How do you improve the durability of a Celtic Tiger?

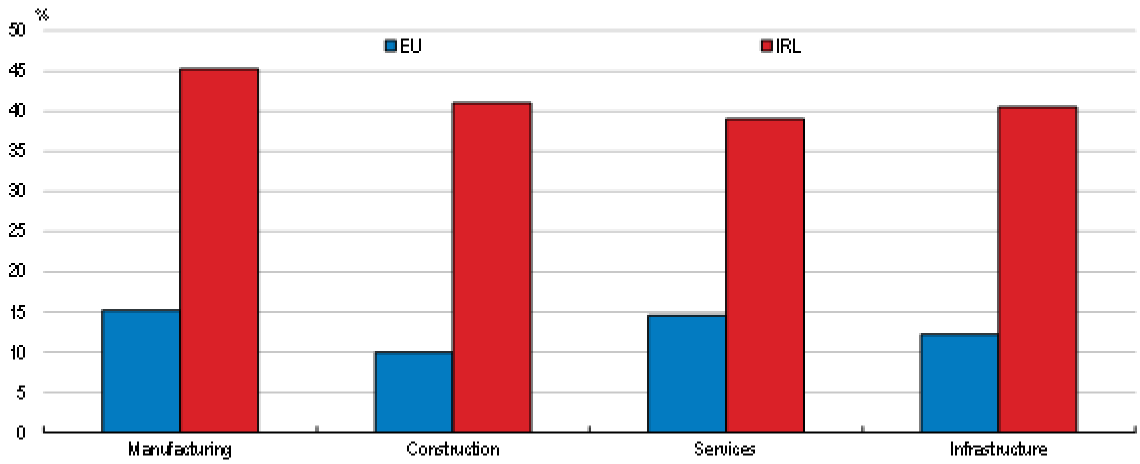
By Ben Westmore and Yosuke Jin, Ireland Desk, Economics Department

The Irish economy is booming and is expected to continue expanding at healthy rates over the next few years. But as the 2018 OECD Economic Survey of Ireland highlights, the outlook is clouded with uncertainty.

Brexit could have serious implications for the Irish economy given the close economic relationship between Ireland and the UK (Figure 1). New OECD estimates suggest that a trade arrangement between the UK and EU governed by the World Trade Organisation's Most-Favoured Nation Rules would reduce total Irish exports by 20% in some sectors such as agriculture and food.

Figure 1. Brexit uncertainty is impacting upon the Irish economy

Proportion of firms expecting a negative impact from Brexit.



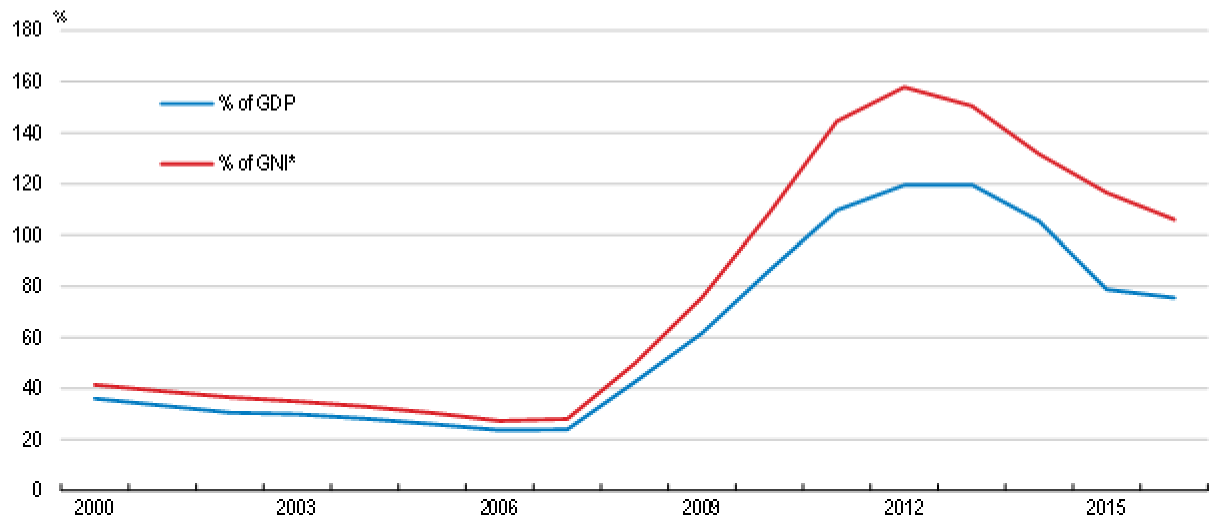
Source: EIB Investment Survey.

In addition to Brexit risks, rising international tax competition is a concern for Ireland. The Irish economy has been highly successful at attracting foreign direct investment, with foreign-owned firms accounting for close to half the country's gross value added over recent years. As a result, reductions in effective corporate tax rates in other countries may have a negative impact on the Irish economy if they encourage some multinational firms to relocate their operations elsewhere.

In this context, the importance of raising the resilience of the Irish economy cannot be overstated.

Public finances have improved noticeably, but government debt remains high and tax receipts have become more subject to volatility (Figure 2). Further reducing public debt would create scope for budgetary policy to support the economy in the event of a negative shock – such as a disorderly Brexit. This could be achieved by broadening the tax base in a growth-friendly way. For example, VAT preferential rates and exemptions should be phased out and the property tax yield raised through more regular revaluations of the tax base.

Figure 2. Gross government debt ratios are declining but remain high



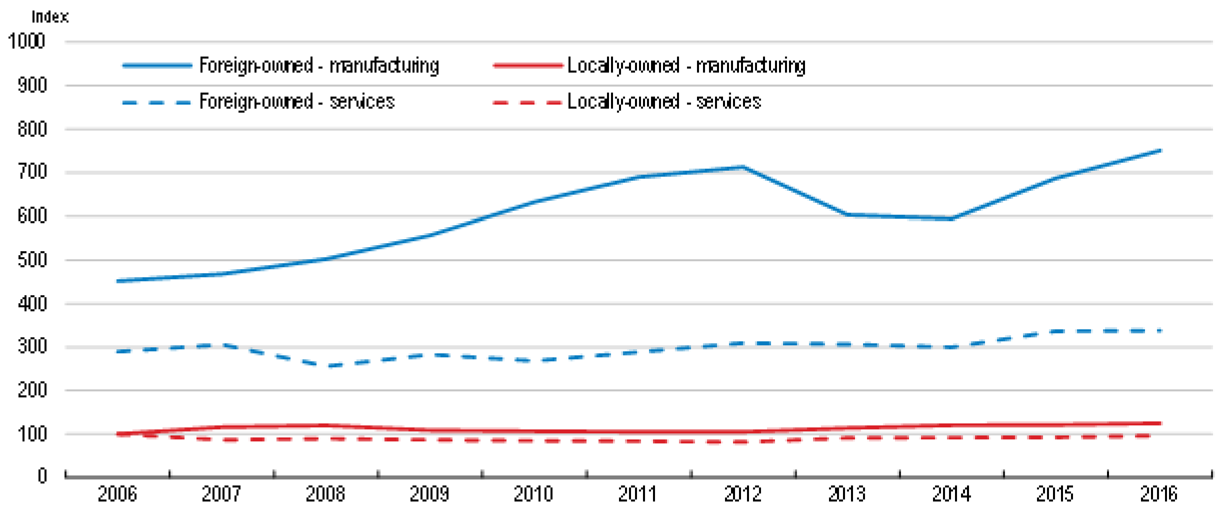
Source: Central Statistics Office and OECD.

Financial sector vulnerabilities also need to be further addressed. While non-performing loans on bank balance sheets have declined by around 60% from their peak, the stock remains high. Measures that reduce judicial inefficiencies relating to the repossession of collateral and further encourage NPL write-offs will promote the efficient allocation of capital as well the ability of the banking sector to withstand any further adverse economic shocks.

Above all else, the long-term durability of the Irish economy will rely on policy reforms that encourage a broad-based recovery in productivity. Most Irish firms have experienced declining productivity over the past decade. This has largely reflected the poor performance of local firms, with the large productivity gap between foreign-owned and local enterprises having widened (Figure 3). New firm level analysis undertaken in tandem with this *Economic Survey* confirms this is the case (Department of Finance, 2018; the findings of this work will be discussed in more detail in a blog post over the coming days). The resilience of the Irish economy hinges on unblocking the productivity potential of these local businesses. Pruning back regulatory barriers to entrepreneurship, such as costly regulations related to commercial property and legal services, is a start. However, productivity spillovers between foreign-owned firms and local businesses also need to be fostered by encouraging the accumulation of high-level managerial skills and research and development intensity in the latter.

Figure 3. The large productivity gap has widened

Labour productivity index (Irish firms in 2006=100)



Source: Department of Business, Enterprise and Innovation.

Creating a more sustainable growth environment will raise the ability of policymakers to confront key challenges that exist for the wellbeing of the population. Particular areas that should be a focus include health, housing and getting people into work. To address these challenges, universal healthcare coverage should be provided, stringent housing regulations that are constraining dwelling supply rationalised and some social benefits withdrawn more gradually as labour earnings rise.

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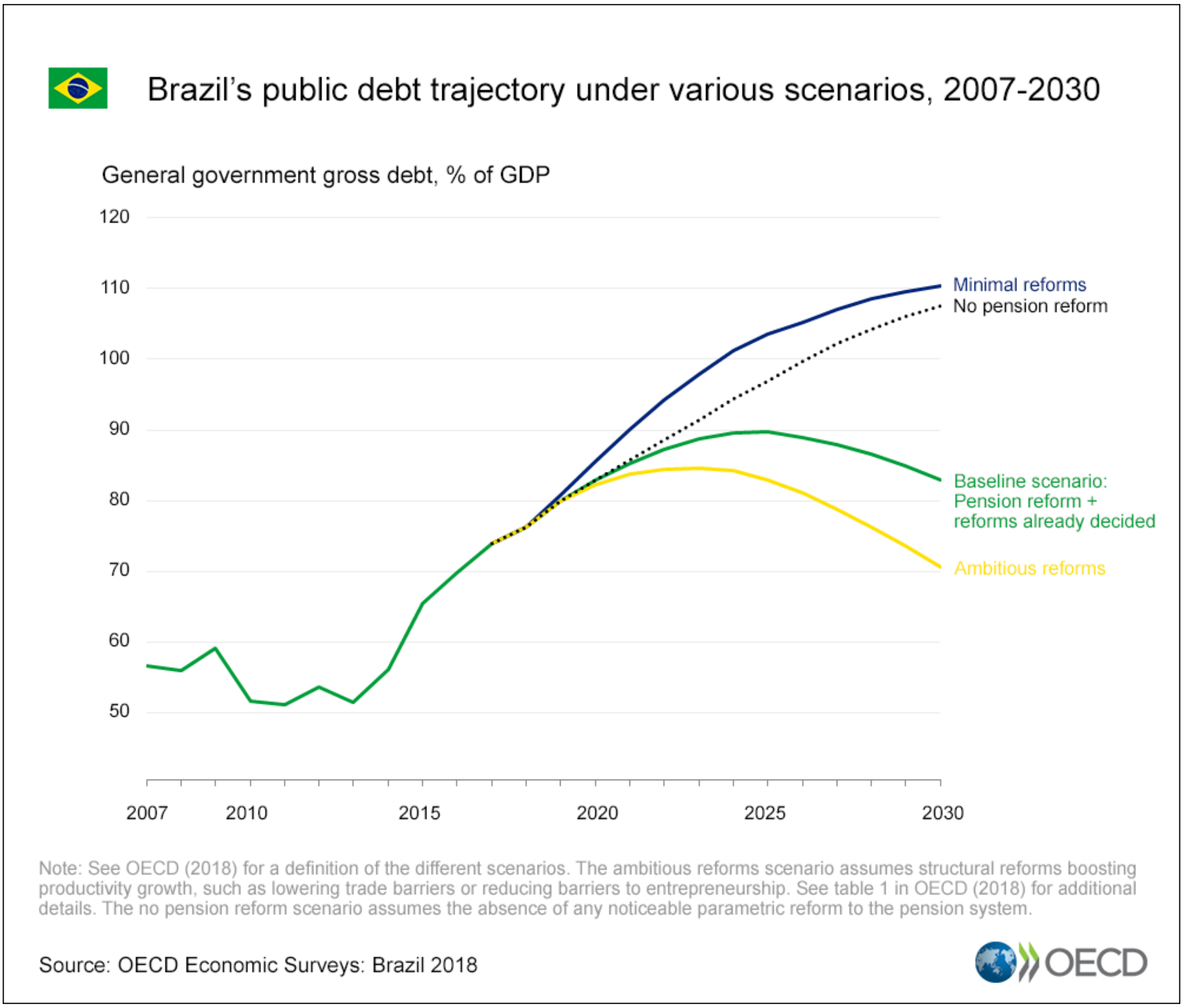
OECD (2018), *OECD Economic Surveys: Ireland 2018*, OECD Publishing, Paris.

Towards a more prosperous and inclusive Brazil

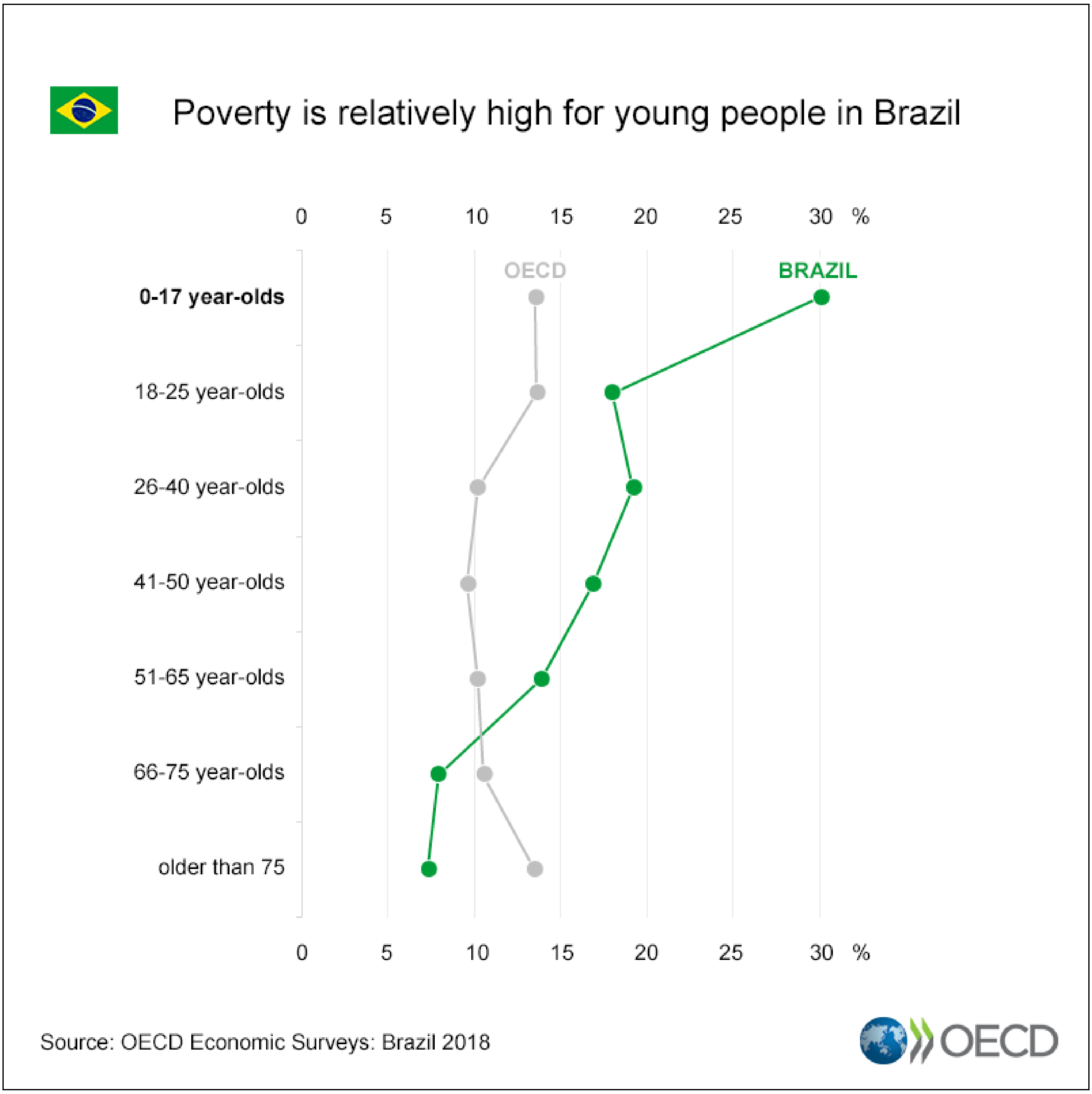
By Jens Arnold and Alberto González Pandiella

Over the past two decades, strong growth combined with remarkable social progress has made Brazil one of the world’s leading economies. However, Brazil remains a highly unequal country, recent corruption allegations have revealed significant challenges in economic governance and the situation of its fiscal accounts is challenging with high and rising public debt (OECD, 2018). This calls for wide-ranging reforms to sustain and continue progress on inclusive growth. The government has started to put in place significant reforms, including a fiscal rule and a financial market reform that aligns directed lending rates with market rates. The long and deep recession is over and growth is projected to accelerate significantly this year. But more needs to be done to improve the living standards of all Brazilians.

The overall budget deficit is close to 8% of GDP driven by rising expenditures. Gross public debt has increased by approximately 20 percentage points of GDP over the last 3 years and stands around 75% of GDP. Implementing the planned fiscal adjustment and achieving fiscal targets is crucial for restoring the credibility of fiscal policy and avoiding a fiscal crisis. A comprehensive social security reform has become the most urgent element of the fiscal adjustment, as much of the worsening of the deficits is due to rising pension spending. A pension reform is also an opportunity to make growth more inclusive through better targeting of benefits. Aligning Brazil’s pension rules with those practiced in OECD countries could be done in a way to preserve the purchasing power of pensioners while significantly improving the sustainability of the pension system. For example, in OECD countries people retire on average when they become 66 years old, while the effective retirement age in Brazil is 56 years for men and 53 for women. Establishing a formal minimum retirement age would help, in addition to rethinking the current benefit indexation mechanisms. Without reform, pension expenditure will more than double by 2060 (OECD, 2017), which would lead to unsustainable fiscal dynamics (Figure 1).



Improving the effectiveness of public spending, and in particular public transfers, will also be crucial for further social progress. At present a large and rising share of social benefits is paid to households that are not poor, which reduces their impact on inequality and poverty. Already, poverty is more than three times higher among children and youths than among those aged above 65 (Figure 2). Limiting future increases in those social benefits that do not reach the poor would be a first step. That would instead allow shifting more resources towards transfers that do reach the poor, such as Bolsa Família, which is highly regarded across the world and reaches the poor like hardly any other social programme in Brazil. This would help particularly children and youths. Currently Bolsa Família only represents 0.5% of GDP out of the 15% of GDP that Brazil spends on social transfers (OECD, 2018). There is also scope to reduce transfers to the corporate sector, which have increased markedly over recent years. These transfers, often granted in the form of tax exemptions or subsidised lending, have not been associated with visible improvements in productivity or investment, but they benefitted primarily the more affluent, besides creating fertile ground for corruption and political kick-backs.



Further advances in living standards will also hinge on finding a new inclusive growth strategy, ensuring that the benefits of growth will be broadly shared across the population. Productivity will have to become the principal engine of growth in the future, because the demographic bonus that has supported growth in Brazil is reversing. But raising productivity will require significantly higher investment and trade. Brazil has one of the lowest investment rates among OECD and emerging market economies and it is also less integrated into global trade. Boosting investment and trade would raise productivity, helping Brazilians to access higher wages and living standards.

References:

OECD (2018), *OECD Economic Surveys:Brazil*, OECD Publishing, Paris.

OECD (2017), "Pension Reform in Brazil, OECD Policy Memo", April 2017, https://www.oecd.org/brazil/reforming-brazil-pension-system-april-2017-oecd-policy-memo.pdf.

The Slovenian economy is bouncing back

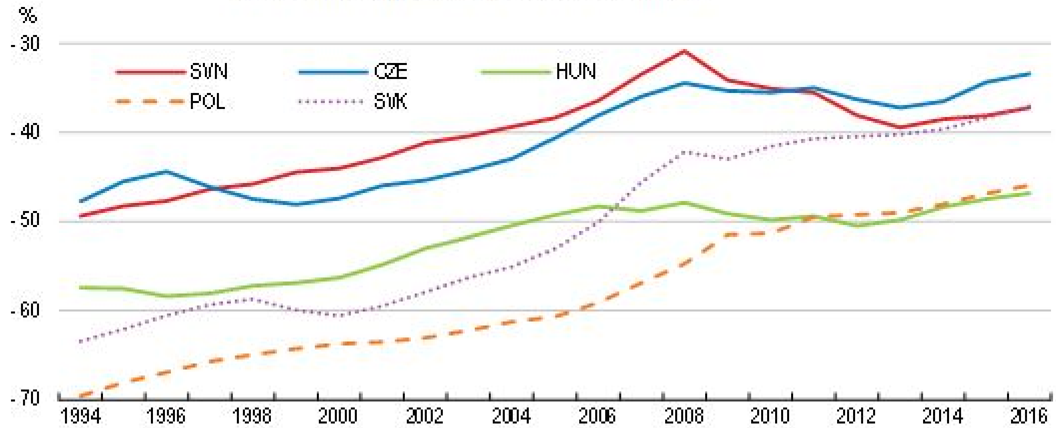
by Rory O'Farrell, Slovenia Desk, OECD Economics Department

Slovenia would do well if its economy performed as well as its ski-jumpers. In 2015, Slovenian Peter Prevc became the first ski-jumper in history to jump 250 metres. As impressive has been his ability to land successfully, being among the few jumpers to receive a perfect 20 points for style. While the Slovenian economy has been successful in bounding forward, it has taken hard falls in the past, and a lack of resilience means it has taken a long time to recover.

Prior to the international crisis, the bounding Slovenian economy converged with advanced OECD economies, before suffering a double hard landing with the onset of the international financial crisis and a subsequent domestic banking crisis. However, thanks to recent structural reforms, business restructuring, supportive monetary conditions and improved export markets, Slovenia is leaping forward again. GDP growth is accelerating and broadening, unemployment is down, and both consumer confidence and the trade balance are reaching record highs. The government may need to step in early with tighter fiscal policy to ensure a controlled landing.

Convergence in GDP per capita has faltered, unlike other countries in the region

Gap to the upper half of OECD countries[1]



1. Percentage gap with respect to the weighted average using population weights of the highest 17 OECD countries in terms of GDP per capita (in constant 2010 PPPs).
Source: OECD, National Accounts and Productivity Databases.

However, unlike its agile youthful ski-jumpers, Slovenia is not breaking any records in terms of productivity. Indeed, its growth has lagged that of regional peers. Labour productivity is low compared to the OECD average, in part due to large numbers of workers employed in relatively low-productivity small firms, and this has yet to show a strong improvement. Productivity gains were also held back by low investment, as the crisis-afflicted banking sector was unable to lend to domestic firms, and Slovenia has been less succcesful in attracting foreign direct investment than other countries in the region. In addition, a lack of competitive pressure, due to heavy regulation and ineffective competition policies and enforcement, has inhibited Slovenian firms from developing the efficiency needed to drive productivity forward.

The nimbleness of the Slovenian economy is also being reduced by a rapidly ageing population. Older workers with obsolete skills have tended to take early retirement rather than retrain, and a poor reallocation of labour is leading to labour shortages. In the past such shortages were filled by training young Slovenians, but a shrinking youth population means this is no longer possible. In addition, public spending pressures due to ageing (in terms of health and pensions) are mounting.

However, with an improving economy Slovenia is in a good position to move ahead with reforms that will boost long-term growth. As with any ambitious endeavour, occasional mishaps are inevitable. The just released OECD Economic Survey of Slovenia highlights the need to maintain a fiscal cushion to soften future landings as well as the reforms needed to create a more agile economy to sustain incomes and well-being.

Find out more:

OECD (2017), *OECD Economic Surveys: Slovenia 2017*, OECD Publishing, Paris.

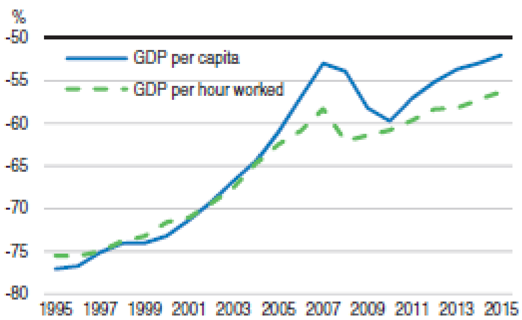
Latvia: time to reboot inclusive productivity growth

by Andrés Fuentes Hutfilter and Naomitsu Yashiro, Latvia Desk, OECD Economics Department

Latvia's economy is growing strongly. Driven by the recovery of exports and investment as well as strong private consumption, real GDP growth is expected to strengthen from 2% in 2016 to around 4% this year and next. Exporters have gained market shares. More disbursement of EU structural funds is boosting investment. Real wage growth is supporting private consumption. Growth is also underpinned by the government's strong track-record in pursuing pro-growth reforms. Administrative burdens to entrepreneurship have been reduced and the efficiency of the judiciary has been enhanced. The quality of education and training has improved and active labour market policies have been upgraded. Government finances are solid: The government budget was in balance in 2016 and government debt is 40% of GDP, lower than in most OECD countries.

The gap in GDP per capita remains large

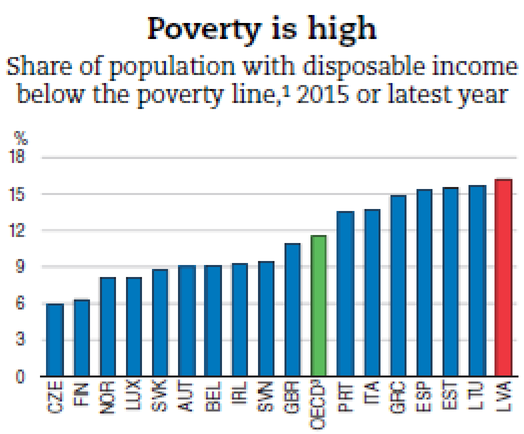
Gap vis-à-vis the upper half of OECD countries[1]



1. Percentage gap with respect to the weighted average using population weights of the highest 17 OECD countries in terms of GDP per capita and GDP per hour worked (in constant 2010 PPPs).

Source: OECD (2017), OECD National Accounts Statistics and Productivity Statistics (database).

Important challenges remain. Productivity is lower than in other Baltic or central European economies and the gap with leading OECD economies remains large (chart A). Yet, productivity growth has slowed after the financial crisis, as elsewhere. To converge to the living standards of high income countries, Latvia has to reinvigorate productivity. As the 2017 Economic Survey of Latvia argues, better integration in global value chains, especially in sectors characterised with rapid technology changes, is key. Latvia has made progress in diversifying its exports. For example, exports of ICT services have increased. But most exports still rely on low-value added activities, such as wood processing or transit transport services.



1. The poverty line is half of median household income. Household income is adjusted to take into account household size.
2. Unweighted average.

Source: OECD (2017), OECD Social and Welfare Statistics (database).

Poverty is among the highest in OECD countries (chart B) and is concentrated in some regions in part reflecting high unemployment. Lack of access to good and affordable housing makes it more difficult for low-income workers to move to well-paying jobs. Access to health services and higher education are also uneven and limit access to economic opportunities for low income households. Many young Latvians emigrate. These issues and policies to address them are analysed in the 2017 Economic Survey of Latvia.

Further reading

OECD (2017), *OECD Economic Surveys: Latvia 2017*, OECD Publishing, Paris.

Is Mexico a new 'China'?

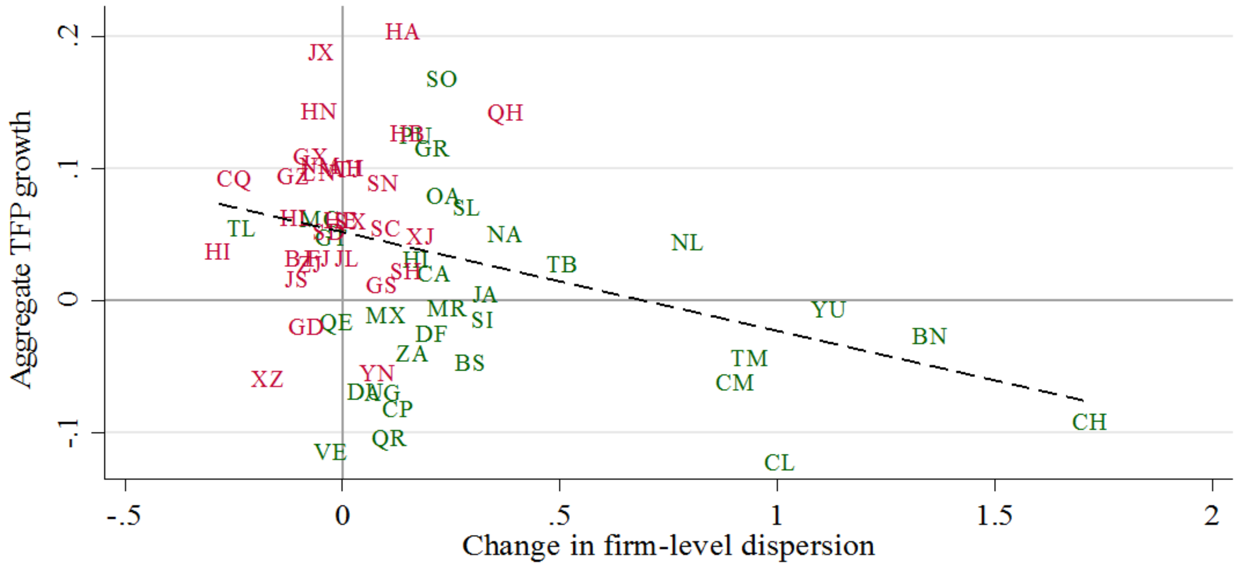
By Sean M. Dougherty, Head of the Mexico Desk, OECD Economics Department.

China's spectacular growth during the 1990s and early 2000s made it the envy of many other emerging economies. Yet more recently, relative labour costs have risen substantially, and economies such as Mexico's, which lost export market share for some time, have made a partial comeback. However, Mexico's increasing competitiveness masks one of the country's fundamental concerns, which is weak productivity improvements. In a new working paper being released today, while the Global Forum on Productivity opens in Lisbon, we examined the evolution of multifactor productivity in Mexico's manufacturing sector, as compared to China's (see Dougherty & Escobar, 2016). Firm-level micro-data were used to examine the distribution of productivity across Mexico's states, and also to track the misallocation of resources.

It turns out that Mexico's increasing competitiveness and attractiveness masks one of the countries' fundamental concerns, which is the absence of productivity improvements. Mexico's productivity lags behind that of other major emerging economies, and it has suffered from a negative growth trend – at least until the recent package of structural reforms (OECD, 2015a). It turns out that multi-factor productivity differs considerably across firms and regions, a situation not unlike that in many OECD countries. While Mexico's most productive firms are performing relatively well, and can compete with China's, the vast majority of firms are struggling to perform better with limited success, leading to a growing dispersion in productivity (see figure below). A similar situation is observed in other OECD countries where there is a rising gap in productivity between the most advanced firms and the laggards, and the gains in productivity of the most advanced firms are not enough to improve aggregate productivity (OECD, 2015b).

Aggregate TFP growth and firm-level dispersion

In China's provinces (in red) and Mexico's states (in green)



***Source*: Dougherty and Escobar (2016).**

Note: dispersion is measured as the standard deviation of firm-level productivity (see Figure 4).

We also took advantage of Mexico's federal structure to study the drivers of productivity using econometric techniques to address potential reverse causality. Our findings suggest that among other factors, a stronger rule of law increases productivity in Mexico. This is robust to previous OECD evidence, which suggests that firms in Mexico's states with more effective legal systems tend to be substantially larger and more productive (Dougherty, 2014).

Our results also show that among the institutional quality-related variables, *informality* has the strongest effect on productivity. Moreover, we consider informality as a source of distortions that contribute to the misallocation of resources. Our results are robust to various methods, and imply a strongly negative relationship between informality and productivity. Among different size firms, informality in microenterprises (up to 10 workers) has the strongest negative effects on productivity. The results also suggest – for the first time that we know of – that more productive states and industries suffer *more* from informality than less productive ones. This is likely due to resources being perversely tied up in informal activities, akin to the ‘Zombie firms’ that are now being investigated at OECD. Tackling informality is a complex challenge, and one that requires a multi-faceted approach (OECD, 2013, 2015a).

The results also suggest that the mere presence of foreign investment improves productivity – with the exception of *Maquiladora* industries, which are missing out on productivity gains. This is likely due to *Maquila’s* undue emphasis on low-end, low-skill assembly operations, which have often not fared very well in competition with China. Moreover, weak education quality simultaneously acts as a major restraint on productivity, and it aggravates informality.

In summary, we can conclude that Mexico is not a ‘China’, yet.

References:

Dougherty, S. (2014), ‘Legal reform, contract enforcement and firm size in Mexico’, *Review of International Economics*, Vol. 22, No. 4, September 2014.

Dougherty, S. and O. Escobar (2016), ‘Could Mexico Become the new “China”? Policy Drivers of Competitiveness and Productivity’, OECD Productivity Working Papers n°4. (Also forthcoming in the *European Journal of Comparative Economics*.)

OECD (2013, 2015a), *Economic Surveys of Mexico*, OECD Publishing, Paris.

OECD (2015b), *The Future of Productivity*, OECD Publishing, Paris.