CONFIDENTIAL

MINISTERIAL CONFERENCE ON

THE LONGER-TERM PERFORMANCE OF OECD ECONOMIES: CHALLENGES FACING GOVERNMENTS

13 th - 14 th February, 1984

NOTE
BY THE SECRETARY-GENERAL

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0.1 This paper takes a step back from today's settings for today's policy instruments to examine how economic policies affect the structure, and hence the longer-term performance, of OECD economies. High unemployment and rising public sector debt set the context in which economies must be able to adjust to continuing rapid but uncertain changes in technology and trade. Four features of economic structure are singled out as likely to encourage successful adaptation: a stable and non-inflationary policy environment; sufficient flexibility to maintain both efficiency and high employment in the provision of public and private goods and services; an open world system of trade and finance to increase and distribute the gains from new technologies; and a high degree of social consensus. The latter is not only good in its own right, but is necessary to maintain economic flexibility and political stability.

0.2 There are two compelling reasons why now is the right time to bring these issues to the front of the stage. First, the experience of the 1970s – the "school of hard shocks" – provides a compelling reminder that sustained improvement in living standards requires not only a continuing adaptation to continuous change, but also the flexibility to adjust to sudden shocks, nationally and internationally. Second, many government programmes and policies are already in the process of being cut back, reformed, or replaced, under the twin pressures of budgetary imperatives and structural change.

0.3 Thus, the time is ripe for trying to approach a wide range of policy issues in a consistent way, to ensure that government cutbacks are well placed, and that policies and programmes are coherent in their approach to government, to the private sector, and to the world economy. Both market and governmental processes are prone to failure in some degree because they have to deal with an uncertain future. Perhaps the most basic challenge for governments is to find ways to harness political and economic forces to produce social and economic structures robust enough to cope satisfactorily with a rapidly changing environment.

0.4 For the public sector, the challenge is to limit and scale down the costs of public services, and to maintain a stable policy environment, while improving the ability to achieve social and economic objectives. For the private sector, which for this discussion comprises all business enterprises – including those owned or regulated by governments – the challenge is to achieve and maintain sufficient flexibility to ensure that changes are seen as opportunities rather than threats. These objectives are mutually reinforcing, since a stable and efficient public sector makes less claim on the resources of the private sector, helping to reduce costs and maintain incentives to work, to save, to invest, and to innovate. Similarly, a more flexible and innovative private sector generates jobs and investment more robustly, lessening the transfer load and financing requirements of the public sector.

0.5 A national economy that is flexible and efficient stands to gain more from the changing opportunities offered by open world markets, and is likely to have a bigger stake in improving the international framework for trade and investment. In the reverse direction, economies that are more open to world markets need to be capable of absorbing inevitable shocks. If this is well understood, then domestic political forces are more likely to embrace adaptability, and to reject rigidity. Flexibility and openness are thus mutually reinforcing. But they are also threatened in the same way when things go wrong. Political forces, policies or administrative structures that reduce flexibility, whether of domestic or world markets, reduce the benefits which the open system can bring, and conversely.

0.6 Consistent domestic policies to improve responsiveness require a high degree of consensus if they are to work. Consensus requires the costs of change to be shared in a manner that is widely perceived to be equitable. This in turn requires, among other things, the maintenance of the basic "safety net" policies of the welfare state.

0.7 There are three main parts to the paper. All are concerned with government policies to achieve social objectives in a flexible, efficient and equitable manner, and to provide a stable environment for sustained and non-inflationary economic growth. The first part deals with the public sector itself, the second with employment, investment and technology, and the third with the international system of trade and finance, and hence with the economic linkages between nations.

CONTENTS

Part 1

PRESSURES ON THE PUBLIC SECTOR

1.1 Ministers are invited first to discuss the activities of governments themselves: starting with size and effectiveness and then turning to public sector deficits and debt. The scope for policy change is, of course, limited by institutional rigidities and political pressures that, in the short term, largely determine the scale and structure of public sector activities.

Size and Effectiveness

1.2 In order to contain the size of public sectors, to reduce deficits and to respond to growing taxpayer resistance, most governments have been trying to restrain public expenditure. This has not proven easy, given protracted recession, expenditure commitments via indexation and otherwise, and interest payments on a growing public debt. Many governments are also trying to reorient public expenditures to different policy priorities; such restructuring is especially difficult under overall restraint.

1.3 Between 1960 and 1983 the share of total public expenditure in GDP for OECD economies rose by an average of more than 20 percentage points, to approach 50 per cent. While Chart 1 displays diversity in both size and growth, the public sector share in all but two countries exceeded, by the end of the period, the highest individual share in 1960.

1.4 Public expenditures have also changed in composition, away from governments' own consumption and investment towards transfers. Public transfers alone – social security transfers to households, subsidies to enterprises, and interest on the public debt – accounted on average for half of total public expenditure in 1983, compared to some 40 per cent in 1960.

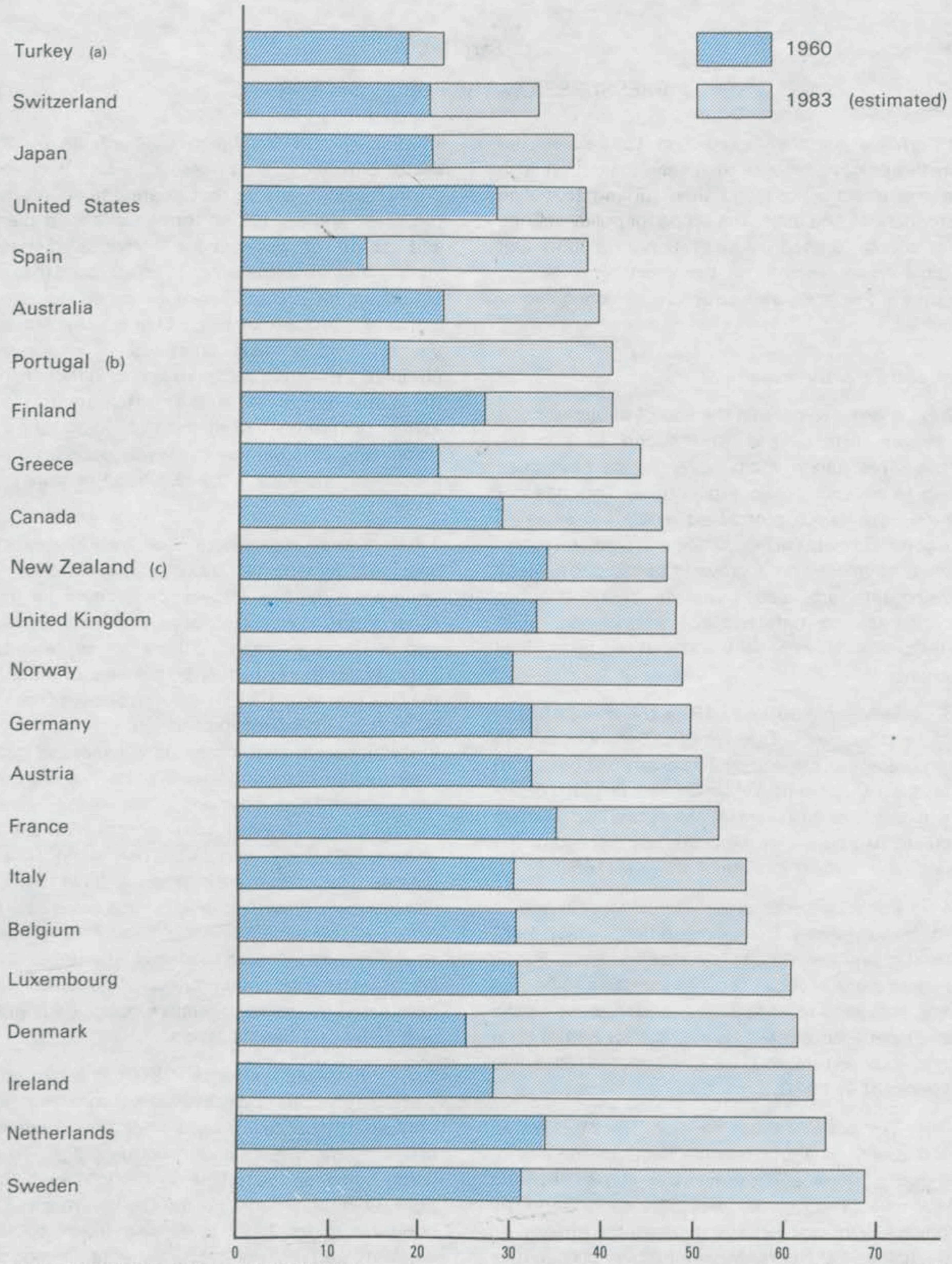
1.5 The scale of these developments has raised sharp questions about feasible limits to the size of the public sector and the transfer burden, beyond which overall economic performance is seriously impaired. Worries include detrimental effects on individual and entrepreneurial initiative; disincentive effects of higher cash benefits and subsidies; distortions due to the level and pattern of taxation; and the inflationary and "crowding out" effects of public sector borrowing. In a number of countries voters are increasingly saying that existing tax burdens are too great and are asking for reductions in the size and scope of government activities. Especially among the industrialising Member countries, the education, health, and social insurance systems are still in the process of being built up. All are under financial and political pressures to increase the effectiveness of the public sector, and face many of the same difficulties in their attempts to do so. Within government itself the expanding range and complexity of initiatives overloads decision-making processes, increasing the likelihood of policy mistakes.

1.6 Social expenditure – on health, education, pensions and other income maintenance programmes – is the largest component of public expenditure. It has also been the fastest growing and is the one taken up here for more detailed analysis. From a little over 50 per cent of the total in the OECD area in 1960 it grew to about 60 per cent by 1983. Growth of expenditure can be traced to four influences: cost increases in excess of general cost inflation; demographic shifts; extensions of coverage and eligibility; and increases in real benefit per recipient. Relative cost increases and demographic shifts have contributed only slightly over the period. The major determinants have been the discretionary growth in programme coverage, eligibility and real benefit levels. Although coverage and eligibility may increase modestly, the future cost of social expenditure commitments is likely to be dominated by trends in relative costs, demographic shifts and real benefit levels.

1.7 Between now and 1990 it is expected that demographic shifts will increase commitments, but only slightly so; fewer children of school age being offset by more people of retirement age. To illustrate, consider the following thought experiment: hold unemployment in the seven major OECD countries at its 1982 level, and freeze coverage, eligibility and real per capita benefits. Demographic trends would then imply a real increase in social expenditure of some ½ per cent per annum. If, in

CHART 1

TOTAL PUBLIC EXPENDITURE IN OECD COUNTRIES: 1960-1983



(a) 1962-1982. (b) 1960-1982. (c) 1959/60-1981/82.

addition, the relative costs of health and education services were to increase by 1 per cent per annum, as in the recent past, real social expenditure would then increase by about 1 per cent per annum. This is less than the prospective growth rate of real GDP and would imply some reduction in the share of social expenditure in GDP.

1.8 The actual problem of controlling social expenditure is more difficult than the above arithmetic might suggest, since many earnings-related social insurance systems guarantee increases in real benefits for those who become eligible on the basis of past increases in real income. These systems thus entail future real benefit increases, particularly where populations are ageing. Total real social expenditures in the major seven economies would therefore rise faster than 1 per cent unless these commitments are cut or there are reductions elsewhere in the social expenditure system. In countries still developing their social expenditure systems, spending is likely to grow faster than in the major seven, and perhaps faster than their own GDP. By contrast, in some of the richer small countries with more extensive social expenditure programmes, expenditure reforms may well lead to slower relative growth.

1.9 Pensions and other income maintenance transfers broadly succeed in finding their way to those with lower incomes. Across-the-board cuts in pensions, unemployment compensation and other cash benefits create hardship, and the scope for further selectivity is limited. It may be necessary to re-examine the role of government as a supplier of high levels of security to the well-insured if there are difficulties finding resources for minimum levels of security on a broader scale. Pension benefits may need to be curtailed but, because of the long-term nature of the pension contract, this requires the mechanism for adjusting benefits to be specified well in advance.

1.10 Part of the historical growth in social expenditure has not reflected intentional expansion of benefits so much as inability to cut back in areas of declining demand (e.g. falling school enrolments) and to preclude unintended groups being the beneficiaries of support programmes. Efficient control of future social spending requires some programmes to be cut while others grow, all under continuous pressure to do more with less. This means reform within a coherent long-term framework for social policies. Efficiency is especially important in health and education, since they make up the largest and fastest growing elements of direct government spending on goods and services.

1.11 Government involvement in the socio-economic system is not always reflected in an expenditure or revenue line in a budget: there is a myriad of "off-budget" activities. These include tax exemptions, tariffs and import quotas, credit practices (loans and loan guarantees and quantitative guidance), governmental regulation – including of prices and interest rates – and expenditures by non-budget agencies. While off-budget activities and direct budget expenditures may provide alternative ways of meeting public objectives – including transfers from producers to consumers and vice-versa – there have been other reasons for an expanding use of off-budget measures. Off-budget activities may appear attractive both to recipients and public agencies in search of greater autonomy and lesser exposure to central surveillance and budget cutbacks. Governments themselves have sometimes seen cosmetic advantages in the use of off-budget measures. True costs, though less apparent, are not necessarily less. Only very few Member countries have highly developed procedures for monitoring off-budget activities, but most – including the less advanced – now appear concerned with the implications of their spread.

1.12 *In summary*, except for those countries where new welfare state initiatives are under way, the dominant reason for the growth of government has been the increasing role of the state in transferring income. On budget, this is done out of taxation revenues as payments to the old, the poor, and the unemployed, by the provision of health and education services, and by the payment of subsidies to activities ranging from agriculture to manufacturing. Off budget, the transfers take such forms as tax-reliefs, regulated prices and interest rates, protection from foreign or domestic competition and guaranteed loans. The idea of government as a mechanism for enriching some at the expense of others is older than Adam Smith; in the current century, and especially in the past twenty-five years, this has been combined with large increases in social expenditures intended to provide a broader and more equitable distribution of income and public services. The pace of increase and the resulting pervasiveness of these activities has led many to conclude that longer-term economic potential has become impaired; that a shrinking private sector has become "overloaded". Most OECD governments find that the balance of political and economic pressures has swung from favouring a steady expansion of public services to demanding a reduction in the financial claims that governments make on taxpayers. Thus there has been widespread adoption of budget limits, and a growing realisation that the days are past when public expenditures can grow in one field without being cut back somewhere else.

Issues for Discussion

- ***Setting the appropriate scale for government spending, and choosing the best path for getting there.***
- ***Controlling the size and improving the responsiveness of social expenditures.***
- ***Off-budget activities: measurement, effectiveness, and control.***
- ***Establishing a stable fiscal framework: are policy rules or other commitments to future tax and spending policies credible and useful?***

Deficits and Debt

1.13 Virtually all OECD countries are in deficit on general government account, by amounts of up to 12 per cent of GDP and on average by more than 4 per cent of GDP. This figure is double what it was in 1979, and compares with an average deficit of less than half a percent in the first half of the 1970s. Despite efforts by most governments over the last three or four years to reduce them, budget deficits now represent as much as 20 per cent of gross private savings and more than half of savings after depreciation provisions. There has been growing acceptance that effective fiscal planning requires a conceptual separation of temporary or "cyclical" government borrowing from "structural" elements in the budget deficit (which arise expressly from government policy or need explicit government action to change). This approach does not avoid facing the difficult budget problems but can give an improved framework for fiscal planning.

1.14 It is, however, important to note that "built-in stabilizers", though self-correcting in the recovery phase, can add to structural budget deficits nonetheless, by increasing outstanding debt and hence future interest payments. Only if bonds issued to cover cyclical deficits were redeemed – by future budget surpluses – would this be avoided. During the period 1978-84, the collective structural deficit of OECD countries will have been cut from about one-and-a-half per cent of GDP to approximately zero structural balance (despite increasing interest payments); yet the combined debt/GDP ratio will have increased by over 10 percentage points of GDP and is still increasing.

1.15 The appropriate speed of deficit reduction depends not just on the cyclical availability of "excess" private savings, but on the build-up of public debt and how this influences the private sector's willingness to hold government bonds. Persistently increasing government debt/GDP ratios may be a sign of fiscal instability if they go along with increasing amounts of public debt in private portfolios, relative to other assets, and rising interest payments.

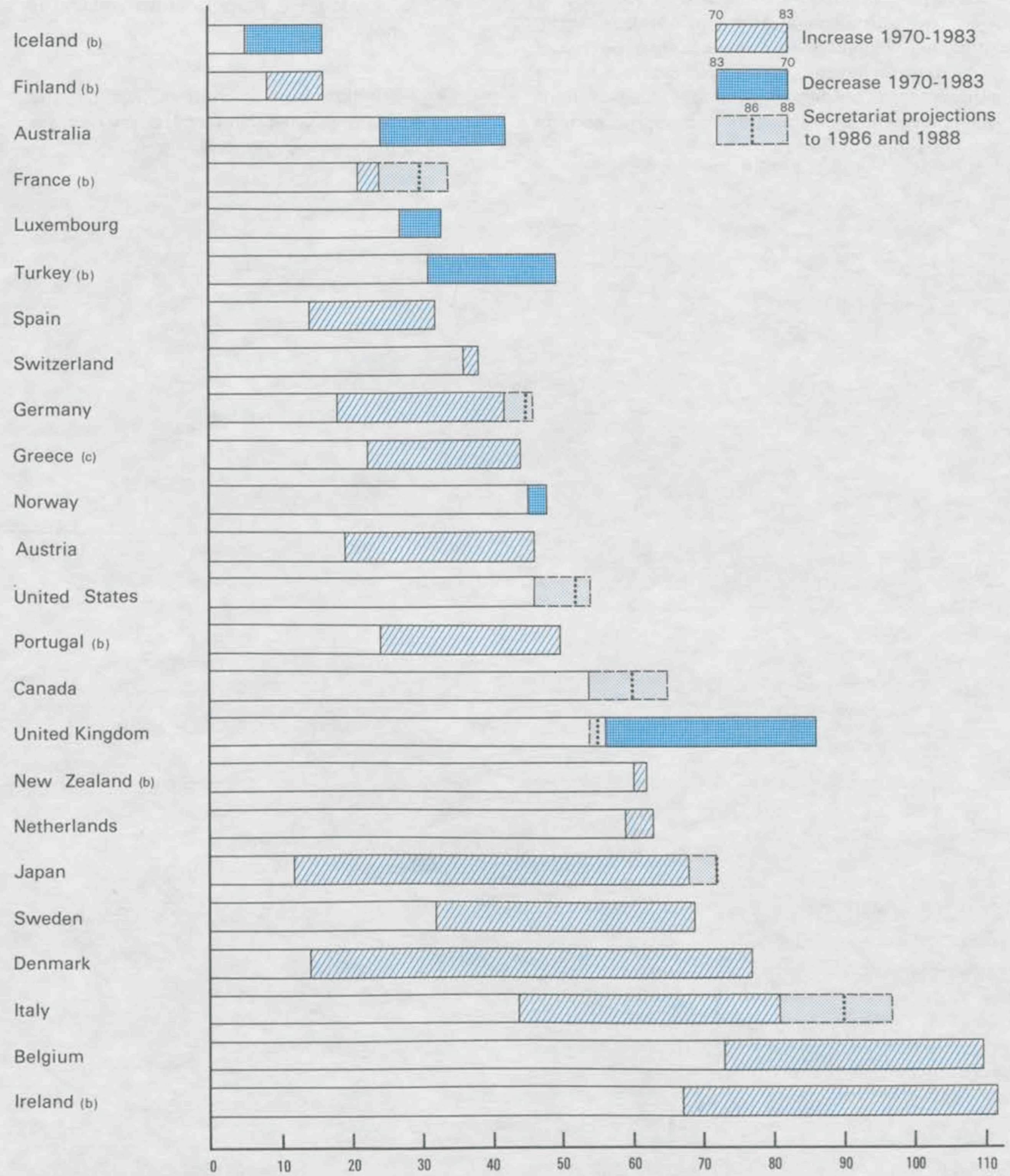
1.16 Since country circumstances and priorities differ, there is no generally optimal ratio of debt to GDP; Chart 2 shows actual and projected debt ratios. As well as the "normal" demand for government debt on the part of private financial investors, the role of government as an investor in nationalised industries and public infrastructure must be recognised. Some forms of government expenditure – in infrastructure, research or education, etc. – may yield a rate of return sufficient to cover the interest payments and to repay the loans; or the debt service costs may be seen as a legitimate charge on future generations for the less tangible benefits they will reap from today's investments. Some governments may appropriately choose to run a long-run budget deficit, and perhaps even allow for an increasing public debt/GDP ratio over protracted periods. The phase of historical development is important: during long periods a number of OECD economies have been, appropriately, capital importers, some of the borrowing being reflected in the public sector accounts. Of course, the region as a whole is traditionally, and appropriately, a capital exporter to the developing world.

1.17 *In summary,* debt/GDP ratios have risen faster than is consistent with longer-term stability of public finances, contributing to higher real interest rates and hence to less capital formation. Most OECD governments have adopted or proposed medium-term plans that envisage reduction of structural deficits. Fulfilment of these plans will lead to eventual declines in debt/GDP ratios. All have agreed that macro-economic policies should provide a stable environment for steady non-inflationary growth. In the meantime, recession-induced deficits are large enough to keep debt/GDP ratios rising for most OECD countries. Claims on private savings remain heavy. A double policy challenge thus remains. First, OECD governments should ensure that public and private sector savings are large enough to meet their combined investment requirements and also to permit increased capital exports to the rest of the world. In some cases intent to reduce structural deficits needs to be translated into

CHART 2

GOVERNMENT DEBT-GDP RATIOS IN OECD COUNTRIES: 1970-1983 (a)

(Countries ranked by 1983 ratio)



(a) Except where otherwise noted, debt relates to general Government which includes central, state (or provincial) and local Government sectors and incorporates Social Security funds. Figures for 1983 are Secretariat estimates. The terminal year is 1981 for Iceland, Luxemburg and Switzerland and 1982 for Portugal and Turkey.

(b) Central Government debt.

(c) Public sector debt (including nationalised industries) for the years 1976 and 1982.

action, and in all cases persistence with phased reductions in deficits depends on the creation and maintenance of political will and social consensus, in turn requiring enough internal budget flexibility to meet emerging needs, and to repair new holes in the safety net. Second, since there is likely to be limited fiscal room for several years, governments must find other means of dealing with the medium-term unemployment problem. This second challenge is the main topic of Part 2.

Issues for Discussion

- ***Setting medium-term targets for structural budget deficits, and for debt/GDP ratios.***

- ***Transition from current budget deficits to the medium-term targets, in a context of high unemployment.***

Part 2

LIVING WITH CHANGE: FLEXIBILITY AND EFFICIENCY IN THE PRIVATE SECTOR

Structural Change, Investment and Employment

2.1 Structural change in OECD economies is not new. Chart 3 shows how significantly civilian employment in OECD countries has shifted from agriculture and manufacturing to government and other services from 1960 to 1983, and this despite a tendency to protect rural employment. For much of the period these changes helped to produce, and were facilitated by, rapid and widespread growth of output and employment. Looking forward from 1983, the medium-term prospects are less rosy, with almost 33 million now unemployed in the OECD, and an average unemployment rate almost three times as high as a decade previously. Most forecasts show OECD unemployment rates continuing at very high levels for several years, thus making durable job-creation a vital requirement of any medium-term economic strategy.

2.2 What are the policy options? First, there is general agreement that a stable non-inflationary macro-economic framework is essential. Going beyond that, three distinct strategies can usefully be distinguished to expose the issues starkly for argument. It must be realised that actual policies will involve differing mixes of all three, with the chosen mix depending on each country's political and social structure, stage of development and on the pressure of events. The first two strategies place a high value on adaptation in response to change, while the third attaches a higher value to supporting the existing pattern of output and employment. The first, or *market,* strategy relies essentially on the ability of the market system to solve the complex problem of matching workers with jobs, and placing investment where returns are highest. The second, or *interventionist,* strategy involves greater state involvement in setting targets for investment and employment, and in supporting activity in the chosen industries. The third, or *defensive,* strategy attempts to shelter the existing structure of activity and employment from the effects of change. Usually the defensive strategy is intended to provide only temporary assistance to smooth the path of adjustment, but when new opportunities do not appear, then temporary tends to become indefinite. Most OECD governments rely heavily on the market strategy, and adopt the other strategies when they perceive evidence of market failure, or where the market result creates excessive political or social pressure. What the various approaches mean in practice is best illustrated by contemporary issues: low investment, new technologies, and labour market rigidities.

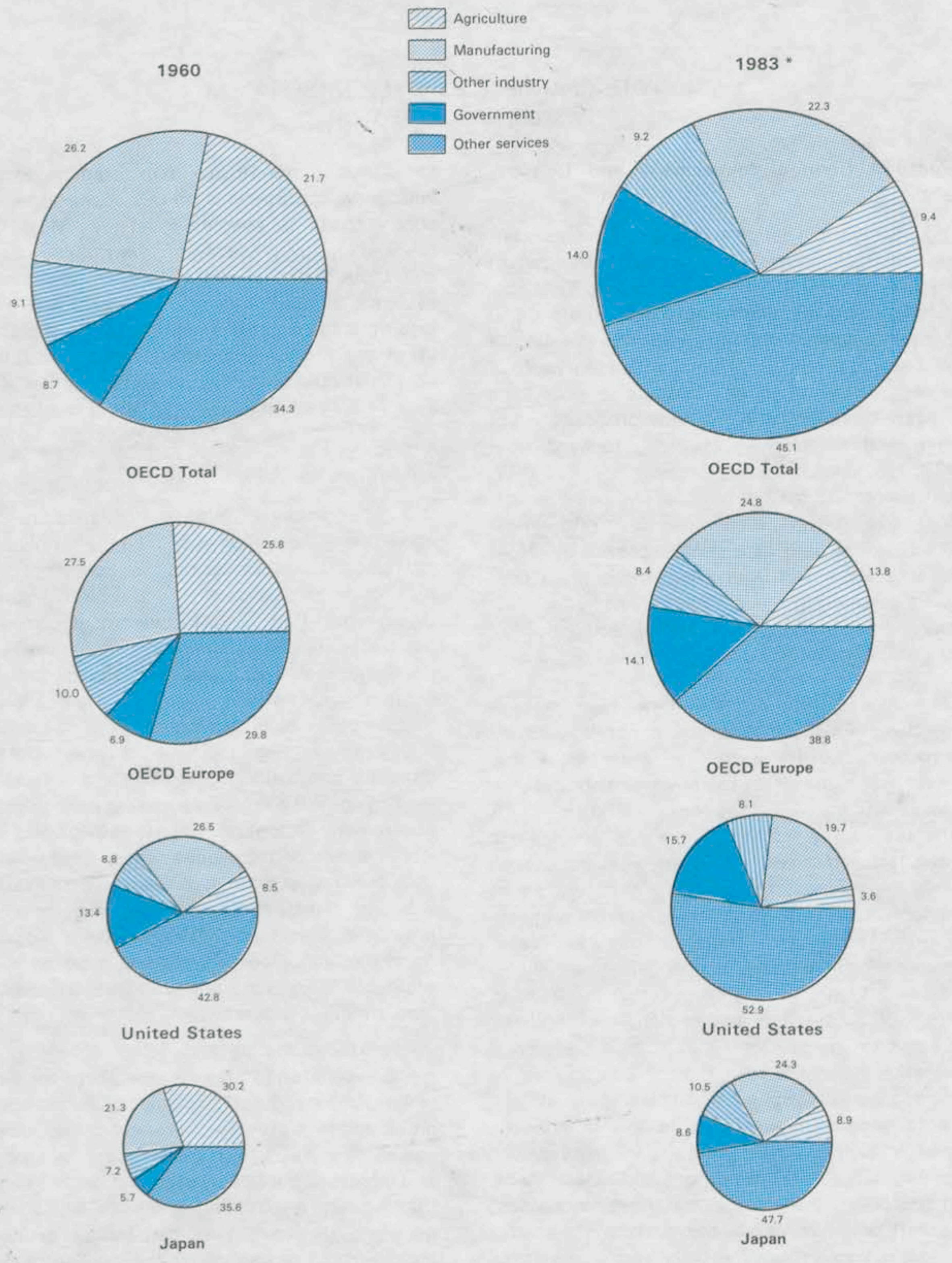
Investment for Jobs

2.3 Especially in Europe, low investment and ageing capital are seen as limiting the supply of new job opportunities. Under the first policy option, the reaction to this perception would be to ensure, as discussed in Part 1, that government current and capital spending was not creating undue pressure on domestic capital markets, and that the tax and financial systems did not artificially limit the ability of enterprises to obtain capital from domestic and foreign savers. High real interest rates would then represent competition for savings at the world level, leading domestic firms and governments to respond accordingly, adopting capital-saving and more labour-intensive techniques where applicable, and thus conserving what was scarce. If the resulting stock of capital were then not large enough to provide sufficient jobs, it would be a signal that domestic labour costs were too great to support profitable new ventures, suggesting inadequate labour market flexibility.

2.4 Under the second policy option, governments would tend to take a view about the amount of investment required to produce new job opportunities, and then provide investment grants, favoured access to markets, loan guarantees, tax incentives and increased public investment in order to achieve the desired result. Under the defensive option, governments would tend to continue or increase subsidies and protection for the existing pattern of employment and economic activity, for example by restricting lay-offs, capital flows and imports.

CHART 3

STRUCTURE OF CIVILIAN EMPLOYMENT 1960-1983 *(1)



1. Areas of the circles are proportional to total employment.

* Secretariat estimates.

New Technologies

2.5 Current and foreseeable changes in micro-electronic and communications technology have created great uncertainty about future employment. Some have even argued that thinking machines will render human workers obsolete in the same way that horses were replaced by railways and motor vehicles. Most others would argue, with more support from historical evidence, that electronic process control will upgrade the use of labour and also help to make much more efficient use of energy, raw materials and capital equipment, the other scarce factors of production, thus expanding the opportunities for output without reducing employment. Under this view, new technologies are likely to increase flexibility, since production equipment that can be reprogrammed easily to different tasks helps to cut obsolescence and to keep output in line with changing demands.

2.6 Under the first policy option, the reaction to this uncertainty would be to maintain the competitive environment and to ensure that the social framework, insofar as it is affected by government policies, was well-tuned and ready to respond to new opportunities, without policy makers having to try to select the most promising ventures. Attention to safety net policies, and to the timely and flexible provision of public services, education and other infrastructure, is especially important where changes occur quickly, and where the skills and capital required for the new products and processes are very different from those released by the declining sectors.

2.7 Under the second and third policy options, governments would respond in two additional ways. Governments following the interventionist strategy would select and subsidize certain sectors, firms, or products thought likely to provide a starting point for the development and application of promising future technologies. Governments following a defensive strategy would restrict new job-displacing technologies by limiting the entry of foreign products, financially supporting firms using older techniques, or restricting foreign investment.

Labour Market Flexibility

2.8 Unemployment is often decomposed, as are budget deficits, into structural and cyclical components. The level of structural unemployment depends on labour-market institutions, labour force growth, the skill structure of the labour force, and a host of other changing factors.

2.9 Most current estimates of structural unemployment in OECD countries are much higher than they were several years ago, and there is a premium on medium-term policies designed to increase the flexibility of labour markets. All of the policy approaches outlined above include more attention to flexibility and breadth in education, training, retraining and adjustment assistance for displaced workers, and to housing mobility, although the form of the policies differs somewhat under the three approaches.

2.10 When it comes to flexibility of wages, working conditions, job descriptions and tenure, the three policy options are more distinct. The first places a premium on institutions and arrangements for industrial relations and income distribution that provide the most scope for flexibility of wages and employment. The main role for public policy would be to encourage competitive labour markets by restricting monopoly elements. In the second option, governments would take a more active role in advertising job openings, in assuring mobility of housing and portability of pensions, facilitating local and community employment initiatives, and in tri-partite bargaining with business and labour about wages and working conditions. Under the third option, governments would take inherited wage and employment rigidity as largely given and adopt subsidies to existing employment and industry, protection from foreign competition, restrictions on lay-offs, and enforced work-sharing as alternative ways of dealing with the consequences of labour market rigidities.

2.11 Political pressures, and the desire to have specific policies that can be seen to focus directly on the provision of new jobs, have led many OECD governments to follow the third option to an extent that may be reducing the longer term flexibility of their economies. In each case, the reasons are pressing, and there is the prospect of avoiding immediate hardship. The problem is, of course, that resulting damage to the overall flexibility of the economy is not felt until it accumulates over the years.

2.12 Building or recovering flexibility and the social consensus to support it is a long-term investment, with costs that are immediate but with benefits that accrue largely to the credit of future governments. For such investment to be feasible, it is necessary for governments and the social partners to take a long view, to be convinced that the gains exceed the costs, and to agree that both the immediate costs and the longer-term gains will be fairly shared.

2.13 *In summary,* if governments do not start soon to invest more of their political capital in building or rebuilding the flexibility of the economy, the foreseeable pace of technological change will lead to ever-increasing payments for subsidies to investment and employment, transfers to the unemployed and protection for increasingly uncompetitive industries. All of these will put further upward pressure on non-wage labour costs, on government deficits and on interest rates, producing inflation or crowding out the public and private investment spending necessary to build a solid base for longer-term growth. On the other hand, successful attempts to increase flexibility will be reinforcing: For example, increased wage flexibility can lead to a more efficient industrial structure, higher average wages and lower non-wage labour costs which in turn make it easier to generate more jobs and more flexibility. A stable macro-economic policy environment, with low inflation and predictable tax systems, can help this process by reducing overall uncertainty and thereby making the most effective use of private sector adaptability.

Issues for Discussion

- ***Taking advantage of new opportunities: lessons from national experiences in living with change.***
- ***Practical means for increasing employment by improving social consensus and labour market flexibility.***

Part 3

NATIONAL POLICIES AND THE INTERNATIONAL FRAMEWORK

The World System of Trade and Finance

3.1 World trade has grown faster than national economies over the past quarter century and financial linkages among countries have developed more rapidly still. The growth of world markets for goods and capital, spurred by advances in transportation and communications, and generally supported by national policies, has encouraged the production of goods where, broadly speaking, costs are least. Financial integration has facilitated the channeling of global savings to where returns are highest. These interdependent trends have permitted and encouraged faster growth of real incomes around the world. Benefits from this open system of international trade and finance occur most clearly in a context of fairly smooth and predictable growth. In these circumstances, everyone gains from trade and, even though there may be disputes and inequity in the process of sharing those gains, there is widespread support for the open system, and for the interdependence it brings.

3.2 These gains from the interdependent system have come under increasing challenge in recent years, reflecting the more turbulent economic environment and protracted recession. Can interdependence contribute to instability? An interdependent world economy, like an electric power grid, can smooth out local disturbances, but can amplify large ones. The world oil shocks of the 1970s remain a vivid reminder of this. Similarly, the accumulation of large stocks of international debt became a potentially powerful transmitter of instability when expectations were unsettled by a major disturbance.

3.3 A second concern has been that growing market integration, and the global diffusion of technologies among regions with very different wage levels, may create sustained pressures on employment and standards of living in OECD economies. A rise in structural unemployment and proliferation of non-competitive sectors may thus appear as the only alternative to continued downward pressure on real wages to preserve "competitive parity" with successive generations of emerging competitors.

3.4 There is an important sense in which these concerns are beside the point. The forces pushing towards increased integration in the world economy are very powerful; resistance will distort but not arrest the process. More importantly, if there is sufficient flexibility within economies, the gains from integration will exceed the costs. It must not be forgotten that developing countries' demand for imports has consistently matched – and indeed run ahead of – their export receipts. This is the counterpart of net capital exports from the OECD to developing countries. The implication is, of course, that the pressures faced by sectors losing competitiveness will be more than counterbalanced by opportunities in export sectors. Provided resources shift, complementarity in trade relations can be maintained in the course of integration. Living standards globally can converge *upwards,* rather than levelling down.

3.5 It is also important to recognise that economic interdependence – even among the industrial countries – falls short of full economic integration. Integration is an uneven process and interdependence is far from uniform. Larger economies continue to perceive their economic futures as primarily determined by domestic policy choices; and there is a good deal of truth to this. Even for smaller economies heavily dependent on trade, an important degree of domestic policy autonomy can exist if there is sufficient economic flexibility. These qualifications do not change the basic facts of large and growing interdependence. In this context, the central issue for the foreseeable future is how to maintain an open international trade and financial framework in an increasingly integrated, multi-polar, though asymmetric, world economy. Two topical examples – international indebtedness and structural adjustment – illustrate the dimensions of this issue.

International Indebtedness

3.6 The rapid accumulation of sovereign debt during the past decade was based in part on expectations about the future which have since become untenable. A number of developing countries and international banks have thus found themselves in overextended positions. The required adjustments are sufficiently large and long-lasting to pose a continuing threat to the overall stability of trade and financial relations. The strategy guiding international efforts to contain this threat has been to find the right mix of financing and adjustment to preserve and eventually strengthen the open international trade and investment system.

3.7 This strategy has so far worked, but both optimistic and pessimistic scenarios can readily be imagined for the years ahead:

- An *optimistic* scenario would see growing trade between the developed and developing countries in the course of a global recovery in which the level of real interest rates recedes and the pattern of global capital flows becomes more sustainable. In such a scenario, the trading climate would permit expanding opportunities for profitable investment, promoting flows of private capital to the developing world; expanding trade and financial linkages would provide the means for a gradual resolution of existing debt problems.
- A *pessimistic* scenario would see the strains perpetuating; with more inward-looking development policies, increased protection and distorting export subsidies embraced as less painful than alternative domestic adjustments. Such actions in the current environment of high unemployment would provoke retaliation. The end result would be lower global trade in an increasingly distorted pattern, in turn discouraging private investment flows, or making them more dependent on yet further interventions by governments to provide "protected markets" to potential foreign investors. Financial strains would thus be perpetuated with official action needed to preserve the stability of the overall financial system and pressures would mount to find official substitutes for hesitant private flows.

3.8 Which of these outcomes occurs is primarily determined by the cumulated policy choices of national governments. These include the basic macroeconomic policies required to avoid renewed inflation, crowding out of private investment and exchange rate instability. The question is whether there is sufficient political will to promote increasing interdependence and openness on the trade and investment side, thereby validating financial interdependence, and whether the overall gains of such an approach are perceived as sufficiently great to outweigh short-term costs.

3.9 In any event, developing countries seem bound to experience a period of scarcity of international capital, reflected in relatively high real interest rates, greater creditor selectivity and sharper risk assessment. Commercial capital will remain available even to countries with large debts, provided the borrowers are able, through adjustment policies and efficient resource allocation to meet the interest cost of the debts, and to assure adequate social and political stability. Official resource flows are subject to growing resource constraints and distortions arising from attempts to gain commercial advantage over competitors; officially supported capital flows should meet the difficult test of efficiency of resource use and should respect the multilateral character of the trade and finance system.

Issues for Discussion

Ensuring that the pattern of external finance for indebted countries

- ***promotes positive adjustment, and hence improves resource allocation within both developed and developing countries;***
- ***helps to increase the efficiency of the open world system of trade and finance.***

International Implications of Structural Adjustment Policies

3.10. Structural adjustment provides a second important concrete example of pressures bearing on the open international trade and finance system. Over the last decade, the demands on governments to counter the perceived adverse impacts on domestic firms of adjustment policies implemented in other countries have intensified. The underlying factors which have been at work in this process are the severity of the recession, the pace of technological change and intense international competition.

3.11 At the same time, the inherently greater sensitivity of an integrated world economy to differentials between countries in costs, competitive conditions and market opportunities has altered the international dynamics of structural policies. Government support measures which alter relative cost positions are fast translated into changes in world market share – leading other producing countries to seek to match them. Protectionist measures tend to spread more rapidly than in the past, as trade diversion quickly shifts the pressure of competitive imports from markets which close towards markets which remain open.

3.12 Indeed, protection is more pervasive than generally assumed. After full implementation of the Tokyo Round, tariff protection will be at its lowest level since the First World War but the number of known restrictive trade agreements on manufactured imports introduced by US, EEC, Japan and Canada has quadrupled since 1975. The product categories currently subject to discriminatory and non-conventional forms of protection comprise at least 15 per cent of world trade in manufactures and a quarter of OECD manufactured consumption.

3.13 The proliferation of offsetting border and non-border measures can undermine world economic growth, increase international frictions and damage the framework for international trade:

- Since over one-third of OECD area investment is geared to serving foreign markets, increased uncertainty regarding the potential introduction of new trade barriers, of duties and subsidies, and of administrative obstacles to the flow of payments, technology and enterprise, dissuades firms from innovating and expanding.
- Such uncertainties also discourage export-oriented investment and generally outward-looking strategies in developing countries, with adverse implications for world-wide economic development.
- Defensive and protectionist policies may result in shifts of adjustment burdens, in particular employment problems, from one country to another. Efforts by governments to counter such shifts can easily lead to a vicious circle of retaliation.
- It is particularly difficult for small economies and for developing countries successfully to offset subsidies and other trade-distorting measures implemented by others, especially those measures that influence competition for third-country markets.

These risks are unlikely to diminish over the present decade.

3.14 The extent to which defensive measures impede world economic development, shift the burden of adjustment, or lead to international friction depends both on the measures themselves and on the economic environment:

- Measures that are taken unilaterally, outside the framework of internationally agreed rules and consensus, are particularly corrosive.
- The potential for international friction may be greatest when the assisted sectors are those characterised by slow growth in demand and excess capacity at the global level.
- Measures that are credibly temporary in scope impose less threat to the overall system than measures that do not limit the time period over which assistance is provided.

3.15 Given the dangers inherent in competitive subsidisation and retaliation, the central task is to identify more clearly those structural policies which may give rise to harmful international repercussions and to explore options for international co-operation in dealing with them.

Issues for Discussion

Ground rules to avoid policies and practices that distort international trade in the course of providing

- ***support for declining activities;***
- ***protection and subsidies for the high-technology sector.***

Policy Responses

3.16 *In summary*, it can thus be seen in both of the examples treated here – international indebtedness and structural adjustment – that there are two broad policy responses. One is to resist the fundamental trends toward increasing world integration, by aiming for greater domestic or regional self-sufficiency, in the hope that short-term employment benefits or longer-term insulation from foreign disturbances, might compensate for a lower global efficiency of resource use. This may appear feasible from a single-country perspective, but if many countries attempted to implement it, none would find the results acceptable. The other response is to accept a collective responsibility to increase the flexibility and stability of the open system. This approach is not easy politically. If it is to succeed, it requires commitment to maintain a stable macroeconomic environment and action to halt and reverse the current drift towards market-distorting and trade-restricting measures.

NOTES AND REFERENCES

Documents referred to in the notes are listed below

Part 1

Size and Effectiveness

paras. 1.2 to 1.5:

For detailed information on public sector size and composition see "The Role of the Public Sector". For a review of the overall effects of public sector growth, see "Consequences of Public Sector Size and Growth".

paras. 1.6 to 1.10:

Past trends in social expenditure growth and projections until 1990 are outlined in "The Growth of Social Expenditure : Recent Trends and Implications for the 1980s" and its supporting documents.

para. 1.11:

Off-budget activities are discussed in "Off-Budget Expenditure : An Economic and Political Framework" and "Budgeting for Loans and Loan Guarantees"; implications for the budget process and public management are discussed in "The Capacity to Budget – Adaptation of the Budget Process in OECD Countries : A Framework for an Intergovernmental Study".

Chart 1:

Public expenditure includes all general government expenditure, according to the standardised System of National Accounts (SNA). It comprises all capital and current expenditure, including social security, by central, regional, and local governments, but excludes public enterprises. The data are published regularly by the OECD in *National Accounts, Volume II. Detailed Tables.* The 1983 figures are estimates.

Deficits and Debt

paras. 1.13 to 1.14:

"Structural Budget Deficits and Fiscal Policy Responses to the Recession" provides concepts and estimates for structural budget deficits. The latest Economic Policy Committee (EPC) General Assessment [pp. 46-58] provides an analysis of possible structural budget deficit trends up to 1986. OECD Economic Outlook, No. 31, July 1982, pp. 40-43 describes the use of "cyclically adjusted" budget deficits in short-term economic analysis.

paras. 1.15 to 1.16:

For general government debt/GDP ratios in the major seven economies see the latest "Economic Prospects, General Assessment", Table 2.8, p. 56. "Medium-term Financial Strategy: The Co-ordination of Fiscal and Monetary Policies" contains tables, for most OECD central government sectors over the period 1970-82, showing interest payments, internally and externally held public debt and its relation to private sector financial assets.

For a discussion of the impact of inflation on public sector deficits and government debt/GDP ratios, see pp. 20-23 of "Public Sector Deficits, Problems and Policy Implications" and pp. 52-55 of the latest "Economic Prospects, General Assessment".

Chart 2:

For the United States, Japan, Germany, the United Kingdom, Italy, Canada, Belgium, the Netherlands, Norway, Spain and Sweden, public debt figures refer to end-of-year general government debt held by private and overseas sectors, the central bank and public corporations. They are thus net financial liabilities, exclusive of intra-sectoral borrowings. The sum of central government and local authorities gross debt is used for Australia, Austria, Denmark, Luxembourg, New Zealand and Switzerland. Total public sector debt (i.e. including public corporations) is given for Greece. Central government (state) debt is given for France, Finland, Iceland, Ireland, Portugal and Turkey. Details about the data sources may be obtained upon request from the OECD Secretariat (Economics and Statistics Department).

Part 2

Structural Change, Investment and Employment

para. 2.1:

See *OECD Employment Outlook*, pp. 7-11 and *Economic Outlook*, No. 34.

para. 2.3:

Capital shortage unemployment problems are discussed in "The Present Unemployment Problem" pp. 20 and 35-44.

Economic Outlook, No. 33, pp. 47-49

paras. 2.5 to 2.7:

The analogy with horses is from Leontief, W. "Technological Advance, Economic Growth and the Distribution of Income", *Population and Development Review* 9, No. 3 (September 1983).

OECD work on the links between technological change and employment is in *Micro-Electronics, Robotics and Jobs* and *Assessing the Impacts of Technology on Society*.

Labour Market Flexibility

paras. 2.8 to 2.9:

"Intergovernmental Conference on Employment Growth in the Context of Structural Change – Issues for Discussion".

For a discussion of the cyclical/structural unemployment split, see *OECD Employment Outlook*, pp. 7-8, and *Economic Outlook*, No. 33, pp. 47-49.

paras. 2.10 to 2.13:

For further discussion of the possible effects of labour market rigidity, see *The Challenge of Unemployment*, pp. 45-66. See also pp. 98-108, which discuss how efficiency and equity in the labour market can be reconciled.

para. 2.13:

This is elaborated in *Positive Adjustment Policies – Managing Structural Change*, in particular Part II Chapter B: Industry Policies and Chapter E: Manpower and Social Policies.

Chart 3:

Civilian employment includes all those persons with a job, excluding members of the armed forces. The government sector closely approximates the SNA definition of general government. These figures are published regularly by the OECD in *Labour Force Statistics* and summarised in *Historical Statistics*, which accompanies the July issue of the *OECD Economic Outlook*.

Part 3

The World System of Trade and Finance

paras. 3.1 to 3.5:

See *World Economic Interdependence and the Evolving North-South Relationship* and *Development Co-operation*, Chapter 2.

paras. 3.4 to 3.5:

See "The International Flow of Technologies"

Short-term macro-economic interdependence is analysed in "International Economic Linkages"

paras. 3.6 to 3.9:

See *External Debt Surveys*, 1982 and 1983, and *Development Co-operation*, Chapter 3

International Implications of Structural Adjustment Policies

para. 3.10:

On the international implications of domestic policies, see Part III of *Positive Adjustment Policies – Managing Structural Change*

paras. 3.10 to 3.15:

See *Government Assistance to Industry: The Positive Adjustment Perspective*

para. 3.15:

On the methods available for assessing the impact of subsidisation, see *Transparency for Positive Adjustment – Identifying and Evaluating Government Intervention*

OECD SOURCE DOCUMENTS

Part 1

1. "The Role of the Public Sector" [CPE/WP1(82)4].
2. "Consequences of Public Sector Size and Growth" [CPE/WP1(83)8].
3. "The Capacity to Budget – Adaptation of the Budget Process in OECD Countries: A Framework for an Intergovernmental Study" [CT/PUMA/514].
4. The Welfare State in Crisis (OECD, 1981).
5. "The Growth of Social Expenditure: Overview and Main Issues" [SME/SAIR/SE/83.09].
6. "The Growth of Social Expenditure: Recent Trends and Implications for the 1980s" [SME/SAIR/SE/83.01] and accompanying documents.
7. "Off-Budget Expenditure: An Economic and Political Framework" [CT/PUMA/506].
8. "Budgeting for Loans and Loan Guarantees" [CT/PUMA/523]
9. Measuring Local Government Needs: The Copenhagen Workshop (OECD, 1981).
10. "Structural Budget Deficits and Fiscal Policy Responses to the Recession" [CPE/WP1(83)1 and 2].
11. "Economic Prospects, General Assessment" [CPE(83)6].
12. "Public Sector Deficits, Problems and Policy Implications", OECD Economic Outlook, Occasional Studies, June 1983.
13. "Medium Term Financial Strategy: the Co-ordination of Fiscal and Monetary Policies", OECD Economics and Statistics Department, Working Papers, No. 9, July 1983.

Part 2

1. Technical Change and Economic Policy (OECD, 1980).
2. "Intergovernmental Conference on Employment Growth in the Context of Structural Change – Issues for discussion" [SME/SC/83.17]
3. "Industrial Adjustment and Government Support: Report for the Economic Policy Committee" [IND(83)5].
4. Micro-electronics, Robotics and Jobs (OECD, 1982).
5. Industry in Transition (OECD, 1983).
6. Assessing the Impacts of Technology on Society (OECD, 1983).
7. OECD Employment Outlook (September 1983).
8. "The United States and Europe: Coping with Change" The OECD Observer (May 1982).
9. The Challenge of Unemployment : A Report to Labour Ministers (OECD, 1982).
10. "The Present Unemployment Problem" [CPE/WP1(83)6].

Part 3

1. External Debt of Developing Countries – 1982 Survey (OECD, 1982).
2. External Debt of Developing Countries – 1983 Survey (OECD, 1984).
3. World Economic Interdependence and the Evolving North-South Relationship (OECD, 1983).
4. "International Economic Linkages" OECD Economic Studies No. 1 (OECD, 1983).
5. "The International Flow of Technologies" [SPT(83)22].
6. Development Co-operation – 1983 Review (OECD, 1983).
7. The Internationalisation of Banking : The Policy Issues (OECD, 1983).
8. "Government Assistance to Industry: The Positive Adjustment Perspective" [CPE(83)11].
9. Transparency for Positive Adjustment – Identifying and Evaluating Government Intervention (OECD, 1983).

General

1. Facing the Future : Mastering the Probable and Managing the Unpredictable (OECD, 1979).
2. Statement on Positive Adjustment Policies: Communique by the OECD Council at Ministerial Level of 18th May, 1982 [C(82)57(Final)Annex].
3. Positive Adjustment Policies – Managing Structural Change (OECD, 1983).
4. "Positive Adjustment Policies: Review of On-Going Work in the Organisation" [CPE(83)12].