ECONOMIC POLICY REFORMS

GOING FOR GROWTH
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www.oecd.org/growth/GoingForGrowth2007

Going for Growth was launched in 2005 as a new form of structural surveillance complementing the OECD's long-standing country and sector-specific surveys. In line with the OECD's 1960 founding Convention, the aim is to help promote vigorous sustainable economic growth and improve the well-being of OECD citizens.

This surveillance is based on a systematic and in-depth analysis of structural policies and their outcomes across OECD members, relying on a set of internationally comparable and regularly updated indicators with a well-established link to performance. Using these indicators, alongside the expertise of OECD committees and staff, policy priorities and recommendations are derived for each member. From one issue to the next, *Going for Growth* follows up on these recommendations and priorities evolve, not least as a result of governments taking action on the identified policy priorities.

Underpinning this type of benchmarking is the observation that drawing lessons from each other's successes and failures is a powerful avenue for progress. While allowance should be made for genuine differences in social preferences across OECD members, the uniqueness of national circumstances should not serve to justify inefficient policies.

In gauging performance, the focus is on GDP per capita, productivity and employment. As highlighted in the 2006 issue, this leaves out some important dimensions of well-being. For instance, while a high GDP per capita tends to make for better health and education outcomes, it is not sufficient to ensure social cohesion, even if higher employment helps. However, for economic policy purposes, GDP per capita and employment better approach well-being than any other available indicators.

Going for Growth is the fruit of a joint effort across a large number of OECD Departments, including for this year's thematic chapters Economics; Employment, Labour and Social Affairs; and Financial and Enterprise Affairs.

EDITORIAL

Recent economic developments have been propitious in many OECD countries, notably where GDP per capita is far below the best performers. In Japan and Korea growth has retained momentum, while in those European countries that were lagging behind, the recovery has been strong and is potentially sustainable over the next few years.

This improvement largely stems from cyclical factors, with the European recovery finally taking hold following a series of false starts. But to some extent it also reflects deeper progress achieved in the area of labour and product markets. Despite subdued growth, Europe overall has enjoyed sustained job creation, with the rate of "structural unemployment" falling by a full percentage point over the past few years, while product markets were significantly liberalised.

From the perspective of pursuing structural reforms, this welcome improvement in short-run economic prospects has ambiguous consequences: a strong recovery makes reforms both easier to implement and seemingly less necessary to undertake, since the threat of major difficulties is fading for a while. This is confirmed by recent OECD research, summarised in our special chapter on the "political economy of structural reforms".

Temptations to ease up on reforms should undoubtedly be resisted. In Continental Europe and Asian OECD Members in particular, enhanced competition in product and financial markets are needed to boost productivity and long-term growth. Reforms on that front could also shift the composition of national income away from business profits into higher labour incomes and employment.

Last year's issue of *Going for Growth* amply documented the growth dividends accruing from further financial market liberalisation and good innovation policies. This year's issue features two special chapters on product market competition.

The first one attempts to quantify the benefits from increased product market competition in terms of innovation and productivity. It is no coincidence that the United States and Northern Europe, who started early to open up their product markets to competition, benefited most from the new information and communication technologies. OECD research suggests that open product markets stimulate innovation by pushing companies to catch up on the competition or to take the lead. Areas where further progress is needed in many OECD countries include dismantling barriers to competition in the energy, transport and communication sectors, as well as professional services, not to mention agricultural markets OECD-wide. Easing formal or informal restrictions to foreign ownership in countries such as Japan, Korea or Mexico is also called for.

The second chapter on product markets deals with the policies influencing competition across OECD countries and the institutions that drive them. It lays out some of the challenges and complexities facing those in charge of promoting greater competition. It stresses that enforcement of competition law is weak in some countries and that regulations still limit competition in many sectors, notably network industries. It also serves to highlight the importance of independent and powerful regulators, well-endowed with economic expertise.

Notwithstanding the intricacies of, and obstacles to, product market reforms, more difficult challenges face OECD countries in the areas of labour markets and education.

Granted, unemployment has receded over the years in many OECD countries. Tangible progress was recently made too in curtailing incentives for early retirement, translating into greater participation of people in their fifties and sixties.

Even so, employment rates remain low in parts of Continental Europe. And in most OECD countries, labour market performance has been a source of continued concern, with worries focused more and more on a perceived rise in earnings inequalities. Indeed, new information technologies and competition from large emerging economies are seen as exerting a negative influence on the jobs and incomes of the less-skilled workers, while boosting the prospects of the higher-skilled ones. In the United States, this may indeed have contributed to a marked polarisation in labour income gains, with only modest or no increases available for the bottom half of the wage distribution. Elsewhere, it may have worsened employment prospects in those countries where domestic labour market institutions were already deficient.

In a world where skills are becoming increasingly important, education systems have an essential role to play in equalising and raising opportunities, starting from early childhood education, the coverage of which often remains inadequate. Too many youngsters are also dropping out from secondary education without adequate vocational skills in various English-speaking and Central European countries. At the same time, raising tertiary graduation rates is still a common objective in the OECD at large. The challenges facing tertiary education are particularly daunting in Continental Europe where both substantially higher funding and much stronger managerial autonomy for universities are needed.

Labour market reforms are also required in many member countries to achieve full employment and overcome the "insider/outsider" divide. Following the recent revisiting of the OECD Jobs Strategy, a special chapter is devoted here to those reforms.

It is of course much easier to recommend labour market reforms than to implement them. One of the roadblocks obstructing successful reform lies with the widespread perception that they are just one more negative shock, on top of the ones brought on by the new globalised world. However, it should be clear by now that strategies that rely on reforming by stealth and at the margins of the labour market have failed. They did little to restore full employment and most likely increased precarity at work.

In fact, lack of reform has often worsened perceived insecurity, depressing household confidence. Reform sluggishness is understandable, given that adapting to rapid economic change can be a tall order. But it is also paradoxical, since the effectiveness of good labour market policies in various OECD countries is there for all to see and emulate. This is the case for active labour market policies and unemployment compensation, which can and should be designed so as not to trap recipients into inactivity while providing them with adequate income. It also holds for tax wedges and the cost of labour, which should not bar unskilled youth from employment. Taking advantage of existing best practice with regards to making-work-pay policies, more progress could be achieved as well to reduce in-work poverty and allow parents to better combine employment and family responsibilities.

In a global context where labour market outcomes, in terms of income and job quality, might become more and more polarised, it is important that labour market institutions do not unwittingly aggravate such trends. Alas, this may actually be the case in the crucial area of employment protection legislation. In many countries, too stringent protection for permanent employees has been offset by increasingly flexible modalities for temporary contracts. This has most likely contributed to labour market duality in Continental Europe. At the same time, the divide between insiders and outsiders has also worsened in Japan and Korea.

In countries such as France, Germany and Spain, with stringent employment protection legislation for permanent workers, youngsters and women are crowded out from employment and suffer from erratic career paths. Experience from various other European countries suggests ways to level the playing field. Specifically, it points to reforming permanent contracts to make the costs of firing less unpredictable to employers while also providing income support and efficient re-employment services to workers in the event of lay-off.

At the end of the day, why does good practice not always spread to countries where policy changes are badly needed? One reason may be that in these countries reform is perceived, often wrongly so, as a threat to social cohesion and deeply held values. Our empirical research nonetheless shows that this need not be the case. But, quite aside from any philosophical objections to market-oriented reforms, this may also reflect resistance from those who fear they may lose from change. Indeed, economic analysis suggests that while market-oriented reforms help boost global incomes, they may also induce losses for some people, at least in the absence of offsetting compensation.

Because they take time to materialise and are often diffuse, gains from reforms are perceived as uncertain. By contrast, those who stand to lose from change can easily identify themselves and unite to block reforms, thus leading to "the tyranny of the status quo". The difficulties confronting collective action in the reform area are well illustrated in our special chapter on the "political economy of structural reforms", which suggests that crisis is the main driver for institutional change. What would be needed, rather, is timely reform to avoid situations where finally the cost of inaction becomes so manifestly prohibitive that it dwarfs the short-run costs of reform.

On a brighter note, our empirical research suggests that smaller countries may be more alert and adept at introducing timely reform. The same would seem to hold where political systems are conducive to government stability or where the fiscal position is strong enough to allow adequate compensation for losers.

Some reforms may also be easier to carry out than others: liberalising financial markets, international trade and, to some extent, product markets seems politically less sensitive than labour market reforms. Historically, such reforms have indeed been implemented first. This may also reflect the fact that, as already mentioned, financial, trade and product market reforms can grease the wheels of labour market reforms, since they contribute to shifting part of foreign and capital incomes to wage earners.

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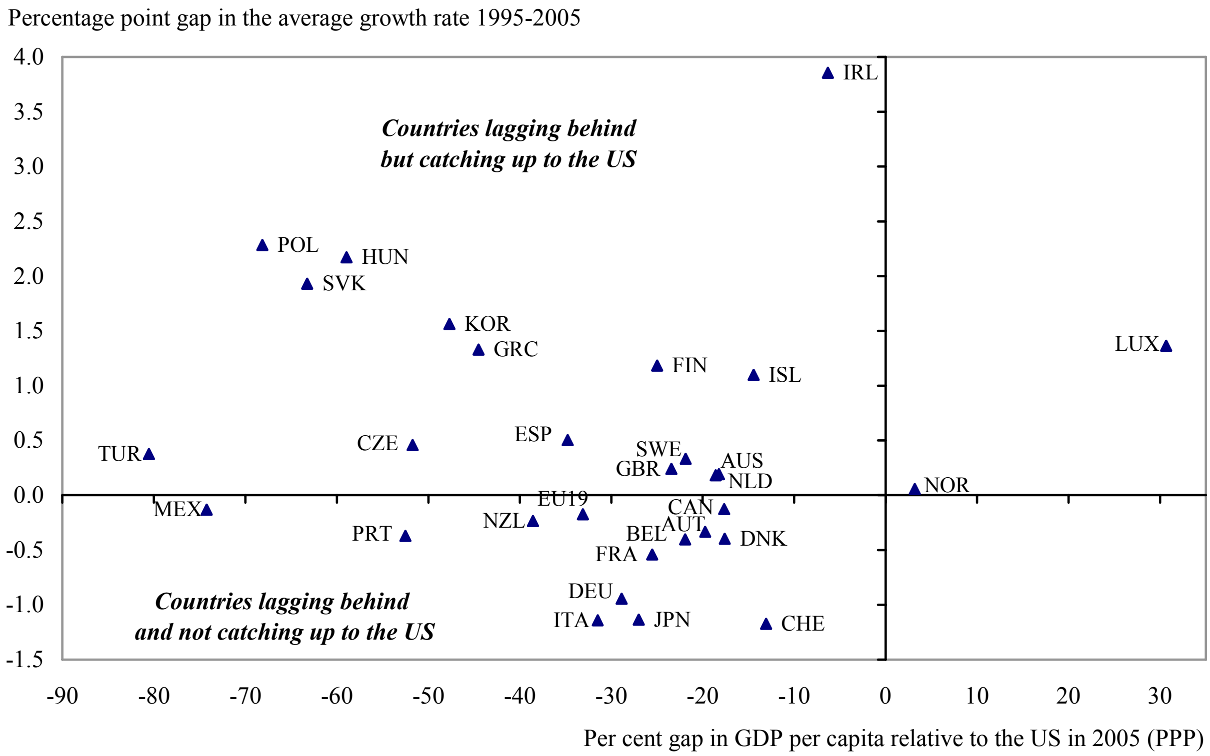
The convergence process

Over time

GDP per capita levels and growth rates

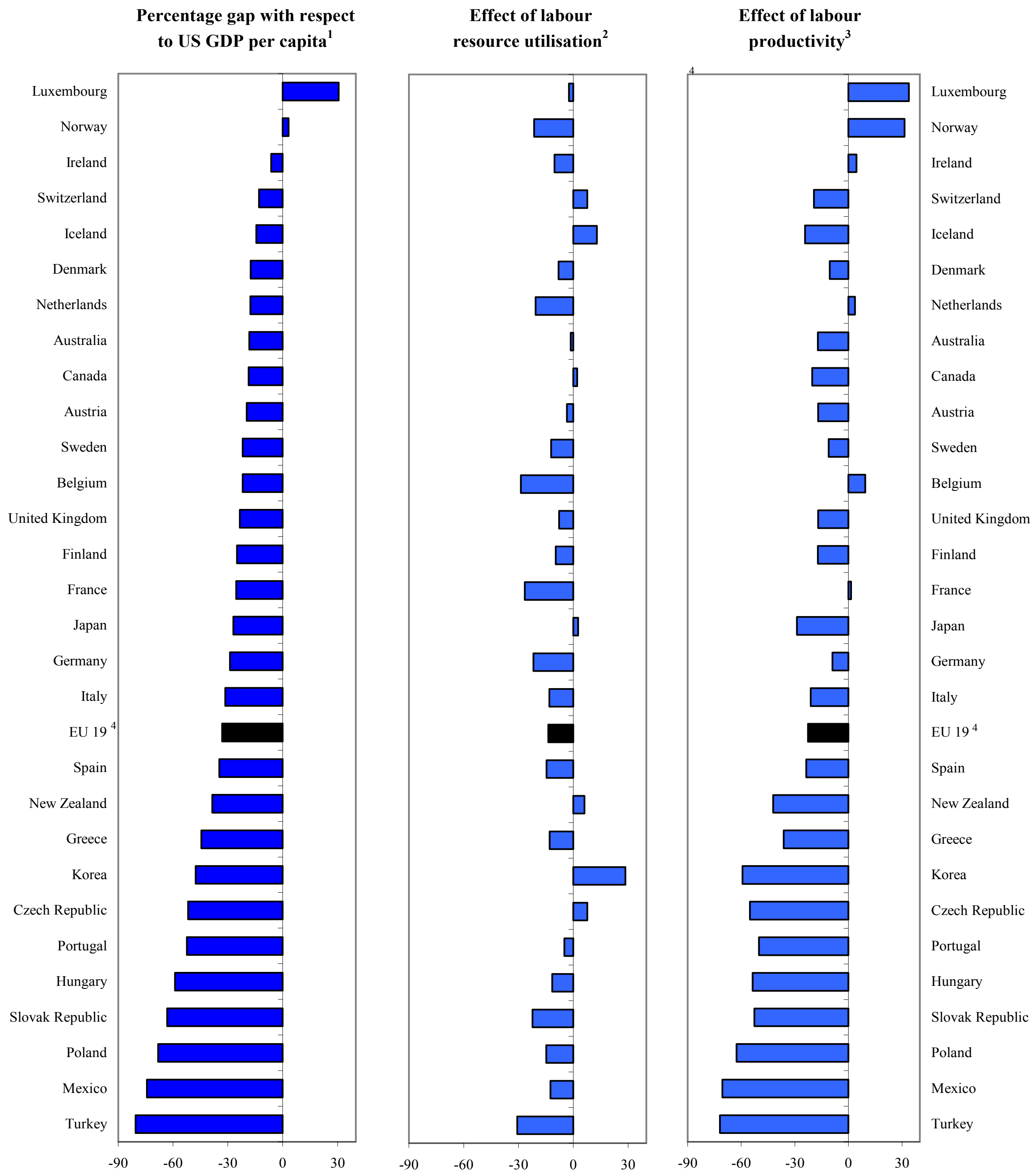
Gap vis-à-vis the United States[1]



1. For Luxembourg, the population is augmented by the number of cross-border workers in order to take into account their contribution to GDP. Data for Greece do not take into account the large upward revision to GDP announced in late 2006.

Snapshot as of 2005

The sources of real income differences

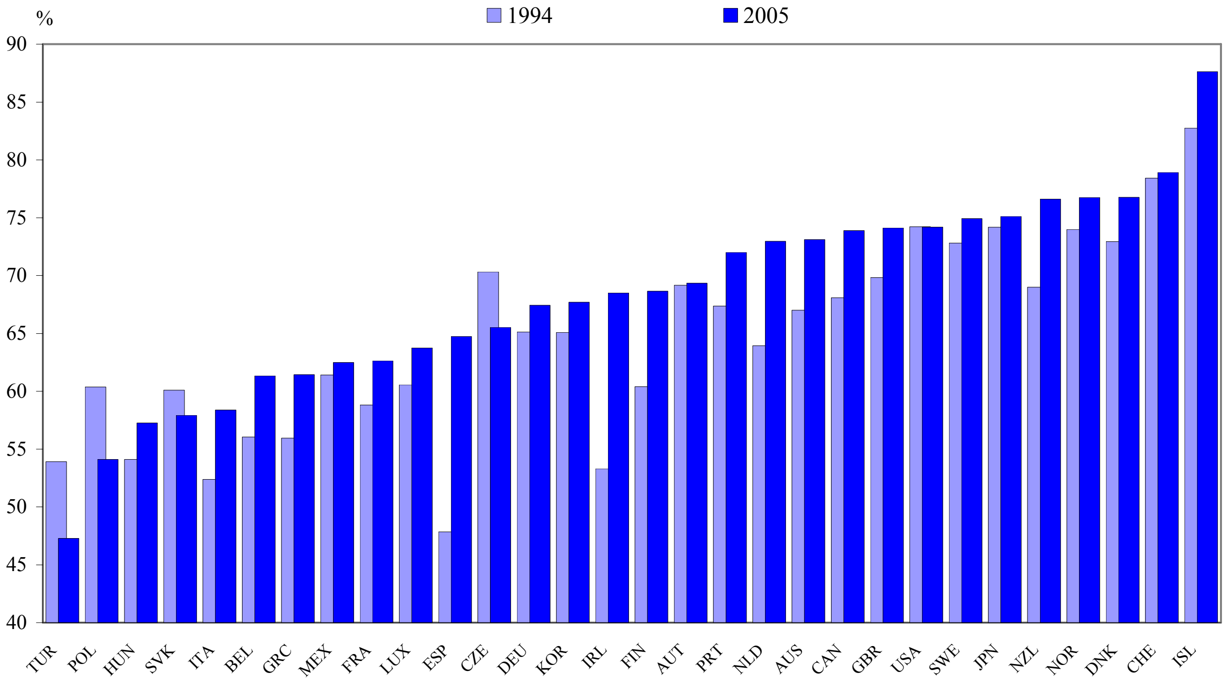


1. Based on 2005 purchasing power parities (PPPs). In the case of Luxembourg, the population is augmented by the number of cross-border workers in order to take into account their contribution to GDP. Data for Greece do not take into account the large upward revision to the level of GDP announced in late 2006.
2. Labour resource utilisation is measured as total number of hours worked divided by the population.
3. Labour productivity is measured as GDP per hour worked.
4. EU states that are also OECD members.

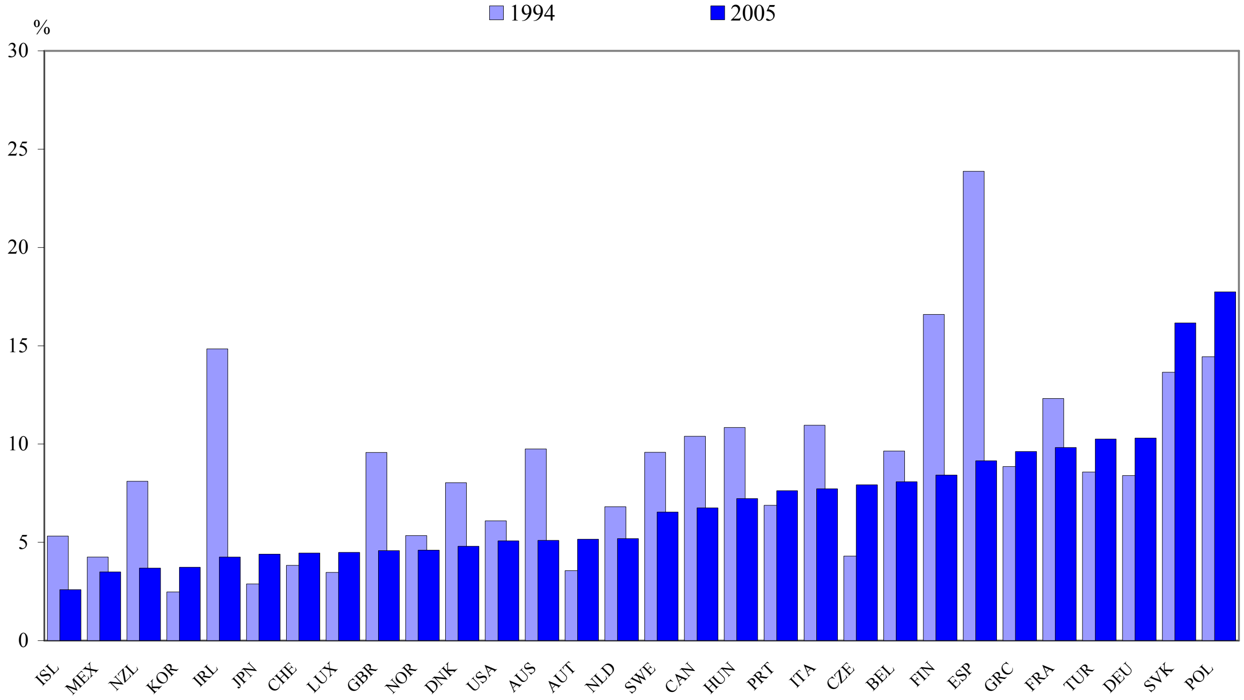
Labour market performance

Improvements

Employment rates have risen in most OECD countries since the mid-1990s...

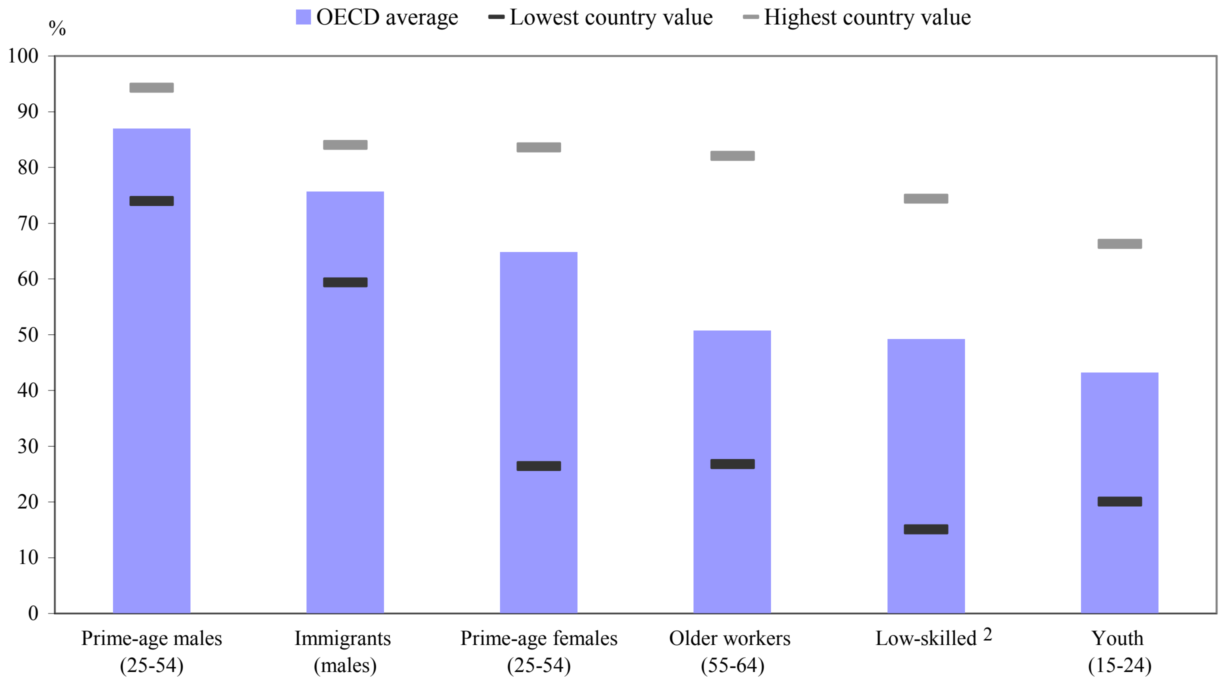


… and unemployment rates have tended to fall



Challenges

Employment rates across population groups, 2004[1]



1. Some of the groups overlap. For each category except male immigrants, OECD average is calculated as population-weighted averages across all OECD countries. For male immigrants, Iceland, Japan, Korea, New-Zealand, Poland and Turkey are excluded.
2. Data for the low-skilled group refer to 2003 except for Iceland, Italy and the Netherlands, 2002.

Policy reforms that can reduce unemployment

In the average OECD country, the unemployment rate can be reduced by 1 percentage point…

- by reducing the average unemployment benefit replacement rate by 8 percentage points

or

- by reducing the overall tax wedge on labour income by 3.5 percentage points

or

- through product market liberalisation of the same order of magnitude as that which has taken place in the average OECD country over the past ten years

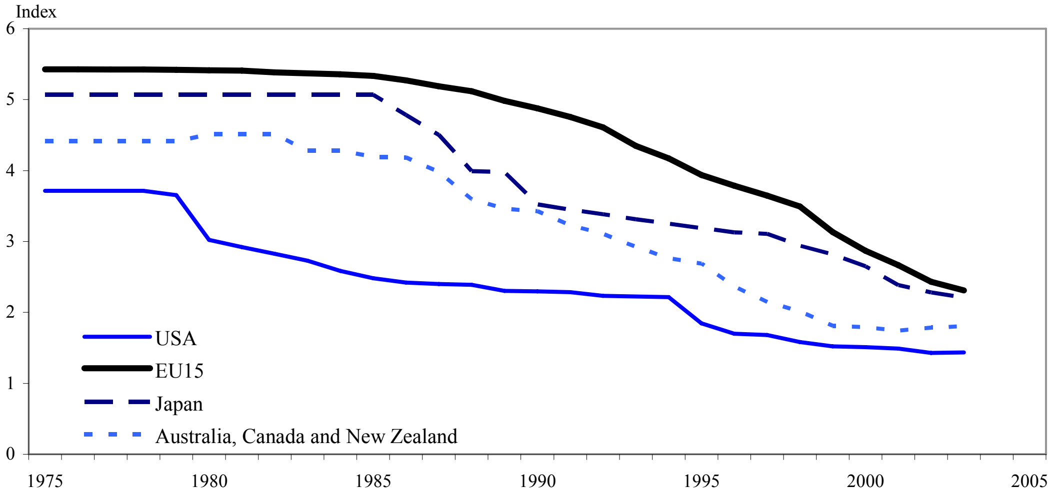
or

- by raising spending on active labour market policies per unemployed worker (as a share of GDP per capita) to the Swedish level

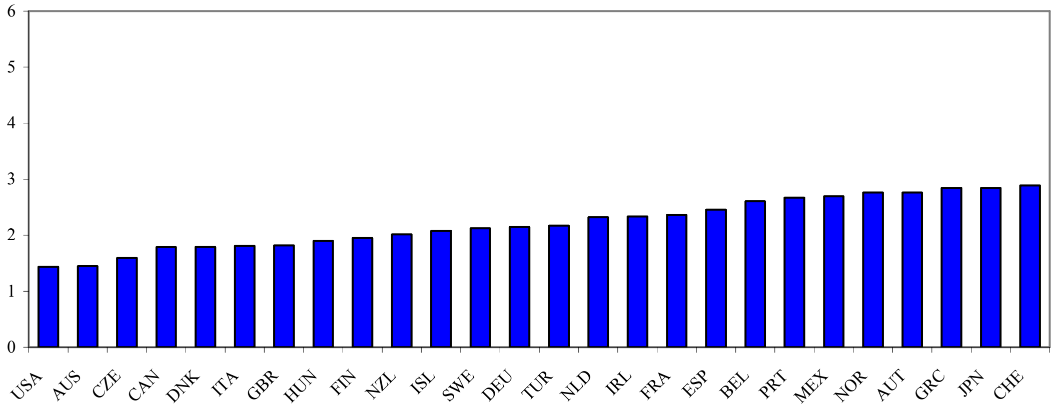
…or by several percentage points through a combination of the above policy reforms

Product market regulation and competition

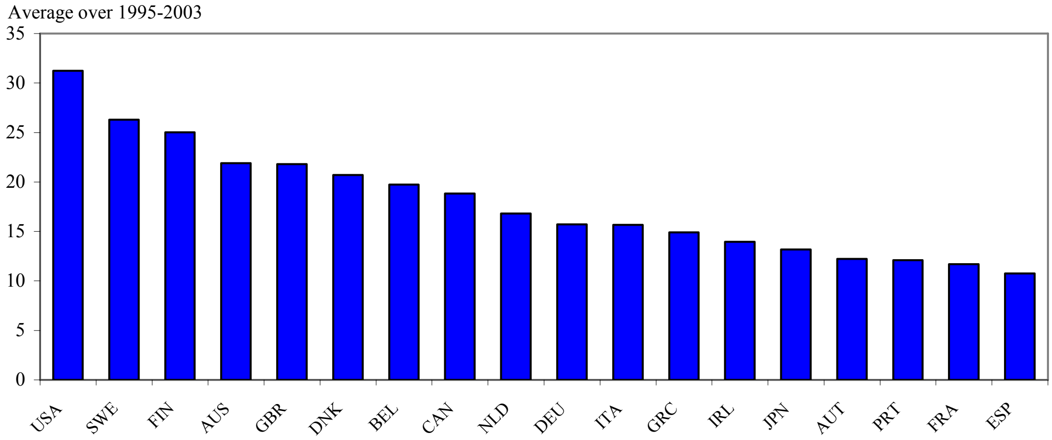
Developments in the regulation of network industries[1,2]



Competition law and policy indicator, 2003[2]



ICT investment as share of total investment



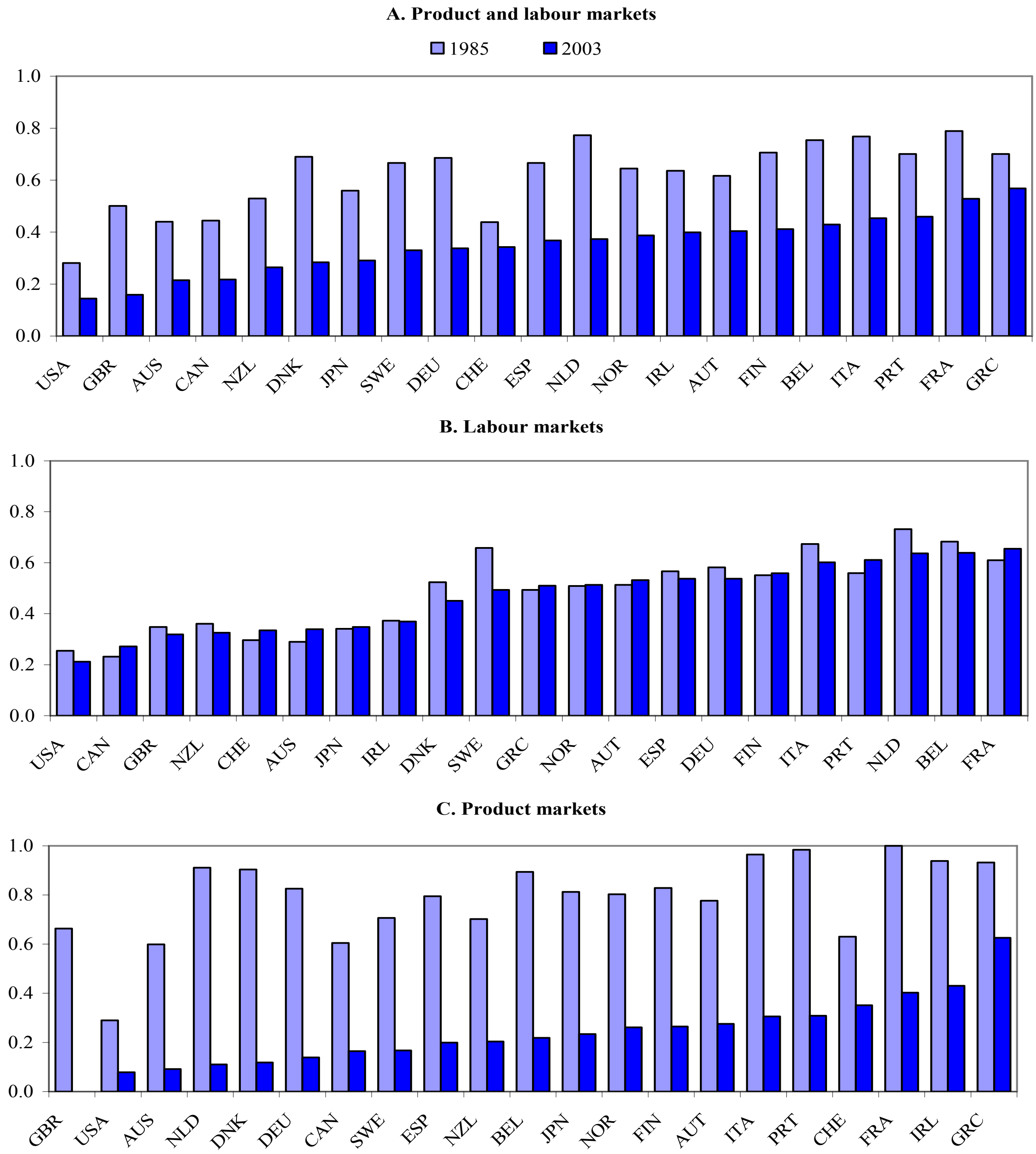
1. Based on summary indicators of competition-restraining regulatory conditions in seven network sectors: airlines, telecommunications, electricity, gas, post, rail and road freight. EU15 excludes Luxembourg.
2. Indicator scale of 0-6 with 6 designating an overall framework least conducive to competition.

Labour and product market reforms over the past two decades

More progress has been achieved with product than with labour markets

Structural policy rigidities in 1985 and 2003

Synthetic indicators of product and labour market policies[1]

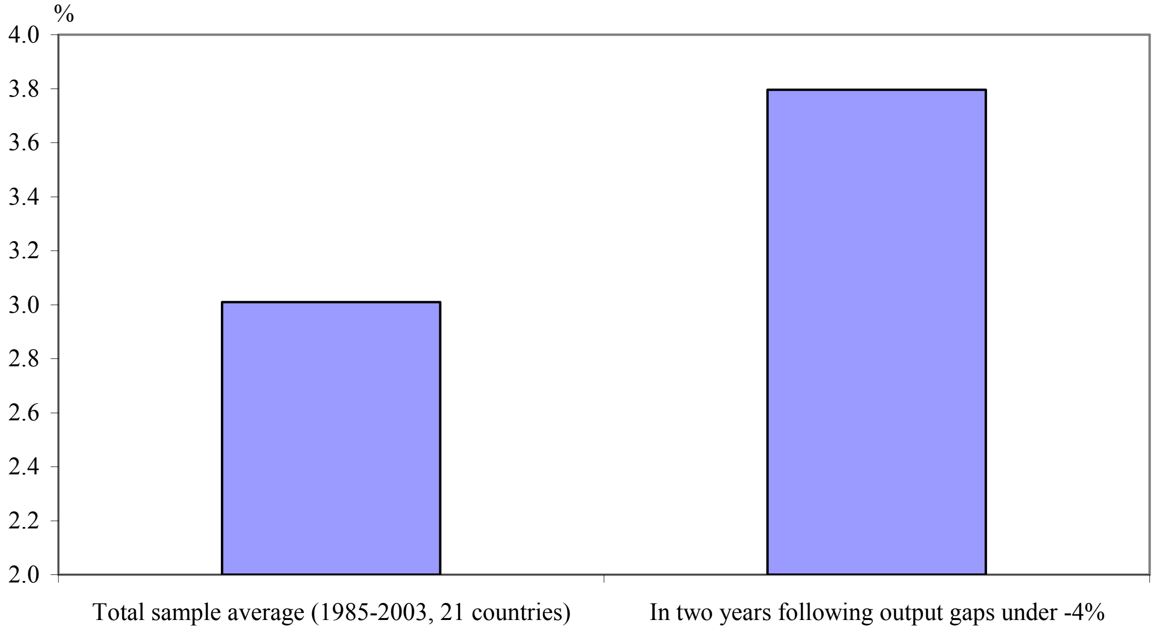


1. The product market indicator covers competition-restraining regulations in energy, transport and communications sectors. The labour market indicator covers employment protection, benefit systems, implicit tax rates on old-age work and labour tax wedges. All indicators are normalised ranging from 0 to 1, where 1 indicates the highest degree of rigidity. The overall indicator displayed in panel A is a weighted average of the indicators reported in panels B and C, with equal weights given to the two indicators.

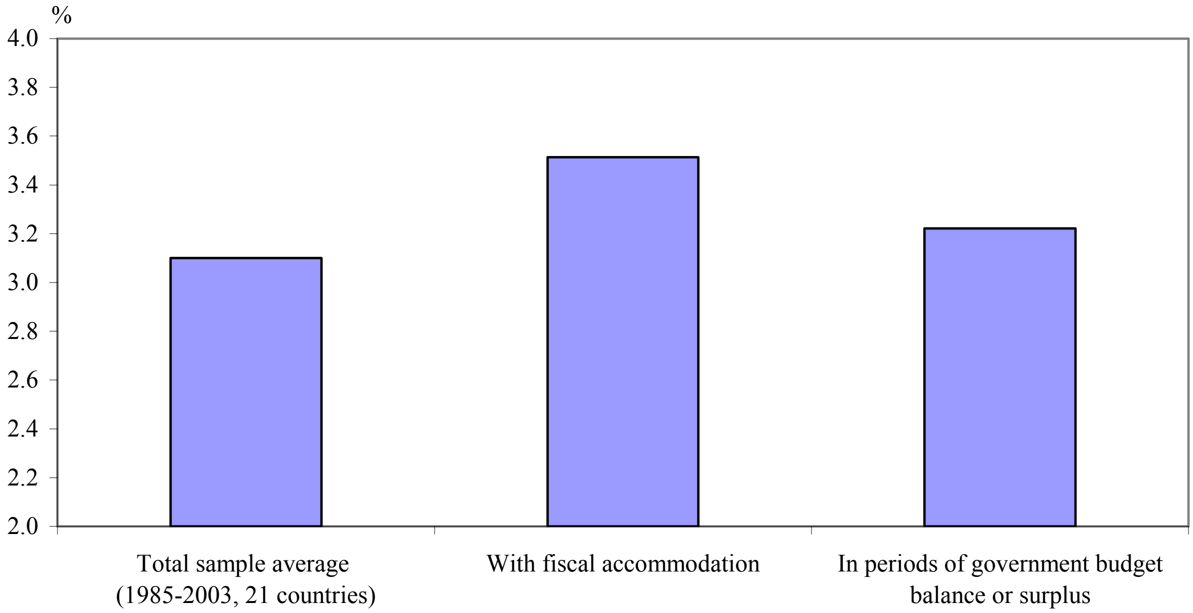
The economic and political context of reform

Annual percentage reduction in synthetic indicator of labour and product market policies[1]

Crises and overall reform efforts



Fiscal policy and progress in labour and product market reform



1. The indicators are described on the previous page.