

Meeting of the OECD Council at Ministerial Level

2006

Key Information



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Les questions clés

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Preface

Dear Minister,

This year's OECD Ministerial Council Meeting (MCM) will be held under the chairmanship of Kostas Karamanlis, the Prime Minister of Greece, with the overarching theme "Delivering Prosperity".

This may seem like a self-evident goal for an Organisation for Economic Co-operation and Development. But it is a question that we need to look at more closely, given the current large and persistent divergence in growth rates across and within OECD countries as well as in the global economy.

The information in this brochure provides background for the main topics that ministers will address:

- **Short-term economic prospects in member countries:** This session will focus on the information contained in the latest OECD Economic Outlook, to be released at the start of the MCM.
- **Medium/long-term macroeconomic and structural issues:** This session on "Delivering Prosperity" will look at how to correct the imbalances affecting the global economy.
- **Implementing economic reforms for growth and employment:** Ministers will discuss how to boost growth and employment in a context of ageing populations.
- **Growth, investment and development:** Ministers will be invited to adopt reports on intellectual assets and value creation, as well as a Policy Framework for Investment. They will also discuss how to use aid more effectively to promote private investment in order to reduce poverty and foster development.
- **Trade negotiations under the Doha Round:** Ministers are likely to focus on how to advance the Doha Development Agenda within the time-frame agreed at the WTO ministerial meeting in Hong Kong in December.
- **OECD in the future:** Ministers will discuss the strategic directions of the OECD to help it shape globalisation, as well as the prospects for enlarging the membership.

Many important players from emerging and developing countries have been invited to join the ministerial meeting. At the same time, delivering prosperity is an issue for citizens of all our countries, not just for politicians.

With this in mind I would strongly encourage you to participate in the OECD Forum 2006 which takes place on 22-23 May in Paris. The Forum is a "civil society summit" which brings together leaders of government, business, labour, civil society and the media to discuss the issues on the ministerial agenda.

This year's ministerial meeting is a milestone for me, as it will be my last as OECD Secretary-General. I would like to take this opportunity of thanking OECD members for their support over the past ten years and look forward to introducing you to my successor, Angel Gurría, at this year's MCM.



Donald J. Johnston

World Economy

ECONOMIC SITUATION AND PROSPECTS

Global expansion is broadening

The buoyancy of world growth witnessed over the past few years is projected to be sustained going forward, helped by supportive financial market conditions. The US economy would decelerate marginally, with growth settling around its potential rate. In Europe, where the cycle has been lagging, the pace of activity would gradually pick up. Momentum in Asia, where Japan in particular has been putting up an impressive performance, would remain vigorous. As this robust expansion now enters its sixth year, inflation and inflation expectations are generally low and expected to remain subdued, despite the pressures stemming from higher energy prices. This is in part a tribute to the improvements in central bank credibility in recent years but is also to some extent a benefit of globalisation.

Growth is steady and robust in North America ...

The US economy is on course to continue to expand at a healthy pace, having weathered a series of shocks quite well, including the one imparted by the devastating hurricanes that hit late last summer. Profitability is high, business confidence strong, job creation robust and unemployment low. Wage growth remains subdued in the light of sustained productivity gains. Growth performance and prospects are also remarkable in Canada.

... somewhat weaker in Europe ...

In the euro area, business and consumer confidence have improved and activity has gathered strength, following a spell of weakness in the latter part of 2005, notably in the three largest member countries. Overall, the strength of the external environment should feed through to euro area domestic demand. Unemployment has declined over the past year but remains comparatively high and is expected to recede only gradually. In the United Kingdom, domestic demand has slowed in conjunction with a cooling housing market, but looking ahead, activity is expected to pick up.

... and strong in Japan

Overcoming a number of its post-bubble problems, and buoyed by the vigour of the expansion throughout much of Asia, Japan is now enjoying a broad-based recovery. The upswing was initially driven by exports and business fixed investment, but household spending, including residential investment, has gained momentum, supported by an improving labour market. Corporations are starting to re-leverage and the outlook is for continued robust growth.

China and India are catching up

Over the past three years, growth has averaged 10% per year in China and 8½% in India. This year and next, it may moderate somewhat as effective exchange rate appreciation works its way through in China and as a tighter fiscal and monetary policy stance contains domestic demand in India. Nonetheless, the catch-up process in these and other large emerging market economies would carry on. On the external side, slackening

import growth has translated into a ballooning current account surplus in China, contrasting with India's significant current account deficit.

Tensions and risks

Some of the factors that have thus far sustained overall growth may no longer do so further out. Valuations in some housing markets are quite stretched. If long-term interest rates were to rise significantly from their still low levels, housing would be one channel through which activity would slow. At the same time, current account imbalances have reached unprecedented magnitudes. Although they have not entailed any major disruptions to date, these imbalances cannot continue to worsen indefinitely. And the longer that policy-induced or market-driven adjustments are deferred, the higher the likelihood that their unwinding will be painful. There are other imponderables, not least energy prices, which in a context of limited spare capacity could be driven up substantially by any supply disruptions.

Monetary policy challenges

Against this backdrop, monetary accommodation has now been removed in the United States. Core inflation has remained in check, but with limited if any economic slack left and some pressures on costs, a slightly restrictive policy stance may be warranted, subject to the incoming data. In Japan, deflation seems to be waning at long last, but only gradually so, despite vigorous growth, which argues for keeping the policy interest rate at zero over the near term. In the euro area, core inflation remains subdued and headline inflation is set to ease. Going forward, further removal of monetary accommodation should wait for tangible signs that slack is shrinking and that underlying inflation pressures are mounting.

Fiscal consolidation is called for in many countries

On the budgetary front, consolidation generally remains an overarching imperative. In this perspective, advantage should be taken of the cyclical upturn to step up the pace of fiscal adjustment. Indeed, the underlying general government deficit in the OECD countries as a group has exceeded 3% of GDP in 2005 for the fourth year in a row. This would call for serious adjustment efforts even in the absence of the fiscal pressures associated with ageing populations which – despite the pension and healthcare reforms implemented over the past few years – are continuing to build up.

DELIVERING PROSPERITY

Divergence and imbalances

Over the past two decades, living standards in a number of OECD countries, notably Japan and some Continental European economies, have ceased to converge to those enjoyed by the best performers. The implied social costs are only too visible, and are set to worsen as ageing pressures affect some countries more severely than others. Another deep-seated, albeit somewhat more recent, development is the widening of international imbalances. Insofar as they reflect inappropriate policies, these also present policy makers with a challenge.

How can policy help?

The conjunction of these two trends raises the question of how to improve performance where growth is lagging and to ensure sustainable expenditure patterns within and across OECD regions. Boosting national saving in the United States and moving towards exchange rate flexibility in China would help to reduce external imbalances, but growth-enhancing structural reforms in Europe and Japan may be less effective. Indeed, while some of these reforms might boost imports, they would also add to export capacity over the longer run.

Content of structural reforms does matter

In fact, the impact on external imbalances of structural reforms hinges on their exact nature. Financial market reform involving greater competition would help, as it would boost investment and reduce saving. Product market liberalisation – not least in the services sector – may also help by spurring growth and imports. However, labour market reforms may be accompanied by a rise in precautionary saving, stronger competitiveness and larger surpluses, as in Germany recently. Even so, while they do not automatically reduce current account imbalances, structural reforms make it less painful to cope with the consequences of their abrupt unwinding, should it occur, in that they bolster resilience and budgetary wherewithal.

Reform implementation is often a challenge ...

Economic reforms are pressingly needed in many OECD countries, especially in the large euro area members. Insufficient progress has been achieved in recent years with respect to pension reform and the financial disincentives faced by ageing workers, as well as in politically difficult areas such as employment protection legislation, wage bargaining systems or disability benefits. This is partly because reforms often generate highly visible costs concentrated on clearly identifiable groups while benefits may seem more uncertain, tend to accrue later and are generally more diffuse.

... but policy synergies and appropriate sequencing can help

Successful macroeconomic policies keeping aggregate demand close to potential output may facilitate the conduct of structural reforms by mitigating any deflationary pressures associated with structural change. Financial market reforms can also provide support via lower market interest rates, easier access to credit and more potent monetary policy transmission when fiscal and monetary margins of manoeuvre are limited. Lastly, product market reforms, inasmuch as they reduce rent-seeking and product prices, raise real labour incomes and employment.

MAKING THE MOST OF INTELLECTUAL ASSETS

Key strategic elements for value creation

Intellectual assets are fast becoming key strategic elements for value creation, notably in firms that are driving the evolution towards a knowledge-based economy. The expansion of the services sector, stronger competition resulting from globalisation and deregulation, and the emergence of new information technologies have accelerated this evolution and brought to the fore the issue of how knowledge is created, disseminated, retained and used to obtain economic returns. This has led to a structural change, from traditional scale-based manufacturing, which mainly relies on tangible assets, to new innovation-oriented activities which rely largely on research and development (R&D), patents, software, human resources and also new organisational structures. Nevertheless, intellectual assets are difficult to measure, manage and report and some of them tend to be mobile across firms.

Investment in intellectual assets is growing fast

Annual investment in some intellectual assets in the OECD is estimated to be roughly comparable to that in machinery and equipment, and is growing faster. However, much of their contribution is not reflected in current official measures of economic activity, which prevents policy makers from having an accurate picture of economic growth, productivity and cyclical developments. A recent study found that the contribution of unmeasured intellectual capital to economic growth was 10%-11% of gross domestic product (GDP) in the United States over the period 1995-2003, rivalling the contribution of tangible capital, and both types of capital contributed equally to labour productivity growth in those years.

Improved measurement of their contribution is needed

For financial markets and companies, the contribution of intellectual assets to value creation cannot be assessed without improved information. The only intangible assets recognised in financial statements have traditionally been purchased intellectual property, such as patents and trademarks, and acquired items such as goodwill. If other information does not fill the void, there could be a misallocation of resources by both company management and the capital markets, leading to an increased cost of capital. OECD analysis shows that improved disclosure about intellectual assets and about how value is created with them (i.e. value drivers) is critical for both company managers and the efficiency of capital markets.

Industry-specific measurement standards would help

One way to enhance public disclosure and the broader dissemination of information is for governments to encourage the diffusion of best practices, already pioneered by a number of firms, by promoting voluntary standards. Given the wide range of intellectual assets held by firms in different industries, and the comparatively early stage of development of reporting frameworks, the approach to improved disclosure should remain principles-based and voluntary. Industry-specific standards would seem to offer the best way forward since they can accommodate the very different roles of the various intellectual assets from sector to sector.

REFORMING FOR EMPLOYMENT

Over the past decade, employment rates have risen in many OECD countries, and the long-term trend rise in unemployment has been halted or reversed. Still, wide cross-country disparities in labour market performance remain. While women and older workers have benefited disproportionately, youth and the less educated have lost ground. Recent reforms have often failed to prepare economies adequately for new challenges, including how to maximise the net benefits from technological progress and globalisation, and to cope with ageing populations. But the OECD Jobs Strategy reassessment has yielded valuable lessons about what works for whom and in what circumstances.

Well-designed “activation”, “making work pay” policies are effective

One key lesson is the need to get work incentives right. This involves the nexus between unemployment benefits, active labour market policies and “making work pay” policies. Too high or open-ended unemployment benefits combined with lax monitoring of the unemployed and little or no financial gain from taking a low-paid job tend to lock people into “unemployment” or “inactivity” traps. However, well-designed “activation” policies can encourage the unemployed to look for work while maintaining fairly high benefit levels. One increasingly popular approach is that of “mutual obligations”, where governments provide effective re-employment services, training and financial incentives to unemployment benefit claimants who, in return, have to look actively for a job, improve their employability, or risk benefit sanctions. This strategy, possibly combined with well-targeted in-work benefit schemes, has proved successful in promoting re-employment.

The new challenge is to extend them to other inactivity benefits

But “activation/mutual obligations” policies face a new challenge. The proportion of the working-age population relying on sickness, disability, sole-parent, early retirement or social assistance benefits exceeds that on unemployment benefits. Many of them would like to work but need assistance to do so. Countries are beginning to experiment with variants of “activation/mutual obligations” to help this heterogeneous group find work. These experiences need to be monitored closely to see what works and why.

Policies allowing labour demand to expand with supply are important ...

Demand-side policies can help too. To improve the job prospects of certain groups, overly strict employment protection legislation needs to be avoided. Partial reforms, making it easier to hire people on temporary contracts without changing the protection offered to core workers, can be counterproductive. However, some countries have found innovative reform avenues combining more labour market flexibility with adequate worker protection. One of these is to make the costs of firing permanent workers more predictable. Another is the “flexicurity” approach, which facilitates hiring and firing decisions while providing efficient re-employment services and income support to laid-off workers.

... including wage flexibility and competitive product markets

Wage flexibility also enhances labour demand, with decentralised and centralised bargaining yielding more favourable outcomes than bargaining at the sectoral level. A further benefit of decentralised bargaining is that local wages better match local productivity, mitigating regional imbalances. Where legal minimum wages are high,

targeted cuts in payroll taxes can improve the employment opportunities of vulnerable groups, though this can be expensive for the public purse. Finally, competitive product markets boost labour demand and, ultimately, both employment and real wages. While anti-competitive regulations have been reduced in most OECD countries, many have further scope for lowering domestic barriers to entry, expanding employment opportunities and reducing restrictions on foreign trade and investment.

Removing group-specific barriers also lifts employment

Remaining distortions in the design of pension systems and *de facto* early retirement schemes discourage labour force participation by older workers. Widespread use of seniority pay and a dearth of training opportunities further undermine their employment prospects. Women face obstacles in the form of tax disadvantages for second earners and lack of part-time jobs. Poorly designed family-support policies also discourage female participation, including lack of suitable parental leave provisions and high childcare costs. The latter can be reduced by increasing competition in the childcare market and by turning child benefits into childcare subsidies – although this may result in lower targeting of public spending. Regarding youth, inadequate basic education makes school-to-work transitions difficult. An effective approach has been sustained intervention to avoid early school failure, targeted employment programmes and remedial training.

Lifelong learning is essential to improve employment prospects

There is strong evidence that training is associated with better-paid jobs and that it facilitates transitions from temporary work into stable employment. Lifelong learning policies should ensure that training markets function well, including through improved skills recognition systems, enhanced information on the contents and outcomes of courses, better quality training provision and greater certainty about the returns to training. While financial constraints faced by workers may call for public support to adult learning, complementary contributions from the recipient or the firm are also warranted, given that they capture much of the returns from training.

There is room to take advantage of interactions between policies

Recent experience has shown that there are several roads to success. Still, reforms need to be implemented as a coherent policy package, taking into account not only country objectives and starting points but also policy interactions. For example, the potential disincentive effects of high and long-lasting unemployment benefits need to be counteracted by well-designed activation policies. Likewise, the adverse effects of high labour taxes on labour demand can be mitigated by setting the minimum cost of labour at a reasonable level. Also, reforms that enhance wage flexibility will have larger employment effects when they are carried out in an environment of strong product market competition.

There is a growing consensus that structural policy settings, such as poorly designed benefit systems, may amplify employment losses due to adverse macroeconomic shocks, or make them more persistent. The fact that shocks to the economy can interact with other policies to damage jobs heightens the importance of avoiding excessive macroeconomic fluctuations and cushioning adverse shocks. Stability-oriented monetary and fiscal policies help in this regard. However, sound public finances are necessary to allow fiscal policy to play a stabilising role. And some reforms expand potential output but may not be accompanied by an immediate expansion of demand. In such cases, stability-oriented macroeconomic policy can help bring forward the employment gains from reforms.

FACTS FOR ECONOMIC POLICY

Putting statistics to good use

Statistical facts are extremely important for good economic policy. But facts alone are not enough. They need to become knowledge before policy makers can use them: and in an era of unprecedented information flows, that link cannot be taken for granted. Therefore, the OECD, with its longstanding experience in fostering facts-based policy discussions, is embarking on a major long-term initiative to address this, built around a series of World Forum conferences held every two to three years.

OECD World Forum on “Statistics, Knowledge and Policy”

The OECD organised the first “Statistics, Knowledge and Policy” World Forum in Palermo (Italy) in 2004. More than 540 people representing various constituencies from 43 countries attended and it was also followed via Webcasting by several thousand people around the world. The OECD is now building on the success of that first Forum with a long-term project to create a place – both real and virtual – for the public and private sectors, as well as citizens, to come together in a co-ordinated worldwide attempt to study and improve the nexus between statistics and policy making.

The next World Forum will be held in Istanbul from 27-30 June 2007. Sponsored by the Turkish Government, the Forum should bring together 800 delegates from developed and developing countries. This second Forum will promote evidence-based decision-making through the statistics-knowledge-policy chain, and will give particular focus to national and international indicators of progress (economic, social and environmental). The OECD plans to partner with international agencies, including the United Nations and the World Bank. Discussions will range from technical presentations on key indicators, through to fact-based discussions on key “global” policy areas (globalisation, migration, health, etc.), as well as conversations around what a replacement set of Millennium Development Goals might look like once the current set expires in 2015.

Regional pre-conferences are being arranged over the next 12 months for Latin America, Asia, the Middle East and Africa.

Indicators for measuring progress and policy making

Within the Organisation, a “horizontal” project on indicators for measuring progress and policy making is being established. This work will bring together different parts of the OECD to share best practice – and develop recommendations – around how sets of indicators are developed, disseminated and eventually used by decision-makers within the OECD and in its member countries.

The OECD Factbook

In March 2006, the OECD released the second edition of the *OECD Factbook: Economic, Environmental and Social Statistics*. It presents, in an integrated way, a carefully selected range of indicators covering broad thematic areas (population and migration, macroeconomic trends, economic globalisation, energy, prices, labour market, science and technology, environment, education, public policies and quality of life). The publication has quickly become an OECD best-seller.

Trade, Investment and Globalisation

MAKING DOHA WORK

The opportunities of growth through trade must be seized, in order to maximise the contribution which open markets for trade and investment can make to economic development and increased human welfare, i.e. to “delivering prosperity”. The 6th World Trade Organization (WTO) Ministerial Conference in Hong Kong, China in December 2005 created opportunities through which to realise the promise of the Doha Development Agenda (DDA) and propel the negotiations to their conclusion by the end of 2006.

The stakes are high to complete the DDA in a timely manner and ensure that it is a strong “development round”. Failure to do so will mean a missed opportunity for all WTO members that will not present itself again for some time. It will also mean a stalling of the motor of multilateral trade reforms that could bring significant systemic risks to the multilateral system, particularly if preferential regional arrangements come to be seen, mistakenly, as an alternative to that system.

The OECD has a major role to play in realising the promise of the DDA, through the leadership provided by its members, its analysis of the gains on offer and the risks at stake, and the monitoring of donor commitments in the pursuit of aid effectiveness.

Agriculture

Agriculture remains a stumbling block for ongoing negotiations, and progress has been particularly difficult in the area of market access. Given the overall high level of support to agriculture, and the trade-distorting nature of much of that support, internationally-agreed disciplines are of particular importance for opening agricultural markets in OECD and non-OECD countries. Farm policies in many OECD countries frustrate developing country efforts to exploit their comparative advantage in agriculture, while at the same time are relatively ineffective in achieving their stated domestic objectives.

OECD analysis has sought to strengthen the case for further policy reform in three areas: demonstrating the extent of support and border protection provided to agriculture, particularly in many OECD countries; clarifying the characteristics of alternative policies that are less trade distorting, yet still allow countries to pursue their national objectives; and, identifying the implications of liberalisation for countries and for various categories of farm households, so as to anticipate and to facilitate any required adjustments.

Non-agricultural market access

The DDA is a single undertaking. The text agreed in Hong Kong links the level of ambition for agriculture and non-agricultural market access (NAMA), specifying that this ambition is to be achieved in a balanced and proportionate manner consistent with the principle of special and differential treatment. The “Swiss formula” approach agreed in Hong Kong can help developing countries reap the benefits of liberalisation and allow all countries to maximise the gains from international specialisation.

The question of preference erosion is a pertinent one. However, OECD analysis finds that for all but a handful of developing countries, the gains from across-the-board liberalisation on a most-favoured nation basis would more than offset the losses from preference erosion. And where there are net losses, the answer is to provide development assistance to the countries concerned to enable them to diversify their exports.

Services

The services sector is now the biggest area of economic activity for all country groupings; yet service barriers – usually in the form of behind-the-border regulatory requirements – remain particularly high. Liberalisation in services holds promise for economic development, employment and technology transfer for both developed and developing countries. Developing countries in particular stand to be among the major beneficiaries, not least because of their growing role as exporters of services.

Progress in this area can underpin the development dimension of the DDA. Sufficient resources and political will should be devoted to the plurilateral request and offer process underway in order to jump-start this area of the negotiations and seize the opportunities offered by liberalisation in trade in services.

Rules

Negotiations on rules, including enhanced disciplines on anti-dumping, subsidies and countervailing measures, including fisheries subsidies, and regional trade agreements, also form part of the single undertaking in the DDA. Efforts must be made to help this area “catch up” on progress made elsewhere in the negotiations.

Trade facilitation

Steady increases in trade volumes and complexity in recent years have significantly changed the operating environment for the international trading community. For many countries, the “hidden costs” of trade are so high that the welfare benefits from more efficient customs procedures could equal those from reducing tariffs. Developing countries in particular stand to gain from more efficient trade procedures; provided they take part in the reform process, two thirds of the gains would accrue to these countries under a DDA agreement in this area.

Negotiations on trade facilitation, including technical assistance and capacity building for developing countries, are a key element of the DDA. Negotiating modalities in this area were broadly agreed prior to Hong Kong, and momentum must be maintained to reap the benefits of rules in this area.

Aid for trade

The Doha Ministerial Declaration emphasises that commitments to help developing countries overcome their trade-related institutional and human resource capacity gaps are core elements of the development dimension of the multilateral trading system. The Hong Kong Ministerial Declaration calls for the expansion of aid for trade to help developing countries, particularly least developed countries (LDCs), benefit from WTO agreements and more broadly expand their trade.

The greatest benefit for development and the integration of poor countries into the global economy will come as a result of developing countries’ own trade reform. The international community is ready to support and complement these efforts through an aid for trade package that supports an ambitious outcome of the DDA. The OECD is contributing to these efforts by monitoring donor commitments and providing analysis on how to improve aid effectiveness.

TRADE AND STRUCTURAL ADJUSTMENT

With the emergence of new sources of competition, accelerating technological change and shifting societal concerns, adjusting to globalisation is an issue of concern to both developed and developing countries. Against this backdrop, the OECD launched a “horizontal” project to identify, for both developed and developing countries, the requirements for successful trade-related structural adjustment *via* the reallocation of labour and capital to more efficient uses, while limiting adjustment costs for individuals, communities and society as a whole. Eight sectors were chosen for particular attention: agriculture, fisheries, textiles and clothing, steel, shipbuilding, motor vehicles, health services and international sourcing of IT and business process services. The findings of the Trade and Structural Adjustment Project (TASAP) were reported at the OECD Ministerial Council Meeting (MCM) in 2005. A sectoral follow-up is being conducted in four sectors/subsectors: coffee, tobacco, telecommunications and chemicals, and an extensive “horizontal” follow-up, described below, has been launched.

The TASAP study finds that in tackling the challenge of structural adjustment, all countries, developed and developing – albeit with differing degrees of emphasis – will benefit by adopting at the national level an appropriate policy framework: macroeconomic policies which promote stability and growth; labour market policies which help develop workers’ skills and facilitate a smooth transfer of resources from declining to expanding activities; an efficient regulatory framework; a sound institutional and governance framework; and liberal trade and investment policies which support structural adjustment by contributing to growth, innovation and competitiveness. For the poorest countries, the study emphasises the importance of appropriate institution building and the development of human and physical capital.

The study further emphasises that governments are strongly encouraged to pursue reform across different policy areas in a complementary way: to reduce resistance to change by helping ensure that those disadvantaged by one reform benefit from another, and to foster synergies between policies. Governments are also encouraged to rely, as much as possible, on generally applicable measures to address adjustment costs, including through the tax and social security system, for reasons of both equity and efficiency.

The study finally underscores that multilateral efforts, including through the Doha Development Agenda, are of particular importance in promoting the mutual interests of trade liberalisation, locking-in domestic reform and providing a roadmap for future liberalisation and reform.

Globalisation and Structural Adjustment Project

After the MCM in 2005, it was agreed to launch the Globalisation and Structural Adjustment (GSA) project. It has three components. GSA I aims to quantify the challenges arising from the integration of many non-OECD economies, including China, into the global trade and production networks for goods and services. GSA II aims to analyse how recent developments in business support services, including cross-border delivery of services, may enhance the performance of manufacturing. GSA III aims to study how trade liberalisation affects labour markets, including the impact of trade on wages and benefits and the impact of trade on job creation and destruction. The final reports are expected to be completed by the MCM in 2007.

INVESTMENT FOR DEVELOPMENT

Policy Framework for Investment

Despite positive trends in the past decade, private investment in many countries, especially developing and transition economies, continues to fall short of development needs. This has led to renewed interest in the importance of private investment for promoting the broad-based growth that will help drive poverty reduction. In support of the 2002 Monterrey Consensus on financing for development, OECD ministers in 2003 proposed a Policy Framework for Investment. Completed in 2006, the Framework draws on good practices from OECD and non-OECD countries and aims to mobilise private investment that supports steady economic growth and sustainable development.

The Framework is a non-binding, flexible tool for framing and responding to the important policy challenges countries face in pursuit of development. Its core purpose is to encourage policy makers to ask appropriate questions in order to identify their priorities, to develop an effective set of policies and to evaluate progress. It covers ten policy fields identified in the Monterrey Consensus as critical for the quality of a country's investment environment: investment policy; investment promotion and facilitation; trade; competition; tax; corporate governance; policies for promoting responsible business conduct; human resource development; infrastructure and financial sector development; and public governance.

The Framework was developed by a Task Force of officials from about 60 governments, with participation by the World Bank, UNCTAD and other international organisations, as well as business, trade union and civil society organisations.

Avenues for future use of the Framework include: **tool for co-ordinated self assessment** and action-plan development within governments; **blueprint for regional dialogues**; **aid for peer reviews** of individual governments' policies, including OECD investment policy reviews; **reference for donors' programmes**; **reference for public-private dialogue**; and **reference point for co-operation** and co-ordination between international organisations.

The Framework will be reviewed by the OECD, non-OECD partners and stakeholders in light of changes in circumstances and experience gained in using it.

Responsible investment in weak governance zones

The OECD has developed a Risk Awareness Tool for Investors in Weak Governance Zones, i.e. investment environments in which governments are unable or unwilling to assume their responsibilities. These "government failures" lead to broader failures in political, economic and civic institutions, creating the conditions for endemic violence, crime and corruption that block economic and social development.

The Risk Awareness Tool helps investors respond to the challenges of observing the same basic behavioural standards in these zones as in other investment environments. Investors need to use heightened care in managing their investments to meet the heightened risks of these environments. The Tool helps investors to identify, analyse, treat and monitor these risks. It is based on the premise that a durable exit from poverty will need to be driven by the leadership and the people of the countries concerned. It helps investors play an effective supporting role in this process.

GLOBAL RELATIONS

In 2005, the OECD Council adopted a strategic framework for the Organisation's global relations with non-members. The framework allows for flexibility in individual areas of work while encouraging a coherent overall OECD approach to global relations. It is built round three key objectives: contributing to the harmonious functioning of the global economy; promoting shared prosperity; and encouraging shared knowledge for better public policy.

Mutual partnerships

The OECD undertakes global relations for several diverse reasons: to mutually influence policy development; anticipate risk; encourage responsible partnership and encourage significant economies outside the OECD area to engage more actively in its work. While the Organisation has specific programmes with Brazil, China and Russia (*see below*), other major economies such as India and South Africa participate actively in more general programmes and as observers or full participants in OECD subsidiary bodies. Over the past year, a trend has emerged in the Organisation's relations with these five major economies. The emphasis is moving beyond general co-operation activities to bringing these economies closer to OECD standards and disciplines.

The OECD has a long-standing programme of co-operation with transition countries in Europe, notably South-Eastern Europe, the Caucasus and Central Asia. Experience has demonstrated that partnering with local or regional organisations to undertake region-specific activities is important to ensure success. As the OECD strengthens its presence in Asia, its partnership with the Asian Development Bank has been critical to successfully implementing many of the Organisation's activities in the region. The Organisation agreed to host the Africa Partnership Forum, which should help strengthen its co-operation in support of NEPAD's objectives. A similar approach is used in Latin America where the Inter-American Development Bank is one of the OECD's key partners. Countries such as Argentina, Brazil and Chile are strongly engaged with the OECD. Chile successfully hosted the first meeting of the newly-created Global Forum on Education.

Global Forums

The OECD Global Forums provide a framework for dialogue on global issues that cannot be resolved by a single country or region. Currently there are nine Forums: sustainable development; knowledge economy (biotechnology and e-commerce); governance; trade; international investment; international taxation; agriculture; competition; and education.

Country programmes

During 2005, the Committee on Co-operation with Non-Members, under the supervision of the Council, launched a review of each country programme. The reviews are future-oriented, resulting in a framework to guide co-operation, and determine the priorities and objectives of each programme.

Brazil: The OECD is currently developing its framework for co-operation with Brazil. While this co-operation is supported by a relatively small country programme, relations are, in fact, anchored in Brazil's active and highly appreciated direct participation in OECD bodies as an observer or full participant. The emphasis on Brazil's participation in

subsidiary bodies encourages a peer-to-peer sharing of policy dialogue and the alignment of Brazil's policies to OECD standards. A third *Economic Survey of Brazil* is in preparation.

China: The new framework for co-operation with China points to the need to integrate China more directly into the work of OECD committees. Several committees, including the Statistics Committee and the Education Committee, have recently invited China to participate in their work as a regular observer. The country programme is focused on governance. Further adapting institutions and the functioning of the state to an increasingly market-oriented economy is crucial to maintain economic growth. Governance reform is required to address emerging strains related to rising inequalities and environmental deterioration, and to reduce widespread gaps between expenditure responsibilities and the fiscal resources available for provincial and lower levels of government.

India: Co-operation with India has been on-going since 1995 with India and the OECD co-hosting a number of important events. However, this relationship has intensified over the past year as the Indian authorities have shown a growing interest in OECD work and policy approaches. India has requested an *OECD Economic Survey* that has now been launched. Several OECD subsidiary bodies have included developing their relations with India as a key element of their pro-active outreach strategies. India was recently invited to become a full participant in the Steel Committee, a regular observer in the Committee on Statistics, and other requests from India for participation as an observer are currently under examination by the Committees concerned. While co-operation with India in the context of general global relations programmes such as the Global Forums is important, clearly, the Organisation can engage in a more fruitful, mutually beneficial relationship by working with India directly.

Russia: The Council adopted a new framework for the OECD-Russia Programme in February 2006. It should be noted that in 1996, the OECD and Russia agreed that Russia's accession was "the ultimate goal shared by both parties". To help achieve this goal, the Framework focuses the evolution of OECD-Russia co-operation towards bringing Russian policies and practices closer to the standards upheld by the OECD as best practice and embodied in various OECD instruments.

One of the key components of the programme of co-operation with Russia in 2007-2008 should be a follow-up to the regulatory reform review of Russia completed in 2005 and published under the title *Russia: Building Rules for the Market*. Its aims would be to strengthen the rule of law, secure property rights, increase the transparency and accountability of state institutions, and combat corruption. Other important issues to be addressed by the work programme are improving public budget management, the quality of the labour force and the development of its financial system. The sixth *Economic Survey* of the Russian Federation will be completed in September 2006.

South Africa: Co-operation with South Africa is undertaken through OECD support of NEPAD objectives as well as bilaterally. While no country programme *per se* exists with South Africa, it is active as a full participant or observer in ten different OECD Committees. In 2006, a review of South Africa's agriculture policies was published.

Regional initiatives

The OECD's global relations do not stop with the major world economies. Important regional initiatives also comprise an integral part of these relations and help foster the co-operation on important issues of mutual interest with a wide range of non-member economies worldwide.

Making Development Sustainable

REDUCING POVERTY THROUGH PRO-POOR GROWTH

For many countries and millions of people, the Millennium Development Goal (MDG) of reducing poverty by half by 2015 will not be met. There is progress, but getting closer to the target requires a significant increase in the rate of growth and its impact in reducing poverty. Going for growth is very important, but doing this without equal attention to the pattern of growth will reduce the impact of growth on poverty reduction.

Increasing aid and making it more effective

There will be more aid available from Development Assistance Committee (DAC) donors to support pro-poor growth (i.e. a rate and pattern of growth that increases the participation of the poor in the growth process). If donors live up to their public statements there will be around USD 130 billion of official development assistance (ODA) by 2010, compared to USD 80 billion in 2004. And the sharpest increase will be in Africa, doubling the amount of aid to the continent to some USD 50 billion by 2010 (see *Development Co-operation Report 2006*, Chapter 1).

We also know more about how to deliver aid more effectively, particularly important when scaling up aid by these magnitudes. The 2005 Paris Declaration sets out principles and how to go about implementing them in key areas such as supporting effective ownership by developing countries over their development policies, aligning assistance around their national development and poverty reduction strategies, harmonising donor procedures and managing aid for results (see www.oecd.org/dac/effectiveness/parisdeclaration).

How to spend increased aid to reduce poverty?

So, on what should we be spending these higher volumes of more effective aid to reduce poverty?

Economic growth is essential for, and frequently the major contributing factor to, reducing poverty.

However, the same rate of growth has often quite different impacts on poverty reduction, as the experiences of, for example, Senegal (high poverty reduction) and Burkina Faso (low poverty reduction) demonstrate. These differences relate to differences in initial conditions when growth was initiated (e.g. macroeconomic stability, the quality of governance, the investment climate) but also to the extent that governments have in place policies that increase the ability of the poor to participate in the growth process.

DAC work on the contribution of growth to reducing poverty, via its Network on Poverty Reduction (Povnet), includes the following policy guidance for donors (see *Promoting Pro-Poor Growth – Policy Guidance for Donors*, OECD 2006):

- Both the pace and the pattern of growth are critical for long-term and sustained poverty reduction. Rapid and sustained growth needs to be broad-based across activities and regions. Policies that address both pace and pattern together are likely to be more effective in reducing poverty. In other words, growth needs to be more pro-poor.
- Gender biases, inequality and risk and vulnerability need to be addressed. Higher growth does not necessarily lead to higher inequality, but high inequality can reduce the poverty reduction impact of a given rate of growth. Poor people often avoid higher risk opportunities with potentially higher payoffs because of their vulnerability, which can

reduce the rate of growth and the extent to which it is pro-poor. Women face particular barriers in these areas, related to access, assets and participation in the labour force, with consequent impacts on pro-poor growth.

- Market failures and weak access hinder pro-poor growth as they hurt the poor disproportionately. Markets that are important for the livelihoods of the poor need to work better and policies to this end need to be accompanied by measures to increase the economic capabilities of the poor so they can better participate in them.
- Past perceptions of policy dichotomies (e.g. as between economic growth and social policies) have been misplaced. These dichotomies are much less relevant when we look at both pace and pattern of growth interdependently and recall that poverty is multidimensional. Policy trade-offs do exist, but they can be better managed, particularly by focusing on the binding constraints, by careful sequencing, by looking to policies that are complementary rather than compensatory and by building institutional capacities to deal with the trade-offs.
- For pro-poor growth policies to emerge, the poor need to be better informed and empowered to take part in the policy-making process and to ensure such processes are evidence-based rather than based on narrow vested interests. For this, the state needs to be more accountable to the interests of the poor and to provide the opportunity for structured public-private dialogue.

Donors' role in a pro-growth agenda

For donors, the pro-poor growth agenda is not business as usual and more of the same will not be sufficient. At the policy formation level, donors need to focus on supporting in-country policy processes, they need to be responsive to country situations and they need to strengthen organisational capacities and incentives for field staff to empower them to negotiate, co-ordinate and implement programmes. It is particularly at the “sectoral” level – e.g. in areas important for pro-poor growth such as private sector development, agriculture and infrastructure, that a pro-poor growth lens on thinking and practice requires a rethinking of agendas and how to implement them, as illustrated by the following examples:

- *Private sector development* needs more attention to removing barriers to firms joining the formal sector and to impediments holding back women entrepreneurs, to strengthening the institutions behind policies (e.g. competition, tax, finance) and needs to focus on promoting market outcomes rather than targeting firms or sectors directly.
- *Agriculture* needs to move away from seeing the sector as synonymous with the farm, to take account of the different rural worlds in which poor people live and farm, and to make serious inroads into the risk and vulnerability that limits greater entrepreneurship in the sector.
- *Infrastructure* needs to be more country-driven and programmatic, contribute more to the pattern and not only to the pace of growth, to pay much more attention to maintenance and service delivery and to make real inroads into the barriers holding back effective public-private partnerships in provision and service delivery.

ACTIVE SOCIAL POLICY

Is social policy a burden on society, damaging the entrepreneurial spirit, discouraging work and savings? Worse, does it risk creating a culture of dependency among the beneficiaries of social programmes and their children? Or is it rather an investment in the future, which relieves fears about the impact of technology and globalisation on the lives of millions of OECD citizens and thus allows the adoption of policies that favour economic growth? These were some of the questions that lay behind the discussions of OECD social policy ministers when they met in Paris in April 2005. If economic growth has been the backbone for the large improvements in living conditions of OECD citizens in recent decades, growth alone is not enough. It has to be accompanied by social policies that look forward rather than backward, that recognise new problems and search for new solutions, and that are not hostage of an outdated model of social protection.

What is active social policy?

One term summarises well the nature of the challenge facing traditional social policies and the adaptation that is required: active social policies. What does it mean? In a nutshell, it implies that social policies cannot just compensate individuals against a few, well-defined risks confronting individuals during their working life and secure adequate income in old age through publicly-provided benefits. Active social policies are more ambitious. They encourage individuals to participate as fully as possible in economic and social life. They aim to change the conditions in which individuals develop rather than alleviating the distress these conditions cause. They shift away from the reactive, compensatory approach of the past toward putting the emphasis on investing in people so as to maximise their potential to become self-sufficient members of society.

Three key goals

In practice, active social policies give priority to three types of goals:

- *Giving children the best possible start in life.* Many social problems have their roots in childhood. Children who grow up in disadvantaged households are more likely to do poorly at school, to struggle to find a job, and to be unemployed, sick and disabled when they become adults. More generally, family instability can damage life chances, as can inadequate care. Giving children the best start in life calls for reforms to the tax and transfer system, childcare support, and help for working parents to reconcile their work and family responsibilities. The priorities are investing in children through early childhood intervention programmes, boosting maternal employment through reforms of taxes and benefits, and reconciling family and work responsibilities through a combination of childcare provision, parental leave and family-friendly workplaces. This set of interventions could also create more favourable circumstances for raising fertility rates, which are currently below replacement levels in most OECD countries.
- *Helping prime-aged individuals overcome barriers to quality jobs.* Getting the jobless into work and assisting the disadvantaged to acquire the skills to get higher pay are the best ways in which economic and social progress can be reconciled. The vicious cycle that goes from joblessness to loss of self-confidence, deteriorating skills, isolation, and exclusion needs to be broken – and the recent success achieved by many OECD countries in slashing some benefit rolls shows that it can be done with the right policies. The

progress achieved by some countries in integrating the unemployed into the labour force now needs to be extended to other groups, such as lone parents and those with disabilities, through greater emphasis on labour-market integration. But welfare-to-work policies are not enough. If benefit recipients are not only to get jobs but also to keep them and avoid poverty, welfare-in-work policies are also essential. For more socially disadvantaged individuals, alternatives to paid work in the open economy need to be found to encourage participation in social life, and to ensure that a culture of dependency does not take hold of children who grow up in families that are dependent for prolonged periods on welfare benefits.

- *Protecting the well-being of the elderly by enhancing their participation in economic and social life.* Pay-as-you-go pension systems have contributed to large improvements in the well-being of the elderly, but their increasing costs as OECD populations age threaten their financial sustainability and the capacity to invest in younger generations. The solution cannot be simply to reduce old-age pensions, as breaking the commitments on which people have based their retirement plans would undermine trust in government and put living standards in old age at risk. Pension reforms need rather to find a more realistic link between benefits, on one side, and the life expectancy and income of the working-age population, on the other. They need to encourage a longer working life by closing pathways to early retirement and correcting disincentives to work that are embedded in both public and private pension systems. Active social policies also need to address those barriers to work that many elderly face and to improve the quality of, and access to, long-term care, ensuring that family care responsibilities do not push people out of the paid labour force unnecessarily.

Huge potential payoff

The potential payoff of active social policy is huge: more and better jobs; lower reliance on transfer payments; more narrow distribution of market income. Because of these potential benefits, active social policies hold the promise of reducing the negative effects of social protection systems on economic growth. Implementing this agenda would not only better serve the “public good”, but would also reduce social isolation and exclusion, help individuals realise their personal goals, and provide them a more secure life in old age.

EDUCATION FOR ALL

Education for all (EFA), especially universal access to primary education by 2015, has been an agreed development goal since the World Conference on Education for All in Jomtien, Thailand in 1990. However a report from UNESCO in 2005 indicates that there are still 115 million children of primary school age out of school, of whom 53% are girls. The majority of these children live in sub-Saharan Africa and South Asia. The International Working Group on Education estimates that over half of developing countries are behind schedule and likely to fail to create universal primary education by 2015. There is, then, a pressing need for more action in favour of achieving this goal, as recognised by donors through, for instance, the expansion of the Fast-Track-Initiative (FTI) managed by the World Bank.

Improving completion rates

Universal access to primary education is, however, only part of the story; there must also be a focus on primary school completion which in turn highlights the importance of the quality of provision. Completion of primary school, which is a major problem in developing countries, is linked not only to the quality and relevance of the schooling provided but also to a number of other factors such as family poverty, the presence of school fees and other costs associated with attending school, for example transportation. As completion rates improve, access to secondary and tertiary education also becomes an important factor.

Improving completion rates will therefore require, among other things, systemic and cross-sectoral analytical, administrative and financial approaches to improve schools, teacher quality and training; family and individual support structures, such as health, transportation and parental education, as well as developing other educational opportunities at secondary level and beyond within a lifelong learning framework. Thus, focusing on primary education, while of central significance, is only a partial solution. Other sectors of education will need to be developed in order to provide further purpose in completing primary education and to improve the general level of a nation's education.

Challenge of reaching the poorest children

Reaching the poorest children is without doubt one of the biggest challenges. These include rural peoples, those from ethnic minorities, those with disabilities and those in conflict or post-conflict situations. There is also a paucity of quality data about these children covering almost every aspect of their lives. For instance, few studies have been carried out gathering reliable data on the prevalence of children with disabilities, making systematic planning and investment for necessary education, health and other services impossible.

For these groups, effective education and completion of primary school is especially hindered by large classes, low-quality teaching and teacher training, inaccessibility of schools, poor health, poverty and lack of perceived relevance of school to parents.

How the OECD contributes

Building on its current expertise, and bearing in mind the issues introduced above, the OECD has focused on approaches intended to strengthen understanding by nationals of

the systems in which they work, and to identify key areas where reforms are needed with the intention of strengthening both access and completion rates.

There has been a particular focus on disadvantaged groups. Work has been carried out in Africa, Latin America and the Caribbean, Asia and South East Europe.

The following themes have been especially significant in this work:

- Strong collaboration with development agencies and national ministries on a regional basis with a focus on understanding the nature and extent of the challenges to be faced and by improving quality across the education sector to increase enrolment and completion rates.
- Policy development – through the preparation of country reports prepared by administrators in national ministries and through peer reviews. These are intended to raise awareness of the functioning of the system and, through discussion and analysis, to identify areas where there are weaknesses and methods to address them.
- Building further capacity in national ministries for data gathering and development alongside the creation of relevant indicators, especially in the field of special education, to strengthen policy making.
- Strengthening the skills of teachers through in-service education to identify children experiencing difficulties in learning and providing appropriate adapted teaching, thus improving the quality of provision for all students including those from disadvantaged backgrounds and those with disabilities.
- Bringing together administrators and teachers to establish a common understanding of the challenges faced and to develop joint solutions especially in the dissemination of relevant knowledge and skills to other teachers.
- Promoting quality assurance, accreditation and the recognition of qualifications in tertiary education. This has been pursued through developing guidelines in cross-border higher education in both developed and developing countries. These recognise the different responsibilities of governments, higher education institutions and students, as well as of accreditation, academic and other professional bodies.

Reaching the goal of education for all

If education for all is to be achieved at all, let alone by 2015, greater attention will need to be paid to understanding, supporting and resourcing countries who are lagging behind. The expansion of the Fast-Track-Initiative is a step in the right direction.

Education ministries will have to clarify their legal frameworks and policies in order to meet the needs of the disadvantaged and to give full consideration to how secondary and tertiary education function. In addition, learning in a lifelong perspective should be reformed to meet the EFA goals. In order to reach these essential goals, the OECD will continue to provide its expertise to support development decision-makers on a bilateral and a multilateral level.

FOCUS ON WATER

Securing safe, reliable water and sanitation services for all is essential in reducing poverty and making development sustainable. Over 1 billion people worldwide lack access to safe water and 2.6 billion people are without access to adequate sanitation. About 80% of diseases in developing countries are water-related, leading to an estimated 1.7 million deaths each year.

To tackle these challenges, countries agreed through the Millennium Development Goals (2000) and commitments at the World Summit on Sustainable Development (2002) to halve the number of people worldwide without access to safe water and sanitation by 2015. Achieving these goals will not be easy, but with reliable financing and proper management of water resources they will be possible.

Water management challenges

All but a few OECD countries have connected close to 100% of their populations to safe water supplies, and the majority are connected to wastewater treatment. Challenges remain, however, among them managing water resources in OECD countries in such a way as to ensure sufficient quantities of clean water to support human needs and essential ecosystem functions, and to tackle the pollution and depletion of groundwater resources.

While most OECD countries have a well-established system of water charges for households and industry, measures are needed in some countries to address concerns about the financial burden of water charges on poorer segments of society. Subsidies to agricultural water use – which accounts for about 50%-75% of total use – remain common in all OECD countries, and exacerbate water problems. Furthermore, most OECD countries will face a significant financial challenge over the next 20 years to renew ageing water services infrastructure.

Sustainable water financing

The challenge is greater still in developing countries. Stable financing is needed to expand water supply and sanitation services to those without access. Over the longer term, a sustainable financing system should rely primarily on water user charges to cover operating and maintenance costs, with provisions for affordable access by the poor. But initial investments in infrastructure development and expansion might be sourced from public spending, international development assistance, and private financing.

Private sector water operators have reduced their activities in many developing countries in recent years, because the financial and political environment is too risky. For the near future, most public-private water partnerships are likely to focus on OECD and emerging market economies, where framework conditions for foreign investors are more stable.

Total official development assistance (ODA) commitments to the water sector amounted to almost USD 4 billion in 2003-2004. This represented an increase over previous years, reversing the declining trend seen since the 1990s, but allocations to the water sector have fallen from 9% of total ODA commitments in 1999-2000 to 6% in 2003-2004. Furthermore, most water-related ODA is targeted to just a few recipients, with little going to those who need it most. Only 15% of bilateral aid to the water sector allocated in 2000-2004 went to recipients in Sub-Saharan Africa.

Good Governance

BETTER REGULATION FOR BETTER CORPORATE GOVERNANCE

By assessing the economic impact of corporate governance regulation, governments can restrain the tendency to unnecessary regulation and the associated unintended consequences that may hinder rather than help sound financial markets and good business practices.

Corporate governance inadequacies are usually associated with spectacular corporate scandals. These events always cause heated debates and often result in new laws and regulations. While regulatory improvements have been necessary, corporate governance is about much more than just mechanical compliance with a set of rules. It is about value creation. It is about the tools that shareholders, boards, managers and others need in order to build competitive enterprises. More should be done to improve understanding of the economic implications of different kinds of corporate governance practices.

Challenge of developing good regulation

Current experience confirms that the OECD will need to intensify its efforts to promote an exchange of experiences about applying the OECD Principles of Corporate Governance in practice – what works and what does not. The question is not whether there should be more or less regulation. The challenge is to have good regulation that gives investors and corporations the conditions they need to develop dynamic and competitive enterprises that enjoy the confidence of the financial markets.

To ensure that the OECD's work in the area of corporate governance remains relevant, it continues to involve practitioners. One example is a forthcoming "Boardroom Guide to the OECD Principles of Corporate Governance", which is being developed by a high-profile group of boardroom leaders and experts. The Guide is written by the private sector for the private sector and provides practical advice on how to meet the standards that are set out in the OECD Principles.

Corporate governance of state-owned enterprises

But not all companies are private. Some are government-owned. And that is why the OECD in 2005 issued the Guidelines on Corporate Governance of State-Owned Enterprises. Considering the size of the state-owned sector in many countries, better corporate governance can lead to significant reductions in the burden on public finance, better services for consumers, increased transparency and a level playing field between state-owned and private sector companies. Better corporate governance of state-owned enterprises is also an important step in the privatisation process, affecting privatisation revenues and the overall conditions for economic growth.

Ensuring implementation

The challenge now is to ensure that the Guidelines for State-Owned Enterprises are also implemented. For that purpose, the OECD is developing practical guidance on privatisation and better corporate governance of state-owned enterprises. This "how to" manual will contain first-hand experiences from both OECD and non-OECD countries in areas such as performance measurement and value creation in state-owned enterprises; the link between corporate governance and privatisation; how to nominate and evaluate boards of state-owned enterprises; and how to improve transparency through better reporting.

MOBILISING INVESTMENT AND MODERNISING GOVERNMENT IN THE MENA REGION

During the past year, the OECD has expanded significantly its relationship with countries in the Middle East and North Africa (MENA). The MENA-OECD Initiative on Governance and Investment for Development, led by MENA governments and supported by the OECD, has succeeded in creating regional networks of policy officials, in bringing those officials into contact with their OECD counterparts, and in promoting the development of national reform agendas. It is an inclusive Initiative, bringing together international organisations such as UNDP, the World Bank, and UNIDO; the EU; and regional bodies such as the Arab League, Islamic Development Bank, and Arab Monetary Fund. The private sector and NGOs have also been active participants.

The Initiative consists of two programmes: **Governance for Development**, aimed at modernising public governance structures and processes; and an **Investment Programme**, aimed at improving investment climate and policies. Both are carried out through a series of Working Group meetings, each chaired by a MENA country and co-chaired by an OECD country. The Working Groups cover such areas as investment policies, regulatory reform, budget and public finance, corporate governance, tax policies, judicial systems, civil service reform and integrity, e-government, financial markets and relations with media and NGOs.

National Action Plans

After a brief survey phase, each of the participating MENA countries is drawing up a National Reform Action Plan with concrete, time-bound objectives. Progress in implementation will be reviewed in the Working Groups and two Steering Groups. In some cases, implementation can be effected through rather straightforward policy changes; in others, significant programmes and resources may be required. In the latter cases, international and national assistance agencies have signalled their willingness to consider providing financial support.

To mark the first anniversary of the Investment Programme, ministers and senior officials from MENA and OECD countries met in Jordan in February 2006 to discuss national and regional action plans and to agree to a Declaration on “Attracting Investment to MENA Countries – Common Principles and Good Practice”. The Governance for Development Initiative, after its launch at a ministerial meeting in Jordan in February 2005, was holding a meeting of its Steering Group at ministerial level in Egypt on 20 May 2006 to discuss national action plans, regional co-operation, and the work plan for the next phase.

Expanding the MENA-OECD Initiative

There is considerable interest among the OECD’s MENA partners in stepping up and expanding the work of the Initiative. Egypt has succeeded Jordan as Chair of both the Investment and the Governance Programmes. Jordan’s essential leadership in launching this Initiative has been appreciated by all participants. Bahrain has created a regional Centre for Investment and the UAE has established a regional Institute for Corporate Governance to support the work of the Initiative. Morocco, Tunisia, Egypt, Jordan, Lebanon, Saudi Arabia, Bahrain and the UAE all chair Working Groups and other MENA countries are active participants.

FOSTERING ENTREPRENEURSHIP

Entrepreneurship policies are critical to structural reform in OECD member economies. Policies to promote new firms and foster the growth of small and medium-sized enterprises (SMEs), as well as policies to encourage self-employment are usually developed with one of two objectives: stimulating economic growth by improving productivity performance or addressing labour market disadvantage. Policies are required that will provide an entrepreneurial business environment, develop an entrepreneurial culture, facilitate SME access to financing and strengthen the science-innovation interface.

Entrepreneurial environment and culture

The institutional environment should be conducive to entrepreneurship and facilitate entry, growth, transfer of ownership and smooth exit of enterprises. The design and implementation of policies for competition, international trade and investment, financial markets, labour markets and education should take account of the impact on SMEs.

Regulatory frameworks affecting SMEs should entail low compliance costs, the transparent and equitable application of rules and legislation, simple and transparent license and permit systems, efficient bankruptcy laws and procedures, understandable and coherent product standards in world markets, clearly defined property rights, fair and reasonably priced dispute settlement procedures, and light, predictable administrative procedures.

Integration of entrepreneurship teaching at all levels of the formal education system will facilitate the development of a culture that promotes entrepreneurship. Entrepreneurship education should support both the development of both entrepreneurial individuals and mindsets in the general population and technical business management skills in potential entrepreneurs. Particular attention is required to train teachers in providing entrepreneurship education.

Women often face particular barriers in enterprise creation and growth, related to attitudes in society and constraints in financing businesses. The gender dimension must be considered in the design of policies to promote entrepreneurship.

Fostering SMEs

SME financing gaps may arise from agency problems, asymmetric information, and other market and policy imperfections. Many OECD countries have partial gaps, which tend to be severe, especially in early-stage firms. However, financial gaps are more pervasive in emerging, transition and developing economies. Innovative approaches should be adopted to overcome constraints and diffuse viable solutions in SME financing through debt and credit, and through risk-capital. The financing gaps can be mitigated by a range of actions including enhancing guarantee funds and making better use of related public funds, bolstering early stage finance to innovative SMEs, improving the exit environment for venture capital, encouraging SMEs to join the formal sector, expanding micro finance, and increasing financial awareness and competence among SMEs. Public programmes should be guided by the principle of risk-sharing.

Strengthening the science-innovation interface will support the development of high growth and innovative SMEs. Incentives to higher education institutions need to be adjusted in order to encourage them in activities to transfer knowledge to SMEs.

TRANSPARENCY AND TAXATION

The liberalisation and increasing integration of financial markets have contributed to global growth, paved the way for greater financial innovation and facilitated international commerce. At the same time, these developments have opened more avenues for those who wish to abuse the financial system for illicit purposes, including tax abuse.

Financial and tax crimes thrive in a climate of secrecy where normal good governance measures are undermined by lack of transparency and a failure of financial centres to co-operate effectively with the law enforcement agencies and tax authorities of other countries. Governments have responded to these threats by developing legislation to detect and deter financial crimes and by strengthening their law enforcement and tax enforcement capacity.

Towards a level playing field in transparency and information exchange

The OECD launched its effort to address the problems raised by tax havens in 1998 as part of a broader initiative to counter harmful tax practices. Key features of this initiative are promoting transparency and effective exchange of information on tax matters. More than 60 countries are now working towards a level playing field in the areas of transparency and effective exchange of information so that illicit activities do not simply shift from countries with high standards to countries with low standards.

Enhancing co-operation to combat financial crime

Given the similarities of the techniques used for tax crimes, money laundering and terrorist financing, experts specialising in the detection and investigation of these crimes can greatly benefit by working closely together and sharing best practices. The OECD and FATF are best placed to facilitate co-operation between national tax authorities and anti-money laundering authorities. OECD countries now regularly share the latest investigative techniques used to counter financial crimes and are currently analysing the benefits of joint operations in combating these crimes in certain high-risk areas.

Putting tax compliance on the good governance agenda

Tax and corporate governance issues can intersect in several different contexts. It is important to ensure that tax rules do not inadvertently encourage behaviour that is contrary to good governance such as by permitting the deductibility of bribes (today all OECD countries deny the tax deductibility of bribes to foreign public officials). Corporate governance issues also arise in the context of the transparency and accountability of boards of directors in assessing the financial and reputational risks associated with their tax strategies.

In each of these inter-related areas, OECD countries are leading by example. National measures are reinforced by multilateral action to develop and implement high international standards. The G7, G20 and the EU have consistently supported the initiatives taken by the OECD.

TRUST IN GOVERNMENT

Public trust in government is a prerequisite for effective public policy, a healthy democracy and a thriving economy. Accumulated trust is capital for governments to invest in the necessary reforms to foster economic and social development. But this capital can evaporate very quickly, as many governments have learned. A decline in trust can also lead to higher transaction costs, driving up the cost of government.

Maintaining trust

To maintain trust, governments need constantly to adapt to meet the changing needs and expectations of citizens and businesses. In November 2005, OECD ministers identified a number of actions to boost public confidence, including promoting openness, integrity, responsiveness, accountability and transparency. They also highlighted the need to continually improve the performance of government, essential to ensuring competitiveness in today's globalised world.

New work on public governance

This ministerial mandate, which will guide OECD work on public governance in the medium term, has resulted in several new lines of work:

- Measuring the public sector for international comparison.
- Giving citizens and business a greater voice in policy making.
- Integrating risk assessment and management into policy development and delivery; and
- Strengthening coherence and co-operation among levels of government for quality public services.

The four lines of work will draw on different policy areas, *e.g.* budgeting and public expenditure, public sector employment and management, regulatory reform, e-government and integrity. They will strengthen the empirical base for benchmarking and the development of policy instruments of good public governance.

Sharing expertise

Demand for the public governance expertise of OECD countries is rapidly expanding to facilitate both domestic development and integration into the world economy. The OECD is engaged with key partners in China, Russia, the Middle East, Latin America and transition countries in Central and Eastern Europe.

FIGHTING CORRUPTION AND PROMOTING INTEGRITY

The detrimental repercussions of corruption on economic growth, competition, social cohesion and government are now widely recognised. The OECD has been at the forefront in combating corruption by helping governments and civil society take action to prevent, detect and sanction bribery and by promoting integrity in the public service.

Combating bribery of foreign public officials

The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, together with its ongoing peer review process, represents a landmark in international co-operation to fight bribery. The Convention provides an international benchmark for anti-corruption efforts worldwide. Its in-depth review mechanism distinguishes it from other anti-corruption conventions, including the United Nations Convention against Corruption (UNCAC). Rigorous and comprehensive country reviews have proven to be a powerful impetus for change. Many of the 36 Parties to the OECD Convention have strengthened their legislation following recommendations by the OECD Working Group on Bribery. The Convention and the 1997 Revised Recommendation of the Council on Combating Bribery in International Business Transactions have thereby helped to raise national standards in the fight against corruption and to level the competitive playing field for companies doing cross-border business. Nevertheless, much remains to be done. Some Parties have yet to fully and effectively implement the standards set in the Convention and the 1997 Revised OECD Council Recommendation. In addition, major non-OECD economies are not yet Parties to the Convention.

Preventing conflict of interest in the public service

To maintain citizens' trust in public institutions, OECD countries have made significant efforts to review and update their arrangements for preventing and managing conflict of interest in the public service. A progress report requested by the OECD Council on implementing the 2003 OECD Recommendation on Guidelines for Managing Conflict of Interest in the Public Service found that three-quarters of OECD countries had enhanced their standards, in particular in codes of conduct and regulations. The report also identified emerging challenges at the public-private sector interface, calling for guidance in high-risk areas such as lobbying and post-public employment.

What are the next steps?

Maintaining and improving the most relevant and widely-respected international anti-bribery standard are among the OECD's priorities. This will involve: i) a revision of the 1997 Revised Recommendation; ii) accession of new countries to the Convention; iii) continued monitoring by the Working Group on Bribery and iv) innovative approaches to enhance law enforcement capacity and know-how in dealing with foreign bribery cases.

In parallel, practical guidelines and policy principles will be developed to provide governments with a framework for regulating, lobbying and post-public employment. Finally, the OECD will explore creative avenues of co-ordination in applying the international anti-corruption frameworks, notably UNCAC, to ensure optimal co-operation within national governments and between them.

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