

Boosting incomes and jobs: The OECD strategy

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1. Introduction

I am delighted to be here in New Delhi to tell you about the OECD approach to boosting incomes and jobs. The OECD is perhaps best defined in two words, namely as a “convergence club”. That is, the place where policy makers from a wide variety of fields meet together to learn from each other and to emulate best practice. Emulating best practice is how economies that are lagging behind can achieve economic convergence. The objective, as stated in our founding Convention, is for all members to achieve vigorous and sustainable economic growth. And for those where living standards are lower to catch up.

Over the past two decades, however, we have not seen enough convergence within the OECD club. Trend growth has improved in some OECD economies. But at the same time, Japan and large Continental European economies have tended to fall further behind the best performers in terms of GDP per capita (**Slide 1**). With demographic ageing hurting Europe and Japan more than North America, the risk, looking forward, is one of accelerating divergence across the OECD.

Faced with this lack of convergence challenge, the OECD felt it had to take a more proactive role in promoting economic reforms. As a result, two years ago, we launched a new flagship publication called *Going for Growth*.

With *Going for Growth*, the OECD inaugurated a new type of economic surveillance, the so-called benchmarking surveillance. It is based on cross-country comparisons. We try to compare the quality of structural policies using national indicators which capture the thrust of these policies. These are indicators of labour market policies, product market policies, and so forth.

Once we have constructed these policy indicators, we test for their influence on economic performance. For each OECD member, we can thus use these policy indicators to identify areas where policies are weak and need to improve. This is by no means a mechanical exercise. You still need to apply good judgement and rely on country experts, who know local institutions and national idiosyncrasies.

This *Going for Growth* exercise has allowed us to put forward a number of policy lessons that I would like to share with you today. One may of course wonder to which extent this benchmarking exercise holds policy lessons for a large, emerging country like India. After all, the argument goes, many of the economic challenges India is facing today differ from those facing the more advanced OECD countries.

However, not all OECD countries belong to the club of mature economies. Several of our members are actually middle income, emerging countries, such as Mexico, Turkey and several central European countries. And even among our richest member countries, policies and institutions can be very different. Despite all these differences, it is striking to observe how much OECD countries still manage to learn from each other. In fact, we are all catching-up economies. So India itself may perhaps find lessons to learn, positive or negative, from OECD experience.

These opening comments may hopefully shed light on the general philosophy of our approach to economic surveillance. Let me now guide you into our main findings. I will proceed in four steps:

- First, briefly describe our methodology.
- Second, sum up our main findings as regards the policy determinants of productivity and employment.
- Third, draw on these lessons to discuss some of the policy challenges facing India today.

2. The OECD approach to economic surveillance and benchmarking

As a starting point, the surveillance assumes that GDP *per capita* is a reasonable proxy for well-being. We then break it down into labour utilisation and labour productivity (**Slide 2**). These components are in turn subdivided. For instance, labour utilisation is broken down into rates of employment – *i.e.* the share of persons at work – and number of hours worked per employee. Here, it appears, for instance, that Continental Europe has a large deficit in terms of labour utilisation. The question is then: is it a problem or not? After all, working less may be part of the good life.

The next step is to relate each of these sub-components of GDP per capita to policies. To this end, as I already said, we have designed our own policy indicators, dealing for instance with labour and business regulations. And we have carried out extensive empirical analysis to gauge their effects on the components of GDP. Moving back to the European example, one can thus wonder whether low labour utilisation might not be the consequence of a stronger preference for leisure compared with, say, the United States. But our own research suggests that in Europe many misguided policies have tended to drive people out of labour markets. So, in many respects, low labour utilisation in Europe reflects bad policies. In the end our methodology looks like a medical investigation. We look first for symptoms, in terms of performance. Then, we look for viruses: bad policies.

Let me now discuss our key policy findings. Regarding, first, the impact of policies on productivity. And, second, regarding the policy determinants of employment.

3. The policy determinants of productivity

Past experience has taught us a lot about what policies can do to enhance productivity.

Good macroeconomic policies matter

OECD research finds that low and stable inflation, well-developed financial markets and a low tax burden increase productivity through various channels.ⁱ A good and stable macroeconomic environment tends for instance to boost investment and R&D spending, which in turn stimulate productivity.

Public infrastructure

Public expenditures pursue a variety of aims, many of them unrelated to growth. Empirical research nonetheless suggests that public investment in infrastructures does increase productivity and growth.ⁱⁱ

Human capital

Another source of growth is “human capital”. Its role has been well-documented by the empirical literature over the years. Our own researchⁱⁱⁱ suggests for instance that a one-year increase in the average

number of years of education can raise GDP per capita by 4 to 7 percentage points in the long run. **(Slide 3)**

It seems that human capital makes it easier to reap the benefits from technological progress. Better education not only benefits those who went to school but also those who work with more educated people. We therefore encourage governments to subsidise primary and secondary education, at least up to a point.

Public spending on tertiary education may also be needed, but future graduates who will often earn a lot of money should contribute to finance their own studies to a significant extent.^{iv}

Labour regulation

It may not be intuitive at first, but labour regulation also matters a lot for productivity growth. Here I have in mind things such as hiring and firing laws.

If too stringent, labour regulation raises the cost of adjusting the workforce. This may then slow down the adoption of latest production techniques, because these typically require work-place reorganisation and substantial changes in the composition of the workforce. Lack of flexibility may be particularly costly when firms have to adapt to major technological innovations. This is at least what OECD research suggests.^v Labour regulation is typically less strict in English-speaking OECD countries than in most continental European ones **(Slide 4)**.

In this context, it is important to note that differences in labour regulation may help explain why some countries coped better than others with the emergence of new information and communication technologies (NICTs). It is clear that English-speaking and Nordic countries have benefited more from NICTs than large continental European ones, where labour regulation is much stricter.

Business regulation

Another key factor for productivity is the degree of competition in product markets. At the OECD, we built indicators to assess the stringency of anti-competitive regulation. These indicators try to capture barriers associated with state control of companies and state involvement in business operations. Here I am talking about barriers to start-ups, administrative opacity, barriers to competition and so forth.

Product market competition has many benefits for productivity. It improves the allocation of resources across industries. It also puts pressure on managers to reduce inefficiency and waste at the firm level. Perhaps even more importantly, competitive product markets help disseminate best production techniques. Ordinary firms are thus better able to catch up towards leading firms, those that are at the “technological frontier”.

Based on our indicators, English-speaking OECD countries and a number of small European countries have fairly competitive product markets. By contrast, product markets remain more regulated in large European countries, not least in services sectors **(Slide 5)**.

What is true at the firm level also holds for a country as a whole. Lightly regulated countries incorporate best production techniques more quickly than others.^{vi} It is therefore no coincidence that lightly regulated countries have enjoyed a pick-up in productivity growth during the 1990s, while countries with more pervasive anti-competitive barriers have experienced a productivity slow down **(Slide 6)**.

Trade openness

Openness to international trade is another factor that can facilitate dissemination of best practice and allow for faster productivity catch-up. Trade openness has in practice the same beneficial effects as more open product markets.

In order to quantify concretely some of the gains from liberalisation, we recently tried to evaluate the benefits that would arise from a large reduction of the barriers still inhibiting trade, foreign direct investment and product market entry in the OECD area.^{vii}

We began by identifying across the OECD the countries which have, in one sector or another, the most flexible regulatory framework. And computed what would happen if every country aligned itself on “best practice” so defined.

The barriers that were relaxed in this thought experiment comprised:

- Business regulation, which I have already discussed.
- Tariffs, including for agriculture (**Slide 7**).
- Obstacles to FDI (**Slide 8**)

We found that this reform package could lead to gains in GDP of up to 4 to 5 per cent in OECD countries. And this is clearly a lower bound, because we left aside non-tariff public interventions in agriculture, and all labour and financial market regulations.

4. The policy determinants of labour market performance^{viii}

Let me now turn to labour market performance. This is one major area of OECD expertise. Perhaps our most publicised work has been the so-called *OECD Jobs Strategy*. It is a set of policy recommendations to increase employment in OECD countries, which was first published in 1994. It has been key in shaping the reform agenda in OECD member countries. And it has been revisited this year.

The main conclusion from this work is clear-cut. In order to increase employment, governments need to increase labour supply and labour demand at the same time.

Labour supply (the workers' side of the market)

In this area, it is essential to get work incentives right. And, in particular, tax incentives. When labour taxes are high, they often lead to lower after-tax wages. This discourages work and pushes people into the informal sector, where you do not have to pay labour taxes. High labour taxes are typically found in continental European OECD countries, while they are comparatively lower in English-speaking ones (**Slide 9**).

High labour taxes are perhaps less of an issue for prime-age male workers, since they often have to work to make a living anyway. But it can be a problem for more marginal groups in the labour market, such as young people and females. When formal work does not pay because labour taxes are high, young people can choose to stay in education, and women can decide to stay home. For instance, our research shows that high labour taxes on married women keep them out of the labour market.

Older workers are also sensitive to tax incentives. In many continental European countries, continuing to work beyond your late 50s does not pay, often because you can receive some form of early retirement benefit if you leave the labour market immediately. These work disincentives differ widely across OECD countries, however (**Slide 10**). But the evidence is clear: where these disincentives are high,

as in a number of continental European countries, older workers leave the labour market prematurely (**Slide 11**).

More broadly, in order to provide adequate work incentives, governments need to design their welfare systems carefully. For instance, our research finds that high unemployment benefits that are available for a long duration reduce employment. Especially so when the unemployed do not have a strong obligation to look for jobs.

Labour demand (the employers' side of the market)

In addition to getting the incentives to work right, it is necessary to ensure that companies are ready to hire those who are ready to work. This largely depends on the cost of labour. At the OECD, we focus on various cost elements, including wages and taxes paid by employers, as well as costs related to labour regulation.

Taxation and wages

As a general rule, in order to achieve high employment, wages need to be in line with productivity. Wage determination is primarily the responsibility of the social partners: employees and employers. OECD countries have adopted different institutional arrangements for wage bargaining, depending on their history and tradition for social dialogue.

However, some systems work better than others. Very decentralised bargaining, such as in the United States, has been associated with full employment. Systems in which wages are set for an entire sector or an entire region, which prevail in a number of continental European countries, have been less successful.

Another key issue in wage setting is the level of legal minimum wages. The employment consequences of a minimum wage obviously depend on its level. If the minimum wage is kept moderate, it will not destroy jobs. But if it is high and binding, it will reduce the chances of low productivity workers to find work. We therefore emphasise the need to ensure that minimum wages are set at levels that do not harm job creation.

In several OECD countries, the cost of unskilled labour is high due to elevated taxes on labour and strong minimum wages (**Slide 12**). When this is the case, the evidence is unambiguous. High payroll taxes increase labour costs, reduce labour demand and therefore destroy jobs. Especially for low-productivity workers in countries with high minimum wages.

Labour regulation

Labour regulation is an important feature of labour markets. Since labour regulation reduces both hires and lay-offs, it is unclear whether it strongly impacts on employment. However, because it is reducing job turnover, strict labour regulation makes it harder to find a job. This undermines the job prospects of people at the margin of the labour market, such as young and low-skilled workers. Stringent labour regulation therefore needs to be avoided.

Product market competition

Before concluding this general overview I would like to stress that competitive product markets are good for employment and the purchasing power of workers. Strong competition induces companies to cut prices and increase output. Lower prices imply stronger purchasing power for consumers, while higher

output stimulates employment. Our empirical analysis confirms that the benefits from labour market reforms are greater when, in parallel, competition is stronger in product markets.

5. Some implications for Indian economic challenges

Let me finish this presentation by discussing possible policy implications for India. India's growth performance has been steadily improving since the beginning of the reforms in the 1980s. GDP per capita growth has risen to almost 5% annually since the turn of the century compared to 1.3% before reform. This acceleration has been mainly driven by a productivity pick up and, more recently, by a rapid rise in the share of the population of working age.

Yet, despite its pick-up, labour productivity growth has been half that of China's, reflecting both slower investment and less technological progress.

As you may know, we are currently working on what will be the first-ever *OECD Economic Survey* of India. This survey will provide an extensive analysis of growth drivers and growth impediments in India, with particular emphasis on the role of economic policies.

It is our view that there has been a significant easing of business regulation and that the economy has responded strongly to these reforms. This makes us optimistic that further reforms could boost Indian growth and make the current upswing durable. Indeed, the current strong economic upswing makes change easier.

I will focus primarily on issues related to what I have already highlighted in my discussion about OECD countries. This is not to deny, of course, that other important areas, more specific to India, are also in need of reform. For instance, public sector performance or the efficiency of the legal system.

So let me start with two sets of policy issues: first, insufficient infrastructure and human capital; and second, pervasive regulation in labour and product markets.

Infrastructure and human capital

Poor infrastructure, ranging from poor roads to relatively scarce and low-quality electric power, are preventing India from fulfilling its growth potential.

In the case of roads, this largely reflects inadequate investment both from the public sector and in public-private partnerships. For instance, while China invests over 3 percentage points of GDP in roads, India invests less than half a percentage point. Public expenditure needs to be restructured to allow greater investment.

Shortages of electricity also suggest under-investment, but the reality is somewhat more complex. Supplying free electricity to large sections of the community is artificially boosting demand, while very high prices for industry are holding back investment. Reform has started but the problem remains how to bring all the states on board. Setting rational prices for electricity does not mean that the poorest segments of the population would be harmed. Other instruments such as targeted benefits are available to deal with poverty issues.

The level of human capital also remains low, although it has been growing rapidly. At the beginning of this decade, still only 50% of a cohort completed primary education, while such education is almost universal in China. The key area for improvement appears to be increasing the efficiency of public education at the primary school level.

Likewise, only 6% of a cohort received tertiary education, and there is clear need for improvement in quality, outside a number of prestigious institutions.

Labour and business regulation

The other, final issue I would like to highlight today is labour and business regulation.

Labour regulation applies only to larger scale firms in India – basically those over 100 employees. However, it is particularly stringent, since employees can only be made redundant with the permission of the government, which is rarely granted. As I mentioned earlier, this may entail numerous costs.

On the productivity front, strict labour regulation may slow down the adoption of latest production techniques. This is particularly a problem for a country such as India, which needs to catch-up with the ‘frontier’ rapidly. This is all the more an issue as current labour regulation even controls the job description of employees.

Strict labour regulation may also account for the rising share of employment in the small scale informal sector, which is much less productive. Because it is reducing job turnover in the formal sector, strict labour regulation may also hamper the job prospects of the least skilled workers, which in turn may raise equity concerns.

Business regulation is still burdensome, although it varies across states. Policies that used to reserve certain industries for very small firms still exist.. And despite ongoing trade liberalisation, in 2003 India still had one of the highest tariff rates in the world. But change is underway in both of these areas.

A set of policies – such as strict labour regulation for larger firms and tax advantages for very small firms – have led to an overgrown small enterprise sector. This sector is flexible but has low productivity.

More broadly, strict business regulation may slow down the adoption of new technologies. And, therefore, the speed of the productivity catch-up towards OECD levels.

Overcoming resistance to labour and product market reforms is difficult but possible

As OECD’s experience shows, reforming labour and product markets is difficult. Structural reforms have three unfortunate characteristics:

- Their costs arise upfront, while their benefits are typically gradual.
- Their costs are concentrated on well-organised groups while benefits accrue to groups with little lobbying power.
- Their costs are easy to identify, while their benefits are spread through indirect and complex mechanisms.

All in all, reforms are often daunting tasks and some of them fail to come through despite being well-founded.

At the OECD we have recently worked on the political economy of structural reforms. The analysis covers labour and product market reforms across the OECD and spans the past three decades.

Discussing the results would take too long. One policy lesson I would like to mention, however, is that many of the top reformers actually have “bunched” their reforms into packages. So that the net losers from one type of reform may be the net winners from another type. By spreading the net gains from reforms more evenly across the population, such a strategy may help overcome resistance to change.

In particular, there has been a fairly strong relationship between the intensity of labour and business deregulation over the past decade (**Slide 13**). However, product market liberalisation typically came before labour market reforms (**Slide 14**).

This suggests that reforms in both fields are complementary. In India, more loosening is still needed in the area of business regulation. OECD’s experience suggests that these reforms, as well as those that have already occurred, could then pave the way for labour market reform. Our experience is that however difficult, at the end of the day labour market reforms are unavoidable. They are unavoidable because the status quo is just too costly.

In India, for instance, the existing combination of greater competition and unchanged labour regulation is probably not sustainable. Indeed, it is putting pressure on many large employers to expand output through capital investment and reduce employment wherever possible, pushing jobs into the informal sector. This may reduce the extent to which public opinion supports strict labour regulation, thus making reform of labour institutions more feasible.

And of course, there are still reform opportunities in other areas of the economy, notably in financial sector. Change there would also tend to facilitate the implementation of reforms in other markets.

On this note, let me open the floor to questions and comments.

ⁱ See OECD (2004), *The Sources of Economic Growth in OECD Countries*; Jaumotte F. and N. Pain (2005a), “From Ideas to Development: The Determinants of R&D and Patenting”, *OECD Economics Department Working Paper No.457*.

ⁱⁱ See OECD (2004), *op.cit.*

ⁱⁱⁱ See OECD (2004), *op.cit.*

^{iv} For OECD evidence on the high private returns that accrue to people with higher education degrees, see Blondal S., S. Field, and N. Girouard (2002), “Investment in Human Capital through Post-Compulsory Education and Training: Selected Efficiency and Equity Aspects”, *OECD Economics Department Working Paper No.333*. This work is currently being updated by the OECD Economics Department.

^v OECD research finds support for this view using both micro and macro data. At the micro level, OECD research finds that product innovation is negatively related to the stringency of labour regulation. See Jaumotte F. and N. Pain (2005b), “From Innovation Development to Implementation: Evidence from the Community Innovation Survey”, *OECD Economics Department Working Paper No.458*. At the macro level, using cross-country time-series data, a clear negative impact of labour regulation on patenting is found. See Jaumotte F. and N. Pain (2005a), *op.cit.*

^{vi} For OECD evidence on the effects of business regulation on productivity growth at the industry level, see Conway P., D. De Rosa, G. Nicoletti and F. Steiner (2006), “Regulation, Competition and Productivity Convergence”, *OECD Economics Department Working Paper No. 509*.

^{vii} OECD (2005), “The benefits of liberalising product markets and reducing barriers to international trade and investment in the OECD”, *OECD Economics Department Working Paper No. 463*.

^{viii} This section builds mainly on the recent reassessment of the *OECD Jobs Strategy*. See in particular: OECD (2006), *OECD Employment Outlook*; Bassanini A. and R. Duval (2006), “Employment Patterns in OECD Countries; Reassessing the Role of Policies and Institutions”, *OECD Economics Department Working Paper No. 486*, and *OECD Social, Employment and Migration Working Paper No.35*.

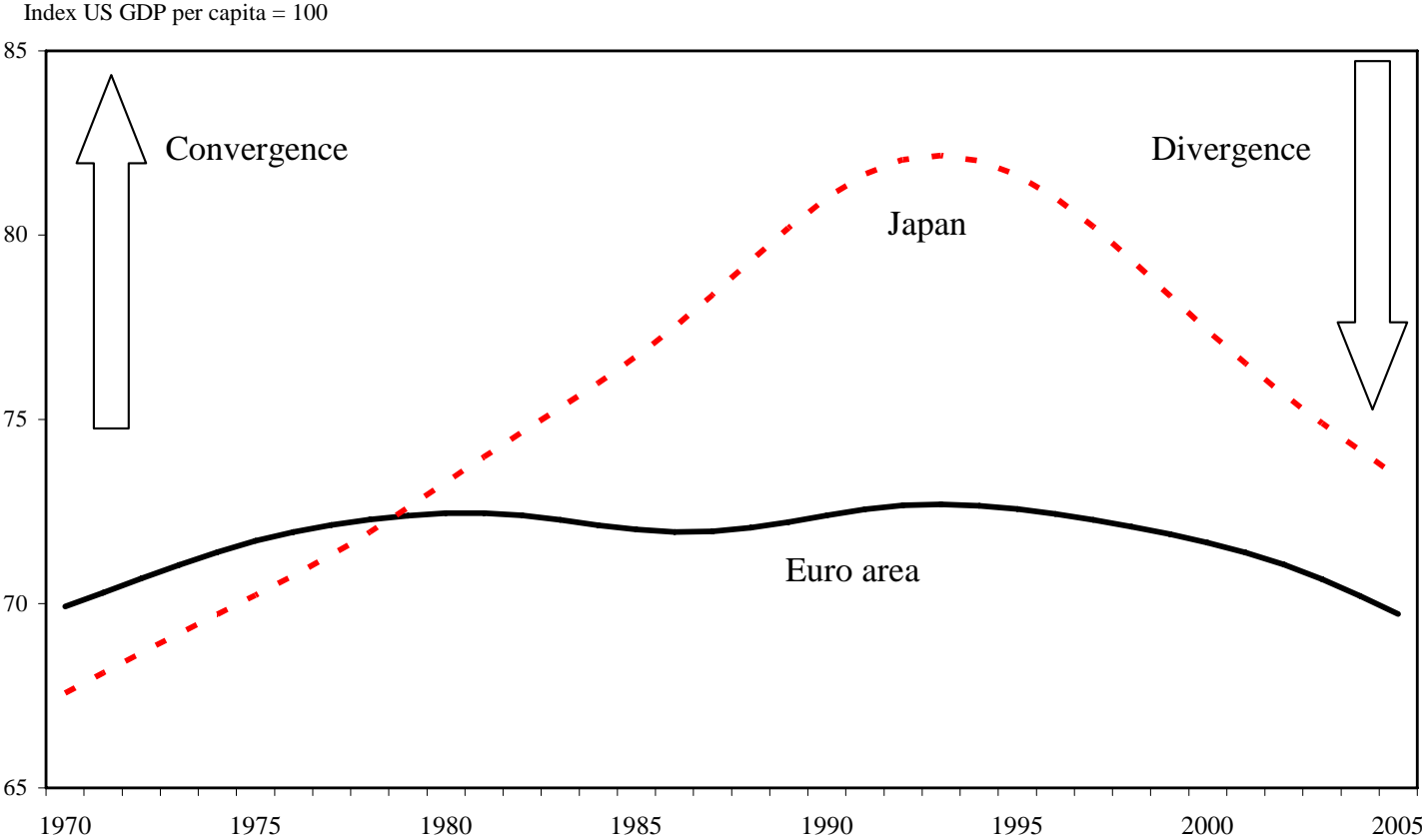
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GDP per capita has diverged over the past 15 years or so

Real per capita GDP relative to the United States
Trend indices, based on 2000 PPPs and 2000 prices ¹

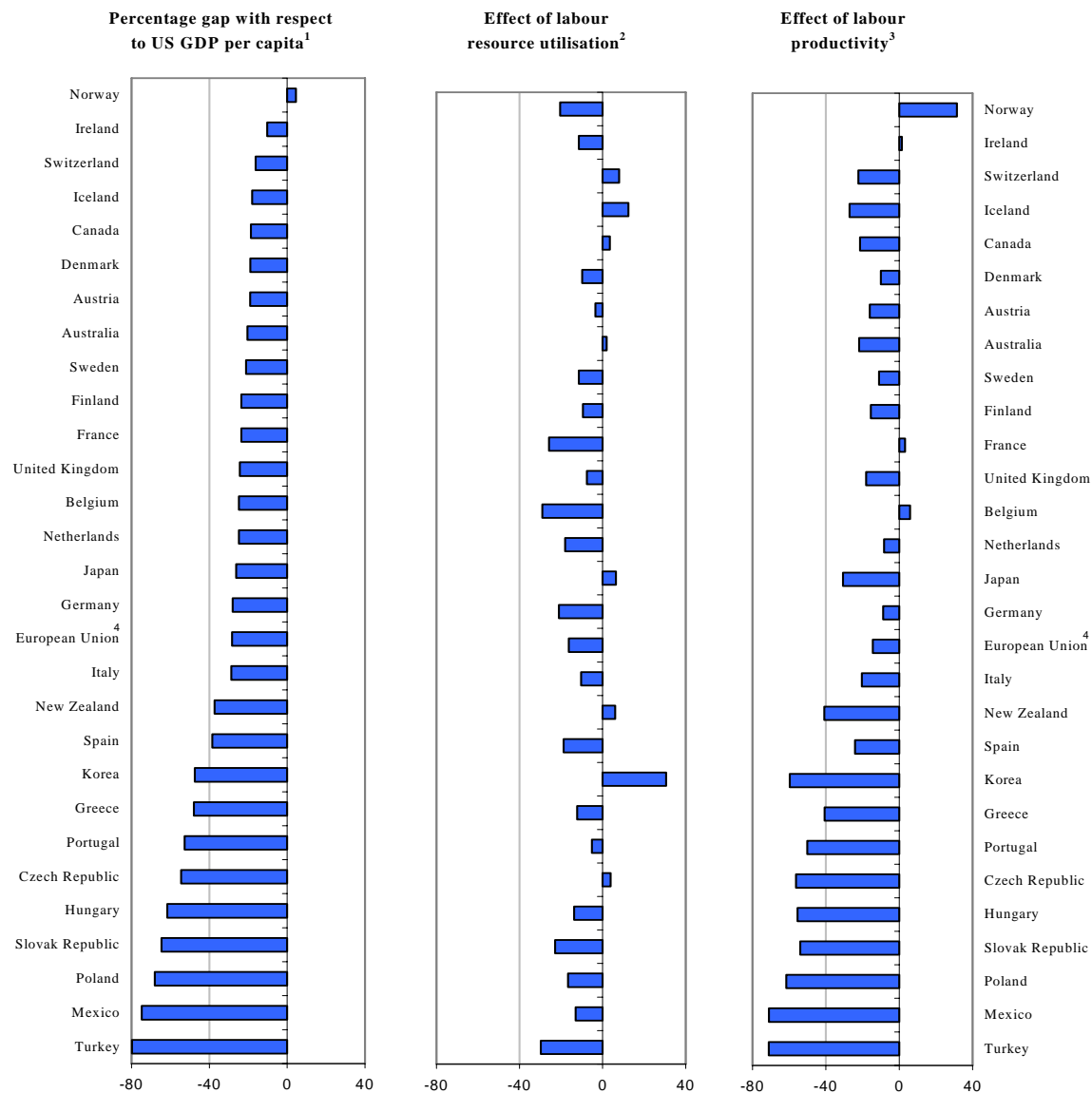


1. Trend calculated using a Hodrick-Prescott filter (smoothing parameter set to 100) over a period including projections through 2012.

Source: OECD Annual National Accounts; OECD Economic Outlook 78 Database.

Why do real incomes differ?

Percentage point difference in PPP-based GDP per capita with respect to the United States, 2004



1. Based on year 2000 purchasing power parities (PPPs).

2. Labour resource utilisation is measured as total number of hours worked divided by population.

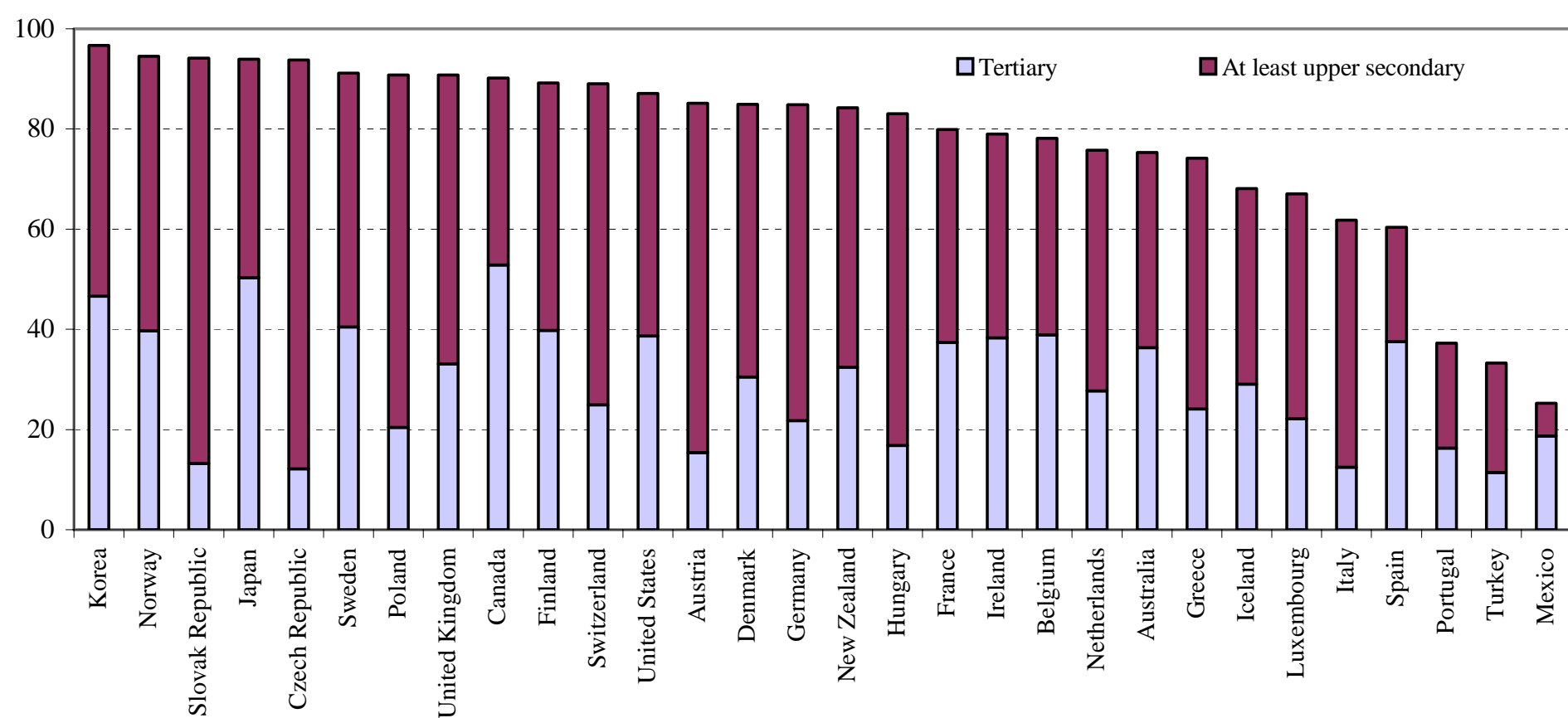
3. Labour productivity is measured as GDP per hour worked.

4. Excluding Luxembourg.

Source: OECD, *National Accounts*, 2005; OECD, *Economic Outlook*, No. 78; and OECD, *Employment Outlook*, 2005.

Educational attainment varies widely across OECD countries

Percentage of individuals with diploma among the population aged 25-34 ¹

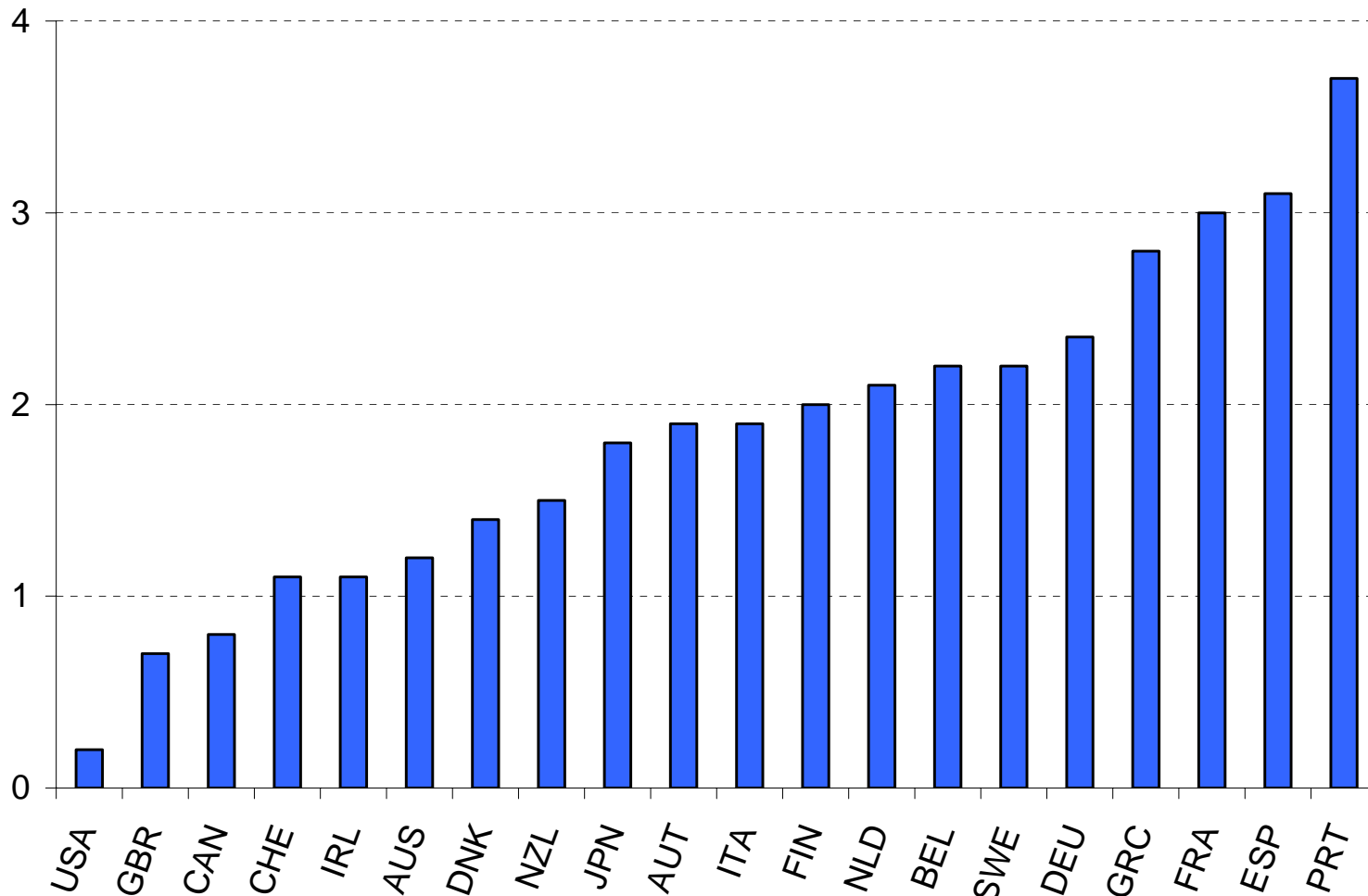


1. 2003 except for denmark, Greece, Iceland, Italy, Japan, Luxembourg, Netherlands, Norway and Switzerland (2002).

Source: OECD Education Database.

English-speaking countries have less stringent labour regulation than most continental Europeans

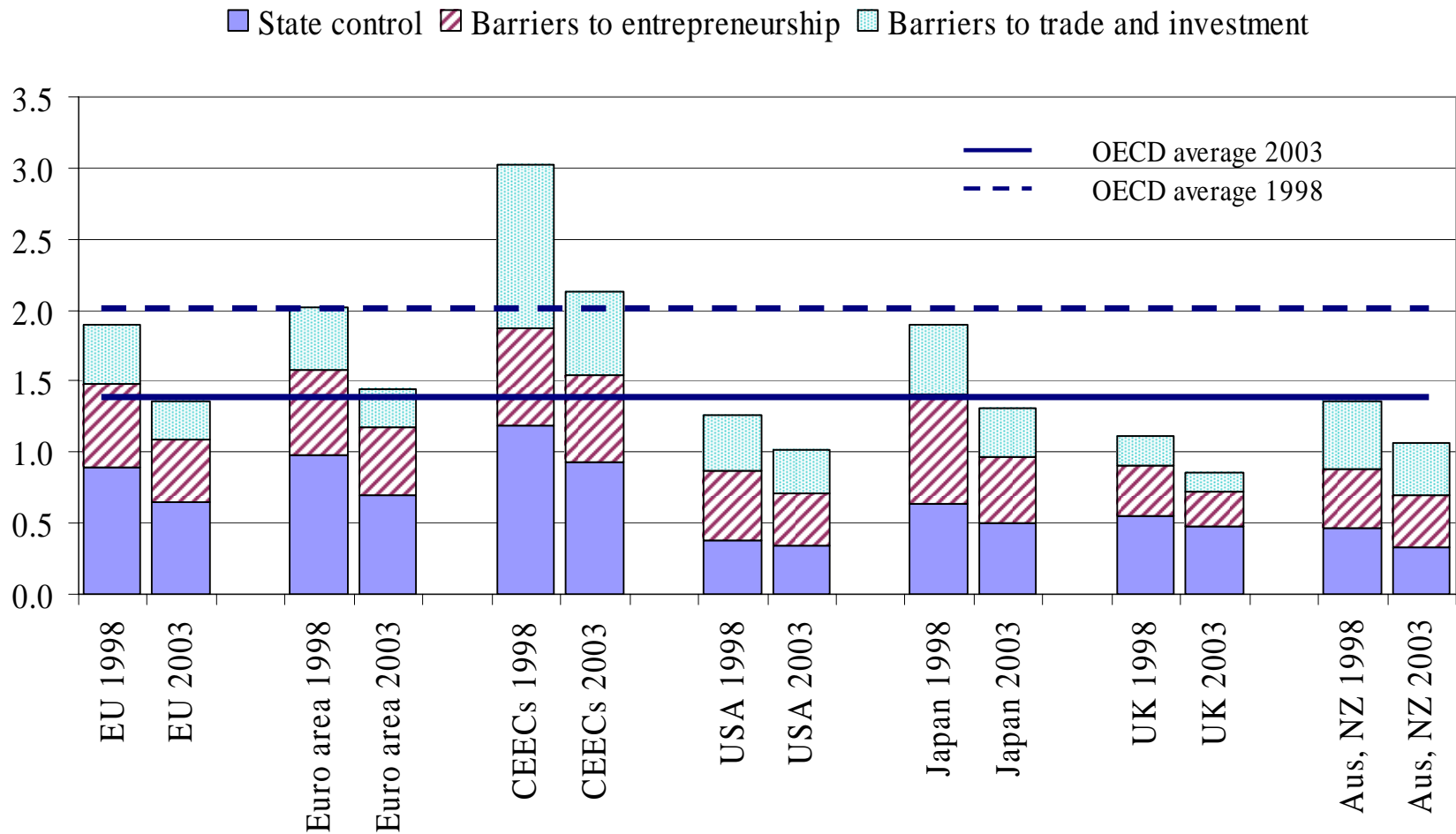
Stringency of employment protection legislation¹ in selected OECD countries, 2003



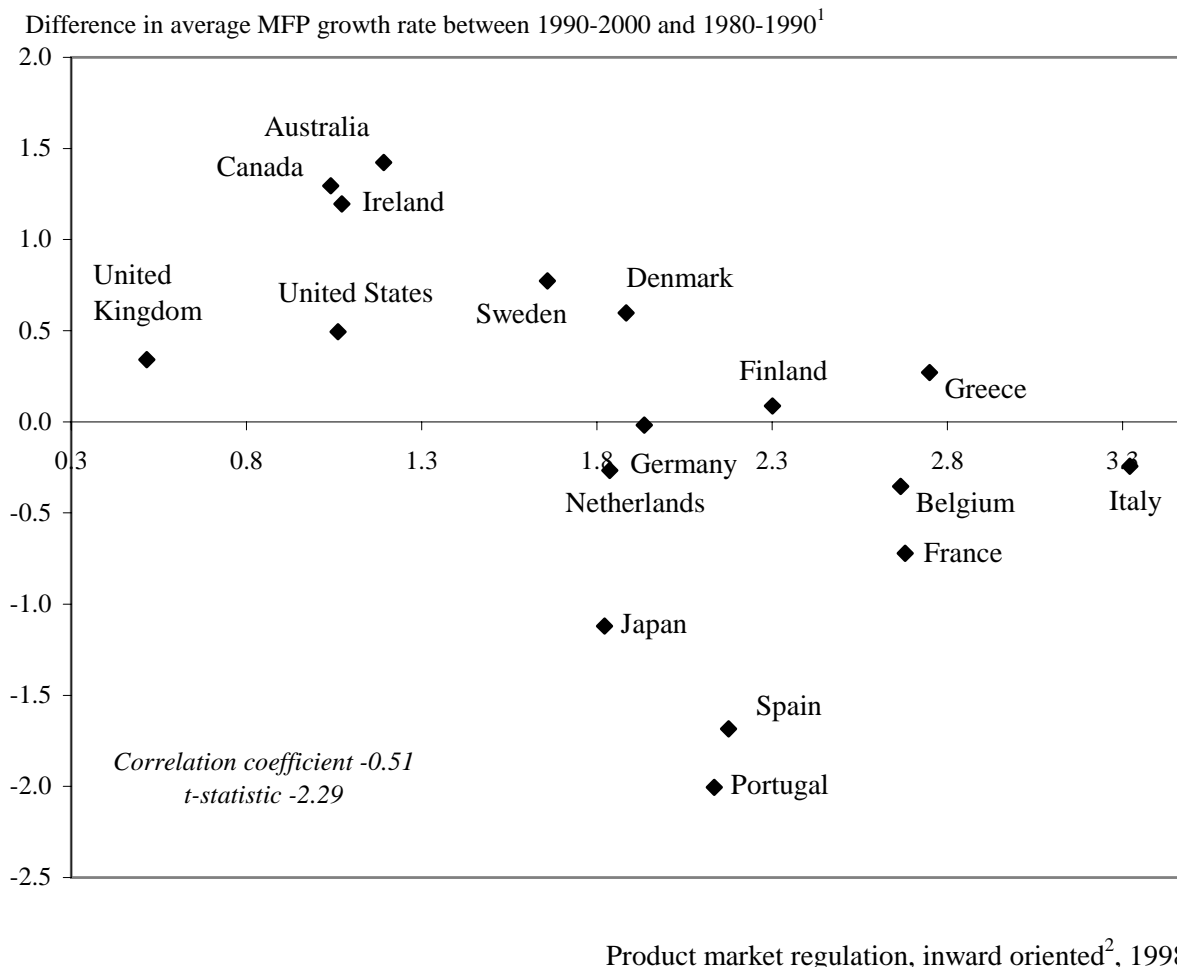
1. Index scale of 0-6 from least to most restrictive.

Source: OECD Employment Outlook, 2004.

Business regulation is converging towards a more liberal stance but cross-country differences remain



Cross-country differences in business regulation may have contributed to divergent productivity trends



1. Adjusted for hours worked.

2. Indicator of economy-wide regulation excluding barriers to international trade and investment.

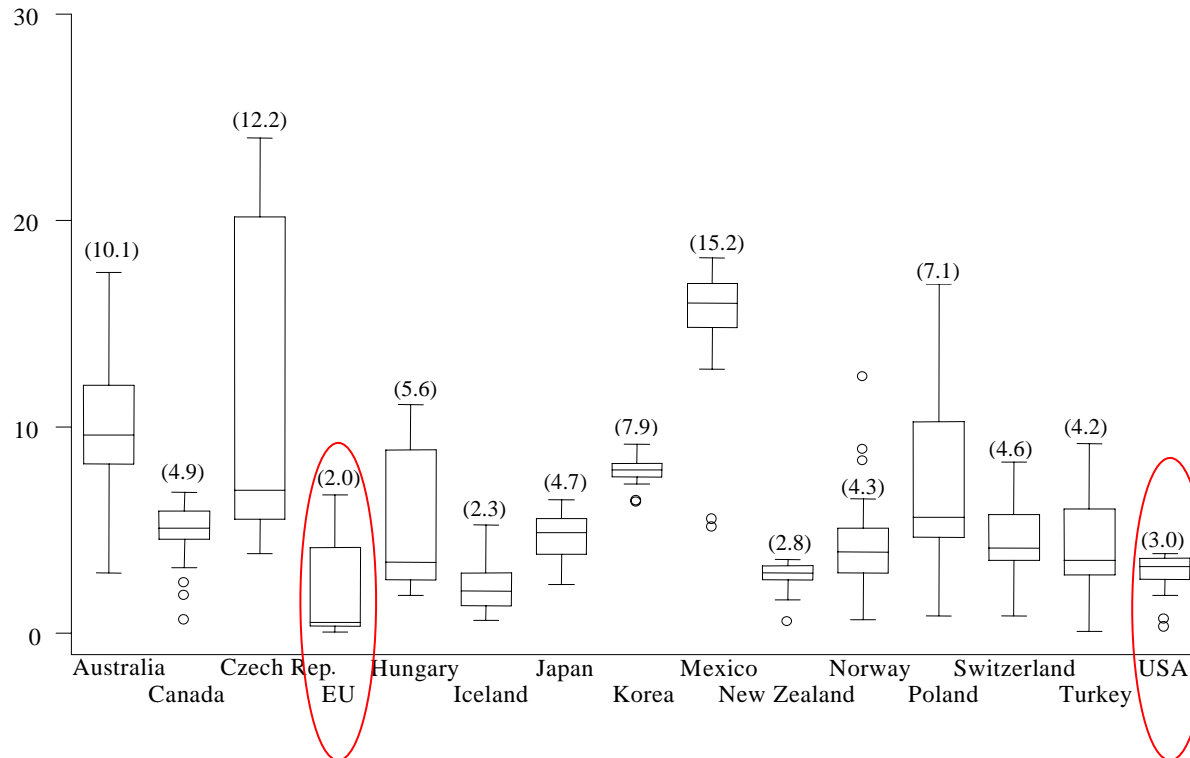
The indicator ranges from 0 to 6, from least to most restrictive. See Nicoletti et al. (1999).

Applied tariff levels could be further reduced in the EU15, US and other OECD countries

Median and dispersion of bilateral applied tariffs by importing countries in 2001¹

(Average values in parentheses)

Dispersion reflecting the compound effect of regional preferences and OECD import product mix²



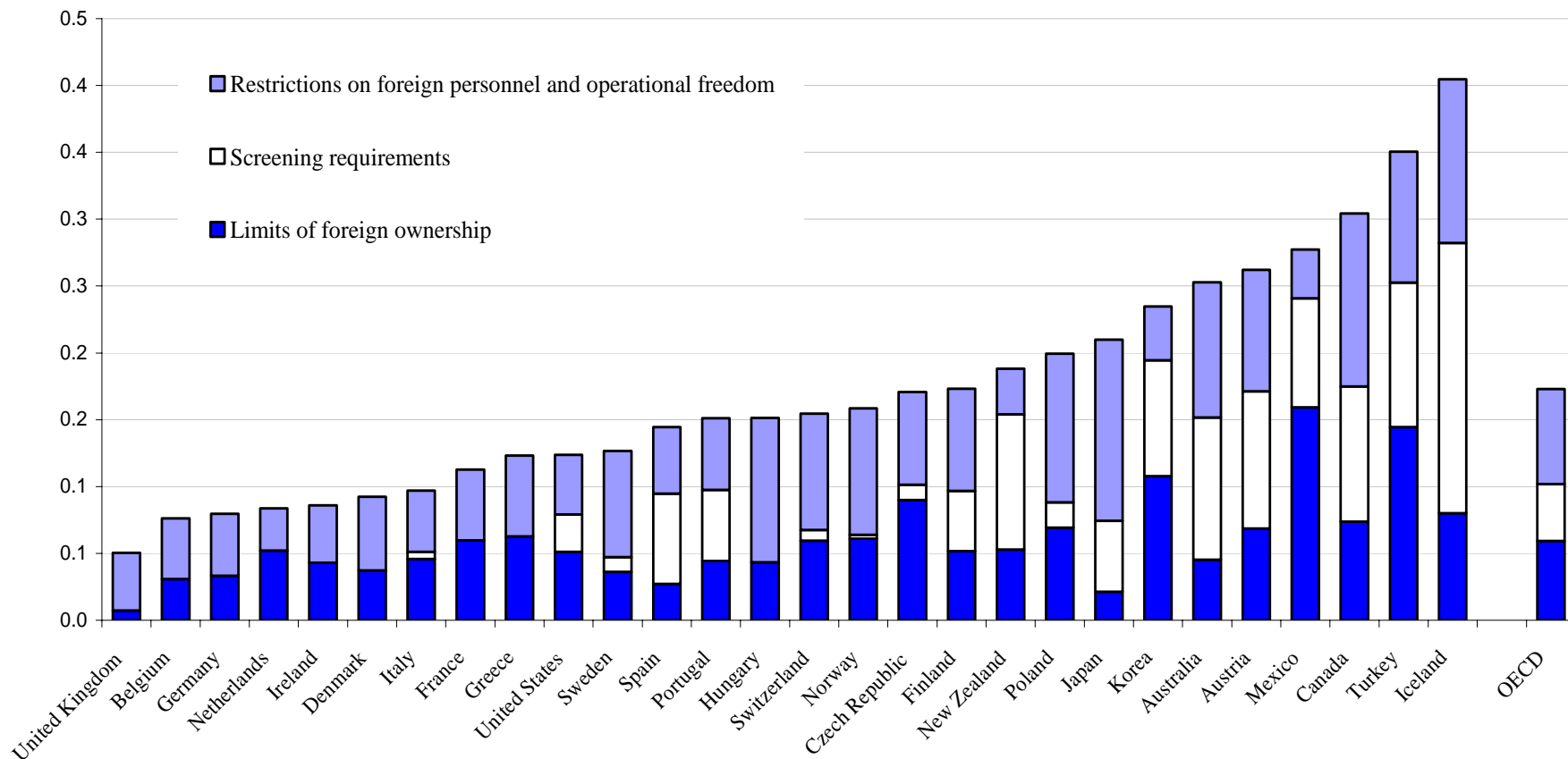
1. The box plot shows, for each country, the variation in the tariffs imposed on imports from partner countries. The median value of the tariff is depicted by the horizontal line in the box, the third and second quartiles of the cross-country distribution by the edges of each box, and the extreme values by the two whiskers extending from the box. Dots identify outlier observations.

2. ISIC rev.3 two-digit industry-level tariffs were aggregated to national level using the weights of the OECD import product mix.

Source: International Trade Center, Geneva and CEPII, Paris.

OECD indicators of FDI restrictions

OECD indicators of FDI restrictions, 2001¹



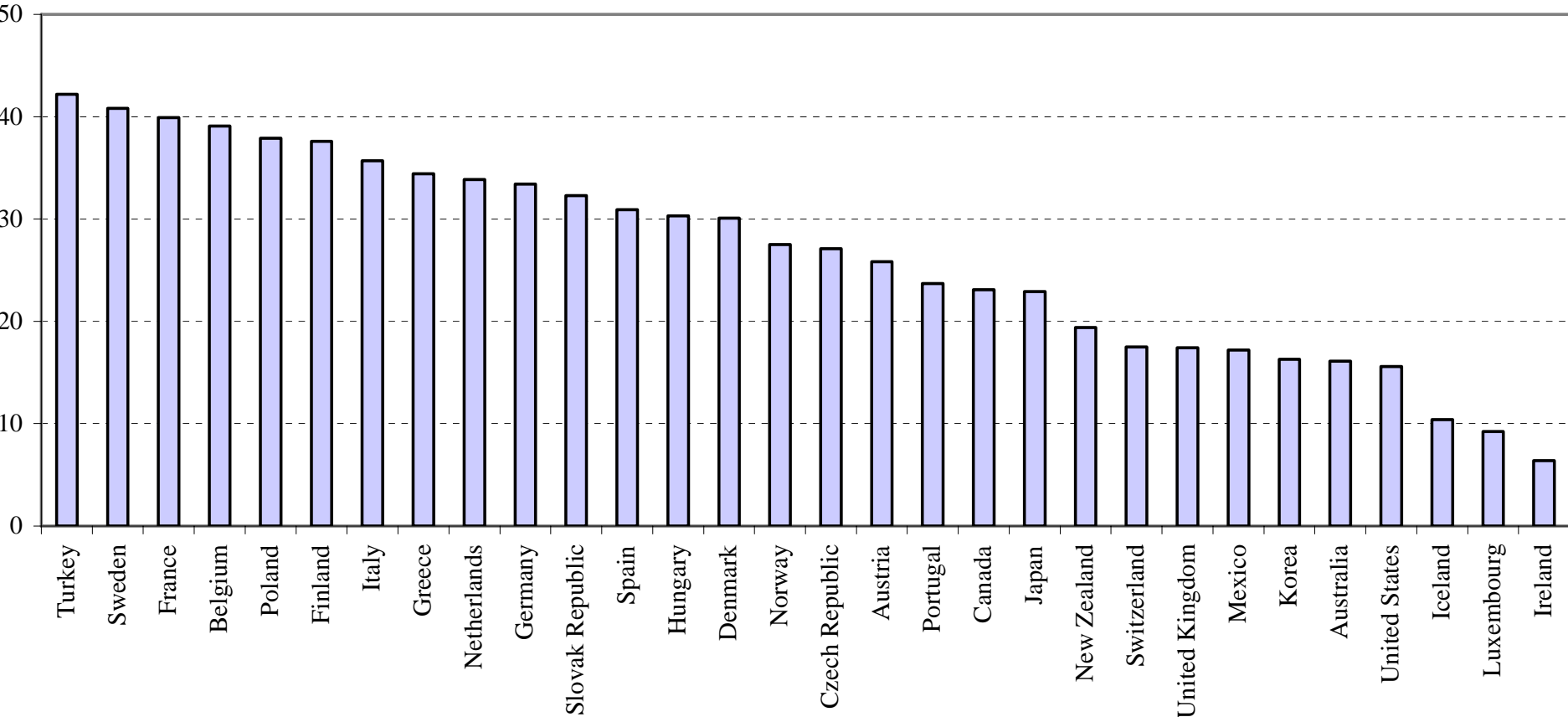
1. The indicators range from 0 (least restrictive) to 6 (most restrictive)

* OECD (simple average)

Source: OECD, Golub, S. (2003)

Labour taxes are typically higher in continental European OECD countries than in English-speaking ones

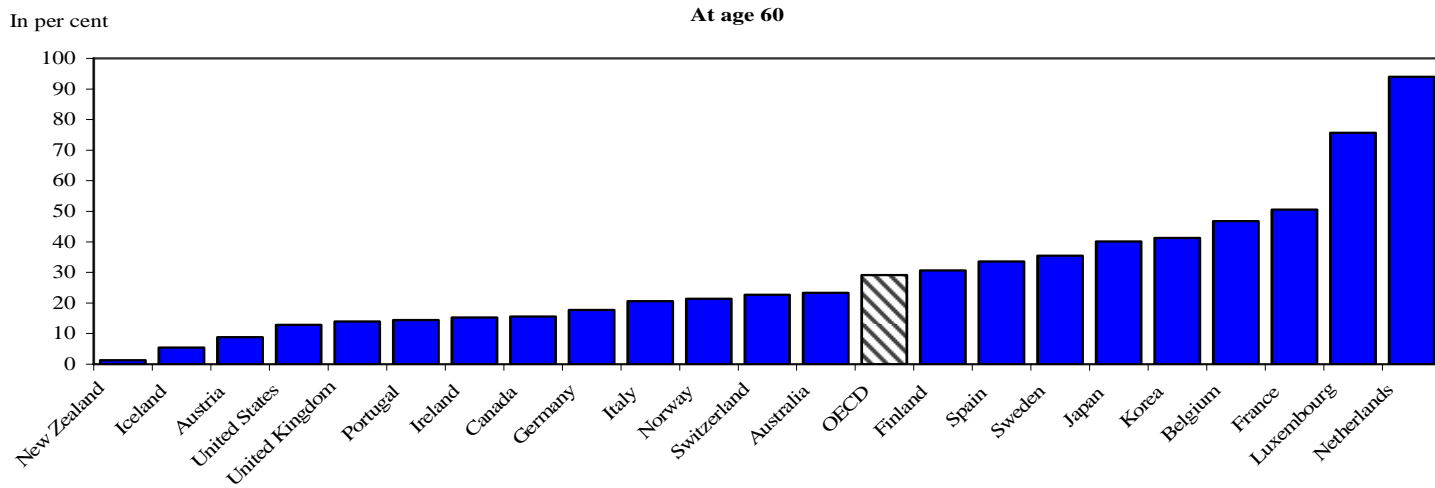
Labour tax wedge (single earner couple with two children earning the average wage, in per cent)



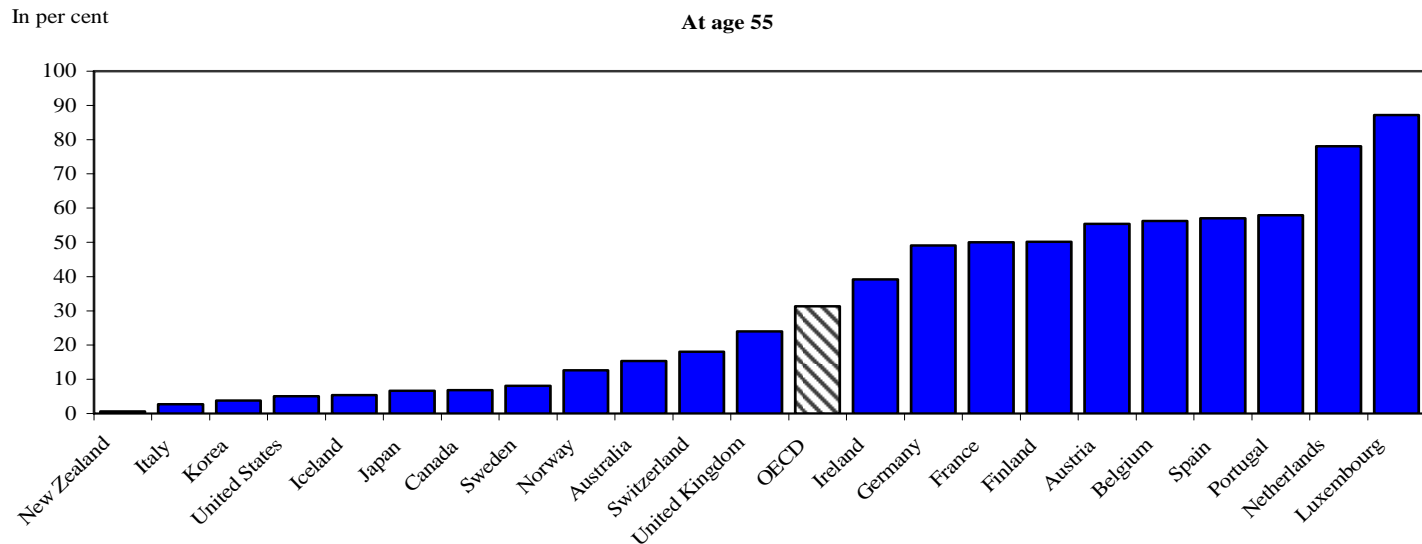
Source: OECD, *Taxing Wages*.

Financial disincentives to continued activity...

Implicit tax rates on continued work over next 5 years in current old-age pension systems¹



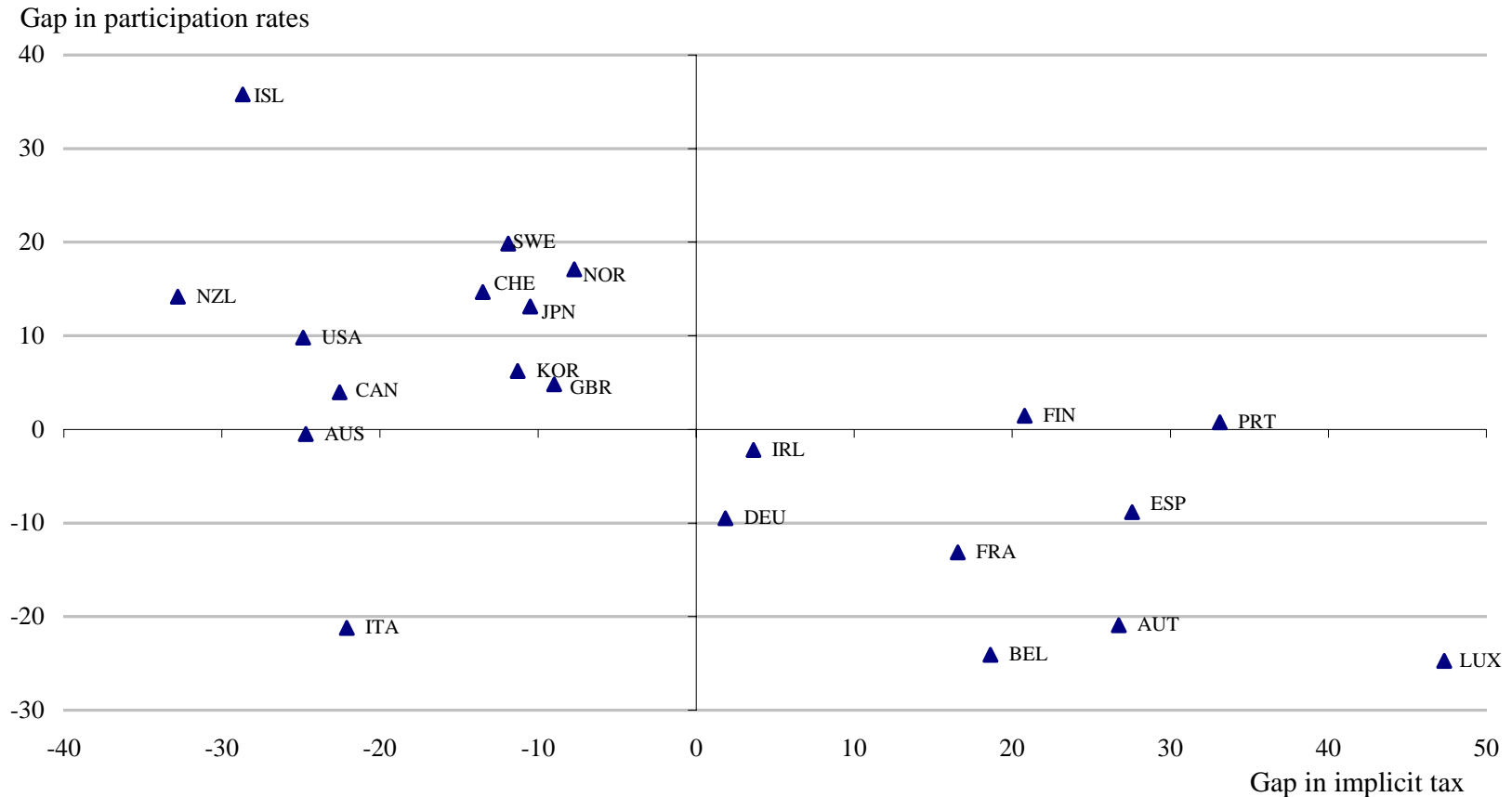
Implicit tax rates on continued work over next 5 years in current social transfer programmes¹



1. Single worker with average earnings.

...reduce older workers' participation rate

Percentage points gap vis-à-vis OECD average

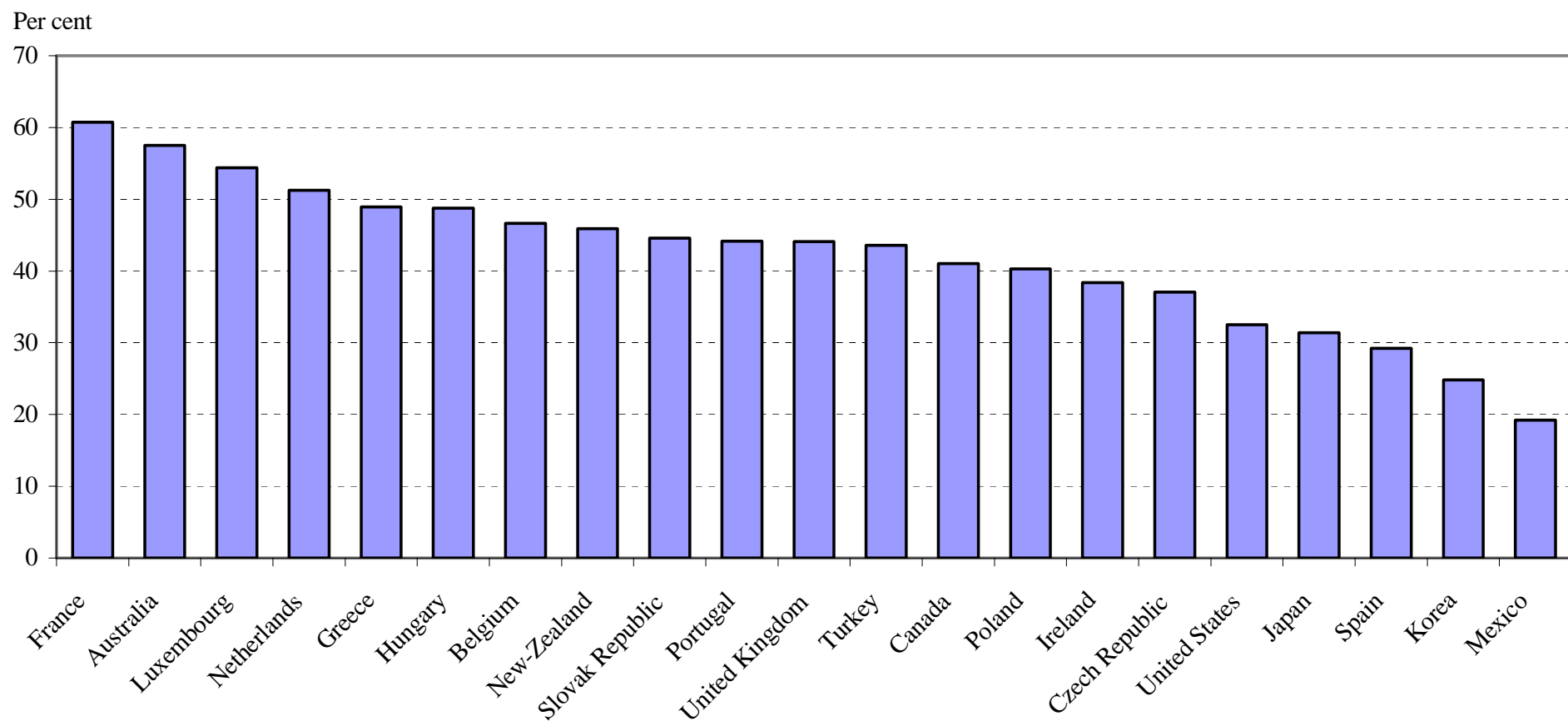


1. Average of implicit tax on continued work in early retirement route, for 55 and 60 years old.

Source: OECD Labour Force Statistics, 2004; OECD Economic Policy Reforms: Going for Growth 2005.

Statutory minimum wage levels differ across those OECD countries where such minima exist

Ratio of minimum wage to full-time median earnings ¹



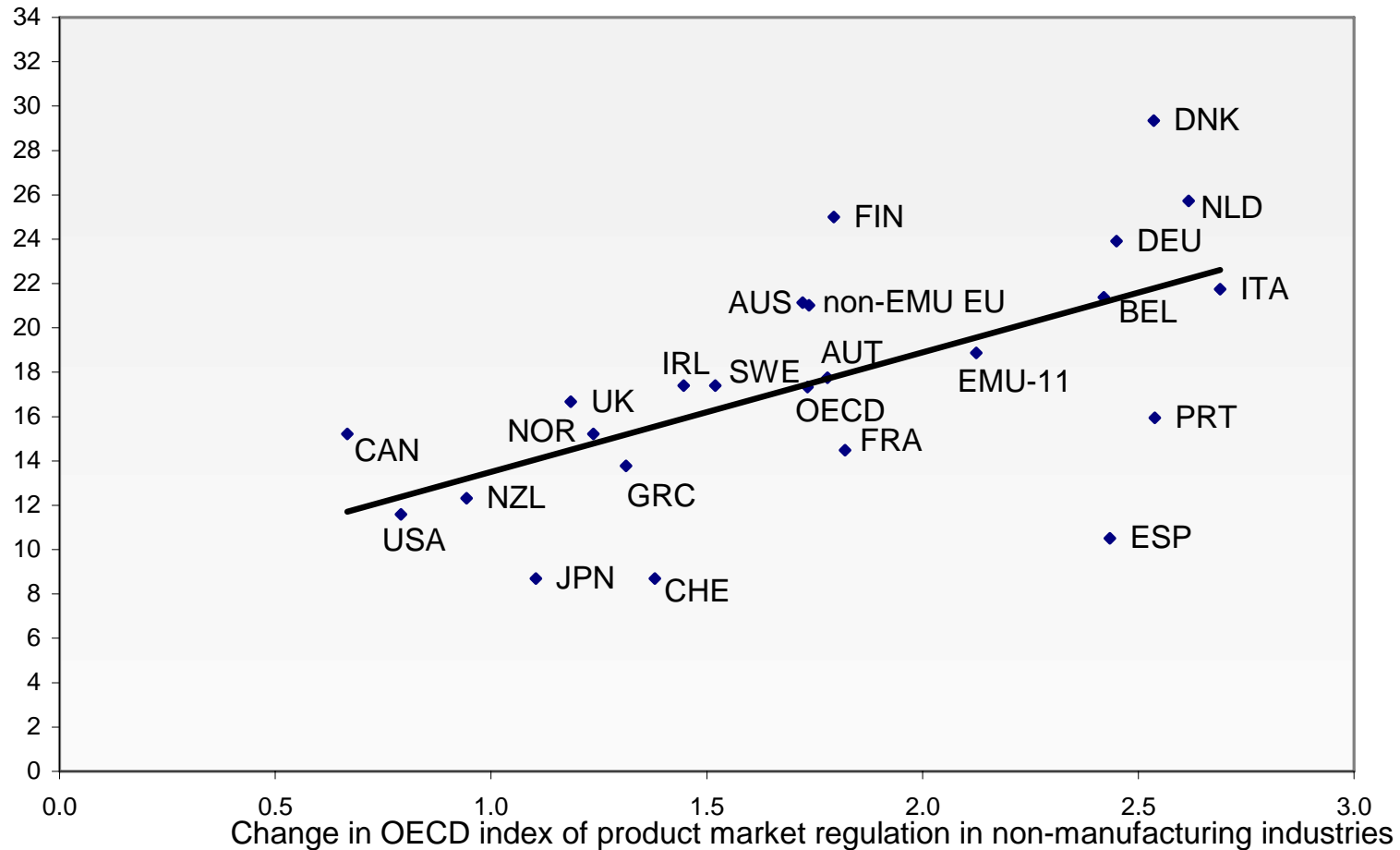
1. 2003 for all countries except France, Greece, Hungary and Portugal (2002).

Source: OECD Labour Market Statistic Indicators.

Business deregulation and labour market reform tend to go hand in hand...

Product market deregulation and intensity of labour market reforms, 1994-2004

Labour market reform intensity, per cent of maximum possible score



Correlation coefficient: 0.62

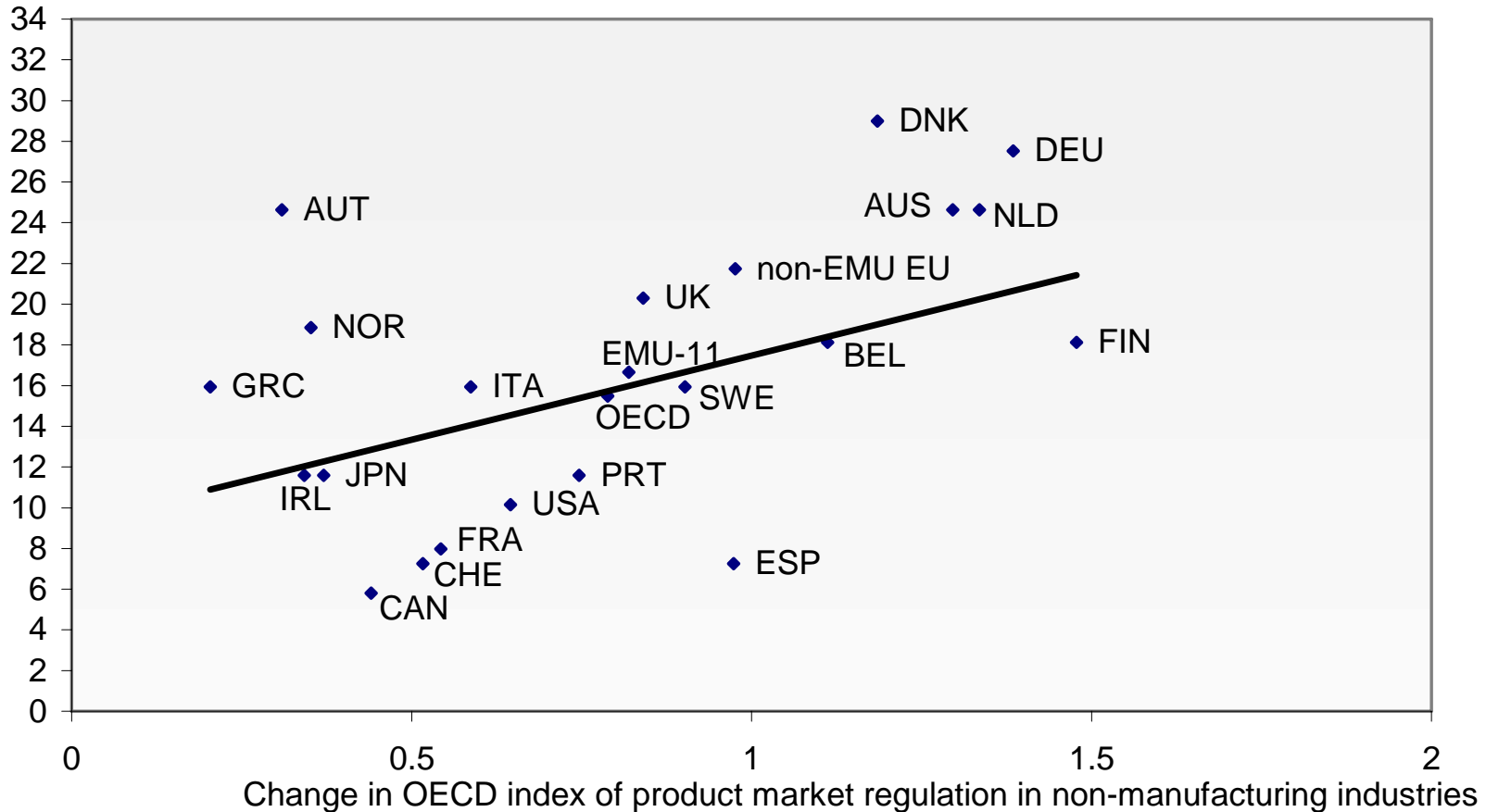
t-statistics 3.44 ***

Source: Brandt, Burniaux and Duval (2005)

...with business deregulation possibly paving the way for labour market reform

Product market deregulation (93-98) and intensity of labour market reforms (99-04)

labour market reform intensity, per cent of maximum possible score



Correlation coefficient: 0.40

t-statistics 1.91 *

Source: Brandt, Burniaux and Duval (2005)