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PROMOTING POTENTIAL GROWTH: THE ROLE OF STRUCTURAL REFORM

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ABSTRACT/RESUMÉ

Promoting potential growth: The role of structural reform

The global crisis has left many G20 countries with an unenviable legacy of lower potential output and high government indebtedness. Global imbalances, which had narrowed during the recession, are now beginning to widen again, as the recovery takes hold. Structural reform will be needed not only to recover the crisis-driven output loss and to maintain it in the longer term, but also to put the public finances back on a sustainable path and to rebalance global growth. To contribute to the policy debate, this paper summarises the analysis carried out by the OECD on the effects of a host of structural reforms on GDP growth, public finances and external current account balances.

JEL Codes: F30, O40, J08
Keywords: global imbalances, potential output, structural reform

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Promouvoir la croissance potentielle : Le rôle des réformes structurelles

La crise mondiale a légué à de nombreux pays du G20 une production potentielle plus faible et un endettement public plus important. Les déséquilibres de la balance courante, qui avaient diminué pendant la récession, recommencent désormais à augmenter au fur et à mesure que la reprise prend forme. Des réformes structurelles seront nécessaires non seulement pour récupérer la perte de production potentielle due à la crise et la maintenir à plus long terme, mais aussi pour remettre les finances publiques sur une trajectoire soutenable et rééquilibrer la croissance mondiale. Ce document contribue au débat de politique économique en résumant l'analyse effectuée par l'OCDE sur les effets des réformes structurelles sur la croissance du PIB, les finances publiques et les déséquilibres de la balance courante.

Codes JEL : F30, O40, J08
Mots-clés : déséquilibres globaux, produit potentiel, réforme structurelle

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1. Introduction[1]

The global crisis has left many G20 countries with an unenviable legacy of lower potential output and high government indebtedness. While long-term growth rates may well have been unaffected by the crisis, potential output is expected to have fallen by about 3% in the G20 countries for which OECD estimates are available. At the same time, a combination of fiscal stimulus measures, cyclical revenue losses and expenditure hikes, and the disappearance of revenue buoyancy driven by asset price bubbles has resulted in sharp increases in budget deficits, which are projected at about 4.3% of GDP in 2011 in the G20 countries for which OECD estimates are available. The global crisis has also contributed to a temporary narrowing of global current account imbalances. Having reached over 5% of world GDP in 2008, the combined current account surpluses and deficits of the world's major countries and economic areas almost halved in 2009. These imbalances are beginning to widen again, with the notable exception of China's current account surplus, which continues to fall in relation to GDP.

Structural reform will be needed not only to recover the crisis-driven output loss and to maintain it in the longer term, but also to put the public finances back on a sustainable path in many G20 countries and to rebalance global growth. To shed light on how structural reform can contribute to meet these objectives, this paper summarises the analysis carried out by the OECD on the effects of a host of structural reforms on GDP growth, public finances and external current account balances. Emphasis is placed on the policy domains selected on the basis of the country-specific reform priorities identified in *Going for Growth* (OECD, 2010a), the OECD flagship publication on structural policy surveillance, and discussed in greater detail in the country-specific *Economic Surveys*.[2]

This paper is structured as follows. Section 2 briefly describes the effects of the global crisis on potential output, public finances and global current account imbalances and looks at the role that structural measures could play to address such issues. Section 3 reports the main findings of OECD analysis on the impact of structural reform on these outcomes. Section 4 concludes.

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1. This paper was prepared for the G20 Workshop on the Framework for Strong, Sustainable and Balanced Growth, held in Toronto on 7-9 May 2010. The authors are indebted to Linda Rousova for research analysis and Workshop participants for helpful comments and discussions, while remaining solely responsible for any remaining errors or omissions.

2. *Going for Growth* focused originally on the OECD member countries and the European Union and is now being extended to Brazil, China, India, Indonesia, Russian Federation and South Africa. By contrast, in addition to the OECD member countries, *Economic Surveys* are already available for Brazil (four editions since 2001), China (2005 and 2010), India (2007) and Russian Federation (seven editions since 1995). *Economic Assessments*, a less comprehensive surveillance exercise, are available for Indonesia (2008) and South Africa (2008), and full *Economic Surveys* are being produced for these two countries for publication in 2010. Argentina and Saudi Arabia are the only G20 countries for which no *Economic Survey* or *Economic Assessment* has so far been carried out.

2. The effects of the crisis on potential output, public finances and global imbalances

Potential output and public finances

The global crisis has taken its toll on potential output in several G20 countries. Even as economies recover, the crisis could well reduce medium-term potential output by about 3% on average relative to pre-crisis levels in the G20 countries for which OECD estimates are available (**Table 1**).[3] Most of the drop in potential output is expected to have been due to lower capital intensity in production, followed by higher unemployment. This is because higher cyclical unemployment usually translates into higher structural unemployment, as workers lose attachment to the labour force and their skills deteriorate during lengthy spells of inactivity. The size of this latter effect depends on the functioning of labour markets, which varies significantly across countries and has been somewhat different in the current crisis relative to previous ones, not least because unemployment has been notably lower than expected in Europe on account of considerable labour hoarding in some countries. As for the timing of long-term output losses, much of the reduction would have occurred by 2010, although there are large variations across countries, reflecting in part differences in the magnitude of the shock, policy settings and labour market institutions. Structural measures in labour and financial markets could address, and possibly revert, such longer-term consequences of the recession.

Notwithstanding its impact on the level of long-term output, the crisis is unlikely to have reduced potential output growth. The expected fall in potential GDP growth from about 2.5% per year on average over the seven years preceding the crisis to around 2% per year in the long term is due to reasons, including slower growth in potential employment due to ageing populations, which are unrelated to the global crisis. The effect of changes in total factor productivity (TFP) growth and labour force participation are more difficult to take into account, especially because there can be mutually offsetting effects during downturns. Structural measures, such as for fostering competition in product markets, could enhance innovation and potential output.

The global crisis has also wreaked havoc in the public finances, with an increase in the budget deficit to about 4.3% of GDP in the G20 countries for which OECD estimates are available (OECD, 2009b).[4] This outcome is related essentially to the impact on the budget of fiscal stimulus measures, cyclical revenue losses and expenditure hikes, and the disappearance of revenue buoyancy driven by asset price bubbles. As a result of large budget deficits, government indebtedness is set to reach all--time highs in several countries in the near term (**Figure 1**), which calls for consolidation to restore long-term fiscal sustainability. Structural measures enhancing medium-term growth would facilitate fiscal consolidation, while possibly avoiding additional pressures on the budget and in some cases contributing to raising public savings.

3. This estimated output loss is about one percentage point lower on average than for the OECD area as a whole (OECD, 2009a and 2009b). These estimations will be updated in the forthcoming edition of the OECD *Economic Outlook* (OECD, 2010b).

4. See http://www.oecd.org/dataoecd/16/1/44829122.pdf for more information.

Table 1. Effects of the crisis on potential output and public finances

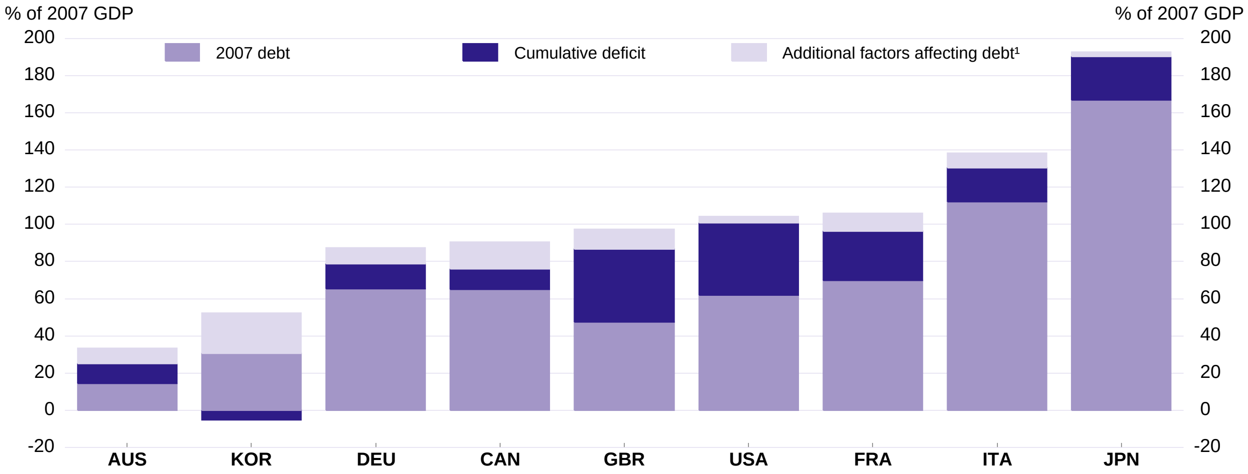
	Potential output effects[1] (%)			Potential output growth (%)		Headline budget balance (% of GDP)	
	Employment	Cost of capital	Total	Before the crisis[2]	After the crisis[3]	2007	2011 (proj.)
Australia	-0.5	-2.1	-2.6	3.4	3.0	1.7	-2.4
Brazil	..	..	..	..	..	-2.7	-0.9
Canada	-0.5	-1.9	-2.4	2.8	1.6	1.6	-2.1
China	..	..	..	..	..	1.9	1.6
France	-0.9	-1.9	-2.8	2.0	1.3	-2.7	-6.9
Germany	-1.7	-2.2	-3.9	1.2	1.4	0.2	-4.5
India	..	..	..	..	..	-4.4	-9.5
Indonesia	..	..	..	..	..	-1.2	-1.3
Italy	-1.9	-2.1	-4.1	1.0	1.1	-1.5	-5.0
Japan	-0.4	-1.7	-2.1	1.1	0.9	-2.4	-8.3
Korea	..	..	..	4.4	3.5	4.7	0.8
Mexico	..	..	..	2.5	2.2	..	..
Russian Federation	..	..	..	..	..	6.0	-2.2
South Africa	..	..	..	..	..	1.7	-4.9
Turkey	..	..	..	4.6	3.8	..	..
United Kingdom	-1.1	-1.8	-2.9	2.5	1.6	-2.7	-10.3
United States	-0.4	-2.0	-2.4	2.6	2.2	-2.8	-8.9
Memorandum items							
Simple average	-0.9	-2.0	-2.9	2.5	2.0	-0.2	-4.3
Weighted average[4]	-0.7	-2.0	-2.7	2.3	1.9	-1.0	-5.0

1. The effects of the crisis on potential output are calculated through two distinct channels (OECD, 2009b): a fall in potential employment, which is mainly due to a rise in structural unemployment as a result of hysteresis-type effects, and the negative effect of a permanently higher cost of capital on the long-term capital-labour ratio and thereby on productivity. The calculation of the effect of lower potential employment on potential output includes a "scaling" effect as other factors of production (capital) are reduced by the same proportion, so that an x% fall in potential employment also reduces capital inputs – and thereby potential output – by x%.
2. Refers to the 2001-07 average.
3. Refers to the average of 2011-17 projections.
4. Weighted by GDP in 2009 in the case of potential output and by GDP in 2007 and 2009 in the case of budget balances.

Source: *Economic Outlook No. 87* database.

Figure 1. Government indebtedness, 2007-11

Decomposition of the 2011 gross government debt



1. Refers to the level of gross debt in 2011 minus the sum of gross debt in 2007 and the cumulative deficit for 2008-11 (all measured in per cent of 2007 GDP) and includes debt-increasing equity participation in companies.

Source: *OECD Economic Outlook No. 87* database.

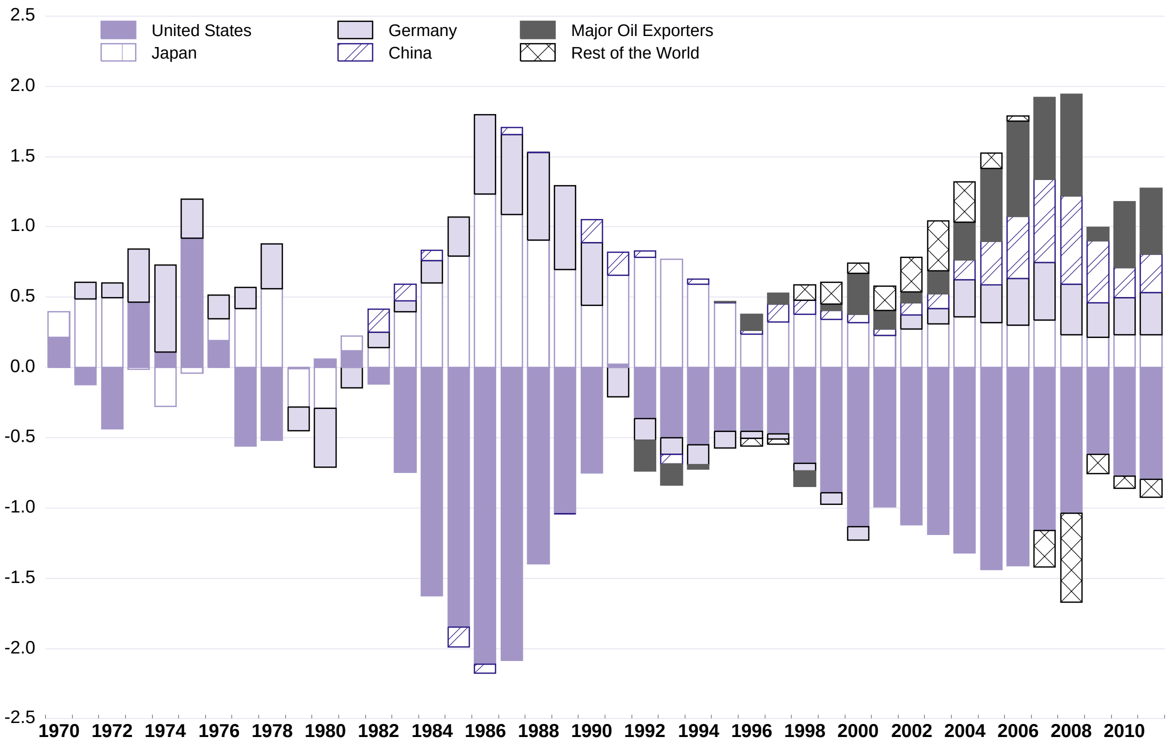
Global imbalances

Global current account imbalances narrowed sharply during the recession. These imbalances, measured as the sum in absolute terms of current account positions of major countries/regions, had risen to over 5% of world GDP in 2008 but nearly halved during the recession (**Figure 2**).[5] More than one-half of this reduction has come from the United States, where the current account deficit shrank by one-half between mid-2007 and mid-2009 on the back of higher household savings (due to the fall in asset prices and higher uncertainties) and lower investment, which more than compensated for the decline in government saving. Surpluses in Germany and Japan also narrowed as the crisis hit exports strongly, while the combined surpluses of the oil-exporting countries shrank as oil prices collapsed and exports of oil slowed due to weaker world demand. The fall in the Chinese surplus reflected the sharp fall in export demand and stronger imports driven by strong domestic demand supported by large policy stimulus.

5 See OECD (2009a and 2009b) for more information.

Figure 2. Global imbalances, 1970-2011

Current account balances, in % of world GDP



Source: *OECD Economic Outlook No. 87* database.

The narrowing of global imbalances has been due essentially to temporary factors. OECD estimations suggest that the world trade collapse, together with the fall in oil prices, accounts for more than one-half of the reduction in global imbalances since mid-2008. As the recovery continues and output gaps close, and in the absence of changes to exchange rates and policies, global current-account imbalances are therefore set to widen again, while probably not reaching the level of immediately prior to the crisis.[6] The latest indicators show that the deficit of the United States and the combined surpluses of Japan and Germany are beginning to widen, while the Chinese current account surplus continues to drop in relation to GDP. Assuming the value of world trade recovers to its end-2007 level by end-2011, OECD estimates suggest that global imbalances would widen by about 1 percentage point of world GDP over the next couple of years.[7] These developments suggest that structural reform would contribute significantly to a sustained reduction in global current account positions by lowering savings in some surplus countries, raising investment in others, and encouraging higher savings in deficit countries.

6. Results from the OECD's Global Model suggest that, in the absence of policies to adjust domestic absorption, exchange rate realignments may do relatively little to resolve external imbalances. For example, the United States' current account balance would improve by only ¼ to ½ per cent of GDP following a 10% depreciation of the effective exchange rate, with much of this improvement coming from an increase in the investment income balance.

7. This is based on a regression of global current account imbalances on world trade growth (values), oil prices and a trend over 1975-2008 (not reported but available upon request). The projection assumes oil prices remain at just under $80 per barrel and excludes the estimated time trend from the forecasting period.

3. The impact of structural reforms on potential output, public finances and current account positions

Long-term growth

OECD analysis on the impact of structural reform on potential output - through labour productivity and utilisation (average hours worked and employment) - has focused on a number of policy areas, including product and labour market regulations, tax policy and human capital. These policy areas have featured prominently among the structural priorities identified in *Going for Growth* since 2005.[8] Because actions in different policy domains are interconnected and often mutually-reinforcing, policy initiatives to raise labour productivity will also likely have an influence on utilisation, and vice versa.

Empirical evidence[9]

The impact of different structural policies on GDP per capita can be gauged using simulated "multipliers" for the average OECD country (**Table 2**). The multipliers can be reported for unit changes in different policy items, such as a reduction in the average replacement rate of unemployment benefits by ten percentage points, and for one-standard-deviation changes in policies to allow for comparability across policy instruments. The multipliers can also be simulated over a ten-year period and at steady state to shed light on the time horizon required for different reforms to come to fruition.

On the basis of the simulated multipliers, it appears that the most effective policy levers to raise GDP per capita in the long term are related to education, particularly reforms aimed at lifting the average number of years of education of the adult population and improving performance (based on PISA scores of 15-year-olds). In addition, steady-state effects are also strong for reform of tax systems (a cut in average tax rates), employment protection legislation (a reduction in average unemployment benefit replacement rates) and enactment of pro-competition regulations in product markets. Other reforms, such as raising the standard retirement age, reducing the implicit tax on continued work at older ages and cutting marginal tax wedges, can also have a significant growth dividend.

The time it takes to reach the steady state differs across policy areas. Labour market and tax reforms are assumed to work relatively fast, especially for reforms affecting hours worked. By contrast, productivity-enhancing reforms converge towards steady-state productivity levels at a slower pace. Although human capital reforms have a strong steady state effect on GDP per capita, these reforms take a long time - around 50 years - to become effective for all cohorts and even longer to have their full effects on GDP per capita.[10]

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8. **Annex 1** reports the five priorities identified in the latest edition of *Going for Growth* for the G20 countries for which information is available.

9. The body of empirical work includes the OECD *Growth Study* (OECD, 2003), the OECD *Jobs Strategy* (OECD, 1994) and its reappraisal (OECD, 2006), as well as a wide range of other studies carried out in the context of structural policy surveillance. See **Annex 2** for a summary.

10. This is because policy can only influence the length of education and PISA scores for the 15-24 age cohort The profile of adjustment also differs across countries depending on their demographic structure. The effects of reform are felt sooner for countries with large young cohorts relative to older cohorts, although the full effects take up to 50 years to materialise.

Table 2. **Average effects of reforms on GDP per capita**

Average across OECD countries

	Definition of "unit" shock	OECD average	OECD standard deviation	Simulated effect (unit changes)		Simulated effect (one-standard deviation changes)	
				After 10 years	Steady-state	After 10 years	Steady-state
Labour market policies							
Average replacement rate	-10 ppt.	27.2	11.0	1.9	3.0	2.0	3.2
Employment protection legislation (EPL)	-1 index point	2.2	0.8	0.3	0.4	0.2	0.3
Maternal leave weeks	+10 weeks	27.0	20.5	0.1	0.2	0.2	0.3
Childcare benefits	-0.1 ppt.	0.6	0.1	0.0	0.0	0.0	0.0
Childcare support	+0.1 ppt.	0.6	0.1	0.0	0.0	0.0	0.0
Standard retirement age	+1 year	64.3	2.3	0.2	0.3	0.3	0.6
Implicit tax on continued work	-10 ppt.	26.9	19.9	0.2	0.4	0.4	0.8
Average weekly normal hours and overtime	+1 hour	44.3	4.7	0.1	0.1	0.4	0.4
Taxation							
Average tax wedge	-10 ppt.	30.0	9.9	3.3	5.2	3.1	5.0
Marginal tax	-10 ppt.	32.4	9.5	1.1	1.1	1.1	1.1
Product market regulation							
Gas	-0.1 index point	3.3	1.1	0.1	0.1	1.1	1.0
Electricity	-0.1 index point	1.8	1.3	0.1	0.1	1.0	1.2
Road	-0.1 index point	1.6	1.4	0.1	0.1	1.5	1.3
Rail	-0.1 index point	3.6	1.5	0.1	0.1	1.5	1.4
Air	-0.1 index point	2.0	1.6	0.1	0.1	1.7	1.5
Post	-0.1 index point	3.0	0.5	0.1	0.1	0.4	0.4
Telecommunications	-0.1 index point	1.6	0.9	0.1	0.1	0.9	0.9
Overall	-0.1 index point	2.5	0.8	0.73	0.67	5.7	5.1
Human capital							
PISA score	+10 points	496	21.4*	0.1	2.0	0.3	4.1
Average years of schooling (16-24 cohort)	+1 year	12.6	1.0	0.6	8.1	0.6	8.3

* Excluding Mexico and Turkey.

Source: Dougherty *et al.* (2010).

Policy priorities for G20 countries

Many of the structural policy items taken into account in the simulations reported above feature highly in the pro-growth reform agenda of several G20 countries. A review *Going for Growth* priorities since 2005 shows that countries have followed up on *Going for Growth* recommendations (**Figure 3**) in a number of policy domains.[11] By successfully addressing the weaknesses that have resulted in the identification of a particular policy priority, implementation has sometimes resulted in the policy item being dropped from the list of priorities in subsequent reviews. This is especially the case of productivity-enhancing measures, which have on average higher follow-through rates than labour utilisation-related measures.

Product market regulations

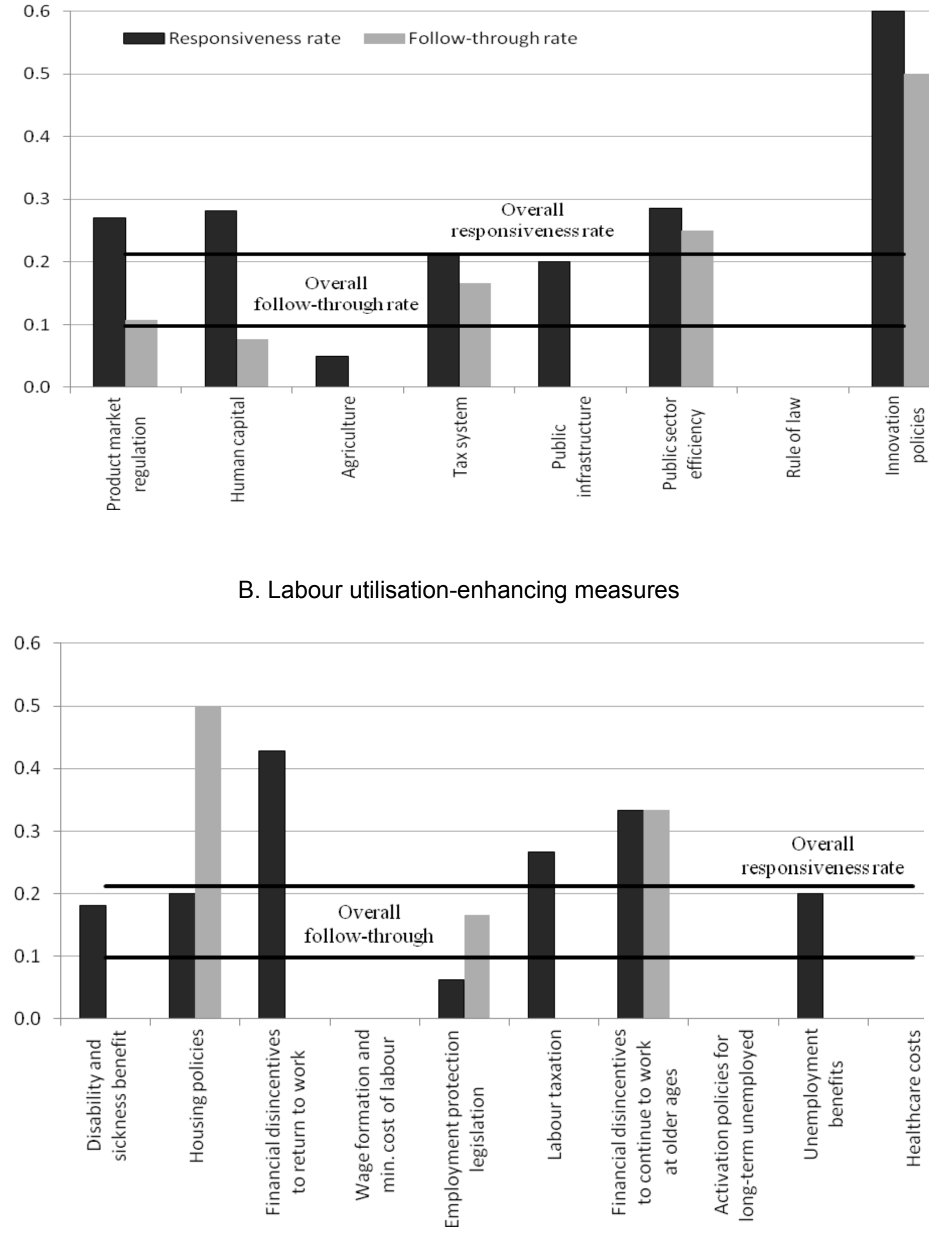
Pro-competition reforms have been among the main policy priorities in many G20 countries. Action has been taken to reduce entry barriers and administrative burdens and to reform corporate governance in a number of countries on the basis of *Going for Growth* priorities (**Table 3**). Pro-competition reforms have also been among key policy priorities identified in *Economic Surveys*, as noted in **Annex 1**, for those G20 countries that have not yet been fully integrated in the *Going for Growth* framework. These priorities include a reduction in state control of economic activities (China, India, Indonesia, Russian Federation), barriers to trade and investment (India, Indonesia) and administrative burdens (Brazil, South Africa). Less restrictive regulations on foreign direct investment (FDI), particularly in services and network industries, have also been identified as priorities in some countries (Indonesia, China, India).

Notwithstanding progress in many areas in recent years, further product market reforms remain a priority in many countries. Priorities include a strengthening of competition in network industries (Australia, the European Union at large, Mexico) and professional services (Canada), an alleviation of regulatory barriers to competition (Brazil, France and Germany), and a reduction of public ownership (Italy, India, Indonesia) and restrictions on foreign investment (Indonesia, Japan, Mexico).

11. The approach taken in *Going for Growth* is based on a systematic international benchmarking framework that ensures consistency across countries and with the more detailed country-by-country recommendations reported in the *Economic Surveys*. Five policy priorities are identified every year: three priorities are selected using the model-based benchmarking exercise and two priorities are selected on the basis of *Economic Survey* recommendations.

Figure 3. Responsiveness and follow-through of *Going for Growth* recommendations since 2005

A. Labour productivity enhancing measures



1. The responsiveness rate is the ratio of the number of years in which some action is taken towards addressing the policy priority to the number of years in which some action could potentially be taken (excluding the year when the priority is set). The follow-through rate is the ratio of the number of priorities dropped following significant action during the previous two years to the number of two-year cycles including the policy priority.

Source: *Going for Growth* database.

Table 3. Implementation of *Going for Growth* priorities in G20 countries, 2005-09

	Action taken[1]
Product market regulations	
Reduce entry barriers in services and/or industries in general	France, Italy, Japan, Korea
Reduce entry barriers in network industries	Australia, Germany, Mexico
Reduce entry barriers in professional services	Canada, Germany
Reduce entry barriers in retail distribution	France
Reduce administrative burdens	Turkey*
Reform corporate governance	Italy*
Reduce the scope for public ownership	Turkey*
Labour market regulations	
Reform disability and sickness benefits	Australia, United Kingdom
Review wage formation or minimum cost of labour	Turkey
Reform employment protection legislation	France
Taxation	
Simplification, reduction of distortions and base broadening	Canada, Japan, Mexico, United States
Lower labour taxes	Australia, Germany, Italy, Poland, Turkey
Reduce implicit tax on continuing to work and work at older age	France, Germany*, Turkey
Reduce implicit tax on returning to work following childbirth	Germany, Korea, United kingdom
Improve educational outcomes	
Reform primary and secondary education	Australia*, Germany, Mexico, United Kingdom
Reform tertiary education	France, Germany, Italy
Financial regulation	
Privatisation, non-performing loans, regulation and supervision	Japan, Korea, United States
Other areas	
Agricultural support	Japan
External exposure	Japan, Korea*
Public sector efficiency	Germany*, Turkey*, United Kingdom
Innovation	Japan, Korea
Public infrastructure	United kingdom

1. Refers to the categories "actions taken" and "actions taken implying removal of the priority" (identified with an asterisk) in the assessment of progress made in implementing *Going for Growth* recommendations (OECD, 2010a).

Source: *Going for Growth* database.

Labour market regulations

Work incentives can be reinforced by reforming benefit entitlements and strengthening active labour market policies. A combination of well-designed benefit (unemployment, sickness and disability) systems, assistance to jobseekers and close monitoring of their job-search intensity contributes to lowering unemployment, increasing hours worked and lifting labour market participation. Nevertheless, there has been relatively limited progress in these areas in most countries since 2005, although action has been taken to reform disability and sickness benefits in Australia and United Kingdom.

Policy initiatives to make employment protection legislation more flexible have a bearing on both labour productivity and employment. Reform efforts that facilitate hiring/firing and alleviate the minimum cost of labour may also have the side-effect of discouraging informality, which often arises as a means of bypassing cumbersome regulations and results in a segmentation of the labour market that hinders productivity growth and diffusion of new ideas. Turkey has taken steps to implement *Going for Growth* recommendations in this area by cutting social security contributions for low-wage earners. Brazil has also taken action in this area following an *Economic Survey* recommendation to alleviate the tax burden on labour income (OECD, 2009c). A reform of minimum wage setting has been recommended for Indonesia (OECD, 2008) as a means of reducing barriers to the formalisation of labour relations, but action has yet to be taken.

Finally, reforms that provide workers with greater choice regarding work schedules help to promote labour force participation of certain groups, notably women with young children. In general, progress to address *Going for Growth* priorities in this area has been timid, although France has introduced a new fixed-term contract for specific projects.

Taxation

Various aspects of tax reform have been identified as policy priorities in structural and country-specific surveillance. The underlying argument is that tax reform can be growth-friendly to the extent that it shifts the composition of the tax take towards non-distorting instruments, such as taxes on immobile bases, such as property and consumption. Reform of indirect taxation with a view to simplifying value-added taxation at the sub-national level has been recommended for Brazil (2009c).

The growth implications of labour taxation have motivated reform discussions with several G20 countries. The basic argument is that potential output could be boosted through higher participation by reducing average labour taxes, while lowering marginal rates may increase hours worked and enrolment in tertiary education.[12] Accordingly, reductions in the implicit tax on returning to work or on working at older age have been identified as *Going for Growth* priorities for France, Germany and Turkey. An alleviation of the tax burden on low-income workers would also contribute to tackling informality in the labour market, as noted above.

Tax policy can also influence productivity through various channels. A reduction in the top marginal statutory rate on personal income can encourage entrepreneurship, although the effects of such a policy move on income redistribution would need to be taken into account. In addition, lowering statutory corporate tax rates can lead to particularly large productivity gains in firms that are dynamic and profitable. Accordingly, Italy has taken action to reduce average and/or marginal tax wedges by lowering income tax rates in line with *Going for Growth* recommendations.

Human capital

Education policies have a bearing on labour productivity and utilisation through their impact on workforce skills and innovation. Consistently, action has been taken in several G20 countries to reform education systems in line with *Going for Growth* priorities with emphasis on the primary and secondary levels in Australia, Germany, Mexico and United Kingdom. *Going for Growth* has also identified a number of policy priorities to reform tertiary education in France, Germany and Italy on the grounds that improvements in higher educational attainment are often associated with increasing labour force participation and hours worked, in addition to stronger innovation performance. In recognition of the fact that early childhood education helps to broaden opportunity and stimulate subsequent learning, the latest edition of *Going for Growth* includes a recommendation for Australia to enhance the quality of and improve access to services, especially for disadvantaged groups.

Financial regulation

The global crisis has brought deficiencies in financial regulation to the fore and motivated remedial policy action in many G20 countries, not least the United States, where initiatives to improve and streamline financial regulation are among policy priorities identified in the latest edition of *Going for Growth*. Reform is under way in the United States and many other countries to strengthen prudential regulation of financial markets.

12. Reform in this area should nevertheless take into account its joint effects with existing benefits, which could alter effective average and marginal tax rates, particularly for low-skilled workers or second-earners.

The relationship between financial regulation and competition has also underpinned the identification of policy priorities for G20 countries.[13] In Korea, for example, there has been considerable progress in the privatisation of banks and investment trust companies in line with *Going for Growth* policy priorities to extent pro-competition reforms to banking and financial sector at large. Moreover, reform that facilitates access by small firms to more abundant, less costly credit would generate a growth dividend by encouraging firm entry and technology diffusion. Consistently, there has been much progress in Brazil, for example, to tackle the root causes of financial exclusion by facilitating access to services by the underserved population, typically small businesses and low-income individuals (2009c).

<u>Other areas</u>

Going for Growth priorities have included initiatives in other structural policy domains, including measures to address public infrastructure deficiencies in the United Kingdom, where action has been taken in line with identified priorities, and to strengthen the rule of law in Mexico. As for government efficiency more generally, Germany has taken steps to increase competition in government procurement, whereas Turkey has focused on introducing results-oriented budgeting in public services. Innovation-promoting policies, including through the use of competitive grants, have been put in place in Japan, whereas Korea has made progress in improving in the quality of higher education in support of innovation. Action has been taken in Canada to ease foreign ownership restrictions, and a further relaxation of FDI restrictions, especially as regards foreign ownership, would be welcome in other countries, including Indonesia.

Public finances

OECD analysis on the effect of structural reform on public finances has focused on the efficiency of government spending, especially on health care and education, and on the fiscal costs associated with pension and health care entitlements. Synergies between pro-growth structural reform in various areas, including product and labour markets, and underlying fiscal positions are recognised and, in general, pro-growth policies are also often associated with a strengthening of budget positions. Evidence for OECD countries suggests that policy actions that can lead to productivity gains or reductions in structural unemployment tend to improve the budget balance in the long term.

Reform to boost the cost-effectiveness of government spending may have a double dividend of strengthening public finances and fostering growth. In principle, reform may aim at achieving better outcomes by using the same amount of technical inputs and spending, which would be budget-neutral. Alternatively, the objective of reform may be to achieve the same outcomes using fewer inputs, which would generate savings to the budget that could in turn be reallocated to finance the delivery of growth-enhancing services and public investment. As noted above, reform options to address *Going for Growth* priorities have been wide-ranging, including in the areas of public procurement and budgeting procedures.

Pension, education and health care reform could generate significant budgetary savings. These reforms could yield a concomitant growth pay-off to the extent that budgetary savings are reallocated to growth-enhancing programmes. In many OECD countries, empirical evidence suggests that an improvement in health spending efficiency could significantly raise life expectancy without putting an additional financial burden on the budget (Erlandsen, 2007). OECD research also shows that there is considerable scope for efficiency gains in the provision of education services in some countries

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13 Recent OECD evidence shows that the impact of pro-competition reform in banking is strong in industrial sectors that rely heavily on external sources of funding and that, outside a few specific areas of regulation, there is no policy trade-off between banking sector stability and competition (OECD, 2010a). It should therefore be possible to strengthen regulation while preserving the benefits of competition in terms of improving access to financial services and lowering the costs of financial intermediation.

(Sutherland and Price, 2007). Moreover, pension reform would be pro-growth to the extent that labour utilisation is improved through the removal of incentives for early retirement.

The elimination of agricultural and fuel subsidies could have a double dividend of fostering productivity gains and creating savings in the budget that could be reallocated to the provision of pro-growth goods and services. Although more is needed, steps have been taken in Japan to reform support to agriculture and in Indonesia to replace fuel subsidies by targeted income transfers to low-income households, which are most vulnerable to adverse income shocks arising from fluctuations in fuel prices. More comprehensive reform of existing subsidies to consumers and producers would also be desirable in India (OECD, 2007). A reduction in producer support to agriculture would be desirable in Japan, Korea and the United States on the basis of *Going for Growth* priorities.

Current account balances

Structural reforms are likely to influence a country's external current account position by affecting both savings and investment behaviour. Reforms in this area have both demand- and supply-side effects, whose balance depends on the types of reforms implemented and the framework conditions prevailing in individual countries.

With regard to investment, product market deregulation that removes barriers to entry may foster foreign investment, which may weaken the current account before balancing mechanisms gradually set in. Reform to this effect would be desirable in Germany on the basis of the policy recommendations reported in the most recent edition of *Going for Growth* (2010a) and *Economic Survey* (2010c), where the non-tradable sector, particularly services, remain shielded from productivity-enhancing competition that could unleash opportunity for investment and therefore contribute to a reduction in the country's large saving-investment gap.

Likewise, financial market reform to improve enforcement and transparency of legal and regulatory framework conditions for financial systems would have a positive effect on innovation and investment in new enterprises. The attendant increase in capital inflows may in turn result in a smaller current account surplus. Moreover, efforts to raise effective labour supply by removing regulatory impediments in labour market regulation would affect the current account by boosting trade competitiveness (if domestic demand for labour is not fully elastic) and the profitability of domestic capital. The reform options identified above to strengthen financial regulation and to boost labour participation may also therefore have concomitant effects on the implementing countries' external positions.

Specific social reforms may influence savings decisions and subsequently the current account balance. Otherwise desirable policy initiatives, such as a strengthening of formal social safety nets, which would reduce public savings through an increase in social spending, could also have the side-effect of reducing private savings in some emerging-market economies, especially China (OECD, 2010d). By the same token, policies that would encourage private saving in deficit countries, such as the United States, by for example scrapping income tax deductibility for mortgage payments or shifting the personal income tax further to a consumption base, would have an influence on the current account.

Other structural reforms may have an effect on the current account. Initiatives to reduce oil consumption could lower the current account deficit in oil-importing countries, although the final impact depends on how such policies affect the fiscal deficit and consumption of other goods.

4. Conclusions

Structural reforms can not only have a direct positive impact on potential output, but also facilitate fiscal consolidation, including by increasing public savings, and address some of the determinants of global current account imbalances through their effect on savings and investment. Structural reform priorities reflect country specific characteristics in terms of different economic structures, institutional settings and social preferences. Nonetheless, evidence across a number of policy areas leads to an assessment that provides general information on the likely impact of specific reforms on per capita GDP and the time needed for such impact to materialise fully.

Several structural reform priorities have been identified for G20 members on the basis of the benchmarking exercise that underpins *Going for Growth* and the country-specific surveillance of structural policies documented in the OECD *Economic Surveys*. The policy priorities selected in the latest edition of *Going for Growth* for G20 countries are reported in the paper, as well as their likely impact on GDP. The paper also summarised the impact of a number of structural reform items on current account positions, based on a body of empirical analysis carried out by the OECD.

A review of action taken in response to *Going for Growth* recommendations indicates that over the past five years action a number of countries have implemented reforms to address the underlying weaknesses that have led to the identification of particular policy priorities. In several cases, such reforms have been carried to completion, which has resulted in particular policy items being dropped from the list of priorities in subsequent reviews. However, despite progress in many areas, initiatives to raise potential output, while addressing fiscal consolidation and current account imbalances, should continue to rank highly on the policy agenda of G20 countries.

Annex 1. *Going for Growth* policy priorities for G20 countries

Country		Policy priority[1]	GDP impact (steady state)	Policy target	Policy sub-domain
Australia	1	*Reform disability benefit schemes*	+	Labour utilisation	Disability and sickness benefits
	2	*Strengthen competition in network industries*	+	Productivity	Product Market Regulation
	3	*Improve the performance of early education*		Productivity	Human capital
	4	Maintain a flexible wage bargaining system	+	Labour utilisation	Wage formation and minimum cost of labour
	5	Improve fiscal incentives for work force participation	+	Labour utilisation	Labour taxation
Brazil	1	Improve the efficiency of education	+	Productivity	Human capital
	2	Reform product market regulation	+	Productivity	Product Market Regulation
	3	Improve infrastructure	+	Productivity	Public infrastructure
	4	Revamp the structure of taxation	+	Productivity	Tax system
	5	Improve policy enforcement	+	Productivity	Other policy areas
Canada	1	*Reduce barriers to competition in network industries*	+	Productivity	Product Market Regulation
	2	*Further reduce barriers to foreign ownership*	+	Productivity	Product Market Regulation
	3	*Further reduce barriers to competition in professional services*	+	Productivity	Product Market Regulation
	4	Reform the Employment Insurance system	+	Labour utilisation	Unemployment benefits
	5	Further reform the tax system	+	Productivity	Tax system
China	1	Reform product market regulation	+	Productivity	Product Market Regulation
	2	Improve tertiary education	+	Productivity	Human capital
	3	Make further financial and banking reforms	+	Productivity	Product Market Regulation
	4	Strengthen the legal system	+	Productivity	Rule of law
	5	Reduce restrictions on labour mobility	+	Productivity	Other policy areas

Country		Policy priority[1]	GDP impact (steady state)	Policy target	Policy sub-domain
Germany	1	*Reduce average tax wedges on labour income*	+	Labour utilisation	Labour taxation
	2	*Reduce regulatory barriers to competition*	+	Productivity	Product Market Regulation
	3	*Improve education outcomes*	+	Productivity	Human capital
	4	Reduce fiscal impediments to full-time female labour force participation	+	Labour utilisation	Implicit tax on returning to work
	5	Ease job protection	+	Labour utilisation	Job protection
European Union	1	*Ease regulatory barriers to business operations*	+	Productivity	Product Market Regulation
	2	*Raise competition in network industries*	+	Productivity	Product Market Regulation
	3	*Reduce producer support to agriculture*		Productivity	Agriculture
	4	Raise labour mobility within the EU		Labour utilisation	Other policy areas
	5	Further integrate the European financial market integration		Productivity	Product Market Regulation
France	1	*Reduce the minimum cost of labour*	+	Labour utilisation	Wage formation and minimum cost of labour
	2	*Reform employment protection legislation*	+	Labour utilisation	Job protection
	3	*Reduce regulatory barriers to competition*	+	Productivity	Product Market Regulation
	4	Reduce implicit taxes on continued work at older ages	+	Labour utilisation	Implicit tax on continued work at older ages
	5	Improve the quality and efficiency of the tertiary education system	+	Productivity	Human capital
United Kingdom	1	*Further reform disability benefit schemes*	+	Labour utilisation	Disability and sickness benefits
	2	*Improve the education achievement of young people*	+	Productivity	Human capital
	3	*Improve public infrastructure, especially for transport*	+	Productivity	Public infrastructure
	4	Improve public sector spending efficiency		Productivity	Public sector efficiency
	5	Give greater weight to economic considerations in planning decisions		Labour utilisation	Housing policies
India	1	Reform product market regulation	+	Productivity	Product Market Regulation
	2	Improve educational attainment	+	Productivity	Human capital
	3	Reduce job protection in the formal sector	+	Labour utilisation	Job protection
	4	Strengthen the tax system	+	Productivity	Tax system
	5	Enhance infrastructure quality	+	Productivity	Public infrastructure

Country		Policy priority[1]	GDP impact (steady state)	Policy target	Policy sub-domain
Indonesia	1	Devote more resources on education	+	Productivity	Human capital
	2	Reform product market regulation and FDI restrictions	+	Productivity	Product Market Regulation
	3	Moderate the minimum wage	+	Labour utilisation	Wage formation and minimum cost of labour
	4	Strengthen the rule of law	+	Productivity	Rule of law
	5	Deepen financial markets	+	Productivity	Product Market Regulation
Italy	1	*Reduce public ownership and regulatory barriers to competition*	+	Productivity	Product Market Regulation
	2	*Improve educational outcomes*	+	Productivity	Human capital
	3	*Reduce the tax wedge on labour income*	+	Labour utilisation	Labour taxation
	4	Decentralise wage bargaining	+	Labour utilisation	Wage formation and minimum cost of labour
	5	Strengthen innovation incentives	+	Productivity	Innovation policies
Japan	1	*Ease regulations in network industries*	+	Productivity	Product Market Regulation
	2	*Reduce producer support to agriculture*		Productivity	Agriculture
	3	*Reform employment protection legislation for regular employment*	+	Labour utilisation	Job protection
	4	Reform the tax system	+	Productivity	Tax system
	5	Remove restrictions on foreign investment	+	Productivity	Product Market Regulation
Korea	1	*Ease regulation in network industries*	+	Productivity	Product Market Regulation
	2	*Reduce producer support to agriculture*		Productivity	Agriculture
	3	*Reform employment protection legislation for regular employment*	+	Labour utilisation	Job protection
	4	Improve the innovation system	+	Productivity	Innovation policies
	5	Increase the role of private childcare facilities	+	Labour utilisation	Implicit tax on returning to work
Mexico	1	*Raise achievement in primary and secondary education*	+	Productivity	Human capital
	2	*Reduce barriers to entry in network industries*	+	Productivity	Product Market Regulation
	3	*Reduce barriers to foreign ownership*	+	Productivity	Product Market Regulation
	4	Reform the state-owned oil company	+	Productivity	Product Market Regulation
	5	*Improve the “*Rule of law”		Productivity	Rule of law

Country		Policy priority[1]	GDP impact (steady state)	Policy target	Policy sub-domain
Russia	1	Reduce state control over economic activity	+	Productivity	Product Market Regulation
	2	Lower barriers to trade and investment	+	Productivity	Product Market Regulation
	3	Improve secondary and tertiary educational outcomes	+	Productivity	Human capital
	4	Raise the quality of public administration	+	Productivity	Rule of law
	5	Improve health outcomes	+	Productivity	Public sector efficiency
South Africa	1	Improve educational efficiency	+	Productivity	Human capital
	2	Reform product market regulation	+	Productivity	Product Market Regulation
	3	Improve incentives for formal labour participation	+	Labour utilisation	Job protection
	4	Enhance benefit systems	+	Labour utilisation	Activation of long-term unemployed
	5	Shift away from direct taxation	+	Productivity	Tax system
Turkey	1	*Reduce the minimum cost of labour*	+	Labour utilisation	Wage formation and minimum cost of labour
	2	*Improve educational achievement*	+	Productivity	Human capital
	3	*Reform employment protection legislation*	+	Labour utilisation	Job protection
	4	Simplify product market regulations	+	Productivity	Product Market Regulation
	5	Reduce early retirement incentives for the workers in the formal sector	+	Labour utilisation	Implicit tax on continued work at older ages
United States	1	*Improve primary and secondary education*	+	Productivity	Human capital
	2	*Restrain health care costs*	+	Labour utilisation	Healthcare costs
	3	*Reduce producer support to agriculture*		Productivity	Agriculture
	4	Improve and streamline financial regulation	+	Productivity	Product Market Regulation
	5	Reform the tax system	+	Productivity	Tax system

1. The policy priorities are those included in the 2009 edition of *Going for Growth*, complemented by the main policy items identified in the 2010 edition of *Going for Growth* for Brazil, China, India, Indonesia and South Africa. In the case of Russia, policy priorities have been selected among those identified in *Economic Surveys*.

Source: OECD.

Annex 2. Expected effect of policy actions on steady-state growth and the external current account position - preliminary results

Policy	GDP-per-capita impact [1]	Current account position	Empirical evidence (GDP impact)	Empirical evidence (current account impact)
Labour market policies				
reducing the average replacement rate	++		Bassanini and Duval, 2006	
easing employment protection legislation	+	improves	Bassanini and Duval, 2006; Nicoletti et al., 2003; OECD, 2003	Kennedy and Sløk, 2005
reducing the share of disability and sickness benefits recipients	+		Dougherty *et al.* (2010)	
increasing paid maternal leave weeks	+		Jaumotte, 2003	
reducing family cash childcare benefits	+		Jaumotte, 2003	
increasing public support for childcare	+		Jaumotte, 2003	
increasing the standard retirement age	++		Bassanini and Duval, 2006	
reducing implicit tax on continued work	+		Bassanini and Duval, 2006	
increasing statutory standard and overall weekly hours limits	+		Causa, 2008	
decenteralising wage bargaining and collective agreements	+		Bassanini and Duval, 2006	
Taxation				
reducing average tax wedge	++	improves[2]	Bassanini and Duval, 2006; Nicoletti et al., 2003	Alessina et al., 2002; Nicoletti et al., 2003; OECD, 2003
reducing marginal tax	+		Bassanini and Duval, 2006; Jaumotte, 2003; Causa, 2008	
shifting tax structure towards less distortionary sources	+	improves	Johannsson et al., 2008; OECD, 2003	Jarrett, 2005 (no estimates)
reducing the overall tax burden ratio	+	weakens	Johannsson et al., 2008 OECD, 2003	Kennedy and Sløk, 2005

Product Market Regulation				
deregulation of product markets	+	Weakens in the short term	Conway *et al.*, 2006; Jaumotte and Pain, 2005; Bassanini and Duval, 2006; Nicoletti et al., 2003; Boulhol *et al.*, 2008; OECD, 2003	Kennedy and Sløk, 2005
easing regulation in energy, transport and communications	+			
Openness			Boulhol *et al.*, 2008	
reducing FDI restrictions	+	improves[3]	Nicoletti *et al.*, 2003	Kennedy and Sløk, 2005
lowering tariff barriers	+	weakens[4]	Nicoletti *et al.*, 2003	Nicoletti *et al.*, 2003; OECD, 2003
R&D incentives				
increasing R&D tax subsidies	+		Jaumotte and Pain, 2005; OECD, 2003	
increasing R&D direct subsidies	+		Jaumotte and Pain, 2006; OECD, 2003	
Infrastructure				
introducing incentive-based regulation and independent regulator	+		Égert *et al.*, 2009; Égert, 2009	
Financial regulation				
reducing barriers to banking competition	+		Ahrend *et al.*, 2009; Bourlès *et al.*, 2010 de Serres *et al.*, 2006	
deepening the stock market through securities reform	+	weakens	Leahy et al. 2001 Jaumotte and Pain, 2005	OECD, 2003; Kennedy and Sløk, 2005
Human capital				
increasing PISA scores	++		OECD, 2004 and Boulhol *et al.*, 2008	
increasing average years of schooling (16-24 cohort)	++		Boulhol *et al.*, 2008	

1. (+) indicates a 1% GDP-per-capita effect of a 10% change in the policy indicator, and (++) indicates an effect that is greater than 1%.

2. This indirect effect comes from an increase in exports and a decrease in imports on the balance of trade (Nicoletti *et al.*, 2003), an increase in investment (OECD, 2003; Alesina *et al.*, 2002) and a decrease in net FDI outflows (Nicoletti *et al.*, 2003).

3. Contrary to the theoretical predictions that lower barriers to FDI should deteriorate current account positions (through an increase in imports and a decrease in net FDI outflows, based on Nicoletti *et al.*, 2003), reducing FDI restrictions is found empirically to improve the current account, probably because of an important degree of substitution between FDI and imports (Kennedy and Sløk, 2005).

4. Lower tariff barriers may deteriorate current account positions by increasing imports (Nicoletti *et al.*, 2003), and reducing investment (OECD, 2003) and net FDI outflows (Nicoletti et al., 2003).

Source: OECD.

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