Council at Ministerial Level, 29-30 April 2003

AGENDA FOR GROWTH
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Introduction: a discussion on policies to foster long-term growth

1. The current cyclical downturn has afflicted virtually all OECD countries. Naturally, the immediate policy focus has been on how to re-ignite demand. But over the longer term, citizens’ welfare is more closely linked to trends in their real incomes than to fluctuations around the trend. The policy settings that determine long-term growth are therefore crucial and must be given due emphasis in the present situation. This note provides background to a discussion by Ministers of policies to strengthen long-run growth.

Background: recent growth trends

Growth trends have diverged …

2. Growth patterns through the 1990s and into this decade have turned received wisdom on its head. Much of the post-war era had been characterised by other countries catching up to the United States in terms of GDP per capita. But over the 1990s, the US economy began to grow faster than the OECD average (Table 1). A few other countries enjoyed a growth revival along the lines of the United States: this was most pronounced in Australia, Canada, Ireland and Spain. Current OECD estimates of trend growth of GDP per capita is on the order of 2¼ per cent in the United States, 1 per cent in Japan and 1¾ per cent in the European Union. When combined with different demographic trends such rates imply that, within the current OECD Membership, the US economy is set to become steadily more dominant.

[see Table 1. Diverging growth trends]

… caused by multiple factors

3. The revival of US growth was driven by labour productivity, which has continued to grow strongly despite the current downturn. Accelerating labour productivity was in turn driven by a surge in investment - not least of ICT equipment in what we now know was partly an excess of capital spending - and by an acceleration of technical progress. At the same time, labour input also grew strongly as the employment rate rose and working hours lengthened. Employment rates also rose elsewhere, though not in Japan, while working hours generally declined.

[see Figure 1. The causes of real income differences]
Raising labour utilisation: a challenge for Europe in particular

Policy settings are to blame …

5. There is nothing ideal about heavy use of labour resources. Indeed, as real incomes go up it would seem natural for people to want more leisure. To the extent such an outcome is the result of free individual choice, not influenced by government policies, welfare is enhanced. In practice, this is rarely the case. Government policies have a pervasive influence on levels of labour supplied and employed. And particularly in continental Europe this influence appears to be strongly negative.

6. Indicators of structural unemployment remain high in many continental European countries though structural policy reforms and an improved macroeconomic climate have led to some reduction over time (Figure 2). But unemployment is only the tip of the iceberg. The gaps with other countries are even larger when employment is considered. Relatively low overall employment rates in continental Europe is the result of low employment of groups sometimes considered at the margin of the labour market: young, old and female workers (Figure 3). In addition, average working hours are relatively low. In Japan, estimates of structural unemployment remain relatively low but have tended to drift upward, suggesting a need for policy reform. Considering that populations of working age either are, or soon will be, shrinking in many European countries and Japan it is particularly important to avoid barriers to employment.

... and reform options need to be considered

7. The policies responsible for weak employment are well-known even if estimates of their influence in individual countries are subject to wide error margins. Policy settings are difficult to reform, however, because reforms imply real or perceived trade-offs with other important policy objectives. This may be particularly so when individual policies are considered in isolation. By contrast, policy reform over a broad front makes it possible to overcome trade-offs and achieve efficiency gains through synergies between individual policies that form part of a package.

8. There are a number of individual policy areas in which such trade-offs are very real, but where additional policy reform and appropriate policy design may help to make progress.

- Unemployment benefits provide social protection but may also raise unemployment when they are of long duration and high relative to wages. Hence, the social objective may be undermined by trapping people in unemployment - some empirical estimates suggest that differences in levels and duration of unemployment benefits could account for 2-3 percentage points difference in unemployment rates between the European Union and the United States. Yet, countries legitimately consider certain standards as necessary to avoid individual hardship. In this regard, the question is whether effective activation policies and other types of active labour-market policies may serve to strengthen work incentives and thus help ease the policy trade-off.

- Low-productive workers pose a particular challenge. Where wages are flexible, in-work poverty is a threat. Where minimum wages, social transfers or wage bargaining institutions lead to wage floors, these workers may suffer high unemployment. A number of countries have introduced policies to boost incomes for those at the low end of the labour market without reducing work incentives. Some countries have introduced in-work benefits while
others have provided rebates on non-wage labour costs for such workers. These policies have clearly produced beneficial effects. However, in-work benefits and payroll-tax rebates also create disincentives to work for those with incomes just above those of the target groups and for those whose taxes rise to finance these schemes. Hence, the question is how far these policies can be extended.

- Active labour-market policies appear capable of boosting employment - when they are well designed. However, they are expensive and blanket expansion of these policies is therefore not the answer. But there appears to be scope for greater concentration on measures that have proved their worth while de-emphasising the less effective policies.

- Taxes are a necessary source of revenue for public expenditure that may well support growth or employment objectives. But at the same time taxes, in particular when they are levied on labour, may directly reduce employment (Figure 4). Indeed, above certain levels of overall taxation and public expenditure it becomes very difficult to avoid heavy taxation of labour. Hence, the need for tight expenditure control.

  [see Figure 4. The tax wedge on labour is high in some countries]

9. In other areas, it is less obvious that policy is faced with a strong trade-off. Lack of reform may instead be due to hesitancy to take on vested interests.

- A main reason for low employment of older workers in some countries is the availability of early retirement options with income levels that are high relative to those from work. At the same time, it is not obvious that older workers suffer particular employment difficulties in countries where they remain on the labour market. The presumption is therefore that attractive conditions for early retirement are costly to budgets and detrimental to employment while having at best unknown social value. A problem for their reform is, however, that in many countries they have come to be seen as an acquired right, while for firms they often represent a convenient way of suppressing labour whose productivity does not match the wage. Moreover, to ensure that an added supply of older workers meets with added demand from employers the right framework conditions have to be in place, including wage-setting that reflects workers productivity and adequate access to training so as to maintain and update skills.

- Strict firing restrictions protect those having jobs but at the same time may make it more difficult for those without jobs to get one. The net social impact is not clear and at the same time employment, particularly of marginal groups, may suffer. In order to address this problem many countries have softened protection of temporary jobs (Figure 5). The implication has been a very high degree of job uncertainty for a substantial part of the workforce with an uncertain pay-off in terms of employment. Reforming excessively tight job protection for those on permanent contracts is difficult, however, since these groups are well positioned to resist changes.

- Evidence shows that anti-competitive regulation of product markets tends to reduce employment. At the same time it appears to provide little social benefit in terms of employment safety or security of labour income for the society at large. It does, however, usually confer benefits in the form of higher profits or wages to those directly concerned. Progress in reforming such regulation may have boosted employment rates by between ½ and 2½ percentage points across OECD countries over the past couple of decades. This progress
shows that resistance can be overcome but there is still far to go in several countries (Figure 6).

[see Figure 5. Most reform of job protection has concerned temporary contracts]

[see Figure 6. Product markets have been liberalised but country differences remain]

10. Making greater use of labour resources is clearly necessary. But in a context of severe population ageing it is almost like running to stand still. Projections of the fiscal implications of ageing that already embody substantial progress in labour utilisation suggest that public expenditure on pensions and health could rise by 6-7 per cent of GDP over the next three decades for the OECD area as a whole - and substantially more in some countries. This raises the question whether greater immigration could boost employment and help overcome the fiscal burden associated with ageing. In the long run, this is not obviously the case. Eventually, immigrants also grow old and demand pensions and health expenditure. But if immigrants have the right age profile and if they have a high employment rate, greater immigration might help smooth the peak of age-related public finance problems. But it is unclear whether, in fact, migration is a process that can be controlled in manner consistent with these considerations. And in any case, some of the countries that can look forward to substantial ageing problems have a bad record in ensuring immigrant employment. This points to the more general issue of integrating immigrants and the policies necessary to achieve such integration.

11. In a growth context, the human capital embodied in labour resources is also important. Both the quantity and quality of human capital is hard to measure, however. As an imperfect indicator of quantity, the average years of schooling of the working-age population suggests considerable progress over past decades (Figure 7). Empirical work implies that, in the past, each additional year of schooling might have boosted real income levels by up to 6 per cent. Given these orders of magnitude, policies that affect the quantity and quality of human capital supply are obviously crucial. As regards the quality of compulsory schooling, the OECD PISA survey of the achievement levels of 15-year-olds has revealed large variations in student outcomes across countries but also within them. These differences are suggestive of considerable scope for reforms to improve outcomes. It is noteworthy that cross-country performance is only weakly related to higher educational spending; nor is there evidence of much of an effect from lower class size. Going beyond compulsory education, most returns of human capital investment accrue to the individual and in many cases these returns seem substantial. This raises the question whether, at the margin, public support for tertiary education produces social benefits comparable to those of support for compulsory education. Government support for tertiary education is often motivated by concerns for equal access but effectively also implies substantial support for well-off families.

[see Figure 7. Widespread progress in strengthening human capital]

12. Beyond initial education, lifelong learning is often seen as an ideal. Its achievement is not being helped by typical institutional set-ups whereby different ministries are responsible for education and training. Better co-ordination in these two areas would provide a useful policy contribution. But training is influenced by policy settings in many areas and therefore co-ordination will need to go wider. For example, the amortisation period for training investments may be short for older workers in countries where transfer policies lead to low retirement ages. More generally, population ageing and the need to raise effective retirement ages are likely to make training increasingly important. Many countries pursue policies to enhance training via subsidies or mandated employer spending. Such policies are often based on the premise that too little training is provided. However, it is difficult to assess the appropriate amount of training. In the absence of such information, policies may have to focus on giving the right incentives to provide and engage in training.
Allowing new technologies to drive productivity

New technology has led to a productivity rebound in some countries …

13. It used to be a puzzle why one saw computers everywhere except in the productivity statistics. No longer. Information and communications technologies (ICT) have boosted productivity growth in three ways. First, the production of ICT equipment itself has seen massive productivity growth. Second, stimulated not least by falling prices of such equipment, enterprises have equipped their personnel with much more computing power. This boosts labour productivity in enterprises using ICT. Third, greater use of ICT has also allowed production, consumption and exchange to be reorganised in a way that economises on both labour and capital. Between them, these three channels may have boosted US labour productivity growth by around 1 percentage point per year between the early and the late 1990s. Countries that are not as large producers of ICT equipment could not hope for as big an effect from the first channel, but could still enjoy the benefits of lower ICT prices and reorganised production. Indeed, some other countries (Australia and Canada are examples) have witnessed in the 1990s a significant build-up of ICT equipment that has boosted combined labour and capital productivity (Figure 8).

[see Figure 8. Multi-factor productivity accelerated in some countries but not in others]

… but not in others ...

14. Meanwhile, ICT has not played the same role in other countries. Prices of ICT equipment and certain services making use of ICT appear to be higher and/or have fallen less steeply in many countries outside the United States. And the build-up of ICT capital contributed much less to growth in Japan and the major continental European countries. The countries where the build-up of ICT capital was weak also were the ones where labour and capital productivity did comparatively badly. This is consistent with evidence that increased use of certain types of ICT equipment over the 1990s was associated with better productivity performance (Figure 9).

[see Figure 9. Increased ICT use is associated with a pick-up in multi-factor productivity]

… reflecting different policy settings

15. There are many reasons why ICT appears to have boosted growth in some countries but not in others. Clearly policy settings have played a role. Prices of ICT equipment have reflected, *inter alia*, the extent of competition in those markets, including the protection given to domestic producers through, for example, non-tariff barriers to imports. Internet use is strongly associated with the costs of such use, which again has been related to the degree of competition prevailing in the telecommunications sector. Countries that moved early to reform their telecommunications sector - separating competitive segments from non-competitive ones, liberalising the former and implementing pro-competitive regulation in the latter - saw prices fall and internet penetration rise earlier than others. As well, the use of internet for transactions is helped by a regulatory and legal environment for such transactions that inspires confidence in their integrity.

16. The ICT revolution also illustrates a more general point. The take-up of new technology usually requires restructuring within and between enterprises. Restructuring of existing enterprises is made more difficult by labour-market regulations that prevent enterprises from smoothly adjusting their workforce. And anti-competitive product-market regulation makes it difficult for enterprises to exploit new business opportunities. There is evidence that enterprises in countries with more heavy-handed product-market regulation are slower to catch-up to the international technological leaders in their sector. And strict job protection appears in most cases to be a drag on productivity growth.
17. Evidence on the production of ICT equipment provides an illustration of the role played by enterprise turnover. In the technologically turbulent ICT sector, the emergence of new high-productive enterprises adds significantly to sector-wide productivity growth. Hence, policies that put barriers in the way of new enterprises are likely to be bad for growth. It is not just excessively tight product and labour-market regulations that are an issue here - though empirical evidence shows that they are - but also policies that hinder the access to financing for new enterprises or that put administrative barriers in their way. In other, more stable, industries, labour productivity is driven mainly by gains in productivity within individual, on-going enterprises and by the disappearance of low-productive enterprises from the market. This pattern points to policies that ease the exit of low-productive enterprises. Such exits free-up resources to be used more productively elsewhere. And the risk of exit puts pressure on on-going enterprises to produce more efficiently. Bankruptcy provisions that lead to swift restructuring or closure, and that do not prevent a failed entrepreneur from trying again, are a boon to growth.

18. But failure and closure of enterprises bring social costs. Workers who are displaced may have difficulties in finding a new job or may have to accept sizeable wage cuts. In these conditions, acceptance of policy settings that allow the market to rip among enterprises may be conditioned by other policies that allow displaced workers to quickly find new jobs and that provide adequate income support while they search.

More generally, innovation and its diffusion are key to productivity …

19. ICT is but a manifestation of the role that innovation and its diffusion play for growth. R&D is a main driver of innovation. We can measure the cost of it, but cannot directly observe its output and effectiveness. Over the recent past, business R&D spending has risen slightly while government spending has fallen back (Figure 10). The differences across countries in R&D effort are wide. To some extent this reflects country - and thereby domestic market - size, though as globalisation continues this effect may become weaker. But policy is also important and getting it right is crucial, with empirical evidence pointing to a substantial impact of R&D on growth.

[see Figure 10. R&D spending differs widely across countries]

20. Because R&D often confers benefits to the economy that exceed those to its originator, most countries give support to R&D. A challenge in this regard is to do so in a way that does not distort the direction of research and avoids substituting government failure for market failure by attempting to pick winners. More generally, governments have a complicated role to play in several fields. Government laboratories typically undertake basic research which may not be immediately marketable but which may nonetheless be important in the long run. As well, future researchers are educated in institutions that are typically government-run or -sponsored. And the interplay between government and business R&D appears to be important.

21. Protection of intellectual property rights helps to raise the return on an innovation. In most cases, this will also raise the incentives to innovate. However, it is not necessarily the case where innovation is a collaborative process or where innovation by one enterprise builds on that of another. Hence the design of IPRs is crucial. This is also the case because overly strict IPRs may deter the diffusion of an innovation and limit competition. Conversely, competition in product markets may often be a spur to innovation pointing to the importance of general pro-competitive policies.

Improving the allocation of capital and its governance

22. As with labour utilisation, there is nothing magic about a high investment level. Japan is an example of a country with a high investment level and a very poor growth record over the past decade. But
saving and investment can also be too low. Where continuous government deficits pre-empt private investments, this can be the case. The re-emergence of widespread budget deficits, which in many countries are structural, underlines this risk. Policies have an important role in providing a framework conducive to reaching the right investment level; the allocation of investment to where the returns are high; and the governance structures that will ensure sustained high returns. Recent events show that the existing framework was insufficient in important respects.

Recent events have underlined the need for reform

23. While financial markets in general, and capital markets in particular, supported technological advance and the entry and growth of new enterprises and sectors through the 1990s there was a gradual loss of contact with reality. The argument that companies had achieved permanent qualitative gains in efficiency was used to defend equity valuations that were out of line with historical standards. At the same time, the ease of raising capital on the public markets induced firms to undertake excessive investments in a number of economic sectors. The bubble has now burst.

24. The recent equity price bust has not, thus far, caused the collapse of institutions, notably banks, that might require intervention by central banks or large injections of public funds. But the resiliency of banks to date no doubt partly reflects the fact that, with structural changes in intermediation, banks have succeeded in passing on risks to other market participants - who may not be equipped to face them. Numerous problems have also appeared in the insurance sector while many defined benefit pension plans face very large funding shortfalls, raising concerns for the sustainability of future resources income for small investors but also for financial stability. Greater transparency in risk transfer mechanisms as well as improved and more prudent risk management techniques would certainly contribute to restore financial soundness and confidence in these institutions.

25. In the wake of the 1990s equity boom and subsequent bust, some highly publicised abuses of power by corporate management and large corporate failures have severely shaken confidence in the fairness and transparency of capital markets. The misdeeds that have surfaced since 2000 raise serious questions about how the system needs to be strengthened. Corporate management too often provided incomplete and deceptive information, running counter to requirements for internal safeguards and disclosure. Management was too often able to manipulate board structures and remuneration policies to the detriment of shareholder interests. Auditors frequently provided lucrative consultancy services which in some cases may have given rise to conflicts of interest. Research provided by intermediaries was often slanted to facilitate commercial or investment banking operations by affiliated institutions.

26. Other market participants have had fewer obvious conflicts of interest, but on balance did not resist the rising tide of abuse. Thus, the timeliness and accuracy of analyses of the rating agencies has been called into question. While there is no reason to believe that institutional investors as a group were neglectful in their duties, many doubt whether the investor community sought to detect excesses with sufficient vigilance. And, in some cases, conflicts of interest have inhibited the funds management industry from fulfilling its duty to investors.

27. Efficient capital markets are necessary to underpin future growth in the OECD area and depend on an effective system of checks and balances that subject corporate management to market discipline. There must be strong incentives for the corporate sector to disclose reliable information. Reliable disclosure involves the internal governance procedures of the corporation as well as the regulatory regime established by self-regulatory organisations and market supervisors. Those responsible for processing and disseminating the disclosed information (financial intermediaries and rating agencies) must have strong incentives to analyse information rigorously and to provide investors with objective advice. As the public increasingly confides its assets to institutional investors, those investors must have adequate governance.
regimes and incentive structures to ensure that they act in the interests of final investors and to promote their oversight role over corporations to whom they provide finance. In short, there is a need for improved standards in corporate and financial governance, accounting, audit and disclosure as well as for more effective enforcement of existing standards and regulations. Educational efforts are needed to help small investors, including pensioners, better understand the functioning and inherent risks of financial markets.

28. If confidence is to be restored, the corporate sector, the financial services industry and oversight agencies will have to adapt to rules and behavioural standards that squarely address the failings of recent years. While a few cases of clear violations of laws or blatant conflict of interests may have attracted most attention, these weaknesses can be addressed by vigorous enforcement and carefully targeted changes in laws and regulations. More significant are the efforts required to strengthen the framework by lessening conflicts of interest and aligning the interests of market participants with those of final investors. A related challenge will be to find the right balance between tightening laws and regulations where needed and allowing market participants to introduce reforms.

Epilogue: No need to wait

29. There is no reason why policy reform to boost long-term growth should wait for better times. Indeed, policy reforms to strengthen long-term growth may boost confidence and strengthen the resilience of economies as they go through the current rough patch. And a downturn may be the right time to speed up reforms that are good for both long-term growth and short-term demand. Nevertheless, reforms may sometimes involve painful adjustments. Hence policies need to take account of such transitional effects and try to carefully balance supply-enhancing policies with appropriate demand management policies.
Table 1. Average trend growth in GDP per capita over selected periods

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2. Mainland only.
3. Excluding the Czech Republic, Hungary, Poland and the Slovak Republic.

Source: OECD Economic Outlook, No. 72.
Figure 1. The causes of real income differences
Percentage points difference in PPP-based GDP per capita with respect to the United States, 2000

Percentage gap with respect to US GDP per capita = Effect of labour resource utilisation (1) + Effect of labour productivity (2)

1. Based on the ratio of total employment to population and average hours worked.
2. GDP per hour worked.
Source: OECD.
Figure 2. The NAIRU is high in Continental Europe
Indicator of structural unemployment, in 1990 and 2002

Figure 3. Overall employment rates reflect those of marginal groups
2001

1. Further information on the estimation method can be found in OECD Outlook, No 68, December 2000.
Figure 4. **The tax wedge on labour is high in some countries**

1. For a single individual at the income level of the average production worker. Tax wedges are calculated by expressing the sum of personal income tax, employee plus employer social security contributions together with any payroll taxes as a percentage of labour cost. The effect of indirect taxes is not taken into account.

*Source*: OECD, Taxing Wages.
Figure 5. **Strictness of employment protection**

Synthetic OECD indicators of restrictiveness

Panel A. **Regular employment**

Panel B. **Temporary employment**

1. For definition, see Source. A higher indicator value implies a more restrictive policy stance.

Figure 6. **Product markets have been liberalised but country differences remain**

Change in regulatory stance, 1978-1998

1. Reports changes in the regulatory stance in seven non-manufacturing industries (gas, electricity, post, telecommunications, passenger air transport, railways and road freight) between 1978 and 1998. The regulatory stance is measured by a synthetic indicator ranging between 0 (least restrictive) and 6 (most restrictive).

Figure 7. Widespread progress in strengthening human capital
Average years of education in OECD countries\(^1\)
1970 and 1998

1. Average number of years of education in the population aged 15-64 years, based on data on level of education attained and assumptions about the number of years of education implied by different levels of education attainment.
2. Western Germany in 1970.
Source: OECD.
Figure 8. Multi-factor productivity accelerated in some countries but not in others
MFP growth rates, business sector, 1990s and 1980s
(based on cyclically-adjusted series)


*Source*: OECD.
Note: Countries with the largest increase in the penetration of PCs in the 1990s have experienced a more rapid pick-up in MFP growth over the 1990s. Correlation coefficient: 0.61; T statistic: 3.0.

Source: OECD (2001), The New Economy Beyond the Hype: the OECD Growth Project.
Figure 10. Expenditure on R&D in OECD countries
Total expenditure on R&D as a percentage of GDP, 1980s and 1990s

Source: OECD