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Going for Growth: OECD structural surveillance

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Let me first tell you how delighted I am to participate in this Czech Seminar and tell you a few things about how structural surveillance is evolving at the OECD.

As you all know, we do a lot of structural surveillance on a country-by-country basis, with reports such as the Czech survey. But there is also a lot of transversal cross-country work being done in the OECD and especially in the Economics Department. Until recently, however, a lot of this good analytical work did not fully translate into concrete policy recommendations.

What we started to do only recently is “benchmarking surveillance”. That is, comparing economic performance across OECD countries as well as the quality of structural policies. Comparing, in order to push each Member country to do better. I would even say comparing in order to shame countries into doing better. This new surveillance is encapsulated in a publication called “Going for Growth”, which we launched last March.

Benchmarking surveillance fits very well with what in essence the OECD is. I have indeed a two-word definition of the OECD. That is a “convergence club”. A place where policy-makers from various countries meet together to spot best practice and emulate proactively good examples. This is at least what good policy makers should do to boost long-run economic convergence in their country. That is, convergence in terms of GDP per capita.

Unfortunately the “convergence club” has not so far delivered sufficient convergence. Indeed, economic catch-up started to stall during the 1980s and degenerated into relative decline during the 1990s (Graph 1). Today GDP per capita in France, Germany or Italy lingers 30% below US levels and, on current trends, this gap will widen over the foreseeable future. Overcoming Europe’s relative decline will be hard to achieve in a context where ageing will exert a strong depressing influence on GDP per capita.

Assessing the extent to which one is lagging behind is of course rather unpleasant, even more so if the gap is worsening. And the natural temptation is to minimise the significance of the comparison. In the end, aren't we all unique and truly incomparable! And so proud of our own way of life, which is worth so much more than a mere GDP per capita estimate. For instance, Europeans may have a stronger preference for leisure but the increased welfare associated with more leisure is not recorded in GDP statistics. In this case, benign neglect in the face of a low GDP per capita could be warranted.

This reticence in the face of potentially misleading comparisons is not without legitimacy. And it needs to be taken seriously. But recent methodological progress in the art of benchmarking can be of help.

The OECD has now developed a diversified set of structural policy indicators. When tested econometrically, they explain economic performance fairly well. It then becomes easier to understand what lies behind comparatively low GDP per capita. And to find out what reflects bad policies as opposed to legitimate societal choices. If it turns out that low GDP genuinely reflects weak policies, then ignoring international comparisons becomes a fault.

In sum, with *Going for Growth* the OECD is moving beyond a superficial form of benchmarking, that only focuses on apparent performance. Instead, we are engaging in “deep benchmarking”, focusing on policies and on how they influence performance.

I. Where do Europe’s problems lie? What does benchmarking reveal?

The starting point, here, is a set of *performance* indicators, such as GDP per capita and its main components: labour utilisation and labour productivity. These components are in turn subdivided. For instance, labour utilisation indicators are broken down into overall rates of employment and number of hours worked per employee. Overall rates of employment are themselves split into employment rates by age group: between 25 and 55, above 55, etc.

In addition, we have built *policy* indicators. In the first edition of *Going for Growth*, these indicators span labour and product markets, as well as education and taxation. The range of indicators will be broadened over time, and this time, in the second edition, it will also include innovation policies. To give one example, our labour market indicators include measures of the stringency of employment protection legislation, of the implicit tax on continued activity, of the tax wedge on labour income and of the relative cost of unskilled labour.

These performance and policy indicators can be put to various uses:

- They can help produce a “group diagnosis” for the OECD as a whole and for large regional blocks. This shows Europe’s performance lagging behind the US one both in terms of productivity and labour utilisation, with a huge gap in labour utilisation (Graph 2). It also suggests that while in recent years substantial progress may have been achieved in increasing competitive pressures on product markets, this is not the case with labour market reforms (Graphs 3 and 4).
- The indicators can also help yield a better and deeper understanding of issues. Consider the indicators relating to the employment rate of ageing workers. In my view, they provide a graphic illustration of how to link structural policy indicators to economic performance.

As noted, Continental Europe lags behind in terms of GDP per capita largely because of a low rate of labour utilisation, and, more specifically, because the labour force participation of ageing people is weak. The over 55 are basically absent from the labour market whereas they are still very active in Asia, North America and other English-speaking countries, as well as in Nordic countries (Graph 5).

Beyond these uncontroversial statistics, however, how should low labour utilisation on the Continent be interpreted? Is it a reflection of different cultural choices, a better way of life? Or does it stem from misguided policies hampering labour supply?

To shed light on this debate we have computed indicators of the “implicit tax on continued activity” (Graphs 6 and 7). This tax represents the income forgone by a person who continues to work instead of joining publicly-sponsored pre-retirement schemes.

The troubling fact is that in those countries where the implicit tax is high, the participation rate of ageing workers is generally well below the OECD average (Graph 8).

To evaluate more precisely the labour disincentives produced by these implicit taxes, we have simulated what would happen in a state of the world where social and pension systems are neutral with respect to labour supply all across the OECD.

Strikingly enough, we find that in the absence of biased public policies, the French and the Germans may wish to work as long as their American or Scandinavian counterparts (Graph 9).

This is the OECD's contribution to the ongoing debate between Ed Prescott on the one hand and Olivier Blanchard and Alberto Alesina on the other. Prescott's work suggests that excessive marginal tax rates explain low labour utilisation in Europe while the guys in Cambridge, Mass., see differences in societal choices. Prescott is using effective marginal tax rates to put his case. We are saying that high implicit marginal tax rates, associated with various social transfers, are also very important. Pension systems being a case in point. Bad policies matter.

II. Policy priorities for Europe

Benchmark indicators can help design priorities for action for individual countries as well as the EU at large (Table 1).

Let me remind you first of our assessment of the progress achieved over the past five years:

- On the positive side, a significant move toward more flexible and open product markets, thanks largely to good work carried out in Brussels. This should contribute to higher productivity gains in the future.
- Less encouragingly, not enough progress as regards labour markets. While in certain areas such as pension reforms some progress has been achieved, in other crucial areas such as employment protection legislation, inaction has been the rule.

In the large continental EU economies, boosting the low overall rate of labour utilisation is the main challenge. Based on our indicators, the main policy priorities to improve labour utilisation in large European countries include:

- Strengthening work incentives by reducing the tax wedge on labour income and the implicit tax rate on continued activity.
- Better protecting employment prospects by increasing flexibility in wage setting and bargaining. Great care should be taken in particular not to increase further the cost of unskilled labour.
- Alleviating the “insiders/outside” syndrome by loosening employment legislation protection.

- Lowering the obstacles to geographic labour mobility, by enhancing the portability of accrued pension rights and other benefits, could contribute to reduce unemployment in some regions (Graph 10).

We also identify the scope for raising labour productivity. Here, as mentioned, product market regulation reforms have already moved in the right direction. In the EU countries these gains have been largely driven by the implementation of EU directives, mostly in the context of the Single Market initiative. But more product market reform is needed:

- Earlier reforms to the Common Agricultural Policy have been significant, but the overall level of assistance is still too high (Graph 11). Further reducing producer support is thus needed.
- In network industries, competition is still undermined by a dominant incumbent in some sectors. Competition policy should do more to reap the potential gains from liberalising network industries. The scope for improvement could be substantial. Notably in the electricity sector, where the dispersion of prices for industrial use among EU countries is large (Graph 12).

- Many obstacles are still preventing the realisation of a single market in various service sectors. In this context, pushing ahead with the draft EU services directive – otherwise known as the Frankenstein directive – would be desirable, if politically arduous.

To raise productivity in Europe it will also be important to increase spending on R&D and tertiary education. Here what is needed is more privately funded R&D as well as more private funding of tertiary education.