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Health and innovation

In recent years, health care spending has been increasing rapidly in virtually all OECD countries. With a large chunk thereof being paid from the public purse, this has been putting pressure on government budgets. On current policies, things are set to worsen, and not just due to population ageing.

This problem has long been identified and quantified, but long-run projections in this area have traditionally been rather superficial and arbitrary. Recent research conducted in the OECD Economics Department sheds new light on the underlying forces and how they may play out, taking into account paradoxical factors such as healthy ageing or supply-induced demand. It concludes that for any plausible combination of assumptions underpinning the projection, public outlays on health and long-term care are set to rise substantially, even if policy action is taken to contain them.

Innovation is a key driver of long-run growth, and has therefore received special attention in the second issue of *Going for Growth*, released earlier this year. But what drives or favours innovation itself? New OECD research examines the role of framework conditions and science policies.

It documents the importance of “fundamentals” such as macro-economic stability, well-developed financial markets and openness to foreign investment. The research also explores the powerful influences of product and labour market regulations as well as the eminently ambivalent role of intellectual property rights. The importance of human resources is highlighted too, even though they cannot be boosted overnight.

Science policies also have a role to play in the form of non-business R&D or fiscal incentives. The impact of such incentives on R&D depends on circumstances and on whether they consist of subsidies or tax relief.



Jean-Philippe Cotis
OECD Chief Economist

Projecting public health and long-term care expenditures

Public spending on health and long-term care has accelerated recently in OECD countries, raising concerns about likely future trends. New OECD projections suggest that in the absence of policy action to break with recent developments, it could almost double as a share of GDP in the average OECD country by 2050. Even with cost-containment measures, the projected rise in expenditures could be dramatic in some countries. Given the orders of magnitude involved, major public policy challenges lie ahead, which up to now have typically received less attention than those related to pension and transfer spending.

Public health and long-term care expenditures are growing rapidly

The growth of public spending on health and long-term care in OECD countries has been limited for some time via the implementation of cost-containment policies. These policies acted essentially through wage moderation, price controls and postponement of investment. However, in recent years, the scope for additional measures along these lines has been drying out, and public expenditures have recently accelerated. Going forward, these pressures will add to those arising from other social liabilities, such as insufficiently reformed pension schemes. It is therefore crucial for policy to identify future expenditure drivers and quantify their most likely effects on overall public spending.

The effects of ageing on health care costs are cushioned by offsetting factors

Both demographic and non-demographic factors will be shaping future expenditures patterns. The former may have offsetting effects on spending. On the one hand, ageing populations will put upward pressure on health and long-term care costs since these tend to rise with age. On the other hand, longevity gains will translate at least partly into additional years of good health, reflecting a "healthy ageing" process. This will lower the average health cost per individual in older age groups, all the more so as major health costs tend to come at the end of life. Healthy ageing should also reduce the share of dependents per older age group, thereby mitigating future pressures on long-term care costs. On balance, however, ageing will push health and long-term care spending up.

Non-demographic factors will push spending up, especially in the absence of policy action

Non-demographic factors will also push spending up. Health care costs typically grow faster than income, for two main reasons. First, technological progress increases the variety and quality of products and treatments. Second, even when technological progress is cost-saving and reduces the relative price of health products and services, overall expenditures may still rise because of the high price elasticity of demand for health care. Long-term care expenditures as a share of GDP are also likely to increase, due to a "cost disease" effect, *i.e.* the relative price of long-term care will rise because the scope for productivity gains is relatively

low in this sector while labour costs tend to rise in line with economy-wide developments.

Significant increases in expenditures are projected...

Against this background, two alternative scenarios are explored. In a "cost-pressure" scenario, non-demographic pressures on spending are assumed to remain fully operative, resulting in spending trends that correspond to observed trends over the recent past. In a "cost-containment" scenario, policy action is assumed to curb non-demographic drivers of expenditures. In both scenarios, public health and long-term care expenditures are projected to rise significantly over the coming decades. In the "cost-pressure" scenario, average spending across OECD countries would almost double from close to 7% of GDP in 2005 to some 13% by 2050. In the "cost-containment" scenario, average expenditures would still reach about 10% of GDP by 2050, or an increase of 3 ½ percentage points of GDP.

...with striking differences across countries

Striking differences emerge across OECD countries, however. In the "cost-containment" scenario, a group of countries stands out with increases in spending at or above 4 percentage points of GDP over the period 2005-50. It includes rapidly ageing countries (Italy, Japan, Spain), countries that will experience a dramatic change in their population structure (Korea, Mexico, Slovak Republic), and countries with currently low labour force participation (Italy, Ireland, Spain). In the latter, as rising participation reduces the scope for providing care informally within the family, greater reliance on public provision is to be expected. By contrast, Sweden is in the lowest range of projected increases in expenditures. This country is already in a mature phase of its ageing process and already spends a high share of GDP on health and long-term care.

Upside risks are significant

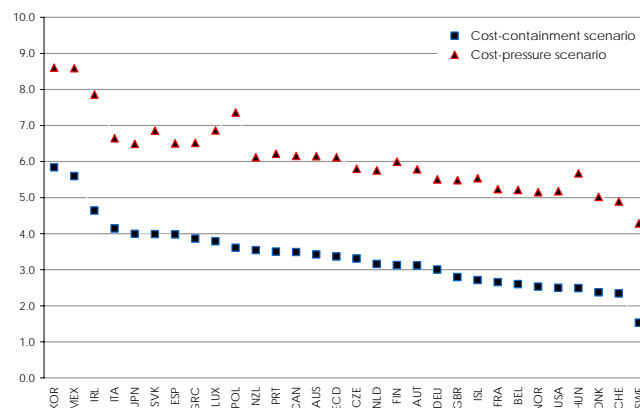
These projections may be on the low side, notably because of the combination of "healthy ageing" effects and fairly low income elasticities of demand for long-term care. In particular, an expansion of morbidity – *i.e.* a scenario in which increases in longevity would translate into a higher share of life in bad health together with higher longevity gains, would produce a more pessimistic outlook. Likewise, technology could exert greater pressures on health care demand than assumed in the projections, while dependency could

rise more than expected, reflecting *inter alia* a continuation of recent obesity trends and lower provision of informal care.

Cost-containment could involve difficult trade-offs

In light of the heavy pressures on public finances that are likely to emerge, policy action is needed. It would involve curbing the impact of technology and prices on health care spending and mitigating the cost-disease effect in long-term care provision *via* productivity gains. These will not be easy tasks. In order to improve cost-efficiency at the microeconomic level, reforms will have to be deeper and more sophisticated than those implemented so far. And in any event, policy makers will face difficult trade-offs. In particular, reining in the impact of technological progress on health care demand without foregoing the benefits it provides to patients will be challenging. Likewise, new ways will have to be found to minimise the pressures on long-term care expenditures that may arise from an increased participation of women and older workers in the labour force, which yet is much needed for the sustainability of old-age pension systems.

Total increase in health and long-term care spending by country, 2005-2050
In percentage points of GDP



Source: OECD calculations.

Further reading: OECD Economics Department Working Paper No. 477, "[Projecting OECD health and long-term care expenditures: what are the main drivers?](#)"

OECD Economic Outlook No. 79, June 2006

How do macroeconomic and structural policies condition business innovation?

Wide disparities in private sector innovative activity currently prevail across the OECD, with significant implications for economic growth. New research points to the important role played by economy wide factors such as macroeconomic stability, well developed financial markets, pro-competitive regulations in labour and product markets and openness to international trade.

How can innovation performance be compared across OECD countries?

Innovation is commonly considered to be the successful development and application of new knowledge. In practice, it is convenient to view innovation as a process that encompasses many different activities, ranging from initial research (R&D) to the registration of inventions (patents) and eventual commercial applications. Patents may be taken out on inventions arising from outside the formal R&D process, and commercial applications can include designs and trademarks that are not reflected in either patents or R&D. As a result, there is no straightforward summary measure of innovative activity at the national level. In practice, however, most innovation performance criteria tend to be strongly correlated, which facilitates cross-country comparisons and empirical analysis. In particular, those OECD countries that rank high on business sector R&D expenditures as a share of GDP also typically rank high on patents per capita (Finland, Japan, Sweden, Switzerland, United States), and *vice versa* (Australia, Ireland, Italy, Portugal, Spain).

The macroeconomic framework

The OECD growth study published in 2004 identified a number of important framework conditions and policy settings that could help to support private sector fixed capital investment. New OECD research suggests that similar factors also contribute to knowledge capital. For instance, strong output growth and low inflation are both found to have a positive influence on the rate of growth of R&D, suggesting that a stability-oriented macroeconomic framework provides a business environment that is conducive to innovation. Factors which help to lower the level of real interest rates can also help to stimulate innovation because of the impact this has on the cost of capital. For the average OECD country, a 1½ percentage point reduction in real interest rates is estimated to raise R&D expenditures by almost 5%, and the level of patents by close to 3%.

Financial factors

R&D projects are inherently more risky than others, and external investors typically require a premium to compensate for such risks as well as for asymmetric information between borrowers and themselves. In this

context, the availability of internal finance, as reflected in profitability and cash-flow, is likely to be an especially important source of finance for expenditure on innovative activities, especially for new entrants into the research process.

OECD empirical analysis confirms that the scale of financial development, stock market capitalisation and strong corporate profits all have sizeable effects on R&D expenditures. However, the impact from greater financial development is lessened when the corporate profit share is high, indicating that greater availability of internal finance reduces the need to obtain external funding.

Product and labour market regulations

The expected innovation effects of product and labour market regulations are complex but powerful. Neo-Schumpeterian economic theory suggests that there is an optimal degree of product market competition. It should be high enough to prevent incumbent firms from becoming conservative and sticking too long with existing technology. But competition should not be so intense that it lowers incentives to innovate by reducing the expected rents to be earned. Likewise, strict employment protection may impede workplace reorganisations needed to benefit from technological leaps, but could also facilitate process innovations, by reducing labour turnover and allowing firms to make better use of the specific skills of their workforce.

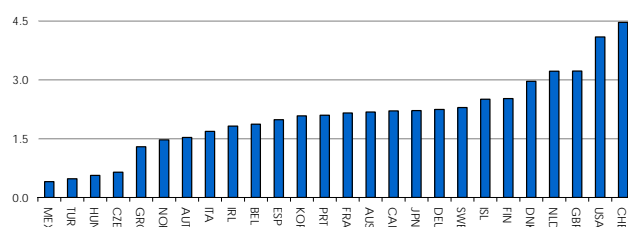
In practice, lighter product market regulations, conducive to stronger competition, are found to help rather than hinder R&D intensity. In addition, reduced employment protection legislation seems to boost patenting. Low levels of product market regulation are estimated to raise R&D intensity by 10% above the OECD average in Australia, the United Kingdom and

the United States, while heavy regulation depresses R&D in Ireland, Italy and Portugal.

International openness

Finally, trade and (inward) FDI openness appears to stimulate both R&D expenditures and patents. Such effects are stronger where the domestic research base, as measured by the share of scientists and engineers in total employment, is large. These findings confirm that more open economies have greater exposure to foreign knowledge and also hint at complementarities between science policies and favourable economy-wide conditions. Those countries that are estimated to receive the greatest benefits from international openness are Ireland, the Netherlands, Switzerland and Belgium.

The "size" of the financial sector in member countries as a ratio of GDP
Total loans to private sector and securities market capitalisation, 2000-03 average



Source: World Bank financial structure database.

Further reading:

OECD Economics Department Working Papers Nos. 456, 457 and 459, "[An overview of public policies to support innovation](#)", "[From ideas to development: the determinants of R&D and patenting](#)", and "[Innovation in the business sector](#)", all by Florence Jaumotte and Nigel Pain.

Do science-specific policies foster business innovation?

While new OECD research suggests that economy-wide conditions and policies contribute to explain current cross-country differences in private sector innovative activity, it also shows that science-specific policies play an important role in explaining R&D and patenting. In particular, fiscal incentives for R&D as well as research in the non-business sector affect innovation. While intellectual property rights also matter, the case for further strengthening them looks rather weak in most countries. Finally, any significant expansion in research activities should be accompanied by measures to raise the supply of human resources for science and technology and needs to be spread out over time.

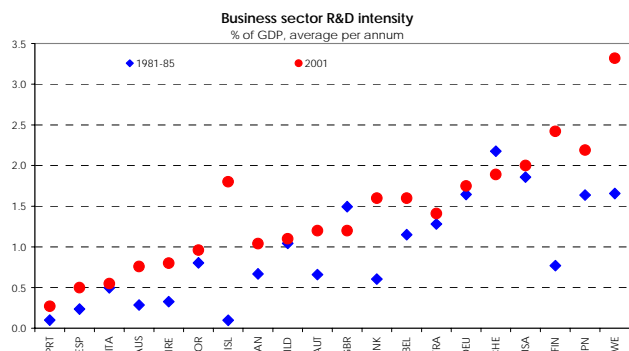
Do fiscal incentives for R&D work?

All OECD countries provide fiscal incentives to encourage private-sector innovative activity, either through direct government funding of private sector R&D or *via* tax incentives. There are pros and cons to both types of instruments. Tax incentives for private sector R&D usually cover a wider range of research activities and may be less prone to capture by interest groups than direct funding. However, they are less effective for supporting young firms with little taxable income. They also increase the possibility that research

efforts will be duplicated unnecessarily, or that research of little value to society will be undertaken.

In practice, new OECD research suggests that the effect of direct public funding is positive only when the corporate profit share is low. The availability of government funds can then help firms to alleviate financial constraints. In comparison, tax reliefs for R&D are more frequently found to stimulate R&D and patenting. On average, a 10% increase in tax subsidies raises the level of R&D spending by almost 5%. In light of

these findings, recent changes in the mix of public funding for private R&D, with reduced use of grants and more extensive use of tax incentives, have stimulated private sector R&D in most OECD countries. Nevertheless, a more complete evaluation of public support schemes would also need to consider that all of the incentives for R&D involve budgetary costs for the public sector. These need to be balanced by spending cuts or tax increases, which may have negative economic effects.



Source: OECD Main Science and Technology Indicators database and R&D database.

What are the benefits from non-business sector R&D?

Another form of government involvement in research activities is through basic research performed in universities and other public research organisations. Such activities generate basic knowledge which in turn creates beneficial “spillover” effects for the private sector. Empirical evidence confirms that research in the non-business sector is a major driver of innovation, both through direct patenting and via its wider effects on private sector R&D. In countries such as Sweden and Finland, relatively high non-business R&D expenditures are estimated to raise business sector R&D intensity by around 25% above the OECD average (a gap equivalent to 0.4% of GDP), while in Spain and Ireland, low non-business R&D spending depresses business sector R&D. The beneficial effects of non-business R&D also appear to be greater when it is partially financed by industry. In most OECD countries, such direct involvement of private firms in public sector research activity has been edging up steadily over time.

Should intellectual property rights be strengthened further?

Legal protection of intellectual property (IP) rights is also widely seen as an important means of stimulating innovation. There has been a gradual upward convergence in the strength of IP protection across the OECD over the past two decades. By 2000 protection was strongest in the United States, Austria and Germany.

While the general tendency of IP policies is to offer ever greater protection of IP holders’ rights – particularly for patents – available evidence on the efficacy of such policies is far from clear. On the one hand, enhanced protection of IP rights provides incentives for inventors to undertake research and subsequently disclose information about their inventions. In a context of very open product markets they may help protect innovation rents while allowing competition to curtail

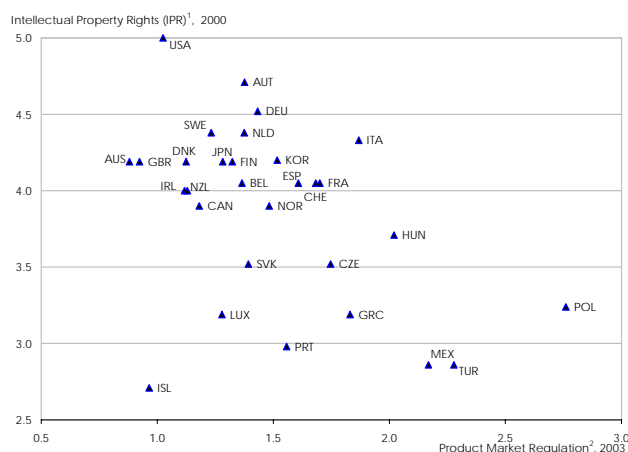
pure monopolistic rents. On the other hand, the monopoly rights granted by patents or copyright may go too far and create a genuine barrier to entry for new competition. This would entail significant social costs, even when patent holders enter into licensing agreements with potential users. This problem is potentially most acute in fields where the research process is cumulative, *i.e.* where new inventions build heavily on existing ideas, as is in biotechnology and information technology.

In practice, stronger IP protection appears to have a substantial positive effect on patenting but only a limited one on R&D. To sum up, while available evidence indicates that there are benefits from having protection for IP rights, the case for further strengthening these rights from their already high levels looks rather weak.

How important are education and labour market policies?

Many countries have set specific targets that imply a significant rise in R&D expenditures as a share of GDP over the coming years. However, such targets are unlikely to be met, and the increased expenditure would not be used effectively, without substantial increases in the numbers of researchers employed. Given the limited supply of trained scientists and engineers available to perform R&D at a given point in time, large increases in public spending could push wages up without having much effect on innovation in the short run. This suggests that any significant expansion in both business and non-business research activities should be accompanied by measures to raise the supply of human resources for science and technology, and may be feasible only if spread out over time.

Competition-restraining product market regulations and intellectual property rights



1. Index scale of 0-5 from least to most restrictive. 2. Index scale of 0-6 from least to most restrictive. Source: Paik and Wagh, 2002 and OECD, *Economic Policy Reform, Going for Growth*, 2005.

Further reading:

OECD Economics Department Working Papers Nos. 456, 457 and 459, “[An overview of public policies to support innovation](#)”, “[From ideas to development: the determinants of R&D and patenting](#)”, and “[Innovation in the business sector](#)”, all by Florence Jaumotte and Nigel Pain.

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H. Ziegelschmidt

[The impact of structural policies on trade-related adjustment and the shift to services](#)

What policy reforms are most urgently needed to remove obstacles to output and employment growth in service sectors and to enhance economies' ability to adjust to structural change as a result of changing trade patterns? This paper reviews the impact of the structural policy framework conditions on the development of the service sector and economies' adjustment capacities. The paper builds on and summarises a vast body of previous work and briefly reviews policy recommendations given to countries in various surveillance processes in the OECD.

P. M. Kongsrud and I. Wanner (April 2005), "The impact of structural policies on trade-related adjustment and the shift to services", No. 427

[Assessing the OECD Jobs Strategy: Past developments and reforms and Annexes](#)

In 1994, the OECD published a set of recommendations -- known as the OECD Jobs Strategy -- to deal with high and persistent unemployment that affected many member countries. These recommendations are currently being reassessed by the OECD and this paper contributes to this process. It provides a detailed description of labour market reforms in member countries over the past ten years, together with a short overview of changes in macroeconomic policies and reforms affecting product markets. It attempts to rank countries according to their past reform efforts, using an aggregate reform intensity indicator, and analyses the link, though in a very preliminary way, between reforms and labour market performance. Overall, there is little evidence of a link between initial conditions and subsequent reform efforts, with some countries taking only modest measures despite a poor starting point, but others carrying out ambitious programmes notwithstanding relatively favourable initial conditions. Over the past decade, member countries have employed very diverse reform strategies, from comprehensive reform package (Denmark, Finland and the Netherlands) -- as recommended in the initial Jobs Strategy -- to reforms more narrowly targeted on specific fields where deep action was undertaken (France, Italy, the United Kingdom and Ireland). The intensity of reforms has differed markedly across policy fields, with more action being undertaken in areas that are more widely accepted by the population, such as active labour market policies and cuts in labour taxes.

N. Brandt, J.-M. Burniaux and R. Duval (May 2005) "Assessing the OECD Jobs Strategy: Past developments and reforms and Annexes", No. 429

[Measuring cyclically-adjusted budget balances for OECD countries](#)

An important tool in the analysis of fiscal policy is the distinction between structural and cyclical components of the budget balance. This paper describes work undertaken to re-estimate and re-specify the elasticities underlying the Economics Department's calculations of cyclically-adjusted budget balances. Account is taken of tax reforms introduced since the previous updating exercise. A number of methodological innovations have been introduced to better account for the lags

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between taxes and activity and to ensure greater cross-country consistency in the estimates. The methodology underlying cyclical adjustment of expenditures has also been reviewed. Finally, the country coverage has been extended. The overall results are broadly consistent with the previous set of estimates. The sensitivity of government net lending to a 1 percentage point change in the output gap remains at around 0.5% of GDP for OECD economies on average.

N. Girouard and C. André (July 2005) "[Measuring cyclically-adjusted budget balances for OECD countries](#)", No. 434

Sources of inflation persistence in the euro area

In recent years, inflation in the euro area has failed to decelerate decisively while cyclical slack built up in the economy. Is this phenomenon more than a peculiarity in recent data? Is it related to structural policy settings? Econometric analysis conducted on two decades of quarterly data covering 17 countries yields a yes on both counts. First, inflation is shown to respond more weakly to cyclical slack in the euro area than in countries such as the United Kingdom, the United States or Canada. Secondly, this lack of responsiveness is found to be related to more rigid structural policy settings. The results pass a wide range of robustness checks.

B. Cournède, A. Janovskaia and P. van den Noord (July 2005), "[Sources of inflation persistence in the euro area](#)", No. 435

The new OECD international trade model

This paper provides a detailed description of recent research to re-estimate and re-specify the international trade volume and price equations used in the OECD Economics Department to analyse international trade developments. New panel data estimates of the factors affecting export performance, import penetration and exchange rate pass-through into trade prices are reported for both OECD and non-OECD economies. The model set out has already been used successfully to monitor the global consistency of the international trade projections in the Economic Outlook.

N. Pain, A. Mourougane, F. Sédillot and L. Le Foulher (August 2005) "[The new OECD international trade model](#)", No. 440

The labour market impact of rapid ageing of government employees: Some illustrative scenarios

This paper estimates and discusses some of the potential labour market implications arising from the rapid ageing of government employees in a number of OECD countries. Under alternative scenarios for future public employment policies, available labour resources for the private sector are estimated taking into account the declining age cohorts entering the labour market. These scenarios suggest that, in the absence of considerable increases in labour utilisation, maintaining government sector hiring at their historical share of new labour market entrants will entail sharp declines in the production of government services. On the other hand, if present levels of government services are to be preserved, governments are likely to hire an increasing share of labour market entrants, creating a strong crowding-out effect for the private sector. Alternatively, productivity in the government sector would have to increase substantially.

J. Høj and S. Toly (September 2005), "[The labour market impact of rapid ageing of government employees: Some illustrative scenarios](#)", No. 441



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Germany	-	Public finances, education, labour markets, product markets
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- [OECD structural surveillance](#), OECD Seminar: Growth Strategies: Czech Ambition and OECD Experience, Paris, January 2006
- [Launch of OECD Economic Policy Reforms: Going for Growth](#), Paris, February 2006
- [Interim press briefing on the economic outlook](#), Paris, March 2006
- [Press conference on the OECD Economic Outlook No. 79](#), Paris, May 2006

Recent Publication

[Economic Policy Reforms: Going for Growth 2006](#)

Across the OECD, governments are seeking to undertake structural reforms to strengthen economic growth. *Going for Growth 2006* takes stock of the progress made in implementing policy reforms to improve labour productivity and utilisation that were identified as priorities in the 2005 edition. It also provides comparative indicators covering structural policy areas such as labour markets, education and product market regulation. These indicators enable countries to see their economic performance and structural policies in comparison with others. A special feature of *Going for Growth 2006* is the focus on innovation, a key driver of economic growth. It provides comparative indicators on performance and relevant policies in this area, and country-specific policy recommendations for each OECD country to improve innovation performance. In addition, this issue contains two analytical chapters, one on the link between the regulation of financial systems and economic growth, and the other on alternatives to GDP as a measure of well-being. The publication draws on the knowledge accumulated at the OECD in these various fields.

