Does carbon leakage through international trade reduce the effectiveness of carbon pricing policies?

Category: Climate,Uncategorized
written by oecdecoscope | September 3, 2024



By Jonas Teusch, Filippo Maria D’Arcangelo, Tobias Kruse, and Mauro Pisu

Carbon leakage, whereby foreign emissions increase because of domestic climate policies, blunts the effects of domestic climate policies on global emissions. Traditionally, the empirical literature has not found much evidence of carbon leakage (e.g. Venmans et al, 2020). However, carbon prices were historically low and most existing evidence is limited to the EU’s emissions trading system where free allowances may have protected the international competitiveness of EU producers in emissions-intensive trade-exposed sectors.

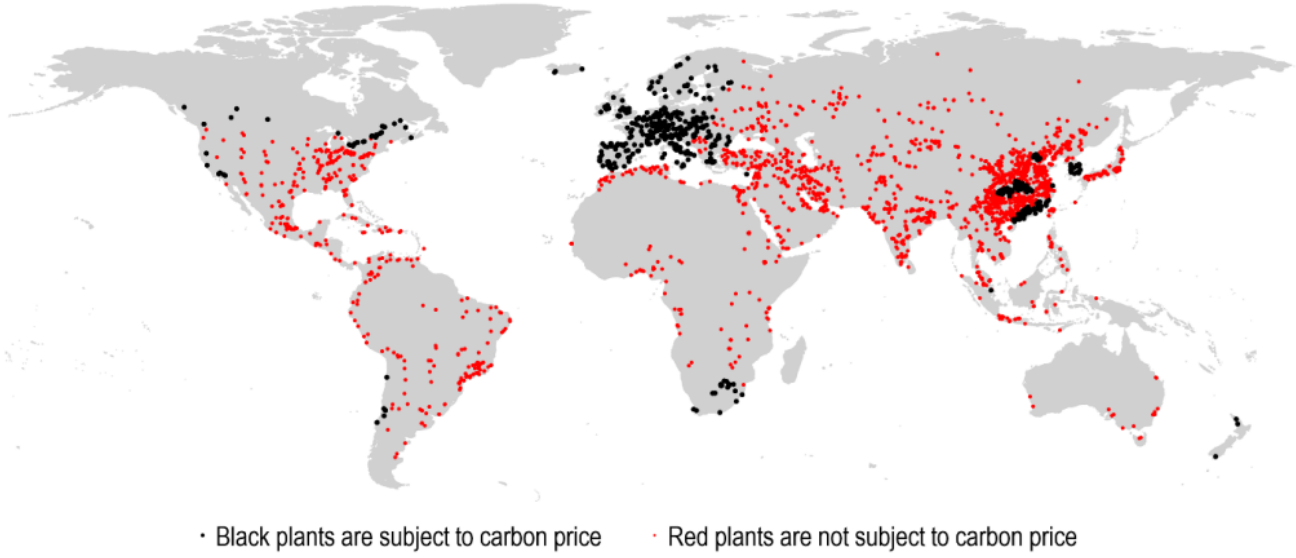
In our recent paper (Teusch et al, 2024), we leverage satellite data from Climate TRACE to track emissions and carbon prices for cement and steel at the plant level across 140 countries. These two sectors alone account for more than 40% of industrial greenhouse gas emissions. We then use plant-level data to estimate the effect of carbon prices on emissions. Finally, we combine these data with international product-level trade data to quantify the effect of carbon

prices on emissions embodied in the international trade of steel and cement products and obtain an estimate of carbon leakage in these sectors.

The recent rise in carbon prices was uneven across countries

Carbon prices have become more common over the past years and increased noticeably (OECD, 2023; World Bank, 2024). While most of the plants covered by this study are still not subject to carbon prices, carbon pricing systems now exist around the world (Figure 1). The average plant-level carbon price across all cement and steel plants in the dataset rose by a factor of seven (from USD 1.4 per tonne of CO_2e in January 2015 to USD 10.9 in December 2021). As carbon prices started from a low base, they remain low on average.

Figure 1. Carbon pricing systems now exist around the world



Note: The map depicts the carbon pricing landscape in 2021. It shows all steel, cement and aluminium plants covered by the Climate TRACE dataset.
Source: Teusch et al, 2024.

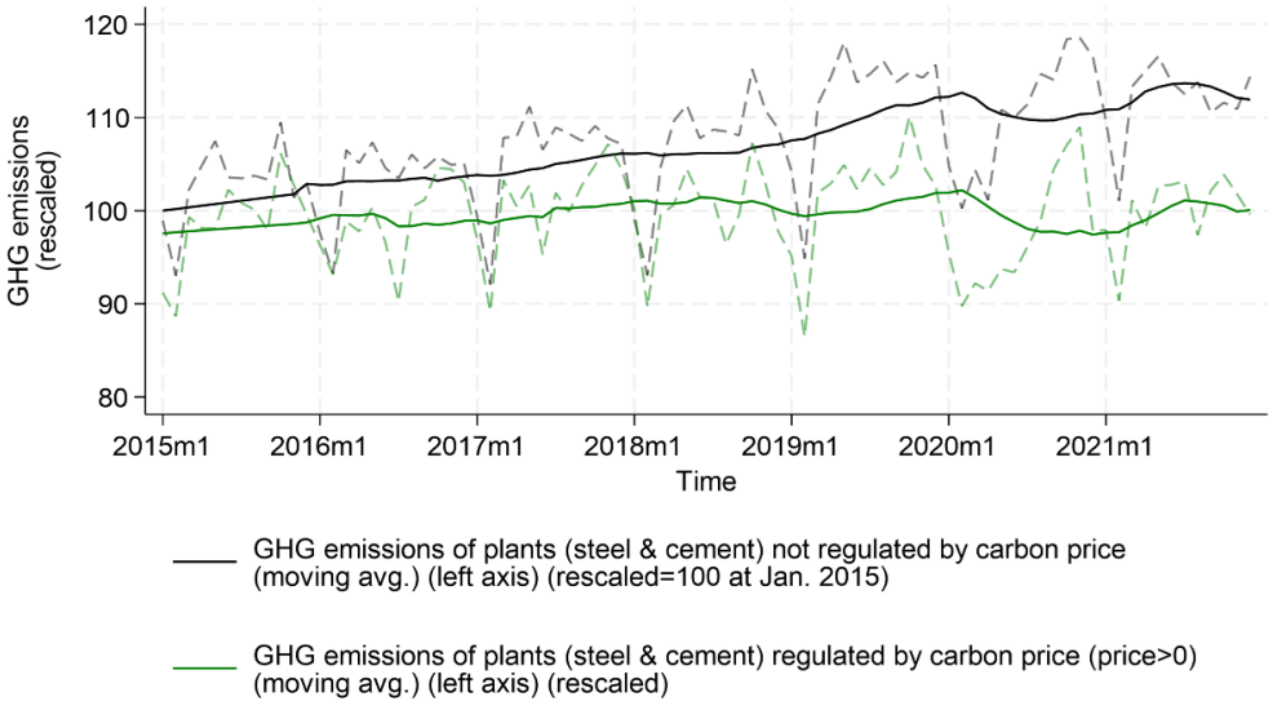
The rise in carbon prices was uneven across countries, resulting in rising carbon price asymmetries. Carbon price asymmetries, computed as the average difference between the domestic carbon price and the carbon prices of trading

partners (weighted by traded volumes), surged by more than 350% between 2015 and 2021, highlighting the heterogeneity of carbon price developments across countries and rising carbon leakage risk.

Carbon pricing can reduce emissions in steel and cement

Despite their reputation as "hard-to-abate" sectors, cement and steel plants respond to rising carbon prices by reducing emissions. Emissions from plants subject to carbon prices were stable between 2015 and 2022 whereas they rose for plants not covered by carbon prices (Figure 2). Empirical results based on panel regressions (controlling for confounding factors) suggest that, on average, cement and steel plants have reduced emissions by 1.3% in response to a USD 1 per tonne of CO_2 increase in carbon prices.

Figure 2: Emissions from plants facing no carbon prices increased whereas they remained stable for plants facing carbon prices



Note: The black solid line shows the 12-month moving average GHG emissions of plants (in steel and cement sectors) never regulated by carbon pricing rescaled to equal 100 in January

2015. The dashed grey line shows the average monthly GHG emissions of those plants. The green solid line shows the rescaled 12-month moving average GHG emissions of plants (in steel and cement sectors) regulated throughout the sample (i.e. that are always regulated by carbon pricing). The dashed green line shows the average monthly GHG emissions of those plants. The graph excludes plants that switch treatment status in the sample period.
Source: Teusch et al, 2024.

Carbon leakage through international trade offsets a moderate share of domestic emission reductions

On average carbon leakage through international trade offsets 13% of domestic emission reductions. Leakage, which we estimate using a gravity model of international trade, is driven by volume effects (increased imports); there is no evidence that countries import more from dirtier countries. One possible explanation for the relatively moderate leakage effect is that these sectors receive free allocation and other forms of government support (Garsous, Smith and Bourny, 2023), which reduces the carbon leakage risk. Another complementary explanation is that carbon price asymmetries across countries are not yet large enough to affect international trade flows in a more significant manner.

Carbon pricing may lead to additional spillovers

Carbon pricing asymmetries can lead to international spillovers in addition to carbon leakage through international trade. For example, carbon pricing can lead to downstream leakage, e.g. when carbon pricing on steel production impacts downstream manufacturing activities and locational choices. Carbon pricing can also induce positive spillover effects, for example via the diffusion of cleaner production techniques (including from regulated to unregulated facilities). Considering the importance of technology diffusion for reducing global emissions, innovation-related spillovers would

merit further work.

Estimating and quantifying these spillovers is crucial to better understanding the impact of carbon prices asymmetries and mitigation policies on global emissions. Timely and granular sources of data covering emissions and output at product level are key elements to progress in this area and inform policies.

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Paving the way towards prosperity in Malaysia

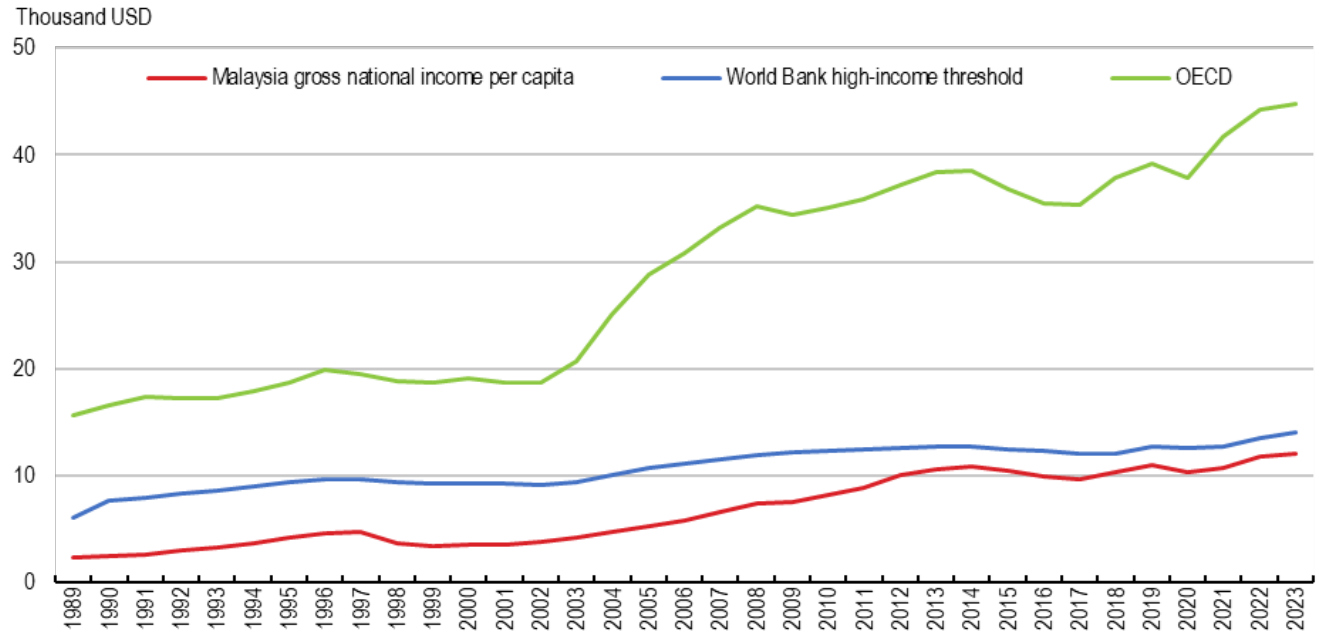
Category: Malaysia,Uncategorized
written by oecdecoscope | September 3, 2024



by Jens Arnold and Ken Nibayashi

Malaysia's economy has achieved an impressive growth since the 1960s, with average yearly growth of over 6%. It has been ahead of regional peers in terms of per capita incomes and has been able to consolidate this lead. While incomes were only one-third of the World Bank's threshold for high-income countries in 1989, it has approached and is set to surpass that threshold by 2028 (Figure 1).

Figure 1. Rapid economic development has boosted Malaysia close to high-income status



Source: World Bank, GNI, Atlas method (current USD).

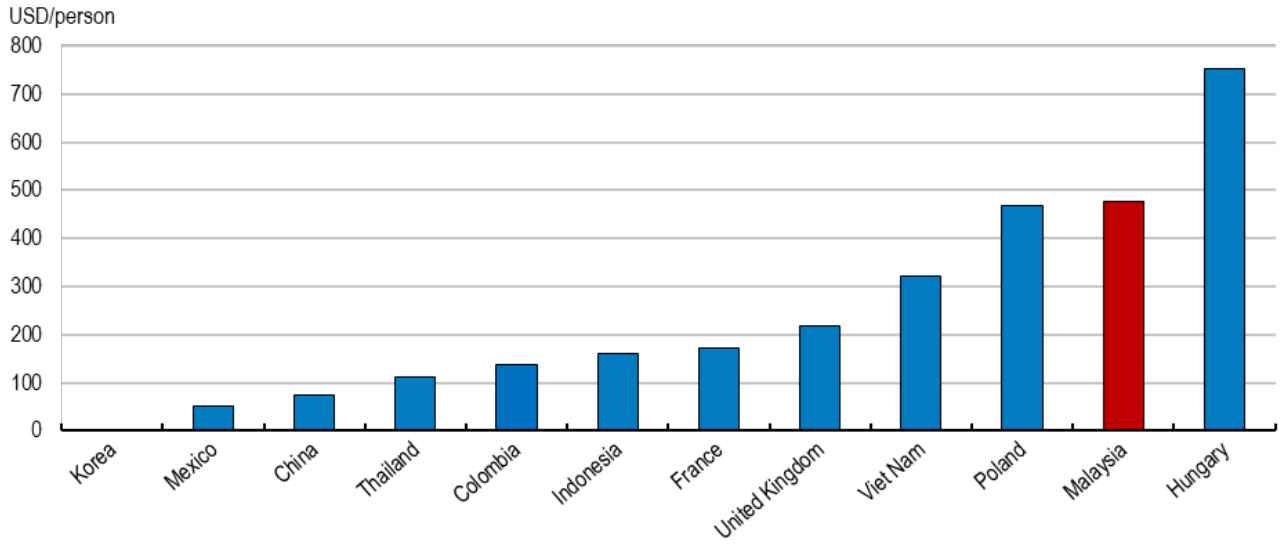
Strong growth has also propelled impressive social progress. Poverty has declined consistently over the last decades, and poverty rates have narrowed across different ethnic groups. Income inequality has also fallen, and labour force participation has trended upwards. At the same time, more could be done to create better and more equal opportunities in Malaysia, as highlighted in the recent *OECD Economic Survey of Malaysia* (**OECD, 2024**). Income inequality remains higher than in regional peers, and labour force participation among women remains some 26 percentage points lower than among men, partly related to difficulties of accessing affordable childcare. As incomes rise, Malaysians are likely to demand better public services and better opportunities, and this may require different policies from those that were successful in the past.

Pension coverage, for example, is narrow and inadequate. More than 60% of the population are not covered by any old-age pension scheme, and those who are often fail to receive a decent pension. As the population ages, more and more elderly Malaysians will reach retirement age without any type of old-age pension to rely on. Non-contributory social assistance pensions could help fill current coverage gaps in the future, but their current coverage and benefit levels are very low.

In the same vein, social assistance programmes could do more to support those in need. Different programmes are fragmented and poorly targeted, managed by multiple agencies at different levels of government. Benefit levels are generally too low to make a real difference for vulnerable households. Even for the lowest income decile, cash transfers augment market incomes by only around 13%, and overall spending on social assistance amounted to only 1% of GDP in 2023.

By contrast, Malaysia spent 3.5% of GDP on fossil fuel subsidies in 2023, which are counted as social assistance in its public accounts. But these subsidies are particularly ineffective as a social policy tool. Estimates suggest that the most affluent 10% of income earners receive almost three times more in fuel subsidies than the decile with the lowest incomes. Fossil fuel subsidies also provide the wrong price signal for reducing greenhouse gas emissions, and Malaysia's fuel subsidies are particularly high in international comparison (Figure 2). Shifting spending from subsidies to pensions and well-targeted, unified social assistance benefits could support substantial improvements in social inclusion.

Figure 2. Fossil fuel subsidies per capita in selected countries, 2022



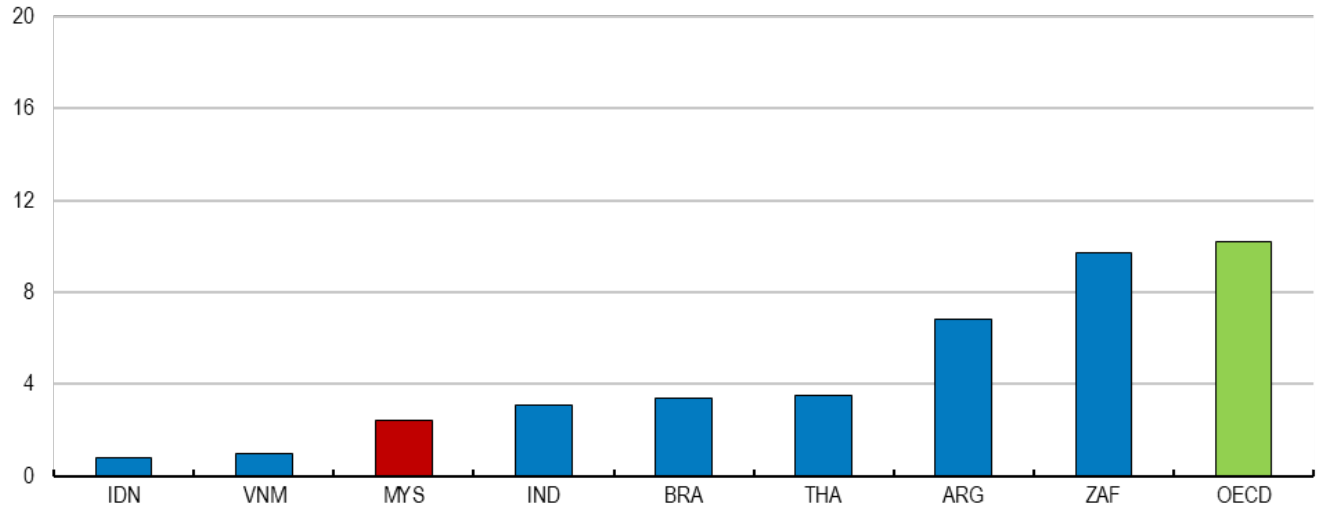
Source: IEA Fossil Fuel database.

These kind of reforms could boost the effectiveness of taxes

and transfers for reducing inequalities. Currently, public policies reduce income inequality by 2.4 points of the Gini coefficient, a widely used inequality measure (Figure 3). This reduction in inequality is more than what Indonesia and Viet Nam achieve, but it falls short of the 3.5 points in inequality reduction that taxes and transfers generate in Thailand, and is much less than in the average OECD country where taxes and transfers reduce inequalities by more than 10 points of the Gini coefficient.

Figure 3. Inequality reductions are small

Impact of public policies on income inequality



Source: World Bank (2023); Commitment to Equity Institute (2023), OECD Income Distribution Database (2024).

Better labour market policies could also help Malaysia to make further progress towards higher material living standards. More than one in four workers in Malaysia work in informal jobs, particularly older and less educated ones. Incentives for formal job creation could be improved through less rigid labour market regulations and by exempting low-wage workers from mandatory contributions to the pension fund, especially as non-contributory basic pensions are expanded. Even for those with higher skills, labour market reforms could improve job quality and strengthen productivity. Many people, particularly recent tertiary graduates, work in occupations that do not match their skills. Better alignment of tertiary

education with labour market needs, a reorganisation of vocational education and training and more investment into adult education could help to reduce skills mismatches.

Delivering better public services and creating better opportunities will also call for substantial reforms on the fiscal side. Spending existing public resources in a more effective way should be a first step, for example by phasing out fossil fuel subsidies, but also through a better coordination of fragmented policy programmes in areas such as social protection or support to small and medium enterprises. Beyond these improvements in spending efficiency, there may also be a case for raising additional public revenues. Current tax revenues remain below 12% of GDP, which is low even in a regional comparison, and places tight limits on what Malaysia's public sector can deliver. Establishing a well-designed value added tax, broadening the tax base of personal income taxes and improvements in tax administration would be ways to expand the resources available. Providing solid financing for future spending needs that will arise as Malaysia becomes a high-income country is likely to be one of the major challenges in coming years.

Malaysia's ascent towards a high-income economy is remarkable, with robust and resilient growth and visible improvements across many dimensions. The analysis and policy recommendations presented in the newly launched *OECD Economic Survey of Malaysia* (**OECD, 2024**) are aimed to help the country build on its past achievements and maintain a strong performance in the years to come.

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Stepping up structural reforms to improve Egypt's business climate

Category: Egypt,Private sector,Uncategorized
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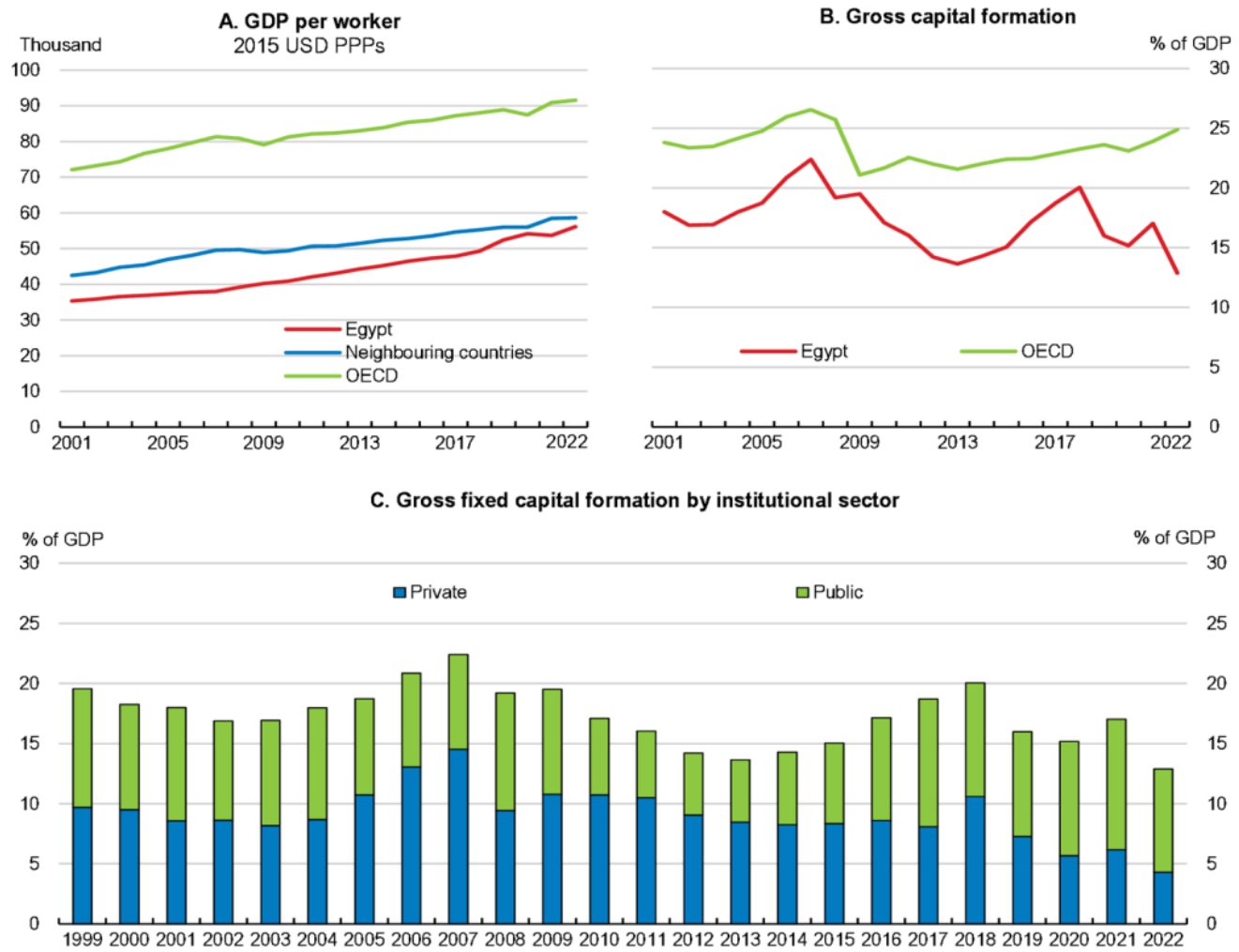


by Ania Thiemann, Economist and Competition Expert, Competition Division.

Egypt's challenging business climate is holding back productivity and therefore also living standards. Labour productivity is still far below the OECD average (Figure 1), with low overall investment and a declining share of private investment in the total. Low investment in innovation, and research and development (R&D) also contributes to low productivity growth, as Egypt spends less than 1% of GDP on R&D. Market mechanisms, such as business entry and exit, and

growth of the most efficient firms, appear to be weaker than in many similar emerging markets. Underlying these facts are deep-seated structural causes that impede market competition, investment and efficient resource allocation. These barriers stifle the country's potential for long-term sustainable growth and restrict the development of a robust private sector. To ensure sustainable economic growth, as set out in Egypt's National Structural Reform Programme, thorough policy reforms are required that can boost market competition. Regulatory and trade barriers, as well as a dominant state presence need to be addressed to revive private sector activity.

Figure 1: Low output per worker is related to low investment



Note: Data for Egypt in all three panels refer to fiscal years (from July of indicated year to June of the following year). Neighbouring countries refer to Algeria, Israel, Jordan,

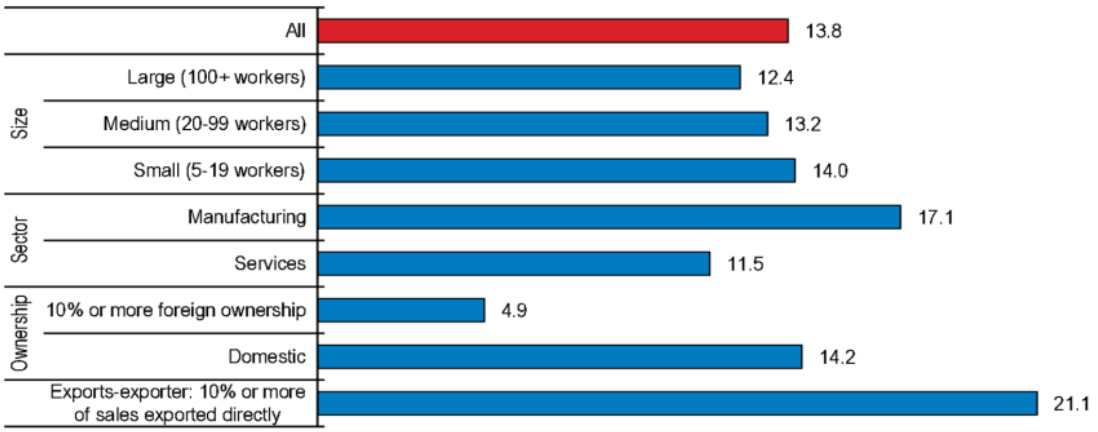
Lebanon, Morocco, Tunisia and Türkiye.
Source: IMF, World Economic Outlook database – October 2023; OECD, National Accounts database; Ministry of Planning and Economic Development; and OECD calculation.

Removing regulatory barriers to enhance market entry and expansion

A central and long-standing challenge is the heavy regulatory burden that acts as a barrier to market entry and expansion, while also promoting informality. Complex and lengthy processes for obtaining business licenses and permits during the post-establishment phase constrain both domestic businesses and exporters (Figure 2). Despite recent reforms, the administrative load remains heavy, stifling Egypt's business dynamism compared to regional and global averages, with comparatively low entry and exit rates. Moreover, overall regulatory quality remains low, reflecting lengthy and opaque decision-making processes and implementation.

Figure 2: Business licensing is a constraint on domestic businesses and exporters

Percentage of firms in Egypt identifying business licensing and permits as a major constraint, 2020



Note: Share of respondent firms out of 3075 firms surveyed.
Source: World Bank, Enterprise Surveys.

To support a more dynamic private business sector, Egypt needs

to streamline its business registration and licensing processes. Licensing requirements can be replaced by online registration in most cases, while a more efficient on-line application system would speed up processes. A new online platform for business registration was opened up in 2023, but difficulties remain with local permits. Simplifying procedures and reducing bureaucratic hurdles can encourage new business formation and attract more investment. Additionally, improving the transparency of administrative procedures would also reduce opportunities for corruption, which is a crucial step towards creating a fair and competitive market landscape.

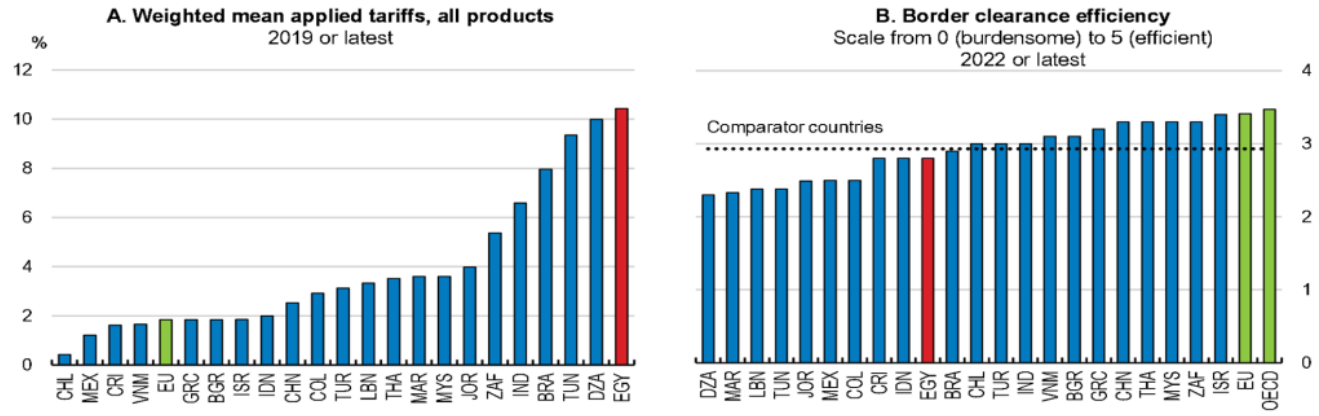
Strengthening competitive pressures through trade and investment

High tariff and non-tariff barriers to trade mean that the Egyptian market remains relatively insulated from global competition. Such trade restrictions limit the country's integration into global value chains and reduce the spillover benefits of foreign technology and know-how, which are essential for boosting productivity.

Liberalising trade policies and reducing tariffs can enhance Egypt's competitiveness on the global stage. The creation of the National Single Window (*Nafeza*) to support external trade, should help speed up customs procedures. Border clearance has improved but remains comparatively slow (Figure 3). To support faster import release, the authorities are working on a new risk management system, which should speed up processes by reducing the number of inspections to those selected by the risk matrix. However, Egypt should also simplify its tariff regime, as tariffs remain high and unwieldy, with particularly high tariffs for agricultural products, and for products that compete with Egyptian manufactured goods (with tariff rates of 40-60%), in a system with 7 850 tariff lines. Foreign traders whose products already meet domestic standards should not have to preregister their products, and import licences could be replaced by a simple registration with the customs

authorities, as is the case in Europe. A more open and predictable trade regime would benefit domestic businesses and investors, as well as supporting more inward foreign investment. This in turn would facilitate the transfer of technology and expertise, thus foster productivity growth.

Figure 3: High import tariffs and slow border clearance are hampering trade



Note: In Panel A, data for the countries presented refer to 2019 except for Thailand (2015), Tunisia (2016), Israel (2017), Mexico (2018), Jordan and Malaysia (2020). Weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country. When the effectively applied rate is unavailable, the most favoured nation rate is used instead.
Source: World Bank, World Development Indicators; World Economic Forum (2019), Global Competitiveness Index 4.0.

Reducing the state's footprint in the economy

State-owned enterprises (SOEs) play a significant role in Egypt's economy, to the detriment of competitive market conditions by crowding out private sector activity. The government's recent steps to level the playing field, though commendable, need to be more comprehensive and sustained. Over-reliance on SOEs in various sectors, such as utilities and transport, but also in manufacturing, prevents private enterprises from competing on an equal footing. Privatisation

and divestment of SOEs should be pursued more aggressively to reduce the state's dominance in the market. This move will not only improve efficiency but also stimulate private investment. The OECD's guidelines on privatisation could serve as a valuable framework for Egypt in this regard.

Further actions to support private businesses: Access to finance and digital diffusion

Access to finance remains a significant hurdle for many businesses in Egypt. Banks overwhelmingly prefer to lend to the government, leaving private enterprises, especially small and medium-sized enterprises (SMEs), with limited financing options which hampers business expansion and innovation. Enhancing financial inclusion by opening up the banking sector to competition, notably by FinTechs with Open Banking regulation, can mitigate this issue. Policies aimed at improving the creditworthiness of SMEs and developing a robust microfinance sector will also support private sector growth. Improving digital financial services could play a critical role in this transformation.

Digital inclusion is key to boost productivity and competitiveness. However, Egypt lags behind in terms of digital infrastructure, and adoption by SMEs. The legal framework for digital business models needs significant improvement to allow for dematerialised businesses to expand. Investing in digital infrastructure and fostering a regulatory environment that supports digital innovation are therefore crucial steps to create a more vibrant business sector and help enhance overall economic efficiency.

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Upgrading Korea’s growth model

Category: Korea,Uncategorized
written by oecdecoscope | September 3, 2024



By Jon Pareliussen, OECD Economics Department

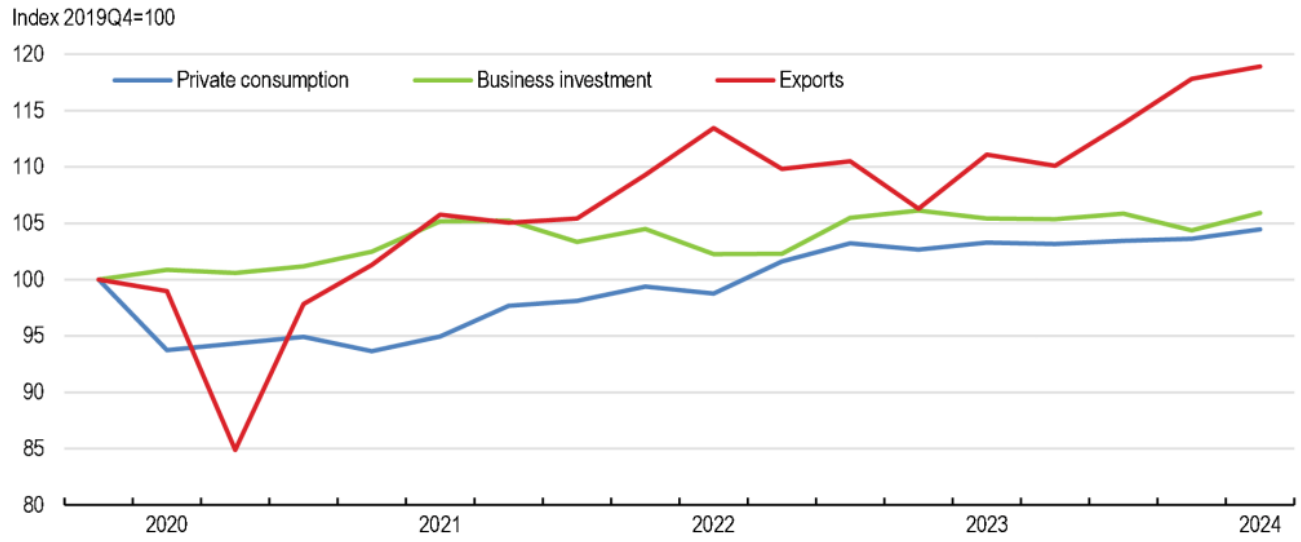
After going through a soft patch, exports are again driving economic growth in Korea as demand for computer chips has soared to power a wave of investment in artificial intelligence. Korea’s export-oriented growth model has served the country well for decades, along with sound macroeconomic policies and a strong commitment to education. Even so, the 2024 OECD Economic Survey of Korea argues that Korea needs to upgrade its growth model to revitalise private consumption as an additional growth engine, to become greener, happier and halt the declining fertility trend.

Korea’s export-led growth model has changed over time. Past periods of reforms that boosted competition and exports at the

same time were more successful with fewer negative side-effects than periods of more heavy-handed “dirigiste” industrial policy. However, export-oriented growth in any shape or form tilts society’s resources towards production, investments and exports and thereby away from consumption and leisure (Figure 1). For example, compared to the OECD average Korea spends a large share of GDP on supporting businesses while a comparably small share is used to support people through the social safety net. Energy, of which two-thirds is used in industry, is relatively cheap, while food and clothing are expensive in relative terms compared to OECD peers.

Figure 1. Exports drive growth

Real GDP level by component



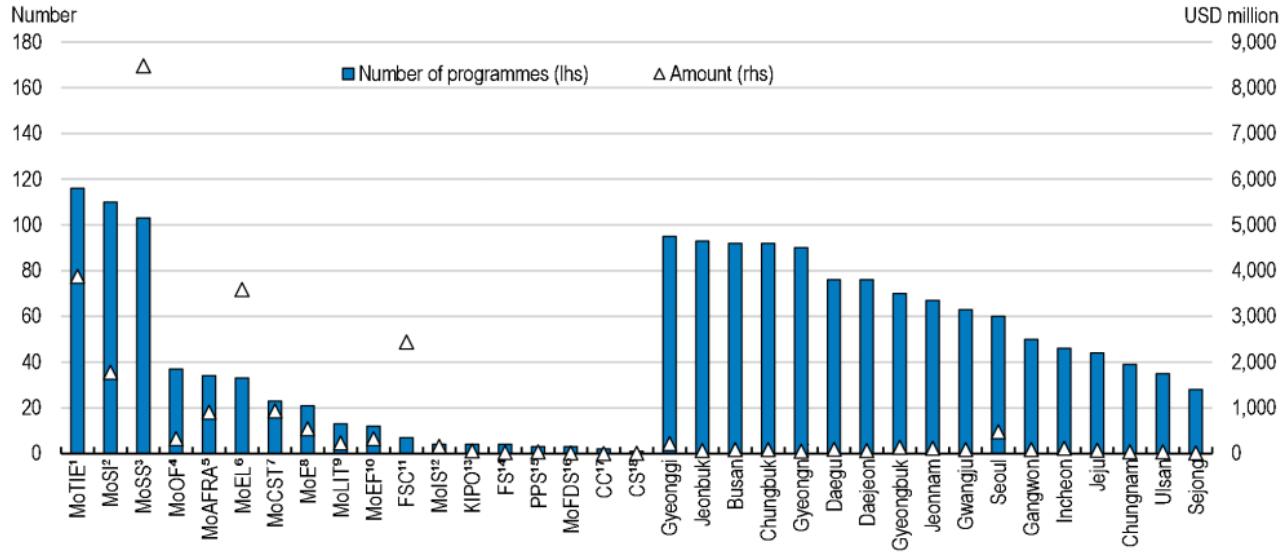
Source: *OECD Economic Surveys: Korea 2024*.

Many of the large manufacturing-heavy business groups benefitting from export promotion policy in the past gained dominance in a shielded domestic market, contributing to large productivity gaps between large and small companies and between manufacturing and services. Eventually, to meet these imbalances, the government’s duty to support SMEs became enshrined in Korea’s constitution. Today a cobweb of support schemes and regulations supports the SME sector (Figure 2), in which 85% of employment is found, while SME productivity keeps

lagging. Consolidating these supports would facilitate productivity catch-up by levelling the playing-field in the domestic market and incentivising SMEs to grow. Room remains to further open up to foreign investment and trade and reduce public interventions in the economy.

Figure 2. A cobweb of subsidies are available to SMEs

SME support programmes by entity



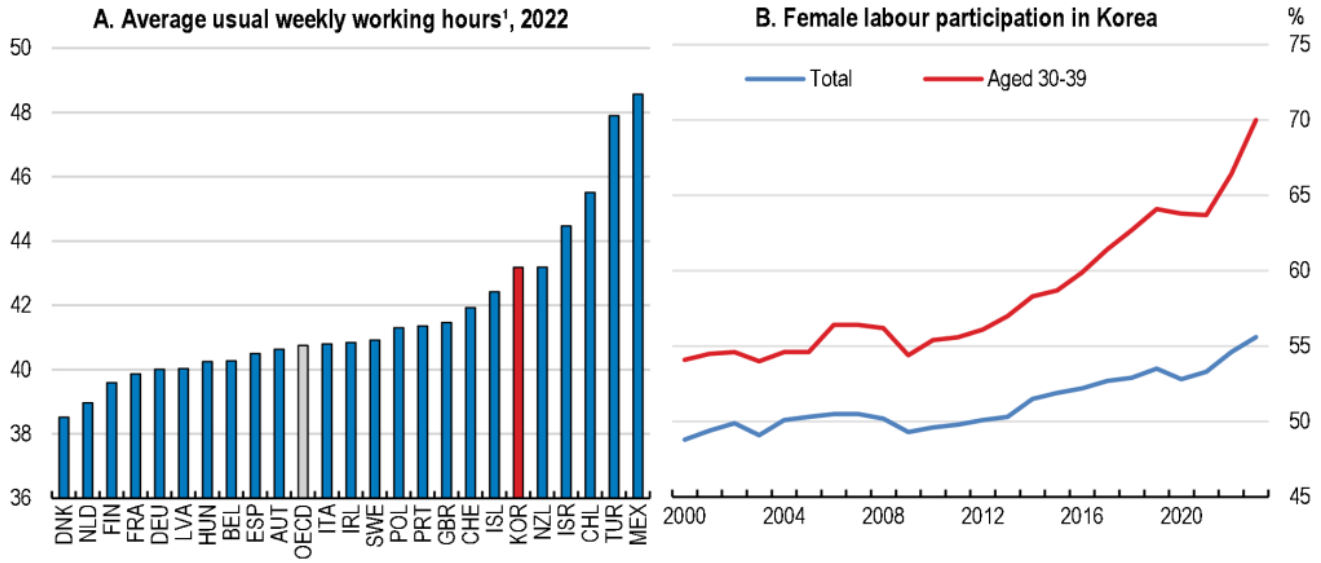
1. Ministry of Trade, Industry and Energy. 2. Ministry of Science and ICT. 3. Ministry of SMEs and Startups. 4. Ministry of Oceans and Fisheries. 5. Ministry of Agriculture, Food and Rural Affairs. 6. Ministry of Employment and Labor. 7. Ministry of Culture, Sports and Tourism. 8. Ministry of Environment. 9. Ministry of Land, Infrastructure and Transport. 10. Ministry of Economy and Finance. 11. Financial Services Commission. 12. Ministry of Interior and Safety. 13. Korean Intellectual Property Office. 14. Forest Service. 15. Public Procurement Service. 16. Ministry of Food and Drug Safety. 17. Communications Commission. 18. Customs Service.
Source: Ministry of SMEs and Startups.

Concerns of adding cost to business and reducing external competitiveness have also so far stood in the way of aligning climate policies sufficiently with Korea’s climate targets. Setting the overall cap of the emissions trading scheme in

line with the 2030 target will take the country three-quarters of the way to meet its 2030 emission reduction target, while a failure to do so would put the target in question. Reforming electricity supply and use to a market-based system where the true cost of energy and emissions is fully reflected, would reduce the society-wide cost of the green transition.

Korea's imbalances between producing and consuming are mirrored in mothers' and fathers' struggle to balance work and life (Figure 3). This is a key reason why Korea has the lowest birth rate in the world, falling to 0.72 child per woman in 2023. If carried forward, today's young adults will outnumber their grandchildren by nine to one, with dire consequences for labour supply and public finances. The OECD Economic Survey of Korea discusses the complex structural causes of low fertility and argues that reversing the trend would require broad structural reforms to product and labour markets, filling gaps in family policies, and changing gendered norms and practices. Adapting to inevitable ageing requires postponing retirement, boosting female and youth labour participation and promoting work immigration.

Figure 3. Women increasingly participate in the labour market, where hours are long



1. Average usual weekly hours worked on the main job for full-time employed.

Source: Statistics Korea; and OECD Labour Force Statistics database.

An upgraded growth model building on these recommendations would boost average incomes and let more accrue to those who will spend more, in particular low-income households and households with children. Such reforms could revitalise private consumption as an additional growth engine and make Korea not only richer, but also greener, happier and more family-friendly.

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A roadmap for efficient, inclusive and sustainable housing in Slovenia

Category: Housing,Slovenia,Uncategorized
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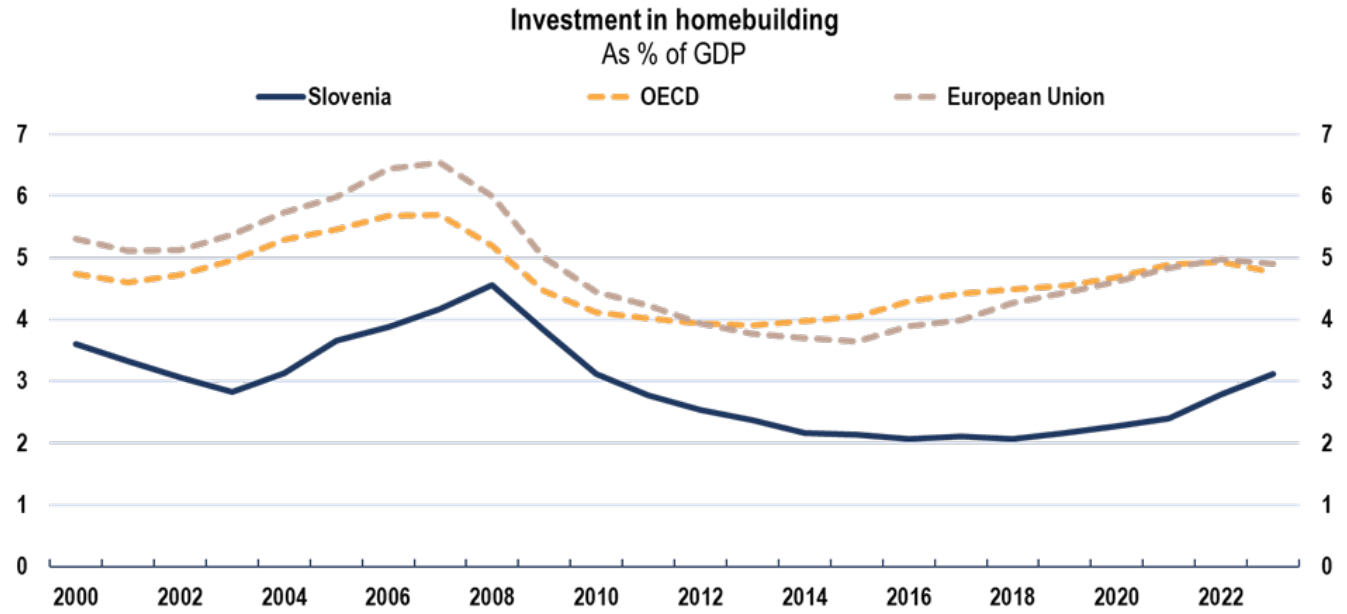


By *Volker Ziemann, OECD Economics Department*

Like many other countries, Slovenia faces complex housing sector challenges that must be addressed to preserve the

current high quality of life. High demand and a limited supply have led to low residential mobility, soaring prices, a high prevalence of commuting and increasing concerns about housing affordability. Slovenia's investment in homebuilding lags behind both the EU and OECD averages (Figure 1). Insufficient investment is a major factor contributing to the housing shortage and rising prices.

Figure 1. Residential investment is subdued



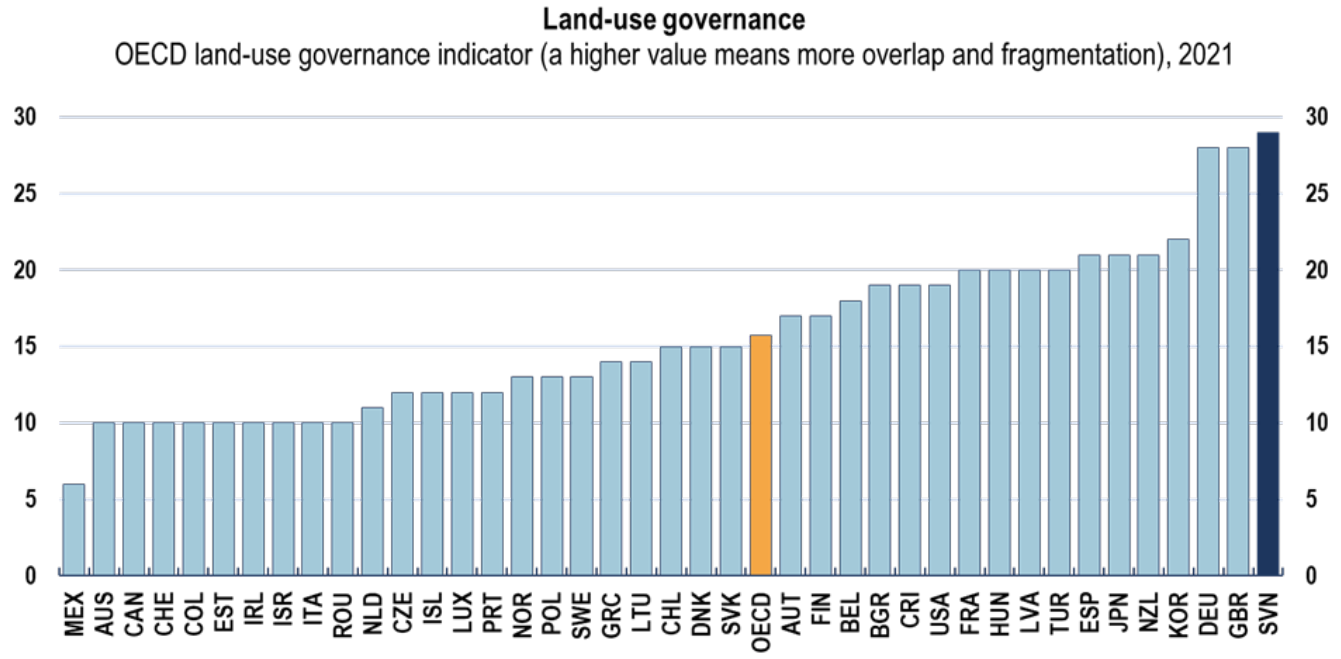
Note: Data refers to the European Union including 27 countries. Unweighted averages for OECD and European Union aggregates.
Source: OECD Economic Outlook: Statistics and Projections database; Eurostat National Accounts database; OECD calculations.

The roots of Slovenia's housing challenges can be traced back to the 1990s privatisations. While this led to high homeownership rates, it also had unintended consequences. The housing supply became restricted, mobility decreased, a private rental market remained in its infancy. As a result, many young families and first-time buyers find themselves today with limited housing options. Moreover, the ageing housing stock further defies ambitious climate goals. To address these challenges, the latest OECD Economic Survey of

Slovenia proposes a comprehensive roadmap of reforms that would help to ensure that all Slovenians can access high-quality, affordable, and sustainable housing.

Inefficient spatial planning and cumbersome permitting processes have stifled residential construction. While there have been some recent improvements, the pace of investment remains insufficient to meet the growing demand. Streamlining spatial planning processes, notably through better coordination across levels of government (Figure 2), and establishing one-stop shops for building permits would help improve the governance of housing markets and unlock the potential for new housing.

Figure 2. Inefficient land-use governance restricts construction activity



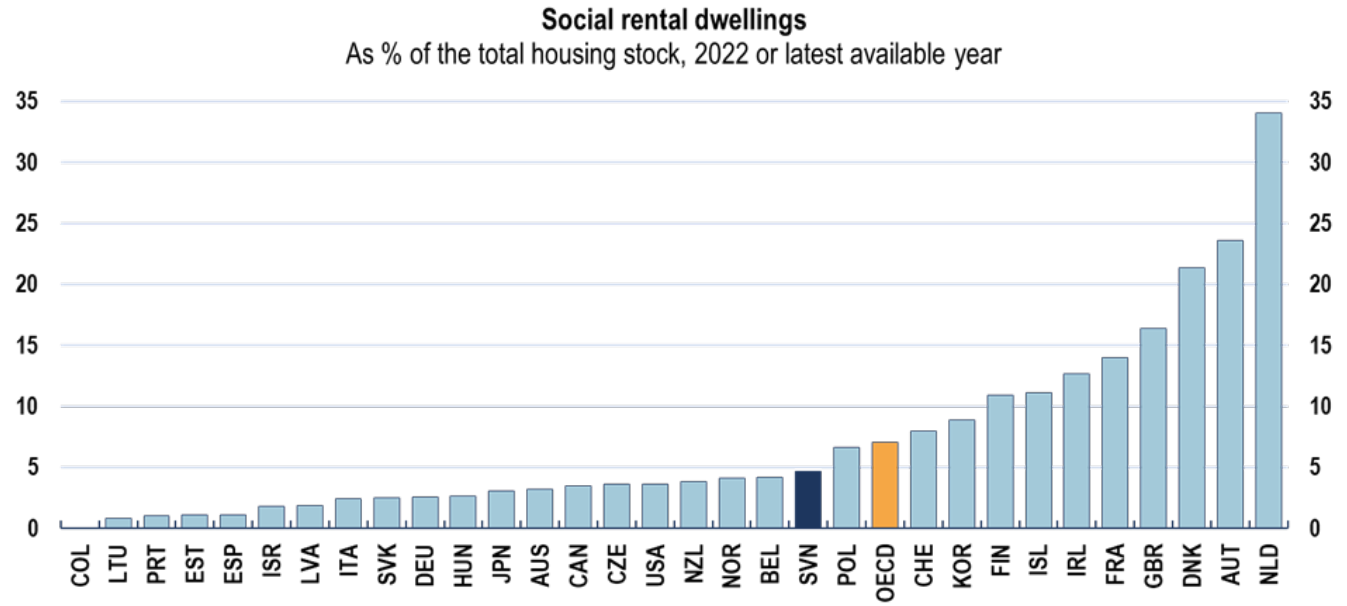
Source: OECD Housing Governance Indicators Dashboard, https://www.oecd.org/housing/policy-toolkit/data-dashboard/housing-governance.

The **private rental market** is underdeveloped, and a more accommodating framework is needed to make it grow. A lack of standardised contracts, tax biases, and an imbalance in tenant-landlord rights have hindered its development. Slovenia

can foster a thriving private rental sector that offers attractive long-term housing solutions by introducing clear regulations and ensuring fair treatment for both parties.

The proliferation of secondary homes and short-term rentals, fueled by favourable regulations and tax incentives, has further exacerbated the affordability crisis. These properties often sit vacant for much of the year, removing them from the long-term rental market and driving up prices. **Harmonising the taxation** of rental revenues and implementing a comprehensive recurrent tax on immovable property based on actual market values could incentivise owners to make these homes available for long-term rentals, increasing supply and easing pressure on the market. Taxing land more than the structure on it could further incentivise the construction of underdeveloped or idle land.

Figure 3. There is scope to expand the social housing stock



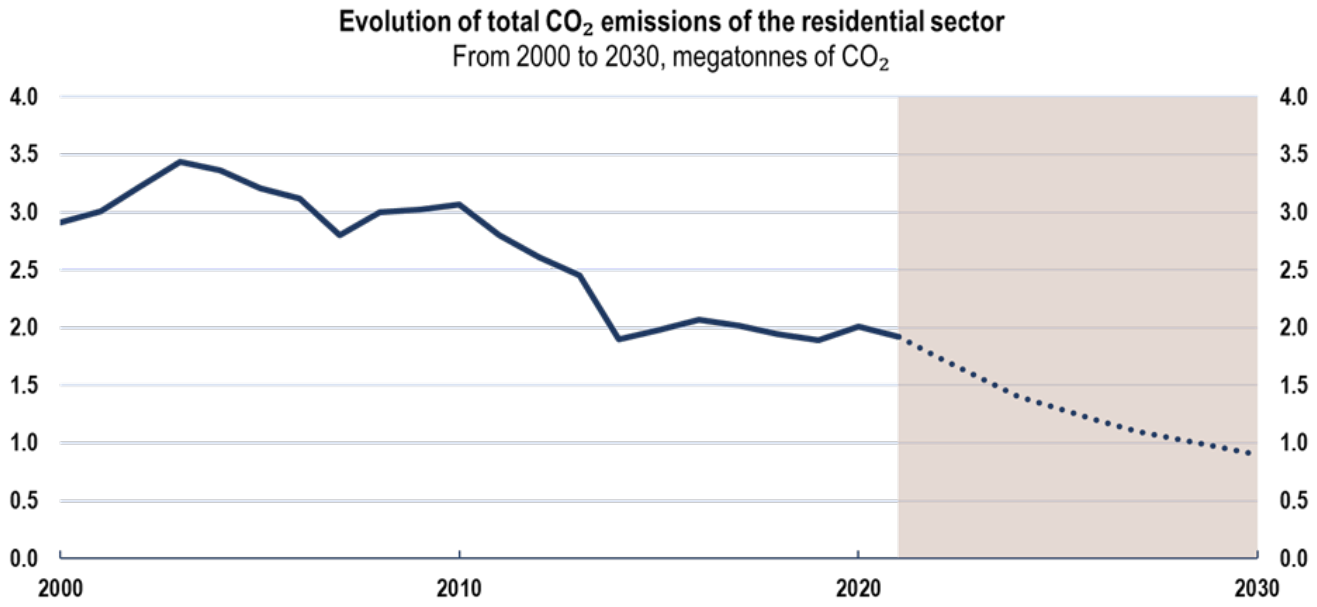
Source : OECD Affordable Housing Database (AHD).

Slovenia's social housing sector is also underdeveloped compared to that of its European neighbours (Figure 3). The upcoming Housing Act presents an opportunity to rectify this situation. A revised social rent formula, coupled with incentives for potential providers, including limited-profit

housing associations, could pave the way for increased investment in social housing, providing affordable options for low-income families and individuals.

Slovenia's mortgage markets are small, limiting access to finance for aspiring homeowners. Promoting competition in the banking sector and empowering consumers with financial knowledge is crucial to expand housing finance and increase homeownership opportunities. Moreover, making more and better use of credit registers could reduce lending margins and fuel demand for mortgage financing.

Figure 4. Incentivising renovation is needed to accelerate the decarbonisation of homes



Note: Dotted line refers to projections.
Source: IEA Energy Efficiency Indicators, 2023.

Finally, the **decarbonisation of Slovenia's housing stock** is a pressing concern (Figure 4). A significant portion of residential buildings are outdated and energy-inefficient. The recent energy crisis has underscored the urgency of transitioning to energy-efficient housing. While the investment required is substantial, a combination of fiscal support measures and enforceable regulations can help homeowners make the necessary upgrades.

Slovenia’s housing challenges are complex and multifaceted, but they are not insurmountable. By implementing comprehensive reforms that address inefficiencies and policy bottlenecks, Slovenia can create a more efficient, inclusive, and sustainable housing market.

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Mexico and the benefits of global value chains

Category: international trade,Mexico,Uncategorized
written by oecdecoscope | September 3, 2024



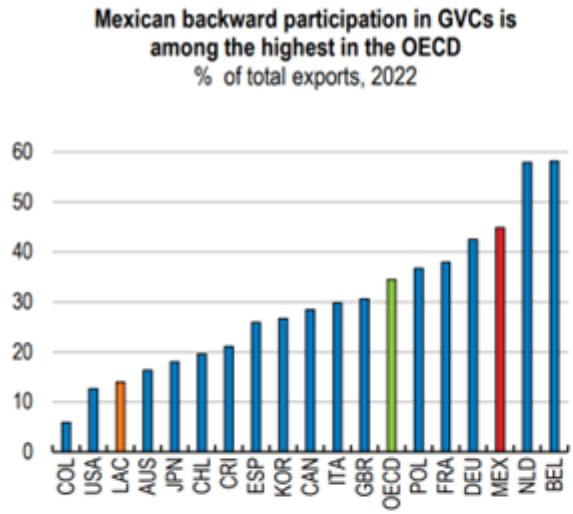
By Elena Vidal and Alberto González Pandiella, OECD Economics Department

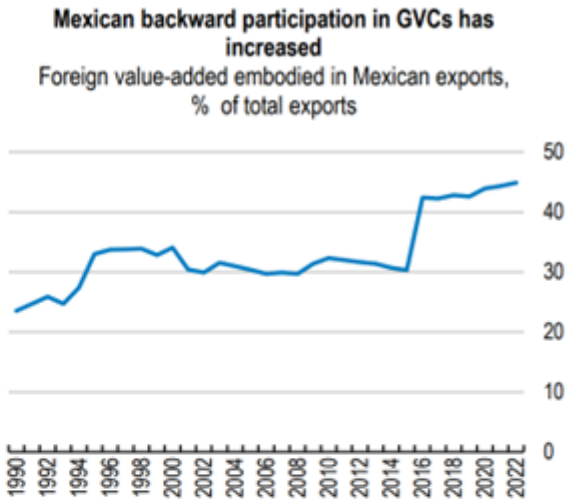
At the beginning of the 1990s, Querétaro, a state in central Mexico, was primarily known for its agriculture and small-scale industries. Many residents migrated to larger cities or the United States in search of better prospects. Today, Querétaro is a recognized hub for the aerospace industry. Thousands of jobs were created, and local talent has thrived thanks to partnerships between companies and local

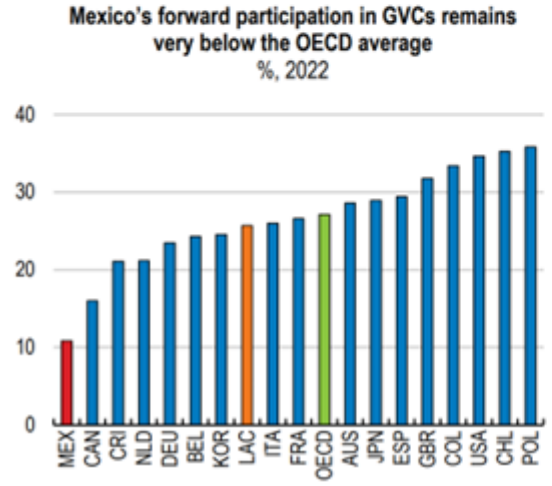
universities and technical schools.

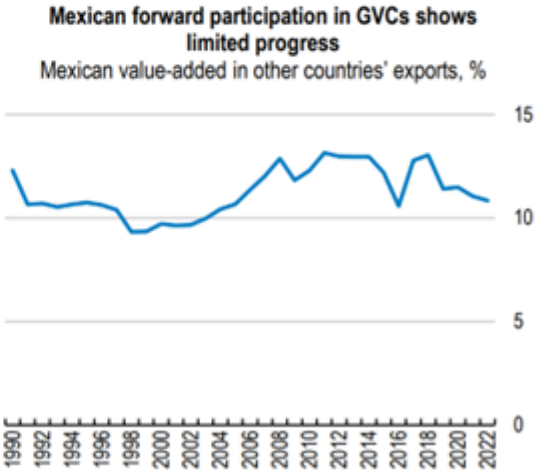
The 1994 North American Free Trade Agreement (NAFTA) was crucial in this success story and triggered a transformation of the Mexican economy, which became deeply integrated into global value chains (GVCs), with exports as a share of GDP tripling between 1994 and 2023. This success story is not without shadows and significant challenges remain. Not all the states in Mexico benefited from the trade agreement equally, and Southern states lagged, contributing to the high inequalities seen in Mexico today (OECD, 2024). Disentangling backward and forward linkages shows also that Mexico's GVC participation is mainly driven by backward linkages to GVCs, i.e., the share of foreign value added in Mexico's total exports is large (Vidal and González-Pandiella, 2024). Conversely, Mexico's forward participation, i.e., the share of Mexican value added embodied in foreign countries' exports, is relatively low, (Figure 1). This reflects a strong specialisation in assembling processes and Mexico being a prime exporter of final goods assembled for the US manufacturing sector. Moving up in the value chain and developing stronger forward linkages would boost productivity and promote more and better remunerated formal jobs.

Figure 1. Mexico's backward participation in global value chains is high and increasing while forward participation remains low









Note: LAC is an unweighted average of Chile, Colombia, Costa Rica, Argentina, Brazil, and Peru. Backward GVC participation corresponds to the foreign value added which is embodied in a country's exports as a share of this country' s total exports. Source: UNCTAD-Eora Multi-Region Input-Output tables (MRIO) (1990-2017); and estimations (2018-2022).

Ongoing nearshoring trends provide historic opportunities to spread the benefits of integration into GVC to other regions in Mexico (González Pandiella and Maravalle, 2024). Nearshoring also holds the promise to improve supply chain linkages, shifting from low-cost assembling processes to higher value-added functions being carried out in Mexico. Identifying which public policies can help to grasp these opportunities is of upmost relevance at the current juncture, with a new government taking office in September 2024.

According to our recent paper (Vidal and González-Pandiella, 2024), the following 5 public policies would help :

1. **Keep free trade agreements and maintain low tariffs**. Mexico's current trade policy stance of maintaining wide trade agreements and low trade tariffs is conducive to GVC participation. Seeking new trade agreements, especially in services, and enhancing trade integration with Latin America would also help to increase GVC participation.
2. **Improve infrastructure, logistics, and connectivity.** This would particularly increase most remoted regions chances to integrate into GVCs.
3. **Increase investment in research and development (R&D).** This would boost firms' local innovation activities and facilitate that higher value-added activities can also take place in Mexico.
4. **Improve the rule of law and the business environment.** This is essential for attracting foreign investment and encourage domestic entrepreneurship, as it reduces risks, uncertainties and costs associated with cross-border transactions.
5. **Increase female labour participation and enhance educational outcomes.** Higher female labour market participation increases the pool of available talent and skills, allowing firms to tap into a more diverse workforce. This diversity can lead to a wider range of perspective and ideas, boosting firms' innovation and adaptability and their ability to move to more sophisticated sectors and activities. By having a larger workforce equipped with relevant skills, companies can better manage risks associated with labour shortages or disruptions, enhancing the resilience of supply chains.

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Norway: Rougher waters ahead

Category: Norway,Uncategorized
written by oecdecoscope | September 3, 2024



By *Hansjörg Blöchliger, head of Norway and Iceland desk, Economics Department*

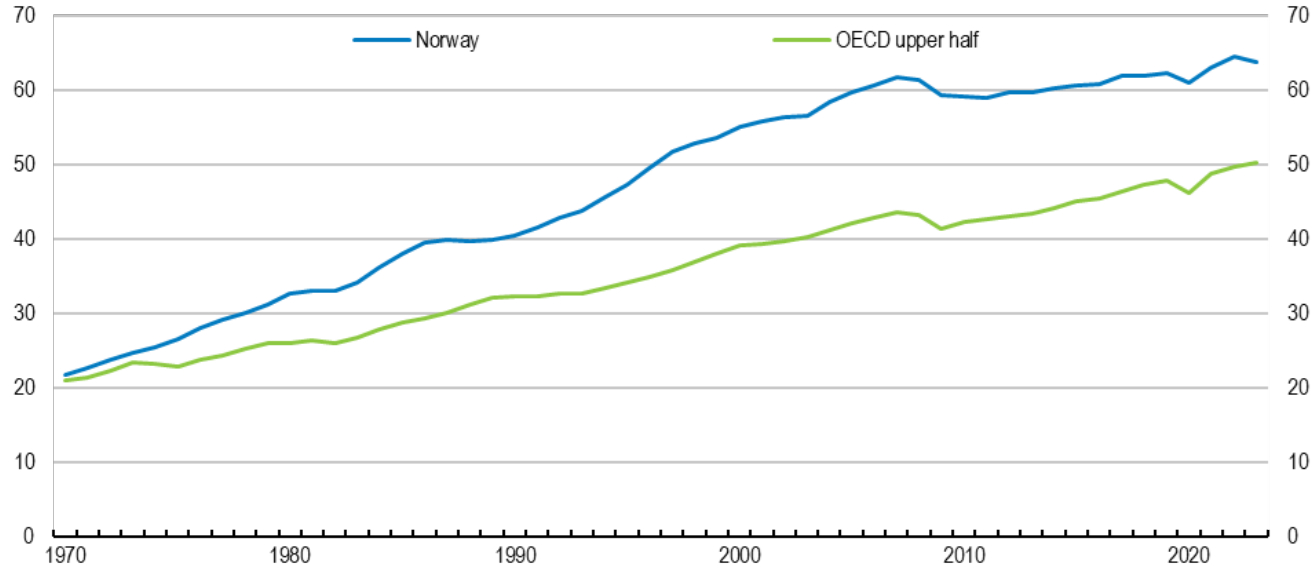
Life remains good in Norway. GDP per capita is still among the highest in the OECD, boosted by high oil and gas revenues and supported by sound fiscal and macroeconomic management. Thanks to huge domestic energy sources, the country has weathered the energy crisis well, as shown in the latest OECD Economic Survey of Norway. Norway is also one of the most egalitarian countries and offers largely equal opportunities for both men

and women.

The unemployment rate is low at around 4% albeit rising slowly, and labour participation is reverting to historical highs. Overall economic growth is expected to accelerate from 0.5% in 2023 to 1.2% in 2024 and 2.1% in 2025, while the mainland economy excluding the oil sector will grow a bit less.

Figure 1. Living standards are among the highest in the OECD

GDP per capita, thousand USD PPP



Source: OECD, National Accounts database.

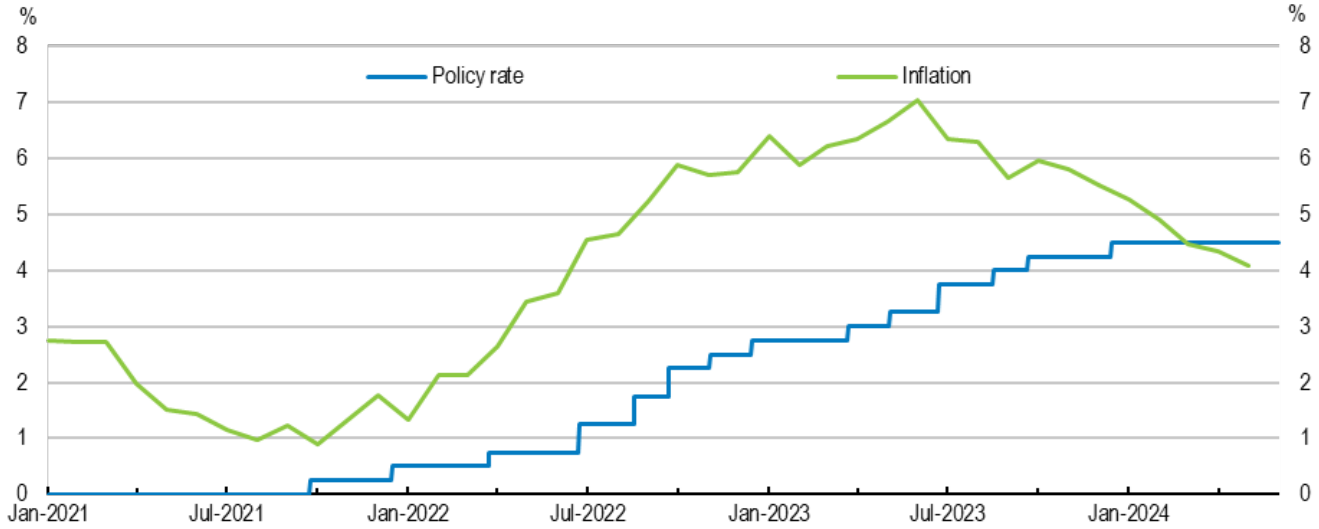
The lead is shrinking

Yet everything does not run smoothly. Growth is subdued, while inflation is too high for comfort at close to 4%. It is receding gradually and expected to reach the central bank's target of 2% only in a couple of years. Since December 2023, the key policy rate has remained at 4.5%. Imbalances in the labour market are rising. Notably, qualified labour in the technical professions and in health care is lacking. And at around 0.5% per year, productivity growth is among the lowest in the OECD – it would have been even lower without the boost from the oil sector. Because of low productivity growth,

Norway’s lead over the richer half of the OECD countries has shrunk from around 42% to 27% over the past 15 years.

Figure 2. Inflation is falling but remains too high for comfort

Consumer price inflation and key policy interest rate



Note: Inflation refers to national CPI adjusted for tax changes and excluding energy products (ATE).
Source: Statistics Norway; Norges Bank.

With economic activity picking up again, monetary policy should remain sufficiently restrictive to bring inflation down over the medium term. Fiscal policy should work in the same direction as monetary policy and avoid any stimulus. The electricity support scheme for households should be phased out. High housing demand should be met by making city space denser and by allowing for more construction notably close to public transport hubs.

Structural reform could help raise productivity

The administrative and regulatory burden is high, especially for young firms, and business dynamism is relatively weak. The government should improve the general legal and administrative

environment for businesses, and it should conduct regular evaluations of regulation, to foster startups and to help them become more productive.

Stronger and more relevant skills could also reinvigorate productivity growth and employment. Norway has a well-functioning work-based secondary vocational education and training (VET) system, but tertiary VET lacks scope to meet the demand for high-skilled workers. The government should strengthen tertiary VET by extending the current short cycles and/or opening university colleges to upper-secondary VET graduates.

Public spending should be contained and made more effective

Public spending as a share of GDP is the highest in the OECD, partly reflecting a generous welfare system as well as ambitious regional development objectives. Yet depleting oil resources and the fiscal consequences of ageing call for fiscal prudence and for upgrading the fiscal framework. To contain public spending, Norway should implement a medium-term budgeting framework and an expenditure rule, and it should broaden the remit of the fiscal council.

Sickness and disability as a share of GDP are by far the largest of the OECD, and the share of young people receiving disability benefits has almost doubled over the past ten years. The government should reduce the sick leave compensation rate towards the level of the other Nordic countries. It should also strengthen early intervention, especially for the young, to encourage them to return to work after sick leave.

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Demographic challenges to productivity: How to reconcile population ageing with economic growth?

Category: Ageing,Uncategorized
written by oecdecoscope | September 3, 2024



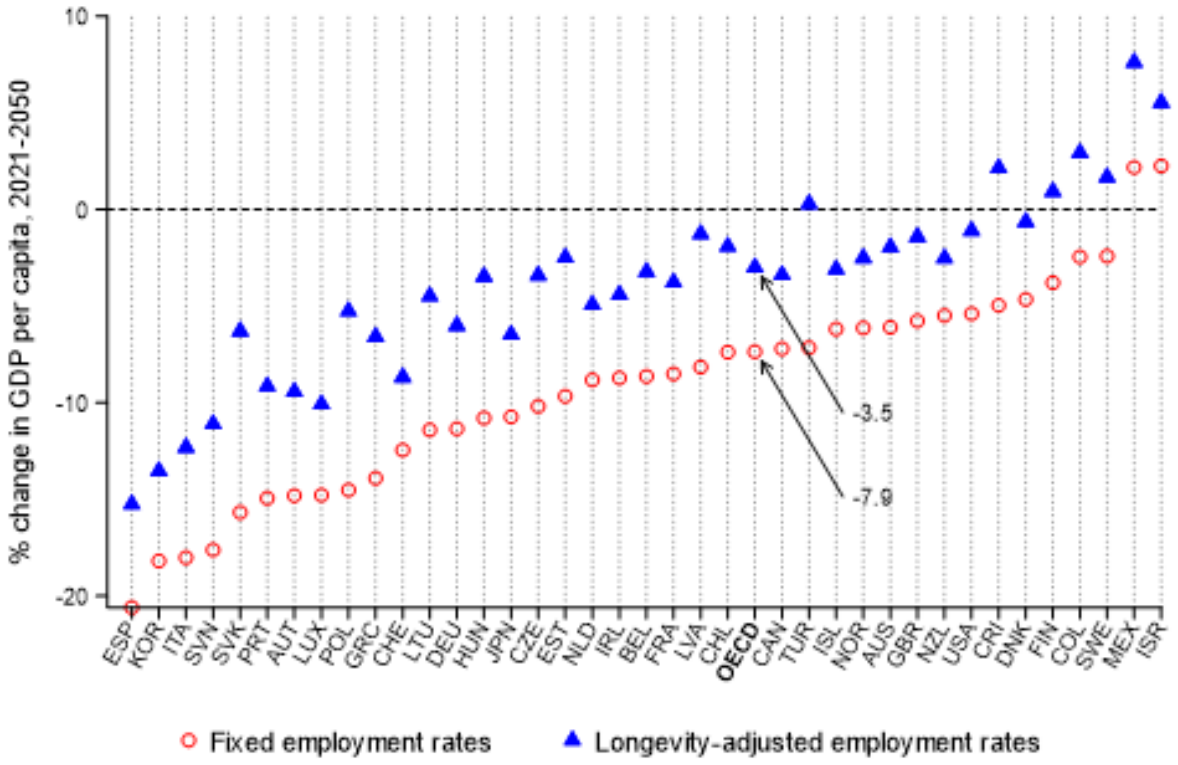
By *Christophe André, Peter Gal, Álvaro Pereira and Matthias Schief*

People in OECD countries are, on average, living longer and often ageing in better health than in the past. This a major and welcomed achievement. Nevertheless, rapid ageing in most advanced and many emerging economies also raises concerns about productivity and economic growth (Andre, Gal and Schief, 2024) as well as fiscal sustainability (Rouzet et al., 2019; Crowe et al., 2022).

The steady increase in the share of older people as longevity increases is currently compounded by a cohort effect, as the relatively large cohorts born in the middle of the 20th century retire and are replaced by smaller cohorts, reflecting fertility declines over the past decades. The fall in the

share of workers in the population is set to reduce, all else equal, per capita income across the OECD by nearly 8% over the next three decades, with some countries experiencing up to a 20% shortfall. While an extension of working lives resulting from additional years of healthy life would mitigate the fall in GDP per capita, it would generally not be sufficient to fully offset it (Figure 1).

Figure 1. Ageing will weigh on GDP per capita, even with longer working lives



Note: The figure shows the estimated impact on GDP per capita of the projected change in the share of workers in the population, everything else equal, under two scenarios. The first one assumes fixed age-specific employment rates. The second one allows employment rates to move in line with healthy ageing, with each year of increased life expectancy assumed to reduce the effective age of older workers by two-thirds of a year for employment rate calculations based on the observed relationship between life expectancy and healthy life expectancy increases in the past (see more details in the source).

Source: Andre, Gal and Schief (2024) using data on age-specific employment rates from the OECD and population projections from the 2022 revision of the UN World Population Prospects.

Drawing an analogy with climate change, one can think of two policy approaches towards ageing: mitigation and adaptation. Mitigation would aim to prevent further ageing by raising fertility rates and immigration. Fertility is crucial to prevent a fall in population. However, a rise in today's fertility rates would only raise the share of workers in the population in about two decades, when today's newborn enter employment. Furthermore, measures promoting fertility have so far had limited success (Shen et al., 2020) and although policies to reconcile work and parenthood can support fertility (Fluchtmann, van Veen and Adema, 2023), their impact remains highly uncertain. Immigration can have a sizable impact on population growth and, with the help of well-designed integration policies, contributes to economic dynamism and innovation (Bernstein et al., 2022). However, even if immigration is important in some individual countries, stabilising the OECD-wide old-age dependency ratio would require much higher net immigration rates than those observed since the turn of the century.

Given the limited scope to *mitigate* ageing, OECD economies and societies will have to focus on *adapting* to it. Healthy ageing is a pre-condition for prolonging working lives, which should be supported through better integration of individuals in the economy and society, promoting healthier lifestyles at all ages, adapting health systems, and improving social and environmental health determinants. Fighting age discrimination and removing disincentives to continued work at older ages embedded in pension systems and other institutional arrangements is also crucial.

In many countries, there is scope to increase labour participation in younger groups as well, notably women and

youth. Beyond quantity, the quality of jobs can be improved, by promoting better work-life balance – which would also favour gender equality and may help raise fertility rates – and by investing in skills, improving labour market matching and productivity.

Indeed, demographic headwinds could be offset by rising output per worker. Understanding how population ageing itself impacts productivity growth is therefore crucial. There are various micro- and macro-economic channels to consider, pointing in different directions (Table 1).

Table 1. Productivity and ageing: A summary of the evidence

Mechanisms		Ageing dimensions involved		
		I. Workforce ageing	II. Workforce decline	III. Rising old-age dependency
More micro	1. Differences in productivity by age	Mixed		
	2. Dynamic effects through innovation and entrepreneurship (business dynamism, entrepreneurial activity, job mobility, innovative activity (e.g., patenting))	Negative		
	3. Adoption of labour-saving technologies (automation, robots)	Positive		
	4. Changing structure of aggregate demand towards less productive activities	Negative		Negative
	5. Capital deepening	Positive / Mixed		
More macro	6. Higher government spending on ageing-related expenditures			Negative

Note: This table summarises findings in the literature along two dimensions: the main mechanism through which ageing may impact productivity (captured by rows 1- 6) and the various dimensions of ageing that are mostly mediating the effects (columns I.-III.). The studies and reports underlying this table are discussed in Sections 3.1-3.7. of the source.
Source: Andre, Gal and Schief (2024).

At the more microeconomic level, workers' productivity increases with experience but may decline at older ages due to poor health or obsolescence of skills. Notwithstanding, the impact of ageing on firms' productivity is unclear, as younger and older people work in teams and can complement each other (OECD, 2020). However, ageing tends to reduce innovation and business dynamism (Hopenhayn et al., 2022). Conversely, ageing incentivises automation, which can raise productivity. Artificial intelligence may offer new opportunities to overcome the ageing challenge, notably through alleviating labour shortages (Filippucci et al., 2024).

Ageing can also impact productivity through macroeconomic and financial developments. Savings accumulated by older generations can boost investments, but a lower bound on interest rates could prevent interest rates from falling enough, leading to secular stagnation (Eggertson et al., 2019). Risk-aversion among older people may direct savings towards conservative investments, at the expense of innovation financing. Rising age-related government spending may crowd out productivity-enhancing investments, while tax distortions may slow productivity growth, as would demand shifts towards lower-productivity services, like leisure or elderly care. This co-existence of positive and negative effects may explain that so far ageing has not been associated with lower GDP per capita (Acemoglu and Restrepo, 2017).

In sum, policies should reconcile the individual benefits from living longer with the societal challenges that this may create, not only by efforts to mitigate, but also to adapt to ageing. This involves promoting healthy ageing, removing obstacles and disincentives to extending working lives, mobilising labour resources in all age groups, encouraging lifelong learning, and supporting business dynamism.

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The return of industrial policies

Category: Public finance,Uncategorized
written by oecdecoscope | September 3, 2024



By Valentine Millot and Łukasz Rawdanowicz

Industrial policies have again risen in prominence in advanced economies with the series of economic crises, rising geopolitical risks and increased awareness of environmental

challenges.

In our recent paper (Millot and Rawdanowicz, 2024), we contribute to renewed debates about these policies by discussing the *pros* and *cons* of industrial policies motivated by different objectives, and propose a few principles to inform policy guidelines.

What is industrial policy and how much is happening?

While discussions about industrial policies are intensifying, their exact definitions and their differences with trade, environment, innovation and tax policies are debated. Industrial policies commonly refer to government financial and non–financial support to businesses to boost or reshape specific economic activity. Government support to businesses can be broadly available to all firms across the economy (i.e. horizontal) or be more narrowly targeted based on activity, technology and/or location. In our paper, we focus primarily on targeted measures, which are both increasingly used in recent years and raise more concerns about their implications for domestic and international markets and rules-based trade.

Assessing the scope and scale of government industrial policies, and their evolution over time, is notoriously difficult (Warwick and Nolan, 2014; Terzi, Singh and Sherwood, 2022; OECD, 2023). This is due to a persistent lack of reliable and cross-country comparable data (OECD, 2023; Juhász, Lane and Rodrik, 2023) and the absence of consensus about the definition of industrial policies.

The OECD has made headway in filling the data gaps. Through the QuIS project and sectoral studies for selected industries, the OECD has gathered harmonised data that facilitate the benchmarking of industrial strategies across countries in terms of industrial policy expenditures, priorities, instruments and recipients (Criscuolo et al., 2023; OECD,

2023).

Available data suggests that many governments around the world have actively provided various forms of support to selected industries, though with different intensity across time and countries, and that industrial policies are an important part of economic policies in advanced and emerging-market economies.

Recently, several advanced economies have revived industrial polices to support green and digital transitions as well as employment. For example, to meet these objectives, the US government implemented in 2022 the CHIPS and Science Act and the Inflation Reduction Act (IRA). These initiatives have been partly motivated by the perceived need to respond to the growing economic power of China, which has been using large-scale state interventions for decades. In response to strategic and environmental challenges and, in some cases, also in reaction to US and Chinese industrial policies, several OECD economies have proposed or implemented similar measures.

Industrial policies should be justified by cost-benefit considerations

Industrial policies can play a role in addressing important economic, social and environmental challenges that markets cannot deal with on their own. When they are successful, industrial policies can bring large benefits for the nation concerned. They could also have positive international spillovers, for instance if they lower the cost of the climate transition.

However, industrial policies entail costs, including fiscal ones. They can create market distortions that have negative effects on innovation and the availability and prices of goods and services. Costs can be particularly high when measures effectively limit competition and increase protectionism.

Ultimately, they may reduce market contestability and undermine the rule-based trading system.

Debates about industrial policies have not yet been resolved in view of challenges with their evaluation and the existence of both negative and positive examples (Karp and Stevenson, 2012). Still, a serious assessment of costs and benefits should be attempted to inform policy makers. It should extend beyond measuring the short-term direct impact on the targeted sectors, firms or technologies. Analysis should focus on overall effects in the longer term, including domestic and international spillovers and on a wide range of fiscal costs. The uncertainties surrounding the estimates of the costs and benefits calls for considering various alternative scenarios of possible outcomes. The distributional impact of industrial policies across firms, households and taxpayers should also be assessed.

Despite well-grounded economic, social and environmental justifications for some industrial policies, there are legitimate concerns that the benefits of some of these policies could be limited and the costs high. This mainly relates to measures curbing competition and the practical and political challenges in designing and implementing effective measures.

Thus, while governments may want to experiment with future and welfare-oriented industrial policies, they should exert moderation in scope, exercise caution in design and implementation, and be mindful of possible negative international implications that can undermine the rule-based trading system.

Towards policy guidelines

While our understanding of industrial policies is imperfect and continues to evolve with new data and evidence, basic principles inform tentative policy guidelines for governments

planning to use targeted industrial policies:

- Be clear and realistic about what they are trying to achieve. Industrial policies can help to deliver urgent climate objectives, improve economic security and resilience, and support distributional outcomes, but to a varying extent.
- Prioritise areas where existing structural challenges cannot be addressed solely by markets and other government policies and where these challenges imply high and growing societal costs. Consider whether industrial policies are effective and efficient to pursue those objectives, and what other government policies will be needed for the full range of expected benefits to be achieved.
- Design tailored, proportionate and comprehensive measures based on the diagnosis of main problems and experience. This will help to boost benefits and to minimise the economic and fiscal costs, both domestically and internationally. Favour measures that:
    - do not restrict competition and encourage the development of markets and new entrants rather than favouring incumbents.
    - minimise negative spillovers on international markets and help promote international co-operation and rules-based trade.
    - are limited in time and size, using for example sunset clauses and claw-back arrangements. Still, ensure that policies are sufficiently persistent and predictable to be able to change the behaviour of firms and individuals, including by clear and consistent messaging on the duration and terms of policies.
    - are transparent to enable public debate and independent analysis as well as to protect against domestic capture.

- incorporate evaluation from the start. Ensure that data necessary to undertake it are collected. Establish regular review and feedback mechanisms and adapt policies as you learn. Introduce institutional safeguards for ending the government support where objectives are not being achieved or unintended consequences alter the cost-benefit assessment of programmes.
- ensure a competitive, non-discriminatory and transparent design of the selection process of businesses to be helped, to avoid favouring incumbents and deterring new entrants. Consider delegating such selection processes to expert institutions free from political pressures, while safeguarding democratic oversight and accountability.

- Work with stakeholders when identifying the main obstacles to achieving the policy objectives as well as the need for and appropriate design of industrial policy measures, including to mobilise public support.

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The law of the strongest? Firm performance during the COVID-19 crisis

Category: COVID-19,Uncategorized
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The large decline in economic activity triggered by the COVID-19 pandemic posed significant risks to the corporate sector. In the wake of the crisis, two major concerns that emerged were i) the potentially-higher vulnerability of smaller or younger firms, which could make them bear the brunt of the severe recession, with the likelihood of lasting economic damage; and ii) the risk of a debt overhang effect, whereby firms, even if rescued, would accumulate more debt, negatively impacting their post-pandemic investment and growth.

In a recent paper (Franco, Hitschfeld, Pina and Puy, 2023), we investigate whether these concerns materialised by analysing

more than 150,000 non-financial companies, listed and non-listed, from both manufacturing and services sectors, operating in more than 50 countries, through the COVID-19 cycle until end 2021.[1]

Larger and older firms have not outperformed smaller and younger ones

A first key finding is that larger and older firms did not outperform their smaller and younger counterparts in terms of revenue growth and investment spending, both during COVID-19 and the subsequent recovery. The underperformance of large firms in terms of revenues was driven by firms operating in advanced economies (Figure 1), where concerns about rising concentration and market power have been the strongest in the last decade. The relative performance of smaller and larger firms depends on whether their sector of activity in the respective country expanded or contracted over the COVID-19 cycle. In contracting industries, the underperformance of larger firms in terms of revenues is statistically significant, suggesting that smaller firms might have gained market share at the expense of larger competitors in the sectors hit hardest by the pandemic. In contrast, the effect of firm size is more muted in expanding sectors. For firm age, the results for revenues are even stronger in advanced economies but, in contrast to size, are mainly driven by expanding sectors.

Abundant policy support mainly targeted at smaller firms only provides a partial explanation of their comparative resilience. Differences in the "size penalty" between subsamples of countries with larger or smaller fiscal policy support were generally found to be limited, with some evidence of a comparatively better performance of smaller firms in higher-support countries only in 2020.

Figure 1. The effect of firm size and age on revenues in different subsamples



Note: Each bar corresponds to the coefficients on the log of assets in 2019 and the dummy variable of age in 2019 (top quartile of the sectoral age distribution) in a regression model for the log of firm revenues, with the debt burden measured using the interest coverage ratio. A negative (positive) bar indicates that larger or older firms have performed worse (better) in terms of revenues compared to their smaller or younger counterparts. Empty bars indicate non-significant coefficients, dotted bars indicate significance at 90%, dashed bars indicate significance at 95% and filled bars indicate significance at 99%. Country groups with higher and lower policy support are defined based on total fiscal support (above and below the line) excluding contingent liabilities. See Franco, Hitschfeld, Pina and Puy (2023) for further details. *Source*: Authors' calculations based on IMF (2021) and S&P Capital IQ database.

The absence of a "size premium" suggests that, at least until 2021, the COVID-19 pandemic did not induce a systematic reallocation of revenues and investment towards industry leaders, and thus did not result in a broad-based increase in concentration. Larger firms did not even systematically over-perform in sectors under particular scrutiny from a competition standpoint, such as technology and healthcare.

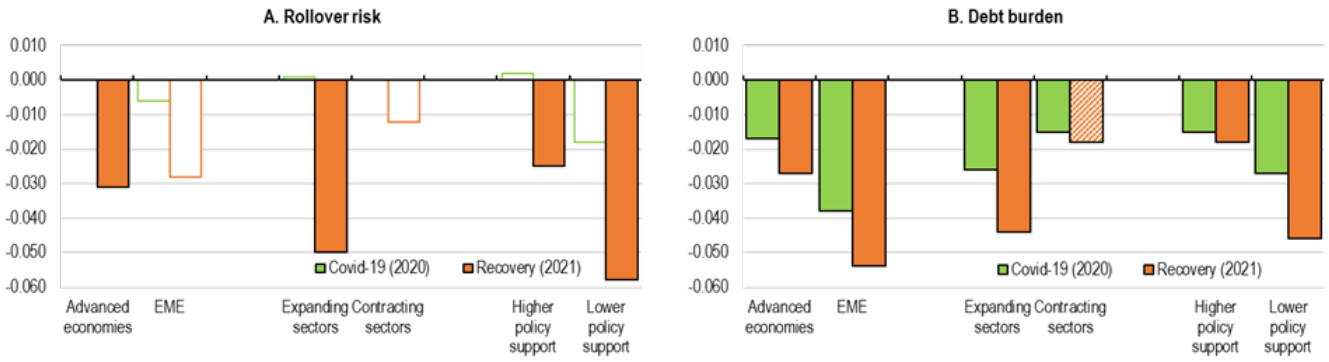
Financial vulnerabilities have weighed on revenues and investment

Ex-ante financial strength clearly attenuated the effects of the shock on revenues during the COVID-19 cycle. Firms that

entered the pandemic in poorer financial shape – with a higher leverage ratio, a heavier debt service burden or a larger share of short-term debt – tended to do worse in terms of revenues. These findings hold across advanced economies and emerging markets, expanding and contracting sectors, and countries with different levels of policy support (Figure 2).

There is also some evidence of a debt overhang effect. Firms that entered the crisis with a higher leverage ratio invested less than others, including on R&D, both in 2020 and in 2021, and firms which became more financially fragile during 2020 (e.g. experiencing an increase in their leverage ratio or a decline in either their interest coverage ratio or their liquidity ratio) tended to record weaker investment spending in 2021. The debt overhang channel thus appears a more likely source of any scarring effects left by the pandemic than the impact of reduced competition.

Figure 2. The effect of firm financial characteristics on revenues in different subsamples



Note: Each bar corresponds to the coefficients associated with rollover risk in 2019 (the ratio of short-term debt to total debt) and the debt burden in 2019 (bottom quartile of the sectoral interest coverage ratio distribution) in a regression model for the log of firm revenues. A negative (positive) bar indicates that more financially vulnerable firms have performed worse (better) in terms of revenues compared to their financially healthier counterparts. Empty bars indicate non-significant coefficients, dotted bars indicate

significance at 90%, dashed bars indicate significance at 95% and filled bars indicate significance at 99%. Country groups with higher and lower policy support are defined based on total fiscal support (above and below the line) excluding contingent liabilities. See Franco, Hitschfeld, Pina and Puy (2023) for further details.
Source: Authors' calculations based on IMF (2021) and S&P Capital IQ database.

References

Franco, G., Hitschfeld, M., Pina, A. and D. Puy (2023), "The law of the strongest? Exploring the drivers of firm performance during the COVID-19 crisis", *OECD Economics Department Working Papers, No 1779*, https://www.oecd.org/economy/the-law-of-the-strongest-exploring-the-drivers-of-firm-performance-during-the-covid-19-crisis-98397076-en.htm

IMF (2021), "Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic", Fiscal Policies Database (imf.org)

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[1] The empirical analysis relies on a number of different econometric methods. A difference-in-differences approach is used for the baseline model, with a set of cross-sectional and first differences regressions being employed to complement and check the consistency of the findings.