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No. 230 – January 2002

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SPRING CONFERENCE, CARDIFF WALES UK

12-15 APRIL 2002

The British American Business Council, amongst other things, promotes trade between the United States and the United Kingdom. The Council has around 4,000 members.

The Council's Spring Conference will take place in April 2002 in Cardiff, one of Europe's fastest growing capital cities.

CONFERENCE OVERVIEW

MEETING THE CHALLENGE

THE PROGRAMME

Managing change is one of the major challenges for businesses in the 21st century. This conference will focus on 4 primary drivers of change:

- Technology
- Government
- Economics
- Finance

Networking sessions, interactive business seminars and presentations by internationally renowned industrialists and politicians, including Baroness Symons, Mr Digby Jones, Mr Steve McCauley, will focus on these areas. In addition, there will be opportunities for one-to-one meetings and a number of social events are also scheduled.

SOCIAL AND LEISURE

A variety of leisure activities will be available during the conference, including:

- A welcome reception at Cardiff Castle
- Gala lunch at Cardiff City Hall
- Gala dinner at the Celtic Manor Resort, the venue to host the Ryder Cup 2010
- Excursions to the National Botanic Garden of Wales
- Opportunities to play golf on the course chosen to host the Ryder Cup 2010
- And see a rugby match at the Millennium Stadium

Non Members of the BABC are welcome to attend. For further information, please refer to either of the following the websites: www.babc.org or www.global-meeting.co.uk or call us on 02920 232322

For exclusive opportunities to sponsor elements of the conference please contact Lynette Northey on: l.northey@andover.co.uk

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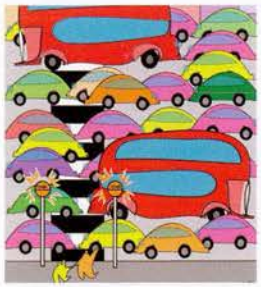

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Healthcare tax

Your spotlight on healthcare mentions that healthcare accounts for a rising proportion of GDP in most countries (*Observer*, No. 229, November 2001). No doubt ageing is one factor and it is easily measured, but it is by no means the only one. We all know that medication and medical treatments are becoming ever more sophisticated and as a result more costly, regardless of whether the patient is young or old. Unfortunately, this factor is very difficult to measure accurately and is not often cited as a cause of the rising cost of the whole system. But there can be little doubt that good healthcare is very important to most people and a lot more important than many of the other projects financed out of taxes. Governments might ask themselves which activities might be reduced, so that the resulting savings could be allocated to healthcare. Such a move would probably prove popular.

Another possible way of making the cost of healthcare more acceptable would be a clearly designated "health tax". Any health tax would have to be tailored to each country's general tax system. In Canada, for instance, the cost of healthcare is divided between the federal and provincial governments and there are federal and provincial sales taxes, which are added to the price of whatever you buy. It should not be too difficult to make these taxes explicitly "health taxes" and channel them in that direction – provided, naturally, that you can get the federal and provincial governments to agree. Another option would be to dedicate taxes on "unhealthy" items, such as alcohol, tobacco and possibly even gasoline, to healthcare. I rather think that a health tax would be more popular than the present taxes that people have to pay while they have no idea where the money goes.

O. Fisher,
Ottawa, Canada

Unsustainable myths

After having spent more than a decade at negotiating tables on sustainable development issues, I was intrigued by the discussions at the 2001 OECD Forum on Sustainable Development and the New Economy, and arguments in your various editions on the subject.

Sustainable development as a concept has clearly come a long way over the years and the phrase has become almost a by-word in political speeches, meetings and discussions. Yet, there remain varying levels of understanding of its meaning. "Sustainable development" and "environment" are not two different concepts, as some would have it. It is environmental management fully integrated in development planning that is the essence of sustainable development. It encompasses social, economic, cultural, religious, moral, scientific and technical dimensions.

This is reflected in the objectives of the two main sustainable development conventions on climate change and biological diversity which resulted from the UN Conference on Environment and Development (UNCED) process launched at Rio de Janeiro in 1992.

It is heartening to note a growing consensus on some key facts: that economic growth may in fact benefit from sustainable development; that many of the solutions to environmental degradation are regulatory ones; and that fears of exorbitant costs or lower standards of living are unfounded.

Still, I am disturbed by how little developing countries' views have been represented in your discussions. Perhaps their views are misunderstood: that developing countries have low environmental standards; that they lack the capacity to undertake sustainable development planning; that poverty causes environmental degradation. These are myths to be dispelled.

The reality is that some multinationals investing in developing countries often undermine sustainable development initiatives instead of supporting them. Capacity-building for them is a tool for expanding market access and increasing profits. In fact, it is the unbridled pursuit of wealth, not the lack of it, that is the greater cause of environmental degradation. And it is commercial, sometimes illegal, logging by large companies that destroy forests, and not, as your editorial implies, the subsistence activities of the local population. Let us remember this as we prepare for the 10-year assessment of UNCED at Johannesburg this summer.

Bernarditas C. Muller,
Paris, France

On the cover

The euro's cash launch in January 2002 was greeted with speculation by some enthusiasts that the new money might one day become the world's number one currency. Our cover of the euro posed proudly on the US flag captures this euphoria. The shot is by Jean-Michel Clajot for REPORTERS-REA. Our lead article (page 7) spells out the challenges ahead.

Tax and wealth creation

Donald J. Johnston, Secretary-General, OECD

It was Louis XIV's finance minister, Jean-Baptiste Colbert, who claimed that the art of taxation was to pluck the maximum amount of feathers from the goose with the least amount of hissing. Colbert's view was close to the truth, even in today's world, but taxation in his day was not used as an instrument to achieve a broad range of economic and social objectives. Rather, it was a tangle of practices and customs designed to finance wars, private and public works, as well as the pet schemes of the royal family – and their aristocratic hangers-on. In fact, until the 20th century, the notion of a progressive tax on income did not strike them as being virtuous.

In the second half of the 20th century many of us realised that taxation was indeed a multifaceted instrument which, if used sensibly, could help each society attain its economic and social goals. This required a delicate balance between rewarding entrepreneurship, innovation and risk-taking on the one hand, and the need to finance important public expenditures on the other, including education and social programmes, as well as the traditional public works which attracted Colbert, like the Canal du Midi. Not easy to do, and few countries, if any, can be fully satisfied with the balances they have struck. After all, there are only three main sources of tax revenue upon which government treasuries depend: income, capital and consumption. Too heavy a tax burden on any one of those will cause it to become unreliable as a source of revenue, as well as generating distortions and inequities. In some cases, it might spur tax evasion or drive part of the economy underground.

I am hopeful that the burgeoning deficits and high debt that accompanied the "tax and spend" philosophy of two decades ago will not return. Yet I am concerned that while many in public life are interested in wealth distribution, they overlook the importance of wealth creation. When I arrived in active politics in the early 1980s, many well-intentioned colleagues saw no limits to levels of taxation and redistribution. Fair enough; if an elected politician has the courage to tax and spend in a transparent way on his or her perceived worthy social objectives, then so be it. We may disagree, but such is the democratic way. The politician will be sanctioned or approved by the electorate.

However, a government can be tempted to exercise a philosophy of social responsibility by penalising the productive sectors instead of introducing reforms which require greater political courage. Yet, in doing so, it runs the risk of undermining the economy's growth potential.

I do not believe that tax systems should be over-burdened with the social convictions of politicians. Have individuals and corporations pay their fair share of taxes, yes! Have social charges disrupt the good functioning of economies, no! Excessive and unbalanced taxation can prevent many individuals and businesses from taking full advantage of the opportunities of the new knowledge-based economies. Taxpayers (including businesses) should share the burden of protecting those who are vulnerable as a result of change, either through well-designed social protection measures or retraining, not through excessively rigid job protection measures and inflexible labour regimes that penalise productivity.

That is why a fair and transparent tax system is so essential for maximising economic growth. Politicians must have the courage to achieve a sensible balance between income, capital and consumption taxes. And they must also have the courage to spend, not on ill-designed social programmes introduced more to collect votes than social returns, but on important investments in creating human capital (e.g. education, training and health), and necessary public infrastructure to increase the productivity of the economy.

I know it is not easy. I have been there. But I think the public is increasingly suspicious of political motivations and better informed about the impacts of undisciplined public finance. At least, I hope so!

I am hopeful that the burgeoning deficits and high debt of two decades ago will not return. Yet I am concerned that while many in public life are interested in wealth distribution, they overlook the importance of wealth creation.

We must all do better. As the snapshots in this *Observer* show, at the OECD we take a lead in a range of taxation issues. We monitor tax data and survey the costs and benefits of various approaches to taxation that have been adopted, changed, abandoned and reinvented over many years; we give frank advice on reform and best practice, and help countries reach consensus on tax matters. We also explore new challenges, such as the taxation of e-commerce, and the problems of harmful tax competition and transfer pricing within large corporations. We have much good and bad experience to offer the world, not least to emerging markets like Russia.

My triangular paradigm may be useful here: it is based on the balanced relationship between: first, economic growth; second, social cohesion and third, good governance. Simply put, governments must unshackle the constituent elements of economic growth by letting market forces play their respective roles. And governments must transfer the benefits of economic growth to enhance social well-being and cohesion through transparent and well-designed taxation. If the paradigm could be made to work, then Colbert's geese would barely hiss at all. ■

• News brief •

Barbados joins tax haven effort ahead of deadline

Barbados will not appear on a forthcoming OECD list of unco-operative tax havens, after discussions with the OECD showed that Barbados has transparent tax and regulatory systems. Recent legislative changes also enhanced the transparency of its tax and regulatory rules, the OECD and Barbados said in a joint statement. Barbados, which already has long-standing information exchange arrangements with other countries, said it was willing to enter into tax information exchange arrangements with those OECD members not covered by existing arrangements. The announcement brings to 11 the number of countries that have agreed to co-operate in making their tax regimes more transparent, from an original list of 35 unco-operative regimes that were published by the OECD in 2000 (see also "Combating harmful tax practices" on page 28 in Spotlight on Taxation).

The OECD is pursuing co-operative dialogue with other non-OECD economies identified as tax havens. It believes that all jurisdictions are well-placed to make a decision to commit to improving the transparency of their tax and regulatory systems and to establish effective exchange of information by a deadline of 28 February, Gabriel Makhlouf, chair of the OECD committee on fiscal affairs, said in a statement in late January.

Work with non-OECD economies in the coming months will focus on financial centres not identified as tax havens, Mr Makhlouf said. The OECD is also progressing in reviews of potentially harmful preferential tax regimes in its own countries and hopes to finalise them by June. ■

Zero economic growth as trade falls –

The economic slowdown saw the OECD area marking time in the third quarter of 2001, with gross domestic product (GDP) showing no change from the previous three months for the second quarter in a row. GDP was up 0.8% from a year earlier, but this was the slowest increase since comparable figures for all 30 member countries first became available in 1995.

Growth in the euro area was just on the plus side at 0.1% in the three months to the end of September from the previous quarter, but in the Group of Seven largest economies, activity shrank 0.2%, with only France, Italy and the UK in positive territory.

Merchandise trade in the OECD area fell for the second quarter in a row, both from the previous quarter and from a year earlier. Exports and imports each fell a seasonally adjusted 1.9% in value terms from the previous quarter, with exports down 6.3% from a year earlier and imports dropping 7.2%. G7 exports fell 5.4% in volume terms from a year earlier, due notably to a 13% fall in Japanese exports and an 11.8% drop in those from the US, although virtually all G7 countries saw a fall in exports with the exception of Germany, where they were up 4.3%. G7 imports also shrank 3.3% in volume terms from a year earlier, with Canada seeing the sharpest fall at 7.6% followed by the US with a drop of 6.8%. Only France and the UK increased their imports over the period.

– but recovery is on the cards

Despite the slowdown, the OECD is confident that a recovery will take place in 2002. The latest *OECD Economic Outlook* posted a forecast of 1% for the OECD area. Chief economist Ignazio Visco, speaking outside a convention in Rome in mid-January, emphasised that while there were downside risks, the US economy was recovering faster than expected from the terrorist attacks of September 2001. In Japan more fiscal consolidation would be needed, while in the euro zone, fiscal discipline should be maintained, though there was some room for interest rate reductions. Neither the Enron issue nor Argentina's problems were of sufficient magnitude to alter the OECD's world view, Mr Visco argued. The next *OECD Economic Outlook* will be published in April. ■

- See: www.oecd.org/macroeconomics

Soundbites

Same world, different audiences

World Economic Forum
New York

"It is not enough to say – though it is true – that without business the poor would have no hope of escaping their poverty. Too many of them have no hope as it is. You must show that economics, properly applied, and profits, wisely invested, can bring social benefits within reach not only for the few but for the many, and eventually for all."

- *UN Secretary-General* ***Kofi Annan*** *at the closing session of the World Economic Forum in New York, February 2002*

World Social Forum
Porto Alegre

"At the same time, you in civil society must show that you are ready to work in partnerships for change, rather than remain aloof through the politics of confrontation. We cannot afford to wait for perfect governance, or to engage in endless accusations and discussions. The challenges at hand are far too urgent."

- *UN Secretary-General* ***Kofi Annan*** *in a message to the World Social Forum in Porto Alegre, Brazil, February 2002*

• News brief •

All countries urged to counter terrorist financing

The Financial Action Task Force (FATF), which leads the international campaign against money laundering and operates from the OECD's headquarters, has now invited the whole world to join a self-assessment exercise. This has already been carried out by FATF members to determine if each country's financial systems are equipped to combat the financing of terrorism. The call came at the end of an FATF plenary meeting in Hong Kong at the end of January. The FATF will begin identifying jurisdictions that lack appropriate measures to combat terrorist financing in June.

All of the FATF's members have already assessed their own systems using eight special recommendations to combat terrorist financing adopted in October when the FATF widened its mission from combating money laundering of criminal funds to include countering terrorist financing. The recommendations include making financing terrorism, terrorist acts and terrorist organisations a criminal offence, freezing and confiscating terrorist assets and assisting other countries as much as possible in financing investigations.

"Countries throughout the world are united in ensuring that terrorists and those who support them are denied access to the international financial system," FATF president Clarie Lo said after the meeting. Other countries wishing to complete the self-assessment questionnaire on terrorist financing should do so before 1 May 2002. The questionnaire is available at www.fatf-gafi.org and the FATF is ready to assist non-members to comply with the special recommendations. ■

- For more on terrorist financing see: www.fatf-gafi.org/TerFinance_en.htm

Road devastation

Some 320 people die every day in road crashes in OECD countries, making a total of 116 000 deaths in car crashes in 2000 in the 26 countries for which figures are available. That is the equivalent of the population of a small city wiped out. The 2000 figures were 1.6% below the number in 1999, but the death toll could be halved if successful measures adopted in some countries, such as specific safety targets in relation to speed, alcohol and wearing seatbelts, were extended to all OECD member states. Strong penalties for infringements and hard-hitting public awareness campaigns to highlight dangers such as drink-driving and excessive speed also appear to help.

Alcohol is a factor in a third of all accidents, and excessive speed in slightly more than a third, OECD figures show. Also, road safety for the elderly needs a rethink. Only six out of every 1 000 male drivers aged 65-74 were involved in a crash in the UK in 1998, lower than any other age group over 25; yet US figures show that older drivers are more likely to die in accidents than younger counterparts, with the death rate at 12.7 per 100 000 people for the over-65s in 1997, compared with 10.3 for 25-64-year-olds. ■

- See also article by Anthony Ockwell on road pricing, page 34.
- For full details of the 2000 road deaths figures: www.oecd.org/transport
- *Ageing and Transport: Mobility Needs and Safety Issues*, OECD, 2001.

Freight flies higher

Air cargo traffic is expected to return to growth in 2002, reversing a slowdown that began in late 2000 and was exacerbated by the events of 11 September, air cargo industry representatives say. Most expect air cargo demand to increase by around 1% in the first half of 2002 and 3% in the second half, after falling somewhat in 2001. Stronger growth of up to 9% is expected in 2003, based on projected increases in levels of economic activity around the world, industry representatives said at an OECD workshop on liberalisation in the air cargo sector in January.

Participants from the air cargo industry, OECD countries and international organisations also looked at whether existing restrictions on international traffic rights, similar to those which operate for passenger airline services, are creating barriers to efficient air cargo services. They agreed that relaxing the restrictions would allow better market access and improve the industry's ability to respond to client needs.

The OECD has suggested two possible avenues for liberalising air cargo services, which were discussed at the meeting. One is a bilateral protocol for liberalising air cargo traffic rights which could be added to existing bilateral agreements; and the other is a new multilateral agreement for liberalising air cargo traffic without compromising essential safety and security aspects. It is now up to OECD governments to decide whether they wish to use these approaches to progress towards market liberalisation in air cargo.

Air cargo plays a vital role in ensuring the competitiveness and commercial success of a large number of industries across the globe. While in terms of weight, air cargo accounts for only about 2% of all cargo moved worldwide, in value terms it constitutes more than a third of the total. ■

The euro:
Laying down the challenge

Patrick Lenain, OECD Economics Department

The smooth introduction of euro banknotes and coins will not guarantee the new currency's economic success. That will depend on structural reforms and completing the European single market.

©/Reuters/MaxPPP/HAZIR REKA

Euro dollar market

After years of preparation and debate, the euro banknotes and coins have finally arrived. Since 1 January cash dispensers in the 12 member countries of the euro zone* have provided crisp euro banknotes instead of national currencies, and all payments by credit card, cheque or transfer have had to be made in euros. Any national currency banknotes and coins left could be spent in parallel before losing their status as legal tender, generally by the end of February 2002.

The introduction of euro cash has important symbolic and political dimensions. It is the realisation of a dream that has long been expressed by political and other visionaries – Victor Hugo wrote about the "United States of Europe" – and is a key step in the construction of Europe as articulated by founding fathers such as Jean Monnet and Altiero Spinelli, and political leaders like Konrad Adenauer, Robert Schuman and, most recently, Jacques Delors. As the bridges displayed on all euro notes suggest, the single currency is expected to link countries from Finland to Spain and from Ireland to Austria more closely together. The windows and gates displayed on the notes also symbolise the passage to a new era.

But what sort of era will it be? In 1990, the European Commission published a report entitled *One Market, One Money*, but is there really one market in the euro area? And how can a single monetary policy operate in a zone where sudden changes, whether in business sentiment or monetary conditions, can lead to asymmetric shocks which affect some countries and regions more than others?

Doubts have been raised as to whether the euro area meets the conditions needed for the single currency to succeed.

Euro economics

The circulation of euro notes and coins is the end of a long process of monetary integration. The most important step in this process was made three years ago, when exchange rates between the euro area's member currencies were irrevocably locked. This established the final framework of Europe's monetary union, with major repercussions, not least of which was the elimination of currency fluctuations within the euro area and the introduction of a single monetary policy. The bulk of non-cash

financial instruments (shares, bonds, mutual funds, time deposits and bank accounts) were converted in 1999 or shortly thereafter. By comparison, the recent substitution of notes and coins, which constitute only 7% of M2 money supply, has more limited economic implications.

Nevertheless, the logistics of the switch were formidable: 50 billion new coins were minted and 14.5 billion new banknotes printed, all of which had to be delivered to the right place at the right time, for a total value of €664 billion. Cash dispensing machines had to be adjusted, computers reprogrammed and soft-drink vendors and pay phones adapted. The overall cost of the changeover (transportation, security, training, software adjustments and so on) is estimated to have run into several billion euros, although no precise estimate is available.

The cost is also being borne by retailers and customers, who have had to post prices in the single currency or grapple with new monetary symbols. Although banknotes are identical throughout the euro zone and coins have a common side, the flip side of the coins is minted with symbols specific to each country, adding to initial confusion as the money spreads across member borders. Some 120 different types of coins are in circulation at the same time (12 series of eight coins issued by each member state, plus the Vatican, San Marino and Monaco), enough to cause headaches for at least some of the 305 million inhabitants of the euro zone. A temporary jump in prices is also likely to have happened, with retailers taking the opportunity to round up prices on conversion.

For all their effort in getting used to new prices, notes and coins, what benefit can Europeans expect to draw from the changeover? One gain often highlighted is the elimination of commission charged on foreign exchange transactions. Yet most of these charges were already eliminated in 1999, so that the new coins and notes will mostly be welcomed by tourists who no longer have to change their money to visit different member countries. On the other hand, the single currency does not mean a single banking system and, though the European Commission has compelled banks to eventually bring fees for intra-euro zone transfers into line with those for domestic transfers, for now, cross-border bank transfers from, say, Greece to the Netherlands, will incur costly handling charges as before.

Another much boasted benefit of the changeover is more price transparency: having one currency exposes price differentials between countries, helping consumers and firms compare prices and forcing suppliers to be more competitive. In fact, the shortcomings of the single market have so far limited price convergence. According to the William M. Mercer Global Information Service, the price of the same litre of milk ranges from €0.67 in Portugal to €1.22 in Italy, while the price of the same colour TV ranges from €543 in Finland to €1 049 in Luxembourg. Taxes may explain some of these differences, but insufficient market competition is also responsible. The greater transparency brought by the single currency should help narrow the gap. Indeed, several magazines and newspapers already post the same price everywhere in the euro zone. For convergence to happen more generally, further regulatory reforms will be needed to remove blockages in cross-border trade within the euro zone, for instance, in the automotive industry, where buying a car in another country is still discouraged.

Today's currency union under the euro simply makes the objective of completing the single market more desirable than ever.

Stability and risk

More important than conducting cash transactions with the euro are the benefits and risks associated with the long-term process of monetary integration, especially the elimination of exchange rate fluctuations since 1 January 1999. Such stability is important in a continent that was often struck by currency market turbulence, most recently in the wake of German unification. The sharp economic slowdown experienced since early 2001 and the terrorist attacks of 11 September have left European currencies unscathed; one can but imagine the monetary tensions that might have occurred without the locking of exchange rates. By contrast, those European currencies outside the euro zone, including the British pound, the Swedish krona and the Swiss franc, are still subject to large fluctuations.

But there are risks to monetary integration too and doubts have been raised as to whether the euro area meets the conditions needed for the single currency to succeed. Monetary union brings its sacrifices, including the loss of autonomy with respect to exchange rate and monetary policies. To outweigh such costs, the economies sharing the same currency should not be too dissimilar; otherwise it would be better to retain autonomous policy instruments. As matters stand, there is some evidence that euro zone economies react differently to common shocks (such as oil price hikes or world trade slumps), in no small part because uneven progress has been made towards labour market flexibility. Also, euro zone economies often appear to react differently to interest rate changes, and European Central Bank (ECB) decisions may therefore have different impacts on different countries. This may improve over time as economies adapt to the new monetary regime, and indeed recent research is reassuring on this point.

Still, specific shocks tend to affect the euro area in an asymmetric fashion, hurting some regions or countries more than others, and this may lead to divergence rather than convergence. Although the ECB began controlling monetary policy for the euro zone three years ago, consumer inflation rates still ranged from 1.3% (France) to close to 5% (Netherlands) at the end of last year. Output growth has also diverged during 1999-2001, with cumulative growth of 8.5% in France, but only 5.5% in Germany. Several small economies, like Ireland, have been through periods of overheating, and could not raise interest rates to cool domestic demand growth or inflation. Also, the recent bursting of the Internet bubble is an asymmetric shock, affecting countries like Finland that are specialised in information and telecommunication products more than larger, more diversified, economies.

These dissimilarities are not an insurmountable obstacle to monetary union, but they require that member economies become more adaptable and adjust to shocks

without relying on help from policy intervention. Budgetary policy of course remains in the realm of national government and can be used to respond to adverse developments, but safeguards enshrined in the Maastricht treaty to prevent excessive fiscal deficits restrict the margin of manoeuvre. All this implies that Europe will reap the full benefit of the euro only if it removes outstanding obstacles to the free flow of goods, services, capital and workers.

Unfortunately, economic integration has so far lagged behind monetary integration. Even in the much-vaunted single market, important sectors are still protected by national barriers – banking and energy being just two. Large public subsidies continue to distort competition, not least in agriculture. Public procurement still favours national suppliers. The lack of labour mobility is also a problem. Whether for cultural, linguistic or institutional reasons, countries affected by adverse asymmetric shocks may suffer high unemployment, even if neighbours have a healthy labour market. Clearly, Europe needs to step up the structural reform agenda to which the European heads of state have expressly agreed. Today's currency union under the euro simply makes the objective of completing the single market more desirable than ever.

Reserve currency?

Another long-term benefit of the euro often claimed by fervent supporters is that the single currency ought to become a more important international reserve currency than the sum of its legacy currencies. This would bring greater immunity from international financial fluctuations, as well as a more prominent role for Europe in designing the international financial system's architecture.

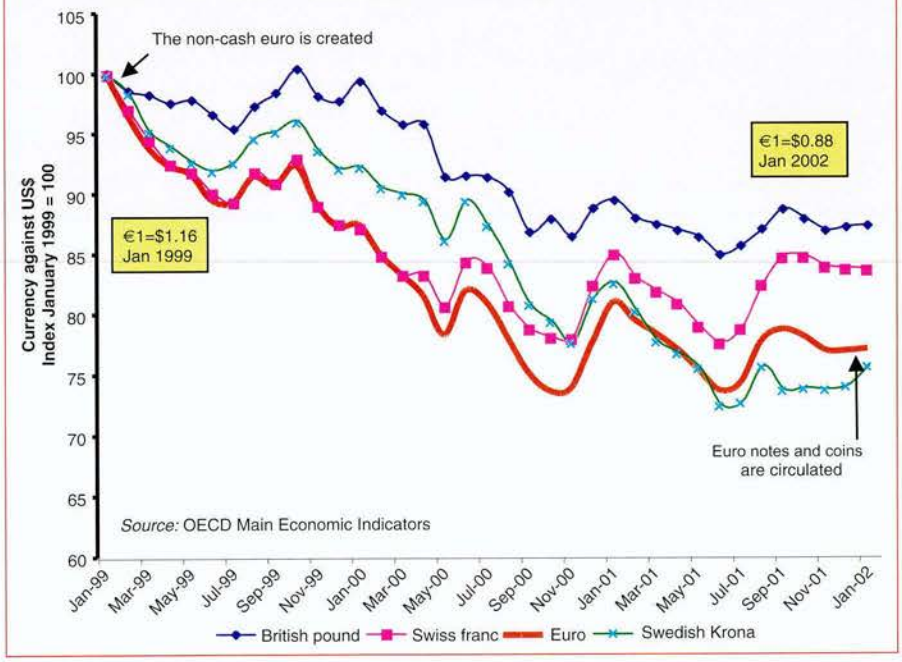
But the euro's performance in international markets has so far been disappointing. Since its launch in 1999, its exchange rate has declined by close to 25% in US dollar terms. And balance-of-payments data indicate that residents in the euro zone make more portfolio and direct investment outside the area than non-residents make inside it. Euro-denominated issues on the international market for bonds and notes still lag well behind those denominated in dollars. According to the Bank for International Settlements, during the first three quarters of 2001 gross international debt issuance denominated in US dollars came to $732 billion compared with only some $535 billion in euros. About half of outstanding amounts of international debt securities are denominated in US dollars, compared to a relatively modest 30% in euros. Central banks also preferred to keep 68% of their foreign exchange reserves in US dollars at the end of 2000, compared to just 12.7% in euros, according to the IMF annual report.

How to achieve a more internationally attractive euro is not clear, though making Europe a more attractive place to invest would be a helpful start. Surveys and business reports indicate that most of the euro zone remains stifled by cumbersome administrative regulations, rigid labour markets and high operating costs – although some progress has been made to address those issues. Investor caution may also reflect the problems of building political cohesion across Europe. After all, despite the fact that Europe has one money and a European Parliament, it is still represented by separate nations in international financial organisations like the IMF and the World Bank. It also sends separate delegations to international economic forums, such as those of the Group of Seven. With the euro, Europe will have to overcome these national prerogatives and speak with one voice in the international monetary arena. It will take work, but if achieved, and if single market reforms are pursued with the same determination and vision as for the euro, then the new currency will not only bring Europeans together, but will also become a harbinger for greater prosperity. ■

** Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. (United Kingdom, Sweden and Denmark are members of the European Union, but for the time being have opted out of the euro.)*

Euro slide

The euro has lost about 25 % in US dollar terms since its non-cash launch in January 1999



Source: OECD Main Economic Indicators

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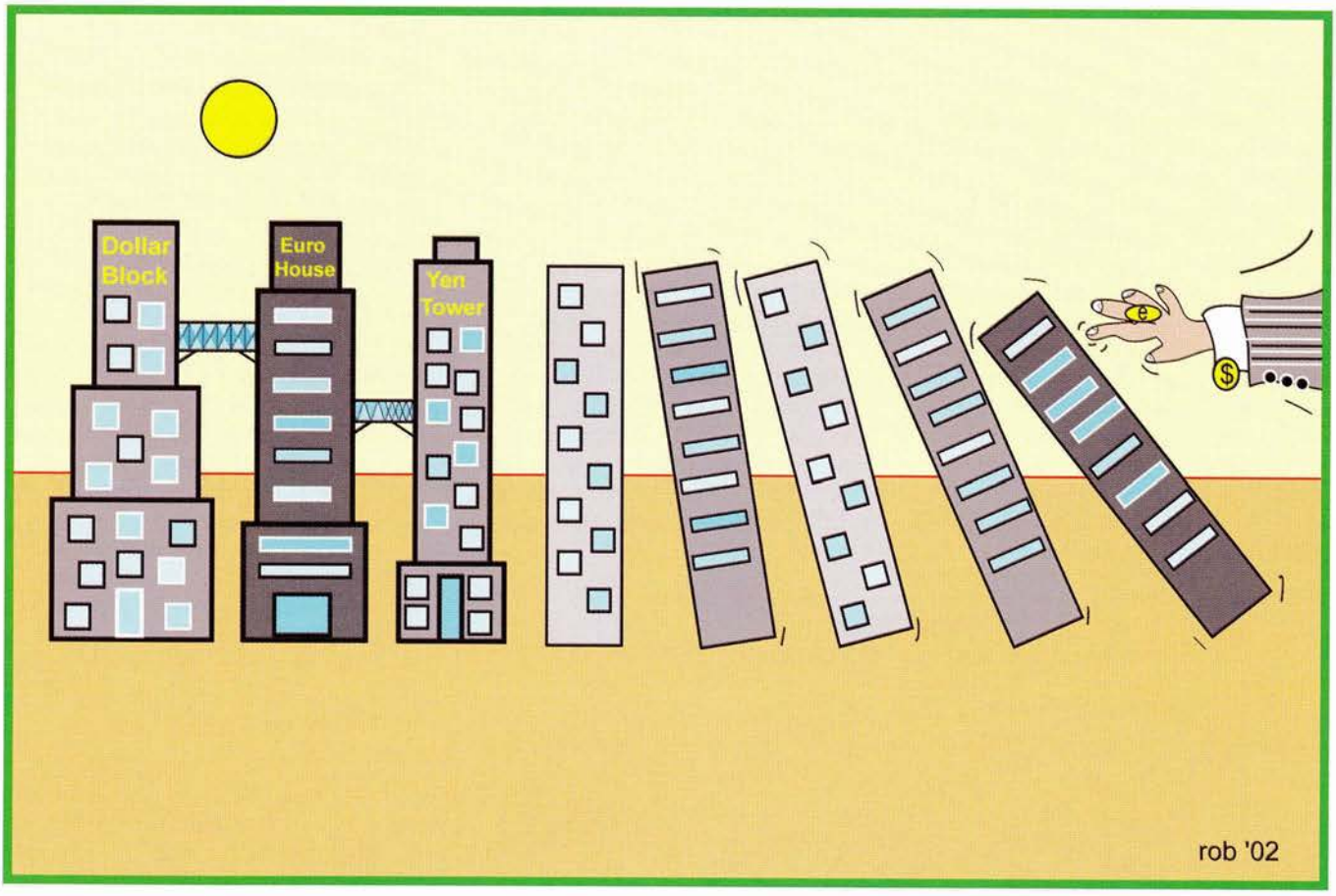
The global financial architecture in transition

Flemming Larsen, Director, IMF Office in Europe



Economic and financial liberalisation across the world has brought many success stories, though there have been some failures too. The international community can help to reduce these risks by making the new financial architecture more adaptable.

During the past quarter-century, economic and financial liberalisation across the world has led to the new, market-based financial economy in which we live. This transformation of the financial system has brought considerable benefits. But as the recent episode in Argentina reminds us, it has also been accompanied by too many financial crises, especially affecting emerging market countries. Some NGOs, voices in the media, and a few economists blame "neo-liberal" economic reforms for these problems. But policymakers have little appetite for a return to strict government regulations and have concentrated instead on the need to make markets function better by adopting rules-based frameworks to guide financial policies and markets. In addition to crisis prevention, the objective is to make countries more resilient in times of financial turbulence.

The immediate benefits of the new financial economy are easy to illustrate. Investors, from individual savers to pension fund managers,

can now better diversify their investment choices across domestic and international assets, thereby increasing rates of return. And businesses are better able to finance promising ideas and fund their expansion plans. As a result, financial resources are invested more efficiently, raising economic growth and living standards.

Other advantages are more subtle, but arguably as important. In addition to the costs of sometimes wasteful allocation of scarce financial resources, the regulated financial systems that existed from the end of the Second World War until the 1970s and 1980s suffered from two serious drawbacks: the temptation of governments to finance growing budget deficits through their privileged access to savings "captured" in financial institutions that are constrained in their lending decisions; and the inability of the regulated financial systems to sanction economic policies that led to high inflation. Financial liberalisation has changed this by inciting governments to pursue sound fiscal policies and price stability.

Historical perspective

If the benefits of a market-based financial system are so obvious, why were the regulations put in place to start with? Part of the aim was to respond to shortcomings of the liberal economic system that prevailed during the gold standard period prior to the First World War, including economic instability and widespread social problems. Together with the establishment of social safety nets and the active use of macroeconomic policies for stabilisation purposes, government-controlled financial systems were also a response to the Great Depression and its many banking failures. The implicit distrust in market forces played a key role in economic strategies adopted after 1945 and for several decades afterwards. Faith in markets has gradually been restored since the early 1970s, when a search for new policies was prompted by the breakdown of the Bretton Woods system of fixed exchange rates, an abrupt economic slowdown, rising unemployment and surging inflation.

Given this historical perspective, it is perhaps not surprising that the return to a market-based financial system appears to be associated, at least occasionally, with a relatively high degree of volatility in exchange rates, stock market values and other financial market prices. However, the international community has only gradually become fully aware of some of the more problematic consequences of the rapidly changing financial system, including those stemming from the pronounced integration of capital markets since the 1980s.

Many emerging markets have benefited from substantial inflows of FDI. However, since 1994, reversals of capital inflows have contributed to severe crises in Latin America, South East Asia and in some transition countries.

Many emerging market countries have benefited from substantial inflows of foreign direct and portfolio investments. However, particularly where short-term flows are concerned, changes in investor sentiment – often motivated by concerns over mounting public debt or financial imbalances – have led to abrupt capital outflows in all too many cases. Since 1994, such reversals have contributed to severe financial crises in most of Latin America, large parts of South East Asia, and also in some transition countries. These crises were often aggravated by cross-border financial contagion, where market liquidity suddenly dried up for particular countries – not because of economic fundamentals in these countries, but because they shared some characteristics with another economy suffering a loss of market confidence. Experience shows that the likelihood of contagion (and herding) mounts when information about a given country's financial health is limited.

The greater investment opportunities of market-based systems also carry risks, including those associated with speculative bubbles. Unless the increase in risk is

Building the framework

Subject area	Key standards	Issuing body
Macroeconomic policy and data transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices on Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard (SDDS)/General Data Dissemination System (GDDS)	IMF
Institutional and market infrastructure		
Insolvency	Principles and Guidelines for Effective Insolvency and Creditor Rights Systems	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)	International Accounting Standards Board (IASB)
Auditing	International Standards on Auditing (ISA)	International Federation of Accountants (IFAC)
Payment and settlement	Core Principles for Systemically Important Payment Systems	Committee on Payment and Settlement Systems (CPSS)
Market integrity	The Forty Recommendations of the Financial Action Task Force on Money Laundering	Financial Action Task Force (FATF)
Financial regulation and supervision		
Banking supervision	Core Principles for Effective Banking Supervision	Basel Committee on Banking Supervision (BCBS)
Securities regulation	Objectives and Principles of Securities Regulation	International Organization of Securities Commissions (IOSCO)
Insurance supervision	Insurance Core Principles	International Association of Insurance Supervisors (IAIS)

appropriately managed, individuals and financial institutions can become vulnerable to swings in asset prices. This problem may be particularly acute in transition economies because supervisory standards and risk management skills take time to develop.

Also, there is a danger that in globalised financial markets it may be easier to launder illegal money, whether from drug trade or corruption. And it may also become easier to evade taxes by investing in so-called tax shelters. The possibility that financial regulations and oversight mechanisms in offshore financial centres may be inadequate is an additional concern.

Rules-based frameworks

The responses to these problems can be broadly characterised as a new kind of *réglementation* – a framework of rules for the conduct of policies and a guide for financial markets. The approach is captured better by the French term than the English "regulation", since the intention is not to decree what markets are or are not allowed to do (regulate), but rather to foster market decisions on the basis of a clearer understanding of the risk involved and of the principles guiding financial policies. The central idea is twofold: to reduce the risk of abrupt changes in market sentiment through greater transparency, and to enhance the resilience of financial systems when market sentiment does change, for example, as a result of external shocks.

To this end, the international community has developed and promoted a range of voluntary international standards of good practices for economic policies and for the financial infrastructure. (See box: "Building the framework", page 11.)

The IMF and the World Bank, with their global membership (183 member countries), are now preparing Reports on the Observance of Standards and Codes (ROSCs), working in co-operation with national authorities and standard-setting agencies, including the OECD, in order to assess a given country's progress in meeting these standards.

The aim is to provide constructive feedback that can help the authorities identify and implement the regulatory and operational reforms needed for the development of their countries' financial systems and their integration into global markets. The process is also used to set priorities for technical assistance by the multilateral institutions themselves, by other standard-setting bodies, and by bilateral donors. Finally, the ROSCs provide market participants with timely information on progress in implementing standards, which can serve as input into their risk assessment.

As of January 2002, some 142 ROSC modules for 41 advanced, emerging market, and developing countries have been published (www.imf.org/external/np/rosc/rosc.asp).

Crisis resolution

While much can be done to reduce the risk of financial crises, these do occur. However, their costs can be cut considerably. First, an affected country has to address the root causes of the crisis. The international community, mainly through the IMF, can help identify those causes and provide temporary financial assistance. Private creditors may then respond by rolling over existing credit lines and maturing bonds and even providing new financing. Only then will a liquidity crisis be prevented from becoming a costly solvency crisis, to everybody's benefit.

The IMF has proposed the establishment of a legal framework to guide restructuring, including standstill provisions to give a country breathing space to address its problems and negotiate with creditors.

Things can get a lot more complicated in those – fortunately – rare circumstances when a country is unable to return reasonably quickly to market financing and is in need of external debt restructuring to reduce its debt servicing burden. A lack of clear rules on how to resolve unsustainable debt situations for sovereign debtors is partly responsible. To fill this gap, the IMF's first deputy managing director recently proposed the establishment of a legal framework to guide the restructuring process, including standstill provisions to give a country breathing space to begin to address its problems and negotiate with creditors.* The aim is to reduce the cost of restructuring for both sovereign debtors and their creditors. Many difficult issues will have to be resolved before such a framework can be made operational, but it could provide for greater predictability, facilitate the pricing of risk, and help place capital flows to emerging markets on a sounder footing.

The emerging framework of rules – *réglementation* – should help reduce the frequency and severity of financial crises. But such rules are not enough, and countries still need to address policy weaknesses before the crisis hits, including any inconsistencies between their choice of exchange rate regime and other policies. A failure to do so contributed to virtually all of the financial crises in emerging market countries during the past decade, including Argentina.

The new financial economy throws up other challenges too, such as how to deal with unsustainable run-ups in the prices of financial assets or real estate, which can have devastating effects on any economy – emerging or advanced – when the bubbles eventually burst. Another challenge is how to dampen the inherently pro-cyclical lending cycle of the banking system that often contributes to price swings. The most controversial – and arguably most important – issue concerns the role that monetary policy might play in "leaning against the wind" when asset prices rise sharply but inflation does not signal a need to tighten. Any consensus about the best approach to follow in this area is unlikely to emerge soon.

The new financial economy will probably always have some degree of financial volatility. We are in the process of learning how to identify and manage the associated risks. Much progress has already been made and the financial system seems more solid than a decade ago. But the architecture must continue to adapt as the financial revolution continues. ■

* *See Anne Krueger's addresses "A New Approach to Sovereign Debt Restructuring", given at the National Economists' Club, Washington DC, on 26 November, 2001 and at the Indian Council for Research on International Economic Relations, Delhi, on 20 December, 2001 (www.imf.org).*

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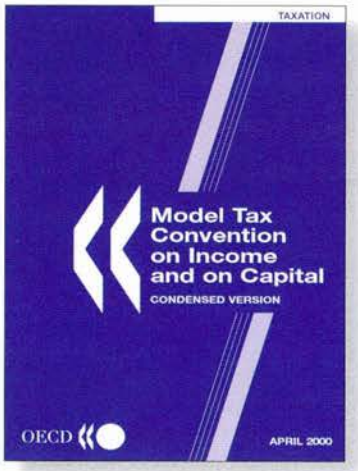

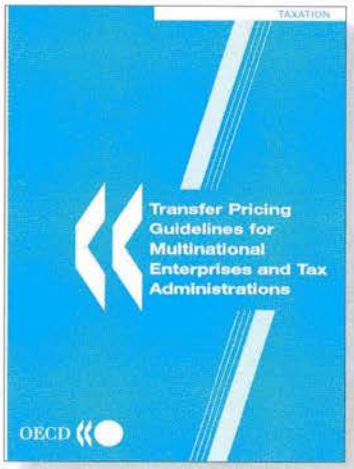

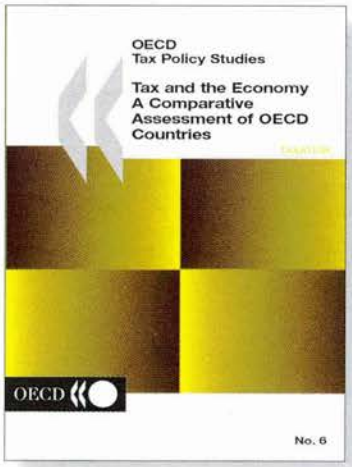

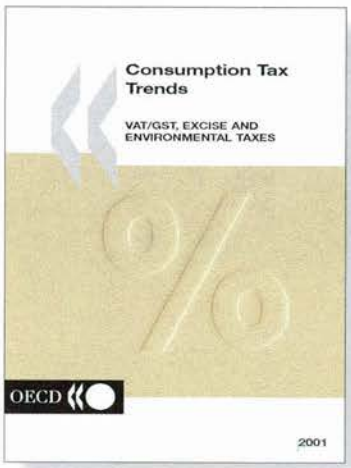

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Introduction
Taxation in a global environment

Jeffrey Owens, Head, OECD Centre for Tax Policy and Administration

Tax systems, and particularly international taxation arrangements, can struggle to keep pace with globalisation and market liberalisation. Most of today's tax arrangements were developed in an era when tax authorities could rely upon exchange controls, highly regulated capital markets and technological constraints to protect them from the negative fiscal effects of global activities. These barriers to cross-border activities protected tax authorities from the full implications of the interaction between national tax systems. While corporations globalised, tax authorities remained constrained by national frontiers.

Yet governments have to function, and in order to finance the services voted for by their citizens, must be able to collect the right amount of tax in this new global environment. The question is, how? Can a fair system of taxation of capital persist side by side with liberalised financial markets and in a world increasingly charaterised by skilled professionals who are highly mobile?

But there are several other questions too, some of which we deal with in this Spotlight. How can fair tax competition flourish between sovereign nations, but unfair competition be eliminated? What is the most appropriate way to tax global enterprises? Does the "new economy" imply new taxes or a need to redesign old ones? How can tax policymakers contribute to creating a "greener" future for generations to come? And what is the role of tax administrations in this new world: are they just the collectors of tax or the facilitators of a wide range of government services?

Governments can respond to the challenge of globalisation in one of three ways. They can retreat behind national frontiers and try to move back towards an "isolationist" approach to global tax issues. The second option is to press for a harmonisation of the international tax system: a sort of global tax code administrated by a global tax authority. And third, they can respond by intensifying their co-operation, which includes putting in place transparent systems and sharing information across borders.

The first option is clearly not feasible in today's global environment. No country can isolate itself enough to be able to ignore the international constraints and consequences of its tax reform, nor would it be desirable. The

second option, while appearing to be a rational response to increased internationalisation of tax issues, is neither desirable, feasible nor, for now, politically acceptable. It would imply governments giving up one of their basic sovereign rights: the right to tax in a way that best suits the political realities, economic needs and social and cultural values within each country. There is no reason why Sweden, Spain, Singapore and Senegal should harmonise their tax systems. This is not to say that smaller economic groupings should not move towards a greater coherence in the design of their tax systems to reflect commonly agreed objectives. But as far as nation states are concerned, there is no consensus on what such a harmonised tax system would or should look like, nor indeed is such a consensus likely to emerge in the foreseeable future.

Intensifying co-operation, the third option, is the only appropriate response to the pressures of globalisation. National governments maintain their power to design their tax systems, but accept that these decisions will be influenced by international considerations. It also means that they must carefully consider how their decisions will affect the ability of other countries to enforce their own tax laws. If, for example, residents of a country are trying to escape tax in that country by using a tax haven, then that country needs information from the haven to help it enforce its tax laws. Co-operation would include reaching agreements on what may or may not be acceptable in the tax area – just as governments have used the World Trade Organization for trade agreements. A premium will be put on facilitating information flows between tax administrations and exchanging experience on best practices. Mechanisms will be required to resolve disputes when they arise.

More generally, tax policymakers will have to accept the constraints imposed on domestic policy formulation that flow from globalisation. For instance, taxing pollution activities in one jurisdiction may just drive the polluters into another with weaker controls. So collective action is required and the international dimension of tax policy will grow in importance for all countries.

Tax administrators will have to modernise, too. New communication technologies open up new possibilities for improving services to taxpayers. Electronic assessment, collection and refunds of tax are now feasible options, and several countries in the OECD have developed these and other e-services. Some non-OECD countries are leading the way: Chile for instance has been developing online tax services since 1994! The aim is a common one: to deliver better service as the key to improving voluntary compliance.

Tax systems not only have to be administered in a fair and effective way, but also must be perceived as being fair and effective.

But the broader challenge facing tax administrations is how to maintain public confidence. Tax systems not only have to be administered in a fair and effective way, but must also be perceived as being fair and effective. In some countries, this may require reviewing the organisational structures of administrations that may have served well for many years but now, with the focus on customer relationship management, may need updating. The whole question of how taxes are collected will need to be addressed. Tax administrations also need to reconcile their desire to have better access to information with legitimate privacy and confidentiality concerns.

Perhaps, as we move into the new millennium, governments will need to reach out and develop a social compact with citizens. They would undertake to provide the service requested by citizens in an efficient and cost-effective manner and to minimise the complexity and compliance costs of tax systems. In turn, citizens would seek to meet their tax obligations. Civil society would put peer pressure on those who wish to avoid their obligations. Illegal tax behaviour would be seen for the crime that it is. Aggressive tax planning by tax advisers would be considered sociably unacceptable. This would help governments to break out of the vicious circle of each new tax loophole, leading to more complex tax legislation that in turn generates further loopholes. Clearly, the trend prevalent in Europe over the past two to three years of reducing tax rates will help to encourage more compliant taxpayer behaviour.

These are some of the key issues that the OECD is addressing by means of its recently created Centre for Tax Policy and Administration (see box).

The OECD recognises that a group of 30 countries cannot respond effectively to these challenges while ignoring the rest of the world. Other countries must be brought into this process and strategic partnerships developed with regional tax organisations. The OECD has accepted the challenges of the new global environment and its partnership programme now extends to more than 70 countries beyond the OECD area. Together, we can set the new international tax standards that we all so urgently require in the 21st century. ■

OECD Centre leads tax debate

In April 2002 the OECD's Centre for Tax Policy and Administration (CPTA) will be a year old. "The OECD is at the forefront of setting tax standards for the global economy," said the secretary-general, Donald Johnston, on launching the Centre. "Intergovernmental co-operation on tax policy issues represents one of the undisputed successes of the Organisation," he added. The initiative was aimed at raising the profile of the Organisation's work on taxation. Mr Johnston pointed out that OECD countries regularly approach the Organisation to resolve politically sensitive issues regarding taxation, such as in electronic commerce, or indeed the whole question of harmful tax practices. The Centre will increase the managerial and organisational capacity of the OECD on tax matters, allowing it to lead in the job of setting standards for the international tax world. The OECD's Model Tax Convention is the basis for the global network of tax treaties and, together with the 1995 Transfer Pricing Guidelines, is a reference for legislators in OECD and non-OECD countries alike.

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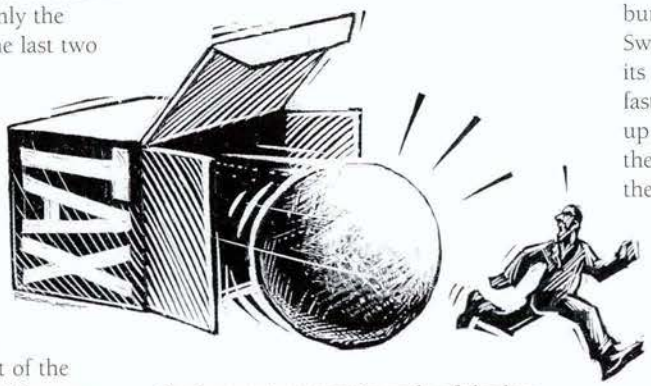
The truth about tax burdens

Christopher Heady, OECD Centre for Tax Policy and Administration

Income tax rates on wages and businesses have been falling in OECD countries, though consumption taxes have risen. With slower economic growth in prospect, will tax burdens fall? A closer look at the trends may provide the answer.

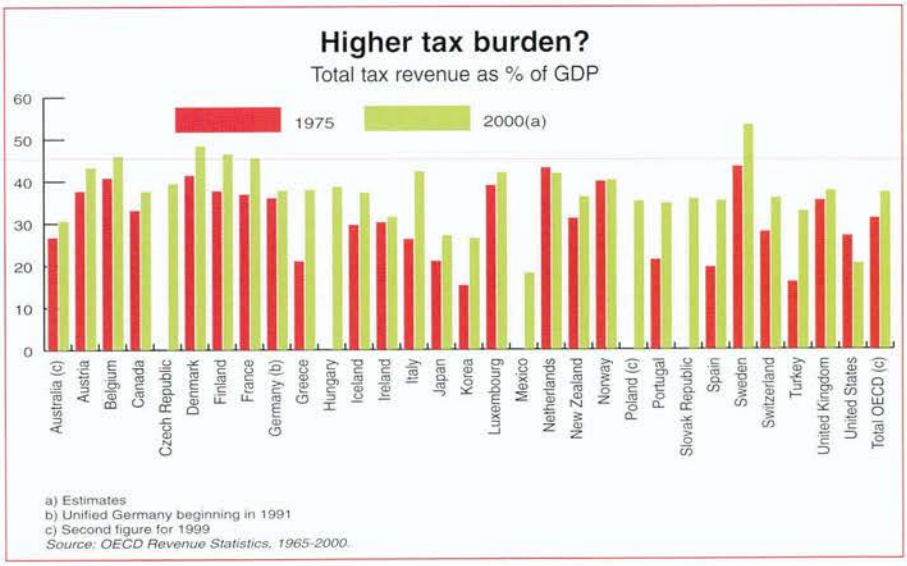
Tax burdens may soon start to ease in OECD countries. Certainly the political pendulum of the last two decades has been in favour of reducing taxes in proportion to the size of the economy. But while recent evidence may point downwards for some countries at least, since 1965 there has been a persistent and largely unbroken upward trend in the ratio of tax to GDP across most of the OECD area. Moreover, the OECD average rose further in 1999 and, according to provisional figures, in 2000.



Very few countries have bucked the trend; only in the Netherlands are tax ratios currently below their 1975 level. In only three other countries, Mexico, the United Kingdom and the United States, has taxation remained stable, with tax receipts rising broadly in line with GDP over a long period. And a few more, including Ireland, Japan, New Zealand and Sweden, have succeeded in reducing the tax ratio from their peaks of 10 or 15 years ago, but not by large amounts. As for transition countries, like the Czech Republic and Poland, tax revenues have fallen relative to GDP, but they appear to be stabilising.

So, if the historic trend has been upwards, why should the next batch of tax revenue figures show tax ratios declining? One reason is that moves to tighten up on public spending take time to show up in tax ratio figures in several countries. Also, the buoyant economic cycle of the late 1990s lifted the tax take even when rate cuts were being implemented because companies became more profitable (and so paid more corporate income tax). The slower OECD-wide growth in 2001 should mean that the effect of any reductions will show through in the fiscal data for 2001.

Still, some countries could face increased burdens in the years ahead. Already, as Switzerland carried out healthcare reforms, its tax ratio, now at about 35%, has risen faster than the average in the 1990s, albeit up from just 31%, a base which is below the OECD average. Other countries, like the UK and New Zealand, have expressed their intention to invest more in healthcare too, though it remains to be seen whether this leads to higher taxes as a result. Meanwhile, poorer OECD countries, like Greece and Portugal, will continue their process of convergence within the European Union, and this is likely to cost tax money as they develop their social protection systems and infrastructure. Several others, like Korea and Spain, must meet the challenge of financing increased social security entitlements from their ageing populations.



Taxing work

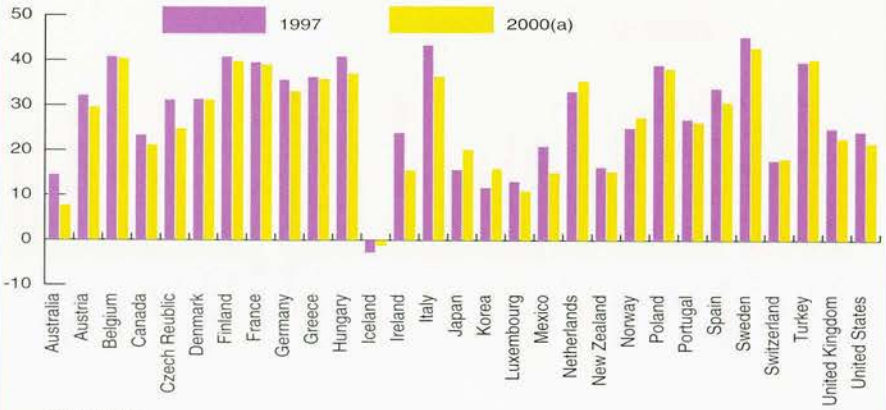
For some people, any tax may be a disincentive to work, but as a rule, the main tax disincentive comes from what is known as the "tax wedge" on labour. This is the difference between what employers pay out in wages and social security charges and what employees take home after tax, social security deductions and cash benefits have been taken into account. So, if your wage packet says 12 000, but your employer pays 16 000 to hire you, then the wedge is 4 000, or 25% of your cost to your employer. The size of this wedge varies, but there are signs that they are being reduced.

Tax wedges for a single worker at average earning levels ranged in 1999 from a low of 14% in Mexico and 16% in Korea to 52% in Germany and 57% in Belgium. For a married couple with one earner at average earnings and two children, they ranged from 11% in Luxembourg to 41% in Belgium and 44% in Sweden. In Iceland, the wedge was minus 2%; this is because cash benefits to such households exceeded their taxes. In other words, for these households, the government pays out more than they receive back. (See article by Willem Adema, page 21.)

Tax wedges for one-earner married couples have fallen since 1997 in most OECD countries. Provisional estimates based on tax and benefit rates in 2000 suggest that Belgium, Germany and Sweden, along with other countries including Austria and Italy, have lowered their tax wedges by about one percentage point for most categories of wage-earners. Australia, meanwhile, has reduced wedges across the board, but with a special emphasis on households with children. Ireland has reduced wedges for all groups except single parents, who nevertheless continue to have the smallest wedge of any group in Ireland. And the UK has reduced wedges for low and average income families with children.

Tax wedge

Income tax plus employee and employer contributions minus cash benefits as % of labour costs, 1997-2000, one-earner family with two children



a) Estimates
Source: OECD Taxing Wages 1999-2000

Tax structure

Over 80% of tax revenue may come from three sources – income taxes, taxes on goods and services, and social security contributions (payroll taxes and other taxes being negligible in most countries) – but the amount collected from each varies widely. Australia and New Zealand do not collect social security contributions at all, for instance, but manage social spending from core taxation. Property taxes are generally lower in Europe (5% of tax revenue) than elsewhere (9%) – although the UK is quite high (11%). And whereas EU countries tend to rely more on consumption taxes and social security contributions than on personal income tax, the US collects more in personal income tax and property tax. Japan falls somewhere between, with a low share of consumption and personal income taxes, but more emphasis on corporate tax and social security contributions.

Despite these different tax structures, there has been an overall shift in the last 35 years towards general consumption taxes, particularly VAT, more at the expense of other taxes on goods and services (like excise duties) than personal and corporate income taxes. This change reflects an acceptance that broad-based consumption taxes are both less distorting and more effective in raising revenue. Exceptions would be New Zealand and Turkey, where the introduction of general consumption taxes has led to deep cuts in personal income tax. New Zealand reduced the personal income tax share of overall tax revenue from 60% in 1985 to 46% in 1990. Turkey cut its share from 44% in 1980 to 28% in 1985. And in Japan, general consumption tax revenues have risen to compensate for falling receipts from corporate income taxes in the 1990s.

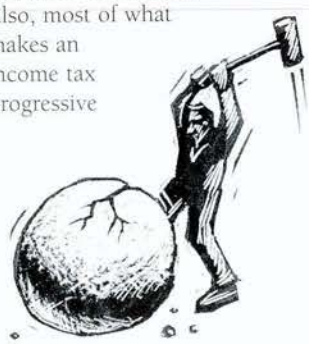
The rise in social security contributions is another notable trend of the last three decades. The OECD average went from 18% of tax revenue in 1965 to 25% in 1999. In fact, in most OECD countries, more money has been raised from social security contributions than from personal income tax. This shift probably reflects the growing pressures on social security expenditure, particularly from population ageing.

Lower income tax rates

Most countries' top marginal rates of income tax have been cut recently, by an average of over 10 percentage points. The US cut its marginal income taxes in 2001 (see p25). However, while top rates of personal income tax have come down, personal income tax revenues have barely moved overall: they were 10.3% of GDP across the OECD area in 1998, compared with 10.5% in 1980. This is because strong economic growth moved taxpayers into higher tax brackets and because many governments partly financed their rate cuts by reducing allowable deductions against taxable income.

Personal income tax may well be what people think about first when it comes to taxes, but nearly as much revenue is raised from indirect taxes levied on sales of goods and services – more in many cases.

Apart from cutting top rates, the number of tax brackets in OECD countries has been cut back too, from more than 10 on average a decade ago to five or six today. Fewer brackets make the tax system easier to manage and understand, both for taxpayers and administrators. What they do not do, despite some claims to the contrary, is make income tax more regressive against lower-income groups. Marginal rates may fall, but the proportion of income paid in tax is still greater for high-income earners. Also, most of what makes an income tax progressive (i.e. redistributive) comes from the first (lowest) slice of income, which in most cases is tax-free.



Corporate tax rates falling

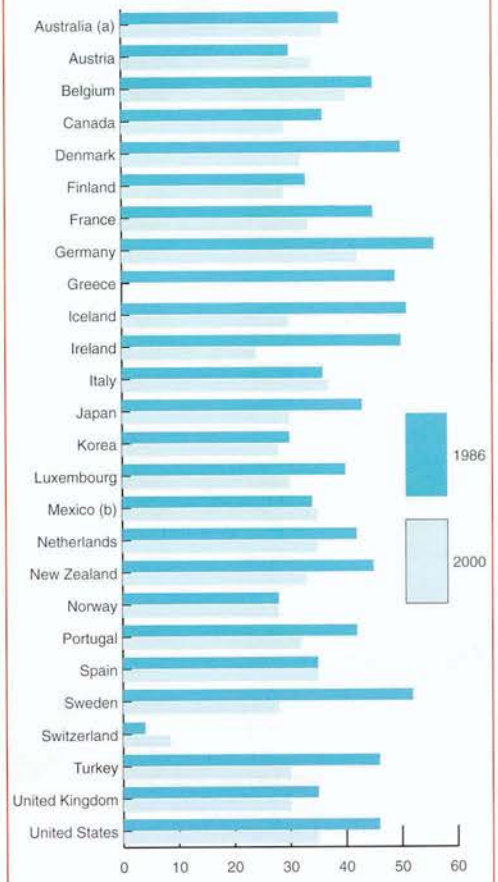
Trends in corporate income tax have followed personal income tax down, again by about 10 percentage points since the mid-1980s. Various incentive schemes have been limited or abolished in Australia, Austria, Finland, Germany, Iceland, Ireland, Portugal, Spain and the US, including schemes for particular regions or sectors, investment credits and property-related "tax shelters". Also, several countries have reduced the allowances for depreciation of capital equipment that companies can use to cut down on taxable income, bringing them nearer to the actual reduction in the economic value of the equipment. Still, taxes on companies and personal taxes on capital income (dividends, interest etc) are generally less heavily taxed than labour income, mainly because of social security contributions.

The rise of VAT

Personal income tax may well be what people think about first when it comes to taxes, but nearly as much revenue is raised from indirect taxes levied on sales of goods and services – more in many cases, examples being France, Korea, Mexico, the Netherlands and Poland. These taxes have increased with the substitution of Value Added Tax (VAT) – or the Goods and Services Tax (GST) for retail and wholesale sales taxes. When countries first introduced the VAT, the average standard rate was 12.5%; in 1998 it was 17.5%. Australia recently introduced a Goods and Services Tax, leaving the US as the only OECD country without a VAT-type tax. Its much smaller sales tax (which accounts for less than 8% of total taxes) is quite different from VAT in several ways; in particular, it is only

Business taxes

Basic rates of corporate income tax of central government



(a) 1991 for base year
(b) 1995 for base year
Source: OECD Tax Database

charged on some goods at the point of sale and cannot be claimed back by business purchasers.

Some services, like property-letting, medical care, financial services, education and gambling, may be exempt from VAT. Also, some countries apply reduced or zero rates to some goods and services, such as books and newspapers, transport and food. The main reason for this is altruistic: some goods, like food, are necessities. And newspapers and books might not be taxed, as reading is something governments do not wish to discourage. Another feature of VAT is that its base can be widened by applying it to new items. Governments have taken advantage of this to help maintain tax revenue flows and to reduce the likelihood of consumers focusing their spending on exempt items.

What does the future hold?

So, are taxes really falling? Personal and corporate income tax rates have come down, but the overall tax burden continues to rise, although its rate of increase appears to be easing. Whether this slower increase reflects the revenue-enhancing effects of high growth rates remains to be seen.

When assessing tax, though, it is also important to know what is done with it. It would be foolhardy to look forward to the day when taxes cease to exist. Taxes help countries to run, they allow investment in important areas that are either beyond the reach of most individuals to finance by themselves or can only be provided collectively. And they are typically spent by democratically elected governments. There will probably always be the need for public money to fund services, and when it comes to health and education in particular, people want those services to be of good quality. Cutting taxes for the sake of cutting can therefore be counterproductive. What we can aim for is a more efficient use of taxation: enhancing its reach and making sure spending is not wasted, but boosts welfare and actually enables economies to grow. Perhaps the imminent dip in the tax burden reflects this new efficiency. And in this age of increased transparency and accountability, a shift towards "better taxation" would be the least we can expect. ■

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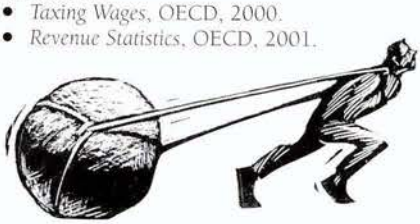
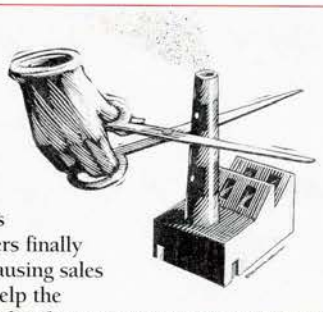


Not so green



When Denmark pushed up a tax on very toxic nickel-cadmium rechargeable batteries, cynics might have quipped that it was just an attempt to raise more tax revenue. In fact, quite the opposite has occurred: a fall in revenue from the tax has been reported. The reason is that consumers finally switched to other less toxic alternatives, causing sales to drop. While this shows that taxes can help the environment, successful environmentally-related taxes can actually erode their own tax base.

But are environmentally-related taxes that significant in OECD countries? On balance, no. Not all taxes that have an effect on the environment were introduced for that purpose. For a start, governments derive their largest revenues from such charges as excise taxes on transport fuels. And despite pressures from the environmental lobby for higher taxes to stem the use of non-replaceable energy resources, the relative importance of these revenues has stayed fairly constant in industrialised countries over the past few years. In fact, between 1996 and 1998, 11 out of the 22 OECD countries that separately identify revenues from such taxes reported a reduction in their contribution to total revenue. Preliminary data for 1999 suggest that the contribution of these taxes to total revenue rose in more countries, but only six out of the 16 countries with data for 1999 showed an increase over 1996 levels.

Excluding fuel taxes, environmentally-related taxes make only a very minor contribution to government revenues. But, as the Danish case shows, this does not mean they are environmentally ineffective.

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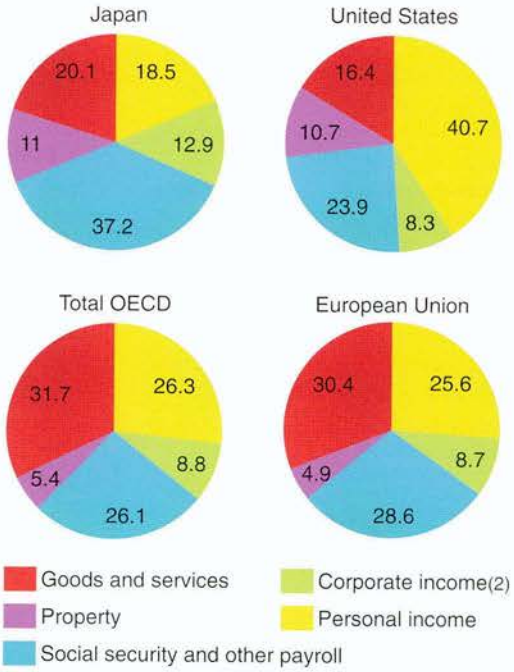
Tax breakdown

Tax revenue of major taxes as % of total tax revenue, 1999



1. Pies do not add to 100 because some minor taxes are omitted and general consumption taxes (mainly VAT) are a subcategory of taxes on goods and services.
2. The breakdown of income tax into personal and corporate income tax is not comparable across countries.
Source: OECD Revenue Statistics 1965-2000

Taxing benefits

Willem Adema, OECD Education, Employment, Labour and Social Affairs Directorate

Public social spending levels vary in the OECD area, but not as widely as some might expect. A closer examination of tax and benefit systems shows why.

Regardless of the overall level of taxation and public spending, public social expenditures constitute over half of all public spending in most OECD countries. But while media reports often suggest great gaps between one country's public social expenditure relative to its GDP and another's, a closer look at how tax and benefit systems interact reveals that the differences between countries are narrower than they seem.

Broadly speaking, public social spending covers four main areas: support to those in retirement; income support to the working-age population; healthcare; and other social services, like childcare. The relative importance of each of these items varies from country to country. For example, public spending to support the retired population in Italy was around 16% of GDP in 1997. Spending on social services, including public childcare facilities, is an important budget item in Denmark, while spending on disability programmes keeps Dutch spending on income support to the working-age population high, despite low unemployment. Health is an important item on public budgets everywhere and averages about 6% of GDP across the OECD.

As ever, there is more to the headlines than meets the eye. Denmark, for instance, may appear from the first chart to spend much more on social protection than, say, Germany or the United Kingdom, but does it?

The answer is no, for the data ignore three very important considerations: first, how income taxes, including social security contributions, affect benefit income; second, the impact of indirect taxes on consumption; and third, how tax breaks with a social purpose can alter the picture.

Take direct income tax and social security contributions, which some governments levy on cash benefits. While almost all social benefits in the Netherlands are taxable, taxation of benefit income in Germany is generally very limited. Consider the case of an average German production worker who in 1997 is the only earner in a family with two children. If that person loses his or her job, he or she receives over $19 000 in annual unemployment benefits and pays no income tax. By contrast, a similar person in the Netherlands receives nearly $25 000, but pays more than $6 000 in taxes. The net income for Germans is higher. Of all public transfer spending, the Danish and Dutch treasuries claw back about 4% of GDP though direct taxation, compared with about 2.5% of GDP in Italy and only around 1% of GDP in Germany. In Australia, Japan, the UK and the US, the tax

Public social spending
From gross to net public social expenditure % GDP at factor cost, 1997*

	Australia	Denmark	Germany	Italy	Japan	Netherlands	UK	US
Gross	18.7	35.9	29.2	29.4	15.1	27.1	23.8	15.8
– Direct taxes (including social security contributions)	0.3	5.1	1.3	2.9	0.2	4.4	0.4	0.4
– Indirect taxation	0.8	4.1	2.3	2.4	0.5	2.5	2.3	0.4
+ Tax breaks with a social purpose **	0.3	0.0	1.6	0.0	0.4	0.1	0.5	1.4
Net	17.9	26.7	27.2	24.1	14.8	20.3	21.6	16.4

* Net social spending is a truer reflection of what governments spend since it takes account of revenues they claw back in taxation and any tax breaks they provide. The indicators are related to GDP at factor cost rather than GDP at market prices – the most frequently used indicator on the size of an economy. The reason for this is that, since adjustment has been made to benefits for the value of indirect taxation, the denominator (GDP) has to be adjusted similarly. As GDP at factor cost does not include the value of indirect taxation and government subsidies to private enterprises and public corporations, it is the most appropriate indicator for international comparisons of net social expenditure.
** Not including tax breaks towards pensions.

claw-back on transfer income is smaller still (See chart below).

A similar picture arises when we look at indirect taxation. Social benefits finance consumption. Consumption taxes, like VAT, reduce the real purchasing value of the benefits. And like income tax, they establish another flow in tax receipts to the government. So, to provide benefit recipients with a net consumption of 100 units, a country like the US, with an average indirect tax rate of slightly over 5%, needs to pay a gross benefit of about 105 units. In Denmark, where the average indirect tax rate exceeds 25%, a much higher gross payment of around 125 units would be needed to arrive at the same net value. Obviously, the flow back of revenue generated by this indirect taxation on consumption from benefit income is much higher in Denmark than in the US. In general, the average rate of consumption taxes in OECD Europe ranges from 12.5% to 16% – Denmark's higher rate is an exception – while average indirect tax rates in other OECD countries are much lower, varying between 5% and 7.5% in Australia, Japan and the US.

Apart from taxing income and consumption differently, some governments grant tax breaks with a social purpose. A children's tax allowance is a common example of such a tax advantage, paid in lieu of cash benefits. Other tax breaks may be offered, for instance, in return for the purchase of private health insurance. Tax breaks and cash benefits often mirror each other when it comes to family support. For example, in Germany the value of tax allowances for families with children approximated $32.5 billion in 1997. Another high-profile example is the Earned Income Tax Credit (EITC) in the US with spending at about $30.5 billion in the same year. This was made up of $6.1 billion in the form of tax credits (a tax advantage that mirrors a cash benefit) and $24.4 billion paid in cash to those low-wage earners whose tax credit entitlement exceeds their tax liabilities.

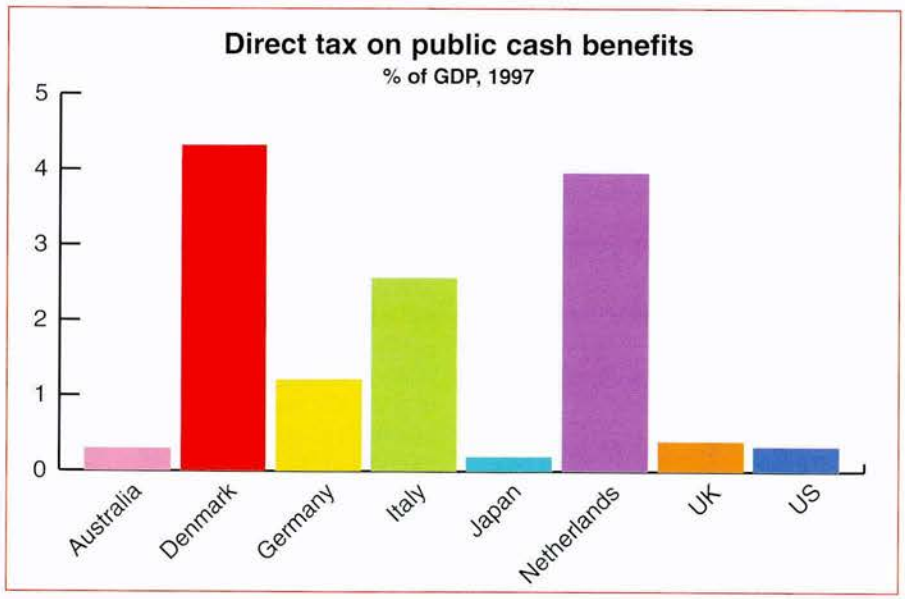
If a German production worker loses his or her job, he or she receives over $19 000 in annual unemployment benefits and pays no income tax. By contrast, a similar person in the Netherlands receives nearly $25 000, but pays more than $6 000 in taxes. The net income for unemployed Germans is higher.

So, what does all this tell us about public social spending in the OECD area? For a start, direct taxes and social security contributions claw back a bigger slice of benefit income in Denmark and the Netherlands (as much as a quarter of benefit income) than in most other OECD countries. Also, the value of benefit income clawed back through taxes on consumption is much larger in European countries than in Australia, Japan or the United States.

Moreover, countries with relatively limited direct taxation of benefit income (Germany, the UK and the US) make more extensive use of welfare-oriented tax breaks than countries with high direct taxes on benefit income (Denmark and the Netherlands). In general, governments claw back more money through direct and indirect taxation of public transfer income than they award in tax advantages with a social purpose. Only in the US does gross public spending actually underestimate public social effort, since the value of the tax breaks awarded exceeds the claw-back in revenue from benefit recipients.

Going back to our earlier question: where does this put Denmark? Gross public social expenditure indicators put public social expenditure in Denmark at six percentage points of GDP above that of Germany and 20 percentage points over that of the US. But accounting for the impact of the tax system as discussed here, net public social spending in Germany (27.2% of GDP) exceeds that of Denmark (26.7% of GDP), while the gap between Denmark/Germany on the one hand and the US is halved to 10% of GDP.

The tax system significantly reduces the variation in the real value of social spending across countries. As we will show in the next issue of the *Observer*, the similarities in the share of GDP devoted to social spending across countries become even more apparent when the role of private social benefits are brought into the picture.



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E-commerce tax:
A sober view of cyberspace

David Holmes, OECD Centre for Tax Policy and Administration

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Getting inside the problem

Cyberspace will not be the tax-free haven some expected it to be. Still, e-commerce poses some difficult challenges for tax authorities.

"What goes up must come down" may not be among the most sophisticated theories of economics, but the dot.com boom of 1996-2000 – and its subsequent crash – is a reminder that certainty in business remains a chimera. The hype is over. How many PowerPoint presentations did we sit through being told that an Internet year was equivalent to four months? Well, when it came to the downturn those presentations were proved right, as the speed of the crash showed. But while large numbers of over-hyped dot.coms have gone to the great recycle bin in the sky, the technology remains.

Nor, with the boom over, should tax policymakers feel tempted to go back to doing whatever it was they did before they knew what IPO meant. "Old-economy" companies have been delighted to hoover up the dot.com technology and expertise at knockdown prices. And as the old economy companies integrate new technology into their strategies, business models change too, not in a headline-grabbing way, but more subtly. These are not start-ups, but they have the global spread and access to markets to ensure that the tax issues that e-commerce raises will go on developing, if not deepening, offering new challenges and opportunities.

The OECD approach to tax and e-commerce has always been balanced: first, ensure that

government tax revenues are secure and second, that obstacles are not put in the way of e-commerce development. That holds as true today as it did back in 1998 when the OECD's Ottawa Taxation Framework Conditions set out the wider principles to be applied (see box). All our work since then has tried to ensure this balance is maintained.

If the bursting of the Internet bubble has changed our work, it is in the longer-term, more realistic view that it has allowed us to adopt. Take online music. A couple of years ago consumption taxes like VAT appeared to be under threat as MP3 and similar technologies created a business model whereby there might have been hundreds, if not thousands, of small enterprises scattered around the world delivering packets of music to customers anywhere for a few dollars a time. Given that consumption taxes are supposed to accrue to the country where the product is consumed, how tax authorities would identify where transactions had taken place and how to ensure collection and compliance were just a couple of the very tricky questions thrown up by the e-commerce revolution.

That rather muddy business model now seems less likely to take off, particularly in the wake of cases such as Napster, which will probably lead to the supply of music over the Internet remaining in the hands of the established music companies. A more probable scenario for online music, if it develops, will be for larger music companies to sell it by subscription, rather than pay-as-you-go. Such companies are more likely to have the resources to be tax compliant and deal with reasonable administrative burdens.

Still, the tax challenges of e-commerce remain and the Guidelines of Place of Consumption have to be refined. Several questions still stand out. For instance, how can a customer's country of residence be verified in an online transaction? Tracing technology is improving all the time and no doubt will hold future solutions, but for now tax administrations have to focus on several criteria, such as language or the size of the online transaction, with smaller ones, like downloading a few dollars' worth of music, likely to be business-to-consumer (B2C). Another question is how to define a business establishment for e-commerce purposes. Multinational insurance companies, for instance, that cannot recoup their VAT, have to pay tax on software they buy. The easiest approach is to pay the tax in the country of their headquarters. The challenge here is how to prevent companies from, say, opening offices in low tax jurisdictions where they have little or no business, simply to declare their taxes there.

While the dot.com crash affected mainly business-to-consumer e-commerce, business-to-business transactions continue to develop under globalisation, thanks to the ability of companies to forge new relationships through co-operative procurement.

Already, it seems clear that while the dot.com crash affected mainly B2C e-commerce, business-to-business (B2B) transactions continue to develop, thanks to the ability of companies to forge new relationships globally through co-operative procurement designed to reduce costs and inventory. Covisint, a company set up by several car manufacturers in the US to pool procurement resources, is a good example of this. New relationships of this kind may well affect taxes.

Not that B2C issues have gone away and to facilitate collection of consumption taxes on cross-border trade for online delivery of software, music, images and the like, we are actively looking into the potential for the technology itself to assist both tax administrations and business.

New business models are also emerging in the telecommunications industry. Suppliers in this sector now frequently provide content as well as simple telecommunication connections through their mobile phones. So, a UK resident whose mobile services are supplied by BT might not be charged VAT on phone calls made while travelling abroad, but under a likely new EU directive, may have to pay tax at the UK rate for downloading news content while on the same trip. Clearly, if telecommunications services are to be taxed at one rate in one country, but the text content at another rate in another country, the complexities for tax accounting will become daunting, particularly for telecommunications companies.

This is typical of the kind of tax issue that must be addressed as innovations progress and the business world evolves. Thankfully, with the hype out of the way, we can examine these questions carefully and calmly, without having to react to every latest news bite. But while there may be a little more time to solve the problems of e-commerce taxation, answers will have to be found. Internet time may have slowed a little, but it certainly has not stopped. ■

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The e-commerce tax framework

E-commerce is one area where no country or group of countries can go it alone and impose taxes without running the risk of double taxation. In 1998 ministers from 48 OECD countries and non-OECD economies, as well as representatives of the business community, met in Ottawa and agreed Taxation Framework Conditions for resolving e-commerce tax issues. The OECD is now working on implementing these. The programme is being carried out in close co-operation with regional tax organisations around the world.

The most urgent issue is that of consumption taxes where immediate decisions are required by enterprises engaged in e-commerce. Following publication in 2001 of agreed principles, the OECD expects to publish model guidelines for their implementation in 2002.

Progress is also being made in the application of tax treaties to e-commerce transactions, the aim being to provide the continuity that business and governments demand. The 2002 update to the OECD's Model Tax Convention will incorporate the outcome of this work.

Improving the U.S. tax system

Chiara Bronchi and **Richard Herd**, OECD Economics Department

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Could it be simpler?

The tax programme of 2001 was aimed at stimulating the economy and lowering future tax rates. More could be done in future to simplify the system and shift the emphasis to consumption taxes.

Only a few OECD countries have a lower ratio of tax revenue to GDP than the United States, and the programme of medium-term tax cuts introduced last year will lower taxation even further. Nonetheless, there exist several areas where reforms are desirable: first, the income tax system is very complex; second, incentives to work, save and create new businesses may still be harmed; and third, the higher proportion of revenues that comes from taxes on income rather than on consumption may be inefficient in the long run. At the moment, though, the 2001 tax cut, higher government spending and the slowdown in economic growth have reduced the scope for further tax cuts without raising tax cuts in other areas, placing the emphasis on the need for a balanced reform.

Income tax, especially at the federal level, has become complex, with a large number of tax breaks. As the number of these tax breaks has risen, the government has tried to limit their cost by reducing their value to upper-middle income taxpayers. The result of this policy has been to multiply the number of possible tax rates for the same income: for middle income earners, there are typically between four and six effective

marginal tax rates at the same income level, depending on precise individual circumstances.

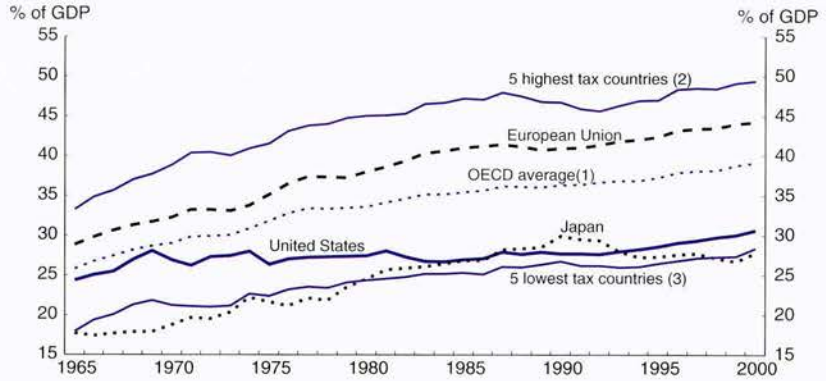
Once individuals have determined their standard income tax bill, they have to calculate their tax bill a second time using the different rules of the Alternative Minimum Tax. Their tax payment is then based on the bigger of the two bills. This was originally designed to ensure that all people with very high incomes paid tax, but as its allowances have not been indexed to inflation, in contrast to those of the basic system, it now serves to limit tax deductions for middle income groups. The AMT should be ended, because as wages grow, more and more people are likely to be drawn into it in the coming years. But it is in the area of corporate taxation where most simplification is required, as compliance is particularly expensive. In fact, costs are perhaps as high as half the yield of the tax due to the cost of the professionals needed to ensure compliance, to minimise payments and to apply the different rules of financial and tax accounting.

Taxation creates economic distortions too, which policymakers must try to minimise. In the United States, joint taxation of married couples can be a disincentive to work for whichever partner is the second earner. Assuming that the combined wage is high enough, the second earner will face a higher tax rate even if their individual wage is low – an incentive to stay home or work less hard. It is not just married couples that respond to taxes: higher income groups may be particularly responsive to changes in tax rates. Quite apart from boosting the value of work, lower rates would lessen the appeal of tax breaks. Such an effect might help to lessen the impact of reductions in marginal tax rates and cut the number of people involved in tax planning.

The tax system could also be reformed to attract even more low-skilled people into the labour force and reduce poverty. The tax system already gives a bonus to low earners. The limits for this bonus could usefully be increased in order that full-time workers earning the legal minimum wage became eligible for it.

Another key feature of the US tax system is that it depends more heavily than other countries on taxing income. Yet a consumption-based tax might boost saving, investment and, eventually, real incomes. While shifting to a full consumption-based tax is unlikely to happen because of the impact on income distribution, a second-best approach might be to lower corporate and capital gains tax rates, thus lowering the tax on saving and investment and moving the tax base towards consumption.

Tax-to-GDP ratios in selected OECD countries and regions



1. Unweighted average. Excluding Czech Republic, Hungary, Poland and Slovak Republic. Including Mexico from 1980
2. 5 highest countries: Belgium, Denmark, France, Norway and Sweden
3. 5 lowest countries: Australia, Japan, Korea, Mexico (from 1980) and United States
Source: OECD

In addition, there are large variations in the taxation of capital income, depending on the financing instruments. Take the interplay of corporate and personal income tax. The system introduces a bias in favour of bond financing and discourages the payment of dividends. This is because profits are taxed twice: once as company profit and again as dividends to shareholders via personal income tax. The combined rate approaches 62% in higher tax states. But the combined rate is lower for retained earnings, if the shareholder realises a capital gain; it is lower still for interest payments that are taxed only once, when they reach the recipient. Congress has begun reducing the deterrents to entrepreneurial activity by placing the majority of limited liability companies outside the corporate tax system, so avoiding double taxation of dividends and lessening biases towards debt financing. Further action is needed.

Income tax, especially at the federal level, has become complex, with a large number of tax breaks.

But it is also necessary to ensure that taxation does not discriminate against the investment that families and young people make in education and training – outlays that will boost further growth.

The tax package introduced in 2001 did not, in the main, focus on taxing consumption or reducing complexity. Rather, it aimed to stimulate the economy and increase incentives by gradually lowering future income tax rates.

Yet such reforms would make the system more efficient. The current situation means that further tax cuts would have to be balanced by more tax increases elsewhere, even if some of the reforms we advocate could be financed by ending certain tax breaks. The introduction of value-added tax could offer a way to finance part of the cuts, but that would require co-operation with the states. In any case, the current system of state sales taxes would benefit from an overhaul. It would be a valuable step towards creating a more uniform tax base across the country. ■

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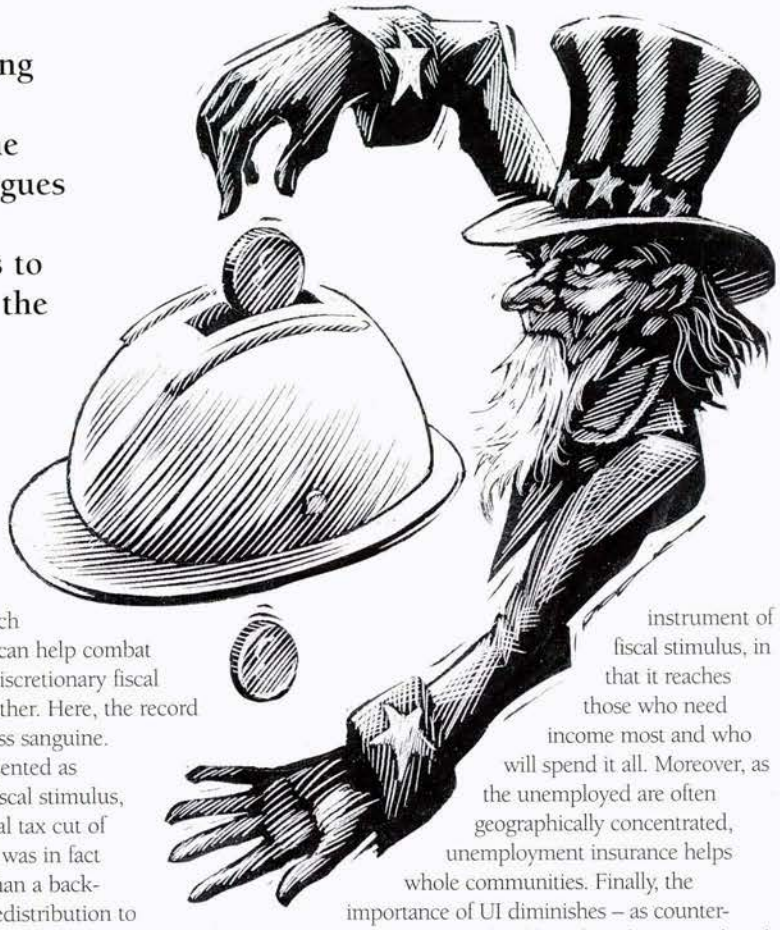
Fiscal policy in the U.S.
Lessons from 2001

Thomas I. Palley, Assistant Director of Public Policy, AFL-CIO, email: tpalley@aflcio.org

Government in the United States is being embraced again, thanks in part to the terrorist attacks of last year, but also the recession. What America needs now, argues Thomas Palley, a leading U.S. labour representative, are sound fiscal policies to promote economic activity, rather than the regressive tax cuts of spring 2001.



Who would have thought it? After two decades during which government economic activity has been under attack, even on the retreat, there is a renewed and vigorous interest in fiscal policy in the United States. This is partly because of the serious events of 2001 that reminded us of the value of government, but it is also due to the recession, which has highlighted government's role in stabilising market economies.

Aided by the smooth workings of automatic stabiliser mechanisms such as the progressive income tax, the huge on-budget surplus disappeared. This has helped dampen the recession's impact and highlighted the virtues of tried and trusted Keynesian principles of mobilising government money to steady the economy. When interest rates were higher, recessions could be fought by lowering them, which immediately reduced debt service burdens. In particular, families could refinance their mortgages with lower, more affordable rates, thereby freeing up disposable income. Now that inflation and interest rates are both down, monetary policy has less room for manoeuvre, increasing the need for alternative mechanisms to combat demand slumps.

Automatic stabilisers are one channel through which fiscal policy can help combat recessions; discretionary fiscal policy is another. Here, the record of 2001 is less sanguine. Though presented as immediate fiscal stimulus, the individual tax cut of spring 2001 was in fact little more than a back-loaded tax redistribution to the wealthy. Thus, 47.1% of the benefits go to the top 5% of income earners, and because many of the provisions are phased in over the next 10 years, it significantly worsens the long-term fiscal outlook. Good discretionary fiscal policy should provide immediate stimulus by getting money to those who will spend it, and it should "sunset" when recovery begins. The spring 2001 tax cut largely failed both of these tests.

Another area where policy failed was unemployment insurance (UI), which was held hostage to demands for corporate tax relief. UI is perhaps the single most effective instrument of fiscal stimulus, in that it reaches those who need income most and who will spend it all. Moreover, as the unemployed are often geographically concentrated, unemployment insurance helps whole communities. Finally, the importance of UI diminishes – as counter-cyclical policy should – when the unemployed find new jobs. Yet, despite these clear benefits, action on UI was blocked by political demands for corporate tax relief. In some instances, this relief contained little stimulus value, either because it rewarded old investments already in place or because it cost a lot. For instance, the proposed investment tax credit made no attempt to target marginal investment spending and instead rewarded all investment spending, including that which would have taken place with or without the tax credit.

Public infrastructure investment is another area where policy can be strengthened. The

September terrorist attacks prompted some increased spending in the form of re-building assistance, and defence and security expenditures. But more is needed. Infrastructure spending can be effective as a generator of jobs, and it can also help address long-unfilled needs and enhance future productivity. Another useful fiscal policy for speeding recovery is federal aid for states. Since many states are subject to balanced budget rules, downturns lead to pro-cyclical cutbacks in state spending, making matters worse. Federal aid for states can mitigate this consequence of state budget rules. If the recession continues in 2002, such aid should be a focal point of federal fiscal policy action.

Thankfully, the era of fiscal repair to resolve unsustainable deficits is over. Looking ahead, government should renew its commitment to the principles of a good tax system – sufficiency, fairness, efficiency and economic stability. Unfortunately, many of the discretionary changes in US tax policy in 2001 betray these principles. The tax cut was unfair because it was skewed towards the richest segments of the population, and its phased-in design promises to reduce future revenue streams in such a way that there will be insufficient resources to meet America's public service and infrastructure needs. This suggests that policymakers should repeal the 2001 tax cut. However, this will be a difficult message to craft. On the one hand, fiscal stimulus may still be needed if the recession continues. Yet on the other hand – and superficially in contradiction – the 2001 tax cut should be repealed because it undermines the long-run fiscal outlook and provides minimal fiscal stimulus. ■

Now that inflation and interest rates are both down, monetary policy has less room for manoeuvre, increasing the need for alternative mechanisms to combat demand slumps.

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Combating harmful tax practices

The more open and competitive global market of recent decades has had many positive effects on tax systems. Tax rates have generally fallen and tax bases have been broadened. Some tax and tax-related practices, however, undercut the gains that tax competition generates. This occurs especially if some countries introduce practices that encourage non-compliance with the tax laws of other countries.

The ultimate losers are honest taxpayers. They end up paying for dishonest practices by shouldering a greater share of the tax burden, and their confidence in the integrity and fairness of the tax systems, and in government in general, declines. Since 1998 the OECD has co-ordinated action so that countries – large and small, rich and poor, OECD and non-OECD – can work together to eliminate harmful tax practices with regard to geographically mobile activities, such as financial and other service activities.

The OECD has published three reports on harmful tax practices: *Harmful Tax Competition: An Emerging Global Issue* (1998); *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices* (2000); and *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report* (2001). These reports, and the work on harmful tax practices in general, are important elements in the OECD's efforts to foster integrity in government and economic growth and development.

With regard to its own member countries, the OECD has provided guidelines for addressing harmful tax practices. These guidelines provide for a standstill from introducing new measures that are harmful, a review of existing measures for the purpose of identifying those that are harmful, and the removal of any practices that are harmful by April 2003 (or by 2006 if certain criteria are met). The OECD's most recent efforts have been to develop guidance that will help its countries identify and eliminate any harmful aspects of their preferential tax regimes.

The OECD is also seeking commitments from tax havens to adhere to the principles of transparency and effective exchange of information. In 2001, Aruba, Bahrain, Isle of Man, Netherlands Antilles and the Seychelles agreed to co-operate in the OECD's work. Earlier commitments were made by Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino. These jurisdictions have been actively involved in developing a mechanism for the effective exchange of information with OECD countries. The OECD expects other jurisdictions to make commitments in the near future. In January 2002 it was announced that Barbados will not appear on the forthcoming List of Unco-operative Tax Havens. (See News Briefs, page 4).

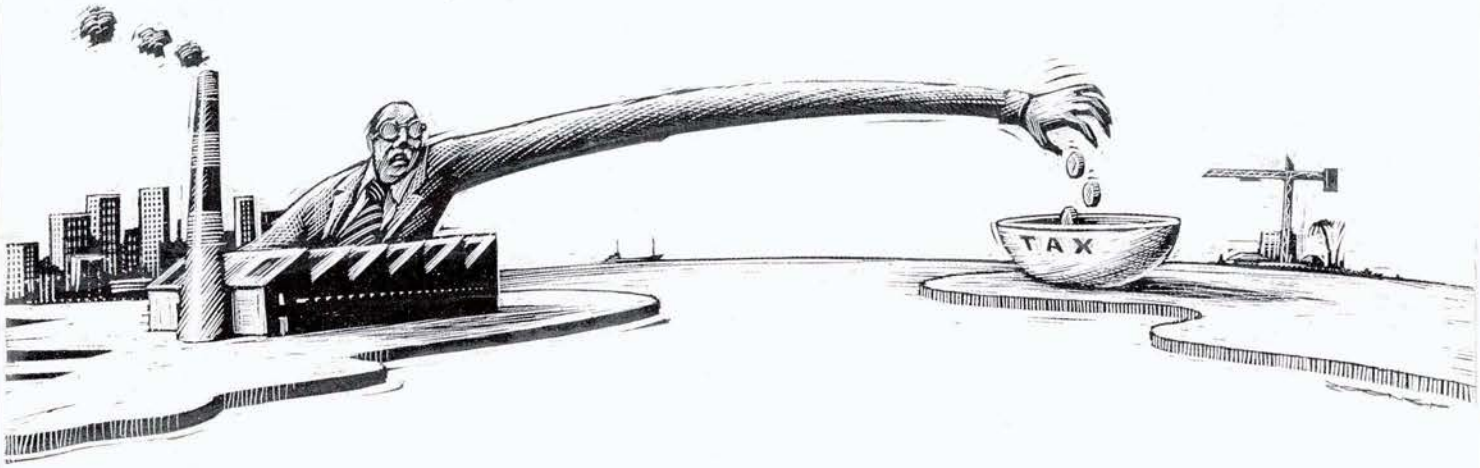
The OECD is working to involve non-OECD countries in its harmful tax practices work as well. In September 2001 it held a Global Forum to this end, involving officials from 88 countries and nine international organisations.

The OECD has also sought and received valuable input from civil society, notably business and labour. Their participation and that of non-OECD countries is a sign that the OECD project is not just about the importance of collecting taxes that are legally due, but that it forms a key part of the international effort to promote integrity and stability in a globalised world.

Transfer pricing:
Keeping it at arm's length

John Neighbour, OECD Centre for Tax Policy and Administration

Transfer pricing can deprive governments of their fair share of taxes from global corporations and expose multinationals to possible double taxation. The arm's length principle can help solve these problems.



Not long ago, transfer pricing was a subject for tax administrators and one or two other specialists. But recently, politicians, economists and businesspeople, as well as NGOs, have been waking up to the importance of who pays tax on what in international business transactions between different arms of the same corporation. Globalisation is one reason for this interest, the rise of the multinational corporation is another. Once you take on board the fact that more than 60% of world trade takes place within multinational enterprises, the importance of transfer pricing becomes clear.

Transfer pricing refers to the allocation of profits for tax and other purposes between parts of a multinational corporate group. Consider a profitable UK computer group that buys micro-chips from its own subsidiary in Korea: how much the UK parent pays its subsidiary – the transfer price – will determine how much profit the Korean unit reports and how much local tax it pays. If the parent pays below normal local market prices, the Korean unit may appear to be in financial difficulty, even if the group as a whole shows a decent profit margin when the completed computer is sold. UK tax administrators might not grumble as the profit will be reported at their end, but their Korean counterparts will be disappointed not to have much profit to tax on their side of the operation. This problem only arises inside corporations with subsidiaries in more than one country; if the UK company bought its

microchips from an independent company in Korea it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. It is the fact that the various parts of the organisation are under some form of common control that is important for the tax authority as this may mean that transfers are not subject to the full play of market forces.

Transfer prices are useful in several ways. They can help an MNE identify those parts of the enterprise that are performing well and not so well. And an MNE could suffer double taxation on the same profits without proper transfer pricing.

Take the example of a French bicycle manufacturer that distributes its bikes through a subsidiary in the Netherlands. The bicycle costs €900 to make and it costs the Dutch company €100 to distribute it. The company sets a transfer price of €1 000 and the Dutch unit retails the bike at €1 100 in the Netherlands. Overall, the company has thus made €100 in profit, on which it expects to pay tax. But when the Dutch company is audited by the Dutch tax administration they notice that the distributor itself is not showing any profit: the €1 000 transfer price plus the Dutch unit's €100 distribution costs are exactly equal to the €1 100 retail price. The Dutch tax administration wants the transfer price to be shown as €900 so that the Dutch unit shows the group's €100 profit that would be liable for tax. But this poses a problem for the French company, as it is already paying tax in France on the €100 profit per bicycle shown in its accounts. Since it is a group it is liable for tax in the countries where it operates and in dealing with two different tax authorities it cannot just cancel one out against the other. Nor should it pay the tax twice.

In a bid to avoid such problems, current OECD international guidelines are based on the arm's length principle – that a transfer price should be the same as if the two companies involved were indeed two independents, not part of the same corporate structure. The arm's length principle (ALP), despite its informal sounding name, is found in Article 9 of the OECD Model Tax Convention and is the framework for bilateral treaties between OECD countries, and many non-OECD governments, too.

The OECD Transfer Pricing Guidelines provide a framework for settling such matters by providing considerable detail as to how to apply the arm's length principle. In the hypothetical French-Dutch bicycle case, the French MNE could ask the two tax authorities to try to reach agreement on what the arm's length transfer price of the bicycles is and avoid double taxation. It is likely that the original transfer price set by the MNE was wrong because it left all the profit with the manufacturer, while the Dutch proposal erred on the other side by wanting to transfer all the profit to the distributor.

More than 60% of world trade takes place within multinational enterprises, which underlines the importance of transfer pricing. No country – poor, emerging or wealthy – wants its tax base to suffer because of transfer pricing.

But all of this assumes the best possible world, where tax authorities and MNEs work together in good faith. Yet transfer pricing has gained wider attention among governments and NGOs because of another risk: that it could be used to shift profits into low tax jurisdictions even if the MNE carries out little business activity in that jurisdiction. This leads to trade distortions, as well as tax distortions.

No country – poor, emerging or wealthy – wants its tax base to suffer because of transfer pricing. That is why the OECD has spent so much effort on developing its Transfer Pricing Guidelines. While they help corporations to avoid double taxation, they also help tax administrations to receive a fair share of the tax base of multinational enterprises. But abuse of transfer pricing may be a particular problem for developing countries, as companies might take advantage of it to get round exchange controls and to repatriate profits in a tax free form. The OECD provides technical assistance to developing countries to help them implement and administer transfer pricing rules in a broadly standard way, while reflecting their particular situation.

Applying transfer pricing rules based on the arm's length principle is not easy, even with the help of the OECD's guidelines. It is not always possible – and certainly takes valuable time – to find comparable market transactions to set an acceptable transfer price. A computer chip subsidiary in a developing country might be the only one of its kind locally. But replacement systems suggested so far would be extremely complex to administer. The most frequently advocated alternative is some kind of formulary apportionment that would split the entire profits of an MNE among all its subsidiaries, regardless of their location. But proponents of such alternatives not only have to show that their proposals are theoretically "better" but that they are capable of winning international agreement. Not easy, since the very act of building a formula makes it clear what the outcome is intended to be and who the winners and losers will be for a given set of factors. Tax authorities would naturally want the inputs to reflect their assessment of profit. Questions like how to apportion intellectual capital and R&D between jurisdictions would become contentious. Such problems would make it very difficult to reach agreement on the inputs to the formula, particularly between parent companies in wealthy countries and subsidiaries in poorer ones.

ALP avoids these pitfalls as it is based on real markets. It is tried and tested, offering MNEs and governments a single international standard for agreements that give different governments a fair share of the tax base of MNEs in their jurisdiction while avoiding double taxation problems. Moreover, it is flexible enough to meet new challenges, such as global trading and electronic commerce. Governments so far appear to agree: much better to update the existing system than start from scratch with something new. ■

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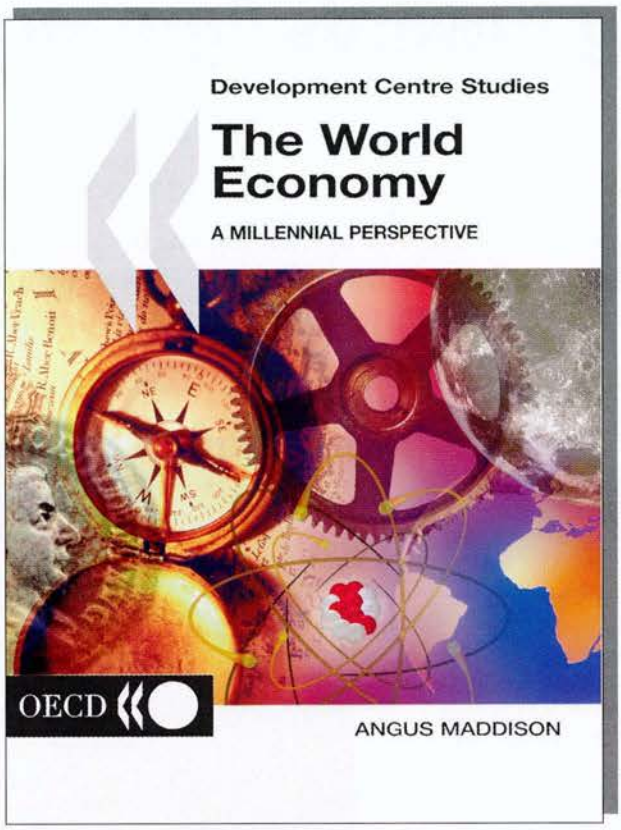
Bestseller



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France:
Moving towards "greener" growth?

Ann Vourc'h, OECD Economics Department

The French authorities are strengthening their polices on the environment as the public increasingly demand better air quality, purer water and better protection for their natural resources. Putting these policies into practice is not as simple as it may seem.

France is a country of contradictory images when it comes to the environment. Traffic-filled cities, yet fast and extensive public transport; bucolic expanses of farmland but rural waterways seriously polluted by fertiliser runoff. In fact, France is often, though perhaps unfairly, considered to be in the slow-to-middle lane among OECD partners when it comes to some environmental standards and public attitudes to poor environmental practices. But that is changing and there are increasing signs that the environment is looming ever larger in people's preoccupations and public debate. In everyday life, the French increasingly aspire to better air quality, purer water and better protection for their natural areas. The authorities are gradually responding, with concrete measures aimed at improving the trade-off between growth and the environment.

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Winning the battle

How can growth be made ecologically sustainable? Until recently, environmental policy relied essentially on regulations, including technical standards, and major strides have been made towards containing industrial pollution. For several years now, in France as elsewhere, the emphasis has been shifting towards economic instruments such as taxes and charges as a means of generating prices for the use of natural resources or the environment that are more in line with the costs that this use inflicts on society. In this way, environmental concerns can be better integrated into economic decisions. After all, as was noted at the OECD ministerial meeting on environmentally sustainable growth, it is often more costly to repair damage than to avoid it.

But using economic instruments to get people to change their behaviour is not without pitfalls. It is not easy to shift from a conception of an environment that is "free of charge" to an approach that charges individuals and firms for its use.

Making the polluter pay

While the principle that the producer of pollution should pay for the costs it generates is widely accepted, in practice many supposedly green taxes do not yet fulfil that role effectively. In France, existing taxes on energy products were either introduced for budgetary reasons or to promote conservation, but they bear little relation to the social and ecological costs that those products engender. Coal, for example, which is one of the most highly polluting fuels, is exempt from all French taxation. Furthermore, energy consumption of households is taxed more heavily than that of businesses, even where both kinds of consumption are equally noxious for the environment.

In an effort to address some of these anomalies and to combat climate change, the French government recently sought to introduce a tax on the intermediate energy consumption of businesses.

The plan was designed to minimise the impact on firms' overall cost competitiveness but maximise incentives to reduce excessive polluting practices. In other countries implementing carbon taxes, competitiveness concerns have led them, perversely, to exempt, or offer reduced rates to, the very sectors that consume the most energy and pollute the most. The proposed French law sought to resolve this problem by charging all firms the same rate of tax on their energy consumption – at the margin. However, in order to minimise the competitiveness impact of the reform, it proposed offering tax deductions to firms on the basis of their initial energy intensity. In other words, firms would be taxed only on some of their energy consumption, but at the margin they would be taxed at the full rate – thus preserving incentives to reduce energy consumption. However, the Constitutional Council rejected the bill as unconstitutional, arguing that because average tax rates paid by firms would differ, the proposed law introduced unequal treatment of taxpayers.

The government is considering negotiating with industry to obtain voluntary commitments to reduce emissions. Judging by international experience, there is a strong risk that this approach may lead to reduction targets that are not ambitious enough for France to honour its pledge under the Kyoto Protocol to stabilise greenhouse gas emissions at their 1990 level by around 2010. Indeed, the authorities face a real quandary, for even if some companies see clean environmental practice as making good business sense these days, it is quite unrealistic to expect all firms to "volunteer" to shoulder the cost of reducing emissions that are currently free of charge. And, apart from a tax or a broad-based emissions permit market such as the one for sulphur dioxide in the United States, there are few instruments that governments can use to induce a change in behaviour. Whatever approach is taken, energy-intensive industries and their cost structures will be affected, but there is little alternative if the goal is to steer the economy towards a productive structure that generates less pollution.

In 2001 the number of diesel cars sold exceeded petrol cars for the first time. And yet in urban areas a litre of diesel fuel produces as much greenhouse gases as a litre of petrol, and more pollution.

Those roads

Road traffic and urban air pollution represent another instance where efforts to move towards greener policies will necessarily impose unwelcome costs on those currently consuming environmental resources for free. Despite relatively efficient public transport in major French cities like Paris, Lille or Toulouse, road traffic has been increasing constantly. So, while the efficiency gains of individual engines have improved and emissions per kilometre and litre of fuel declined, the overall impact of the car has risen in terms of traffic and urban sprawl. In other words, the public costs of car use have risen, though the private costs may have fallen. Moreover, existing fuel taxes are not designed to make cars pay for more of this public cost, which vary according to location, time of day and type of vehicle. Yet, the consumption of one litre of fuel by an old car in town during the rush hour inflicts far more damage than the consumption of that same amount of fuel by a new car on the open road.

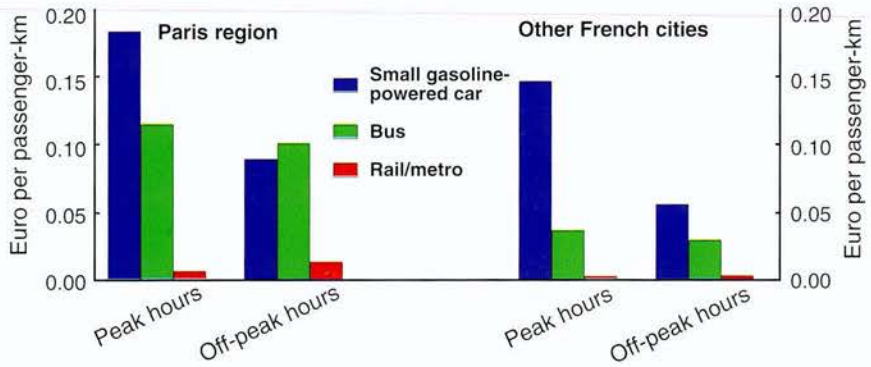
Much could be gained by reforming transport taxes and charges, including tolls. While it is now technically possible, an electronic toll system covering an entire metropolitan area would still be costly. However, these costs are likely to fall over time and would be offset anyway by savings in health and economic costs.

In France, fines for overtime parking are so low that it is often cheaper to pay a parking fine than to feed the meter.

Although the French are accustomed to paying motorway tolls, they might not accept urban road pricing as easily: mobility is often considered a fundamental right that should not hinge on one's ability to pay. But if city road tolls were presented as a way of improving mobility and saving time, support could grow. Already, experience in France and elsewhere suggests this to be the case. (See article by Anthony Ockwell on page 34).

In the shorter term, partial alternative solutions are possible, such as motorway payments allowing access to the centre of metropolitan areas, as is currently under consideration in the Netherlands. In France

Urban transport and pollution costs



Source : Quinet, E. & J. P. Tarous (2000)

– and in Paris in particular – both parking charges and fines could be raised to deter unnecessary traffic and reduce congestion. Street parking charges are significantly lower than market rents for the space occupied. And fines for overtime parking are so low that it is often cheaper to pay a parking fine than to feed the meter – a situation quite unlike London or New York for instance, where fines are many times higher than parking fees. Tackling these issues would help not only to improve environmental policy, but assist other ongoing initiatives as well, like the planning of cycle lanes and green spaces.

If there is scope for improving the effectiveness of environmental policies, it is in eliminating the environmentally detrimental incentives provided by other policies, such as in agriculture and transport. The tax differential between diesel fuel and petrol is large in France, and in 2001 the number of diesel cars sold exceeded petrol cars for the first time. And yet in urban areas a litre of diesel fuel produces as much greenhouse gases as a litre of petrol, and more pollution. New diesel engines are available that produce lower greenhouse gas emissions on the open road, but these are more prone to generate the type of emissions, like nitrogen dioxide, that cause acid rain. Which of the fuels is less polluting overall is an unresolved debate; what is clear is that France's current tax preference awarded to diesel is excessive. The government is aware of this fact. In 1998 it pledged to narrow the differential, but suspended the idea when petrol prices rose in autumn 2000. It has not renewed its pledge since.

There is clearly some way to go before an environmentally coherent strategy emerges in France, though sustainable growth is starting to be reflected in French policies. With the euro out of the way as a priority election issue, perhaps green considerations will come more to the fore in future policymaking. ■

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Road congestion:
What's the deal?

Anthony Ockwell, OECD Science, Technology and Industry Directorate

Road congestion and pollution are a fact of life in cities and towns, but road pricing could stop it from being an inevitable one.

Ever been late for work and blamed the traffic? The likelihood is (assuming the excuse is true) that you were in fact causing the traffic, too. After all, your car forms part of a line and is holding up the car behind. So by definition, we do not just get stuck in traffic, we produce it.

Traffic congestion comes in all shapes and sizes, usually in towns and cities, but not always: the longest traffic jam ever recorded occurred not in New York or Tokyo or Mexico City, but on the French motorway between Lyon and Paris on 16 February 1980. It tailed back for 176 km (109 miles).

Congestion is inefficient, polluting and dangerous. So why not reduce it? Removing just 5% of traffic at peak times could substantially reduce or even eliminate rush hour congestion from many cities. One approach that is beginning to stoke interest among municipal leaders, even in large metropolitan capitals like Paris and London, is road pricing. The theory seems sound enough: introduce a price on bringing cars into congested areas that incite drivers either not to travel unnecessarily or to vary their times of travel or, indeed, to try public transport, walking or cycling. With the right approach, drivers who incur higher prices during rush hour periods would benefit from reduced congestion and travel time, while non-essential travel would take place at less congested and cheaper times.

Could road pricing work? Contrary to some sceptical voices in the car lobby, road pricing is not an attack on car use, but rather a way of enhancing it. If there is an enemy of the car industry, it is inefficient congestion. Road pricing could ultimately be welcomed by car users and producers alike.

Road pricing has been debated in policy circles for many years. In bygone days, technology was a problem: how do you tag cars? Do you set up road tolls? These problems no longer exist, and advances in electronic devices have made sophisticated road pricing schemes more feasible.

Yet, few examples of road pricing schemes exist. Several pilot schemes for urban transport pricing are underway in the OECD area, in places like Bristol and Cambridge (UK), Orange County, California (US), Copenhagen (Denmark), Edinburgh (UK), Genoa (Italy), Gothenburg (Sweden), Helsinki (Finland), Rome (Italy) and Trondheim (Norway). But for the most part, there is hesitancy. The political will is often lacking, perhaps because of uncertainty about voter reaction. Road authorities tend to try other ways of reducing congestion problems arising from peak demand, whether by road widening, various traffic management techniques like bus lanes, co-ordinated traffic signalling systems and so on. But these non-price options are not that popular, which would not be such a problem if they achieved a balance between the supply of infrastructure and demand for road space that might reduce congestion. The trouble is, they don't.

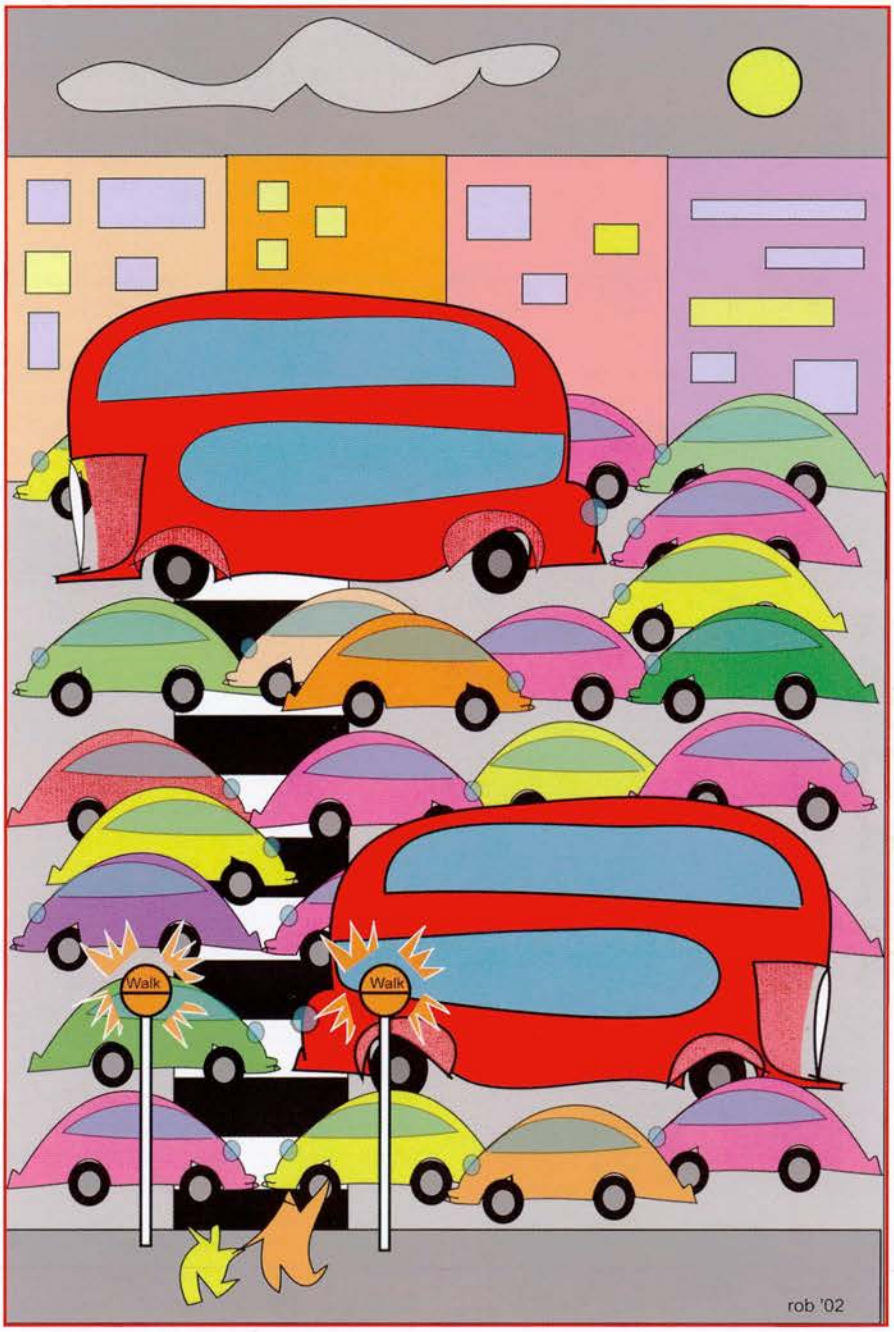
What's the price?

Understanding the meaning of a road price presents its own difficulties. Confusion still reigns over "price" and "tax", for instance. What is being priced and at what cost? The user? The road space? The pollution emitted? And should the price be fixed, or allowed to fluctuate?

In economic terms, price should reflect the demand for a good relative to its supply: so, if a lot of motorists want to drive on a limited road space, the price of using it will rise. However, in practice, when it comes to transport, most road authorities supply roads to "meet" the demand for road space. Users are not really faced with the actual price of using that road. Rather, motorists see road infrastructure as a public good, whose provision is financed from taxation. Supply is theoretically open-ended: as roads become congested, more roads are built, which then become congested, and so on. In practice, public budgets are a constraint, of course, as are land expropriation costs. But when new roads are built or widened, the extra capacity simply leads to new road users and still more demand. Good news for car sales, perhaps, but hardly for the environment, or indeed the taxpayer.

But there is an important difference between the sunk capital cost of a road and the extra costs imposed on society by each additional road user. Road pricing would try to reflect the latter – this is the so-called marginal cost of using road space. In other words, at a certain price, only those users who deem it necessary to travel will do so, and the extra, unnecessary drivers will either abstain, take another route or travel at another time.

To price anything, we need to have an idea of cost. Deterioration of the road surface and a vehicle's own operating costs are direct costs that are fairly straightforward to work out, though these are part of those sunk capital expenditures. Not so for indirect costs for society overall, whether it be from road crashes, pollution, noise or congestion. Attempts have been made though. The Texas Transport Institute estimated in 1999 that the cost of congestion (lost time, wasted fuel, increased vehicle operating costs) for US drivers was US$72 billion in 1997, or 3.7% of GDP.



Other estimates from European sources put congestion costs in the same ballpark.

These figures do not take global warming into account, either. Transport sources generate approximately 28% of total OECD emissions of CO_2, one of the principal gases responsible for the greenhouse effect. Of this figure, road-based transport accounts for approximately 80% of greenhouse gas emissions from transport.

Everyone needs transport as a basic requirement, to shop or to get to work, but should this mean that the burden of external costs is shared equally? Some would say yes. To them, road pricing would be unfair since motorists already pay fuel tax. Not only do these revenues contribute to road construction and maintenance, but they should inhibit congestion too, since the more time people spend in traffic, the more fuel they use and the heavier their expenditures.

However, fuel taxes are not a balancing mechanism: the level of tax per litre of fuel consumed is fixed and bears no relationship to supply and demand of road space.

The same goes for vehicle registration charges. These are a charge on access to the road network. In some countries, access charges contribute to administration and maintenance costs, too. But while access charges may vary according to vehicle type (e.g., gross vehicle mass), they do not discriminate according to usage. In fact, the more the car is used, the less the vehicle charge per kilometre travelled.

Pricing could be the trick to remove that 5-10% of traffic that causes congestion in peak periods.

Road tolls are another charge often cited as a form of road pricing, but again, these are generally aimed at paying for the cost of building and maintaining roads, whether public or private. And they are not aimed at controlling congestion, as anyone using the Blackwall Tunnel in London at peak times will know. Sometimes the toll may be varied according to traffic volume to encourage users to travel during periods of low demand. This is the case on some approach roads to Paris. Several toll operators, such as on the Bergen Ring Road in Norway, have introduced electronic toll collection technology to improve traffic throughflow, paving the way for the broader implementation of electronic pricing technology. In Singapore, an Electronic Road Pricing (ERP) system has been in place since 1998, based on automatic fee collection when vehicles pass one of the ERP gantries (or check points). The rates vary with time of day and can be adjusted to achieve optimal traffic flow.

Opportunity cost, opportunity lost

It is hard to say how effective road pricing can be. Whether people will respond by simply absorbing the price and then taking a business-as-usual approach is uncertain. After all, when the price of a bus ticket rises it does not always lead to less crowded buses, although peak-time pricing on public transport can influence passenger decisions about when to travel. Also, there are questions of policing, as well as defining acceptable congestion, all of which may vary from country to country. Nonetheless, the social costs of inaction are large, and pricing is certainly worth a try.

To be successful, road pricing would have to have several basic elements. First, prices should be allowed to vary according to the level of demand – as traffic volume increases, price increases. And when congestion falls, so should the price, even to zero when possible, as that would maintain public support. In particular, road prices should not be allowed to become "just another municipal tax". Second, a balance between affordability and congestion objectives is important; some people (and not always high earners) have to travel at peak times and may require help from their employers who will benefit anyway from less congestion. Third, revenues should be spent on improving public transport, parking facilities, cycle lanes, etc. A fourth condition would be to ensure that the price is indeed aimed at reducing congestion, particularly as road toll operators might not mind congestion as they may legitimately think it maximises peak time revenue. Hence the need for proper public regulation, possibly even management.

Of course, road pricing alone will not solve every urban environmental problem and should be viewed as part of a broad suite of measures designed to achieve a sustainable transport system. Research and development on solutions to reduce transport emissions, like developing clean technology, would be part of that suite, as might other innovations, such as a greater effort to achieve more flexible work times. But pricing could be the trick to remove that 5-10% of traffic that causes congestion in peak periods in our cities. If that means picking up the children on time and being able to drive into city centres to shop, then surely that would be a price worth paying, even if it means having to find a new excuse for being late to work. ■

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How good is our global education?

The PISA survey

Donald Hirsch, Policy Consultant to the OECD on education

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Can they make sense of it all?

The new PISA survey of student knowledge and skills tells us more than we have ever known about which education systems do well. It reveals some interesting surprises, too. The results may point to a need for improvements to education systems worldwide, though this does not mean a standardised curriculum for all countries.

Today we take for granted international comparisons of growth and inflation. High-quality employment indicators have been available for some time, too, but what about international indicators of education systems? That has been a much harder task, mainly because the true "outcomes" of education cannot easily be measured across systems. Studies can look at how long people spend in education, or at how many students pass exams at roughly comparable levels, but because

these exams are not the same in different countries, that does not really allow you to see how well each system educates its students. International tests have hitherto focused on how well students have mastered certain parts of the curriculum common to all countries – a useful but narrow measure of performance.

PISA – the Programme for International Student Assessment – has now provided a missing piece of the jigsaw. It assesses how well students nearing the end of compulsory education (age 15) are able to apply the knowledge and skills developed at school, to perform tasks that they will need in their future lives, to function in society and to continue learning. Are students able to find the information that they need in a newspaper article? Can they distinguish opinion from fact? Can they use broad scientific understanding to draw valid conclusions from evidence on matters that affect their lives, such as the environment or food safety? These kinds of questions are answered in PISA's assessment of reading literacy, mathematical literacy and scientific literacy.

Co-ordinated by the OECD, PISA is a collaborative effort among the governments of 28 OECD and four non-member countries. The first results, published in December 2001, provide an indicator of the outcome of initial education that is officially recognised across the developed world. Crucially, the survey will be repeated every three years, allowing countries to monitor progress regularly. In 2003, all 30 OECD countries will take part, while at least 13 more non-members, from China to Chile, are joining the survey.

What do the PISA results show? Finnish students did particularly well in reading, and Japanese and Koreans excelled in mathematics and science. Australia, Austria, Canada, New Zealand, Sweden and the United Kingdom were significantly above average for all three types of literacy. Those consistently below average included two relatively affluent economies, Germany and Italy, as well as others with below-average national income like Greece, Mexico, Poland and Portugal. The United States performed bang in the middle.

These averages mask important variations in performance within each country. Since most education systems have been trying particularly to improve the performance of the lowest achievers, the amount of variation in achievement is important.

Germany was one of the countries with the greatest inequalities in reading literacy, with poor performing students dragging down the average. New Zealand is another unequal country, but more students there than anywhere else had top literacy levels, lifting the overall performance to well above average. In Korea and Finland, in contrast, high average scores were achieved with relatively narrow differences. PISA shows clearly that "quality" and "equity" in school systems need not conflict with each other.

PISA also tells us more about performance differences and social background. It shows that while privileged students do better everywhere, the gap is not immutable: it is two to three times wider in Germany, Switzerland and the United Kingdom, for example, than in Korea.

PISA's results may reveal, when we examine them more closely, some things about which kinds of school practices might lie behind good and bad results – such as the atmosphere in the classroom, or policies on setting homework.

Yet they may only hint at the answers to some of the deeper questions about why, for example, students in some countries are so much better at thinking and reflecting about what they read than students in others.

There has been great hesitancy among academics, governments and international organisations in comparing such less tangible aspects of education systems, and in particular the cultural approaches that distinguish them. Japanese schools may produce adults who think in one kind of way, which is fine for Japanese society. Swiss students might think in ways that are appropriate to Switzerland's society. Who is to say which one is "better"? Is it not dangerous to impose a single international "standard" of what schools should teach?

Japanese schools may produce adults who think in one kind of way, which is fine for Japanese society. Swiss students might think in ways that are appropriate to Switzerland's society. Who is to say which one is "better"?

Absolutely: this is a reason for resisting an international curriculum, but not for ignoring the common need for certain key competencies across the international economy. Reading, science and mathematics are basic requirements everywhere, and PISA shows that those skills are unevenly distributed across countries.

The below-average performance of well-off countries like Germany and Italy is likely to stimulate debate. Teaching methods and curriculum approaches in some countries may be scrutinised. International comparisons will be inevitable and a country's educators will have to accept outsiders into the hidden garden of their classrooms, however uncomfortable the experience. The harsh wind of globalisation will not forever spare those concerned with perhaps the most powerful global force of all: that of learning. ■

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The brain drain:
Old myths, new realities

Mario Cervantes and **Dominique Guellec**, OECD Science, Technology and Industry Directorate

In 2000 the British government and the Wolfson Foundation, a research charity, launched a five-year research award that raised little attention outside scientific circles. The £20 million scheme aims to attract the return of Britain's leading expatriate scientists and the migration of top young researchers to the United Kingdom. That same year under greater media coverage, the US Congress announced it was raising the annual cap on the number of temporary work visas granted to highly skilled professionals under its H1B visa programme, from 115 000 to 195 000 per year until 2003.

These are just two examples that illustrate the growing demand and competition for talent in OECD countries. And they show a policy problem: how to attract and hold on to skilled labour. The British initiative also dispels a myth: that the problem only affects developing and transition economies. In fact, the British Royal Society first coined the expression "brain drain" to describe the outflow of scientists and technologists to the United States and Canada in the 1950s and early 1960s.

Global skilled workers

Internationally comparable data on the migration of the highly skilled is incomplete, but sources confirm an increase in migration flows during the 1990s, from Asia to the United States, Canada, Australia and the United Kingdom. The increase comes from strong demand in OECD countries for IT and other skills in science and technology as well as the selective immigration policies that favour skilled workers. Not all skilled migrants are in search of educational, economic or intellectual opportunities. Sometimes, they are forced to leave their homes as a result of war, or political, ethnic and religious persecution.

Skilled migration between OECD countries is also on the rise but appears dominated by temporary flows of advanced students, researchers, managers and IT specialists, suggesting more a pattern of brain circulation than a draining of skills from one place to another. The globalisation of firms has helped fuel temporary flows; in the mid-1990s intra-company transfers accounted for 5-10% of the total flows of skilled workers to the United States from Canada.

Even if the current economic slump has reduced global demand for IT and other specialty workers, foreign talent remains in demand.

The United States is the main pole of attraction for foreign skilled workers; 40% of its foreign-born adult population have tertiary level education. Since the early 1990s, some 900 000 highly skilled professionals, mainly IT workers, from India, China, Russia and a few OECD countries (including Canada, the UK and Germany) have migrated to the United States under the H1B temporary visa programme. The United States also takes in 32% of all foreign students studying in the OECD countries. Indeed, higher education is an important channel for US firms recruiting highly skilled migrants; some 25% of H1B visa holders in 1999 were previously students enrolled at US universities.

But the United States is not the only magnet. Canada also attracts talent and, despite its modest loss of skilled migrants to the US, is in fact a net importer of human capital. Skilled migration to Germany and France has been lower in recent history, but these countries have now implemented policies to attract foreign students, researchers and IT workers. In 2000, Germany launched a sort of "green-card" scheme to recruit 20 000 foreign IT specialists and by the end of the following year had recruited half that number, mainly from eastern Europe. In addition, dynamic Asian economies like Singapore are trying to plug shortages in IT workers through immigration from neighbouring Malaysia or even China. Even if the current economic slump has reduced global demand for IT and other specialty workers, foreign talent remains in demand. In January this year, the UK government announced it would launch a skills-based migration programme and similar schemes exist in Australia and New Zealand.

Winners and losers

The costs and benefits of the brain drain and circulation of talent are hotly debated. International mobility of skilled workers can generate global benefits by improving knowledge flows and satisfying the demand for skills. The contribution of foreign skilled workers to economic growth and achievement in host countries, in particular to research, innovation and entrepreneurship, is increasingly recognised – witness the number of foreign-born US Nobel Prize winners or creators of global high tech companies, such as Intel or eBay, and other successful start-ups.

It is important to distinguish between emigrants from OECD countries and those from developing countries. The risk of a brain drain damaging rich countries is arguably lower, but it does exist. Canada may well lose skilled workers to the United States and import skilled human

capital from other countries. However, the quality of the two-way flow is key, though it is difficult to calculate whether the loss of a top genetics researcher at a public lab can be compensated for by the arrival of even several hundred IT specialists. But as skilled migration between advanced countries is often temporary, there may be a double gain from the circulation of the highly skilled: first from the overseas experience acquired by their genetics researcher, and second from the constant inflow of skilled workers.

In sending countries in the developing world, the challenge is greater. For these countries, capturing benefits mostly depends on attracting back skilled emigrants and providing opportunities for them to use their new technological competencies. Returnees also can bring valuable management experience, entrepreneurial skills and access to global networks. They may even bring venture capital. But this is looking on the bright side.

Mostly, the problems caused by the brain drain in poorer sending countries are great. Migrants from developing countries are generally more likely to stay in the host country than migrants from advanced countries. Survey evidence on the share of foreign PhD graduates in science and technology who stay abroad show that 79% of 1990-91 doctoral recipients from India and 88% of those from China were still working in the United States in 1995. In contrast, only 11% of Koreans and 15% of Japanese who earned science and engineering (S&E) doctorates from US universities in 1990-91 were working in the United States in 1995.

In the longer term, however, return flows of people and capital may not only offset some potential negative effects of international migration but also constitute an economic development strategy in its own right. In Chinese Taipei, for example, half of all the companies emerging from that economy's largest science park, Hsinchu, were started by returnees from the United States. And in China, the Ministry of Science and Technology estimates that returning overseas students started most Internet-based ventures.

The harsh reality is that only a handful of countries have been successful in luring their talented emigrés back home.

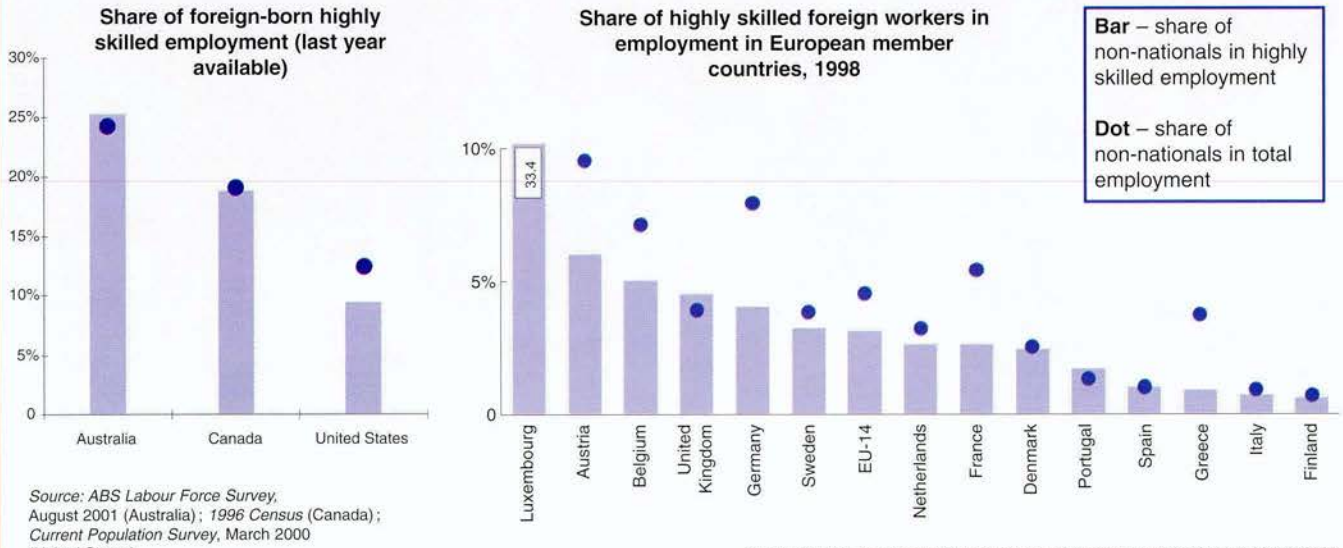
What governments can do

The harsh reality is that only a handful of countries have been successful in luring their talented emigrés back home. The International Organisation for Migration (IOM) estimates that some 300 000 professionals from the African continent live and work in Europe and North America. By some estimates, up to a third of R&D professionals from the developing world are believed to reside in the OECD area. While there are often media reports of successful Indian entrepreneurs in the United States who establish branches or even firms in India only a small number actually return; in 2000, it was estimated that some 1 500 highly qualified Indians returned from the United States, although more than 30 times that number depart each year.

The relative success of Chinese Taipei, Korea and Ireland in fostering return migration has been attributed to the opening of their economies and policies to foster domestic investments in innovation and R&D. Developing countries with some infrastructure in R&D, like India, are more likely to attract the return of migrants, as well as money and business contacts.

"Scientific diaspora" and "immigrant entrepreneur networks" can also help sending countries capture benefits and know-how from emigrants overseas. Grass roots initiatives in South Africa and Latin America have been developed to link researchers abroad to networks in their

Foreign talent



Source: ABS Labour Force Survey, August 2001 (Australia); *1996 Census* (Canada); *Current Population Survey,* March 2000 (United States)

Source: OECD, based on data from the Eurostat *Labour Force Survey,* March 2001

home countries. Indian professionals in the US have been the primary drivers of knowledge and capital flows to India. The Indian government has contributed to the emergence of these private networks through legislative and tax rules that encourage remittances and investment from Indians abroad. The diaspora idea has been put to work by advanced countries too, like Switzerland, whose online network, Swiss-List.com was established to encourage networking among Swiss scientists in the US and to foster contacts with peers in Switzerland.

Governments can do quite a lot to address the causes of the brain drain. Science and technology policies are key in this regard. Developing centres of excellence for scientific research and framing the conditions for innovation and high tech entrepreneurship can make a country attractive to highly skilled workers, both from within the country and from outside. The task is not easy and it takes time; India's investment in human resources in science and technology and own R&D capabilities dates from the 1950s. China has recently launched a project to develop 100 universities into world-class institutions that not only provide higher education training, but also academic employment and research opportunities.

In the OECD, the UK government plans to increase the salaries of post-doctorates by 25% and increase funding for the hiring of university professors. In France, some 7 000 teaching-researcher posts have been created since 1997 to retain talent and encourage the return of post-doctorates working abroad. The European Commission is looking to improve the attractiveness of the European research area and has doubled the amount of funding devoted to human resources in the Sixth Research Framework Programme to €1.8 billion.

The risk of a brain drain is real. Yet countries can create opportunities for research, innovation and entrepreneurship at home and stimulate a return flow of migrants and capital, as well as win access to international innovation networks. With the right mix of policies and sustained international co-operation, several countries could, as one Indian official pointed out, see the "brain drain" be transformed into a "brain bank". ■

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- *International Mobility of the Highly Skilled*, OECD, 2002.
- See also: www.oecd.org/migration
- *Science, Technology and Industry Scoreboard*, OECD, 2001.
- "Brains Abroad", Devan, J. and Tewari, P.S., *McKinsey Quarterly* No. 4, 2001.

One-way ticket holders

Thousands of Bangladeshis cram into Dhaka's General Post Office in October 1999 to mail their applications for U.S. immigrant visas under an American government lottery, known as DV-2001. A total of 3 850 Bangladeshis were chosen for the DV-2001 visas from among 1.5 million applicants. How many will return to Bangladesh is quite another story. Over 20 000 Bangladeshis have already migrated to the United States under similar programmes since 1990 and were given U.S. citizenship.

Licensing life

No, life cannot be patented. But an invention which includes genetic material as an isolated, purified molecule outside the human body can. That means genes. More than 3 000 patents on genetic inventions have been granted since 1980 by the United States Patent and Trademark Office, with the European and Japanese patent offices not far behind. In the US, according to one study, close to 5 000 DNA-based patents have been issued each year since 1995. The human genome contains some 30 000-70 000 genes and a not insignificant percentage (perhaps 1-5%) of human genes are probably claimed in some way on granted patents.

But how are these patents regulated? Legally, they are subject to the very same restrictions as all other inventions: a patent is only granted if the invention is new, includes an inventive step and is non-obvious, and has an industrial use. Some countries also require that the use of an invention should not contravene public order or morality.

Public concerns are not just ethical ones. Some argue that a proliferation of gene patents inhibits public research, since others are prohibited from using inventions that have a commercial intent, however remote. There is also a sense that the claims patents make are either too obvious or not that inventive. For instance, computer algorithms already make it possible to identify the function of a gene by analogy with known functions of very similar genes in different species. Such questions have made gene patenting a politically sensitive area and only five of the 15 EU countries have ratified the 1998 European Directive on Biotechnology.

A recent OECD workshop* reaffirmed that patents and licenses for genetic inventions are critical for the development of new therapeutics. They also turn inventions into tradable commodities which has helped give rise to thousands of biotechnology firms, making the biopharmaceutical industries more efficient and dynamic. Nor has the growth of patents created the barrier to research and development in the industry that many feared would happen given the number and complexity of biotechnology patents since the start of the 1990s.

Still, licensing practices are sometimes found wanting, OECD experts agreed. Public health services continue to find access to genetic tests far too costly and restrictive. However, most are convinced that patents themselves are not the problem. True, some companies take a predatory approach to patent licensing, and this area could be improved.

That means finding best practice guidelines for licensing and diffusion. The message from the experts in the Berlin workshop was clear: To blame patents would be to throw the baby out with the bath water. ■

* *Genetic Inventions, Intellectual Property Rights, and Licensing Practices, OECD workshop, 24-25 January 2002, Berlin. For more information, contact Benedicte.Callan@oecd.org, or see: www.oecd.org/biotechnology*

Slovenia signs investment declaration

Slovenia has been invited to adhere to the OECD Declaration on International Investment and Multinational Enterprises, in recognition of its success in establishing a stable and non-discriminatory business environment, and has accepted the invitation.

The Declaration promotes equally favourable treatment for foreign and domestic investors by the host government and promotes a set of voluntary standards of appropriate business conduct for multinational enterprises.

Since gaining independence in 1991, Slovenia has managed a dual transition from a socialist to an open-market system of government and from a regional to a national economy.

It has an open and generally non-discriminatory regime for foreign direct investment (FDI) with a current FDI stock estimated at US$33 billion.

Slovenia is also becoming a significant investor in its own right in the southeast Europe region. A new OECD review of Slovenia's FDI policies stresses the importance of pursuing liberalisation and recommends further progress in reducing administrative barriers.

Slovenia will be the sixth non-OECD country to adhere to the declaration after Argentina, Brazil, Chile, Estonia and Lithuania. ■

- *Investment Policy Reviews: Slovenia*, OECD, 2001.

Top 10 online sellers

The top 10 bestsellers from the OECD online bookshop in 2001 (www.oecd.org/bookshop):

1. **The World Economy: A Millennial Perspective, by Angus Maddison**
2. **Education at a Glance: OECD Indicators, 2001 edition**
3. **The Well-Being of Nations: The Role of Human and Social Capital**
4. **Knowledge and Skills for Life: First Results from Pisa 2000**
5. **OECD Communications Outlook: 2001 edition**
6. **Education Policy Analysis: 2001 edition**
7. **Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (travel version)**
8. **OECD Employment Outlook: June 2001**
9. **Model Tax Convention on Income and on Capital; Vol I & II**
10. **OECD Science, Technology and Industry Scoreboard: Towards a Knowledge-Based Economy, 2001 edition**

Take Africa's outlook more seriously

"What we have to fight against is a company judging the whole of Africa by what is happening in a single country," OECD Development Centre president, Jorge Braga de Macedo, told a news conference after the third International Forum on African Perspectives at the OECD in Paris in early February.

Senegal's president, Abdoulaye Wade, the first African president to take part in a meeting at the OECD, urged investors at the meeting to take a new – and more informed – look at Africa.

President Wade said that it was time for "a new approach, a regional approach" but one that recognised African countries are changing. "African countries increasingly offer the conditions of good governance," he said.

To help potential investors get a better idea of African possibilities, the OECD Development Centre and African Development Bank have released the first *African Economic Outlook* report, which offers both an overview of the region and the individual economic, social and political situations of 22 African countries.

The *Outlook* offers a portrait of the economic, political and social situation and prospects for each country. It also includes comparative data for the 22 countries, ranging from economic growth to perceptions of corruption and incidences of conflict. The report sees real GDP growth for the 22 at 3.3% in 2002, down from 3.5% in 2001, ranging from 50.7% in Equatorial Guinea to a slight decline of 0.3% in Gabon.

©OECD PHOTO/Jacques Brinon

Abdoulaye Wade, president of Senegal (left), talking with Omar Kabbaj, president, African Development Bank

One of the key words to emerge at the first International Forum on African Perspectives in February 2000 was "Afro-positive", a term coined by Jean-Louis Terrier, the chairman of Credit Risk International.

The OECD's new outlook may help to spread a clearer, healthier view of the real positive potential that Africa's countries and regions hold. ■

- *African Economic Outlook* is available from the online bookshop at www.oecd.org/bookshop

Talking telecoms

The challenges and advantages of competition in the telecommunications sector, notably the role it can play in reducing the digital divide, were high on the agenda at an OECD conference on telecoms policy for the digital economy in Dubai in January 2002. The conference of regulators and representatives of business, civil society and international organisations from OECD and non-OECD countries, stressed the importance of introducing competition and raised awareness among participants of the need for reforms of telecom regulation.

OECD countries' experience in liberalising their telecom markets has provided significant benefits for business and consumers and has enhanced productivity and economic growth, the conference was told.

Philip Sayer, head of Vendor Relationships and Communications with the media agency, Reuters Ltd, which spends more than US$500 million on telecoms a year worldwide, said that competition results in lower prices, better services and better availability of new technology. He noted that regulatory issues, lack of suitable services and high prices had held back growth of its information services over the past 25 years. Reducing leased line and broadband access costs, for instance, would trigger additional sales of telecom services and encourage the growth of e-commerce and inward investment, Mr Sayer said.

Competition also brings benefits to most consumers in terms of lower prices, more choice and better service, but competition policy traditionally pays too much attention to supply side concerns and should be more focussed on consumers' needs, said Michelle Childs, head of policy research with the Consumers' Association in Britain.

India's minister of state for communications, Tapan Sikdar, said his country's experience of telecom liberalisation was a win-win situation for customers, the industry and government, with lower prices and increased availability. ■

- For the final statement from the conference and presentations by speakers: www.oecd.org/ecommerce

Calendar of forthcoming events

Please note that many of the meetings mentioned are not open to the public or the media and are listed as a guide only. All meetings are in Paris unless otherwise stated. For further information, consult the OECD website at http://www.oecd.org/, under "Key upcoming events", which is updated weekly.

JANUARY – Some highlights

21-22 **Telecommunications Policy for the Digital Economy**, conference organised by the Directorate for Science, Science, Technology and Industry (STI). Dubai, United Arab Emirates.

28-30 **Food Safety Regulators**, global forum organised by the Food and Agriculture Organization of the United Nations and the World Health Organization. Marrakech, Morocco. Participants include OECD, UNEP, UNICEF, WTO and World Bank.

30-1 Feb **Financial Action Task Force (FATF)**, plenary meeting to discuss programme of work on money laundering and analyse the self-assessment of all FATF members against the special recommendations designed to deny terrorists and their supporters access to the international financial system. Hong Kong, China.

FEBRUARY

4-5 **Outlook for African Economic Development**, 3rd International Forum on African Perspectives, organised by the Development Centre in co-operation with the African Development Bank. Presentation of the book, *African Economic Outlook*, with the participation of Senegal president Abdoulaye Wade.

4-5 **Migration and the Labour Market in Asia**, workshop organised by the Directorate for Education, Employment, Labour and Social Affairs (ELS) and the Centre for Co-operation with Non-Members (CCNM). Tokyo, Japan.

7-8 **Foreign Direct Investment and Environment in the Mining and Forestry Sectors**, conference organised by the Environment Directorate (ENV), CCNM, and the Directorate for Financial, Fiscal and Enterprise Affairs (DAF).

7-8 **The Steel Industry**, special high-level meeting organised by the STI, third meeting convened to address long-term issues and objectives aimed at reducing over-capacity in the steel sector.

11 **Uses and Limits of Sustainable Development Indicators**, meeting of trade union experts within the framework of the OECD Labour/Management Programme.

14-15 **Global Forum on Competition**, second meeting of high-level competition officials from over 60 jurisdictions around the world, organised by the Directorate for Financial, Fiscal and Enterprise Affairs (DAF).

18-20 **Advanced Nuclear Reactor Safety Issues and Research Needs**, workshop organised by the OECD Nuclear Energy Agency.

27-28 **ODA and Private Finance: Attracting Finance and Investment to Developing Countries**, Development Assistance Committee (DAC)/Development Partnerships Forum.

MARCH

1 **Sustainable Development**: "Improving the Synergies between Official Development Assistance and Foreign Direct Investment to Developing Countries", roundtable organised by the OECD.

4-5 **The Inland Waterways of Tomorrow in Europe**, seminar organised by the European Conference of Ministers of Transport (ECMT).

5-6 **Shipbuilding industry**, a hearing organised by STI and the OECD Council Working Party on Shipbuilding. Dialogue between governments and industry representatives to explore possibilities to bring about more competitive conditions in world shipbuilding.

7-8 **Impact of 11 September events on maritime transport economies**, ad-hoc working group meeting organised by the Maritime Transport Committee.

15-16 **European Council Summit**. Barcelona, Spain.

16-20 **Biotechnology and Sustainable Development**, conference organised by the World Bank, OECD and UNESCO. Alexandria, Egypt.

18-22 **Financing for Development**, conference organised by the United Nations. Monterrey, Mexico.

21 **Combating Crime in Transport**, meeting organised by ECMT.

24-25 **China Development Forum 2002**. "Taking its Place in the International Economy: China's Domestic Adjustment After WTO Accession", forum organised by the Development Research Centre of the State Council of the People's Republic of China. Beijing, China.

26 **China in the World Economy: the Domestic Policy Challenges**. Seminar presenting the OECD report, organised jointly by CCNM and the Development Research Centre of the State Council of the People's Republic of China. Beijing, China.

APRIL

8-12 **Building a Society for All Ages**, meeting of the UN World Assembly on Ageing. Madrid, Spain.

11-12 **Vandalism and Security in Urban Public Passenger Transport**, roundtable organised by ECMT.

18-19 **The Steel Industry**, special high-level meeting organised by STI, fourth meeting convened to address long-term issues and objectives aimed at reducing over-capacity in the steel sector.

21-22 **International Monetary Fund and the World Bank Group**, annual spring meeting. Washington, DC.

25 OECD *Economic Outlook* **No. 71** published.

25-27 **G8 Ministers of Labour and Employment** meet in Montreal, Canada.

MAY

13-15 **Taking care of the fundamentals: Security, Equity, Education and Growth, OECD Forum 2002**, a global gathering of senior figures from governments, business, academia and civil society.

15-16 **OECD Council Meeting at Ministerial level**, annual meeting of foreign affairs, finance, economy and trade ministers.

19-20 **European Bank for Reconstruction and Development**, annual meeting and business forum. London, UK.

28-31 **Industrial Reconversion Initiatives by Civil Society**, international symposium organised by ARUC-Economie Sociale and the Société de développement Angus, with participation of the OECD. Montreal, Canada.

29 **ECMT Council of Ministers**.

30-31 **Corporate Governance**, 2nd South East Europe roundtable organised by CCNM/DAF. Istanbul, Turkey.

JUNE

10-13 **World Food Summit: Five Years Later.** Organised by the Food and Agriculture Organization of the United Nations. Rome, Italy.

26-28 **G8 Summit**. Kananaskis, Alberta, Canada.

AUGUST – SEPTEMBER

26/8 - 4/9 **Sustainable Development**, Johannesburg World Summit 2002.

OCTOBER

1-2 **International Monetary Fund and the World Bank Group**, annual meeting. Washington, DC.

3 **Public Administrations in the European Union: Innovation, Change and Partnerships**, conference organised by the Danish Ministry of Finance. Copenhagen, Denmark.

Women on the move

Trends in International Migration, SOPEMI Report 2001

Women have traditionally been the "trailing spouse" when it comes to leaving their country.

The latest report on *Trends in International Migration* suggests that this may be changing. More women are migrating, and not necessarily to follow their hearts or their husbands' pay cheques.

The report discusses the whole range of immigration topics, of course, including immigrants and the labour force and national policies on illegal immigration.

A spotlight on student mobility notes that more students are studying abroad as part of the general globalisation process, as language skills and cross-cultural experience become job qualifications.

The overall movement of skilled workers between countries is accelerating, thanks to better job prospects and the easing of entry requirements for certain categories of workers (see article by Mario Cervantes in this edition).

Retired people get a mention, too: easier transfers of pensions and the coming retirement of the baby-boom generation are likely to spur the trend toward the increasing mobility of retired expatriates.

Although re-uniting with other family members is still the most common motive for female migration, an increasing proportion of women is settling in other countries for work or because they are refugees.

In some non-Asian OECD countries, foreign women are employed in increasing numbers, especially in the health sector and household services. These women are largely from the Philippines, Indonesia, Peru, some countries in Central and Eastern Europe, and to a lesser degree from Sri Lanka and Thailand.

A growing practice that concerns OECD countries is the trafficking in women from developing and transition countries. Organised prostitution networks and illicit immigration rackets are at the root of a modern form of slavery, affecting women in particular. ■

Better trains


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What Role for the Railways in Eastern Europe?

Except for the high-speed networks, there are few, if any, examples of successful state-run rail services in Europe. Deregulation has not proved a panacea either.

The privatisation of British Rail created a morass of operational knots that the government is now trying to sort out amid public outcry over safety and punctuality. The Dutch have put the brakes on privatising their own system amid fears of similar problems.

So what can transition economies learn from advanced ones when it comes to restructuring their railway systems? *What Role for the Railways in Eastern Europe?* offers some basic guidelines.

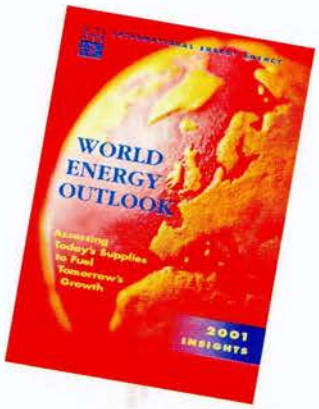
Competition from private cars poses one problem – the rate of car ownership per 1 000 inhabitants is rising steadily in eastern Europe and is already close to western European levels. Air transport is becoming more competitive, and the steady decline of heavy industry in these countries means less income from freight transport. Priorities will have to be drawn to decide which services railways should focus on – passenger or freight, local or international.

For the moment, per-passenger railway subsidies in western Europe are 15-20 times higher than in the east. Rail's advantage is that urban sprawl in these countries is not extensive and residential densities are high. This favours an "open access" approach, that is, to focus on expansion on an international level, in particular for freight transport. More than 50% of the freight revenues of the German and French rail services are from international traffic.

Also, given that rail transport is more technology-driven than labour-driven, investing in high-tech improvements could make existing infrastructures quickly competitive. But problems need to be resolved at border crossing points and in dealing with environmental concerns.

It is clearly in the interest of all countries to learn from past experience, and work together to create rail systems that improve efficiency, reduce accidents and – of course – make the trains run on time. ■

Fuel as usual



World Energy Outlook: Assessing Today's Supplies to Fuel Tomorrow's Growth

When electricity shortages blacked out much of California last year, those countries and industries investing in wind and solar-powered energy must have felt a glow of excitement. After the lights came back on, energy experts were boldly predicting that the solar power industry would double its profits by 2005. Nevertheless, according to the latest *World Energy Outlook*, while its potential is huge, the share of alternative energy sources in the global energy mix is expected to remain small over the next 20 years.

Part of the challenge for developing renewable energy sources is that oil, gas, coal and uranium are more than adequate to meet demand for decades to come, even if it means massive investments in both production and transportation infrastructure. Besides, renewables are still expensive compared with fossil-fuel alternatives. Bioenergy is close to the same cost as coal and gas, but wind is double, and solar is roughly 20 times more expensive.

Hydropower is by far the largest source of renewable electricity in OECD countries. It made up 14% of OECD total electricity generation and 87% of its renewable electricity in 1999. In the future, developing countries will account for 80% of projected increases in hydroelectricity, three-quarters of it in China and Latin America.

Surprisingly, world energy intensity – primary energy demand in relation to GDP – is expected to decline by 1.1% a year between now and 2020; oil is expected to remain the dominant fuel in the primary energy mix with a share of 40% in 2020, almost identical to its share today. This, despite the forecast by the *Outlook* that energy-related CO2 emissions in 2010 will still be too high to meet commitments under the Kyoto Protocol.

A number of technologies under consideration or active development could radically alter the long-term supply picture. The main focus of current research on new technologies is on hydrogen production and use, in which renewable solar and wind generators might be used to produce pure hydrogen fuel out of water. According to the *San Francisco Chronicle*, "if a practical hydrogen storage system can be perfected, and if fuel cells can ever be mass-produced cheaply enough, today's utility customers would have electricity in a stable, portable form capable of being used whenever needed". But for the moment, that's only California dreamin'. ■

Trading up

Towards Arab and Euro-Med Regional Integration

Countries in Europe and the southern Mediterranean have been forging financial ties that will hopefully stimulate good relations as well as open markets on both sides of the sea.

A promising trend in creating such partnerships is the proliferation of free trade agreements between states in the Middle East and North Africa and the European Union since 1993.

Tunisia, Morocco, Israel, Jordan and the Palestinian Authority have all signed bilateral Free Trade Agreements with the EU. And Algeria, Egypt, Lebanon and Syria are involved in similar negotiations.

There have also been renewed efforts to liberalise trade at the intra-regional level through the Greater Arab Free Trade Area (GAFTA), initiated in 1997.

In addition to removing trade barriers on industrial goods, these agreements will ultimately grant preferential and reciprocal access for agricultural products, and establish conditions for the gradual liberalisation of trade in services and capital.

However, these agreements have profound implications for Arab states in the region.

The Southern Mediterranean countries generally view progress in European integration with some disquiet, as they fear being left aside.

But as the EU is by far the main trading partner of the southern Mediterranean countries, these countries could seize the opportunity for instance, to use the euro for their international currency transactions.

Poverty reduction through economic growth has become a more urgent shared objective, and may be another potential long-term benefit from fuller Euro-Med and Arab integration.

Therefore, in negotiating free trade agreements the EU must strive to make them as equitable as possible so that integration may prove to be a more popular word than globalisation. ■

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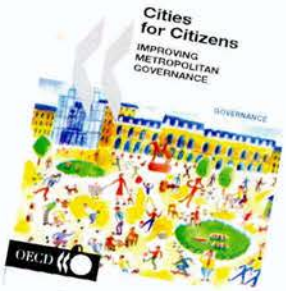


Cities for Citizens: Improving Metropolitan Governance

In the distressed Athens neighbourhood of Perama, efforts at economic and social improvement were somewhat undermined because leaders omitted to explain their plans to residents.
In Canada, various local, regional and community interests converged, transforming metropolitan Toronto and its six local governments into a single, unified Toronto which is deemed better equipped to meet the needs of a diverse population of around 2.5 million people.

The two cities are on different sides of the world but, as *Cities for Citizens* argues, they share the same objective: to be economically resilient while providing services conducive to a high quality of life for their inhabitants.
Metropolitan governments around the world have become players on the world economic stage because of changes wrought by globalisation and technology – and must adapt their approach to governance to keep pace and remain relevant in the face of rapid social and economic developments.

Other factors that are putting metropolitan governments under pressure are population growth – particularly in developing countries; urban and suburban sprawl; aging societies; environmental concerns and a transition to a knowledge-based economy.

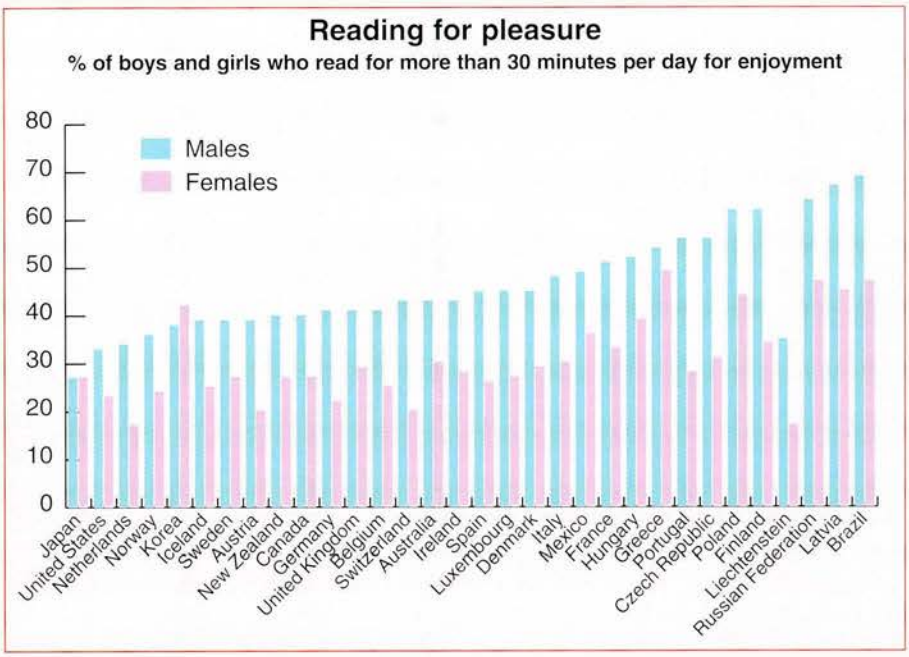
"In a world where the participation of business and civil society is increasingly the norm, the term 'governance' better defines the process by which citizens collectively solve their problems and meet society's needs, using 'government' as the instrument", the report states.

No longer is the hierarchical, top-down approach to governing effective in achieving these goals. This new environment demands a horizontal style of governance that includes partners across a wide spectrum – national, local and regional government, private and public sector, and civil society. Other factors include the use of new technologies, strategic planning, local delivery of services, social inclusiveness, and economic and human development.

As the report indicates, this is a difficult undertaking for OECD countries and non-member countries alike, and there is no one ideal model. Of course, there are drawbacks, too, which are addressed, along with past experiments, including successes and failures. But good metropolitan governance is achievable in large part through commitment, co-operation, inclusiveness, innovation, financing and reform. ■

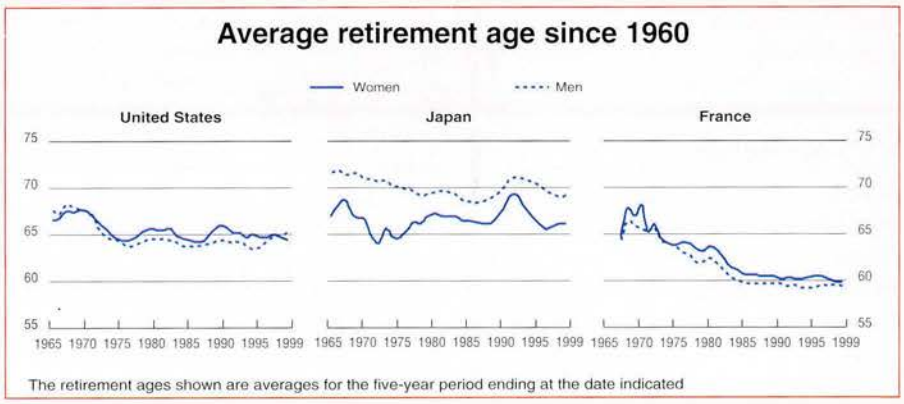
Girls read more than boys

Girls have overtaken boys in the literacy stakes when it comes to reading, both in their ability to understand what they read and in their tendency to read for pleasure. More girls than boys spend at least 30 minutes a day reading for pleasure in all OECD countries with the exception of Korea, according to *Knowledge and Skills for Life: First Results from PISA 2000* (see article by Donald Hirsch). Brazilian girls are the most avid readers, with almost 70% of them spending more than half an hour a day reading for pleasure. And the most reluctant bookworms are boys in the Netherlands and Liechtenstein, where less than 20% read for pleasure. On average across OECD countries, 46% of boys said they read only if they had to, compared with just 26% of girls. Magazines and newspapers top the list for both boys and girls, with fiction the second most popular choice for girls and comic books for boys. The PISA study of education and knowledge levels of 15-year-old students across the OECD found that while girls have generally narrowed the gap with boys in terms of overall educational achievement in the past 30 years, they remain behind in mathematical literacy and also, though to a lesser extent, in science. But the main concern is about the underachievement of boys. When it comes to reading, males in all OECD countries are more likely than females to be among the lowest-performing students. And in all countries except Korea, girls are over-represented in the more demanding upper secondary programmes preparing for entry to university. ■



- For more on PISA, see article by Donald Hirsch in the Society section (page 37) and visit: www.pisa.oecd.org

When I'm 64...



"Will you still need me, will you still feed me, when I'm 64" are the words of a pop song by The Beatles from the 1960s, an era when retirement was just around the corner at that age for most people. Written today and the song may have been different, as retirement ages vary so much. In Japan, for instance, it might have been "when I'm 69", even if the average retirement age for men has dropped slightly since the 1960s, when it was over 70. But while the song may ring more or less true for France's statutory retirement age, in practice, the average Frenchman hangs up his work *bottes* at just 59. Average retirement ages have fallen since the 1960s in several OECD countries, but the trend over the past 20 years is far less clear. If retirement ages for men fell in eight countries between 1983 and 1999, they rose in eight others. For women during the same period, retirement ages rose in six countries, but fell in nine. The result is that the average retirement age in OECD countries changed little between 1983-88 and 1994-99, at close to 62 for both men and women, although women were retiring slightly earlier than before and men slightly later. Maybe the Beatles' song would not be that much out of place today after all. ■

- *Society at a Glance*, OECD, 2001.

MEMBERS	Gross Domestic Product period	% change from previous period	year	Leading Indicator period	% change from previous period	year	Consumer Price Index period	% change from previous period	year
Australia	Q3 01	1.1	2.5	Nov. 01	-0.1	7.5	Q3 01	0.3	2.5
Austria	Q3 01	-0.1	0.8	Oct. 01	-1.3	-5.6	Nov. 01	-0.2	1.8
Belgium	Q2 01	-0.5	1.6	Nov. 01	-0.5	-8.5	Dec. 01	-0.2	2.2
Canada	Q3 01	-0.2	0.8	Nov. 01	2.5	0.7	Nov. 01	-0.9	0.7
Czech Republic	Q3 01	..	3.2		..	..	Dec. 01	0.1	4.2
Denmark	Q3 01	0.9	1.5	Nov. 01	0.6	1.1	Nov. 01	-0.2	1.9
Finland	Q3 01	1.2	0.0	July 01	2.3	-14.8	Nov. 01	-0.4	1.6
France	Q3 01	0.5	2.0	Nov. 01	1.1	-5.2	Dec. 01	0.1	1.4
Germany	Q3 01	-0.1	0.4	Nov. 01	0.2	-8.4	Nov. 01	-0.2	1.7
Greece	2000	..	4.3	Nov. 01	-1.3	-0.4	Nov. 01	0.1	2.4
Hungary	2000	..	5.2		..	..	Nov. 01	0.1	7.1
Iceland	2000	..	5.0		..	..	Nov. 01	0.3	8.1
Ireland	2000	..	11.5	Nov. 01	4.5	-6.8	Nov. 01	-0.1	3.8
Italy	Q3 01	0.2	1.9	Nov. 01	1.3	-0.1	Dec. 01	0.1	2.4
Japan	Q3 01	-0.5	-0.5	Nov. 01	0.4	-2.5	Nov. 01	-0.5	-1.0
Korea	Q3 01	1.2	1.6		..	..	Dec. 01	0.2	3.2
Luxembourg	2000	..	7.5	Nov. 01	-0.1	-11.8	Nov. 01	0.1	2.1
Mexico	Q3 01	-0.3	-1.6	Oct. 01	0.8	2.7	Nov. 01	0.4	5.4
Netherlands	Q3 01	-0.4	0.4	Nov. 01	-0.7	-2.9	Nov. 01	-0.2	4.2
New Zealand	Q3 01	0.7	2.1		..	..	Q3 01	0.6	2.4
Norway	Q3 01	0.9	1.9	Aug. 01	-0.6	-4.4	Dec. 01	0.2	2.1
Poland	2000	..	4.0		..	..	Nov. 01	0.1	3.6
Portugal	Q2 01	0.4	2.5	Nov. 01	0.8	-0.9	Nov. 01	0.6	3.9
Slovak Republic	Q2 01	..	2.8		..	..	Nov. 01	-0.1	6.5
Spain	Q3 01	0.3	2.8	Nov. 01	-0.4	-1.1	Nov. 01	-0.1	2.7
Sweden	Q3 01	0.1	0.6	Nov. 01	0.8	-4.6	Nov. 01	0.0	2.5
Switzerland	Q3 01	0.0	1.2	Nov. 01	-0.3	-4.0	Dec. 01	0.0	0.3
Turkey	Q3 01	..	-7.1		..	..	Dec. 01	3.2	68.5
United Kingdom	Q3 01	0.5	2.2	Nov. 01	-0.3	-2.3	Nov. 01	-0.4	0.9
United States	Q3 01	-0.3	0.5	Nov. 01	1.8	-5.7	Nov. 01	-0.2	1.9
Euro zone	Q3 01	0.1	1.3	Nov. 01	0.6	-4.7	Nov. 01	-0.1	2.0
NON-MEMBERS									
Brazil		..	..		..	..	Nov. 01	0.7	7.6
Bulgaria	Q2 01	2.5	5.0	Oct. 01	2.2	-10.2	Nov. 01	0.2	4.6
China		..	..		..	..		..	..
Estonia	Q3 01	0.9	5.0	Oct. 01	-1.1	12.3	Dec. 01	0.2	4.2
Indonesia	Q3 01	-0.9	3.6		..	..	Dec. 01	1.6	12.5
Latvia	Q2 01	1.6	9.3	Oct. 01	-4.1	-0.1	Nov. 01	0.2	3.1
Lithuania	Q3 01	1.0	5.2	Oct. 01	3.6	1.2	Nov. 01	0.0	1.9
Romania		..	..		..	..	Oct. 01	2.4	29.3
Russian Federation		..	..	July 01	5.3	17.2	Oct. 01	1.1	18.9
Slovenia	Q3 01	0.7	3.3		..	..	Nov. 01	0.4	6.9
Ukraine		..	..	Oct. 01	2.2	12.5	Dec. 01	1.6	6.1

Definitions & notes

Gross Domestic Product: Volume series; seasonally adjusted except for Czech Republic, Slovak Republic, Poland and Turkey. Data for the Euro zone supplied by Eurostat.

Leading Indicators: A composite indicator based on other indicators of economic activity (qualitative opinions on production or employment, housing permits, financial or monetary series,etc.), which signals cyclical movements in industrial production from six to nine months in advance.

Current balance: Billion US dollars; seasonally adjusted except for Greece, Ireland, Brazil, Bulgaria, China, Estonia, Indonesia, Latvia, Lithuania, Romania, Russian Federation, Slovenia and Ukraine. Data for Poland are on a cash basis.

Current Balance			Unemployment Rate			Interest Rate			
period	current period	same period last year	*period*	current period	same period last year	*period*	current period	same period last year	MEMBERS
Q3 01	-1.47	-2.88	*Nov. 01*	6.7	6.3	*Nov. 01*	4.28	6.33	Australia
Q2 01	-1.58	-0.93	*Nov. 01*	4.0	3.6	*	..	..	Austria
Q3 01	2.96	1.93	*Nov. 01*	7.0	6.8	*	..	..	Belgium
Q3 01	3.58	4.65	*Nov. 01*	7.5	6.9	*Dec. 01*	2.10	5.74	Canada
Q3 01	-0.53	-0.50	*Q3 01*	8.4	8.7	*Dec. 01*	4.69	5.42	Czech Republic
Q3 01	1.16	0.94	*Oct. 01*	4.4	4.8	*Nov. 01*	3.54	5.41	Denmark
Oct. 01	1.10	0.82	*Nov. 01*	9.2	9.4	*	..	..	Finland
Sept. 01	1.64	0.67	*Nov. 01*	9.2	9.1	*	..	..	France
Q3 01	4.72	-4.97	*Nov. 01*	8.0	7.7	*	..	..	Germany
Oct. 01	-1.65	-0.68		..	..	*	..	..	Greece
Oct. 01	-0.03	-0.12	*Q3 01*	5.6	6.4	*Nov. 01*	10.22	11.80	Hungary
Q2 01	-0.08	-0.22	*Nov. 01*	1.6	1.2	*Nov. 01*	10.18	11.75	Iceland
Q2 01	0.15	0.40	*Nov. 01*	4.1	3.9	*	..	..	Ireland
July 01	-0.28	-0.15	*Oct. 01*	9.3	10.0	*	..	..	Italy
Oct. 01	9.84	9.08	*Nov. 01*	5.4	4.8	*Dec. 01*	0.05	0.58	Japan
Nov. 01	0.81	1.21	*Dec. 01*	3.3	3.9	*Nov. 01*	4.50	7.00	Korea
Q2 01	0.16	0.32	*Nov. 01*	2.5	2.4	*	..	..	Luxembourg
Q3 01	-3.46	-3.85	*Nov. 01*	2.6	2.2	*Dec. 01*	7.53	17.41	Mexico
Q3 01	2.86	-1.06	*Oct. 01*	2.2	2.8	*	..	..	Netherlands
Q3 01	-0.28	-0.57	*Q3 01*	5.2	5.9	*Dec. 01*	4.86	6.71	New Zealand
Q3 01	6.25	6.39	*Q3 01*	3.6	3.4	*Nov. 01*	6.90	7.43	Norway
Sept. 01	-0.27	-0.64	*Nov. 01*	17.1	14.8	*Dec. 01*	11.06	16.81	Poland
Q3 01	-3.04	-2.61	*Nov. 01*	4.2	4.0	*	..	..	Portugal
Q2 01	-0.40	-0.03	*Q3 01*	19.0	18.5	*Oct. 01*	8.70	10.90	Slovak Republic
Sept. 01	-0.94	-1.28	*Nov. 01*	13.0	13.6	*	..	..	Spain
Oct. 01	0.42	1.06	*Nov. 01*	5.0	5.4	*Dec. 01*	3.71	4.07	Sweden
Q3 01	5.13	7.42	*Nov. 01*	2.1	1.8	*Nov. 01*	1.96	3.45	Switzerland
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Q3 01	-94.98	-115.31	*Nov. 01*	5.6	4.0	*Dec. 01*	1.83	6.45	United States
Oct. 01	-0.09	-5.12	*Nov. 01*	8.5	8.6	*Dec. 01*	3.34	4.93	Euro zone
									NON-MEMBERS
Nov. 01	-1.59	-2.53		..	..		..	..	Brazil
Oct. 01	-0.12	-0.13		..	..	*Dec. 01*	4.65	4.63	Bulgaria
2000	20.52	15.67		..	..		..	..	China
Q3 01	-0.08	-0.05	*Sept. 01*	6.8	5.3	*Nov. 01*	5.67	7.01	Estonia
	..	..		..	..	*Dec. 01*	17.06	13.24	Indonesia
Q2 01	-0.12	-0.12	*Nov. 01*	7.8	8.0	*Nov. 01*	9.30	13.60	Latvia
Q3 01	-0.01	-0.11	*Nov. 01*	12.8	12.3	*Nov. 01*	8.65	11.92	Lithuania
Sept. 01	0.01	-0.03	*Oct. 01*	8.2	10.9	*Oct. 01*	36.40	49.50	Romania
Q3 01	7.58	10.54	*Oct. 01*	1.5	1.4	*Sept. 01*	7.50	11.40	Russian Federation
Sept. 01	0.04	0.02	*Aug. 01*	11.1	11.7	*Nov. 01*	9.73	10.58	Slovenia
Q3 00	1.30	0.32	*Sept. 01*	4.7	5.3	*Oct. 01*	30.50	39.00	Ukraine

Unemployment Rate: Percent of civilian labour force — standardised unemployment rate; national definitions for Iceland, Korea, Mexico, Poland, Switzerland and Turkey; seasonally adjusted apart from the Slovak Republic and Turkey.

Consumer Price Index: Measures changes in average retail prices of a fixed basket of goods and services. HICP for Euro zone including Greece.
Interest Rate: Three months, except for Turkey (overnight interbank rate).

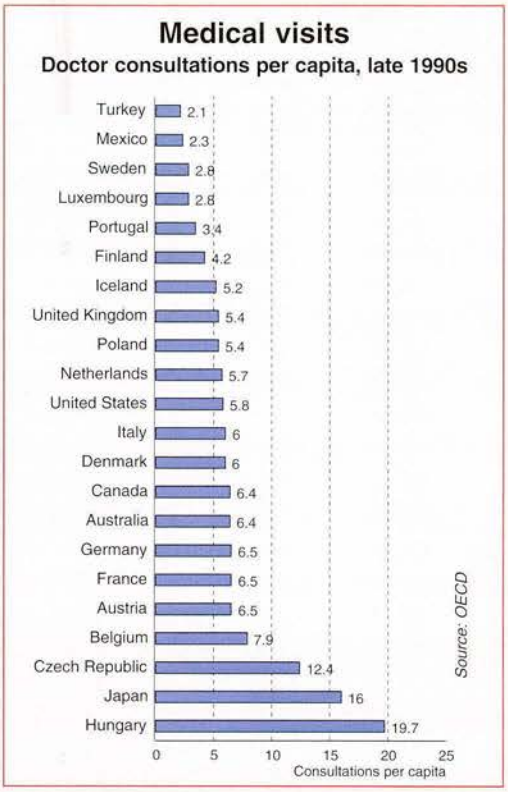
* Refer to Euro zone.

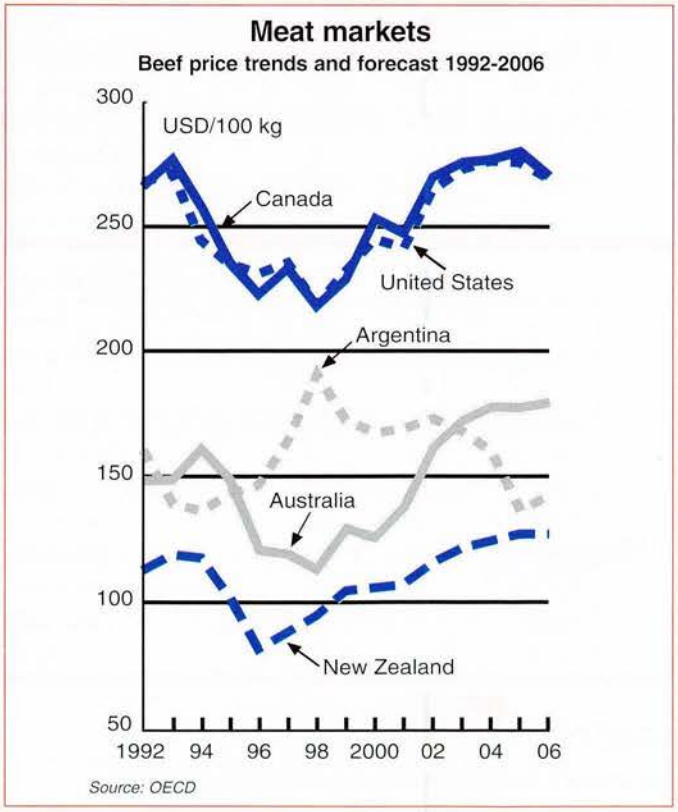
Source: Main Economic Indicators, January 2002; Quarterly National Accounts database.

Doctor, Doctor

Hungarians were consulting their doctors on average almost 20 times a year in the late 1990s, a 79% increase from the frequency in 1980, making them the heaviest users of medical services in the OECD. Hungarians were also among the most likely to be admitted to hospital, with 237.5 admissions per 1,000 population in the late 1990s, second only to Austria (286.3) and Finland (265), according to the latest *Health at a Glance* study. Turks increased their visits to the doctor by 67% over the same period, but were still the least likely OECD residents to call the doctor, with an average 2.1 visits per head of population per year. They were also among the least likely to be admitted to hospital, with 73.9 admissions per 1,000 population. The average number of medical consultations across 18 OECD countries in 1997 was around seven per year. The range cannot simply be explained by the number of doctors available in each case – the number of physicians per 1,000 population increased by between 30% and 40% in both Poland and Hungary over the period, although the ratio of consultations fell by 18% in Poland. On average, across the OECD the rate of increase in consultations has been slower than the growth rate in the number of physicians. Whether consultations are getting longer or doctors are working shorter hours is not clear, since the numbers combine part-time and full-time doctors. ■

- *Health at a Glance*, OECD, 2001. For more on healthcare, see also http://www.oecdobserver.org/healthcare





Where's the beef?

The traditional split in the world beef market between Pacific and Atlantic producers is likely to become blurred over the next few years as an increasing number of Latin American countries secure foot and mouth disease-free status under WTO rules, the *OECD Agricultural Outlook 2001-2006* said. The world market is instead developing a new segmentation according to consumer and processor preferences for grain-fed or grass-fed beef. Strong demand for grain-fed beef, particularly in Japan and Korea, should favour higher exports from the United States and Canada. This is also encouraging traditional grass-fed producers in places like Australia and Argentina to farm grain-fed herds. Beef prices are expected to strengthen in the Pacific market up to 2004, but to weaken in subsequent years as production and exports increase. The outlook for the EU beef sector remains extremely uncertain because of the continuing impact of the BSE (mad cow) crisis. Trends in beef markets could change if Latin American countries increase their access to Asia-Pacific markets more rapidly than expected. This would increase competition for Australia's exports of grass-fed beef to the region; both exporters already produce the same type of meat at fairly similar prices. Argentina has been exporting beef to Chinese Taipei since 1999 and had a market share of an estimated 8% in 2000. ■

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