activities of multinational enterprises. These firms are adopting new business strategies which retain their core competencies while outsourcing a wide range of other functions, thus creating new business opportunities around the globe. OECD countries themselves have been major beneficiaries of these trends, as reflected in the contribution of inward foreign investment to employment and productivity in OECD manufacturing sectors.

Manufacturers are outsourcing services

Confusion about outsourcing also stems from the blurred lines between manufacturing and services and resulting difficulties in interpreting sectoral trends. The amount of services embodied in manufacturing increased significantly in the last decades in most OECD countries. Much outsourcing is a reflection of the fact that manufacturing firms now buy services which they previously produced in-house. For example, they are realising efficiency gains and cost savings by purchasing ICT-based services and reorganising internally to better reap the advantages of information technology. Manufacturing jobs are being reclassified as services, and the skill requirements of services jobs are being upgraded.

Employment and productivity

Still, much remains unknown about the role of outsourcing and offshoring in OECD economies and the impacts on employment and productivity. The degree to which greater

outsourcing of services is affecting overall employment growth in the OECD area is not certain. Nor is it clear how much employment has been lost and created in different OECD countries by the relocation of production facilities as opposed to the general growth in trade and expansion of multinational firms.

Strengthening the empirical base for analysis

By enhancing the empirical evidence and analysing the causes of changes in OECD manufacturing and services sectors, the OECD can inform policymaking in this area. Several OECD databases – on intra-firm trade, intra-industry trade and activities of foreign affiliates – can be updated and linked to shed light on global production and trade patterns. Input-output tables and structural and sectoral models can be used to track the complex relationships between manufacturing and services and the employment implications. Firm-level data can be explored to help explain new global business strategies.

During the coming two years, work will be directed toward developing a more systematic empirical overview of the impact of outsourcing on employment, productivity and innovation in different sectors and countries. For example, what have been the real job and wage effects of offshoring in the information technology industry? This work will build on the current OECD services study, to be the subject of a report to OECD ministers in 2005. It will help explain the changing nature of manufacturing and its strategic importance to OECD economies. And it should lead to a sounder basis for policies to strengthen growth, employment and productivity in OECD countries in a context of increased outsourcing and globalisation.

In addition, the outsourcing of business process services will be one of eight sectors examined in a major project on trade and structural adjustment. A starting premise of this work will be that such outsourcing is not a static zero sum game and that many jobs are either kept or created during the outsourcing process as efficiency gains are transferred to consumers in terms of lower prices or re-invested in new businesses.

STRATEGIES FOR RESOLVING SECTORAL INDUSTRY PROBLEMS: STEEL AND SHIPBUILDING

There is general agreement among governments and industry that international markets for certain industrial products, including steel and ships, have been distorted significantly by government interference. This interference has prevented those markets from operating normally, especially by preventing the closure of inefficient production facilities, and this has resulted in those industries being seriously affected by surplus capacity. With trade tensions rising at the international level, pressures have increased to deal with these issues, both politically and in substance.

The OECD has assumed a leading role in efforts to restore normal competitive market conditions in these two sectors, which, if successful, would strengthen the multilateral trading system. The OECD has succeeded in bringing major players from member and non-member economies together in a multilateral forum, and is providing economic analysis in support of international negotiations on legally binding instruments which will strengthen World Trade Organization (WTO) disciplines.

Steel

Strengthening disciplines on government support

Steel markets have long been distorted by government subsidies and related support measures designed to enhance the competitiveness of existing firms and/or boost capacity. The situation has resulted in overcapacity, which has contributed significantly to the chronic problems that have affected steel trade over the past several decades. In December 2002, negotiations were launched under the auspices of the OECD to address the situation, by negotiating an agreement that would go considerably beyond WTO rules in banning subsidies. All major steel-producing economies are participating in the talks, which are set to conclude during 2004.

If an agreement is to be reached, difficult issues concerning the scope of any exceptions to a blanket prohibition of subsidies and the scope and character of preferential treatment for developing economies will have to be resolved, as will the design of effective enforcement instruments. Considerable progress has been made in other areas, and work on an advanced negotiating text is nearing completion.

Market turnaround

The weak market conditions that served as a catalyst for the steel negotiations have recently taken a remarkable turn for the better. Supported by strong growth in steel consumption in China, the world's largest steel market, global steel demand rose sharply in 2002 and 2003, reaching record levels in each year. This growth has resulted in growing tightness in key materials markets, leading this year to sharp increases in prices and physical shortages in those materials. Some steel producers have had to limit production as a result of the shortages.

International trade in steel products has remained robust, representing 26% of world consumption in 2003. Moreover, with the elimination of safeguard measures by key players, trade tensions have eased.

The outlook for 2004 is promising, as the steel market should continue to grow, with production expected to pass the one billion tonne level for the first time. High prices and low availability of raw materials for steelmaking, however, remain a concern, as does a growing number of bottlenecks in ocean freight.

Eliminating inefficient excess capacity

In addition to the negotiations on a steel subsidies agreement, governments are paying considerable attention to issues related to steel industry restructuring. Peer reviews of crude steel capacity developments have taken place alongside the negotiations, and this is helping to increase transparency and identify ways that could facilitate adjustment. The reviews showed that between 1998 and 2002, some 104.6 million tonnes of capacity were permanently closed, with further closures of up to 35.6 million tonnes of inefficient excess capacity expected for the period 2003-2005. Such closures represent more than 12% of total crude steelmaking capacity, but they are being surpassed by expansion, with global capacity expected to continue to grow for the next several years. Whether world consumption will be able to sustain the growing capacity throughout the business cycle is of concern, especially given the difficulties that the industry has experienced in adjusting to market downturns in the past.

Shipbuilding

World shipbuilding faces looming crisis

For decades the world shipbuilding industry has frequently experienced cyclical rises and falls in demand. This fluctuation, combined with the existence of excess capacity and the availability of government support, has pushed ship prices to below economic levels, as shipyards have attempted to keep their workforces employed.

At the moment the strong demand for shipping is being fuelled by sustained global economic growth, especially in China, as well as by environmental rules that require many single-hull tankers to be scrapped by 2005. This has generated strong demand for new ships, and most yards are working at close to capacity.

However, there is an element in this of natural future demand being brought artificially forward, and at the same time capacity has been expanding continuously. Potentially, overcapacity in the industry could be as high as 30% in 2007, according to recent OECD estimates. Without action to counter the distortions in the market created by this imbalance between capacity and demand, the world shipbuilding industry may head into a new crisis if, as is expected, demand for new ships falls sharply once present demands are met.

OECD leads initiative to find solutions

Faced with this potential crisis, governments and industry in both OECD and non-OECD economies have agreed that there is a need to establish normal competitive conditions in the world's shipbuilding industry. This is to be achieved by a legally binding international agreement to be concluded by end-2005 in a Special Negotiating Group on a new Shipbuilding Agreement that first met in December 2002. In addition to OECD members, Brazil, China, Croatia, the Philippines, Romania, the Russian Federation, Singapore, Chinese Taipei and Ukraine have participated in the negotiations.

It is generally agreed that existing general trade rules, as embodied in the WTO Agreement on Subsidies and Countervailing Measures (ASCM) and Anti-Dumping code, are not ideally suited for shipbuilding, since its special characteristics hinder the effective application of these rules.

Therefore, the efforts to establish "normal competitive conditions" in the shipbuilding industry have focused on:

- a support measures discipline, which would effectively prevent direct and indirect subsidies as well as other official regulations and practices in favour of the shipbuilding industry; and
- a discipline to deal with any other market distorting practices that may be identified.

In support of these instruments, binding dispute settlement before an international panel is envisaged to deal with violations of the support measures discipline and/or other practices. This would be backed up by appropriate "remedies" and "sanctions".

The Special Negotiating Group

Six regular meetings of the Special Negotiating Group and two special sessions (industry consultation and expert meeting) have been held so far. There is widespread agreement that a discipline for support measures is absolutely crucial to the Agreement, but there are still some divergent views about the details of such a discipline.

With respect to the second key issue, that of market-distorting practices and in particular distorting pricing practices, there are still widely diverging views on whether any practices exist that warrant intervention through this agreement. Every effort is being made to search for common ground on this important issue.

High chance of success

Never before have governments and industry been so united in their wish and determination to strengthen fully-binding and enforceable disciplines for these two industrial sectors. If this political will continues to prevail these discussions within the OECD can be successful.

PROMOTING A GLOBAL TAX ENVIRONMENT FOR GOVERNMENT AND BUSINESS

Today's global economy is characterised by integrated capital markets, innovative financial products, multinational enterprises which operate on a truly global basis, increased cross-border consumption and a dominance of services over the traditional manufacturing sector. These characteristics present opportunities for business and challenges to tax systems which were designed in a very different environment.

This more open environment encourages governments to constantly examine and adjust their tax systems so as to maintain their competitiveness and to remove tax obstacles to cross-border trade and investment. Such obstacles can take many forms: double taxation; lack of agreed international "tax rules"; inconsistency in the application of existing rules; anti-competitive tax practices; or lack of effective mechanisms for resolving tax disputes between two or more tax authorities.

In addition to the ever-increasing pressure to provide a favourable tax climate, governments must adjust their tax systems and enforcement capabilities to ensure that illicit tax activities do not proliferate as a result of the more open financial system. Tax authorities are finding it increasingly difficult to counter cross-border tax cheating, particularly when it involves financial centres where secrecy and anonymity are the rule.

Meeting these challenges in an environment of rapidly changing business models is not easy for governments, particularly when a premium is placed on minimising the compliance costs of taxation. The OECD is helping governments, both within and outside the OECD area, to meet these challenges.

Encouraging growth-promoting tax reform

Governments recognise the need to review and reform their tax systems in response to an array of challenges, which include maintaining their international competitiveness, stimulating innovation and entrepreneurship, improving work incentives, and the consequences of ageing populations for financing pensions and healthcare. The OECD helps governments in this task by providing a forum where countries can exchange experiences and collectively analyse significant tax policy issues. A recent example is the OECD's work on employee stock options, which has involved an analysis of tax treaty aspects, transfer pricing implications and the incentives provided by domestic tax treatment. A longer-standing subject of study has been the effect of taxation on work incentives, which played an important role in the development of the OECD Jobs Strategy and continues to be a major concern of governments.

Removing tax obstacles

Cross-border trade and investment would be seriously impeded if trade and investment flows were taxed twice, once in the source country and again in the country of residence. The OECD Model Tax Convention and the worldwide network of tax treaties based on it help to avoid the danger of double taxation by providing clear consensual rules for taxing income and capital. The Convention requires constant review to address new tax issues arising from a changing business environment. Recent updates have clarified the application of tax treaties to e-commerce transactions and stock options.

The Convention also covers commercial and financial transactions between different parts of a multinational group. Transfer pricing – the price charged for goods, services or intangibles between one part of a multinational enterprise and another – may diverge from market prices for a number of reasons, including tax planning. The “arms-length principle” set out in the Convention, and expanded in the OECD 1995 Transfer Pricing Guidelines, seeks to ensure that transfer pricing within the group is in line with pricing between independent firms so that the tax base is allocated fairly between the countries in which the multinational enterprise operates. Work is currently focused on monitoring the application of this principle to ensure a more consistent application and providing more practical guidance on the application of that principle to financial institutions and modern business operations.

Dispute resolution

As global trade and investment increase, so does the risk of cross-border tax disputes. Left unresolved, these disputes can result in double taxation and an uncertain business environment which could impede the free flow of goods and services. Both governments and business need effective procedures to keep such disputes to a minimum and to resolve them satisfactorily when they do arise.

The OECD has helped establish guidelines for so-called “Advance Pricing Agreements (APAs)” in which governments and taxpayers can agree in advance the appropriate approach to determine the “arm’s length” price to be charged in transactions between related entities. These agreements create an assurance in advance for taxpayers that tax authorities will take a consistent approach to a cross-border transaction.

Nevertheless disputes will arise. The mutual agreement procedure (MAP) provided for in tax treaties is the traditional mechanism to resolve these disputes. The MAP has worked reasonably well in the past, but the number of cross-border disputes as well as the complexity of the cases involved has increased. Improving the effectiveness of the operation of the MAP and, equally important, ensuring that the cases involved will come to a timely and satisfactory conclusion, is the focus of an important new project at the OECD, which is also examining a number of supplementary techniques, including arbitration.

Tax co-operation

Exchange of information is the key to better international tax co-operation, which is needed if OECD and non-OECD countries alike are to maintain effective sovereignty over the design of their tax systems and if the tax burden is to be shared fairly between citizens.

The OECD has been at the forefront of global efforts to combat international tax cheating. Over the past five years this work has delivered:

- A standard for access to bank information by tax authorities in OECD member states.
- A Model Agreement for Exchange of Information for Tax Purposes, which is being used as the basis for tax information exchange agreements between OECD countries and offshore financial centres.
- Commitments from 33 offshore financial centres to improve the transparency of their tax and regulatory regimes, and to establish effective exchange of information for tax purposes with OECD countries.
- A process of co-operation with non-OECD economies, including major competing financial centres, in a joint effort to ensure that these standards are applied at a global level.

Over the coming months efforts will be made to improve the process for achieving a “level playing field” in this area, thereby facilitating the negotiation of bilateral agreements which are the key to effective implementation of these commitments. The OECD welcomes the substantial progress that has already been made by some of its participating partners, and encourages the five uncooperative tax havens (Andorra, Lichtenstein, Liberia, Monaco and the Marshall Islands) to enter into this dialogue.

Promoting fair tax competition

The OECD works to promote competition in trade and other areas, including taxation. However, just as there can be fair and unfair trade practices, there can also be tax practices that are anti-competitive and which undercut the potential gains of fair tax competition and undermine public confidence in the fairness of their tax systems. The OECD’s project on Harmful Tax Practices provides a framework for countries to work together to eliminate such practices with respect to financial and other services. In doing so, the OECD seeks to encourage an environment in which free and fair tax competition can take place.

The OECD identified 47 potentially harmful tax regimes within the OECD area in 2000. The result of three years of intense review was published in March 2004: 18 regimes have been abolished; 14 regimes have been amended to remove the harmful features; 13 have been found not to be harmful. Two regimes require further analysis before determinations can be made. The OECD will carry on monitoring the continuing and newly introduced preferential tax regimes that member countries think raise concerns under the preferential regime criteria set out in the 1998 report on Harmful Tax Competition and the progress reports issued in 2000, 2001 and 2004.

Influencing tax compliance

Effective tax administration is not about collecting every last dollar payable under the tax laws. Rather, it is about optimising the overall level of voluntary compliance in a way that demonstrates the system is operating effectively. Increasingly across OECD countries, this has to be accomplished with diminishing budgets.

Better compliance has traditionally emphasised tax audits. However, audits are expensive and, from the perspective of many taxpayers, intrusive. Furthermore, except for the very largest taxpayers, tax administrations are not sufficiently resourced to enable broad, substantial audit coverage of taxpayers.

This is why governments have put a new emphasis on voluntary compliance. All tax administrations have a responsibility to properly educate taxpayers on their rights and obligations and to provide adequate standards of service that will facilitate taxpayers' voluntary compliance while minimising compliance costs. Research in OECD countries has demonstrated that targeted education and service strategies can be effective in helping to address significant non-compliance issues, provided they are combined with an effective enforcement strategy.

As a consequence of all these and other factors, tax administrations today face vastly increased demands that necessitate a more systematic approach to identifying key compliance risk areas. To achieve optimal outcomes, tax administrators must develop strategies tailored to each of the major compliance risks identified for each segment of taxpayers, recognising that non-compliance behaviour and attitudes vary substantially. Governments must also increase the awareness of corporate boards of the reputation and financial risks associated with their chosen tax strategies. These represent some of the most significant challenges to the successful administration of tax laws which are currently being examined by the OECD.

Developing partnerships

The association of countries outside the OECD in the dialogue on key international issues is of critical importance for developing countries and for promoting global tax standards and good practices. The OECD's global tax programme of more than 60 events a year is focused on bringing non-OECD economies into the wider debate and helping countries to achieve sustainable development through a predictable tax base and enhanced ability to attract foreign direct investment.

Good Governance and Security

MANAGING MAJOR RISKS OF THE FUTURE

As the events of recent years attest, the world has become a more dangerous place. The risk landscape has taken on new contours with the emergence of devastating terrorist attacks on civilian targets, new contagious diseases infecting both humans and animals, hugely destructive natural disasters (notably earthquakes and flooding), and severe disruptions to critical infrastructure such as energy supplies, transport and information systems. But what has also changed are the context in which these new threats are surfacing and societies' capacity to manage them. Globalisation is contributing to these changes in important ways by raising the level of complexity of the challenges and by increasing economic, social and environmental interdependence. This in turn is making co-operation among national governments, as well as between the public and private sectors, all the more crucial.

Emerging risks

In 2003, the OECD's International Futures Programme (IFP) published a report on *Emerging Risks in the 21st Century: An agenda for action*, which focused attention on the vulnerability of many of the vital systems underpinning OECD economies – health, transport, water, electricity, information – and set out a number of recommendations for governments and the private sector on improving the management of emerging systemic risks in the future. Three strands of that work are now being followed up.

Reappraising risk management

The first consists of supporting OECD governments in reappraising their risk management policies. The focus is on the consistency of policies, on their ability to deal with the challenges – present and future – created by emerging systemic risks, and on the opportunities for improvement. To this end, a group of member countries has come together to review selected risk-related policies and, on the basis of concrete case studies, to develop an international risk management “toolbox” and explore the possibilities for applying best practices. It is expected that the case studies will concentrate on a range of threats and vulnerabilities that could prove critical to the functioning of member countries' economies. Thus they are likely to address such themes as ongoing vulnerability assessments for critical infrastructures, security and reliability of power supply systems, prevention of disasters triggered by natural hazards such as floods, and public/private management of large-scale accidents.

Sharing lessons from major disasters

The second strand concerns the need to share lessons to be learned from major disasters. Following a proposal submitted at the March 2003 meeting of the Executive Committee in Special Session, the OECD initiated an analysis of the economic and social impact of recent large-scale disasters and identified lessons for the future. The focus is primarily on restoring trust and securing recovery in the aftermath of disaster. In preparing the analysis, the OECD secretariat has drawn heavily on in-house expertise, pulling together a team of specialists from eight OECD directorates and agencies.

Several policy messages stand out from this work:

- Governments are often not well prepared to handle the economic and social impact of disaster. In addition to the loss of life and human suffering, the damage inflicted on the economy can be huge. It is estimated for example that the economic cost of the terrorist attacks of 11 September 2001 amounted to some USD 120 billion, and that of the 1995 Kobe earthquake was around USD 130 billion.
- The public's trust, as well as consumer and investor confidence, are essential ingredients of recovery. They must be strengthened through credible communication and effective government action.
- Such action often needs to be taken in partnership with the private sector, which has an important role not only in disaster prevention but also in response and recovery. Sharing the burden of mega-risks clearly requires improved public-private interaction (see section on *Catastrophic risks*, page 50).
- Finally, major disasters can have global implications that can easily overwhelm the response capacities of any single country, and therefore call for close international co-operation.

The report was published in Spring 2004 under the title *Large-Scale Disasters: Lessons Learned*.

Impact of increased security activity

The third strand of work under development aims at gaining a better understanding of the broader implications of increased security activity. Organised crime, terrorism, disruption of global supply chains, computer viruses – all have played a role in raising people's awareness of the risks they face in today's world. The result has been the emergence of a USD 100 billion market for security goods and services fed by growing demand from governments, businesses and private households. With globalisation and technological progress continuing at a rapid pace, the security economy is expected to expand further in the years ahead. New identification and surveillance technologies such as biometrics and radio frequency ID are coming on stream, and satellite-based monitoring is set to play an ever greater role. These developments promise to have far-reaching economic and social impact over the longer term. The challenge for policymakers is how to meet the apparent need for greater security without unduly impeding economic efficiency, privacy and other democratic rights.

The OECD is about to publish a first report on these issues entitled *The Emerging Security Economy*. It argues that improving security comes at a cost that falls into two types: the investment needed to put in place the requisite security arrangements; and the second-order impact that the security arrangements may have on the operations of the sector in question or of the entire economy. Tighter security, for example, may mean longer delivery times, disruption of global supply chains and of finely-tuned just-in-time delivery systems.

These frictional costs tend to make trade more expensive and reduce trade flows. Similarly, tougher controls on movements of people across national frontiers can impose delays and efficiency losses. New technologies can help to reduce these trade-offs, but they in turn have potential implications for data protection and privacy concerns. More work is required to gain a better understanding of the complexities of the emerging security economy, of how and when governments should intervene, and which policies deserve priority.

OECD WORK ON CORPORATE GOVERNANCE

There is now clear evidence that good corporate governance underpins long-run growth by maintaining public confidence and financial stability, thereby ensuring a lower cost of capital. Good corporate governance requires transparent and reliable disclosure mechanisms about corporate performance. Clearly defined responsibilities and effective powers among the shareholders, the board and management are also needed. By contrast, the costs of weak corporate governance systems include unethical behaviour, a decline in the legitimacy of business, concerns about market integrity and reduced economic performance. Helping countries to improve corporate governance arrangements and the quality of the business environment is thus an important strategic goal of the OECD.

The updated OECD Principles

The OECD plays a leading role in the international movement towards raising the quality of corporate governance. The *OECD Principles of Corporate Governance*, first issued in 1999, reflect a call by member countries for a set of corporate governance standards to guide policymakers, regulators, investors and other private sector actors. Today, the OECD Principles enjoy worldwide recognition and have been endorsed as one of the Financial Stability Forum's 12 key standards considered essential for financial stability.

OECD ministers in 2002 requested an assessment and review of the Principles, the results of which are being presented to the 2004 Ministerial Council Meeting. The review paid particular attention to the improvements and emerging good practices catalogued in a recently-published survey of developments in member countries. Observers from key international institutions participated actively in the assessment process and consultations were held with the private sector, labour, civil society and non-OECD countries. The process also benefited from informal roundtable meetings with senior representatives from prominent international organisations, business and labour convened by the OECD Secretary-General. Public comments on a draft of the Principles were sought via the Internet and attracted many constructive suggestions.

The assessment concluded that the Principles should be revised to take into account new developments and concerns, while retaining their non-binding principles-based approach which recognises the need to adapt implementation to varying legal, economic and cultural circumstances. The revised Principles include a new chapter which sets broad principles for effective implementation and enforcement, including those to be followed when new regulatory measures are being considered. Good corporate governance relies on effective checks and balances. To strengthen them, the revised Principles aim to tighten the oversight of management by the board, and to improve the accountability of the board to shareholders. New principles call for the exercise of informed ownership by shareholders, both through strengthening their ability to influence the board and by

lowering the costs of exercising ownership rights. In addition, the Principles call for increased attention to managing conflicts of interest through enhanced disclosure and transparency. The need to declare and manage conflicts of interest now concerns not only managers and controlling shareholders, but also institutional investors, auditors, brokers and analysts.

Promoting good corporate governance

The Principles are the centrepiece of the numerous activities undertaken by the OECD to improve corporate governance. In co-operation with the World Bank, the OECD has used the Principles as a reference for policy dialogue in a series of regional roundtables aimed at promoting regional corporate governance reforms in Asia, Latin America, Eurasia, Southeast Europe and Russia. This activity has resulted in the preparation of regional White Papers for all areas (except Eurasia), which develop common policy objectives and highlight recommendations for policy actions. The knowledge gained from the roundtables has been made available to the public and is summarised in a recent OECD synthesis report comparing the corporate governance problems faced by widely different emerging market economies and the priorities which these countries have set.

The next stage of the roundtable process is already under way. In the case of the Russian roundtable, the participants have agreed to create two *ad hoc* task forces to examine policy options in two priority areas: the transition towards internationally-recognised financial reporting standards, and dealing with problems arising from related party transactions and the closely-linked issue of transparency of beneficial ownership and control. The results of these discussions, including a consideration of policy options, will be presented in two policy development documents, which are expected to be finalised before the end of the year. In the case of both the Asian and Latin American roundtables, discussions in 2004 will focus on improving implementation and enforcement.

Good corporate governance is also necessary for state-owned companies. The ownership function of the state in its companies has yet to be fully resolved, even after taking into account the beneficial effects of partial privatisation, which in many countries has opened the way to unprecedented restructuring and increased exposure to competition from private entities. The OECD is presently developing a set of new Guidelines that, once completed in 2005, will allow countries to better benchmark the ownership functions of the state.

Regulatory reform is often associated with changes in the corporate governance framework. The OECD's response to the growing demand for up-to-date, comprehensive and comparable information about recent regulatory developments has been to develop the Company Law and Corporate Governance Database, a unique interactive tool for disseminating corporate governance legal and regulatory information. Presently available only to OECD governments, it will be made accessible to the general public via the Internet before the end of 2004.

Considering next steps

Heads of state at the G8 Evian Summit in France in 2003 endorsed the review of the OECD Principles and called for continued global efforts to enhance corporate governance. The Principles, serving as an international benchmark, are central to this process and this has implications for the future work of the OECD. Being general and non-prescriptive, the Principles are compatible with a number of implementation strategies, which vary

according to domestic conditions in the legal, economic and social spheres. There is broad support for the OECD to establish a dialogue in which countries would share experiences regarding effective implementation strategies and disseminate ideas about maturing “good practices”. To ensure a high-quality, policy-relevant, dialogue will also require the development of a broad, generally accepted, framework which would serve to give structure to the dialogue by highlighting the inter-relationships between individual measures. Maintaining such a structured dialogue should remain at the core of OECD work on corporate governance.

FIGHTING BRIBERY AND CORRUPTION

It has been five years since the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (the “Anti-Bribery Convention”) entered into force. Today, the social, political and economic costs of corruption are widely recognised. As a result, governments, NGOs and many international organisations are mobilised to fight corruption, especially as the links between corruption and terrorism, organised crime, drugs and human trafficking are becoming more apparent. Governments need to act collectively to counter this threat by adopting and respecting international agreements that address all aspects of corruption. The UN Convention against Corruption, which was signed in December 2003, is a welcome addition to the existing arsenal of anti-corruption instruments of the OECD, the Council of Europe, the Organization of American States, the European Union and others. These instruments are mutually reinforcing and can have a cumulative impact on anti-corruption efforts.

The OECD Anti-Bribery Convention

These legal instruments vary in scope and geographical representation. What distinguishes the Anti-Bribery Convention of the OECD is that it is exclusively focused on the supply side of the bribery transaction in the context of international business and that it has an integrated mechanism to monitor compliance with the Convention’s obligations. All 30 OECD members, as well as five non-member countries (Argentina, Brazil, Bulgaria, Chile and Slovenia) are parties to the Convention and take part in the OECD Working Group on Bribery in International Business Transactions (the “Working Group”).

The Working Group is responsible for implementation of the Convention and has carried out extensive and rigorous monitoring of countries’ compliance. Monitoring takes place in two phases: the first phase evaluates the adequacy of countries’ legislation to implement the Convention and the second assesses whether a country is applying this legislation effectively. Thirty-four countries have now been examined in Phase 1 and at the end of 2003 eight countries had undergone Phase 2 examinations, including three G7 countries. These country reviews result in recommendations aimed at improving the legislative and institutional framework for detecting, investigating and prosecuting foreign bribery offences. In 2004 and through 2007, the pace of monitoring will accelerate, with seven country reviews scheduled for each year.

Monitoring shows results

The practical impact of the monitoring process is evident in several ways. Tax deductibility for bribes paid to foreign public officials is no longer possible in any OECD country or other country party to the Convention. The specific recommendations resulting from the review reports have obliged several countries to introduce legislative

amendments in order to strengthen their anti-bribery laws. Pressure is also building on countries to step up enforcement of these laws. Some cases have already been successfully prosecuted and, more recently, several investigations have been opened against companies alleged to have violated the foreign anti-bribery laws. The reviews also pinpoint areas where countries need to apply more effort and focus: raising awareness of the Convention and the national foreign bribery laws and removing obstacles to mutual legal assistance. It is clear that governments must pro-actively support the aims of the Convention, including by encouraging greater compliance in the private sector, and strengthening co-operation with non-member countries and with civil society.

The monitoring process has also succeeded in making information on governments' actions to fight corruption and bribery more easily accessible through the systematic publication of all review reports, including recommendations to countries to remedy deficiencies. This has helped to empower civil society to call for changes and demand more accountability. By explaining the measures taken by countries that are parties to the Convention and by frankly assessing their effectiveness, the reports add to the growing understanding of the factors impacting on the fight against corruption and can be used by countries that are not parties to the Convention as tools for identifying best practices.

Co-operation with non-members

Co-operating with non-member countries includes developing partnerships with local governments, the business community, NGOs and civil society, and the media. Regional initiatives such as those carried out in Asia-Pacific (in collaboration with the Asian Development Bank), in the Baltic countries, in Latin America, and in the transition economies of Eastern Europe, central Asia and the Caucasus can be an effective means to build regional co-operation, country ownership, citizens' involvement, and support from the international donor community.

Future challenges

Despite the many successes, challenges remain. One of these is to welcome new members to the Convention while preserving its effectiveness. A recent OECD Council decision should help respond to that challenge by addressing the criteria to be used in accepting new members, the kind of monitoring they will undergo, the governance structure to assist the Working Group in managing new members, and by providing the budgetary stability needed to ensure the continued effectiveness of the Convention. Countries must also be vigilant that certain acts, such as bribery in relation to foreign political parties, or candidates for foreign office, or the use of foreign subsidiaries in bribery transactions are not used to circumvent the Convention. Increasing concern with what are seen as prevalent acts of bribery in the private sector should also be addressed.

With monitoring well under way, more attention is being paid to the role of the private sector in fighting corruption. Recent scandals have raised awareness of the financial losses and damage to reputation that can result from allegations of bribery, corruption or other forms of misconduct by companies. The OECD Guidelines for Multinational Enterprises, which provide a voluntary code of responsible business conduct and contain a mechanism involving "National Contact Points" to promote its observance, can assist countries in managing these risks. In particular, the Guidelines' anti-corruption chapter covers a broad range of corrupt transactions as well as the use of agents, employee awareness, anti-corruption management systems and political contributions.

FINANCIAL MARKETS, PRIVATE PENSIONS AND INSURANCE

While financial markets have recovered somewhat from the financial turmoil and corporate governance failures of recent years, the systemic weaknesses that emerged have not yet been resolved. To respond to these weaknesses, and to restore public confidence and financial integrity, remains a major challenge for financial institutions, policymakers and regulators, irrespective of the improved sentiment that has arisen from the recovery under way. Stronger governance, risk management and disclosure systems will be required to enhance financial integrity in a sustained manner.

The OECD has developed substantial policy analysis of governance by and of institutional investors. These institutions are key actors in the corporate governance of non-financial institutions to whom they provide finance. Their own governance is also at the core of financial integrity. Beyond the revision of the Principles of Corporate Governance, the OECD is developing comprehensive “Principles-compatible” guidelines on the governance of pension funds and insurers, which are the main long-term savings institutions and have a vital role in savings, investment and the sustainability of financial markets.

New challenges

More generally, the fundamentals need to be reconsidered. The emerging new financial regulatory landscape should be assessed to identify the major reforms undertaken, any significant remaining gaps and also the risks of over-regulation. This is all the more important as financial markets, and the economy as a whole, face new challenges and risks connected with population ageing, the individualisation of risk responsibility, the emergence of new catastrophic risks and the integration and globalisation of markets.

Ageing and private pensions

Ageing populations place an increasing burden on social security systems and public debt around the world and will continue to do so. Countries have reacted in a variety of ways. In recent years, pension reforms in many countries have included an increased reliance on privately managed, funded pension systems. While private pensions are expected to relieve some of the burden and their development is to be promoted, this depends on the existence of a soundly-based regulatory framework. The emergence of large corporate pension funding gaps has alerted policymakers to the need for proper funding and investment rules. Current trends toward defined contribution schemes raise the issue of adequacy of future retirement income.

Given the demographic and fiscal pressures for reform, it is increasingly necessary for policymakers to understand the complex features of different pension systems, their impact on financial markets and the best ways to regulate them. The OECD is the leading

international forum to achieve these objectives. Regular monitoring, data collection and analysis, as well as identification of regulatory principles and best practices, are already under way. The OECD Council approved in March 2004 a recommendation on core principles of occupational pension regulation, confirming the Organisation's role as a standard-setting body on pension regulation. The OECD is currently working on new guidelines on funding and investment.

The scale and pace of pension reform worldwide has also created a significant need for comprehensive, comparable pension statistics that can capture the many dimensions of pension systems and help governments assess their programmes and reforms. Indeed, there are presently only scattered bodies of data available on subjects such as retirement income adequacy and trends in coverage, funding and investment.

To fill a significant data gap in pension statistics, the OECD has recently initiated a project to set up a database of pension statistics, as a complement to the statistics it collects on insurance.

Financial education

Pension reforms are increasing the responsibility of individuals who are not always well-equipped to make proper choices and decisions, creating a need for an urgent strengthening of financial education. More generally, the importance of financial education has increased in recent years as a result both of developments in financial markets and of demographic, economic and policy changes. As capital markets become more sophisticated and new products are continuously offered, including hybrid instruments whose risk-return characteristics are not immediately discernible, it is very important that the level of financial education is adequate to provide consumers with the necessary tools to enable them to determine their financial needs, and to seek and effectively use information about financial services and products. As increasing numbers of consumers are responsible for making their own financial decisions, the consequences of poor decisions are becoming serious.

The OECD launched in 2003 a major project to respond to these policy concerns, with the aim of promoting good practices by major actors in this field. It is the only international body which has such a policy-oriented programme to promote financial education.

Private health insurance

If pension developments call for urgent policy action, the same applies to health systems. Here again the consideration of private systems is high on the agenda of policymakers, despite the fact that the overall framework is quite different among countries. The financing of health systems is of serious concern. Private health insurance can play a role in this respect, as a complement to public schemes, but needs an adequate regulatory framework to ensure that the basic social objectives of health policies are met. The OECD analysed these issues in its health project and will continue to develop work in this field, focusing on the relationship between ageing and health.

Catastrophic risks

The past few years have witnessed a number of large-scale disasters, both man-made, such as the terrorist attacks of 11 September 2001, and natural, such as tropical storm Allison in 2001 in the US, extensive flooding in large parts of Europe in 2002, the earthquake

in Algeria in May 2003 or the appearance of new infectious diseases such as SARS. The frequency of such disasters and the magnitude of the losses involved have tended to increase. Since September 11, both government and the private sector, including insurers and reinsurers, have initiated a far-reaching reflection on how to cope with the threat of future catastrophes of comparable or even greater magnitude. This threat raises an operational and financial challenge: large-scale disasters translate into innumerable claims that need to be filed, assessed and processed within a short time frame, and massive compensation payments may have to be made.

The OECD has been examining the key contribution of the insurance sector in the non-financial management of catastrophes, *i.e.* in risk assessment, claim management and risk prevention. It has also gathered information on the national mechanisms for catastrophe indemnification. Regarding terrorism, the OECD has sought to identify criteria to define terrorism for indemnification purposes, analysed the issue of terrorism insurability, and looked at the respective roles to be played by private insurance and reinsurance markets, financial markets and governments in covering terrorism risk. Lastly, it considered the issue of mega-terrorism and options to compensate for extreme losses.

Globalisation

All these new risks emerge in the framework of the globalisation and integration of financial markets. Globalisation affects financial infrastructure and the *modus operandi* of “small” financial markets, while integration has led to further market and supervisory consolidation in several countries. These structural developments also affect the regulatory coherence of national and sectoral financial systems and the related search for better international mutual understanding and co-operation which is proving indispensable in an increasingly global and integrated financial world.

The development of international co-operation in the financial services field and, above all, the liberalisation of regulations applying to the establishment, investment and cross-border operations of financial services companies are essential if individuals and businesses are to have access to the best financial services on offer. This in turn conditions sound economic development and fosters entrepreneurship.

To support the development of open and soundly-regulated trade in financial services, the insurance provisions of the OECD Code of Liberalisation of Current Invisible Operations have been reviewed and updated to reflect current market and regulatory conditions. To enhance transparency and allow gradual liberalisation, member countries will now have to assess their conformity with the new requirements of the Code and lodge reserves accordingly. Sensitive issues, such as the relevance of prudential carve-outs, will have to be reviewed. More generally, the relation between liberalisation and deregulation will remain a priority issue for regulatory and supervisory authorities, in fast-evolving and increasingly integrated insurance markets.

The financial world is now global and OECD countries are working more and more closely with other countries. The OECD is playing a key role in promoting adequate financial regulation and good practices in emerging economies with a special focus on Brazil, India, Russia and China, as well as the Asian and Latin American regions. It also encourages international co-operation through the International Network of Pensions Regulators and Supervisors or the Multilateral Network on Debt Management which was set up in 2003.

INFORMATION TECHNOLOGY AND SECURITY

Strengthening security and trust

Security and trust are crucial to developing a digital economy. Enhancing the security of information systems and networks, as well as building trust in global communications networks, remain key policy challenges for furthering the development of information and communications technology (ICT), and economic growth. As research and surveys show, a lack of security and trust online is likely to have a negative impact on the emerging digital economy. Security and trust in ICT have a central place in the OECD's vision of a global digital economy and the potential it holds for economic growth, better living standards and improved social conditions. User trust in the information society and in global networks hinges on assuring consumers and businesses that their use of network services is secure, reliable and verifiable. The OECD has been working in the area of trust since the infancy of the information economy, producing the Guidelines for Privacy Protection in 1980 and the Security Guidelines for Information Systems in 1992. Building security and trust in the digital economy raises policy challenges which call for the broad analysis and public-private sector dialogue for which the OECD is so well suited.

Strengthening information security so that it can stand up to both internal vulnerabilities and external threats such as cyber-terrorism, computer viruses or hacking is key to securing trust in global networks and to protecting critical infrastructures. The revised OECD Guidelines for the Security of Information Systems and Networks ("Security Guidelines", 2002) go beyond raising public awareness of the risks to information systems and networks, and offer advice on the policies, practices, measures and procedures available to address those risks, while emphasising the need for the adoption and implementation of the Guidelines. They call for all stakeholders (governments, businesses and end users) to develop a "global culture of security". In short, the aim is to foster greater trust and confidence in information systems and networks, and in the ways in which they are delivered and used.

Shared risks, shared responsibilities

In a global networked environment, risks, threats and responsibility are shared. All participants – governments, businesses and end users – have experienced the virus and worm attacks that have rapidly spread across the world. The dramatic recent increase in spam (unsolicited e-mail) adds to existing security risks, as spam is used as a vehicle to spread malicious payload. Beyond technical solutions, strengthening information security calls for a change in risk perception and behaviour by all participants throughout society. Such a cultural change should balance the need for enhanced security with preserving respect for privacy and other important democratic values. The development of a culture of security is a collective responsibility; it should build trust in the global information society by ensuring the reliability, integrity and sustainable development of information

systems and networks. As the nature of the threats to information systems and networks is constantly changing, security of such systems requires an ongoing co-operative effort by all stakeholders, both nationally and internationally.

International support

The Security Guidelines, which are a response to the ever-changing security environment and which call for the creation of a culture of security, have received wide support at both national and international level. They served as the basis for a United Nations General Assembly resolution for the “Creation of a Global Culture of Cyber Security” in December 2002 (UN Resolution A/RES/57/239) and have been recognised by the Council of Ministers of the Asia Pacific Economic Co-operation (APEC) forum and the Council of the European Union.

Implementing security

OECD member countries are actively implementing the 2002 Security Guidelines. In January 2003, OECD countries adopted an implementation plan for co-ordinated national online security policies and undertook a survey to monitor progress in implementing the Guidelines. In October 2003, the Norwegian government hosted the OECD Global Forum on Information Systems and Network Security. The Forum aimed to share information with OECD members, non-members, the business community and civil society, and to enable a forward-looking discussion on expanding the culture of security. Stock was taken of progress made in the national implementation of the Security Guidelines.

A “Culture of Security” web site has been created to provide member and non-member governments with a tool for exchange of information on initiatives to implement the 2002 OECD Security Guidelines. The site provides access to relevant web sites as a first step towards creating a global culture of security; and with the aim of providing a centralised portal for educational security tools for users of information systems and networks.

Actions for the future

OECD member countries have already committed themselves to taking a leading role in strengthening information security. They have decided action-oriented initiatives to build an effective global culture of security. Indeed, drawing lessons from experience at national level, and exchanging practical and detailed information for ensuring information security is essential to enhancing national and global cyber-security. Building on information already gathered, member countries will be carrying out an in-depth inventory of national initiatives to implement the Security Guidelines with a view to assembling a critical mass of detailed information and case studies. This information will be shared among member and non-member economies.

Since spam has the potential to seriously undermine information security and trust, the OECD has decided to take action and help co-ordinate international co-operation to combat spam. Building on its work in 2003 and on the results of the OECD workshop on spam, hosted by the European Commission in February 2004, this action will aim at developing a consistent multi-pronged approach to fighting spam, including facilitating cross-border enforcement against spammers.

Outreach

Outreach to non-member economies is crucial for improving information security on the global scale. To be effective, a culture of security must be global and must involve

non-member economies, as the level of security in interconnected systems is only as good as the weakest link. Non-member economies are in the process of adopting a similar approach to that of OECD member countries, but have specific needs that should be addressed. Information sharing between OECD members and non-members on practical initiatives and experiences is particularly important. To this end, the OECD will continue to strengthen its efforts to co-operate with non-member economies within APEC and beyond, and will further contribute to the World Summit on the Information Society (WSIS) process, as appropriate.

Other essentials for trust

In addition to strengthening security of ICT, building trust in the digital economy requires appropriate privacy and consumer protection. Beyond security, the OECD continues to promote privacy and consumer protection as essential building blocks for trust.

Following up on previous work, the OECD adopted Guidelines for Protecting Consumers from Fraudulent and Deceptive Commercial Practices across Borders in June 2003. The Guidelines set out broad principles for international co-operation and specific provisions covering notification, information sharing and assistance with investigations. They also cover issues regarding the authority of consumer protection enforcement agencies, invite private-sector co-operation, and set the stage for future work on consumer redress. Implementation of the Guidelines is a key work item.

Privacy Online: OECD Guidance on Policy and Practice has been updated and published in 2003. It is aimed at governments, businesses and individuals, and promotes privacy protection at national and the international level. *Privacy Online* outlines methods for adopting and posting a privacy policy, and proposes mechanisms for enforcement and redress, and ways to promote education and user awareness.

PUBLIC GOVERNANCE AND THE ROLE OF THE STATE

Good public governance is critical to long-term economic, social and environmental development. Striving for greater efficiency of the public sector is one element of the strategy for successful modern government; enhancing the opportunities for markets and private initiative is the other.

The OECD is helping member countries to strengthen and maintain their capacity for good public governance in four key areas: modernising government; fostering trust in government; making the most of e-government; and enhancing the legal and institutional framework for markets.

Modernising government

Modernising government beyond efficient public administration and service delivery requires a comprehensive understanding of the system as a whole and how it functions. Governments need to have at their disposal adequate diagnostic and risk analysis tools and to appreciate the civil service culture and leadership and their critical place in good governance. This means more research on the best way to achieve lasting change in behaviour and attitudes.

Experience in OECD countries suggests that one of the most important levers for changing behaviour and attitudes in any public management system is the budget and how it is used for defining objectives, responsibilities and accountability. This can include performance goals, information and reallocation mechanisms. The organisational structure and human resources management are also key elements of a change strategy. The role of various agencies, departments and governmental bodies, the use of private sector service providers and the relationship between levels of government are also crucial dimensions of modern government.

The OECD is about to finalise a major programme to assess the experience of member countries in each of these areas and how they impact on government's strategic management capacities. The five main components of the programme are: governing for performance, developments in civil services, institutional design, governing by contract, and the changing roles of central agencies. The results are being summarised in a review of "Ten Years of Public Sector Modernisation", which will include a discussion of challenges and recommended strategies. The findings of the programme will also contribute to OECD work on fiscal relations across levels of government with its focus on institutional, budgetary, fiscal and macroeconomic issues.

Trust in government

Governments need to be open, accountable and accessible if they are to win and maintain the trust of citizens, investors and consumers. Systematic and effective

consultations with stakeholders in the policymaking process are promising approaches for facilitating communication with citizens. Public service codes of conduct to prevent corruption and better management of potential conflicts of interest are also important, given the increasing links between the public and private sectors.

The OECD Guidelines for Managing Conflict of Interest, adopted by the Council in June 2003, provide a practical framework of reference for reviewing existing solutions and modernising mechanisms in line with good practices in OECD countries. The Guidelines, together with a “toolkit”, help governments develop an effective conflict-of-interest policy that fosters public confidence in the integrity of public officials and public decision-making, especially at the interface of the private and public sectors.

Making the most of e-government

Information and communication technologies offer new opportunities for the government/citizen interface, for reducing administrative barriers and increasing efficiency in public service delivery.

The findings of the first phase of the OECD e-government project were published in early 2003. This report on *The E-Government Imperative* develops a set of guiding principles for successful e-government, ranging from the need for political support to frameworks for co-operation within governments, the dimensions of customer focus and the issues of responsibility. A second report on “Seamless Services”, to be published in Autumn 2004, reflects the challenges faced by e-government leaders in OECD countries in implementing reform strategies. A series of country reviews in 2004-2005 will generate insights into innovative solutions and offer access to comparative data and analysis.

Governance for functioning markets

While the role of the state as a direct product and service provider and market player has been diminishing in OECD countries, its role in setting the framework in which markets operate remains crucial. In fact, quality regulations and institutional governance arrangements are rightly seen as having a dominant influence on the emergence and functioning of innovative and efficient markets. Both elements are also decisive in promoting competitiveness at national and local level.

The OECD’s work on regulatory governance and territorial development covers the national and regional dimensions of market frameworks and competitiveness. In particular, the OECD is helping member countries improve regulations, protect health, safety and the environment, and establish and maintain market frameworks that encourage effective competition and consumer choice. The Organisation is also helping members promote policies to reduce the dependence of regions on transfers and subsidies and instead stimulate regional competitiveness by mobilising local assets. Special attention is given to improving contract frameworks and the efficiency of vertical and horizontal partnerships between levels of government.

As regulatory reform has become part of the broader policy agenda for growth and employment, countries now face a new set of challenges, such as evaluating regulatory performance, making sure public consultations are effective, and deciding whether and how to use regulatory instruments in sectors such as health or education. The OECD report on *Regulatory Policies in OECD Countries: From Interventionism to Regulatory Governance* emphasises the dynamic character of the regulatory reform process. Current OECD work in

this area pays particular attention to the independence of regulators, the evaluation of regulatory policies and the challenges of regulatory policies across levels of government. The country reviews on regulatory reform, which include all the G7 countries, as well as Russia, the first non-member country participating in the programme, are an essential vehicle for advancing the regulatory governance agenda.

The OECD is also addressing regional disparities from a new market-based perspective, since policies for lagging regions have produced unsatisfactory results despite the allocation of significant resources over a long period of time. Country-specific territorial reviews and policy analysis are helping member countries promote regional competitiveness, sustainable development and innovative governance arrangements, especially at local level.

Sustainable Development

IMPLEMENTING SUSTAINABLE DEVELOPMENT

Between 2001 and 2004, OECD work on sustainable development has focused on indicators and peer reviews; on obstacles to reducing environmentally harmful subsidies and to further use of environmentally-related taxes; on social aspects of sustainable development; and on policy coherence and integration. The range of OECD activities undertaken over this period has looked at the “interface” between the environment and the economy, on one side, and between the economy and society, on the other.

Environmental-economic interface

Environmental performance has improved in several respects since 1990 and OECD countries continue to set targets for further improvement. Environmental protection costs have also risen throughout this period. They amount to about 2% of gross domestic product (GDP) or more in countries that have set comparatively demanding standards and could have been at least 25% lower through the greater use of more cost-efficient instruments in many OECD countries. This option has not been exploited, in part because of a lack of integration of environmental and economic concerns in policymaking. Concerns over the social consequences of environmental policies and political economy considerations have also increased costs as they have led to exemptions or lower abatement granted to some of the most polluting activities. Abatement costs could rise markedly in the future as standards become stricter, thus reinforcing the need to use cost-efficient options in coming years. This is particularly the case with the reduction of greenhouse gas emissions, where policies capable of meeting objectives at least cost become increasingly urgent with the approach of the target date of the first commitment period under the Kyoto Protocol (2008 to 2012).

While all OECD countries use some kind of environmental taxes to lower abatement costs and raise revenues, a number of countries have substantially extended their use since the early 1990s, with environmental tax revenues amounting to about 2% of GDP. Several OECD countries have introduced environmental tax reform, often on a revenue-neutral basis (*e.g.*, combining increases in energy taxes with reductions in social security contributions). While the revenue from environmentally-related taxes increased significantly in some countries between 1994 and 2001, proceeds have declined by 8% on average since 1999. About a third of this fall is due to lower revenues from sales of petrol, following tax-induced hikes in prices. This highlights the fact that significant behavioural changes can be achieved by applying appropriate tax rates, or through tradable permit systems that create similar price incentives.

While there is little evidence that environmentally-related taxes have reduced international competitiveness significantly, this conclusion must be qualified by the many exemptions and tax rate reductions currently granted to sectors most exposed to international

competition. As industry usually pays very modest amounts in environmental taxes, significant impacts on competitiveness would not be expected. Moreover, competitiveness concerns must be balanced against the main goal of environmental reforms: to protect the environment by way of encouraging alternatives to harmful products/processes.

Environmental damage is often a by-product of subsidy policies. OECD countries provide about USD 400 billion in subsidies every year – about three-quarters of these subsidies go to agriculture, one-tenth to transport, and the rest to fisheries and forestry, energy production and manufacturing. While there has been a shift towards less environmentally harmful support in agriculture since the mid-1980s, progress has been slow. Agricultural support that is potentially harmful for the environment amounts to about USD 235 billion per year. Most of the USD 6 billion in fisheries subsidies in OECD countries goes to general services – some of which supports research, management and enforcement activities that can benefit the environment. However, some expenditure on general services supports fisheries infrastructure and enhancement programmes that can contribute to over-fishing. Estimates of energy subsidies range between USD 20 billion and USD 80 billion per year. Subsidies to coal and peat production are among the most harmful to the environment, with OECD countries' support to the coal industry estimated at about USD 5 billion per year.

Against this background, the OECD has recommended fundamental changes in policy settings:

- In view of the lack of effectiveness and efficiency of **voluntary agreements**, the OECD *Economic Surveys* have called for a reassessment or a termination of such practices.
- While recognising that **regulations** are the most appropriate instrument to control pollution in some cases, the OECD has recommended that less emphasis should be placed on such instruments, as mounting evidence showed that these can prevent companies from using the most efficient ways to reduce their emissions and thus increase costs for society.
- The OECD recommends that greater use should be made of transparent **taxes** or **tradable emission permits** that concentrate abatement in activities where emissions can be cut at the lowest cost. However, these instruments will only be cost-efficient if they cover all sources of any given type of pollution. As a result, the OECD calls for the removal of current exemptions from carbon and water pollution taxes in the most pollution-intensive activities.
- Where taxes and tradable permits have adverse social consequences, these should be addressed through the standard social security system, for example, by adjusting the way support payments are calculated or by introducing new support instruments.
- A multi-pronged strategy is required to overcome obstacles to subsidy reform. It is important to recognise that a range of options is available to meet societal objectives, and that subsidies are generally inefficient tools for achieving employment or other social policy goals. Other ingredients of successful reforms include the diffusion of innovative schemes; better targeting of existing subsidies; and improved programme design, to improve the efficiency of subsidies aimed at correcting environmental problems – although even these may violate the polluter pays principle.
- For dealing with cross-border environmental problems, the OECD recommends taking advantage of international agreements that allow abatement to be concentrated in areas where it can be obtained at lower cost, while stressing the benefits of further international co-operation.

Social-economic interface

On the economy-social interface, *Economic Surveys* have focused on the sustainability of retirement income systems in OECD countries, and on ways of improving living standards in developing countries. With reference to the first issue, many OECD countries have already taken steps to assure the financial sustainability of public pension systems. In others, however, progress has been slow, and the OECD has recommended specific measures that should be undertaken to accelerate the pace of reforms in ways that do not compromise income adequacy in old age. In particular, the OECD has called on these countries to remove incentives that artificially shorten working lives, such as eliminating opportunities to withdraw from the labour force permanently at an early age via unemployment, disability or special benefit schemes and, in some cases, raising the standard age of pension entitlements.

More generally, the OECD has stressed the importance of a well-functioning social protection system for addressing social problems and for maintaining conditions that facilitate both economic growth and environmental sustainability. Assuring the sustainability of social protection systems requires confronting a range of long-term pressures – in terms of demography, family structures, labour markets, and distribution of economic resources and opportunities – through policies specific to each phase of individuals' lives. This perspective links concerns about sustainable development at the global level with that of preserving social cohesion through well-designed programmes within each country.

With reference to living standards in developing countries, the OECD has stressed that the improvements which have characterised most of these countries since 1990 have proved elusive in Sub-Saharan Africa. In other regions, improvements in living standards have been accompanied by strong export performance, which in part reflects falling protectionist barriers in OECD countries and specific measures to open up OECD markets to the least-developed countries. However, agricultural products from the developing countries still face barriers because of trade restrictions and agricultural subsidies. The OECD strongly encourages member countries to reduce support to agriculture. Living standards in developing countries have also been raised through greater emphasis on poverty alleviation in development assistance and through measures to make assistance more targeted and efficient, and the OECD recommends further moves in that direction. Especially important is targeting assistance to health improvement in the least developed countries. For example, welfare in Sub-Saharan Africa could increase by USD 30 billion or more, if the loss of life years caused by infectious diseases could be reduced by two-thirds, yet this region receives only 20% of bilateral development assistance.

Further work

There is a demand for the OECD to continue to do work on sustainable development and to raise the visibility of this work. Areas identified for further work include obstacles to reducing environmentally harmful subsidies and to further use of economic instruments; on sustainable resource use including material flow accounting, decoupling of environmental pressures from economic growth and resource productivity; and on emerging issues as appropriate.

Round Table on Sustainable Development

The OECD Round Table on Sustainable Development has worked in the past year on whether illegal, unregulated and unreported (IUU) fishing can be halted, how far actions

taken by OECD countries under international agreements on sustainable development really help to further development in the poorest countries and what practical steps can be taken to meet the Millennium Development Goals for water and sanitation access.

Fisheries ministers from OECD and developing countries met in June 2003 and set up a Task Force led by ministers which over the next 18-24 months will produce analysis and recommended action to tackle IUU fishing on the high seas. In March 2004, ministers identified priorities for the forthcoming UN Commission on Sustainable Development (UNCSD) meeting on water and sanitation.

CO-OPERATIVE ACTIVITIES WITH PARTNER COUNTRIES

The OECD Convention mandates the Organisation to promote policies that contribute to sound economic expansion in economies outside its membership as well as in its member countries. As a result, work with non-members – outreach – is an integral part of the Organisation’s regular programme of work. Many countries outside the OECD area have become major players in the global economy, to the extent that inviting them to participate in the Organisation’s work enhances the effectiveness of policy initiatives agreed within the OECD framework.

Forum for building consensus

The OECD provides a forum for participating countries to develop, through a consensus-building process, best practices, guidelines, principles and other “rules of the game”. These may herald, or provide the building blocks for, formal treaties and other binding international agreements. The participation of non-members in initiatives such as the Model Tax Treaty and Transfer Pricing Guidelines, the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, and the Chemical Safety Programme, enhances their efficacy.

Consensus is built through: 1) a shared analysis of the issues and mutual understanding of other countries’ positions; 2) the formulation of a common market-based response to the issues; and 3) surveillance of the follow-up given by each country in a “peer review” process. As a result of this method, non-member economies have shown a remarkable willingness to work with the OECD. For example, countries which objected to the inclusion of the “Singapore issues” (investment, competition, transparency in public procurement and trade facilitation) in the World Trade Organization (WTO) negotiations at Cancún have been willing to discuss these issues within the context of the OECD’s Global Forums and other outreach programmes.

Sharing knowledge and expertise

The Organisation works with non-members to provide the support for policy reform and capacity building they need to develop policies for advancing economic, environmental and social progress. OECD outreach work encompasses policies to enhance the investment climate, advance statistical methodologies, improve both public and corporate governance, build stronger national institutions for trade policy, and more generally to encourage the range of domestic reforms required in all countries to reap the benefits of globalisation.

Currently, three avenues for co-operation exist between members and non-members: OECD Global Forums; Regional/Country Programmes; and OECD Committees, bodies and instruments. Furthermore, the 2004 ministerial meeting welcomes the participation of non-members in its discussions on trade-related issues.

The eight OECD Global Forums make broad use of OECD expertise and aim to deepen and extend relations with non-OECD economies in fields where the OECD has particular expertise and where global dialogue is critical for social, environmental and economic progress. The Forums may promote the worldwide implementation of OECD guidelines and agreements, or act as a venue for the participants to discuss difficult issues in a neutral, non-negotiating context. Currently, the Global Forums focus on sustainable development; knowledge economy (highlighting biotechnology and the digital economy); governance; international taxation; trade; international investment; agriculture; and competition.

Through targeted geographical programmes, the OECD has assisted in policy reform in regions and countries where a basis for mutual co-operation exists. The OECD's co-operation with China is helping to ensure its integration into the world economy in a sustainable and mutually beneficial manner. The OECD has launched a two-year programme to reform China's governance systems and practices. The programme will help Chinese policymakers address critical governance challenges affecting China's social and economic development. A second economy-wide study of China will be published in the Spring of 2005. This study is likely to have a significant impact on China's macroeconomic and structural policymaking. In the framework of the ADB/OECD Anti-Corruption Initiative for Asia and the Pacific, 21 Asian countries have formalised their policy objectives and anti-corruption commitment in a regional action plan. The OECD-Korea Regional Centre for Competition, launched in 2004, offers a new model for capacity building and regional policy dialogue between members and non-members in Asia.

As the secretariat of the Environmental Action Plan for Central and Eastern Europe (EAP), the OECD has successfully promoted several environmental policy initiatives in the transition countries. In Southeast Europe, the OECD co-chairs the Investment Compact which aims to boost private sector investment in the region. In its capacity as the Co-ordinator for General Education Policy and System Change in the Stability Pact, the OECD secretariat has undertaken 13 reviews of varying magnitudes, with another one currently under way. The OECD has been working closely with Russia since the early days of post-communism to support its reform and transition efforts. A major focus of current work is a review of Russia's regulatory reform policies. Ongoing joint activities cover an extensive array of market-reform initiatives, ranging from five *Economic Surveys* to policy reviews in areas including competition, investment, education, agriculture, environment, innovation policy, trade policy, as well as corporate governance reform and the fight against corruption. OECD work has deeply influenced policymaking, and the Russian government has included many OECD recommendations in its reform agenda.

A second *Economic Survey* is under way on Brazil. The transition team of President Lula da Silva asked the OECD for a public budget and expenditure analysis at end-2002. The study influenced the design of the policy of fiscal responsibility pursued by the new government. After working with the New Partnership for Africa's Development (NEPAD) in the development of its own peer review mechanism (APRM), the OECD is launching policy reform initiatives to improve the environment for investment and private sector development in Africa and to support governance reform efforts on the continent.

Non-members also participate in OECD committees and other bodies, allowing for direct exchanges with officials from OECD capitals in the context of general discussions, peer reviews or the development of new guidelines or agreements.

Partnerships with other international organisations

The OECD co-ordinates closely with other international organisations to promote its dialogue with non-members. Recent examples of co-ordinated activities are as follows: The OECD and the Inter-American Development Bank jointly sponsored the Latin American Competition Forum in April 2003 to advance effective competition law and policy in Latin America. The OECD-APEC co-operative initiative on regulatory reform is elaborating an APEC-OECD Integrated Checklist for self-assessment on regulatory, competition and market openness policies. Implementation of the Checklist will enhance competition and regulatory reform. The OECD/World Bank Group regional roundtables on corporate governance issued White Paper recommendations for reforms in Asia, Southeast Europe and Latin America in 2003. A joint publication with the World Health Organization of a handbook on trade in health services helps build consensus on this issue, including in the context of the current WTO negotiations.

HEALTH SYSTEMS: MEASURING AND IMPROVING PERFORMANCE

The past three decades have been a period of change and expansion for modern health systems. Most OECD countries have attained universal coverage for a core set of health services and have improved the accessibility of those services to the population. Population health status has improved steadily, even dramatically, driven by economic and social development as well as concerted efforts to reduce the prevalence of risk factors and promote healthy living. Advances in medical capability and improvements in healthcare have had direct benefits in terms of both cure and prevention of disease.

Nevertheless, it is desirable and possible to improve the performance of health systems still further. Serious shortcomings in the quality of healthcare – at levels that would not be tolerated in other high-risk industries – have recently come to light. Patients and healthcare consumers are demanding more responsiveness to their expectations and preferences. In a number of countries, there are barriers that make it difficult for disadvantaged groups to achieve equitable access to healthcare services and the health improvements such access brings.

Furthermore, health systems are facing major cost and financing challenges. Healthcare costs are growing faster than economies as a whole in most countries, posing problems for public budgets. All signs indicate that countries must expect continued upward pressure on health costs, reflecting development of new treatments that can be expensive and generate new demand. Population ageing will have implications for the financing of health and long-term care services, and is likely to increase the demand for both, raising questions as to the affordability and sustainability of health systems. One possible solution is to increase efficiency in health systems. There is great scope to do so by increasing productivity, reducing waste or enhancing the cost-effectiveness of care, yet achieving efficiency improvement has proven difficult.

Health systems differ in their design, in the amounts and types of resources they use, and in the health outcomes and other results they attain. But health policymakers share common goals and can learn from each other's experiences as to what works – and what does not – when making changes to health systems intended to improve performance. The three-year OECD Health Project, which culminates in a May 2004 meeting of health ministers, has sought to add to the evidence base and provide guidance that policymakers can adapt to their own national circumstances for use in their efforts to improve health-system performance.

Sustainable costs and financing

Richer countries tend to spend more on health, but there is great variation in spending among countries with comparable incomes. Even more importantly, the highest spending systems are not necessarily the ones that do best in meeting performance goals.

Countries have slowed cost growth using a combination of budgetary and administrative controls over payments, prices and supply of services. Although sophisticated payment systems can be technically difficult to employ, there are numerous examples of successful systems – such as discharge-based payment systems for hospitals – that can promote productivity without harming outcomes. On the other hand, systems that keep health-sector wages and prices artificially low are likely to run into problems eventually, such as lower quality, difficulty with recruitment and retention of healthcare practitioners, or shortfalls in the supply of services and innovative medical products.

Spending growth is not necessarily undesirable, particularly if the added benefits exceed the extra costs. But because three-quarters of OECD health spending comes from the public purse, growth strains government budgets. Financing will come under increased pressure as populations age and the share of the population participating in the workforce drops. Using general taxation revenue to finance expansion of healthcare provision increases the burden on taxpayers or diverts resources from other publicly-financed services and programmes. In order to relieve future public-financing pressure, individuals may be called upon to play a larger role in financing their own healthcare.

Cost-sharing requirements for users of health services can reduce the burden on public financing systems. But major savings from user fees are unlikely, particularly as vulnerable populations must be exempted to avoid restrictions on access that could be costly in the long run. Such exemptions impose administrative costs. Apart from this, consumers are likely to skimp on preventive care and appropriate treatments unless they are given incentives to do otherwise.

The role of private health insurance

Complementary private health insurance can help to ensure access to care where cost-sharing requirements are large. But it can also drive up consumer demand and overall costs.

Private health insurance can offset some of the costs that would otherwise be borne publicly. However, subsidies are sometimes needed to encourage purchase of insurance and other interventions may be needed to promote the use of privately-financed services by those with publicly-financed coverage. Even in countries where a sizeable share of the population is privately insured, private health insurance has tended to represent a relatively low share of total health spending, as it often concentrates on minor risks, rather than more costly cases and treatments.

Flat-rate health insurance premiums are a regressive source of financing compared with income-based taxes or social insurance contributions. When premiums reflect health-status factors, they can be as regressive as direct out-of-pocket payments. Nonetheless, private insurance does provide individuals with a means of pooling healthcare risks and avoiding catastrophic expenditure. Complex regulations imposing restrictions on risk selection or targeted subsidies can improve the equity outcomes of private health insurance markets, in terms of both financing and access to care, but require either public subsidies or high premiums for low-risk customers.

Value for money in health systems and care

Ultimately, increasing efficiency may be the only way of reconciling rising demand for healthcare with public financing constraints. Cross-country data suggest that there is scope for improvement in the cost-effectiveness of healthcare systems. This is because the health sector is typically characterised by market failures and heavy public intervention, both of which can generate excess or misallocated spending. The result is wasted resources and missed opportunities to improve health. In other words, changing how health funding is spent, rather than mere cost-cutting, is key to achieving better value.

Recent work by the OECD has identified ways in which the efficiency of health systems can be increased. These include managing demand for elective surgery and other discretionary services, employing pricing systems that reward cost-effective choices among similar medications, using technology assessment to improve the information base needed to manage technology, and employing sophisticated payment systems that reward productivity, appropriate use of services, and contributions to improving health outcomes.

Value for money is a moving target. Increasing value requires experimentation and conscientious performance measurement using actionable and specific indicators. Benchmarking within and across countries, and mutual observation, can help identify effective practices and the circumstances in which they work.

ENSURING EQUITY OF ACCESS IN EDUCATION

For a more equitable society, all individuals should ideally have access to equivalent learning opportunities, regardless of their socio-economic background, social origin, age or gender. Equity of access, which provides a strong base for developing social cohesion, is a concern which pervades all areas of the OECD's work on education. The main questions addressed are:

- How to ensure equity of access in lifelong learning?
- How to address the needs of disadvantaged children?
- How to mitigate the influence of socio-economic backgrounds?
- Can information and communications technology (ICT) help achieve higher equity of access?

Equity of access in lifelong learning

Lifelong learning covers all purposeful learning activities, from early childhood education and care to adult training, which aim to improve knowledge and competencies for all. For equity purposes, this implies the need to promote access, at all educational levels, from pre-school education to primary, secondary and tertiary education, and finally to adult learning.

Very recently, a new project on equity and education was launched by the OECD Education Committee. It intends to provide analytical work on profiles of inequity, their causes and remedies. Nine countries are participating in in-depth analytical work, four of which will be the subject of a study visit. These visits will produce policy options and recommendations to improve equity. A unique feature of this work is that equity is evaluated in a lifecycle context. Equity of access is also a key theme in the 14-country thematic review of higher education just being launched.

Lifelong learning for all is far from being a reality in every OECD country mainly because of the difficulties in providing sufficient access to pre-school education and to adult learning.

Early childhood education and care

Research on early education shows that children who participate over time in high-quality early childhood education and care (ECEC) are likely to develop higher-order reasoning and problem-solving skills; to be more co-operative and considerate of others; to develop greater self-esteem; and to be better equipped to make effective transitions to compulsory schooling. The effects are generally greater and more long-lasting in children from disadvantaged backgrounds. A recent analysis of the major evaluation studies of centre-based programmes concludes that if certain structural requirements are respected

(e.g. sufficient investment, duration and intensity of programming, favourable child-staff ratios...), positive and long-lasting outcomes in both the cognitive and socio-emotional domains are most likely to be delivered by structured programmes with clear developmental and pedagogical aims. For this reason, most OECD countries provide at least two years of public pre-school education for young children before their entry into primary school. In some countries, this service is entirely free; in others, parents will be expected to defray the high costs of early education through a sliding scale of fees.

However, as pointed out in recent OECD work, without a pro-active stance from the government, there is a large risk of a two-tier ECEC system developing, with children from the upper income groups benefiting from high-quality ECEC while children from low-income groups can access only low-quality programmes.

Adult learning

Adult learning also needs to be further developed in OECD countries. Adult education and training participation rates increase with the level of initial education, reinforcing existing inequalities in levels of educational attainment. Age discrimination in various forms is also a feature of many education systems, increasing intergenerational inequity. The policy challenge is therefore to overcome these disparities both through better initial formal education – leading to fewer drop-outs with no commitment to later learning – and through interventions which compensate for the initial problem by encouraging rather sceptical and perhaps unmotivated adults to re-engage with learning. This means paying more attention to access, curriculum and teaching processes. Otherwise, a lot of adult learning is undertaken by those with most education already provided – further increasing inequities in educational outcomes.

An ongoing OECD thematic review showed that increasing the number of courses is not always sufficient. For instance, creating a learning-rich environment at work can be as important to learning as the number of available training courses; and unless the diversity of learning options is increased, tertiary education may serve, primarily, already privileged groups. The OECD is also examining the financial challenges faced by continuing education and how co-financing arrangements could alleviate the problem.

Meeting the needs of disadvantaged children

All students with organic disabilities, learning difficulties (dyslexia, dyscalculia...) or social disadvantages (children from disadvantaged socio-economic backgrounds, potentially some migrants and minorities) should benefit from a learning environment equivalent to that of other students.

To address the needs of disadvantaged students, countries can choose between special or regular schools, and so include students in special or in regular classes. While the solutions adopted by countries vary substantially, work done by the Centre for Educational Research and Innovation (CERI) of the OECD Education Directorate shows that in order to equip disadvantaged students, as far as possible, with equivalent learning means, such students, even those with severe disabilities, should be educated in regular, mainstream schools rather than in separate institutions, on condition that the extra resources provided in special schools are maintained elsewhere. There is even evidence that non-disabled students benefit from the extra support provided in regular classes as a result of the inclusion of disabled students.

A continuing challenge is to include and maintain disadvantaged children in school. The Youth Empowerment Partnership Programme (YEPP) developed by the CERI is a core element of the OECD's work in this area, bringing together public, private and independent sectors to develop effective community approaches and improved social cohesion.

Mitigating the effect of socio-economic differences

The Programme for International Student Assessment (PISA) showed that:

- The variation in the reading literacy skills of 15-year-olds can be accounted for by the different results of each school and between schools. Substantial variation among schools suggests differences in equity of learning opportunities. Countries with the highest mean scores in reading are also those with high average performance levels across schools. Conversely, there is a clear tendency for larger disparities among schools to be associated with lower overall performance.
- In many countries, a substantial portion of the variation in performance among schools is associated with differences in students' socio-economic background. This is particularly true when the allocation of students to programmes is linked to their socio-economic background. In almost all countries, there is a clear advantage in attending a school whose students are, on average, from more advantaged family backgrounds.

The overall conclusion is that socio-economic background can explain only part of the disparities in education. The quality of schools and the average level of students are of greater significance. In countries where there is a high degree of differentiation between schools from a socio-economic viewpoint, students from disadvantaged socio-economic backgrounds do worse. In such circumstances, talents remain underutilised and students with disadvantaged home backgrounds may not achieve their full potential, *i.e.* inequality of outcomes can be associated with inequity of opportunity.

The role of ICT

People without access to ICTs or without ICT skills become less and less capable of participating in the knowledge society. To bridge the resulting digital divide, it is necessary to undertake a wide range of policy initiatives. This is particularly urgent as ICTs can help achieve higher equity in access to education.

Many OECD countries have developed programmes for:

- Improving access to ICTs in schools, libraries and learning centres with an emphasis on children and schools in poor neighbourhoods.
- Improving the ICT skills of teachers.
- Providing extra financial help for ICT investment.
- ICT training of low-skilled workers.
- Tax initiatives for encouraging companies to invest in ICT training.

Despite encouraging results, much remains to be done. ICTs can be considered as providing major opportunities to improve the quality of teaching and learning and to broaden learning opportunities, but they can also be considered as presenting major risks: their lack of accessibility to, and use by, both students from low income families and adults with low education can lead to further social disparities.

MAKING DEVELOPMENT CO-OPERATION MORE EFFECTIVE

Increasing aid effectiveness was at the centre of the OECD Development Assistance Committee's (DAC) annual meeting of development ministers and heads of development agencies (15-16 April 2004).

As a follow-up to the Monterrey Conference on Financing for Development in 2002, the donor community has committed to provide an additional USD 19 billion in development assistance over the next few years. If these commitments are fully met, this means that by 2006 total DAC official development assistance (ODA) is expected to reach some USD 75 billion at 2002 prices and exchange rates. Estimates of additional aid requirements to meet the Millennium Development Goals (MDGs) would call for even more rapid increases in ODA. As the Monterrey Consensus recognised, however, increased aid volume will not be enough. Aid must also become more effective, to contribute to meeting the MDGs and to poverty reduction, as well as to generate increased public support for aid in OECD countries.

Increasing aid effectiveness

Increasing aid effectiveness is not a simple process, nor is it entirely in the hands of donors. Evaluation results show clearly that the most important determinant of aid effectiveness is the partner country's own policies and capacities. Having said that, harmonising development assistance is a crucial part of delivering aid more effectively. It is all about rationalising our collective management of aid in support of partner countries' own poverty reduction strategies. Admittedly, this is not a new concern. Harmonisation of donor practices has been on the international agenda for many years now, but until recently with little effect. All too often it is business as usual – donors, by confronting poor countries with multiple and uncoordinated administrative procedures, reduce their capacity to manage their own development processes. By the same token, the value of development assistance is also reduced.

The importance of harmonisation

Is this about to change? There is promising evidence that donors are tackling this problem more seriously. In the wake of the Monterrey Consensus, for example, the European Council in Barcelona (March 2002) adopted eight commitments to improve harmonisation and aid delivery. More recently, Poul Nielson, the EC Commissioner for development co-operation, has suggested elaborating a directive in support of better harmonisation. In February 2003, the DAC co-sponsored a High-Level Forum on Harmonisation in Rome which marked a new level of

consensus and commitment on how aid could be implemented more effectively. This strategy, set out in the Rome Declaration, rests on three mutually supporting pillars:

- *Ownership* – Partner countries co-ordinate development assistance.
- *Alignment* – Donors should provide development assistance in accordance with partner country priorities and systems. In that spirit, partner country ownership is key, and partner countries should take the lead in co-ordinating development assistance.
- *Streamlining* – Donors should act together to harmonise their administrative procedures, and, for example, reduce the number of separate projects and of separate missions.

Recognising the importance of sustaining strong political pressure for change, donors also agreed in Rome to hold a second high-level forum on harmonisation. The French government has agreed to host this event in early 2005 with a view to assessing and encouraging progress in implementing the Monterrey Consensus and the Rome Declaration.

In preparation for this event the DAC, in close collaboration with the World Bank, is monitoring progress in implementing the Rome agreement. Preliminary findings suggest, however, that the harmonisation agenda has not yet been sufficiently internalised in development agencies' operational policies at country level.

While it would be unreasonable to expect too much progress over such a short period of time, donors should acknowledge the magnitude of the challenges ahead of them and scale up their actions accordingly, especially at country level. This might signify, for example, that senior managers of development agencies communicate to their staff the relevance of the harmonisation agenda in meeting the MDGs. There is also a more general need, in support of donors' credibility, to demonstrate progress that principles are gradually being turned into practice.

Financing for development

The most important source of financing over time for reaching the MDGs will be domestic savings. But most less advanced countries, by definition, are unable to mobilise savings anywhere near the levels needed. They will require substantial extra external financing. Even when the Monterrey commitments of extra ODA are taken into account, reaching the MDGs will require a further USD 25 billion per year to 2015. It now behoves the international community to consider whether forms of development financing other than traditional ODA might be able to contribute substantially and in time to reach this target. The most important options, highlighted in a recent OECD Development Centre Policy Brief, include: *global taxes* on, for example, currency transactions, energy use or arms sales; *voluntary private-sector* contributions through donations, global lotteries and premium bonds, or global funds; and *financial engineering*, including the International Finance Facility (IFF), a focused use of special drawing rights (SDRs) and/or public guarantees.

Each of these options has economic and political drawbacks and advantages, and it remains the case that the most straightforward way to avoid underfunding the MDGs would be to increase ODA further. With renewed political will, however, enhanced support from public opinion and changes in the domestic attitudes in some OECD countries, a combination of some of these options might succeed in providing the required financing in the time available. The Policy Brief argues that, while it is unlikely that global taxes could be introduced in time, the IFF, in combination with strengthened use of public guarantees and global premium bonds, may stand a better chance of providing the additional funds required.

SECURITY SYSTEM REFORM AND GOVERNANCE: POLICY AND GOOD PRACTICE

OECD members recognise that development and security are inextricably linked. This perception is opening the way to treating security in partner countries as a public policy and governance issue, inviting greater public scrutiny of security policy. OECD governments seek to help partner countries establish structures and mechanisms to manage change and political conflict through democratic and peaceful means. A high-level meeting of the OECD's Development Assistance Committee (DAC) in April 2004 endorsed a paper entitled "Security System Reform (SSR) and Governance: Policy and Good Practice" which offers principles and concrete examples to help guide donors who engage in SSR.

Security and poverty reduction

The "Policy and Good Practice" paper highlights the changes that are taking place in the way that donors think about security. It emphasises that security involves not only state stability and regime security, but also securing the safety and well-being of populations. Security in all its dimensions is fundamental to reducing poverty, protecting human rights and achieving the Millennium Development Goals (MDGs).

SSR seeks to increase the ability of partner countries to meet the range of security needs within their societies in a manner consistent with democratic norms and sound principles of governance, transparency and the rule of law. It includes, but extends well beyond, the narrower focus of more traditional security assistance on defence, intelligence and policing. The security system includes the armed forces, the police and gendarmerie, intelligence services and similar bodies, judicial and penal institutions, as well as the elected and duly appointed civil authorities responsible for control and oversight (e.g. parliament, the executive and the defence ministry).

Improving policy coherence

Development agencies will seek to improve policy coherence on SSR through whole-of-government approaches. Formulating government-wide SSR strategies will require collaboration between defence, foreign affairs, development and other ministries. Development agencies have a key role to play in this dialogue. In partner countries engaging in SSR, they will work to promote a similar coherence of approach that takes into account the security system as a whole.

Donors are committed to facilitating reform that is partner-country owned and led, recognising that reform efforts are otherwise likely to fail. In working with partner countries, donors will also pursue greater co-ordination, harmonisation and an effective division of labour. Assistance must be context-specific as needs, priorities and resources differ substantially from country to country. Donors will encourage local demand and vision for democratic governance of the security system. The objective is to help create a pro-reform environment, such as through support for the involvement of civil society, including women's groups and the media, as well as institutional capacity for change.

Analysis and support should include a regional perspective as cross-border dynamics can have a major positive or negative impact. Aid at the national level may, therefore, need to be complemented with assistance to regional or sub-regional organisations.

ENVIRONMENT: RECENT PROGRESS AND FUTURE CHALLENGES

In April 2004, OECD environment ministers met to discuss their progress in implementing the OECD Environmental Strategy for the First Decade of the 21st Century adopted in 2001. The background report for the meeting, *OECD Environmental Strategy: 2004 Review of Progress*, shows that countries have made a good start in a number of areas, but much more ambitious measures are needed. Current policies are insufficient to adequately protect biodiversity or address climate change, and the decoupling of environmental pressures from economic growth in key sectors is proceeding too slowly. A number of obstacles to environmental policy reform are identified in the report – including both political obstacles, such as poor policy integration, and inadequate information – which will need to be faced. Increasingly, OECD environment ministers will have to work together with colleagues in other ministries, colleagues in other countries, and with partners from business and civil society in order to ensure that appropriate environmental policies can be developed and implemented.

Climate change

Although greenhouse gas (GHG) emissions are still growing in many OECD countries, most have reduced the GHG-intensity of their economic growth. Many have partnered with the private sector and other countries to create synergies in developing tools and new technologies to address climate change. About half of all OECD governments have carbon or energy taxes in place, a similar number have initiated formal voluntary approaches with industry to address climate change, and emission trading schemes are gaining in importance. Nonetheless, it is clear that additional measures will be needed if the objectives of the UN Framework Convention on Climate Change are to be met, let alone the targets agreed by most OECD countries under the Kyoto Protocol. Given that significant climate change impacts are expected in coming decades, despite current commitments to reduce GHGs, efforts will be needed by OECD countries to integrate adaptation to climate change into both domestic policies and development assistance programmes.

Freshwater resources

Most OECD countries have been able to manage their freshwater resources to ensure an adequate supply for human needs, including by expanding the use of water pricing mechanisms to manage demand. They have also given increased attention to social concerns about access to, and affordability of, water services for low income households. At the 2002 World Summit on Sustainable Development in Johannesburg, OECD countries committed to developing integrated water resources management plans by 2005, but they will need to allocate substantial resources to ensure their proper implementation. The worst-polluted water bodies have been cleaned up in OECD countries, and point source

discharges to surface water have been significantly reduced, especially from industrial and urban wastewater systems. However, less progress has been made in addressing pollution arising from agricultural run-off and other non-point sources of pollution. The trend in most OECD countries is towards a worsening of groundwater quality, particularly from elevated levels of pesticides and nitrates and, in some countries, from salinisation.

Biodiversity

Protected areas established to achieve biodiversity-related goals have reached 14.6% of the total land area for OECD countries, and some progress has been made in creating ecological networks with corridors to connect protected areas. Not enough is being done to slow habitat loss and fragmentation outside protected areas or to apply the ecosystem approach to natural resource management, reflecting a lack of integration of biodiversity concerns in sectoral policies (e.g. agriculture, fisheries, forestry, tourism). The percentage of known species that are endangered continues to increase, and indicators of the total numbers of vertebrates in the wild continue to register declines. While a couple of the key international agreements to support sustainable fisheries management entered into force in the last few years, it is too early for their implementation to have slowed the continuing trend towards over-exploitation of fish stocks. The use of market-based instruments (fees, charges and environmental taxes) to promote sustainable use of biodiversity is increasing, as is the assignment of well-defined property rights.

Agriculture

Some progress has been made in reducing the negative environmental pressures from agriculture, but much more is needed. Land use and soil loss have decreased, long-term reductions in on-farm biodiversity have slowed, and some decreases in greenhouse gas emissions from agriculture have been achieved. However, water use in agriculture has risen, and levels of nutrient and pesticide run-off remain high in many countries. Many OECD countries have been addressing the environmental impact of agriculture through increased use of agri-environmental measures and cross-compliance requirements, whereby farmers have to meet environmental conditions to be eligible for support. However, market price support, output payments, and input subsidies – potentially the most environmentally harmful types of support – still account for 80% of total agricultural support. A positive development has been the setting up in all OECD countries of a system of regulatory oversight to address the potential environmental and health impacts of genetically modified organisms (GMOs).

Transport

The environmental and health effects associated with some major air pollutants from transport – such as lead, sulphur dioxide and nitrous oxide – have been decreasing for some time in OECD countries. Emissions of most pollutants remain high, however, and limit-standards for air quality, and critical levels and loads for acidification, eutrophication (nutrient pollution), and tropospheric ozone, continue to be exceeded. Progress in noise reduction, the prevention of habitat fragmentation, and reducing run-off from transport is proceeding more slowly, while carbon dioxide emissions from transport have continued to increase. Many countries have been reforming their systems of transportation taxes and charges to better target environmental externalities and congestion and to foster shifts to less environmentally harmful transport modes; some have introduced or extended tram

and light rail systems, and increased the capacity of inter-city passenger rail, to encourage greater use of public transport. The environmental impacts of rapidly-increasing air transport also need to be addressed urgently, with air transport already responsible for about 11% of transport-related energy consumption. Better integration of transport and urban planning, as well as the use of strategic environmental assessments in transport planning, is needed.

Energy

The efficiency of industrial, household and commercial energy use has improved as a result of technical change, encouraged by a combination of price incentives, and regulatory and voluntary approaches addressed to buildings, appliances and electric motors. However, much of the potential for further energy efficiency improvements remains untapped, including even low or no-cost options. Regarding energy production and transformation, market forces and regulatory reform have fostered fuel substitution from coal to gas in many OECD countries, with resulting environmental benefits. In addition, several new research initiatives have recently been launched on the viability and cost-effectiveness of carbon capture and storage. The combination of structural change and improvements in energy efficiency has led to some decoupling of energy use from economic growth. However, further improvements are not likely without substantially more ambitious policies and measures, including better internalisation of environmental costs in energy prices and hence an accelerated development and diffusion of cleaner technologies.

International environmental governance and co-operation

International environmental governance has been strengthened by the entry into force of a number of multilateral environmental agreements (MEAs). OECD countries have ratified an even larger number of environmental conventions, not all of them yet in force. They have also supported measures to strengthen the control or review mechanisms of several existing conventions, and to improve co-operation among the secretariats of MEAs. Economic agreements also increasingly include environmental elements – for example, regional and bilateral investment and trade agreements, and the 2001 Declaration of World Trade Organization (WTO) ministers (the Doha Development Agenda). Member countries of the OECD Development Assistance Committee (DAC) have made available some USD 50-55 billion per year in the form of official development assistance (ODA) since 1998, with about USD 5-6 billion provided to environmentally-related activities. DAC members are also working to mainstream responses to environmental concerns, such as climate change, into their core development assistance activities. Despite increases in foreign direct investment, resource mobilisation is currently insufficient to meet internationally agreed goals such as the Johannesburg commitment on access to drinking water and sanitation. OECD countries agreed in 2003 on common approaches for incorporating environmental considerations in the provision of export credits. Several OECD countries have since strengthened environmental impact assessment requirements for projects benefiting from credit guarantees, and taken other steps to ensure transparency in integrating environmental objectives into project planning and financing decisions. They have also promoted implementation of the OECD guidelines for multinational enterprises, including their environmental components.

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