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Economic Policy Reforms

Chapter 1

Structural Policy Priorities

Over the past decade, the gap in GDP per capita relative to the United States has widened in a number of countries, including the large continental European economies and Japan. The gap is linked to lower hours worked per capita, lower output levels per hour worked, or both. This chapter describes broad trends in economic performance since the mid-1990s and summarises structural policy priorities for all member countries to enhance GDP per capita. The policy priorities are identified on the basis of cross-country comparisons of performance and policy settings.

Introduction

Over the past decade, trends in GDP per capita and productivity have diverged across major OECD countries. In Japan and some of the largest EU member states, growth rates have declined, contrasting with the acceleration observed in the United States and a few other countries. This diverging performance across the major economies and the concurrent widening of income gaps have brought renewed attention to the influence of institutions and structural policy settings on productivity and GDP growth, and have highlighted the need for reforms to improve growth performance.

In order to support the corresponding reform efforts, the OECD has developed a set of indicators to evaluate the economic performance and the effectiveness of structural policies of member countries. These indicators are used to identify policy priorities for each country to enhance long-term growth. This work builds on the structural surveillance already carried out in the OECD, both the general monitoring reported in the *OECD Economic Surveys* and reviews of specific areas of structural policy (Box 1.1).

For each country, a total of five policy priorities have been identified, mostly in the areas of labour and product markets and, to a lesser extent, education. In all cases, the selection of policy indicators and priorities is made with an overall view to raise GDP per capita. Increasing GDP per capita is obviously not the only objective of governments, who strive to improve living standards and welfare more generally, but higher output increases their scope to attain other goals (Annex 1.A.1). Identifying the same number of priorities for well – and less well-performing countries alike has obvious implications. On the one hand, in countries with weak performance and policy settings that deviate from best practice in many areas, important policy priorities may be left out. On the other hand, in countries with very good performance and policies close to best practice, the priorities identified may not always be seen as having a high degree of urgency.

Box 1.1. **Structural surveillance in the OECD**

This stocktaking of structural reforms aims at providing member countries and interested readers with a cross-country report surveying the wide array of factors and policies that drive long-term growth, in order ultimately to improve performance. This exercise builds on the various structural surveillance processes that are part of the regular work of the OECD. These include general surveillance on a country-by-country basis that is reported in the *Economic Surveys* and cross-country surveillance focused on more specific fields that is reported in a variety of OECD publications.

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Box 1.1. **Structural surveillance in the OECD** *(cont.)*

The general surveillance reported in the *OECD Economic Surveys* involves the monitoring of long-term economic performance and structural-policy settings, in addition to policy recommendations to improve performance. While cross-country comparisons of performance and policies are used extensively in this work, policy recommendations are often arrived at without international benchmarking, and are instead based on in-depth knowledge of country circumstances and policy objectives. By contrast, the present report makes much more systematic use of benchmarking in deriving policy priorities.

The structural surveillance work in the OECD that focuses on more specific issues is organised along the following lines:

- Labour market performance and social conditions are monitored on a regular basis, and this often involves a review of policies on the basis of internationally-comparable indicators (*e.g.* benefit replacement rates, the intensity of employment protection legislation and various aspects of active labour market policies). The results of this surveillance are reported in the *OECD Employment Outlook* and *Benefits and Wages*, and in country reports on the public employment service, work and family life, and ageing and employment policies.
- The extent and the quality of education of the young and of the population at large, and related policies, are reviewed on a regular basis. The reviews are published in *Education at a Glance*, reports from the Programme for International Student Assessment (PISA), and country reviews on national policies for education.
- Developments in taxation of labour income are examined on a yearly basis, and this includes the construction of standardised indicators of average and marginal tax rates for all member countries. The indicators are published in *Taxing Wages*.
- Support to agriculture and the different forms of such assistance is monitored on an annual basis and published in *Agricultural Policies in OECD Countries*.
- Performance and policies with respect to science, technology and industry is reviewed regularly and published in *Science, Technology and Industry: Outlook,* the *OECD Information Technology Outlook*, the *OECD Communications Outlook* and the *OECD SME and Entrepreneurship Outlook*.
- Policies that have an impact on high quality regulation, competition and market openness in product markets are regularly reviewed and published in the series of *OECD Reviews of Regulatory Reforms*.

In some cases, the monitoring of performance and policies is accompanied by country-specific recommendations. This has been the case in *e.g.* reviews of public employment services, work and family life, ageing and employment policies, national education systems, and regulatory reforms.

The policy recommendations that emerge from the surveillance of these various fields may sometimes give emphasis to objectives that go beyond growth or income maximisation and relate to wider dimensions of welfare. Thus, for example, the surveillance processes for labour and social affairs emphasise the need to find a balance between equity and efficiency in their policy recommendations, and the surveillance processes for education tend to stress the importance of equitable access to education in addition to the goal of increasing human capital.

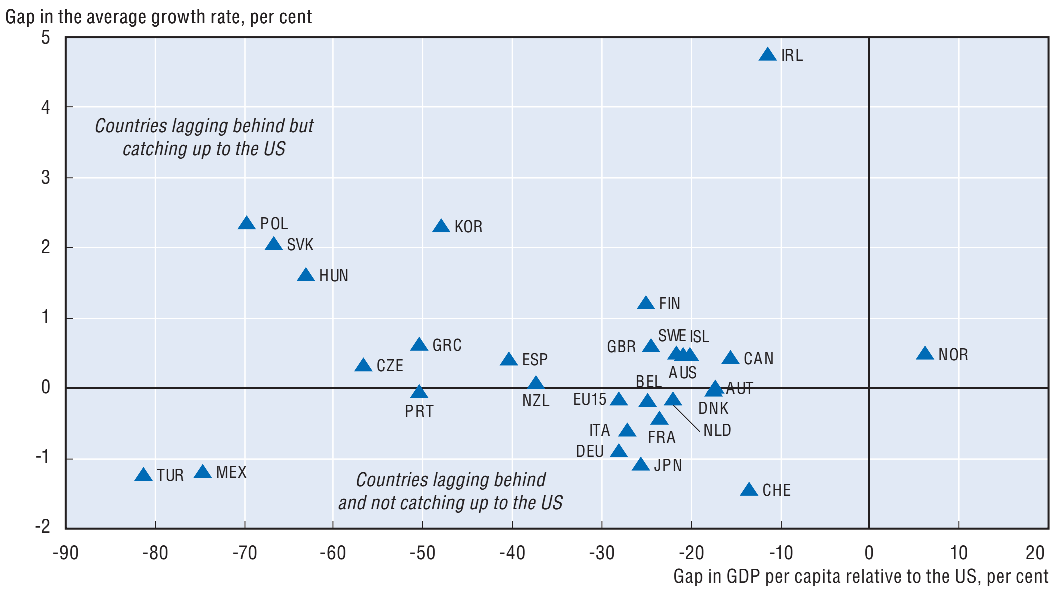
Broad trends in performance

Looking at trend performances over the past decade or so, many countries have managed to pursue or resume convergence of living standards on that of the leading country (United States) despite the particularly strong performance observed in the latter over the period (Figure 1.1).[1] Since 1993, GDP per capita rose relative to that in the United States in over half of member countries: English-speaking and Nordic countries, as well as Central European countries, Greece, Korea and Spain. The countries that grew fastest relative to the United States are mainly those where GDP per capita remains comparatively low (Hungary, Korea, Poland and Slovakia). A notable exception is Ireland, which after more than 15 years of the fastest growth in GDP per capita in the OECD area is close to par with living standards in the United States.[2]

In contrast, the gap in GDP per capita has either remained unchanged or widened in several continental European countries over the same period (Austria, Belgium, France, Germany, Italy and Switzerland) as well as in Japan. For the European Union and Japan, the level of GDP per capita remains between 25 and 30% below that in the United States. While the size of the gap varies quite significantly across EU countries, differences are relatively small among the largest member states (with gaps also between 25 and 30%). The most disappointing performance over the past decade in the OECD area has been registered in Mexico and Turkey, which combined the weakest (after Switzerland) growth rate and the lowest levels of GDP per capita.

The gap in GDP per capita can be broken down into labour-utilisation and labour-productivity gaps (Figure 1.2). Lower total hours worked per person of working age account for the main part of the GDP per capita gap in many continental European countries

Figure 1.1. **GDP per capita levels and growth rates: Gap *vis-à-vis* the United States**[1]

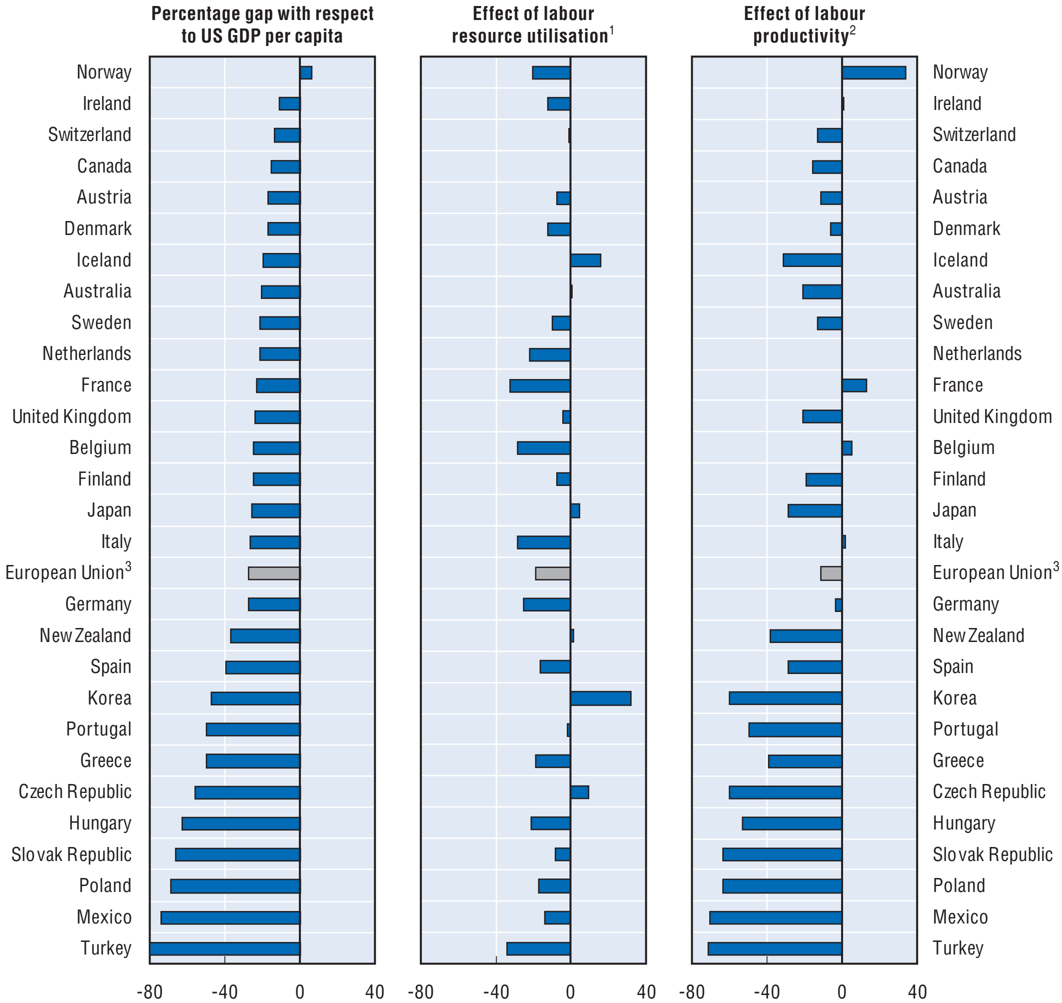


Note: EU15, excluding Luxembourg.

1. The average growth rate of GDP per capita is calculated over the period 1994-2003 on the basis of volumes data from national accounts sources. The level of GDP per capita is for 2002 on the basis of 2000 PPPs.

Source: OECD, *National Accounts of OECD Countries*, 2004 and *OECD Economic Outlook*, No. 76.

Figure 1.2. **The sources of real income differences, 2002**



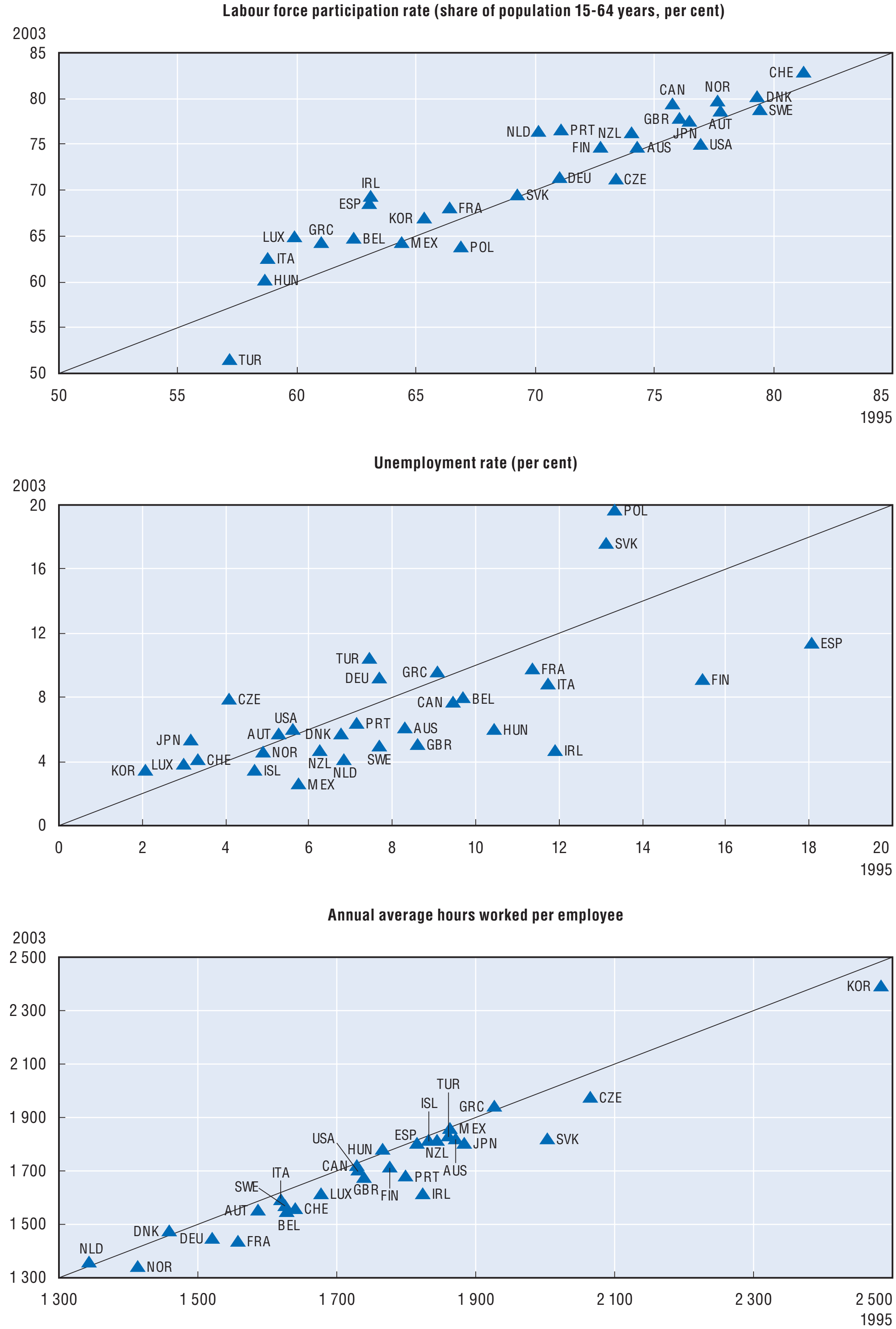
1. Labour resource utilisation is measured as total number of hours worked divided by population.
2. Labour productivity is measured as GDP per hour worked.
3. Excluding Luxembourg.

Source: OECD, *National Accounts of OECD Countries*, 2004; *OECD Labour Force Statistics*, 2004 and *OECD Economic Outlook*, No. 76.

(Belgium, France, Germany, Italy and the Netherlands). This is due to low participation of people of working age in the labour market and high unemployment (Figure 1.3). This effect is typically reinforced by fewer hours worked per employee, as part-time work is more prevalent and annual working hours for full-time workers are lower. Since 1995, labour utilisation in continental Europe has been affected by two opposite trends: relatively strong gains in employment ratios have been offset to varying degrees by a continuing decline in average hours worked per employee. This development often reflects an increasing share of women in the labour force, as women are more likely to work part-time. However, in some countries the decline in average hours has gone beyond what can be accounted for by an increase in voluntary part-time work.

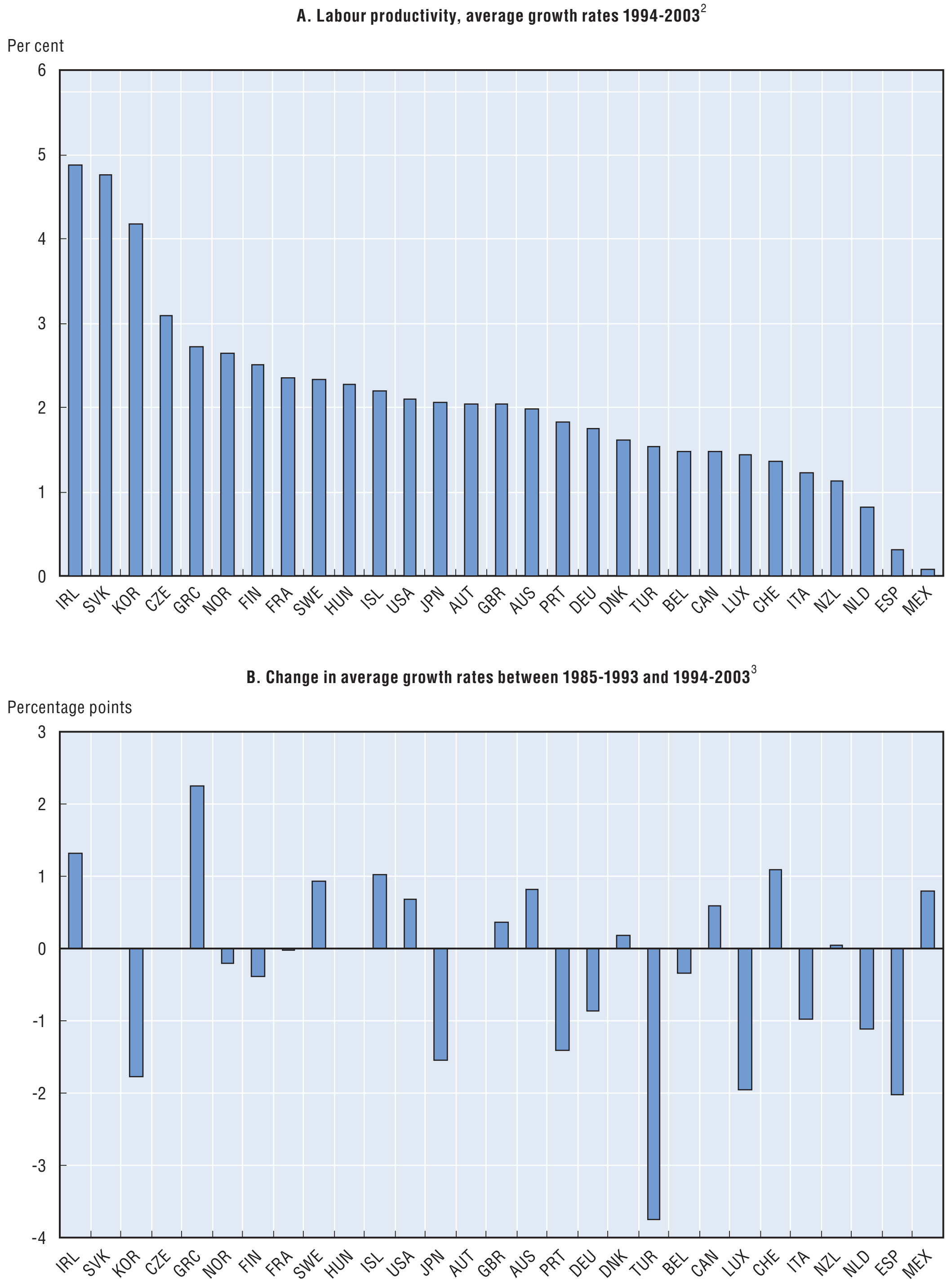
Lower productivity levels per hour worked account for the bulk of the gap in GDP per capita in Japan and most non-US English-speaking countries, as well as in Iceland, Switzerland and most lower-income member countries (Czech Republic, Korea, Mexico, Portugal and

Figure 1.3. **Sources of change in labour resource utilisation**



Source: *OECD Economic Outlook*, No. 76 and *OECD Labour Force Statistics*, 2004.

Figure 1.4. **Labour productivity**[1]



1. Measured as GDP per hour worked.
2. Labour productivity is not reported for Poland due to missing hours data. Slovak Republic covers 1995-2003. For Luxembourg, labour productivity is derived by using domestic employment (including cross-border workers).
3. The change in labour productivity is not reported for Austria; Czech Republic, Hungary and Slovak Republic due to short hours data series.

Source: OECD, *National Accounts of OECD Countries*, 2004; *OECD Labour Force Statistics*, 2004 and *OECD Economic Outlook*, No. 76.

Slovak Republic). Of these, only the Czech Republic, Korea and the Slovak Republic have managed to obtain productivity growth rates well in excess of those in the United States (Figure 1.4), thus narrowing the productivity gap significantly over the past ten years.

Both total hours worked and productivity per hour are below those observed in the United States in a number of European countries (Austria, Denmark, Finland, Greece, Hungary, Poland, Spain, Sweden and Turkey). Among these, Finland and Hungary narrowed the gaps in both labour resource utilisation and productivity during the past decade. While Spain experienced the strongest increase in labour resource utilisation over the past ten years – substantially narrowing the gap *vis-à-vis* the United States – the impact on the gap in GDP per capita was largely offset by weak labour productivity growth.

This simple accounting of the difference in the GDP per capita gap may give a distorted picture of countries' relative strengths and weaknesses because aggregate labour utilisation and productivity can be interdependent. Countries with low labour utilisation may not employ many low productivity workers, thereby artificially boosting measured labour productivity relative to that in countries with high employment rates. Thus, it has been estimated that raising employment rates and hours worked in the large "high-productivity" continental European countries to the level in the United States could reduce their productivity levels relative to the United States by up to 15% (Artus and Cette, 2004). As a result, a labour-utilisation deficit could become a sizeable productivity gap. Increased employment of low-productivity workers in a few continental European countries over the past decade is also estimated to have slowed productivity growth in these countries, but cannot fully account for the very low growth in output per hour worked.

Areas of policy priorities

The purpose of this stocktaking is to identify policy priorities most likely to stimulate GDP per capita in all individual member countries and the European Union. The starting point is the preceding examination of labour utilisation and productivity performance, which is expanded in further detail to uncover specific areas of relative strengths and weaknesses. A broad set of policy indicators is then assembled and compared across countries (see Chapter 2) with the aim of identifying cases where performance and policy weaknesses appear to be linked.[3] More specifically, in order to avoid a one-size-fits-all approach to policy reform, a deviation from best-practice in a particular policy area is considered a candidate for priority selection only if a weak performance is also identified in an area that is affected by the policy in question. Furthermore, the set of policy indicators considered is limited to those that have been shown empirically to have an impact on economic growth. Annex 1.A2 provides further details on the selection of the policy priorities.

At this stage, the stocktaking covers mainly labour and product market policies, supplemented by a few policy/performance indicators for health and education.[4] On the basis of these indicators, three policy priorities are identified for each member country and the European Union (Table 1.1), and are discussed in the country notes in Chapter 3. The table and the country notes also include two additional policy priorities identified for each country that are not necessarily based on cross-country comparison of policy indicators, thereby allowing for important policy requirements in areas not yet covered by quantitative indicators.[5] Considering the potential synergies between the individual policies, the priorities are best seen as a package, as the benefit from taking action on several fronts simultaneously is likely to be greater than the sum of the benefits obtained from acting on individual policy recommendations in isolation.

Policies to improve labour productivity performance

There is broad evidence that policies and institutional settings that foster product market competition play a key role in influencing firms to seek efficiency gains, through adopting either technological or organisational best practices. Growing recognition of this has contributed to widespread reform of product market regulation, leading to a more pro-competitive climate in most OECD countries (see Chapter 4). However, while a certain degree of convergence towards best practice in product market regulation has been observed since the late 1990s, significant scope for improvement remains in virtually all areas: state control of economic activities; barriers to entrepreneurial activity (administrative burdens or restrictions on market access); and barriers to trade (mainly in agriculture and services) and foreign direct investment.

In Europe, progress towards the completion of the EU single market for goods and services has helped boost competitive pressures arising from cross-border activities, even though important non-trade barriers remain. The process of EU integration has also contributed to significant reforms in network services (albeit at different paces across industries and countries), including through privatisation and opening of market access to potential competitors in sectors traditionally dominated by monopolies. Nonetheless, it is a priority for many European countries (including non-EU members) to strengthen competitive pressures in network and other industries:

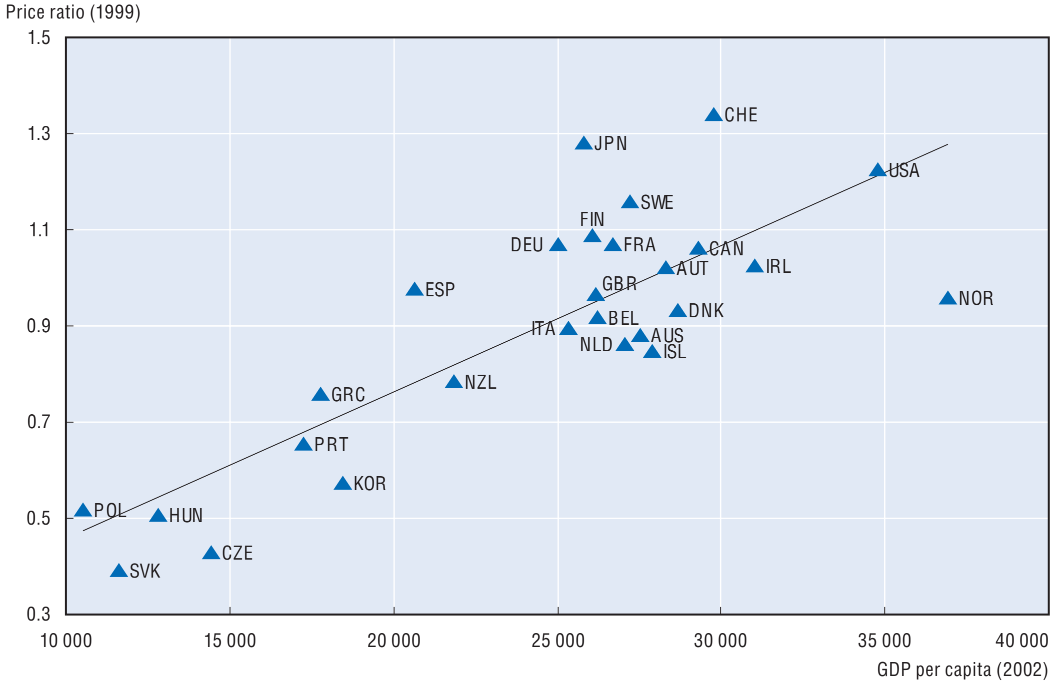
- Barriers to entry in network industries (such as electricity, telecommunication and railways) and/or professional services should be further reduced in Denmark, France, Germany, Greece, Iceland and Switzerland.
- Administrative burdens on start-ups should be lowered (Austria, Czech Republic, Greece, Hungary and Turkey).
- The burdens of regulation on business operations arising from price controls or administrative procedures should be eased (Belgium, Ireland and the Netherlands).
- The extent of public ownership should be reduced (Finland, Hungary, Italy, Norway, Poland, Portugal, Sweden and Turkey).

Considering, in addition, that fully taking advantage of new technological opportunities may require significant labour re-allocation in many industries, efforts to seek efficiency gains may be hampered in some countries by excessively strict employment protection legislation (EPL).

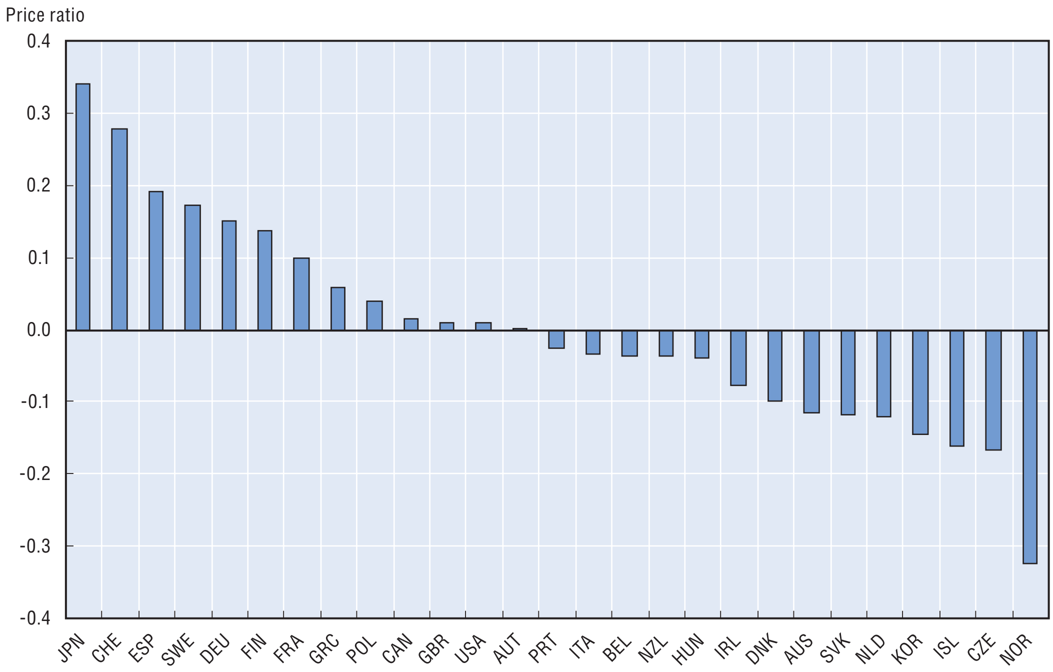
Outside Europe, the productivity gap relative to the United States either widened further or has remained large during the past ten years. While product market regulation is not generally seen as overly stringent, further liberalisation of specific network industries and/or services (such as retail distribution and professional services) continues to be a priority in Japan and Canada – where little reform has taken place since the 1980s – as well as in Korea and Mexico. The case for stimulating competition in service sectors is particularly compelling in Japan, where the price of services relative to that of consumer goods is the highest in OECD countries even after controlling for differences in income levels (Figure 1.5).

Figure 1.5. **Relative price of services and GDP per capita**

A. Ratio of the price level of consumer services to that of consumer goods and the level of GDP per capita[1]



B. The relative price ratio adjusted for differences in the level of GDP per capita[2]



1. Consumer services are a proxy for non-tradable products and goods (semi-durables and durables) are a proxy for tradable products. The level of GDP per capita in 2002 is measured in US dollars on the basis of 2000 PPPs.
2. Measured as the difference between the actual and the fitted value of the price ratio appearing in panel A.

Source: OECD, *National Accounts of OECD Countries*, 2004; *OECD Economic Outlook*, No. 76 and *Purchasing Power Parities and Real Expenditure*, 2002.

Important barriers to competition still prevail in the agricultural sector of many countries, and these take various forms, such as import barriers, domestic price support for specific products and/or transfer payments to farmers. In terms of economic efficiency, high producer support to agriculture results in a misallocation of resources in most OECD countries and creates trade and price distortions in world markets for agricultural commodities, often at the expense of producers in developing countries (OECD, 2004a). While overall policy-determined transfers to agriculture have slightly risen in 2003, some efforts have been made to at least reduce their trade-distorting impact, essentially by gradually decoupling the amount of aid from the quantity of output produced or input consumed. However, reductions in trade-distorting support to agriculture should be a key priority in the European Union as a whole, as well as in Iceland, Japan, Korea, Norway, Switzerland and the United States. In this regard, the pledge to eliminate all forms of export subsidisation made in the context of the recent agreement on a framework for continuing the Doha Round should be fulfilled.

The accumulation of skills and competencies – or human capital – can raise productivity by improving the "quality" of the labour force, thereby also facilitating the adoption of new technologies and/or the innovation process. Differences in the average level of human capital across countries may reflect both variations in quantity (such as the average number of years spent in formal education) and in "quality" of schooling (OECD, 2004b). While some indicators of performance can be constructed, more direct policy indicators are difficult to develop in part due to the lack of consensus about what constitutes "best practice" in this area.

Although the percentage of population that has attained at least upper secondary education has risen in virtually all OECD countries over the past 15-20 years, productivity gains may be hampered in several countries by the significant share of the working-age population still lacking basic skills. Hence, further efforts need to be made to raise the standards of the compulsory school system (Germany, Luxembourg, Mexico, New Zealand, Portugal, Slovak Republic, Spain and the United States) and to reduce the proportion of young people leaving school without at least upper-secondary education (Australia, Iceland, Italy, and the United Kingdom). At the same time, reforms aimed at strengthening human capital investment should take into account the need in some cases to reduce undue delays in labour market entry of young people, in particular from tertiary education.

Policies to improve labour resource utilisation

Incremental changes in policies aimed at improving labour market performance have been common over the past few years, but significant reforms have been rare. The Agenda 2010 programme in Germany is a useful step in the right direction. It represents a shift in policy, especially by reducing work disincentives through the limitation of the duration of unemployment benefits and the lowering of benefit levels for those out of jobs for a long time. In return, extra resources are devoted to providing job-search assistance, such as personalised job counselling and monitoring, so as to improve matching. In addition, a few countries (Austria, France, Finland, Germany, Italy and Portugal) have introduced reforms of their pension systems and/or *de facto* early retirement schemes in the past two years that will ultimately reduce financial disincentive to work at older ages.

In some cases, reforms have also been introduced or extended in areas of labour taxation (Ireland, Netherlands and the United Kingdom), active labour market policies (Australia, Denmark and the Netherlands) and unemployment benefits (Denmark). Some countries have combined a number of measures to raise work incentives, in particular for workers with low earnings potential, so as to strengthen their attachment to labour market. For instance, in-work benefits such as earned-income tax credits have been used in some cases in combination with effective activation policies and/or targeted reductions in employers' social security contributions, (France, Ireland, United Kingdom and United States). While these packages of measures have had some success in raising participation rates among those mainly targeted, they increase effective marginal tax rates in the income range where in-work benefits are withdrawn, potentially reducing hours worked.

Notwithstanding these reforms and a general improvement in labour market outcomes since the mid-1990s, labour under-utilisation remains an area of key policy priority for most continental European countries. In some of these countries (Austria, Belgium, France and Luxembourg), labour force participation among older workers is particularly low but could be boosted by a reduction in the "implicit tax on continued work" (see Chapter 5). Strong financial disincentives to remain in the labour force after the age of 55 often arise from the design of the pension system and/or from other benefit programmes (notably those concerned with unemployment and disability). These can be used as pathways to early retirement rather than for the purposes for which the programmes were designed.

Efforts to cut work disincentives need to be supplemented by measures to stimulate employers' demand for labour. This is particularly the case in countries where unemployment is already high, especially among younger and low-skilled workers. Significant reductions in unemployment rates may be difficult to achieve without a decline in the cost of labour at low income/productivity levels (Belgium, Czech Republic, France, Germany, Hungary, Italy, Poland and Slovak Republic). While this can be attained through a cut in social security contributions on low wages, the impact of such measures would be reinforced if increases in the statutory minimum wage were kept more moderate than for wages in general. This especially applies where such wage floors are relatively high, such as in France, where they are scheduled to rise further partly as a result of introducing the 35-hour week.

Better alignment between wages and productivity at the firm level could also be achieved by changes to centralised wage bargaining processes in certain sectors, as is the case in Italy and Spain. This may in some cases be facilitated by a reduction in the extent of administrative extension of collective wage agreements applied to all firms within a sector, and by the public sector taking the lead in decentralising bargaining. The stringency of employment protection legislation, especially for regular contracts, should also be eased in some countries (Czech Republic, France, Greece and Portugal) in order to boost demand for labour and reduce the incidence of long-term unemployment. Given that such reform to employment protection legislation is likely to raise both job creation and job losses, it should be accompanied by a re-enforcement of measures to assist laid-off workers to find a new job.

Even in countries where aggregate employment rates are less of a problem, targeted reforms could bring about further improvements. For example, the relatively low hours worked per capita and per employee observed in Denmark, Norway and Sweden may

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result from a combination of greater use of disability and sickness benefits, and higher labour income taxation than in other countries. High labour costs, together with high net replacement rates for the long-term unemployed may contribute to prevent structural unemployment in Finland from falling back to levels before the large negative shocks of the early 1990s and to a level more comparable with that observed in other Nordic countries, despite similarities in other labour market institutions and policy settings.

Canada and, to a lesser extent, New Zealand could achieve further improvements in labour-market performance by reforming specific features of their income support system. Australia and the United Kingdom could boost participation rates by limiting entry into disability benefit schemes to those that are unable to work, given the sharp increase in recent years in the proportion of disability benefit recipients among the non-employed. Finally, although participation and employment rates are relatively high in Japan, overall labour resource utilisation has clearly fallen on average over the past ten years. In order to reverse the trend, priority should be given to easing employment protection legislation which impedes firms' willingness to hire, and thus hampers their restructuring effort.

Challenges ahead

With performance diverging across geographical zones, it is not surprising that the same can be observed for policy priorities. More specifically:

- Low utilisation of potential labour resources in continental European countries is reflected in a large number of policy priorities aimed at boosting labour supply and demand. Nonetheless, higher employment may come at a price of lower average productivity, and a number of priorities for these countries also concern liberalisation of product markets and improvements in education systems.

- For countries with low levels of income per capita, but also for Japan, productivity is the main gap in performance, and important policy priorities relate to liberalisation of product markets.

- English-speaking countries generally have high utilisation of potential labour resources but variable productivity performance and strengthening the performance of education systems is a recurrent priority for these countries.

Looking at the distribution of indicator-based priorities across main policy areas, labour and product market policies each account for about 45% of total priorities with most of the rest being accounted for by recommendations in the field of education. Concerning the labour market, the priorities are evenly split between recommendations to reform the income-support system (including the pension system so as to lower financial disincentives to continue work for older people), to reduce tax wedges on labour income and to review labour market regulation, in particular regarding employment protection legislation and statutory minimum wages. With respect to the product market, a similar number of priorities has been identified for each of the broad areas, namely state control over business operation (public ownership and price controls), barriers to entrepreneurship, and barriers to foreign trade and investment.

Table 1.1. **Structural policies and performance: proposed priorities**

	Performance areas	
	Labour utilisation	Labour productivity
Australia	Refocus disability benefit schemes to encourage work by those with substantial work capacity. Increase the weight of employability in the setting of minimum wages ("award wages"). Strengthen employment prospects for lower-skilled workers by improving vocational education. *Reduce tax wedge on low-income workers to improve work incentives for this group.*	*Accelerate reforms aimed at lowering barriers to entry in network industries.*
Austria	Reduce implicit tax on continued work to cut disincentives to work at older ages. *Reform child support benefit system to weaken inactivity traps.*	Raise overall human capital by improving graduation rates from tertiary education. Reduce administrative costs for start-ups and ease entry regulations in professional services. *Strengthen competition law and enforcement by giving more powers to the competition authority.*
Belgium	Strengthen work incentives by reducing the tax wedge on labour income. Reduce disincentives to work at older ages by limiting early retirement through unemployment. *Reduce the incidence of long-term unemployment by strengthening job-search requirements and improving skills of the unemployed.*	Ease sectoral regulations and subject all new regulations to an efficiency test. *Improve educational outcomes for students from ethnic backgrounds.*
Canada	Strengthen incentives to move from welfare to work via stricter job search and activation requirements. *Restrain growth in public health care costs to limit increases in taxation and labour costs.*	Switch from foreign ownership barriers to other means to pursue cultural goals, etc. Further liberalise professional services by removing inter-provincial trade restrictions. *Reduce effective taxation on capital to encourage business investment.*
Czech Republic	Stimulate hiring by cutting the costs of EPL for regular workers. Reduce tax wedge on low-income workers to strengthen work incentives for this group. *Further liberalise the rental housing market to increase labour mobility.*	Implement intended reform of bankruptcy laws and simplify business registration. *Reform system of taxes and benefits to reduce poverty traps for non-employed households.*
Denmark	Strengthen work incentives by reducing the tax wedge on labour income. Assist disabled beneficiaries to rejoin the labour force part time, and introduce a waiting period and stronger certification for sickness benefit. *Reduce implicit tax on continued work embedded in the early retirement scheme.*	Reduce barriers to entry in industries to strengthen competition in product markets. *Improve educational achievements to raise the efficiency of the work force.*
Finland	Strengthen work incentives by reducing the tax wedge on labour income. Reduce implicit tax on continued work at older ages by reforming early retirement pathways. *Promote greater flexibility in centralised wage agreements to expand employment opportunities.* *Reduce the incidence of long-term unemployment by tapering unemployment benefits with duration.*	Reduce the scale of public ownership, especially raising private provision of publicly-funded services.

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Table 1.1. **Structural policies and performance: proposed priorities** *(cont.)*

	Performance areas	
	Labour utilisation	Labour productivity
France	Stimulate hiring by cutting the costs of EPL for regular workers. Stimulate labour demand for youth and low-skilled by allowing for a relative decline in the minimum cost of labour. Reduce implicit tax on continued work at older ages by reforming early retirement pathways.	*Accelerate reforms aimed at lowering barriers to entry in network industries.* *Promote greater competition in retail distribution by reviewing regulation concerning retail outlet locations and pricing rules.*
Germany	Strengthen work incentives by reducing the tax wedge on labour income. *Reduce disincentives to work at older ages by removing preferential unemployment benefit eligibility conditions for older workers.*	Improve secondary education achievements to raise efficiency of the workforce. Liberalise professional services by phasing-out binding fee schedules in specific professions. *Raise competition in government procurement to increase public spending efficiency.*
Greece	Reduce age/gender imbalances in unemployment by easing the most stringent provisions of EPL. *Reduce disincentives to work at older ages by linking pension to lifetime earnings.*	Accelerate reforms aimed at lowering barriers to entry in network industries. Promote greater domestic competition by reducing administrative costs for start-ups. *Simplify the tax code to reduce compliance costs for businesses and to boost private investment.*
Hungary	Reduce the tax wedge for low-income workers to improve their incentives to work in the formal economy. *Refocus disability benefit schemes to encourage work by those with substantial work capacity.* *Downsize the housing loan subsidy programme to reduce housing market distortions and facilitate labour mobility.*	Reduce state control on the operations of network industries to allow prices to better reflect market signals and to facilitate entry. Promote greater domestic competition by reducing administrative costs for start-ups.
Iceland	*Reduce government backing of bonds issued by the Housing Finance Fund to reduce housing market distortions and facilitate labour mobility.*	Lower barriers to entry for domestic and foreign firms especially in the energy and fisheries sectors. Raise overall human capital by improving enrolment and graduation rates from upper-secondary education. Reduce producer support to agriculture, especially the most trade-distorting type. *Raise public-sector efficiency by accelerating performance measurement and management.*
Ireland	Strengthen work incentives for lower-skilled second earners via a tax credit or a subsidy for child care. *Phase-out tax deductibility of mortgage payments to reduce housing market distortions and facilitate labour mobility.*	Ease regulatory burden on business operations to reduce compliance costs. Promote greater competition in network industries and retail distribution by facilitating entry. *Strengthen enforcement of competition law by giving the competition authority more power.*
Italy	Strengthen work incentives by reducing the tax wedge on labour income. *Promote greater flexibility in wage bargaining by decentralising wage-setting arrangements in the public sector.*	Reduce the scope of public ownership by allowing for more competition in the provision of public local services. Raise overall human capital by improving access to, and graduation rates from, upper-secondary and tertiary education. *Improve corporate governance by strengthening directors' independence and minority shareholder rights.*

Table 1.1. **Structural policies and performance: proposed priorities** *(cont.)*

	Performance areas	
	Labour utilisation	Labour productivity
Japan	Stimulate hiring by cutting the costs of EPL for regular workers.	Promote greater competition in network industries and professional services by facilitating entry. Reduce producer support to agriculture, especially the most trade-distorting type. *Improve the soundness and functioning of financial system by resolving the non-performing loan problem.* *Reduce barriers to foreign direct investment to enhance technological transfers from abroad.*
Korea	Stimulate hiring by cutting the costs of EPL for regular workers.	Promote greater competition in network industries and professional services by facilitating entry. Reduce producer support to agriculture, especially the most trade-distorting type. *Improve the soundness and functioning of the financial system by extending privatisation and strengthening financial supervision.* *Reduce barriers to foreign direct investment to enhance technological transfers from abroad.*
Luxembourg	Reduce implicit tax on continued work at older ages by reforming early retirement pathways. Strengthen incentives to move from welfare to work by raising in-work benefits at low wages relative to unemployment benefits.	Improve primary and secondary education achievements to raise efficiency of the work force. *Raise public-sector efficiency by expanding the role of e-government and simplifying administrative procedures.* *Reduce barriers to competition in telecommunications to reap further benefits from liberalisation.*
Mexico	*Shift burden of taxation towards consumption by broadening the value-added tax base.*	Improve secondary education achievements to raise efficiency of the workforce. Promote greater competition in product markets by reducing barriers to entry in industries. Reduce barriers to foreign ownership to enhance technological transfers from abroad. *Strengthen investors' confidence by improving the enforceability of contracts.*
Netherlands	Strengthen work incentives by reducing the tax wedge on labour income. Refocus disability benefit schemes to encourage work by those with substantial work capacity. *Stimulate labour mobility by reforming residential zoning restrictions.*	Reduce compliance costs for businesses by simplifying administrative procedures. *Promote greater competition in network industries and retail distribution by facilitating entry.*
New Zealand	Strengthen incentives to move from welfare to work via activation requirements and back-to-work bonuses. *Stimulate labour demand by reconsidering recent measures that have raised labour costs.*	Reduce barriers to foreign ownership and use other means to protect sensitive land. Improve educational achievement, in particular among ethnic minorities. *Improve the regulatory framework for addressing infrastructure bottlenecks.*
Norway	Refocus disability and sickness benefit schemes to encourage work by those with substantial work capacity. *Use direct transfers rather than provisions of labour market and natural resource policies to achieve regional objectives.* *Reduce future pension contributions by using the Petroleum Fund to pre-fund part of pension liabilities.*	Reduce the scope of public ownership by pursuing privatisation of competitive activities in network industries. Reduce producer support to agriculture, especially the most trade-distorting type.

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Table 1.1. **Structural policies and performance: proposed priorities** *(cont.)*

	Performance areas	
	Labour utilisation	Labour productivity
Poland	Refocus disability benefit schemes to encourage work by those with substantial work capacity. *Increase labour mobility by improving transport and housing infrastructure.* *Stimulate labour demand for youth and low-skilled by allowing for a relative decline in the minimum cost of labour.*	Intensify competitive pressures in a number of sectors by strengthening the privatisation programme. Reduce barriers to foreign ownership to enhance technological transfers from abroad.
Portugal	Stimulate hiring of regular workers and facilitate labour mobility by cutting the costs of EPL.	Improve secondary education achievements to raise efficiency of the workforce. Reduce state control in certain network industries to promote effective competition. *Raise public-sector efficiency by accelerating the reform of public administration.* *Simplify the tax system to reduce compliance costs for businesses.*
Slovak Republic	Reduce the tax wedge for low-income workers to improve their incentives to work in the formal economy. *Promote a rules-based business environment by strengthening the governance of the judicial and enforcement systems law.* *Reduce future pension contributions by raising standard retirement age.*	Reduce state control in certains network industries to promote effective competition. Raise overall level of human capital by improving secondary education achievements and access to tertiary education.
Spain	Promote greater flexibility in wage determination by limiting the extent of administrative extension of collective agreements. Stimulate hiring of regular workers by cutting the costs of EPL for this group. *Reduce future pension contributions by making the public pension system actuarially fair.* *Phase out tax advantages for home ownership to reduce housing market distortions and facilitate labour mobility.*	Raise overall level of human capital by improving upper-secondary and tertiary education achievements.
Sweden	Refocus sickness and disability benefit schemes to encourage work by those with substantial work capacity. Strengthen work incentives by reducing the tax wedge on labour income. *Reduce work disincentives by reconsidering measures that would result in lower working hours.* *Improve labour mobility by reducing housing market distortions.*	Reduce the scope of public ownership by allowing for more competition in the provision of public local services.
Switzerland	*Refocus invalidity pension schemes to encourage work by those with substantial work capacity and to stem rises in tax burden.* *Promote competition in the provision of medical products and services to contain increases in health care costs.*	Further liberalise professional services by removing inter-cantonal trade restrictions. Promote greater competition in product markets by reducing barriers to entry in network industries. Reduce producer support to agriculture, especially the most trade-distorting type.

Table 1.1. **Structural policies and performance: proposed priorities** *(cont.)*

	Performance areas	
	Labour utilisation	Labour productivity
Turkey	Strengthen incentives to work in formal activities by reducing the tax wedge on labour income.	Promote greater domestic competition by reducing administrative costs for start-ups. Reduce the scope of public ownership to allow for more competition in network industries. *Raise public-sector efficiency by implementing results-oriented budgeting in core public activities.* *Reduce genders imbalances in education by raising educational enrolments by women.*
United Kingdom	Refocus invalidity pension schemes to encourage work by those with substantial work capacity. Strengthen employment prospects for low-skilled workers by improving vocational education at the upper-secondary level.	Improve public infrastructure, especially for transport to further reduce bottlenecks. *Raise public-sector efficiency by strengthening incentives to pursue performance targets in publicly-funded services.* *Enhance competition in some service sectors by reviewing planning restrictions.*
United States	Limit increases in labour costs by reforming Medicare to restrain health care costs. *Encourage private saving by shifting the burden of taxation towards consumption.*	Improve primary and secondary education achievements to raise efficiency of the workforce. Reduce producer support to agriculture, especially the most trade-distorting type. *Stand firm on promoting transparency and accountability in corporate governance.*
European Union	*Improve intra-EU labour mobility by enhancing portability of pension and other benefit entitlements.*	Ease internal regulatory obstacles to cross-border trade and entry to strengthen competition. Promote greater competition in product markets by further reducing barriers to market contestability in network industries. Reduce producer support to agriculture, especially the most trade-distorting type. *Enhance competition in financial services by ensuring full implementation of Financial Services Action Plan.*

Notes

1. Given that the high ranking of Norway partly reflects the contribution from exploiting its oil reserves, the United States is considered as the leading country in terms of GDP per capita.
2. However, GDP per capita overstates the level of living standards in Ireland because of large income transfers to abroad from foreign subsidiaries (see Annex 1.A.1).
3. The indicators displayed in Chapter 2 are generally comparable across countries and over time. However, movements in some of the indicators may also reflect changes in the methodology used for the calculation.
4. The efficiency of the health sector is considered even though the link with growth performance is perhaps not as obvious as in the case of education. The reason is that fast-rising health care costs, as have been observed in many countries in recent years, can have an adverse influence on employment rates by putting upward pressures on indirect labour costs. In countries where health care is provided by the public sector, the associated costs are reflected in social security contribution rates and hence the tax wedge. And, in countries where health care is, to a large extent, provided by the private sector, the cost increases will not show up in the measured tax wedge, but will nonetheless be reflected in labour costs.
5. The policy areas covered by indicators will be expanded in the future as planned special studies on particular policy-performance linkages will enrich the indicator set used for surveillance.

ANNEX 1.A.1

Cross-country Comparison of Economic Performance and Living Standards: Some Caveats

In this report, GDP per capita is used as the proxy for living standards mainly for reasons of simplicity and timely availability of data that are measured in a broadly comparable way across countries. Yet, it may in some cases provide a misleading picture of underlying living standards for a number of reasons. First, GDP measures the flow of domestic output, whereas a more accurate measure of living standards would be the sum of consumption and changes in the net stock of wealth, both held at home and abroad. While reliable measures of wealth are virtually non-existent for many countries, net national income per capita would, in this regard, constitute a better measure than GDP per capita as it takes into account both the net flow of income on foreign investment and the depreciation of the capital stock. However, even this measure is not available for all OECD countries and, with a few notable exceptions such as Ireland, Luxembourg and Switzerland, country comparisons would not be altered substantially by the inclusion of these elements.

Second, even though the standardisation of national accounts conventions has made the measurement of GDP broadly comparable across countries, some distortion may be introduced in the conversion of country-specific measures into a common currency. The approach taken in this exercise, which consists in using Purchasing Power Parity (PPP) conversion rates, has become fairly standard in studies involving international comparisons of economic variables measured and expressed in domestic currencies.[1] However, differences in levels of GDP per capita across countries can be sensitive to the base year chosen for the PPP conversion. These limitations notwithstanding, it is unlikely that the broad comparison would change significantly on the basis of a more accurate measure of living standards and in any case, sustained increases in the latter are difficult to imagine without rising GDP per capita.

Third, countries are concerned not only with average living standards but also with their distribution across populations. Trade-offs may exist between levels and distribution of income and, in these cases, policies may be set so as to sacrifice some gains in average living standards in return for greater equity. However, the trade-offs may frequently be less stark than perceived, particularly in a longer term perspective. Some countries (*e.g.* Denmark, the Netherlands and Sweden) have indeed managed to achieve high levels of employment and living standards while maintaining a relatively low degree of income inequality.

More generally, even the best measure of material living standards would not necessarily accurately reflect differences in welfare across countries as the latter depend also on non-material aspects. Furthermore, welfare differences would reflect hard-to-measure differences in preferences of citizens, including with respect to the decision to allocate productivity gains between leisure and income. Viewed from a different angle, to the extent that it seems natural for people to demand more leisure as they become richer, a rise in GDP per capita stemming from an increased use of labour resources, both in terms of employment rates and hours worked does not necessarily imply a welfare improvement. In this regard, various studies have noted that a significant proportion of the gap in GDP per capita in Europe *vis-à-vis* the United States may well reflect a higher preference for leisure in the former and for material consumption in the latter.[2] Even so, it is likely that large discrepancies observed in cross-country employment rates and hours worked have a lot to do with the pervasive influence of different structural policies.[3]

Notes

1. For instance, Chapter 3 shows, for each country, the degree of convergence achieved over time in GDP per capita *vis-à-vis* the United States. There is a question as to whether the comparison should in such cases be made on the basis of constant or time-varying PPPs. For the figures shown in Chapter 3, the constant PPP approach was chosen. However, for most countries, using time-varying PPPs would not significantly after the outcome.
2. For a recent discussion of the welfare aspects of the comparison between the United States and Europe, see Gordon (2004) and Blanchard (2004).
3. For recent evidence on the effect of policies on labour force participation and hours worked, see Chapters 5 and 6, and Nickell (2003).

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ANNEX 1.A.2

Selection of Policy Priorities

This annex provides further details on the process of selecting policy priorities that are listed in Table 1.1 and discussed in the country notes. As mentioned in the main text, the first stage of the selection process is the identification of performance weaknesses *vis-à-vis* the best performing countries. The second stage involves the identification of policy measures that can help to address the observed performance weaknesses. The following discusses the two different processes under separate headings.

In a nutshell, the vast majority of policy recommendations were based on:

- Identified weaknesses in performance at an aggregate level and/or at a disaggregate level based on international benchmarking.
- Associated identified weaknesses in policy settings based on cross-country comparisons.

The identification of performance weaknesses

The top-level indicator of performance is the comparative level of GDP per capita *vis-à-vis* the United States, which has traditionally led the OECD countries in terms of material living standards. Gaps in GDP per capita can in turn be disaggregated into labour utilisation gaps, *i.e.* differences in hours worked per capita, and labour productivity gaps, *i.e.* differences in GDP per hour worked. As shown in Figure 1.2 in the main text, the broad-brush picture that emerges from such a decomposition is that the key performance weaknesses relate to low labour utilisation in Europe and low productivity levels in non-European countries.

The proximate determinants of GDP per capita can be further disaggregated. For example, the source of labour utilisation gaps can be explored by using the following decomposition:

- Hours worked per employed person.
- Aggregate structural unemployment rate.
- Aggregate trend labour force participation rate.
- Population of working age relative to total population.

If the overall labour utilisation gap is due to the aggregate unemployment and/or labour force participation rates, a further dis-aggregation can determine if this is due to high incidence of youth, women and persons over 55 in these two measures. For example, the labour utilisation deficit in Europe is typically linked to high unemployment and low participation rates, the latter often concentrated on low participation of older workers.

While benchmarking of performance on the leading countries is useful to identify weaknesses for laggards, it is less useful for identifying problems for successful economies. This is most obvious for the leading country, with the United States combining high productivity levels, high hours worked per employed person, low unemployment rates and high labour force participation rates. Many other relatively high GDP-per-capita countries also score high on most performance indicators. To the extent that this is not the case in some areas, it is an indication of opportunities to improve on an already good overall performance. Also, recent large movements away from good performance can signal a weakness that needs to be addressed, examples being the increase in structural unemployment in Japan since the early 1990s and the rise in the number of disability benefit recipients in a number of countries over the recent decade.

Identification of policy priorities

To address the identified performance weaknesses, five policy priorities are selected for all countries, irrespective of whether their performance is clearly bad or relatively good. Of those five priorities, three are selected on the basis of cross-country comparison of indicators of the stance of policies, whereas the other two are based on the judgement and experience of country experts. Setting the same arbitrary number of policy priorities for all countries has been motivated by the desire to help improve everyone's performance, the best performing economies included. It may also ensure a certain degree of simplicity and equality of treatment across member countries.

The implication of an identical number of priorities for all countries

Choosing the same number of priorities in each country has also certain implications. While every country can improve specific aspects of performance, some will need far deeper and widespread reforms in order to catch up with the leading countries or to prevent from falling further behind. A fixed number of priorities imply, therefore, that for some member states, policy recommendations that would seem important to implement will be left out. Conversely, for the best performing countries, and where areas of absolute weaknesses are more difficult to identify, the set of priorities may include policy recommendations that may not appear strikingly pressing. Likewise, it may also include policy recommendations that are not selected in less well-performing countries even if the same policy area in the latter is even further away from best practice. These points are illustrated below with some graphic examples.

The selection of indicator-based policy priorities

The selection process

In order to help identify areas of policy priorities in each country, a broad set of policy indicators has been assembled, with a view to allow for direct cross-country comparison. The indicators included in the set are those that have been found to have a significant impact on a specific aspect of performance on the basis of previous empirical work. For the most part, the current set of indicators covers broad aspects of product and labour market policies, reflecting the intensive research efforts conducted in these fields at the OECD. These have been supplemented by a few indicators related to education and health. However, for future exercises more indicators are likely to be added, especially in the areas not sufficiently covered by the current set, such as technology, innovation and access to financial services.

By their nature, these indicators are intended to provide a quantitative summary of the stance of a policy in a particular area. As such, they do not necessarily fully capture all the dimensions of a policy setting, nor the extent to which policies are enforced in each country. For example, the impact on work incentives of high income support for long-term unemployed may be in some cases offset by stringent conditions limiting the access to benefits. This calls for caution and judgment in using indicators of replacement rates to select priorities. The same is true for indicators of product and labour market regulations, where the application of similar rules can vary across countries depending, *inter alia*, on court interpretation of specific provisions. In this regard, selecting a policy priority on the basis of a previously-identified performance weakness contributes to minimising the problem of potentially misleading indicators.

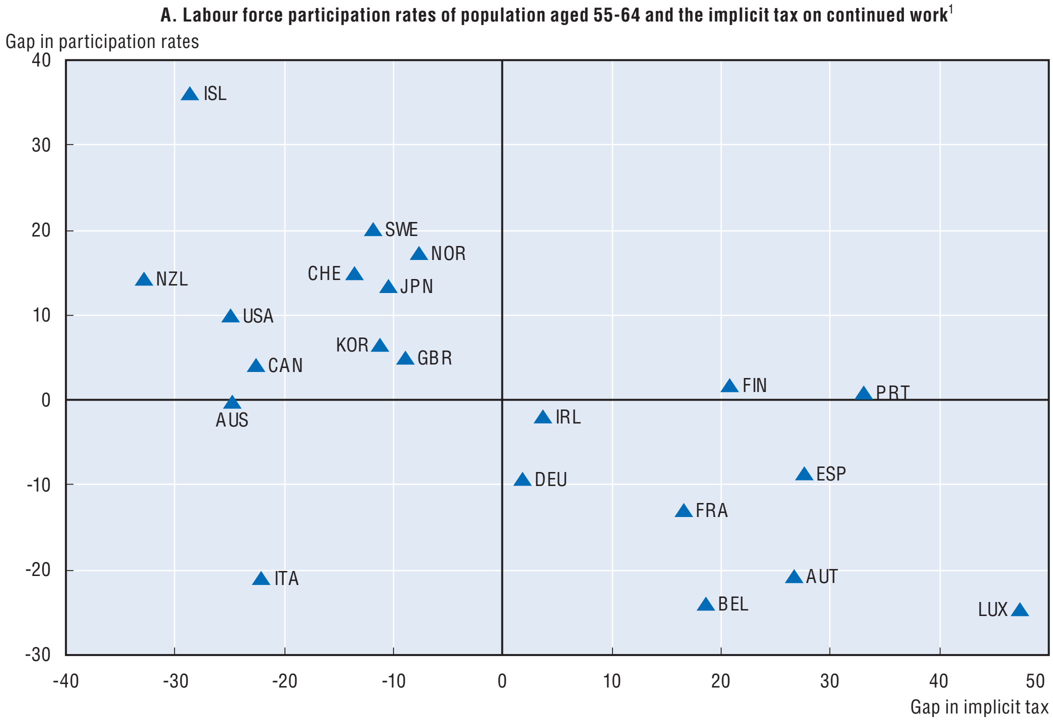
The OECD average is used as a benchmark for policies. Hence, when a country finds itself below average both in a particular performance area and in one or more of the policy settings having an impact on the specific performance area, policy priorities can be selected. In fact, most of the policy recommendations identified as priorities in this exercise reflect a matching between a sub-par performance and an inadequate policy setting. However, there are exceptions which can be illustrated with some examples, which *inter alia* shows how judgement and local knowledge is brought to bear on the selection as opposed to pure mechanical application of indicators.

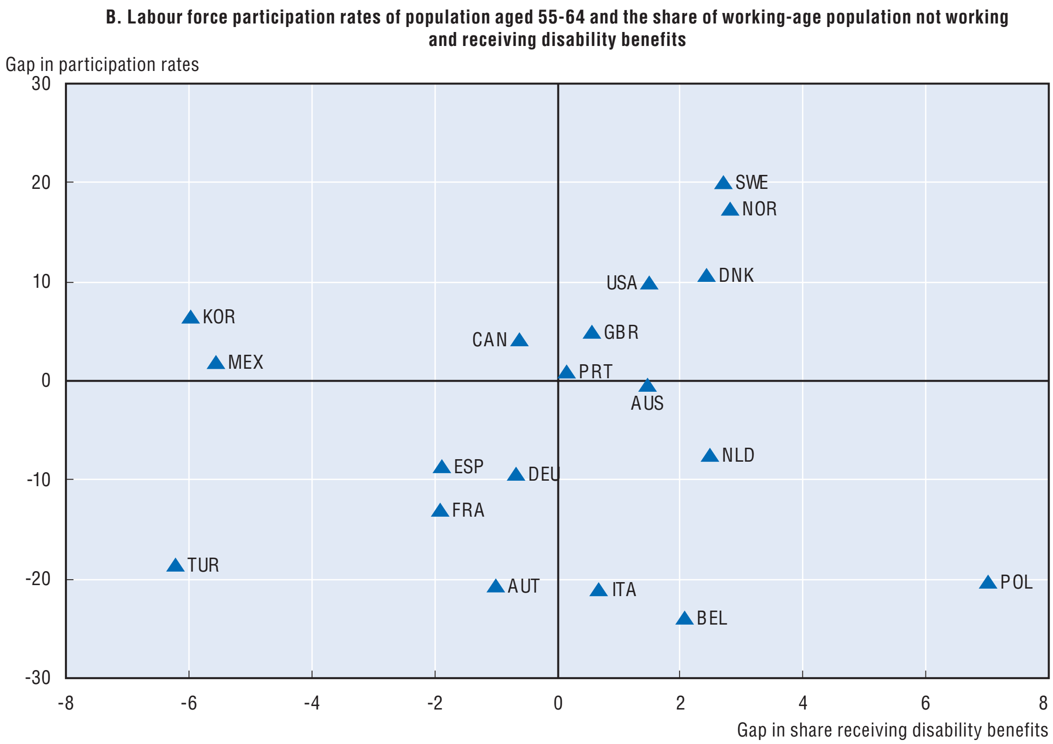
Some examples:

In each example, the performance of OECD countries in a particular area is plotted against one of the relevant policy indicators, with the horizontal and vertical axis representing the OECD average performance and policy setting, respectively. Countries lying below the horizontal axis are seen as having a weak performance in the specific area under consideration whereas countries located to the right of the vertical axis are identified as having a weakness in a policy setting relevant to the performance area. Hence, countries appearing in the lower-right (or south-east) quadrant of each scatter plot can be seen as natural candidates for a priority in the policy setting examined.

For instance, panels A and B of Figure 1.A2.1 plot the participation rate of older workers against two related policy areas, the implicit tax on continued work (panel A) and the share of working-age population receiving disability benefit (panel B). In both cases, a number of countries can be found in the lower-right quadrant, indicating that in these countries participation rates for older workers are below the OECD average and, according to empirical studies, one of the reasons is that these workers face relatively strong financial disincentives to stay longer in the labour market and/or can use the disability benefit programme as an early route to early retirement.

Figure 1.A2.1. **Relating performance to policy: some examples**
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; OECD Transforming Disability into Ability, 2003 and Chapter 5 in this publication.

In principle, a policy priority could be selected each time a country appears in the lower-right quadrant. However, the limit on the overall number of priorities selected for each country implies that some are being left out. For instance, reducing the implicit tax on continued work was selected as a priority in the case of Austria, Belgium, France and Luxembourg, but not Germany and Spain where other priorities were seen as more pressing in light of performance in other areas such as productivity. As for reforming the disability benefit programme, among the countries lying clearly in the lower-right quadrant, it was chosen as a priority for the Netherlands and Poland. It was not selected for Italy and Belgium given that for both countries, reducing the tax wedge was seen as more important given the low overall participation rates.

On the other hand, a reform of the disability benefit system was chosen as a priority for Australia and the United Kingdom even though participation of older workers in these countries is either around or slightly above OECD average. The reason is that for both countries, areas of absolute weaknesses – as defined as performance below OECD average – are not so easy to identify. In such a case, a performance that is close to the OECD average is taken as a relative weakness. However, that alone would not have been sufficient. The priority was selected also because in both countries the share of working-age population receiving disability benefit has been rising markedly since the early 1990s.

Although not shown in the figure, another difficulty occurs in the cases of countries having a performance problem in a specific area but no clear weaknesses in the relevant policy setting. For instance, even though the level of productivity in New Zealand remains below the OECD average, it is not easy to find a problem with the relevant policies. Hence the selected priorities may not seem as pressing.

It should be noted that these caveats concern a small number of recommendations that is likely to diminish as the set of performance and policy indicators is refined and extended to areas not covered in this exercise.

Other key priorities

Notwithstanding future improvements in the set of indicators, there will always remain important policy areas that can not be assessed on the basis of a quantitative indicator. In order to ensure that the exercise does not neglect key policy issues that are not covered by indicators, two additional priorities are thus selected for each country, mostly drawing on the vast and detailed expertise from various OECD working committees; these will normally be issues that have also been addressed by the Economic and Development Review Committee. Hence, details regarding the context and motivation for these additional priorities are usually found in the *Economic Survey* of a particular country. In many cases, these priorities may be supported by a policy indicator but in the cases where they are not, judgment is used as regards their impact on specific area of economic performance.

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