Enhancing independent fiscal institutions in Latin America: a roadmap based on practical lessons from OECD countries

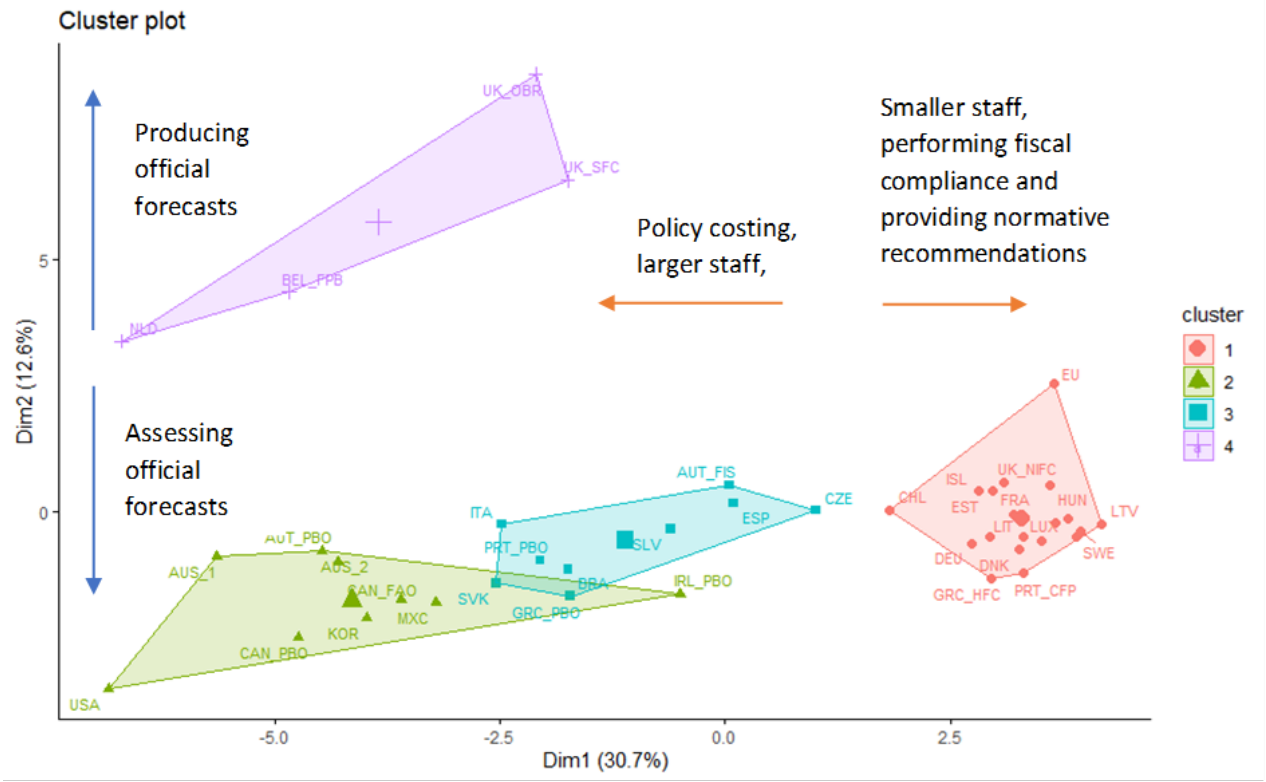
by **Aida Caldera, Paula Garda, Alberto Gonzalez-Pandiella,** Alessandro Maravalle and Elena Vidal, OECD Economics Department

The number of independent fiscal institutions (IFIs) across OECD countries has significantly grown in the last decade, following the global financial crisis. The experience of Latin America countries is more recent and mixed. While some countries, such as Peru or Chile, have well-functioning IFIs, others have less developed institutions and are actively exploring ways to reinforce or establish IFIs.

Strengthening IFIs in Latin American economies could be very beneficial at the current juncture. In most cases, these economies emerged from the COVID-19 crisis with higher government debt as a percentage of GDP and limited fiscal space (Arnold et al. 2023). Strong IFIs can play a pivotal role by fostering fiscal sustainability and enhancing credibility of fiscal policies and support the effective implementation of medium-term fiscal frameworks (Caldera et al. 2024). Evidence from OECD and EU countries suggests that well-functioning IFIs are associated with higher forecasting accuracy, better compliance with fiscal rules and reductions of fiscal deficits. Ultimately, this can facilitate countries access to international financial markets at lower borrowing costs, a valuable prospect in a higher-for-longer interest rate environment.

Our recent paper reviews the diverse experience of OECD countries in establishing and running independent fiscal institutions with the aim of drawing practical insights and establishing a roadmap for Latin American countries. There is a large heterogeneity among OECD countries in the way IFIs are designed and establishing a set of stylised facts about alternative IFIs designs can help to identify good examples and best practices. With that aim, the paper identifies, through cluster analysis, different types of independent fiscal institutions based on their functions and resources (Figure 1). The paper supplements the cluster-analysis with cases studies from Chile, Spain and Korea and with the OECD Principles for Independent Fiscal Institutions to guide the set-up and strengthening of IFIs in the region.

Figure 1. OECD IFIs can be categorized into four groups according to their functions and staff size



Note: The cluster plot reports the projections of original data over the two largest eigenvectors, respectively the x-axis and the y-axis, which explain most of the total variance of the data.

Source: Authors' calculation.

The analysis in the paper suggests that a road map towards independent fiscal institutions in Latin America could have the following key features:

1. Prioritize Legal and Financial Independence. They are crucial to ensure the IFI resilience in the face of policy uncertainty. Defining IFIs in national legislation with clearly specified tasks and functional autonomy is vital, but IFIs can still find difficulties in ensuring funding and recruiting staff. A clear definition of the IFI's mandate in higher-level legislation, establishing their tasks and degree of functional autonomy, namely in terms of funding and recruitment policy, can provide IFIs with the necessary financial and statutory independence. An example of best practice is the Fiscal responsibility Act in Ireland, which sets in legislation the budget of the Fiscal Advisory Council and grants it full recruiting powers.

2. Bolster Leadership Selection and Expertise. Legislation should also specify leadership expertise and include clear guidelines for appointment, including technical requirements and term length for the president of the fiscal council, which would help to guarantee leadership independence. Making the president position a full-time position and making its appointment conditional on a qualified majority in Parliament (such as in the Slovak Republic or Portugal) also helps to strengthen independence.

3. Tailor IFIs' Mandates to Local Needs and Resources. An IFI should be established with a legal broad mandate and sufficient resources that would make it possible to fulfil its functions. Initially an IFI could be small and perform a limited set of functions, those requiring fewer resources according to its budget (e.g., monitoring of fiscal rules, assessment of government economic and/or fiscal forecasts, undertaking long term sustainability analysis). Over time and

after gaining a solid reputation, the IFI could assume gradually more functions as it grows in financial and human resources, such as policy costing and producing macroeconomic and fiscal forecasts. This approach was successfully adopted in the Netherlands.

4. Ensure Timely Access to Information. This is often quoted as a key barrier for IFIs to perform its duties in the case studies in the paper. A good practice is to specify in legislation that the IFI should have access to information to fulfil its function. Reinforcing this requirement with the signature of memorandums of understanding with relevant institutions has been found to be very effective (e.g. in Luxembourg and the Netherlands).

5. Emphasize Communication Efforts. Public visibility and effective communication are essential for IFIs' operational independence and effectiveness. Proactive engagement with the media, independent of government intermediation, can enhance an IFI's reputation and credibility. IFIs could also formally commit to participating in parliamentary hearings, cultivating strong ties with Parliament, and proactively engaging with different parliamentary groups. OECD IFIs practical experiences reveal that planning and resourcing since the set-up of an IFIs the appropriate tools to communicate in an easy and understandable way to non-experts, the Parliament and the broad public is key to influence the public debate and promote sound fiscal policies, build a strong reputation and gain de-facto independence.

6. Invest in Technical Capacities. High-quality and independent technical capacities are essential to build reputation and ensure accurate and transparent fiscal analysis. Staff training, recruitment of experts, and cooperation with international organisations are effective ways to enhance these capacities. When IFIs are young and have few resources, they can build institutional cooperation with non-political bodies recognized for high-quality analysis,

such as Central Banks or academic and research institutions.

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Restoring growth and tackling public debt in Italy

by Cyrille Schwellnus

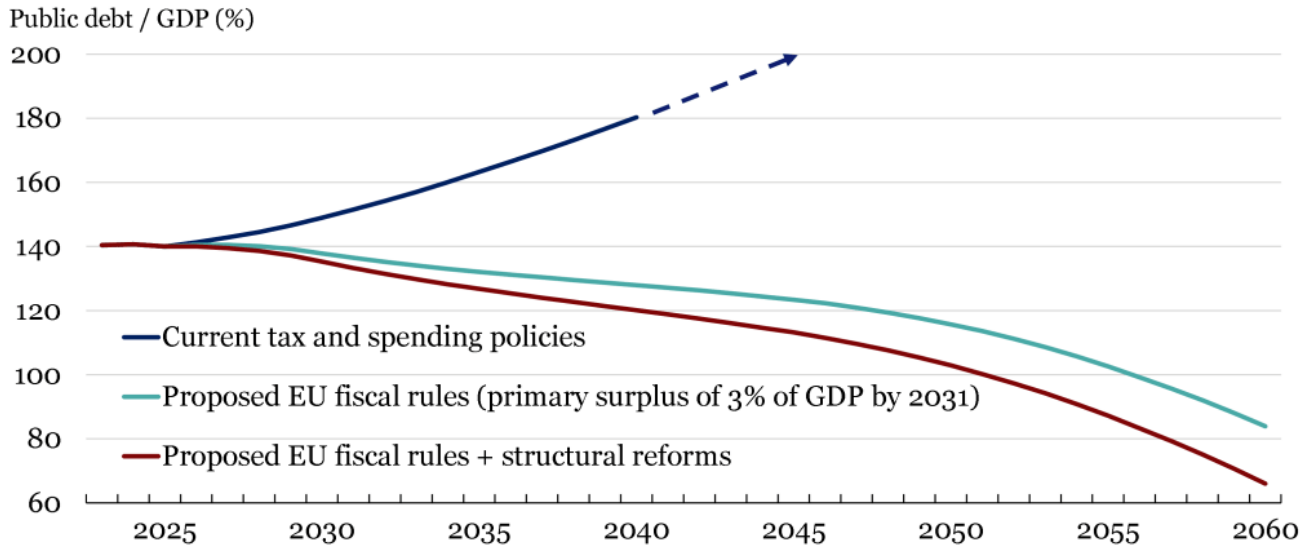
Italy has weathered recent crises well, but growth is now slowing amid tightening financial conditions. Public debt remains among the highest in the OECD, limiting the space for continued fiscal policy support. The 2024 OECD Survey of Italy discusses fiscal and structural reforms to tackle high public debt and restore growth.

Under current tax and spending policies, public debt is on an upward trajectory (Figure 1). Over 2024-40, spending on pensions, health and long-term care is projected to increase by about 2½ percent of GDP and debt servicing costs could rise by 2% of GDP if interest rates remain high.

A sustained fiscal adjustment will be required over several years to put the debt ratio on a more prudent path, meet future costs and comply with proposed EU fiscal rules. Decisively tackling tax evasion, including of value added taxes, and limiting costly tax expenditures, for instance by limiting the coverage of the dependent spouse deduction, would help. The property tax base needs to be updated. Strengthening the ambition of spending reviews and reducing the generosity

of pensions for higher-income households could address spending pressures, while maintaining adequate public services and social protection.

Figure 1: Reforms are required to ensure fiscal sustainability



Note: Ratio of public debt to GDP in percent of GDP. The scenario "Current tax and spending policies" assumes current tax and spending policies, accounting for announced changes in 2025. The scenario "Proposed EU fiscal rules" is based on a stylised simulation of new EU fiscal rules, which results in a primary budget surplus of around 3% of GDP in 2031. The scenario "Proposed EU fiscal rules + structural reforms" assumes the additional implementation of structural reforms in the areas of competition, civil justice, public administration and labour markets.
Source: OECD calculations based on OECD Economic Outlook database and OECD Long-Term Model.

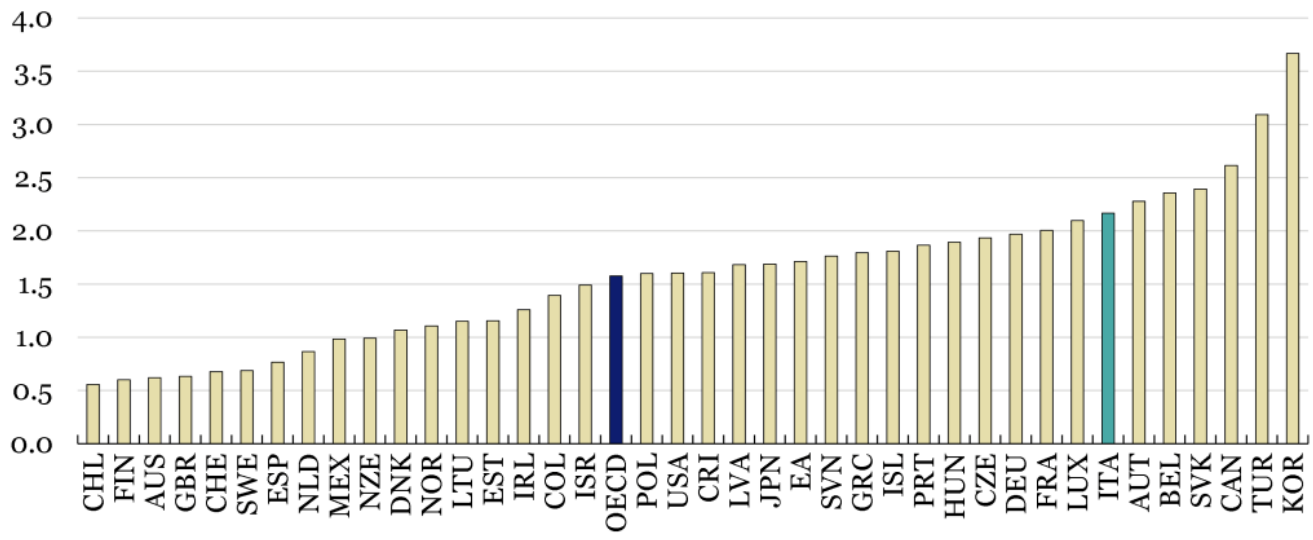
The revised National Recovery and Resilience Plan (NRRP), largely financed by Next Generation EU (NGEU) funds, is an ambitious package of structural reforms, as well as a major ramp-up in public investment. This will support demand in the near term and boost growth over the next years. But, potential output growth is estimated around 1% and will decline further

due to rapid population ageing unless productivity growth is lifted and labour market participation is enhanced. The transition to an innovation-led high-productivity growth model has been hindered by inefficiencies in the justice system and the public administration, weak competition in services, sub-par workforce skills and a rigid labour market.

Strengthening competition, especially in professional services (Figure 2), would boost productivity and lower prices. New "fair compensation" rules risk being perceived as minimum tariffs and should be re-examined. Continuing to improve the effectiveness of the public administration, including by expanding the hiring of specialised personnel and strengthening training and performance incentives, would help to implement the public investment projects in the NRRP that are critical to raise long-term growth. Bringing more women into the labour force by promoting public early childcare education and strengthening incentives for paternity leave would support employment growth in the face of a shrinking working-age population.

Figure 2: Regulatory barriers to competition in professional services should be lifted

0-6 in ascending order of restrictiveness, 2018



Note: Product market regulation indicators, professional services, 0-6 in ascending order of restrictiveness, 2018. The

preliminary 2023 Product Market Regulation data suggest that regulation of professional services in Italy remains among the most restrictive in the OECD.
Source: OECD 2018 PMR database.

Significant progress in emissions reduction was made in the wake of the global economic crisis of 2008-09, but additional policy efforts are now needed to meet emissions reduction targets. Excise taxes could be better aligned with the carbon content of consumption, as foreseen by the ongoing tax reform. Authorisation procedures for renewable energy investments and the expansion of the electricity grid could be simplified. Continuing the strengthening of public transport and the regional train network, as well as updating the system of car purchase and scrapping incentives, would help reduce vehicle emissions. Further reforming the system of tax incentives for energy efficiency home improvements – which in the form of the so-called Superbonus generated large fiscal costs in the past – would improve value for money.

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How can Latin American countries improve their

medium-term fiscal frameworks for better public finances?

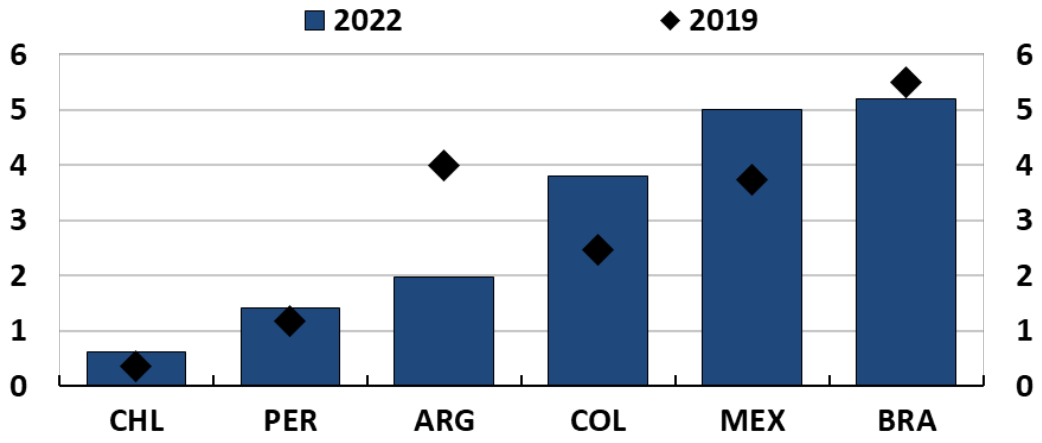
by **Aida Caldera, Paula Garda and Alberto Gonzalez-Pandiella, OECD Economics Department**

Fiscal authorities in Latin America face the challenge of continuing to reduce high public debt levels which increased significantly during the pandemic. This challenge is further compounded by higher interest rates for longer and coupled with other fiscal challenges that the region was facing already before the pandemic (Arnold et al 2023). This includes a need to improve the efficiency of public spending efficiency and to mitigate fiscal policy procyclicality (Cardenas et al. 2021; World Bank, 2020). Despite relatively favorable sovereign debt amortization profiles in many countries in the region, a higher debt service (Figure 1), will mean that countries must increasingly mobilize public resources to ensure debt sustainability. This will need to be achieved without compromising spending in key social programs, health, education and infrastructure, all essential to promote potential growth that is low in the region and to meet increasing social demands.

These fiscal challenges make redoubling efforts to strengthen medium-term fiscal frameworks (MTFFs) particularly timely. A MTFF is a strategic plan where governments outline their fiscal policies and budgetary goals over a medium-term horizon, which is usually a period of 3 to 5 years. Hence, the framework serves as a roadmap for managing government finances and achieving various economic objectives. Most OECD advanced economies have these frameworks in place and existing evidence suggests that successful implementation of MTFFs has many potential benefits (IMF, 2013; OECD, 2019). First, they contribute to maintain a sustainable fiscal stance by generating a credible and predictable annual budget,

underpinned by accurate medium-term macroeconomic projections. By incorporating a medium-term perspective into the fiscal framework, it aids in mitigating short-term bias when executing economic policies. They also enable understanding the origin and size of fiscal challenges as well as the impact of revenue and spending policy proposals before they are adopted giving early warnings about the fiscal sustainability of policies. Beyond their fiscal sustainability benefits, MTFFs also improve the efficiency of spending by promoting more effective allocation of expenditure between sectors and priorities and facilitating the planning and resourcing of multi-year policies that need extended time horizons for implementation, such as large capital projects. Lastly, these frameworks play a crucial role in mitigating the pro-cyclicality of fiscal policies, a key problem in Latin American economies. By providing a structured and medium-term approach to fiscal planning, they facilitate that fiscal policy can play a more significant role in smoothing the economic cycle. This implies providing support during downturns and gaining fiscal space when the economy is experiencing robust growth.

Figure 1. Net interest payments, % GDP



Note: Data for Chile refers to 2021 instead of 2022

Source: IMF, Fiscal Monitor, October 2023.

Latin American and Caribbean countries have experienced a

surge in MFMP adoption (OECD, 2020 here). However, the level of development is heterogeneous and there is scope for improvement.

What areas for improvement?

- **Establish expenditure ceilings**. Multi-year aggregate expenditure ceilings, that is estimates of the total amount the government can spend in the years to come, are key elements during the preparation of the budget. This "top-down" approach to budgeting is an effective way of achieving the central objective of medium-term budgeting, which is to ensure that all expenditure and revenue decisions are consistent with aggregate fiscal policy objectives. By putting in place multi-year ceilings, they also help to avoid resorting to sharp budget cuts to achieve fiscal targets.
- **Increase transparency and improve communication including with the parliament**. An open and transparent budget process helps build citizen trust and can boost tax morale by reinforcing society's perception that public money is being used correctly. In several OECD countries (such as Canada, France, Germany, New Zealand, Portugal, Sweden, or Switzerland), governments present their multi-year bill to their parliaments, detailing the budget for the current year and the subsequent ones. This prevents election cycle impacts on spending and avoids annual negotiations over incremental resources, making it easier to plan multiyear expenditures. Another good practice is that governments give regular updates to Congress on revenue and expenditure projections and targets, to positively engage Congress.
- **Improve coordination across different levels of government**. Establishing coincident medium-term frameworks for the different levels of government and mechanisms that facilitate the flow of information and

allow joint planning and coordination of the execution of policies among different levels of government helps to improve the coordination between ministries and subnational governments.

- **Reduce biases in projections and improve technical capacities**: Only with quality information this framework can serve the purpose of guiding policies and investment forward. Reducing optimism biases in GDP and revenue forecasts is a pending and common challenge in many countries in the region. In this context, strong institutions are needed to forecast fiscal paths and risks, monitor the implementation of MTFFs, and enforce compliance with anchors.
- **Measure contingent liabilities:** Experience in several OECD countries (e.g. Portugal or Spain) show that monitoring and limiting contingent liabilities is particularly important, as they can be conducive to sharp deteriorations of the fiscal accounts and lead to fiscal stress episodes. Extra budgetary funds and contingent liabilities should not be left out but should be integrated into the MTTF.
- **Include risk analysis, including climate change**. A MTTF can bolster risk analysis, including climate change, by incorporating long-term fiscal projections that consider the potential financial implications of climate-related risks and policy responses. This would enable governments in the region to proactively assess and mitigate fiscal vulnerabilities stemming from climate change, and to devise the necessary policy responses to climate change and to integrate its budget implications in medium-term planning.

Improving medium fiscal frameworks in the region will allow governments to better navigate the economic cycles and signal that fiscal policies are sustainable, ensuring that medium-term expenditure strategies are geared towards strategic and

equitable development while maximizing the effective and efficient utilization of resources.

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Addressing the challenges of high government debt and

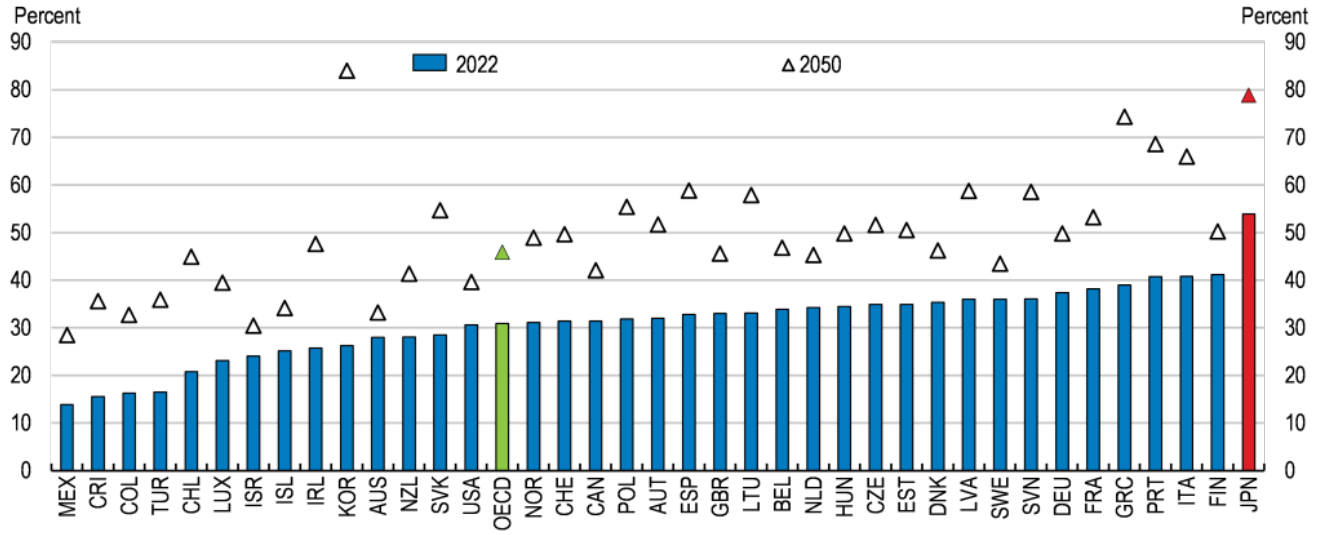
population ageing in Japan

By **Müge Adalet McGowan**, OECD Economic Department

Japan has coped well with the pandemic and the energy crisis, but the fiscal support to help mitigate their impact has pushed up gross public debt to an unprecedented level of almost 245% of GDP in 2022. Demographic change will exacerbate these challenges. Japan's population is projected to decline from 135 million to around 96 million in 2060, while the elderly population will reach 79% of working-age population, one of the highest in the OECD (Figure 1). The government projects that with ageing, social security spending will rise from 21.5% of GDP in 2018 to around 24% by 2040. Without corrective action, this would substantially worsen long-term fiscal sustainability.

The *2024 OECD Economic Survey of Japan* discusses fiscal and structural reforms to bring debt levels down. Japan lacks a credible medium-term fiscal consolidation strategy to put public debt on a downward path and build fiscal buffers to increase resilience to shocks, which should include both revenue and expenditure measures. Containing spending growth requires health and long-term care reforms. Lengthy hospital stays and a high number of medical consultations suggest room for efficiency gains in providing high-quality care to Japan's ageing population. Gradually raising tax revenues, including by increasing the consumption tax rate further in small increments, should be another element of broad fiscal reforms. Raising productivity and employment, particularly among women and older people, is also key to limit the effects of demographic headwinds.

Figure 1. Japan's elderly dependency ratio is high and will continue rising



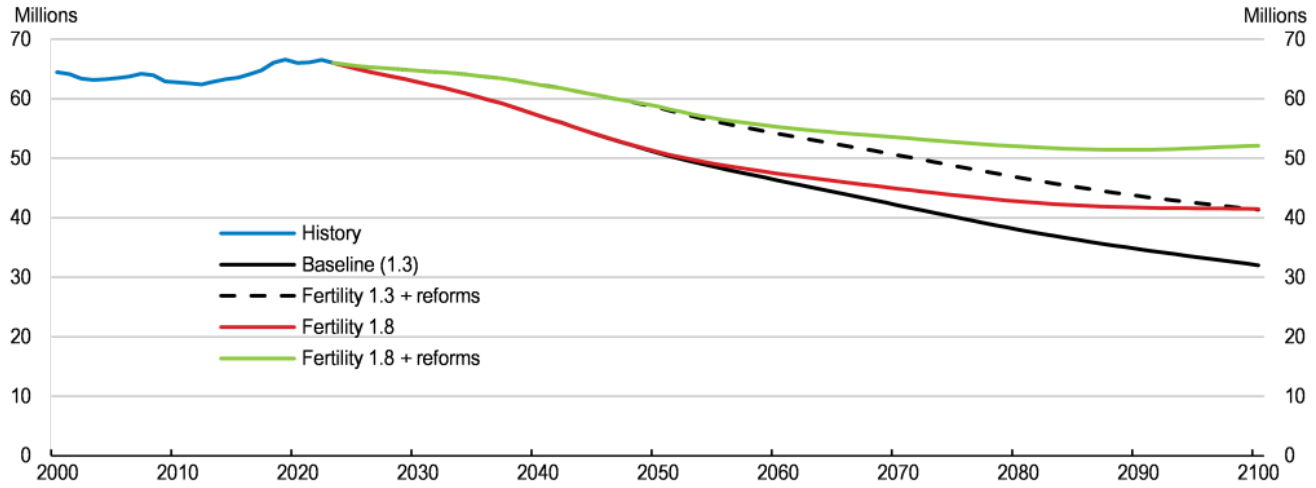
Note: Ratio of population aged 65 and above to population aged 20-64. Projections are based on medium fertility variant.
Source: OECD Demography and Population Statistics database.

Under current fertility, employment and immigration rates, employment would fall by 52% by 2100 (Figure 2). The government aims to increase the fertility rate from 1.3 to 1.8, which would help mitigate the decline in employment. One priority is to strengthen the weak financial position of youth, which leads many to delay or forgo marriage and children. Making it easier to combine paid work and family is also critical so that women are not forced to choose between a career and children. Increasing the take-up and duration of parental leave by fathers can also boost fertility rates. Policies should also cut the cost of raising children, the key obstacle to couples achieving their desired number of children.

Given the difficulty of raising fertility, which partially reflects changing social norms, and the decades-long wait for a pay-off from higher fertility, it is essential to prepare for a low-fertility future, in part by raising labour force participation. Hence, Japan should also continue to remove obstacles to the employment of women and older persons and make greater use of foreign workers, which would have a more immediate impact on labour shortages. Breaking down labour

market dualism, which disproportionately affects youth, women, and older people, is a priority. Abolishing the right of firms to set a mandatory retirement age (usually at 60) and raising the pension eligibility age would also promote employment. These reforms should be accompanied by measures to re-skill older workers, whose participation in lifelong learning is relatively low. Offering long-term residency to workers and their families and broad policies to increase the integration of foreign workers would boost foreign worker inflows.

Figure 2. Reforms to boost fertility, employment rates and foreign worker inflows would mitigate the decline in employment



Note: The reforms include; *i)* a doubling of inflows of foreigners to 200 000 per year; *ii)* a convergence of female employment rates to those of men by 2050; and *iii)* the employment rate for each five-year cohort from 60-64 to 70-74 converges to that of the preceding cohort (i.e., the rate for the 60-64 group would rise to the 2021 rate for the 55-59 age group, etc.) by 2050.
Source: OECD calculations based on the OECD Long-term Model.

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Addressing high public debt: selective expenditure restraint matters

By Álvaro Pina, Mauricio Hitschfeld and Martin Borowiecki, OECD Economics Department

In dealing with significant fiscal challenges posed by ageing and the climate transition and the risk of rising future debt burdens, countries can draw on the lessons from past episodes of large and sustained reductions in debt-to-GDP. Work in the November 2023 OECD Economic Outlook found that there have been 34 sustained debt reduction episodes in OECD countries since the late 1970s, with 25 countries having experienced at least one such episode during this time. Reductions in the debt-to-GDP ratio have mainly hinged on achieving and sustaining a primary surplus over several years, largely via expenditure restraint, as well as favourable cyclical conditions and low interest rates. Expenditure restraint has often been accompanied by growth-friendly shifts in the composition of public spending.

What has made debt-to-GDP ratios fall?

Debt reduction episodes are defined as ones that persist for a minimum of five years and bring down the gross debt-to-GDP ratio by at least 10 percentage points. All episodes start in the year after the debt ratio peaks and end when the debt-to-GDP ratio bottoms out. The analysis spans from the late 1970s to 2019, though data availability is limited for some countries.

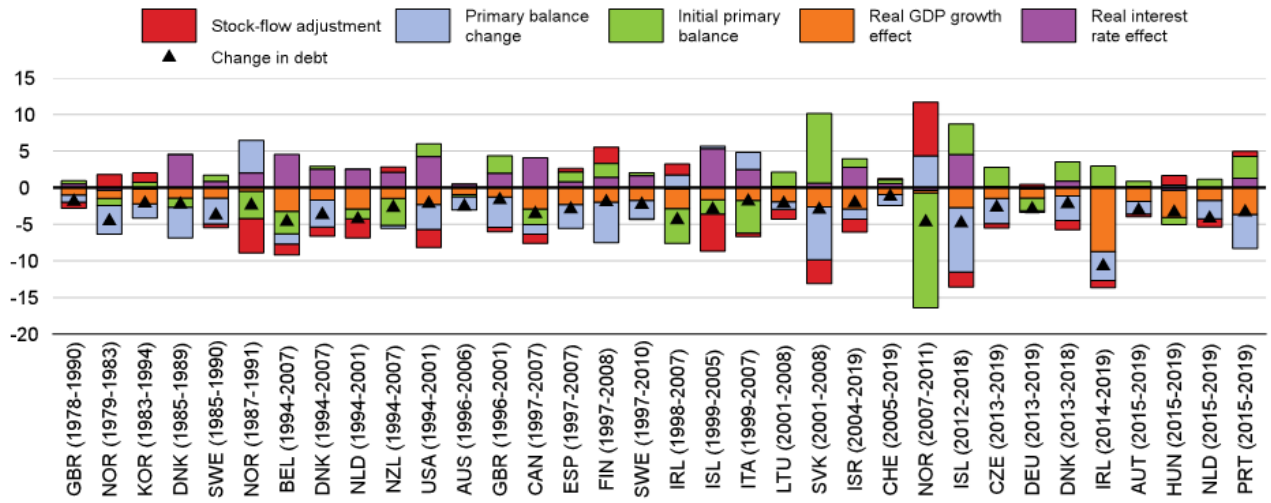
Accounting decompositions of changes in the debt-to-GDP ratio

typically consider three components (Rawdanowicz et al., 2021): the primary balance-to-GDP ratio (hereafter the "primary balance"), the interaction of debt and the differential between interest rates and GDP growth (the so-called "snowball effect"), and a residual stock-flow adjustment that summarises changes in gross debt unaccounted for by the budget balance. In turn, the average primary balance over each debt reduction episode can be decomposed into the initial balance when the debt ratio peaks and the average primary balance change over the length of the episode relative to the initial balance. Likewise, the aggregate snowball effect can be split to show separate impacts from real interest rates (with inflation measured by the GDP deflator) and real GDP growth.

The final decomposition of each debt reduction episode is shown in Figure 1. This highlights two key factors:

- In all but three episodes the primary balance is on average in surplus, helping to reduce the debt ratio. In around 80% of the episodes, this is due to improvements in the primary balance during the episode itself.
- In about two thirds of the episodes, and in all but one of the 14 episodes that have begun since the year 2000, the snowball effect contributes positively to the debt reduction. Cyclical conditions have almost always improved relative to those when the debt ratio peaked, and the real interest rate has often been only marginally positive or even negative.

Figure 1. Decomposition of the average annual change in the debt-to-GDP ratio during debt reduction episodes



Note: Episodes are ordered chronologically by starting year. See Annex 1.B. in OECD (2023) for further details.
Source: OECD Economic Outlook 113 database; and OECD calculations.

Expenditure restraint and shifts in the composition of public spending

Improvements in the primary balance during debt reduction episodes have mainly occurred due to declines in the primary expenditure-to-GDP ratio. This has taken place in over 80% of the 34 episodes considered. In contrast, the primary revenue-to-GDP ratio has risen in fewer than half of the episodes, mostly for ones that began in the 1980s and 1990s.

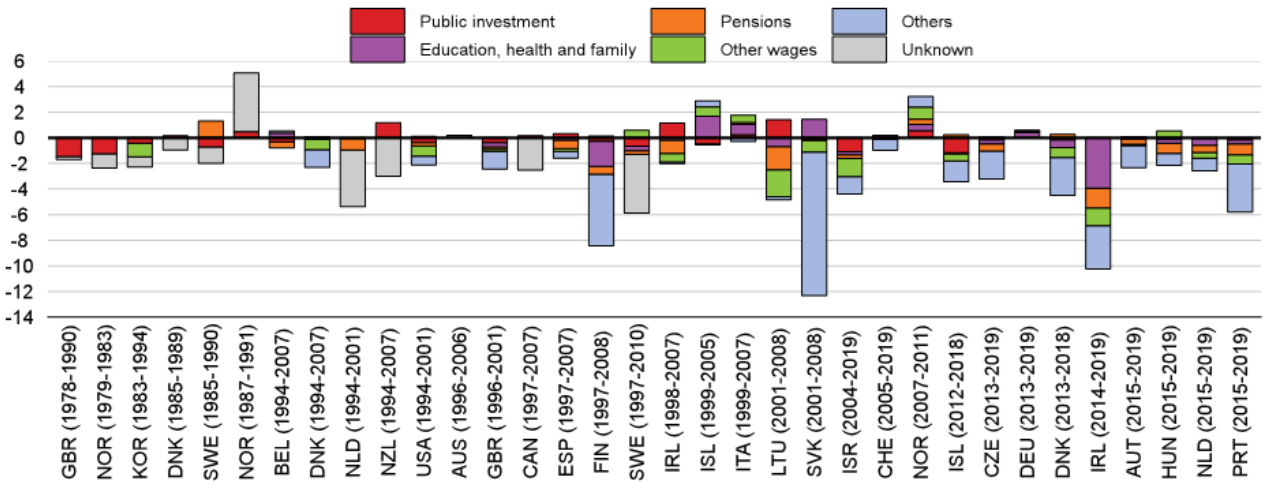
Expenditure restraint has often been accompanied, and likely made more sustainable, by relatively growth-friendly shifts in expenditure composition. Public investment as a share of GDP declined in about two-thirds of the episodes (23 out of 34; Figure 2), but these declines were often smaller than declines in other expenditure items, in contrast to the large public investment cuts often seen in consolidation episodes (Pina, 2016). Spending on education, health and family and children, generally regarded as growth- and equity-friendly (Cournède et al., 2014; Fournier and Johansson, 2016), has generally been

better preserved than spending on pensions and the bulk of non-education, non-health wages and intermediate consumption. Declines in the GDP share of the remainder of public expenditure, including subsidies, unemployment, sickness and disability benefits, other current transfers, and capital transfers have typically been the largest factor behind spending restraint. Many of these items are not growth-enhancing, though some can be very important for poorer households.

A positive differential between GDP growth and interest rates cannot be relied upon to decrease the debt-to-GDP ratio in the coming years, and attaining primary surpluses via expenditure restraint may prove difficult (Arslanalp and Eichengreen, 2023). This reflects the multiple future spending pressures governments face. Reductions in the debt ratio may thus be harder to achieve in the coming decade than in the past. However, past debt reduction episodes illustrate that it is possible to make significant savings in spending items which often harm growth, such as subsidies and certain transfers. In the current context, where the composition of public expenditure needs to change to address new challenges, that lesson remains highly relevant. However, such changes need to be accompanied by improvements to the overall targeting and design of spending programmes to maintain support for those who need it most.

Figure 2. Growth-friendly expenditure has typically been spared during debt reduction episodes

Changes in ratios to GDP, percentage points, average over each debt reduction episode



Note: The chart decomposes the average annual change in primary expenditure as a share of GDP over the length of each episode relative to its initial value into several expenditure components as defined in the OECD Public Finance Dataset (Bloch et al., 2016). In some earlier episodes not all components can be identified due to data limitations. Episodes are ordered chronologically by starting year. See Annex 1.B. in OECD (2023) for further details.
Source: OECD Economic Outlook 113 database; OECD Public Finance Dataset; and OECD calculations.

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New long-run scenarios: A path to offset CO2 mitigation costs

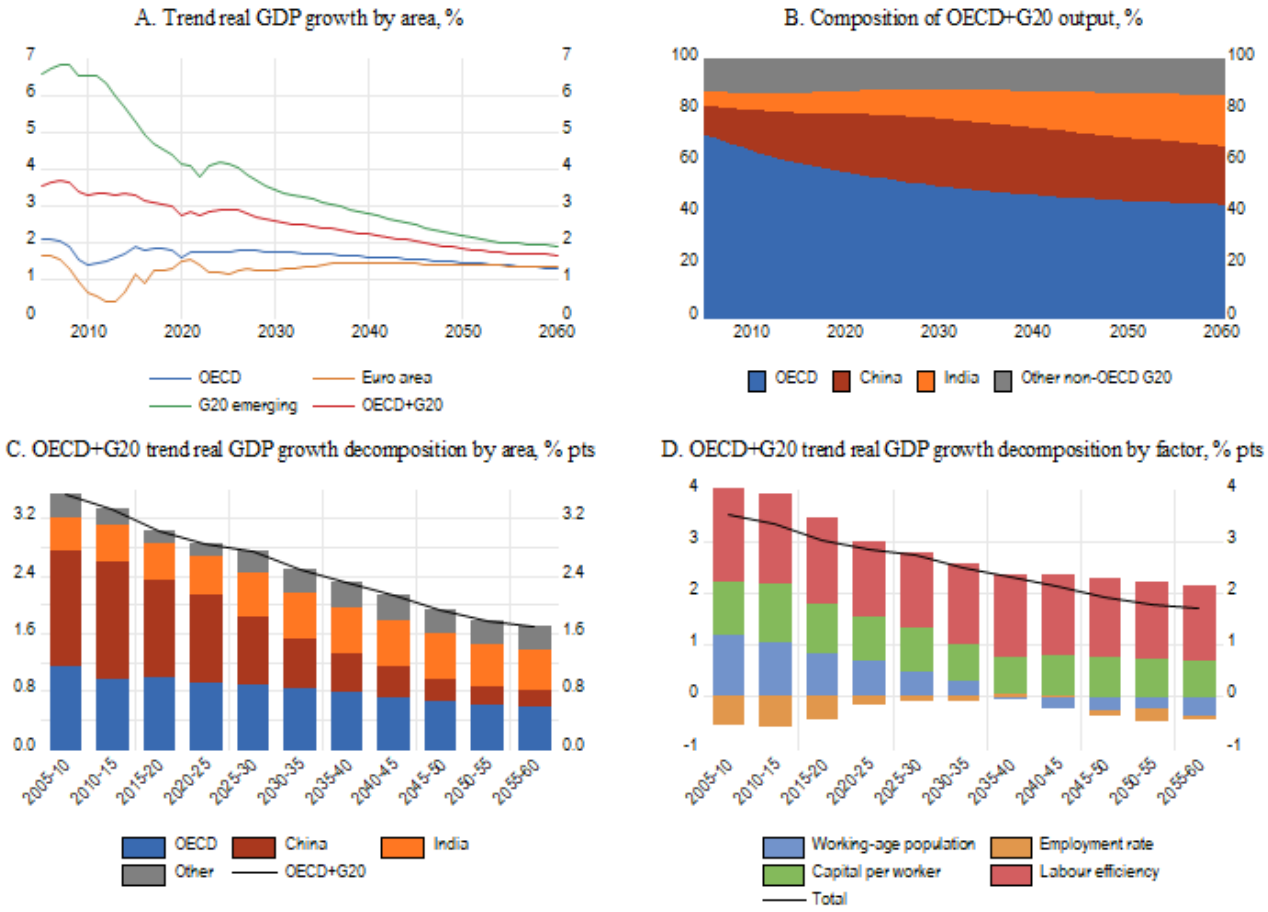
by Yvan Guillemette, OECD Economics Department

Every 2-3 years, the OECD Economics Department publishes a set of country-level economic scenarios to 2060 to quantify some of the most important long-term macroeconomic trends and policy challenges facing the global economy. The latest update includes the standard 'business-as-usual' scenario, in which no major reforms to government programmes are undertaken and

progress on energy efficiency and energy decarbonisation continues along recent trends. For the first time, the update also describes a stylised scenario in which OECD and non-OECD G20 economies successfully transition to low-carbon energy in a way broadly consistent with a net-zero target for greenhouse gas emissions by 2050. While this represents a negative supply shock to all economies, the upshot of the analysis is that fiscal and structural reforms could fully offset the output costs associated with mitigation efforts over the first 10 years of the energy transition.

In the baseline scenario, global CO_2 emissions from energy use remain around current levels, a trajectory incompatible with the UN Paris Agreement's ambition of limiting warming to 1.5°C. This failure occurs despite trend annual real GDP growth for the combined OECD+G20 area gradually declining from around 3% pre-COVID to 1.7% by 2060, mainly due to falling working-age population growth and a deceleration of trend labour efficiency growth in emerging-market economies. China and India continue to account for most of global growth, with India's contribution surpassing China's in the late-2030s.

Figure 1. The baseline scenario in a snapshot



Note: 'G20 advanced' includes Australia, Canada, Germany, France, the United Kingdom, Italy, Japan, Korea and the United States. 'G20 emerging' includes Argentina, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, Türkiye and South Africa. The OECD+G20 aggregate includes all OECD and non-OECD G20 countries.

In per capita terms, growth in the OECD area remains stable, around 1½ per cent per annum, below historical norms. Real GDP per capita growth is projected to slow in most of the G20 emerging-market economies, except those where recent performance has been relatively weak (including Argentina, Brazil and South Africa).

In the energy transition scenario, all countries accelerate their CO_2 mitigation efforts as of 2026, eliminating coal as an energy source by 2050 and lowering oil and gas shares in total

energy supply to 5% and 10%, respectively. Abstracting from gains due to avoidance of environmental damages, this acceleration of the energy transition leads to a reallocation of resources that impact GDP negatively. Global growth slows by 0.2 pp per annum initially relative to the baseline scenario, and by 0.6 pp toward the end of the transition period. The slowdown is more modest in the OECD area, but sharper in the G20 emerging-market area given higher carbon intensity.

An increase in carbon taxation sufficient to bring about the transition could bring in around 3¼ per cent of GDP in additional government revenue in the OECD area over the 2026-2030 period. In the basic energy transition scenario, this extra revenue is channelled back to households as a direct transfer. However, an alternative scenario assesses a tax shift strategy in which revenue from higher carbon pricing is used to lower the tax burden on labour (labour tax wedges). Dynamics are important here because revenue from carbon pricing first rises, but later declines along with CO_2 emissions, implying that tax wedges could be lowered, but would eventually have to rise again. Nevertheless, because higher carbon pricing is politically awkward to implement, the tax shift strategy could facilitate the phasing in of higher carbon taxes, allowing at least the initial part of the energy transition to benefit from the greater efficiency of a price-induced transition.

Via positive effects on employment, this tax shift strategy is shown to fully offset the decline in output otherwise associated with the first 10 years of the energy transition, leaving living standards in 2035 higher than in the baseline scenario in the OECD area and most individual countries. At peak impact around 2035, the euro area and OECD aggregate employment rates are around 1½ pp higher than without the tax shift.

Figure 2. Shifting tax burden from labour to carbon offsets most transition costs to 2035

Level of potential output in 2035, % difference between scenarios (see legend and note)

Note: Blue bars show the % difference in the level of output in 2035 in an energy transition scenario with carbon revenue rebated as lump sums versus the baseline scenario. Orange bars show the % difference in the level of output in 2035 in an energy transition scenario with carbon revenue used to lower tax wedges versus when it is rebated as lump sums. Diamonds show the % difference in the level of output in 2035 in an energy transition scenario with carbon revenue used to lower tax wedges versus the baseline scenario, which corresponds to the sum of blue and orange bars. Chile, Colombia, Costa Rica, Mexico, Norway and Türkiye are not shown as these countries do not have a fiscal block in the OECD Global Long-Term Model.

Additional scenarios show that deploying the extra revenue into a combination of higher R&D expenditure and support for childcare would have similar effects. Other structural reforms, such as product market liberalisation and improvements in governance could also help to offset the output costs of CO_2 mitigation.

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Doombot Recession Outlook

by Thomas Chalaux and Dave Turner, OECD Economics Department

Macroeconomic forecasters make their biggest errors because of a failure to predict future recessions.[1] The problems of predicting the timing of cyclical turning points or future shocks can, however, be mitigated by a prescient discussion of risks surrounding the central published forecast. For example, the recently published OECD Economic Outlook, warns "*[T]he unusually fast and large-scale tightening of monetary policy … could continue to expose vulnerabilities among households, firms, financial market participants and countries*", so that "*[O]verall, the risks to the projections remain skewed to the downside*". Recent work at the OECD attempts to take such risk assessments further by quantifying the probability of a future recession (Chalaux and Turner, 2023).

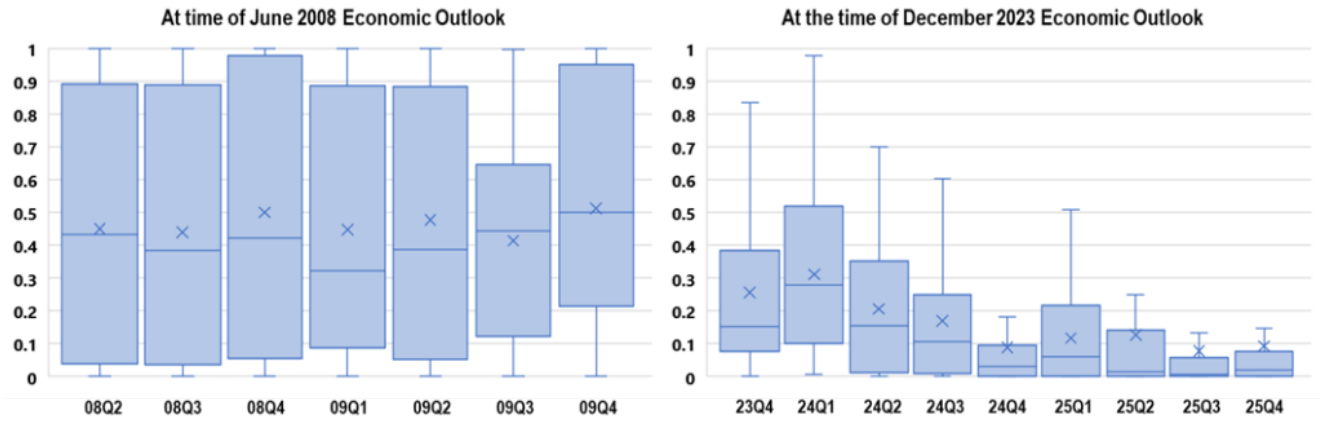
An algorithm, "DoomBot", selects parsimonious models to predict recessions over different quarterly horizons covering the ensuing two years for 20 OECD countries. The models are country- and horizon-specific and are automatically updated as the estimation sample period is extended, so facilitating out-of-sample evaluation of the algorithm. A limited combination of explanatory variables is chosen from a much larger pool of potential variables that include those that have been most useful in predicting downturns in previous OECD work. The most frequently selected variables are financial variables,

especially those relating to credit and house prices, but also include equity prices and various measures of interest rates (such as the slope of the yield curve). Business cycle variables – survey measure of capacity utilisation, industrial production, GDP and unemployment – are also selected, but more frequently at short horizons. The variables selected do not just relate to the domestic economy of the country being considered, but also international aggregates, consistent with findings from previous OECD work.

Looking at the performance of the algorithm over past episodes, the models provide a clear out-of-sample early warning of the Global Financial Crisis (Figure 1, LHS panel). The models are less good at predicting the euro area crisis out-of-sample, but it is clear from the evolution of the choice of variables that the algorithm learns from this episode, for example through the more frequent selection of a variable measuring euro area sovereign bond spreads.

Figure 1. Distribution of recession probabilities among 20 OECD countries

Comparing Doombot projections made in June 2008 and December 2023



Note: The box and whiskers chart shows the distribution of recession probabilities among a sample of 20 OECD countries according to out-of-sample probit model predictions made using the DoomBot algorithm. The LHS panel shows the out-of-sample predictions using information available at the time of the

publication of the June 2008 Economic Outlook, whereas the RHS panel shows the current predictions made with the latest available data. The box shows the inter-quartile range for the 20 countries; the whiskers the extremes; the X is the simple average; and the horizontal bar is the median.

Recession risks to the current outlook

The latest Doombot predictions suggest that the probability of recessions among OECD countries is much lower than prior to the GFC (comparing RHS and LHS panels of Figure 1), although it still remains quite high in historical context, especially over the coming year and among European countries:

- There are 5 European countries – **Germany**, **France, Finland, Portugal and Sweden** – where recession probabilities exceed 50% in two consecutive quarters over the next year and a further four – **the United Kingdom, Italy, Switzerland and Belgium** – where they exceed 25%. The main driver in most of these cases is the turning of the house price cycle, often supplemented by weak signals from activity variables.

- For **Japan**, recession risks for the first two quarters have risen above 25%, partly because of the rise in oil prices. Although oil prices enter into many other country risk models, Japan seems particularly vulnerable in this respect. For **Canada**, recession risks reach 25% in coming quarters driven by weak survey measures of capacity utilisation and a negative yield curve slope.

- For the **United States**, risks of a recession in 2024 appear to be small; there is no warning signal from share prices or survey measures of capacity utilisation that usually pick up weakness at short horizons, and the

slope of the yield curve (a popular signal of recession risks) has recently become less negative. The turning of the house price cycle suggests recession risks increase in 2025, although the models are less reliable at longer horizons.

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[1] For discussion and evidence of the difficulties in forecasting recessions, see An et al., (2018) and Turner et al. (2018) as well as references therein.

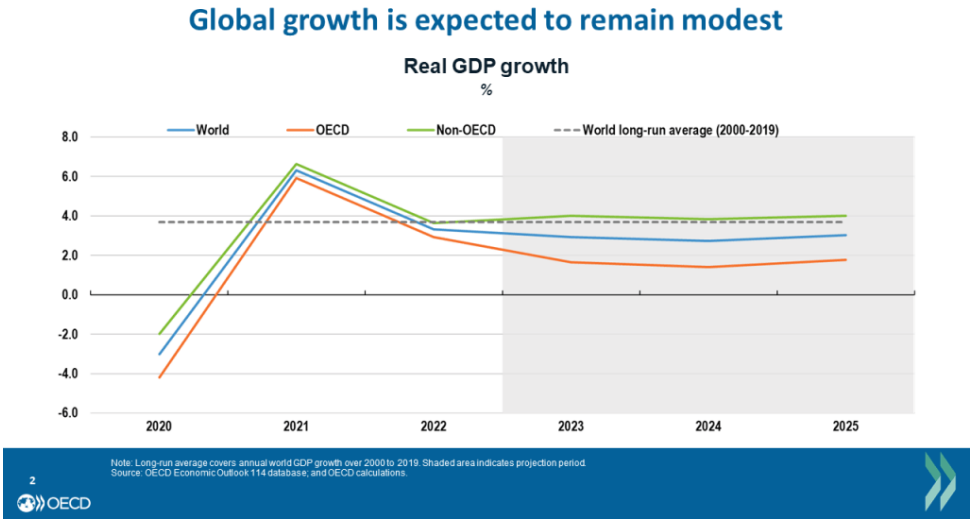
Rétablir la croissance

Clare Lombardelli, Cheffe économiste de l'OCDE

L'inflation s'atténue, mais la croissance ralentit. Le resserrement des politiques monétaires nécessaire pour lutter contre l'inflation produit ses effets. Malgré une croissance

du PIB plus forte que prévu en 2023, le durcissement des conditions financières, la faiblesse des échanges et la confiance en berne pèsent sur l'activité. Les marchés du logement et les économies tributaires des banques, notamment en Europe, en ressentent les effets.

Le rythme de la croissance est inégal. Les économies de marché émergentes connaissent globalement une situation plus favorable que les économies avancées. La croissance est moins rapide en Europe qu'en Amérique du Nord et dans les grandes économies d'Asie. L'inflation, bien qu'en recul, reste préoccupante.

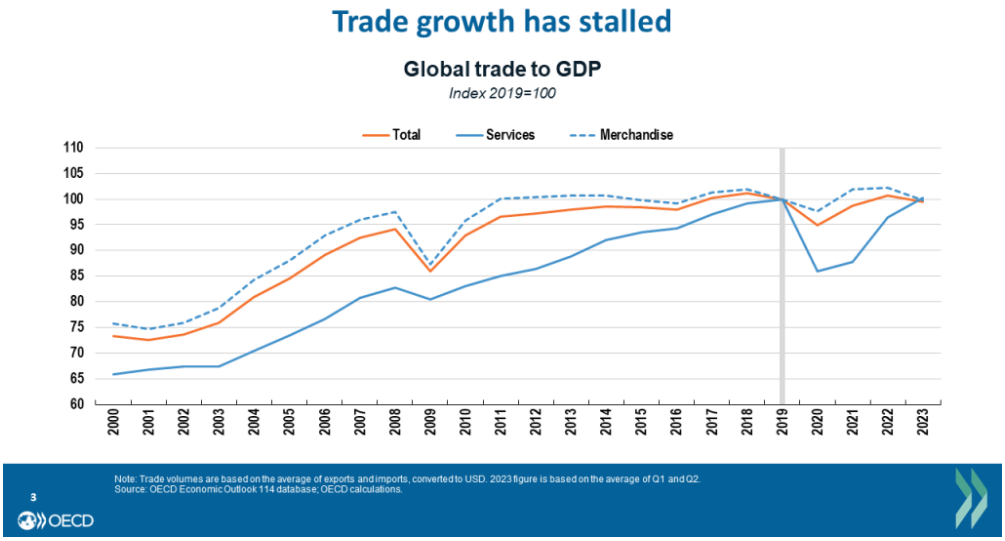


Nous prévoyons un atterrissage en douceur pour les économies avancées, mais cette issue est loin d'être garantie. La relation entre l'inflation, l'activité et les marchés du travail a changé, si bien qu'il est difficile d'évaluer pleinement l'impact du resserrement des politiques monétaires. Aux États-Unis, l'économie se révèle plus dynamique que prévu, et il existe un risque que l'inflation s'avère persistante. Dans la zone euro, les effets du durcissement de la politique monétaire ne se sont pas encore pleinement matérialisés, et l'activité pourrait être plus fortement touchée qu'on ne l'anticipe.

Nombre d'économies de marché émergentes ont fait preuve d'une résilience considérable au cours de l'année écoulée, mais les

pays présentant des vulnérabilités liées à leur endettement structurel sont maintenant surveillés de près par les marchés.

Les échanges mondiaux manquent de dynamisme. Des facteurs non seulement conjoncturels, mais aussi structurels entraînent un ralentissement de l'intégration des chaînes de valeur entre pays. Des opportunités de croissance, liées en particulier à une augmentation des échanges de services, sont inexploitées. Nous devons relancer le commerce mondial. Pour développer la résilience des chaînes de valeur mondiales, il s'agit de promouvoir plutôt la diversification que le protectionnisme ou des politiques de repli sur soi.



Les tensions budgétaires s'accentuent dans de nombreux pays. Compte tenu des évolutions démographiques, de la décarbonation ainsi que de la combinaison d'un alourdissement des charges d'intérêts et d'une croissance lente, les pays sont confrontés à des perspectives budgétaires difficiles. Les gouvernements doivent prendre des mesures audacieuses pour réduire ces pressions et mettre l'accent davantage sur la croissance dans l'élaboration de leurs politiques. Cela signifie qu'il faut réformer les politiques du marché du travail et les systèmes de retraite, intensifier la concurrence et actionner les leviers budgétaires pour accroître les investissements susceptibles de renforcer le capital humain et la productivité, notamment les investissements nécessaires à la

transition écologique.

En résumé, l’économie mondiale est aux prises avec l’inflation, le ralentissement de la croissance et la montée des tensions budgétaires. Les décideurs publics doivent donner la priorité à la stabilité macroéconomique, aux réformes structurelles, aux politiques budgétaires intelligentes et à la coopération internationale, pour favoriser une croissance durable et inclusive.

Pour plus d’infos et de données: https://oe.cd/PE-nov23

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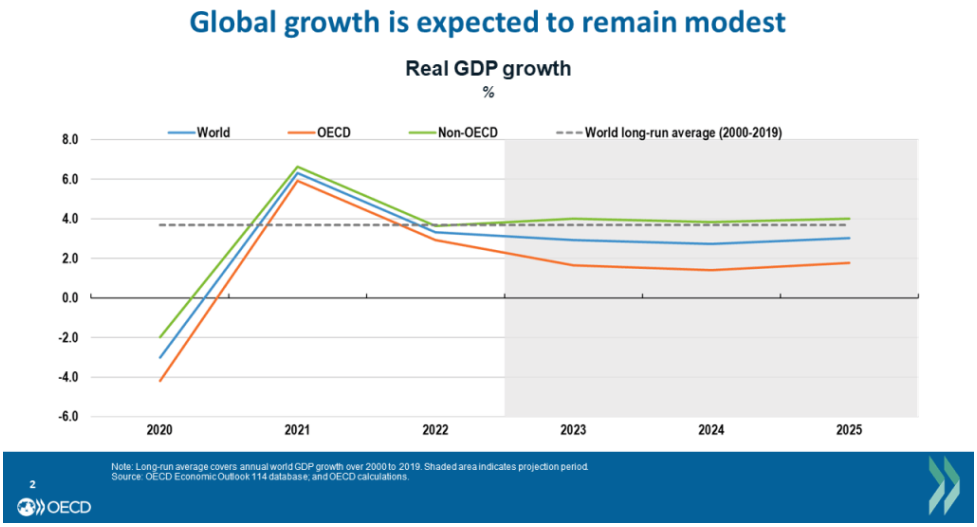
Restoring growth

by Clare Lombardelli, OECD Chief Economist

Inflation is easing, but growth is slowing. The tightening of monetary policy needed to tackle inflation is taking effect. Despite stronger-than-expected GDP growth in 2023, tightening financial conditions, weak trade, and subdued confidence are taking a toll. Housing markets and bank-dependent economies, particularly in Europe, are feeling the impact.

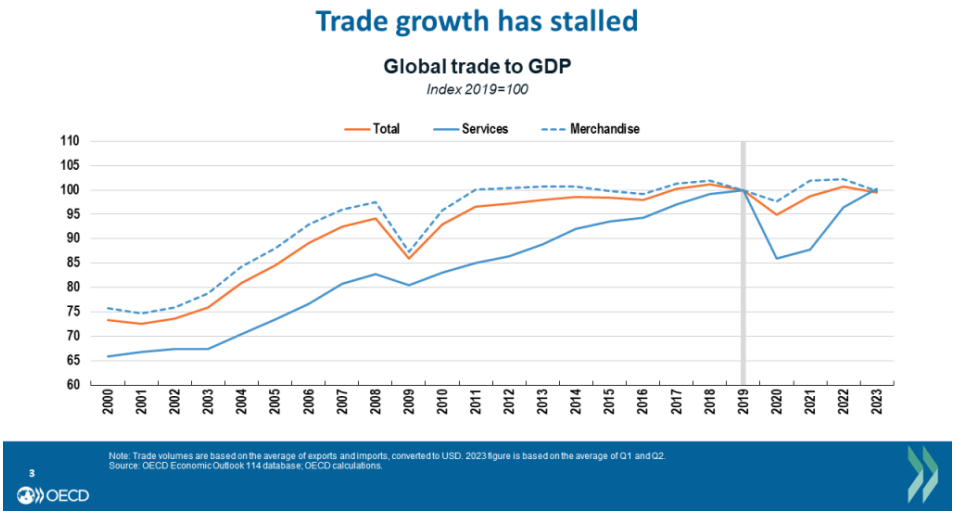
The pace of growth is uneven. Emerging markets are generally faring better than advanced economies. Europe’s growth lags behind North America and major Asian economies. Inflation, while easing, remains a concern.



We are projecting a soft landing for advanced economies, but this is far from guaranteed. The relationship between inflation, activity and labour markets has changed, making the full impact of monetary policy tightening hard to judge. In the United States, the economy is demonstrating more strength than expected, and there is a risk that inflation proves to be persistent. In the euro area, the full impact of tighter monetary policy is still to appear and activity may be hit more strongly than we expect.

Many emerging markets have shown considerable resilience over the past year, but countries characterised by structural debt vulnerabilities have come under market scrutiny.

Global trade is weak. Not only cyclical, but also structural factors are causing a slowdown in the rate at which value chains are integrating across countries. Opportunities for growth, particularly from greater services trade, are being missed. We must revive global trade. Resilience in global value chains is best delivered by diversification, not by protectionism and inward-looking policies.



In many countries, fiscal pressures are mounting. Demographic changes, decarbonisation, and a combination of rising interest payments and slow growth mean countries face a challenging fiscal outlook. Governments need to take bold action to reduce such pressures and give a greater focus to growth in their policy making. That means reforming labour market and pensions policies, increasing competition, and using fiscal levers to increase human capital and productivity enhancing investment, including the investment needed to deliver the green transition.

In summary, the global economy is grappling with inflation, slowing growth, and mounting fiscal pressures. Policymakers must prioritise macroeconomic stability, structural reforms, smart fiscal policies and international cooperation to foster sustainable and inclusive growth.

For more info and data visit: www.oecd.org/economic-outlook/november-2023/

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Institutional shareholding, common ownership and productivity: a cross-country analysis

By Maria Bas[1], Lilas Demmou, Guido Franco and Javier Garcia-Bernardo[2]

The increase in institutional ownership, accompanied by the shift towards passive portfolio management and the rise of common ownership, have transformed OECD countries financial markets in the last decades. These transformations have the potential to influence listed firms' productivity, given the role of equity owners in allocating private savings across firms and influencing firms' investment decisions.

Against this backdrop, and relying on a rich firm-level dataset covering financial and granular ownership information on firms across a wide range of countries and sectors, Bas et al. (2023) study the productivity consequences of these changes via two main channels: a "governance channel", looking at the role of institutional owners' business model (i.e., investment style, time horizon etc.); and a "common ownership" channel, analysing the productivity impact of simultaneous ownership of shares in competing firms (i.e. intra-industry) or potentially vertically integrated firms (i.e. inter-industry).

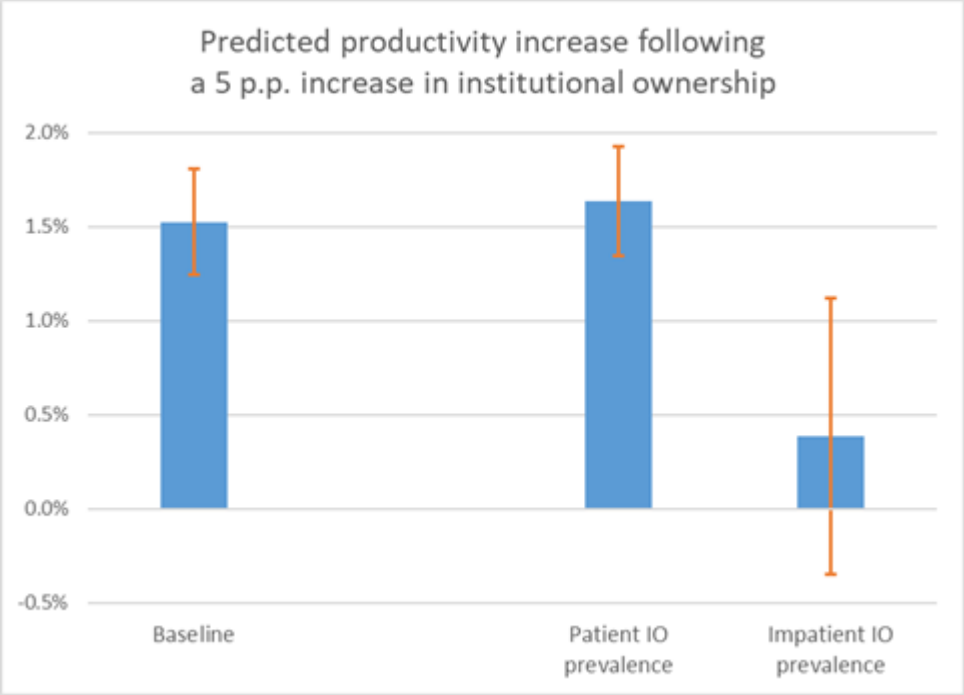
The governance channel

The business model of institutional owners has recently been the subject of debate in two main areas. First, institutional investors tend to have higher portfolio turnover rates than

corporate owners, potentially inducing a focus on short-term outcomes, while long-term-oriented owners are more likely to support innovative and human capital-intensive projects that yield (productivity) benefits over time. Second, institutional investors increasingly rely on passive investment styles, characterized by reduced monitoring but also increased diversification, which can encourage support for R&D activities by attenuating idiosyncratic risks associated with innovation.

Our main findings suggest, overall, a positive relationship through the governance channel: firms displaying higher institutional ownership tend to have higher productivity levels and growth rates compared to their peers (Figure 1). Consistent with theory, there is some heterogeneity across different types of institutional investors depending on their time horizon and investment style. On the one hand, the positive correlation tends to vanish when institutional investors' horizon shortens, highlighting the relevance of the provision of patient capital (Figure 1). On the other hand, the correlation appears larger the higher the shares of large, passive and diversified owners, confirming that a diversified portfolio may favour support to innovative investments despite potential lower monitoring.

Figure 1 Institutional ownership and productivity are positively related at the firm-level



Note: Interpreting results as if they were causal, the blue bars represent the average change in firms' productivity following a 5 p.p. increase in institutional ownership. The orange whiskers indicate the 95% confidence intervals. Source: Bas, Demmou, Franco and Garcia-Bernardo (2023).

The common ownership channel

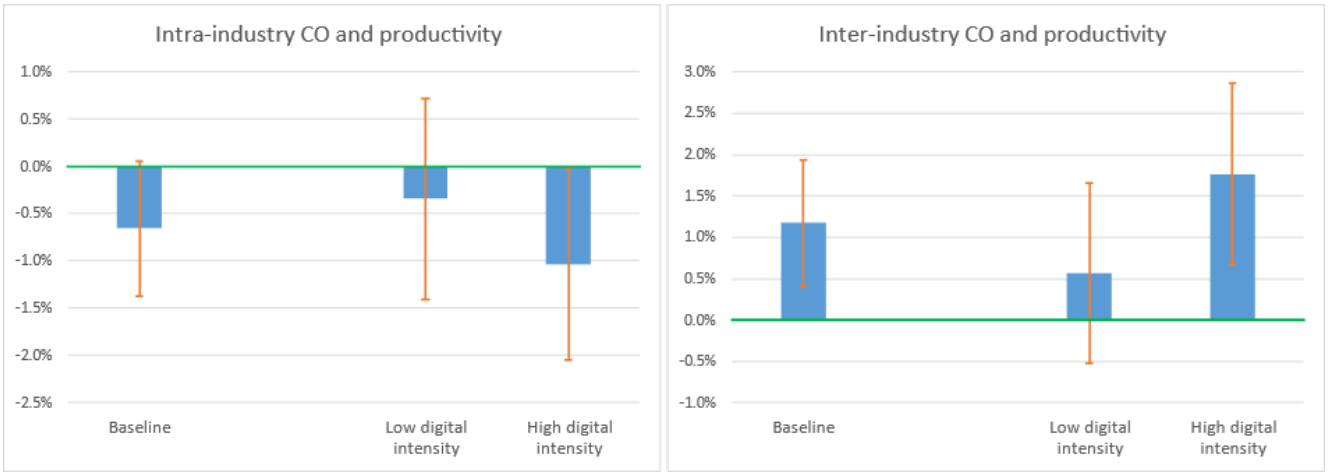
The consequences of common ownership for firms' productivity may vary depending on whether it occurs within industries or across industries.

Intra-industry common ownership. Firms operating in the same industry and belonging to the same investor's portfolio may, in the interest of their common shareholders, compete less intensively on product markets, for instance by colluding more easily, with detrimental consequences for productivity (*competition channel*). At the same time, intra-industry common ownership could benefit innovation and productivity when inter-firm coordination is explicit (e.g. joint ventures or strategic alliances) and firms find it easier to cooperate in their R&D efforts and share knowledge (*cooperation channel*). The estimates from the analysis linking intra-sector common

ownership and productivity are not always significant (Figure 2, left panel). Still a negative relationship appears to prevail when they are, hinting that the competition channel may slightly outweigh the cooperation channel. The negative association is stronger in innovative sectors, further corroborating the potential existence of a competition channel given that these industries tend to be more concentrated.

Inter-industry common ownership. Common ownership along the value chain may lead to stronger business relationships among vertically integrated firms, (*vertical integration / spillover channel*), by attenuating hold-up problems when information asymmetries are high. Moreover, from a general equilibrium perspective, the attempt to increase profits through higher prices and lower competition is not immune to a backlash for common owners, as they risk ending up with lower profits in downstream industries due to higher inputs costs. The empirical investigation supports the existence of a positive relationship between inter-industry common ownership and firm-level productivity (Figure 2, right panel). The positive association is again stronger for firms producing in innovative sectors, potentially due to a more efficient network of vertical relationships and technological spillovers, which are particularly relevant in these sectors.

Figure 2 The productivity implications of common ownership depend on whether it occurs intra- or inter-industry



Note: Interpreting results as if they were causal, the blue

bars represent the average change in firms' productivity following an increase in inter (left panel) or intra (right panel) industry common ownership from 0 to the level observed at the 75th percentile of the distribution of the respective firm level common ownership measure. The orange whiskers indicate the 95% confidence intervals. Common ownership is measured as in Azar et al. (2018) and Azar et al. (2021). Source: Bas, Demmou, Franco and Garcia-Bernardo (2023).

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