



**ECONOMIC POLICY REFORMS:
GOING FOR GROWTH
2006**

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Chief Economist**

Editorial

Over the past two decades, living standards in a number of OECD countries, notably Japan and some Continental European economies, have fallen further behind the best performers. The social costs associated with this failure to converge are plain to see, and will only worsen with demographic ageing. At the same time, potential growth and resilience to economic shocks have improved in other OECD countries. This divergence in performance holds policy lessons for how best to spur sustained growth in living standards.

The first issue of *Going for Growth*, which was released one year ago, brought out some of these lessons. It inaugurated a new form of benchmarking surveillance, complementing the OECD's long-standing country- and sector-specific surveys. This surveillance rests on structural policy indicators with a well-identified link to economic performance, which serve to gauge to what extent GDP divergence reflects differences in the effectiveness of public policies rather than in tastes and societal choices. Using these indicators, alongside the detailed expertise of the OECD's committees and staff, a set of policy recommendations is derived for each OECD member.

Last year, we focused mainly on labour and product markets. In this second issue, we follow up on the progress made in those areas. We document the efforts deployed to raise labour productivity consistent with the priorities that had been identified last year, notably as regards easing barriers to entry and other regulations inhibiting competition, and strengthening human capital formation. Unfortunately, new initiatives to lift labour utilisation have been rarer. In particular, little has been done to reduce the implicit tax on work beyond certain age thresholds.

As indicated last year, our ambition is to gradually broaden the scope of the indicators underpinning the *Going for Growth* venture to take into account other policies that potently influence economic performance. This year, we are extending it to include innovation, recognising its importance as one of the main engines of long-run growth.

The policy indicators used to "explain" innovation performance encompass framework conditions, such as regulations affecting competition in product markets, as well as more specific policies like public R&D spending. Innovation performance is measured through patents or R&D intensity. They need to be interpreted with care, however: R&D spending is not an end in itself; and patents, while obviously a product of innovative activity, are only one way to protect innovators' rights, not to mention that many of them are never exploited commercially and that some are filed for litigation purposes.

We followed the same approach as for labour and product markets: identified weaknesses in the policy settings coupled with sub-par innovation performance or weaknesses in the proximate determinants of innovation (such as skills or financial conditions) are taken to suggest that reforms are called for to move closer to best practice. For example, when innovation performance is found to be below the OECD average while relatively high regulatory barriers stifle competition, we see a *prima facie* case for product market reform and for a recommendation in this area.

In the same spirit, albeit more tentatively, this issue of *Going for Growth* also explores another field, namely financial markets. Building on recent OECD research, it suggests that well-developed financial markets matter for growth and that, in turn, financial development owes a lot to greater competition in the banking sector as well as adequate investor protection. Moving from these general conclusions to pointed policy recommendations for each member country would require, however, further efforts to build a more refined set of indicators OECD-wide.

Lastly, this second issue of *Going for Growth* takes a few steps back to reflect on the yardstick used in the course of surveillance to measure success. One of the key objectives enshrined in the OECD's 1960 founding Convention is "to promote the highest sustainable growth" of members' economies and to "improve the economic and social well-being of their peoples". In *Going for Growth*, real GDP per capita, estimated at purchasing power parity, serves as the gauge, but how well does it proxy more holistic notions of well-being?

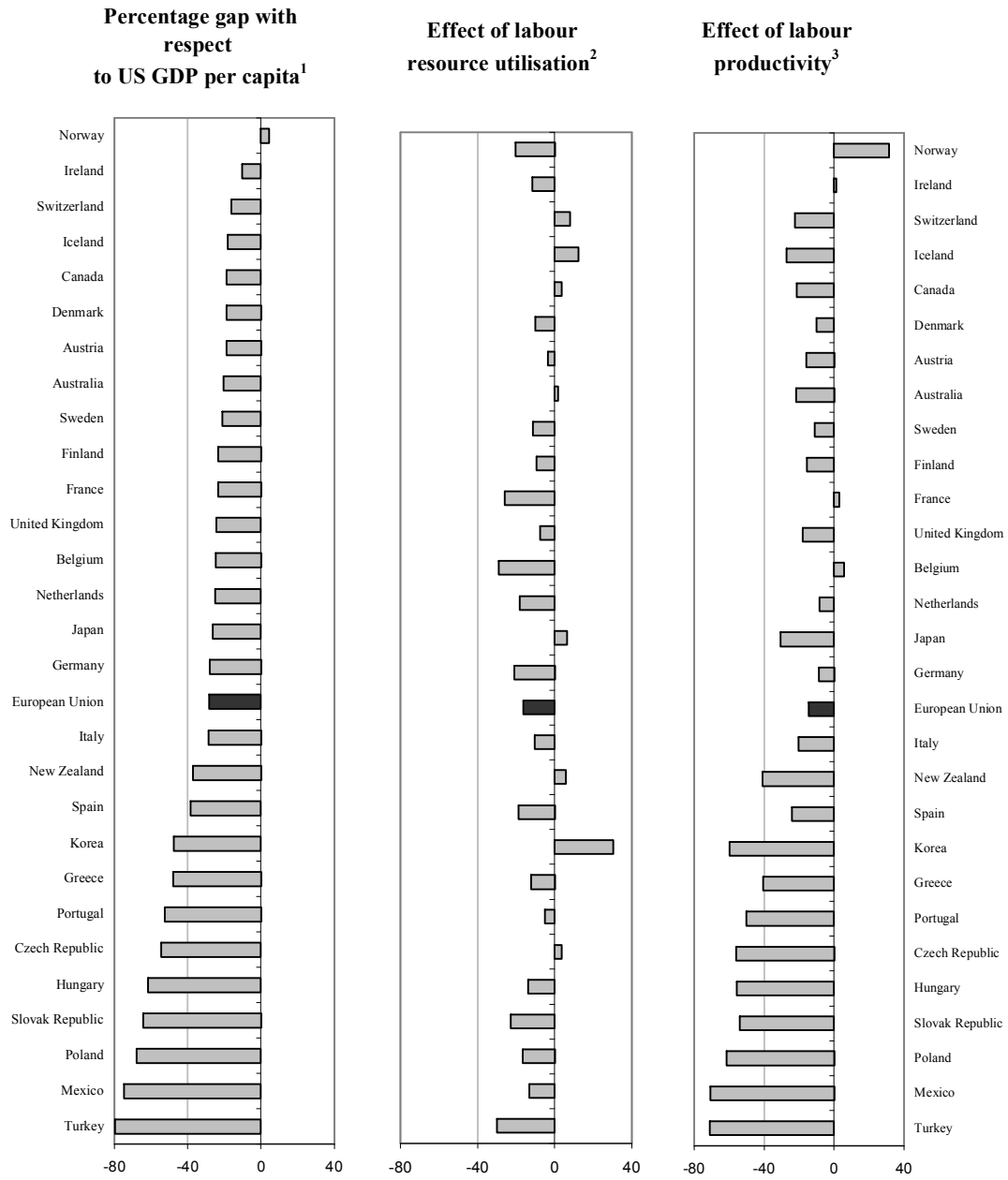
We surveyed a range of alternative indicators of well-being, taking into account such dimensions as income distribution, social outcomes, the environment or reported happiness. While most do add useful information, they all suffer from various drawbacks, including availability, measurement and cross-country comparability problems. Some of the more appealing ones are also strongly correlated with real GDP. In the end, GDP per capita may well be the least imperfect and most timely summary statistic of well-being. Supplementing it with other indicators might help nonetheless to nuance and qualify what could otherwise be an excessively reductionist approach to welfare.

As was the case last year, it should be underlined that this new issue of *Going for Growth* is the fruit of a collaborative exercise involving various OECD Departments including Economics, Employment and Social Affairs, Financial Affairs, Science and Technology, as well as Statistics.

A handwritten signature in black ink that reads "JP Cotis". The signature is written in a cursive, slightly slanted style.

Jean-Philippe Cotis
OECD Chief Economist

Why do real incomes differ?

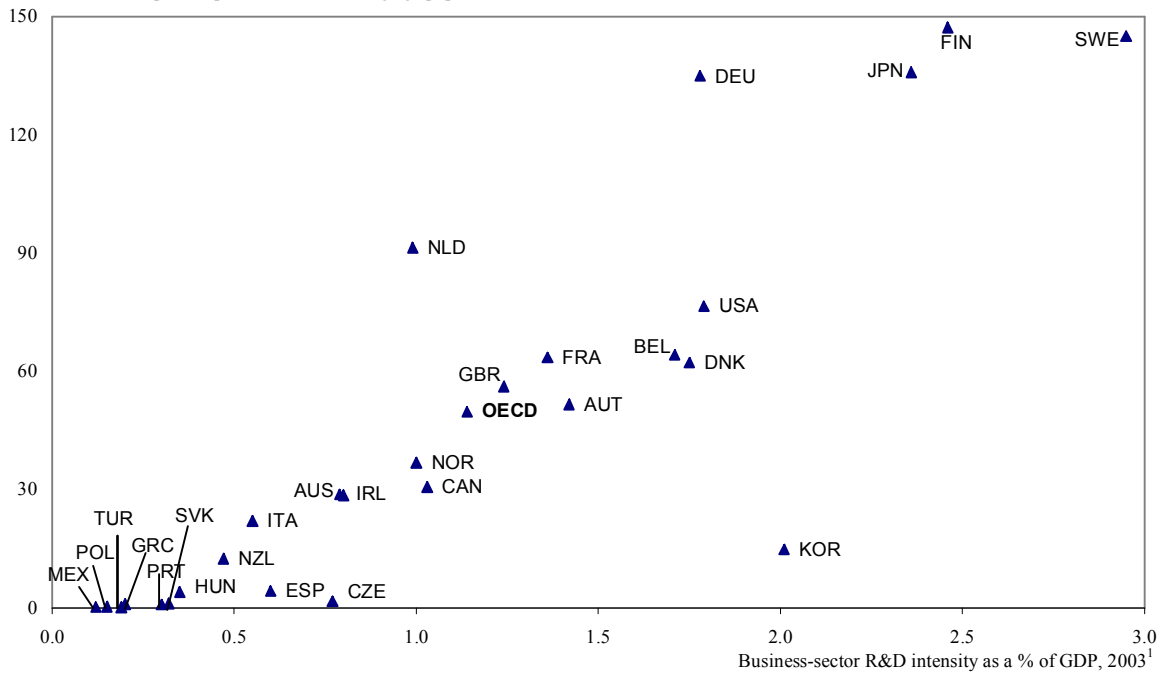


1. Based on year 2000 purchasing power parities (PPPs).
2. Labour resource utilisation is measured as total number of hours worked divided by population.
3. Labour productivity is measured as GDP per hour worked.

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

Business R&D spending and patents are correlated

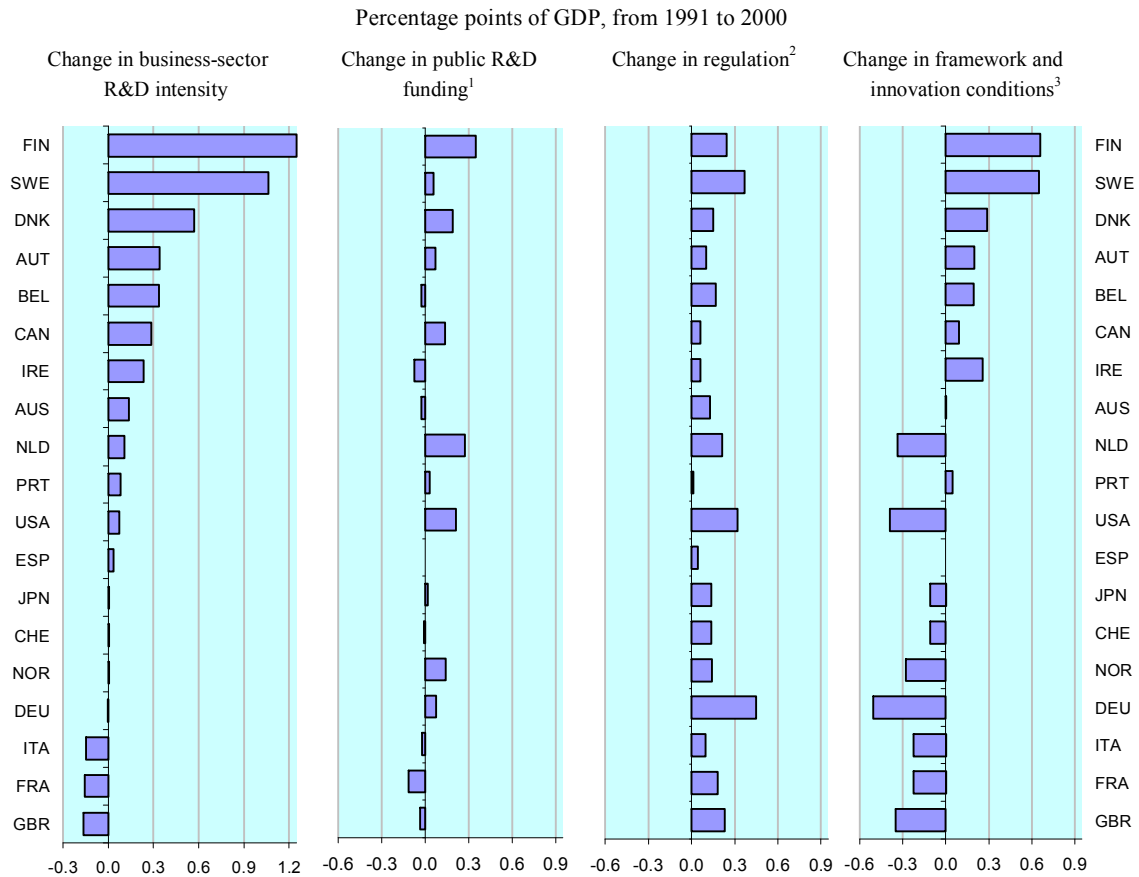
Number of triadic patents per million of working age population, 2001



1. 2002 for Australia, Austria, Portugal, Switzerland and Turkey; 2001 for Greece and Mexico.

Source: OECD, Main Science and Technology Indicators database.

What determines business R&D intensity?



1. Includes public financial support for private R&D (both grants and tax incentives), R&D performed in public institutions and the share of the latter that is funded by the private sector.

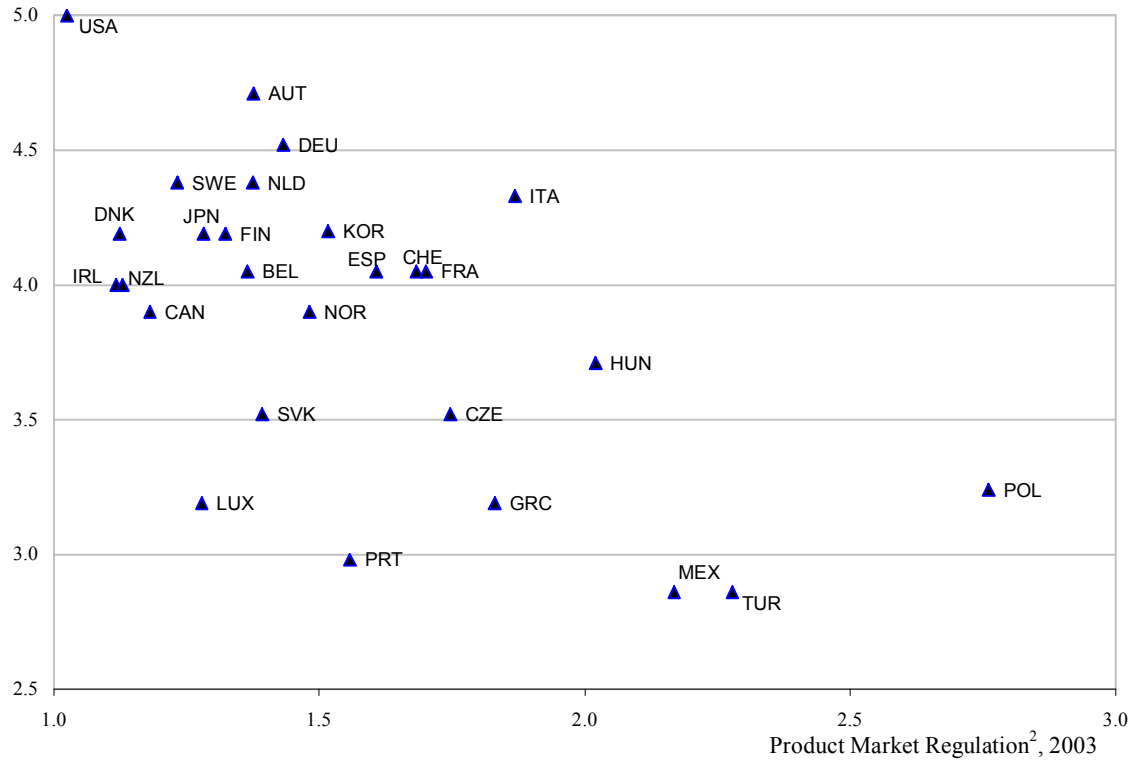
2. Includes product market regulation, employment protection legislation and the strength of intellectual property rights.

3. Includes indicators of a country's exposure and capacity to absorb foreign knowledge as well as of broad financial and economic conditions. Residual factors that can not be accounted for by the statistical relation are also included in this category.

Source: Jaumotte and Pain (2005d).

Competition-friendly regulations tend to go hand in hand with intellectual property rights protection

Intellectual Property Rights (IPR)¹, 2000



1. Index scale of 0-5 from least to most restrictive.

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

Source: Park and Wagh, 2002 and OECD, *Going for Growth*, 2005.

Leading innovators: Nordics, US, Japan, ...

- **Strong productivity growth over past decade (Japan being an exception)**
- **Typically high graduation rates from tertiary education**
- **But several need to boost innovation in services via more open and competitive markets**

France, Germany, Netherlands, Belgium, ...

- **Above-average innovation performance**
- **But need to strengthen tertiary education and contribution of universities to research**
- **Most can improve cost-effectiveness of financial measures supporting private sector R&D**

Non-US English-speaking countries: UK, Australia, Ireland, ...

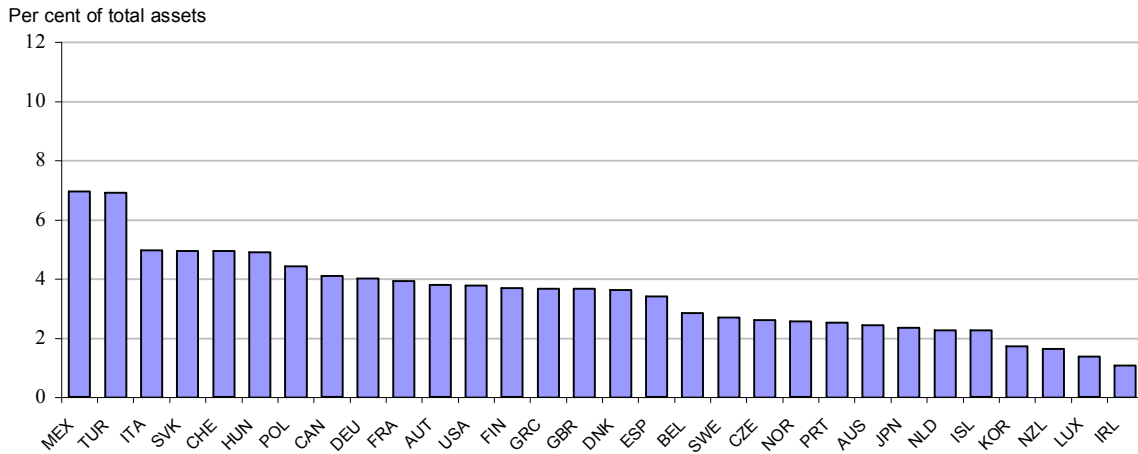
- **Close to or somewhat below-average innovation performance**
- **Productivity performance has generally been good**
- **Common challenge: strengthen links between public research and industry**
- **Need to reduce high rate of early school leavers in Australia and UK**

Southern and Central Europe, ...

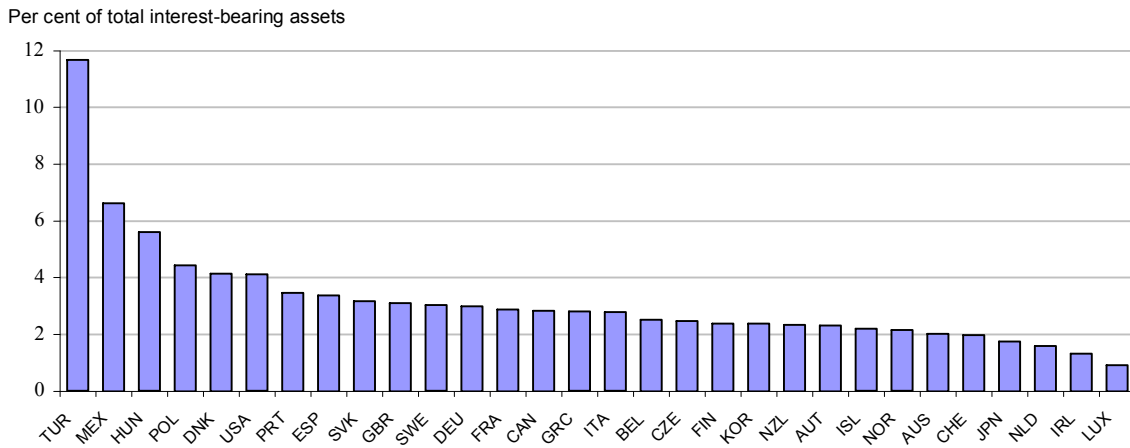
- **Weak innovation performance**
- **Need stronger product market competition**
- **And improvements in education in Southern Europe**

The costs of banking sector intermediation differ across economies...

Overhead costs



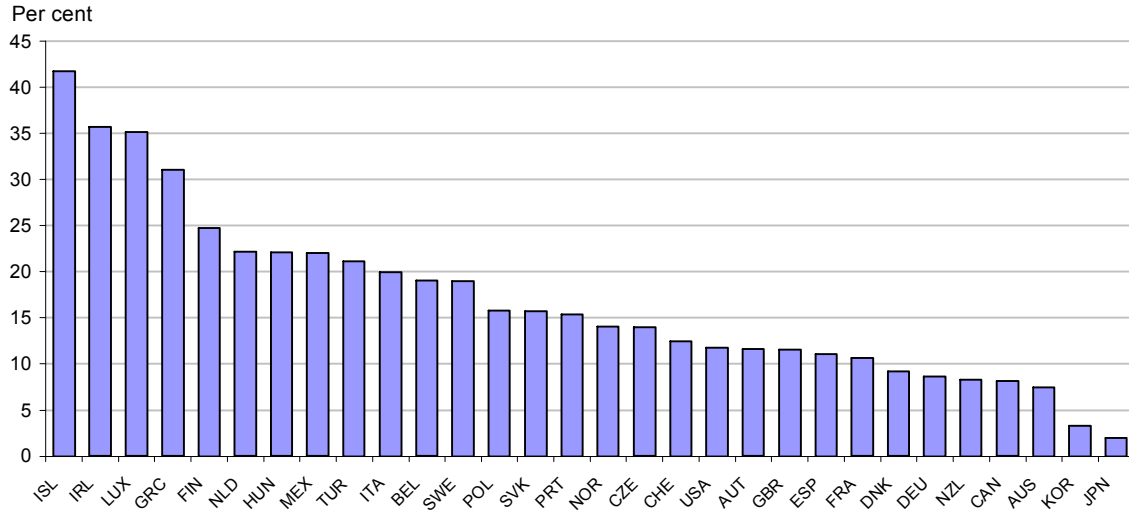
Net interest margins



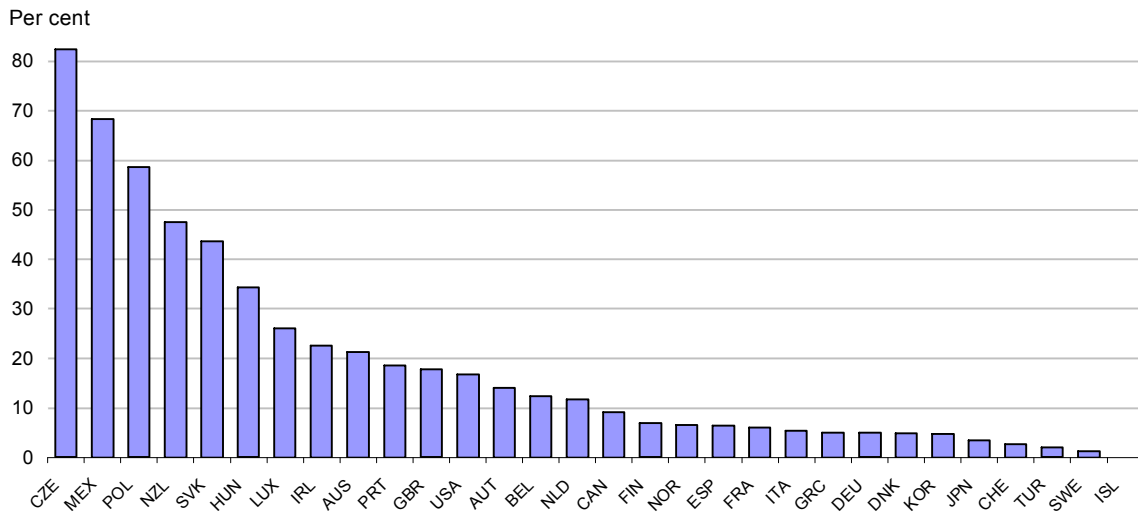
Source: World Bank financial structure database and *World retail banking report*, 2005.

... as does the pressure from international competition
Average 2000-2003

Share of cross-border loans in total domestic borrowing

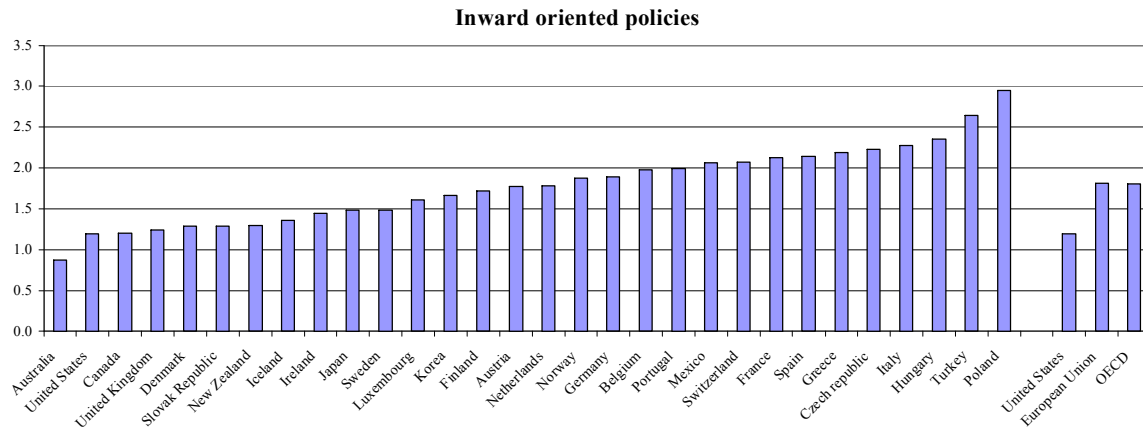
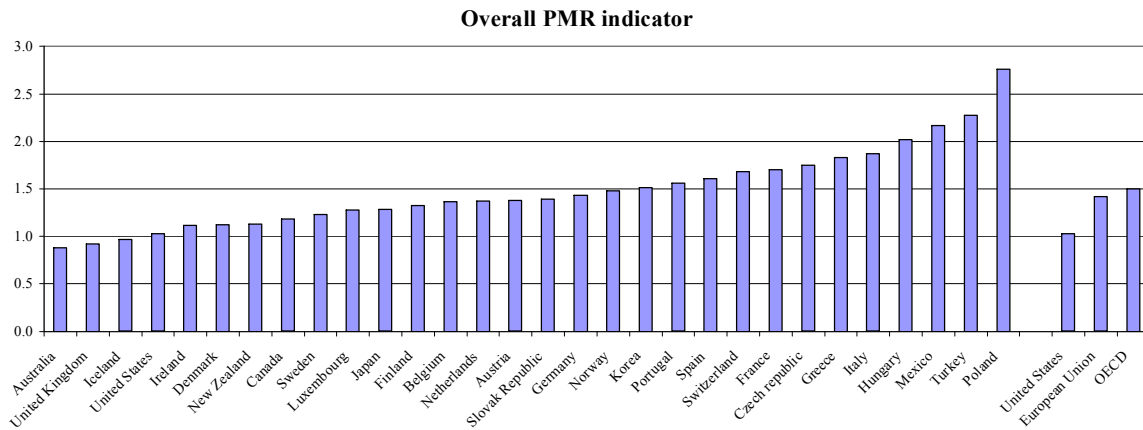


Foreign banks' penetration of domestic loan market



Source: BIS and IMF.

There is ample scope to liberalize product market regulation in many OECD countries ¹

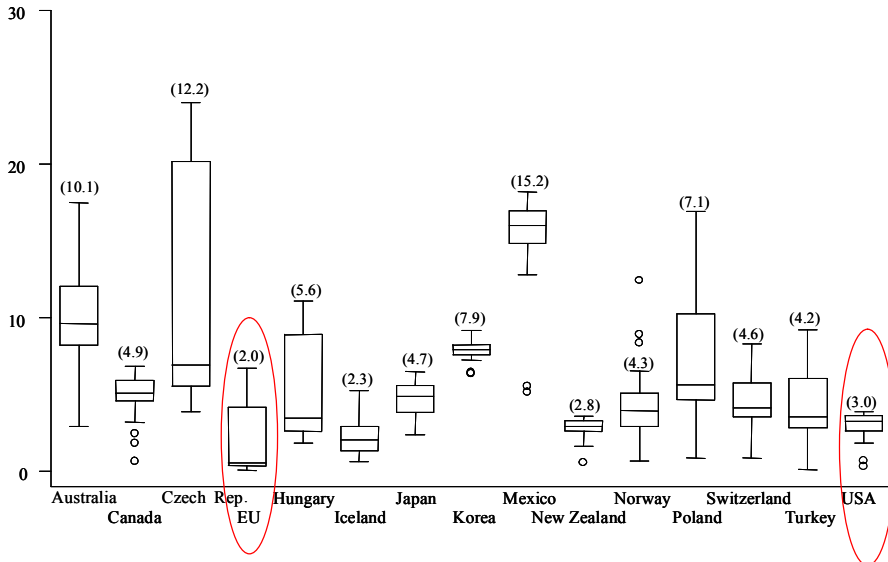


1. The indicators range from 0 (least restrictive) to 6 (most restrictive).
Source: OECD International Regulation Database.

Tariff levels are generally relatively low

Median and dispersion of bilateral applied tariffs by importing countries in 2001^{1,2}

Average values in parentheses

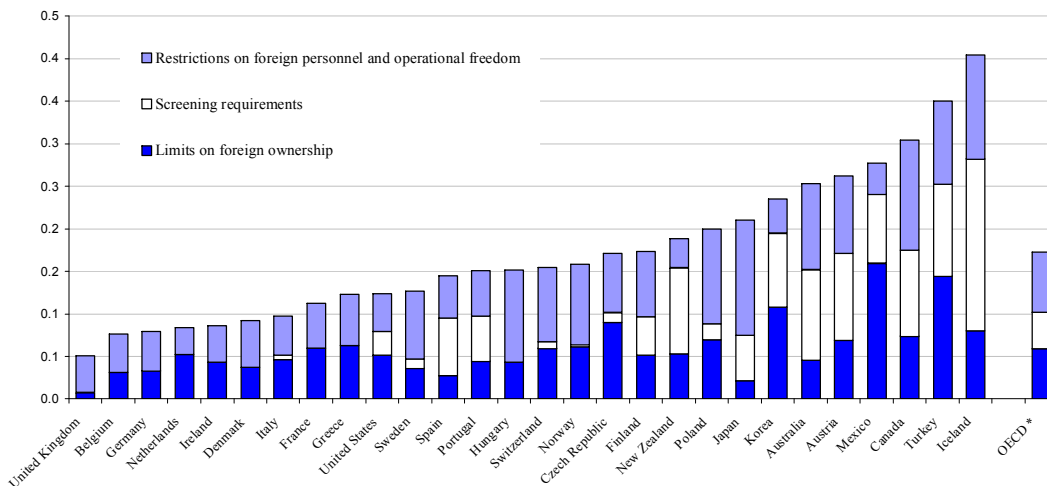


1. The box plot shows, for each country, the variation in the tariffs imposed on imports from partner countries. The median value of the tariff is depicted by the horizontal line in the box, the third and second quartiles of the cross-country distribution by the edges of each box, and the extreme values by the two whiskers extending from the box. Dots identify outlier observations.
2. ISIC rev. 3 two-digit industry-level tariffs were aggregated to national level using the weights of the OECD import product mix. Dispersion reflects the compound effect of regional preferences and OECD import product mix.

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

Significant FDI restrictions remain

OECD indicators of FDI restrictions, 2001¹



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

* Simple average

Source: OECD, Golub (2003).

Quantifying the impact of reforms

% increase in GDP per capita levels

	Bilateral tariffs reduction	FDI reduction	Regulatory reforms	All policies
United States	1.3	0.7	2.6	4.7
Japan	1.3	0.7	2.4	4.4
Germany	0.5	0.5	3.2	4.2
France	0.4	0.6	3.7	4.7
Italy	0.4	0.5	3.4	4.3
United Kingdom	0.5	0.5	3.1	4.1
Canada	1.4	0.7	2.1	4.1
EU 15	0.4	0.5	3.2	4.2
Mexico	1.5	0.7	2.8	5.0
OECD	0.9	0.7	3.1	4.7

Source: OECD Economics Department Working Paper No. 463, 2005.

Distance from best practice

as of 2003

	Electricity	Gas	Telecom	Post	Airline	Rail	Road
United States	X					X	
Japan	X	X			XX	XX	
Germany	X					XX	
France	XX	XX	X		XX	XX	X
Italy		X			XX	X	XX
United Kingdom							
Canada	XX					X	
Mexico	..	XX			XX	X	
OECD	X	X			XX	XX	X

Note: A blank means that regulation is close to OECD best practices. X and XX indicate the extent of the required efforts to move from current levels of regulation toward best practice levels according to OECD indicators, ranging respectively from 1.5 to 3 and 3 and above.

Source: OECD Economics Department Working Paper No. 463, 2005.