

## Economic Survey of Australia, 2003

### Summary

Australia's current and recent economic outcomes place it among the top performers in the OECD. This owes much to a good combination of prudent, medium-term oriented fiscal and monetary policies, and far-reaching reforms to labour, product and financial markets in the past two decades. In current circumstances, there seems to be no reason to change the overall stance of demand policies. Previous structural reforms are likely to continue bearing their fruits for some years. The Government's commitment to reform, its willingness to commission expert advice and to heed it, to try new solutions, and to patiently build constituencies that support further reforms, is also something that other countries could learn from. Nonetheless, the success of past reforms is not grounds for complacency. The Government needs to remain focussed on implementing its current policy reforms and to work assiduously to address other existing and emerging policy challenges. In particular, ongoing and new policy reforms in the areas of welfare, private pensions, education, competition and labour markets would encourage more people to participate in the workforce, and raise their productivity. This will help support longer-run growth prospects, with increases in participation being particularly helpful to counteract the fiscal impact of age-related expenditure in future decades. Australia's immigration policy has delivered economic benefits, in part because of its emphasis on skills and its successful approach to integration. Long-term sustained rises in Australian living standards will be further assured by foreign aid programmes that help improve both economic development and political stability in neighbouring countries, and by policies that encourage more parsimonious and more efficient use of domestic natural resources. ■

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*This Policy Brief presents the assessment and recommendations of the 2003 OECD Economic Survey of Australia. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

## What have Australian economic policies achieved and what remains to be done?

Dogged pursuit of structural reforms across a very broad front, and prudent macroeconomic policies firmly set in a medium-term framework, have combined to make the Australian economy one of the best performers in the OECD, and also one notably resilient to shocks, both internal and external. Incomes growth has remained brisk, employment is expanding, inflation is under control, and public finances are healthy. All the indications are that the continuing effects of previous reforms will continue to help the economy to combat shocks in the immediate future. In order to meet the longer-term objective of raising living standards towards the highest in the OECD, further reforms to labour, product and financial markets and to social policies will be needed, that will encourage more people to join the labour force, remain in it, and steadily raise their productivity. ■

## How have drought and global slowdown affected the Australian economy and what is the outlook?

Underpinned by historically low interest rates, rising terms of trade, strong productivity growth, a generous subsidy to first-time home buyers and high levels of business and consumer confidence, domestic demand growth has barely been affected by the recent cyclical downturn in most other OECD countries. Notwithstanding robust growth and a depreciating exchange rate, consumer price inflation has been kept in line with the Reserve Bank's 2 to 3 per cent inflation target over the cycle. Employment recovered in 2002, and unemployment has continued to fall to just over 6 per cent. Though the severe drought will impact on growth in 2003, the expected improvement in the global environment should help the economy to expand at a robust 3¾ per cent rate in 2004, despite a likely downturn in the residential property sector. The demand for labour should continue to rise, but strong productivity gains are expected to help to keep labour costs and inflation under control. Rising incomes and real-estate wealth, and comparatively low debt-servicing costs for households should support consumer confidence and private consumption. The residential construction boom could be nearing its end, but surveys suggest that business investment will pick up further, underpinned by low financing costs, healthy company profitability and low corporate debt. Exports are expected to recover in line with overseas markets. Together with further terms-of-trade gains reflecting falling manufactured goods prices, this should bring the current external deficit back below 4 per cent of GDP in 2003-04. ■

## What are the risks?

Risks to the short-term outlook are not symmetrical. A delayed recovery in the global economy would weaken the projected pick up in Australian exports. Moreover, the generally depressed and uncertain business outlook in most other countries could eventually sap business confidence in Australia. A large increase in investment underpins Australia's short-term growth outlook and, in the past, this component of demand has been particularly sensitive to global economic conditions and the level of uncertainty surrounding the outlook. It is not yet clear if the house price boom is a bubble that will burst, with negative impact on household financial positions and spending, or an adaptation to an era of strong real income growth and low interest rates. The longer it continues, the greater the likelihood that some of the run-up in prices will eventually be reversed. The other major domestic uncertainty is the length and severity of the drought. While the effects of the adverse seasonal conditions on activity in 2002-03 are becoming clearer, the outlook for economic activity in 2003-04 is underpinned by the assumed breaking of the drought. Consequently, should unusually dry conditions persist into 2003-04, the risks to the outlook for farm production and activity more generally are significant. On the upside, a faster than expected recovery in major trading partners could generate stronger demand for Australian exports, while the domestic economy could display more momentum than anticipated. ■

## How has monetary policy reacted to the changing economic environment?

When domestic and foreign demand slowed in early 2001, macroeconomic policies responded appropriately, given the benign inflation outlook. The Reserve Bank cut the cash rate six times during 2001, and monetary conditions were further eased by the depreciating Australian dollar. With the improvement in the international outlook in the first half of 2002, and with consumer price inflation staying just at the upper end of the Reserve Bank's target range, the Bank raised the cash rate in May and June 2002 by altogether 50 basis points to 4.75 per cent, still low by historical standards. The Bank indicated its intention to move policy back to a more neutral setting over time, but has appropriately desisted from further tightening so far, in view of the loss of momentum in the global economy and the severe drought. ■

## How supportive was fiscal policy?

Part of the buoyancy of domestic demand since mid-2001 owes to the loosening of fiscal policy at a time

when growth had slackened, and was not expected to recover quickly. Easing for the most part took the form of higher subsidies to first-time home-owners and unanticipated increased expenditure for defence, domestic security and border protection. It resulted in a swing in the Commonwealth's underlying cash balance from a moderate surplus in fiscal year (FY) 2000-01 to a marginal deficit in FY 2001-02. Reflecting the gathering strength of the economy, the Commonwealth Budget for 2002-03 appropriately projects a return of the underlying cash balance to small surplus, and larger budget surpluses are projected over the medium-term. ■

### What is the outlook for government debt?

In practice, actual budget outturns over the cycle have on average resulted in surpluses. Together with asset sales in earlier years, and some still to come, the result has been that Commonwealth net debt has fallen to low levels and would disappear altogether in the medium term on current policies. States' net debt is also low and falling. Paying down debt is arguably a desirable way of reducing the fiscal burden on future generations, particularly if capital markets can function efficiently on the basis of private financial assets. However, very low levels of government bonds may hinder the efficient operation of the Australian capital market, and complicate the implementation of monetary policies. It is not obvious, though, that possible capital market problems should be "solved" by public borrowing to purchase private-sector real assets. If capital markets do require risk-free public paper to function efficiently, then an alternative approach would be to fund the unfunded liabilities of the public servants pension scheme. ■

### Are pension policies fiscally sustainable?

The Government's *Intergenerational Report* of May 2002 indicates that, under unchanged policies, public spending could rise by as much as 5 per cent of GDP more than tax revenues over the next four decades, primarily reflecting higher health related expenditures rather than purely age-related spending. Compared with most OECD countries, Australia is well-placed as regards the burden of public pensions which is low relative to GDP and not expected to rise appreciably in the future. The Age Pension is flat-rate, income and asset tested and modest relative to average wages, and is financed out of general taxation. The compulsory funded superannuation scheme that started in 1992 is slowly maturing, thereby reducing entitlements to the Age Pension in the long run. Both the mandatory defined contribution system and voluntary retirement saving plans are effectively taxed on the same basis as owner-occupied housing for equity

reasons. However, the superannuation tax system is unduly complicated, with a lump sum having up to seven alternatives to the standard flat rate income tax normally paid on the withdrawal of superannuation benefits. A simplification of the tax rules is needed with an anchoring to income tax rates. Though currently aligned, the rates of tax on retirement saving are set independently of income tax rates – opening the possibility that the neutrality of the tax treatment on saving through pensions and housing may break down in future. Finally, the means testing of the basic pension may encourage people to retire from the labour force and dispose of assets before the age of eligibility for the state pension, thus lowering incentives to work. This "double-dipping" needs to be discouraged, for example by aligning the preservation age for superannuation benefits with that required for access to the Age Pension (*i.e.* 65 years). More fundamentally, the assets test needs to be reviewed. A further reduction of the taper rate should be considered as marginal effective tax rates for the elderly can be nearly 70 per cent over a wide range of income. Such changes should be given priority over any changes in the taxation of pensions. ■

### What is the long-run outlook for public health spending?

Although spending on public pensions seems fiscally sustainable, the Government's *Intergenerational Report* nevertheless estimates that on unchanged policies and likely developments in productivity and participation rates, total Commonwealth spending will exceed revenue in about 15 years. This mainly reflects the long-standing trend rise in health costs, especially pharmaceuticals, associated with technological advances and other autonomous forces, and the more intensive use of medical services by the elderly. The potential budgetary costs of health care for the aged will also need to be considered. Following the decision to encourage participation in private health insurance schemes, the growth in the use of public hospitals has slowed. Containing the growth of public spending on the Pharmaceutical Benefits Scheme – the fastest growing component of the health care spending – and developing a more affordable and better targeted aged care system, are essential for containing spending pressures and maintaining the sustainability of the health care system in the longer run. ■

### How can public calls on economic resources best be addressed?

The government recognises that rising trends in public calls on economic resources in the future will be

more easily accommodated if total output rises more rapidly, *via* increases in the size of the labour force, and its productivity, and can be further boosted by encouraging more people of working age to remain in, or join, the workforce. Their productivity would be enhanced by policies that increase human capital and the efficiency with which it can be used. ■

### How can employment and labour force participation be encouraged?

To encourage higher employment and higher participation, the government introduced in the 2001-02 Budget a comprehensive welfare reform package, *Australians Working Together*. It extends the mutual obligation requirements (broadly defined community service and active labour market policies) to 35-49 years olds and provides for a phased introduction of participation requirements to qualify for Parenting Payments. The reform also introduced a "Working Credit", that allows welfare recipients to keep more of their income support payments when they take up work. However, the Working Credit lowers the high marginal effective tax rates only transitorily, as the financial benefit depends on the amount of working credits accrued by the person. Hence, further reforms should aim at reducing the high effective marginal tax rates faced by welfare beneficiaries (and others) if and when they take up longer term employment. In the interest of raising participation rates, the Government has also undertaken initiatives to improve the work capacity of people with disability and to tighten the eligibility requirements for Disability Pension Support, to slow the large flow of people into this programme; a revised Disability Reform Bill, addressing this last issue, was unfortunately recently rejected by the Senate. ■

### How has the competitive market for employment placement performed?

Labour market efficiency has also been enhanced by the introduction of a contestable employment placement market – the *Job Network* – as from May 1998. To ensure that disadvantaged job-seekers benefit from the new arrangements, a differential fee structure applies, with the government paying the highest fees for those who are most at risk and hardest to place in a job, and full payment to the agency is made only after a job-seeker has been off allowances for longer than six months. The new system has achieved a substantial reduction in the unit costs of employment assistance for unemployed job seekers and it also seems to have led to a higher level of satisfaction of job seekers and employers. The government's *Active Participation Model* will improve the linkages between the *Job Network* and other welfare arrangements as

from 1<sup>st</sup> July 2003. However, the *Job Network* has had only modest positive effects so far on the job seekers' chances of gaining employment although there is probably a positive impact on productivity because of a better matching of people and jobs. Outcomes may improve over time as service providers learn what works best, and poor service providers lose their contracts. ■

### How has industrial relations reform contributed to higher labour market flexibility?

The resilience of the economy to shocks has been improved by reforms which have made the labour market more adaptable to rapid changes in the economic environment and has permitted the economy to work closer to potential over time as a result. The ongoing reforms of the industrial relations system since the mid-1980s stand out in this respect as they have introduced a large measure of regulatory flexibility, especially by facilitating and encouraging the setting of wages and employment conditions at the enterprise level. The move to decentralised bargaining was underpinned by fundamental changes to the former exceptionally rigid and legalistic award system. These aimed at restricting its role to a safety net of *minimum* wages and other core conditions of employment, rather than, as previously, detailed prescriptions of *actual* wages and conditions. Among the many provisions designed to support decentralised bargaining were increased protection for freedom of association, a ban on union preference clauses in agreements and awards, and a strengthening of the Australian Industrial Relations Commission's powers to give directions to stop or prevent unprotected industrial action. The new system also enables employers to trade off wage increases for changes in work practices. Less adversarial labour relations and greater labour flexibility are likely to have encouraged innovation, and to have facilitated greater acceptance of new work practices, organisational procedures and modern technologies, and thus contributed to the observed acceleration in productivity in Australia over the past ten years or so. ■

### What are the remaining problems?

Despite this long programme of reform, a number of problems remain. So far, the number of formal individual workplace agreements remains quite low, probably reflecting their high initial transactions cost. And effective decentralisation may be inhibited by the growing practice of "pattern bargaining", namely concerted negotiations by the same trade union in a number of different enterprises. It will be important to

assess the effectiveness of the proposed simplified procedures for making individual and collective agreements which are currently before Parliament. Moreover, the award system still plays an important role in setting minimum wages, which – at around half of average weekly earnings – are relatively higher than in most other OECD countries and may therefore constrain employment prospects for the low-skilled. And even though simplified awards impose far fewer constraints on the operation of enterprises than before, the rather extensive coverage of the twenty so-called “allowable matters” still implies a substantial degree of complexity compared with other countries. Hence, the number of employment conditions determined by awards should be reduced further and their specifications tightened to a less comprehensive set of core employment conditions. This would reduce the role of awards as benchmark against which the “no-disadvantage test” of enterprise agreements is conducted, allowing the individual situation of enterprises to be better taken into account when negotiating agreements. The overall reach of industrial relations reform would be extended by the harmonisation of federal and State legislation and practice, not only to reduce regulatory costs for businesses and governments, but also to avoid reforms of the federal system being rolled back at the state level. ■

### **Is there scope for a better transition of the young from school to work?**

Cross-country analysis indicates that human capital, as proxied by years of education and training, plays a very important role in raising labour productivity. While the level of educational attainment in Australia has improved considerably over the past twenty-five years, concern remains regarding the relatively high teenage unemployment and early school leaving rates in Australia, both exceeding the OECD average. Recent reform efforts focus on the better integration of vocational education and training (VET) with the broad education sectors, and the introduction of a National Transition system. In this context, particular attention should be paid to measures raising the incentives to remain in education beyond the compulsory age, including a broadening of the secondary school curriculum and the provision of better advice and guidance in schools. A strengthening of the links between VET and higher education is also desirable both in terms of enhancing the educational pathways and for improving efficiency in the allocation of resources in the two sectors. To improve standards, more flexible and better targeted arrangements for the funding of higher education provision should be considered, along with access on an equitable basis. ■

### **What was the contribution of National Competition Policy to rising living standards?**

The implementation of Australia’s ambitious and comprehensive National Competition Policy over the past seven years has undoubtedly made a substantial contribution to the recent improvement in labour and multifactor productivity and economic growth. The Productivity Commission estimates that Australia’s GDP is now about 2½ per cent higher than it would otherwise have been, and Australian households’ annual incomes are on average around A\$7 000 higher as a result of competition policy. Unfinished business encompasses the completion of the legislative review and the subsequent removal of restrictions which have been shown not to be in the general public interest; the introduction of a contestable national electricity market at the household level; the acceleration of the slow pace of the reform of rural water supply; enhancing competition in fixed-line telecommunications; and opening the postal services market to competition. Some of these reforms are advancing slowly because of resistance from groups that benefit from protection. This calls for continuing strong efforts of the government to convince opposing parties of the overall beneficial effects of enhanced product market competition, possibly accompanied by financial assistance to support the transition to new, more efficient arrangements. ■

### **What has been done to raise the efficiency of the financial system?**

Reforms to labour and product markets have been complemented since the mid-1990s by an extensive examination of regulations applying to the financial services industry. The comprehensive “Wallis reforms” in the late 1990s, which focused on prudential supervision, depositor protection and the promotion of competition among financial service providers, have been largely implemented. The *Financial Services Reform Act 2001* of March 2002, provides for a single, harmonised licensing regime for financial service providers and product issuers, as well as a consistent and comparable financial product disclosure regime, and uniform arrangements for the regulation of financial markets. In addition, the reform seeks to cut compliance costs for financial service providers and to remove regulatory barriers to the introduction of technological innovations. A key element of the *General Insurance Reform Act 2001*, which came into effect in July 2002, is a substantial increase in the level of regulatory capital that must be held by insurers, to be phased in by 1 July 2004. Insurers will be required to hold capital commensurate with the risk profile of the insurance business being underwritten. However, the

collapse of a major insurance company in early 2001 also gave rise to the question of the then adequacy of the investigative powers of the prudential regulator APRA. This issue is currently being examined in the context of the investigation by a Royal Commission into the causes of the insurer's failure, while APRA itself now takes a considerably more proactive stance in its surveillance role. ■

### What are the next steps of tax reform?

Efficiency gains could also be achieved from the recent reforms to the tax system, notably the July 2000 introduction of the broad-based 10 per-cent Goods and Services tax (GST), and the July 2001 introduction of a simplified tax system for small firms and a unified capital allowances system. This is intended to reduce the compliance burden for most businesses and improve the efficiency of investment in Australia. Reforms in international taxation arrangements are also currently under review. However, some important policy issues remain to be addressed, among them the large gap between the top personal marginal income tax rate and the company tax rate, which acts as an incentive for a redefinition of personal income as company income. In addition, the top marginal income tax rate comes into effect at a relatively low income level, raising concerns about work and savings incentives, with potential adverse effects on output growth. And although the issue was addressed in the July 2000 reform package, marginal effective tax rates remain high for many low-income earners, which tends to create poverty traps. Additional benefits would also accrue from a faster-than- envisaged abolition of some harmful State indirect taxes, especially the tax on bank account debits. Another subject of reform should be the narrowly-based payroll tax, which is also under the jurisdiction of the States. ■

### What should be done to promote international trade further?

The Australian market has become progressively more open over the past decade under the influence of both unilateral and multilateral cuts in tariffs and abolition of quotas. A high proportion of imports from developing countries enters the country without paying tariffs. In agriculture only the dairy industry is now supported. Moreover, all remaining barriers against 48 Least Developed Countries and East Timor have now been abolished with immediate effect. However, high effective tariff barriers still affect other developing country exports of textiles, clothing and footwear. Lowering these beyond the cuts planned in 2005 will be particularly important in order to meet the government's pledge to APEC to introduce completely free trade by 2010. They will also be a welcome comple-

ment to the possible free trade agreement with the United States to lessen any potential trade diversion. In any case, this agreement should form a base for continued progress in multilateral trade liberalisation. ■

### What are the overall achievements of Australia's immigration policy?

Australia is an "immigration country" *par excellence*, and it is an assumption of policy that significant net immigration will continue for the foreseeable future. Immigration is accepted as contributing to a higher quality of life through expanding the labour force, output and markets. Current immigration policy has been successful in improving the economic return from immigration. It can be inferred from the high average level of education of immigrants, their relative youth, high participation and declining unemployment rates, that average incomes of successive immigrant intakes have been rising relative to those of the existing population. It is therefore likely that spin-offs for the existing population have also been increasing. However, it is difficult to quantify these gains for the existing population; the government is sponsoring studies in an attempt to better estimate these benefits. Studies also show that most immigrants create net fiscal benefits, especially those who enter through the points-based and business skills routes. ■

### How successful are the policies to promote economic and social integration of immigrants?

Benefits associated with the development of "multicultural Australia" depend on successful economic and social integration. Australia is successful in integrating immigrants on most economic measures, in part reflecting a focus on skills. Although immigrants on average have higher unemployment rates than Australian-born, the gap fell substantially during the 1990s and the difference between the likelihood of unemployment for an Australian-born person and an immigrant diminishes as length of residence increases. The position is relatively less favourable for the unskilled (mainly Humanitarian, and to a lesser extent, family migrants), particularly those with poor English language skills. Unemployment remains a problem for these categories of immigrants, and the consequences of this feed directly into their relatively unfavourable fiscal contribution. The current policy of a lower level of entitlement to social security benefits for non-humanitarian immigrants in the first two years reduces the fiscal costs and increases the incentive to work, which underpins the high participation rates of most migrant groups. (Humanitarian immigrants, once accepted, are immediately entitled to the same benefits

as existing permanent residents). The two year waiting period may discourage some forms of immigration, though it is unlikely that the availability of welfare benefits is an important factor in the migration decision for many people, especially given the limitations on overall numbers. ■

### **What is the role of language skills in integrating immigrants?**

Considerable efforts are made to improve the integration prospects for adult immigrants coming to Australia under the Family Stream and the Humanitarian Program and for adult dependants of Skill Stream migrants, notably through the provision of free or, in some cases, subsidised language tuition where less than functional English is held. In addition, the Government provides funds for English as a second language tuition to school-age children requiring such assistance. Studies repeatedly show that knowledge of English is the single most important factor in successful integration, both economic and social. There are some indications that this policy works, notably the results of the PISA study on education attainment. These showed relatively high levels of achievement for both Australian-born and immigrant children, including those with non-English speaking home environments, with a smaller gap between the groups than in almost all other OECD countries. Successful overall, these integration efforts should continue to be sensitive to the needs of particular groups, notably to ensure that the local ethnic concentrations that are inevitably associated with migration remain the routes to integration that they have been in the past rather than a trap or a means of avoiding integration. ■

### **What are Australia's policies to reduce poverty in less developed countries?**

Policy actions to ensure sustained increases in Australian living standards have to be placed in the context of low incomes elsewhere in the world. Australia cannot neglect the implications of economic and social instability in neighbouring countries. Many of these benefit from Australia's official development assistance programme, which has markedly changed its orientation over the past five years. There has been a welcome increase in programmes aimed at improving the governance structure in partner countries, both through improving economic and financial management, and strengthening law, justice and democratic institutions. Expenditure on basic health and education has risen, while spending on major projects has

dropped. Improvements could still be made to the allocation of funds. The benefits of further redirecting aid spending from University scholarships in Australia toward strengthening the education infrastructure in source countries, should be considered. As importantly, outlays aimed at improving basic transport infrastructure and the governance of neighbouring countries should continue to rise. Such increases may better place the economies of its partners to take advantage of the unilateral reduction in tariffs that Australia continues to put in place. ■

### **What needs to be done to secure the sustainability of Australia's water use?**

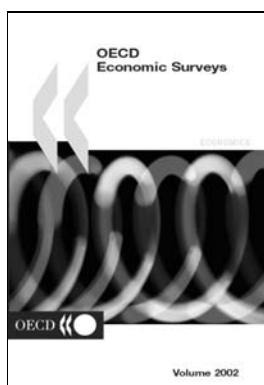
Water use is becoming unsustainable in a number of areas where agricultural usage is high. Stress affects only about a quarter of river systems, but they account for almost 70 per cent of water extraction. Urban consumers now pay for the full cost of the distribution and treatment of water. However, neither urban nor rural consumers pay for the right to extract water from rivers. All jurisdictions have put in place legislation that provides for full cost recovery, and allows water to be separated from land title and hence traded to its most profitable use. All states now need to complete their water resource plans in order to assess sustainable extraction caps, bearing in mind the need of ecosystems, and then let markets allocate water to its most economical use. There is, however, less scope to use economic instruments to overcome the problem of excess salinity of water and soil. Rather, it is important to use cost-benefit analysis to establish the extent of the resources that government policies should devote to containing soil and water salinity, which is very costly to reverse. Some degree of soil salinity may be an acceptable price to pay for improving large areas of land. Indeed, the value of the overall stock of land has been increasing, as has the value of remaining mining resources, thereby increasing the value of the natural capital stock in the Australian balance sheet faster than the stock of physical assets over the past decade. ■

### **For further information**

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