

# Addressing high public debt: selective expenditure restraint matters

Category: Uncategorized

written by oecdecoscope | December 19, 2023



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-

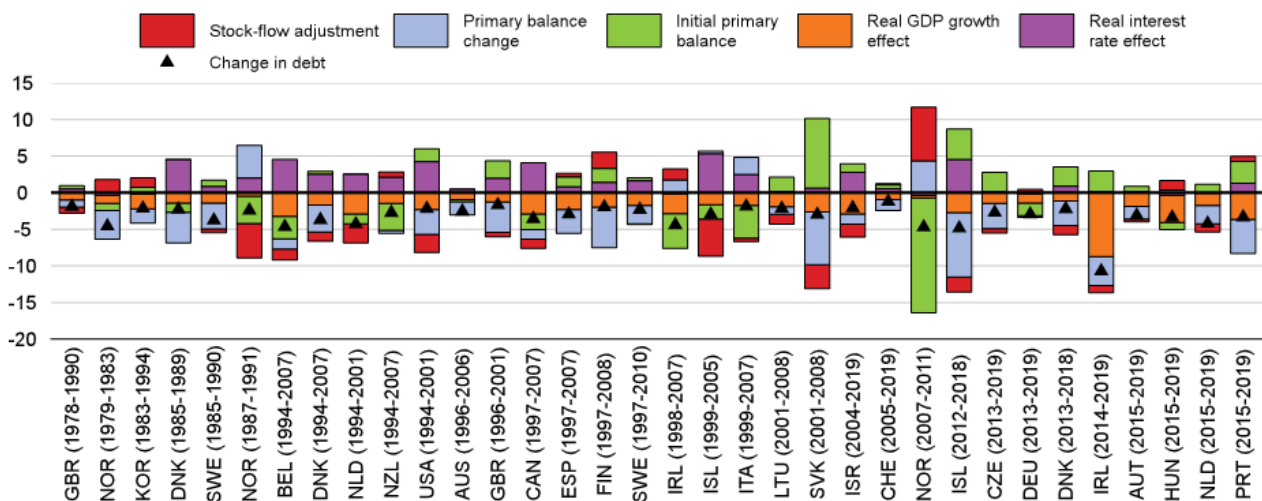
GDP ratio bottoms out. The analysis spans from the late 1970s to 2019, though data availability is limited for some countries.

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.

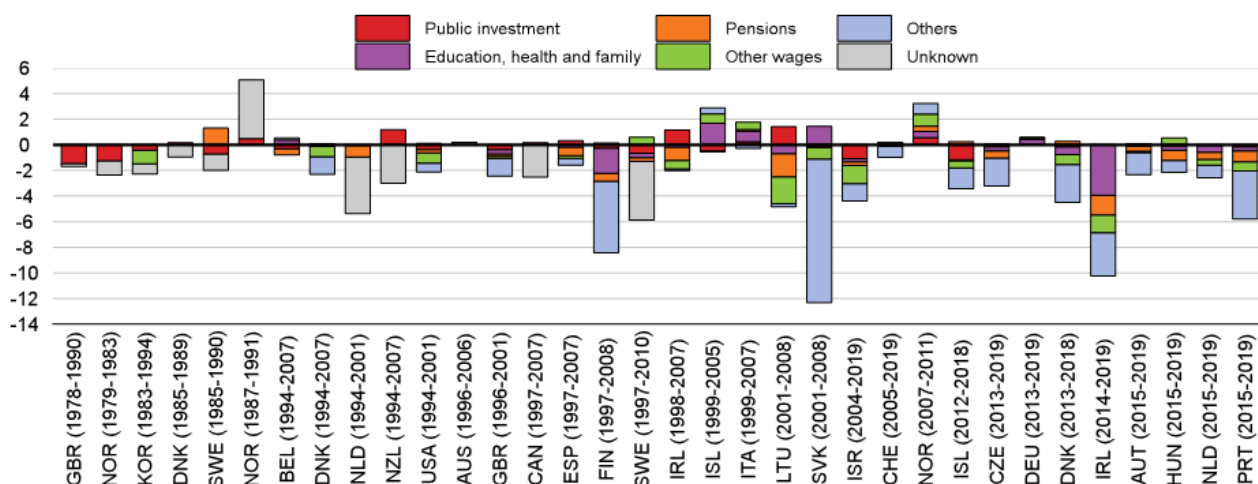
Expenditure restraint has often been accompanied, and likely made more sustainable, by relatively growth-friendly shifts in expenditure composition. Public investment as a share of GDP declined in about two-thirds of the episodes (23 out of 34; Figure 2), but these declines were often smaller than declines 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**

Category: Uncategorized

written by oecdecoscope | December 19, 2023

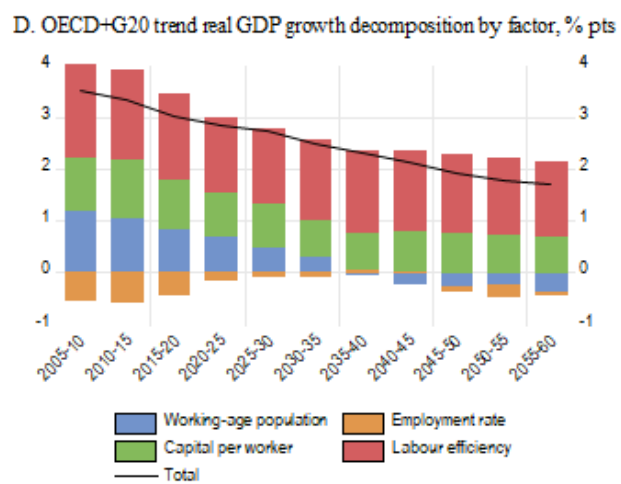
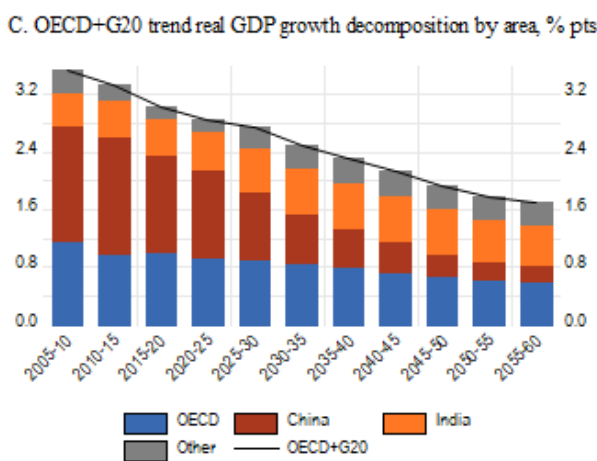
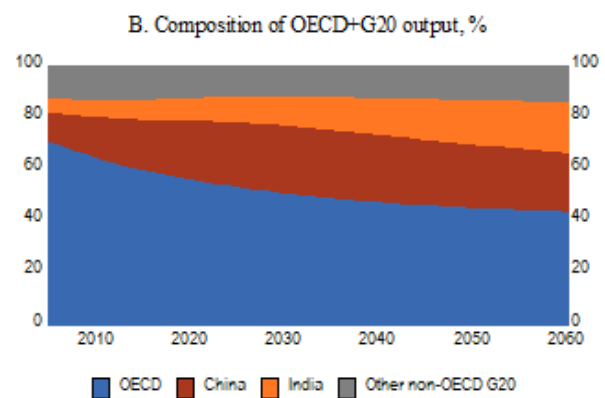
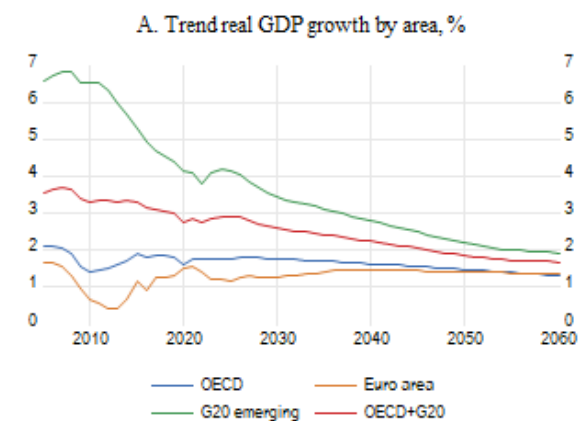


by Yvan Guillemette, OECD Economics Department

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<sub>2</sub> 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<sub>2</sub> mitigation efforts as of 2026, eliminating coal as an energy source by 2050 and lowering oil and gas shares in total

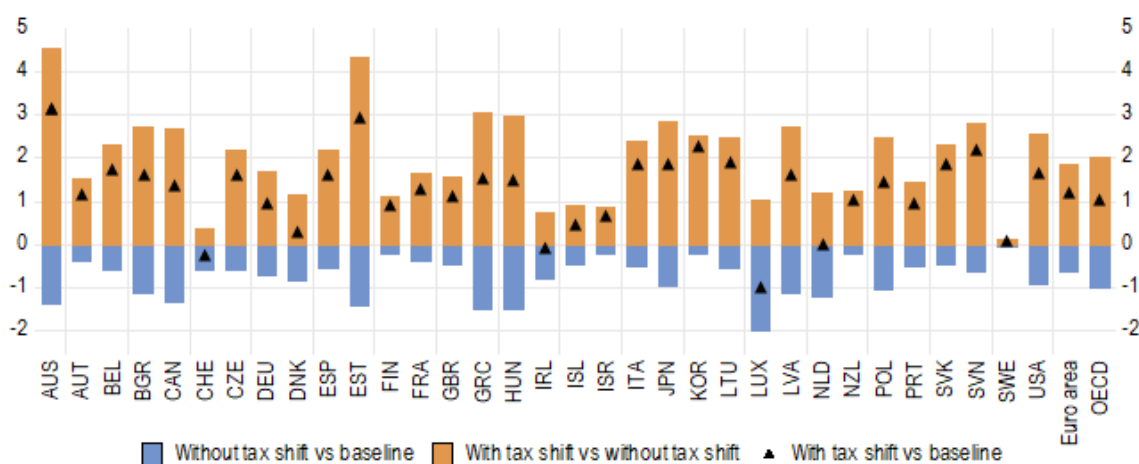
energy supply to 5% and 10%, respectively. Abstracting from gains due to avoidance of environmental damages, this acceleration of the energy transition leads to a reallocation of resources that impact GDP negatively. Global growth slows by 0.2 pp per annum initially relative to the baseline scenario, 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  $3\frac{1}{4}$  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<sub>2</sub> 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  $1\frac{1}{2}$  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. Triangles 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<sub>2</sub> mitigation.

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# Doombot Recession Outlook

Category: Forecast, Uncategorized

written by oecdecoscope | December 19, 2023



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).

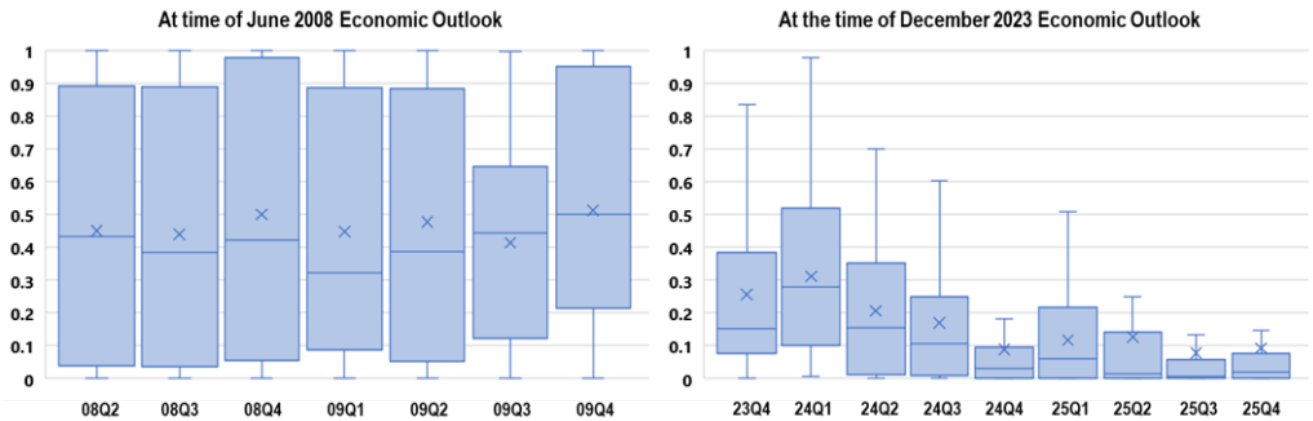
An algorithm, “DoomBot”, selects parsimonious models to predict recessions over different quarterly horizons covering the ensuing two years for 20 OECD countries. The models are

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.

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# Towards stronger, more inclusive and more sustainable growth in Thailand

Category: Thailand, Uncategorized

written by oecdecoscope | December 19, 2023



By **Jens Arnold, Kyongjun Kwak and Kosuke Suzuki**, OECD Economics Department

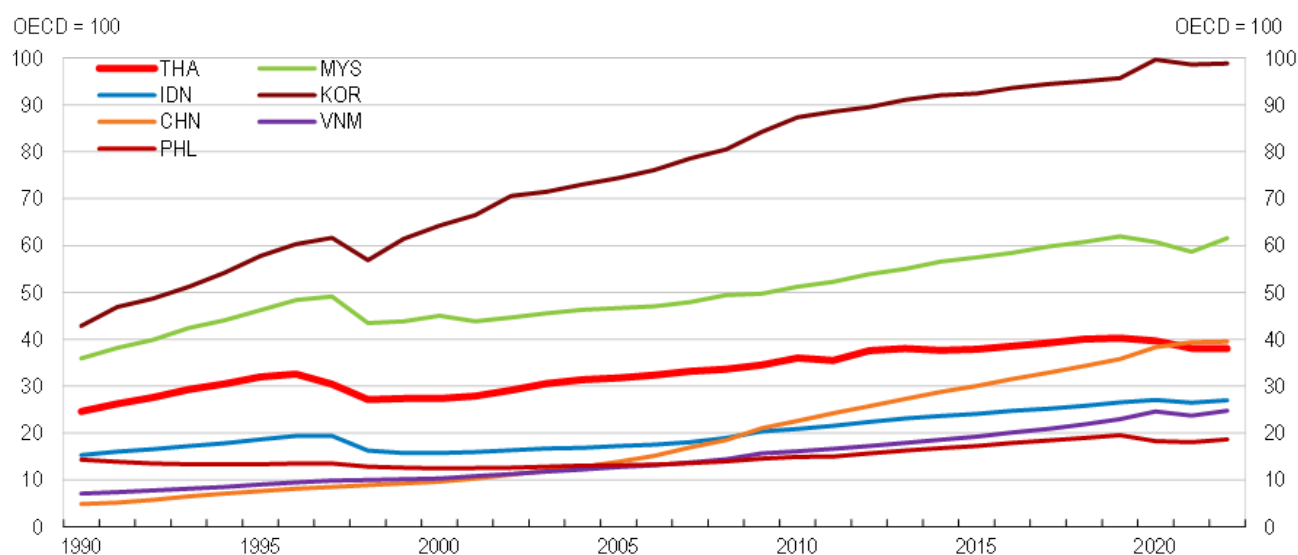
Thailand has achieved remarkable economic and social development since the 1960s. Among countries in Southeast Asia, Thailand was one of the first to open its economy by pursuing an active integration into global value chains and attracting foreign direct investment, which enabled the country to undertake significant investment in infrastructure. Thailand's manufacturing sector was able to gain a competitive edge, while the tourism industry flourished. Amid continuous growth, Thailand became an upper-middle income country in 2011, according to a commonly used classification by the World Bank.

However, Thailand's growth has been losing momentum over the

last decade, as highlighted in the recent edition of the OECD Economic Survey of Thailand (OECD, 2023). GDP per capita has stagnated at the same time as other countries in the region experienced more vigorous growth (Figure 1). The already softer growth momentum was further weakened by the economic fallout from the pandemic, which -among others- severely affected the tourism industry.

## Figure 1. After a rapid catch up, income convergence has stagnated since 2013

GDP per capita relative to the OECD average, computed at 2017 USD PPP



Source: World Bank, World Development Indicators database.

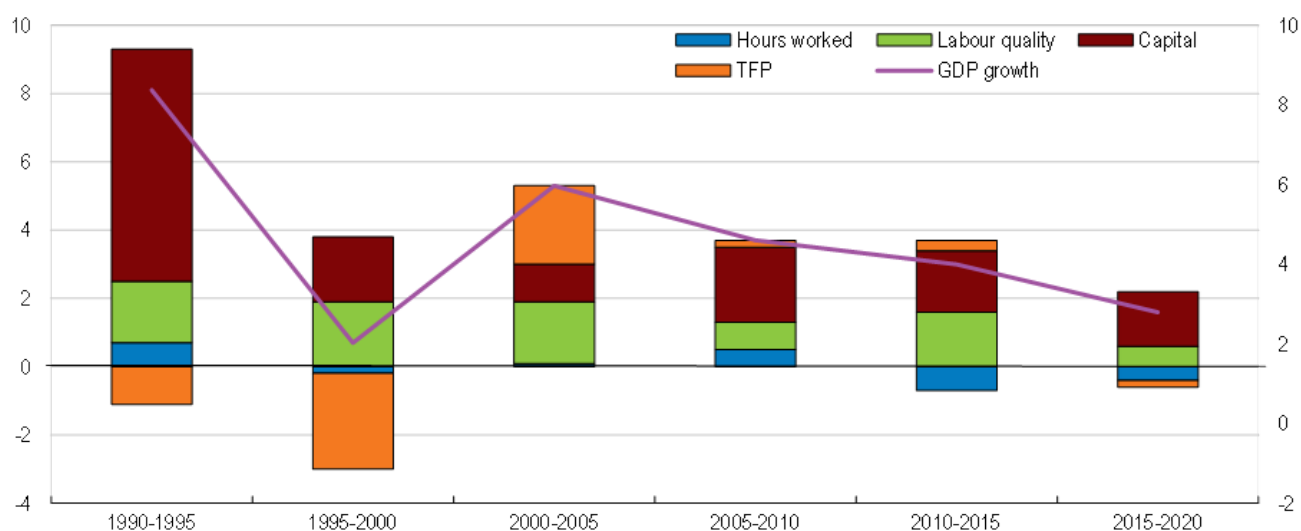
Looking ahead, resuming income convergence and achieving more rapid improvements in material living standards will hinge on Thailand's ability to tackle a number of challenges (OECD, 2023).

Strengthening competition is one of these challenges, as strong competition is crucial for boosting productivity growth, which has been subdued over the last 20 years (Figure 2). A range of Thai industries are characterised by high concentration and low levels of competition, which tends to foster rigid industry structures in which strong performers

find it more difficult to grow at the expense of established low-productivity firms. Thailand ranked 85<sup>th</sup> out of 141 countries in an indicator about the extent of market dominance elaborated by the World Economic Forum, suggesting that many markets for products and services are dominated by a few players. Analysis based on administrative data of Thai registered firms suggests an increase in market power among Thai firms, which coincided with lower business dynamism (Apaitan et al., 2020). Structural impediments to competition including regulatory constraints have been identified across a wide range of sectors, perhaps most notably in services sectors including telecommunications, energy and retail.

## Figure 2. Boosting productivity is crucial to sustain high economic growth

Factors contributing to the Thai GDP growth, annual average, %



Source: Asian Productivity Organisation, APO Productivity database 2022.

Rekindling the convergence process towards higher income levels will also include continuing to attract foreign investment, which has been an engine of growth in the past. Inward FDI stocks still have scope for further increases, including by expanding trade agreements and by relaxing remaining restrictions to foreign direct investment,

especially in the particularly restrictive services sector. Based on the OECD FDI Restrictiveness Index, Thailand's policies are more restrictive than in regional peers, and this holds particularly true for many services sectors. The same regulatory reforms that are required to strengthen competition and enhance the business climate will also be instrumental to attract more FDI.

Boosting growth is one thing, but spreading the fruits of this growth more widely is equally crucial. Income inequality and poverty remain significant concerns, but Thailand has made progress with social protection mechanisms, most of which have been established over the last 25 years. Over those years, Thailand has strengthened its social safety net and achieved a significant expansion in coverage, including among those not formerly covered by social protection policies. A universal public healthcare system was established in 2002. Income inequality has significantly improved since the 1990s, as evidenced by a substantial decline in the Gini coefficient from 0.44 in 1990 to 0.38 in 2021.

However, Thailand's social protection instruments are organised in a number of parallel systems, which has led to significant fragmentation. Social security benefits are currently provided to contributing formal-sector employees, but these amount to only 50% of the workforce. Building on past progress, Thailand can do more to reduce poverty and inequality through improvements in social protection. The main challenges for the future will be to achieve fully universal coverage with basic benefits, reconsider benefit adequacy for some benefits and improve the organisation of benefit delivery, ideally moving from a fragmented system to a single system that can deliver different tiers of benefits depending on the specific situation of beneficiaries.

Future growth will also have to become more sustainable. Thailand has pledged to achieve net zero greenhouse gas emissions by 2065, but the success of the green transition

will hinge on better policy coordination. Currently, several ministries and agencies are involved in the design of environmental policies and there are different and sometimes overlapping plans, making policy coordination complex. A newly created leading environmental agency is tasked to coordinate the overall green transition strategy and monitor policy progress, but it will require a strong mandate to fulfil this task successfully.

At present, the energy sector is a major source of CO<sub>2</sub> emissions. Renewable power generation has advanced but is mostly limited to small-scale producers incentivised by feed-in tariffs. The overall share of renewable energy sources remains lower than in peer countries. More large-scale energy generation from renewable sources through public tenders and renewable energy certificates would help to address rising electricity demand and reduce emissions. That would require reducing private entry restrictions in the retail electricity market.

In addition, an effective carbon pricing mechanism will be key for achieving emission reduction goals. A voluntary emission trading system is in operation, but carbon prices are low compared with OECD countries. Moreover, regulated energy prices, such as a cap on diesel prices, weaken the effect of market prices and fossil-fuel taxes. Stricter environmental regulations should complement carbon pricing. A mix of price-based and regulatory measures is likely to enhance the effectiveness and political viability of mitigation efforts. Stricter air pollution standards could be one way forward, including on coal power plants and internal combustion engine cars.

The recently published OECD Economic Survey of Thailand aims to support the design of policies that can address these challenges and allow Thailand to achieve stronger, more inclusive and more sustainable growth.

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# Creando espacio fiscal y fomentando el crecimiento en América Latina

Category: Posts in Spanish, Uncategorized  
written by oecdecoscope | December 19, 2023



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El crecimiento económico en América Latina está desacelerándose a medida que las políticas monetarias más restrictivas para combatir la inflación surten efecto y las

condiciones externas se tornan menos favorables, de acuerdo con las Perspectivas Económicas de la OCDE recientemente lanzadas. El crecimiento del PIB en 2023 presenta divergencias significativas entre las principales economías. El crecimiento se ha mantenido sólido en Brasil y México, que ha mostrado ser resiliente a la inflación y a tasas de interés elevadas impulsado respectivamente por una cosecha abundante y la fortaleza del consumo privado. Sin embargo, el crecimiento ha sido débil en Argentina, Chile, Colombia y Perú debido a eventos climáticos extremos, a una elevada incertidumbre política y la debilidad de la economía mundial. La inflación sigue en descenso en todos los países, salvo en Argentina, gracias a las rápidas subidas de tipos de interés. La caída de la inflación ha sido más rápida que en otras regiones. De hecho, Brasil, Chile, Costa Rica y Perú ya han comenzado a disminuir sus tasas de política monetaria. En México y Colombia, con inflaciones contenidas, pero aún elevadas, se espera que comiencen a reducir tasas en 2024.

Para 2024 y 2025 persistirá el bajo dinamismo económico en la región, situándose por debajo del crecimiento global (Cuadro 1) y de otras economías emergentes (3.9% y 4.1%). La inflación seguirá cediendo y se proyecta que alcance los objetivos establecidos por los bancos centrales en 2024, antes que la mayoría de los países de la OCDE. Sin embargo, las economías de la región se enfrentan a numerosos riesgos externos e internos. Entre los factores más relevantes se destacan una demanda externa y comercio debilitado y en particular la desaceleración de China, que afecta de manera importante a las economías exportadoras de materias primas como Argentina, Chile, Brasil, Colombia y Perú y la incertidumbre en los mercados financieros internacionales debido a tensiones geopolíticas y la evolución de las políticas monetarias en países avanzados. La inflación podría permanecer en niveles elevados por un tiempo mayor al anticipado. Además, un aumento en la frecuencia e intensidad de eventos climáticos extremos, como la llegada del Niño, podría afectar más de lo previsto a

algunas economías particularmente expuestas a ellos.

## Cuadro 1. Perspectivas económicas de los países de América Latina

	2023	2024	2025
<b>PIB variación, %</b>			
 Argentina	-1.8	-1.3	1.9
 Brasil	3.0	1.8	2.0
 Chile	0.0	1.8	2.1
 Colombia	1.2	1.4	3.0
 Costa Rica	5.1	3.5	3.6
 México	3.4	2.5	2.0
 Perú	0.0	2.3	2.7
<b>ALC-7</b>	<b>2.1</b>	<b>1.6</b>	<b>2.2</b>
OCDE	1.7	1.4	1.8
Mundo	2.9	2.7	3.0

	2023	2024	2025
<b>Inflación, %</b>			
 Argentina	124.0	157.1	62.4
 Brasil	4.6	3.2	3.0
 Chile	7.6	3.9	3.4
 Colombia	11.7	6.3	4.0
 Costa Rica	0.6	1.9	3.1
 México	5.5	3.9	3.2
 Perú	6.4	2.7	2.2
<b>ALC-6 (excl. Argentina)</b>	<b>6.1</b>	<b>3.6</b>	<b>3.1</b>
OCDE	7.0	5.2	3.8

Nota: América Latina (ALC) es la media ponderada por PIB a paridad de poderes de compra de los 7 países en la tabla para el PIB; y la media simple de los países incluidos en el cuadro para la inflación.

Fuente: OCDE Perspectivas Económicas, noviembre 2023.

En este contexto macroeconómico incierto y volátil, resulta clave asegurar la estabilidad macroeconómica y un crecimiento fuerte.

### Momento de enfrentar el desafío fiscal

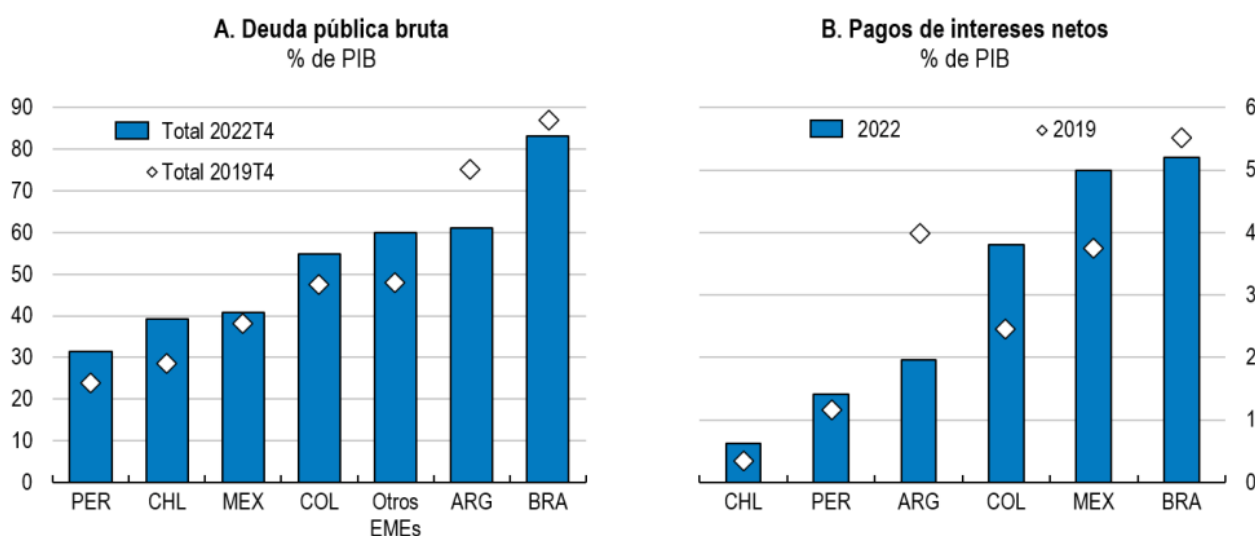
Por el lado de la política monetaria, con la inflación decelerando, la discusión se centra en el ritmo de las futuras reducciones de tasas de interés. El objetivo debe ser que las tasas de inflación vuelvan a sus metas de manera duradera, transitando hacia una posición de la política monetaria más neutral. Esto requerirá diferentes ritmos y tiempos en la reducción de tasas, según las particularidades de cada país. El ritmo de normalización deberá considerar cuidadosamente múltiples riesgos, como el impacto de El Niño y los precios del petróleo más altos, y la política monetaria en las economías avanzadas.

Por su parte, las autoridades fiscales se enfrentan al reto de seguir disminuyendo la deuda pública, que aumentó significativamente después de la pandemia, en un entorno en el que los tipos de interés a largo plazo han aumentado (Gráfico 1). La mayoría de los países ha retirado exitosamente los estímulos fiscales de la pandemia y ha empezado a reducir los déficits, pero enfrentan desafíos significativos dados los altos niveles de deuda, el poco espacio fiscal y el bajo potencial de crecimiento. La consolidación fiscal es un paso necesario para restablecer el margen de maniobra fiscal y evitar los riesgos asociados con elevados niveles de deuda, como pagos de intereses más altos que pueden desplazar los gastos públicos esenciales, especialmente en un contexto internacional de tasas de interés más altas durante más tiempo.

En la mayoría de los casos, los gobiernos de América Latina tienen planes de consolidación fiscal ambiciosos que llevarían a estabilizar la deuda, pero cómo alcanzar estos objetivos es clave. Esto requiere en un primer momento y como prioridad, reforzar los marcos fiscales de mediano plazo para dar una clara y creíble orientación futura sobre cómo se alcanzarán los objetivos fiscales y se reducirá la deuda, basados en proyecciones macroeconómicas y fiscales realistas, al tiempo que se protege la inversión pública, que a menudo es una víctima de la consolidación fiscal en la región. Elementos esenciales son incluir anclas de mediano plazo, como niveles prudentes de deuda, y cláusulas de escape bien definidas con mecanismos de corrección en las reglas fiscales. Se deben fortalecer también los consejos fiscales, dotándolos de independencia legal y de facto, recursos y acceso adecuado a la información, ya que pueden contribuir de forma importante al análisis de la sostenibilidad de las finanzas públicas. Además, superar obstáculos políticos para implementar reformas fiscales que aumenten la eficiencia del gasto, que es baja, y los ingresos tributarios, también bajos en la mayoría de los países de la región, son retos importantes.

El potencial de crecimiento en la región es bajo, lo que limita también el espacio fiscal. Esto hace crucial acelerar las reformas estructurales necesarias desde hace mucho tiempo, y fomentar el consenso necesario para llevarlas a cabo. Impulsar reformas que dinamicen el comercio, que establezcan marcos regulatorios estables para la inversión privada en conectividad, energías renovables y minerales sostenibles, y redoblar esfuerzos para mejorar la calidad de la educación es clave para potenciar la productividad y la inversión. Estas reformas facilitarían la adaptación al cambio climático y la transformación digital, y, al impulsar el crecimiento potencial, contribuirían de manera decisiva a la sostenibilidad fiscal de la región.

## Gráfico 1. El incremento en la deuda pública y los pagos de intereses restringen el espacio fiscal



Nota: Panel A: Otras economías de mercados emergentes (EMEs) es el promedio no ponderado de China, Filipinas, India, Indonesia, Malasia, Tailandia, Turquía, y Suráfrica. Panel B: Los datos para Chile se refieren al año 2021 en lugar de 2022. Fuente: FMI, Base de datos sobre inversores soberanos; Base de datos de Perspectivas Económicas de la OCDE; y FMI, Monitor fiscal, octubre 2023.

## Más información:

**OECD Economic Outlook, Noviembre 2023**– Reporte completo en inglés con las proyecciones macroeconómicas, los principales desafíos estructurales e información detallada por país.

**Perspectivas económicas de la OCDE para países de América Latina**, Noviembre 2023.

Información detallada por país: Argentina | Brasil | Chile | Colombia | Costa Rica | México | Perú

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

Category: Uncategorized

written by oecdecoscope | December 19, 2023



By Maria Bas<sup>1</sup>, Lilas Demmou, Guido Franco and Javier Garcia-Bernardo<sup>2</sup>

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).

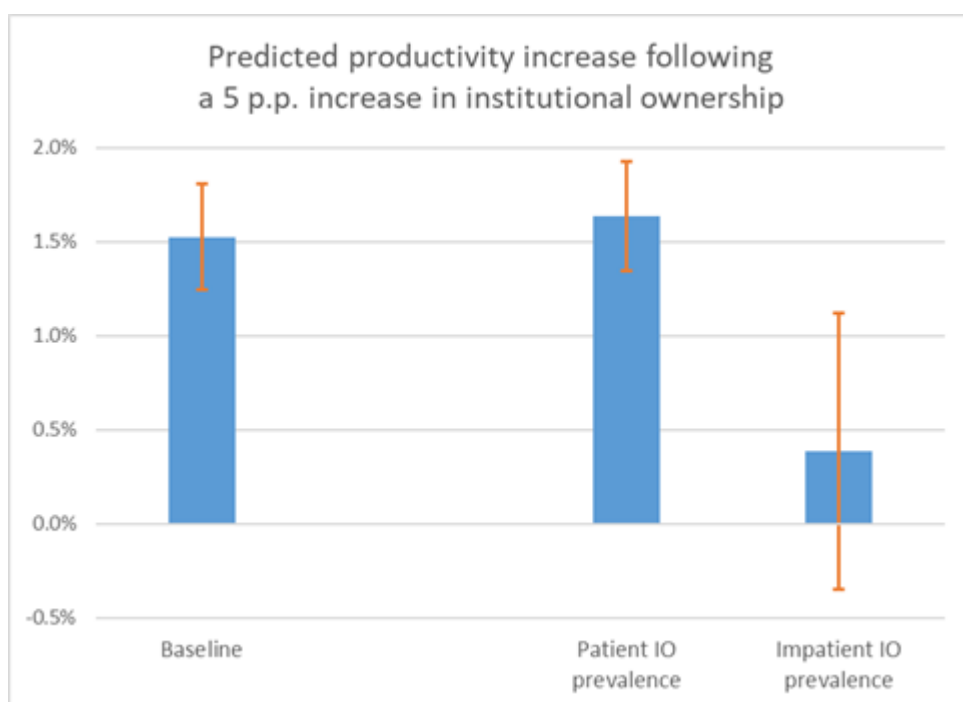
## **The governance channel**

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

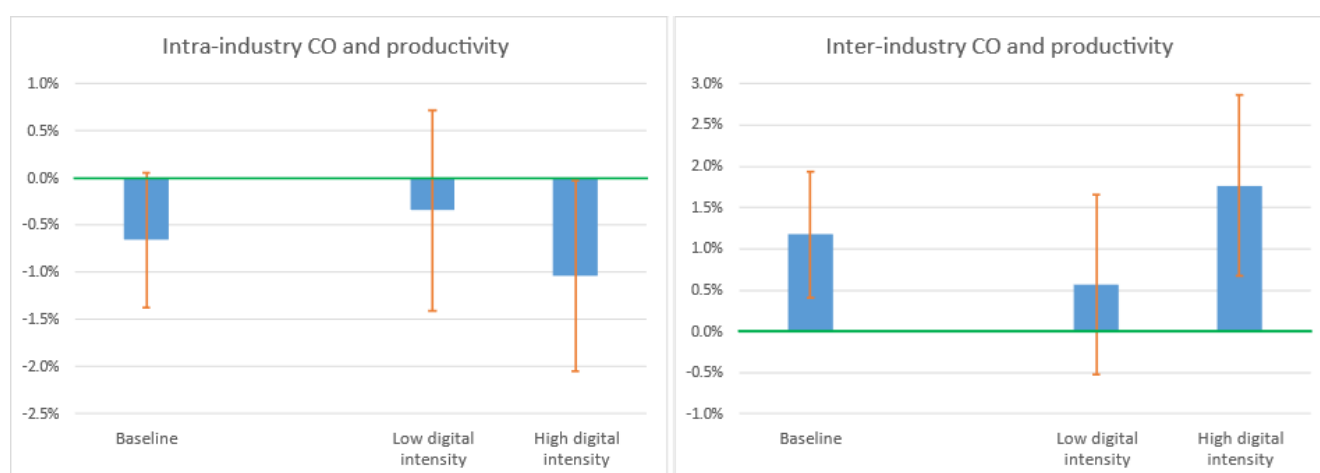
The consequences of common ownership for firms' productivity may vary depending on whether it occurs within industries or across industries.

*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 75<sup>th</sup> 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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# What explains the ongoing credit slowdown in advanced economies?

Category: monetary policy, Uncategorized  
written by oecdecoscope | December 19, 2023



by Lucia Quaglietti, Economist, Macroeconomic Policy Division, OECD Economics Department

Credit conditions across OECD countries have tightened sharply in recent quarters, with rising policy rates quickly reflected in bank lending rates and bank lending standards becoming more restrictive. Credit growth has slowed, especially to households. New mortgage lending to households has fallen by around 30% year-on-year in the euro area and in the United Kingdom in 2023. A key question is whether this reflects the impact of more restrictive lending conditions or whether demand for borrowing has just declined sharply.

Credit growth is shaped by a range of factors that affect credit demand and supply conditions. Estimates of the impact

of these factors on total credit growth to households and non-financial corporations have been obtained for Germany, France, Italy, the United Kingdom and the United States (Quaglietti, 2023). The technique used (structural VARs) permits four types of shocks to be identified: aggregate demand shocks, aggregate supply shocks, monetary policy shocks and credit supply shocks. The contribution of these different shocks to the annual rate of credit growth in 2022 and 2023 is shown in Figure 1, with a longer-term perspective provided in Figure 2. For simplicity, shocks to credit demand are shown as the combined impact of all identified shocks other than credit supply shocks.

- The results suggest that the recent sharp slowdown in credit reflects a combination of tighter credit supply and falling demand, with the balance of these factors differing across economies (Figure 1).
- Tighter credit supply has been a more important driver of recent credit dynamics in the United States than weaker credit demand, although other (non-identified) factors have also contributed to credit growth developments (Figure 1).
- Weaker credit demand accounts for the bulk of the slowdown in Germany, Italy and the United Kingdom. The impact of deteriorating demand conditions appears to be particularly sizeable in Italy, reducing average annual credit growth by 7 percentage points in 2023 (Figure 1). Over the same period, in Germany and the United Kingdom credit demand shocks appear to have lowered average annual credit growth by 1.5 percentage points.
- The current slowdown in credit growth is comparatively mild relative to that seen during the global financial crisis in many countries, with the exception of Italy (Figure 2). In 2009-10, credit supply and credit demand both contracted sharply. This also occurred in Germany and Italy during the subsequent euro area crisis.

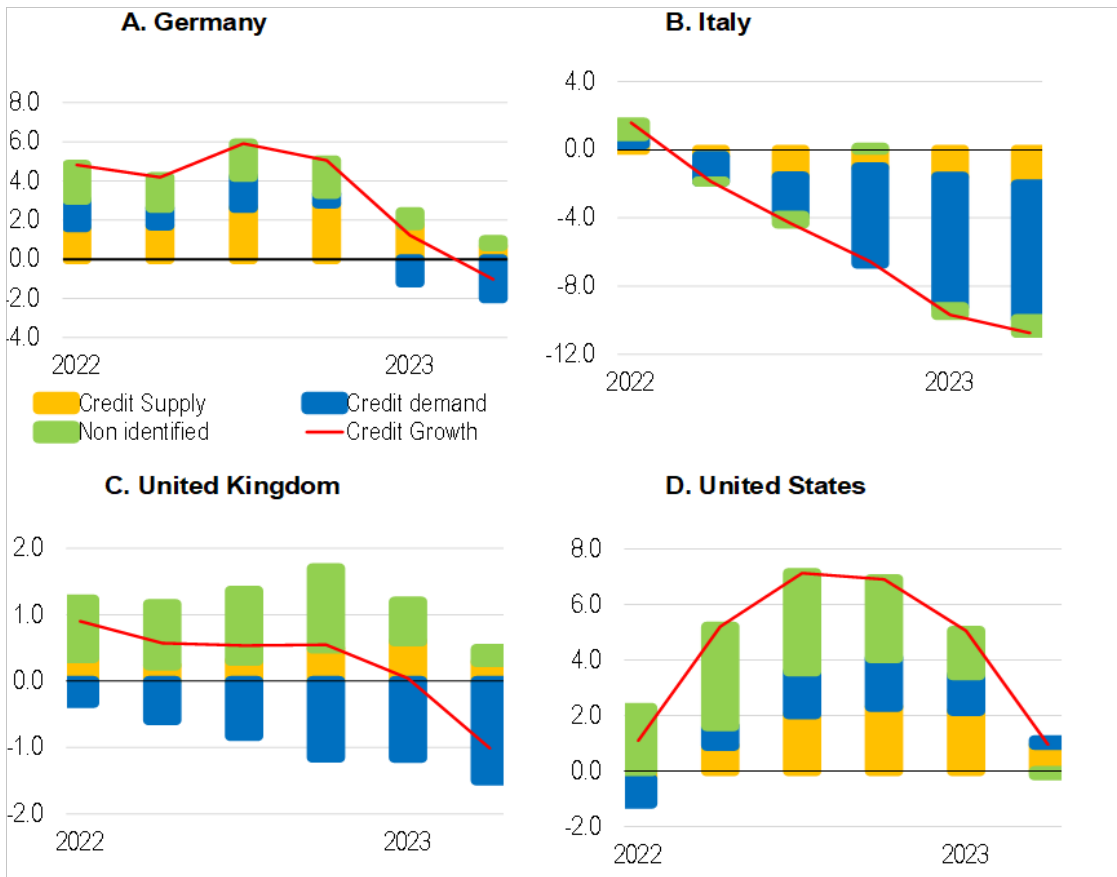
Bank lending surveys broadly corroborate these findings. Banks overwhelmingly report a tightening of credit standards (a supply shock) in the United States, especially for mortgage lending, and a sharp decline in credit demand in the euro area, especially for house purchase.

Higher interest rates, low consumer confidence and falling real disposable income have weakened credit demand by households and firms. The banking sector now is better capitalised than prior to the global financial crisis, and credit supply shocks were still marginally boosting credit growth in most countries as of mid-2023. Even so, banks have tightened credit standards due to rising risk aversion, higher funding costs and balance sheet constraints. In the euro area, the decrease in liquidity following TLTRO (targeted longer-term refinancing operations) repayments may also have contributed to weaker credit supply (Lane, 2023).

So far, there are few signs of a severe and widespread credit shortage of the type seen in the global financial crisis. Ample capital and liquidity buffers and low levels of non-performing loans currently allow banks to continue supplying credit to households and firms, enabling an orderly transmission of monetary policy. But risks remain, especially if the current economic slowdown were to deepen. As banks continue to pass through past increases in policy rates to households and corporates, delinquency rates and non-performing loans could rise, potentially generating credit losses that would weigh on the supply of new credit to the economy. Credit demand could also weaken further in the event of a sharp economic downturn or a swift repricing in asset prices.

### **Figure 1. Contributions of demand and supply shocks to recent developments of credit growth**

Decomposition of the year-on-year percentage change of credit growth relative to its long-term trend



Note: The decomposition is based on the moving average representation of the estimated VARs, and shows in each quarter the contribution of contemporaneous and past structural shocks to credit growth expressed as a deviation from its long-term trend over the period 2000Q1-2023Q2. This trend broadly corresponds to the sample average. Credit demand shocks are obtained as the sum of aggregate demand, aggregate supply and monetary policy shocks. The green bars correspond to unidentified factors [1].

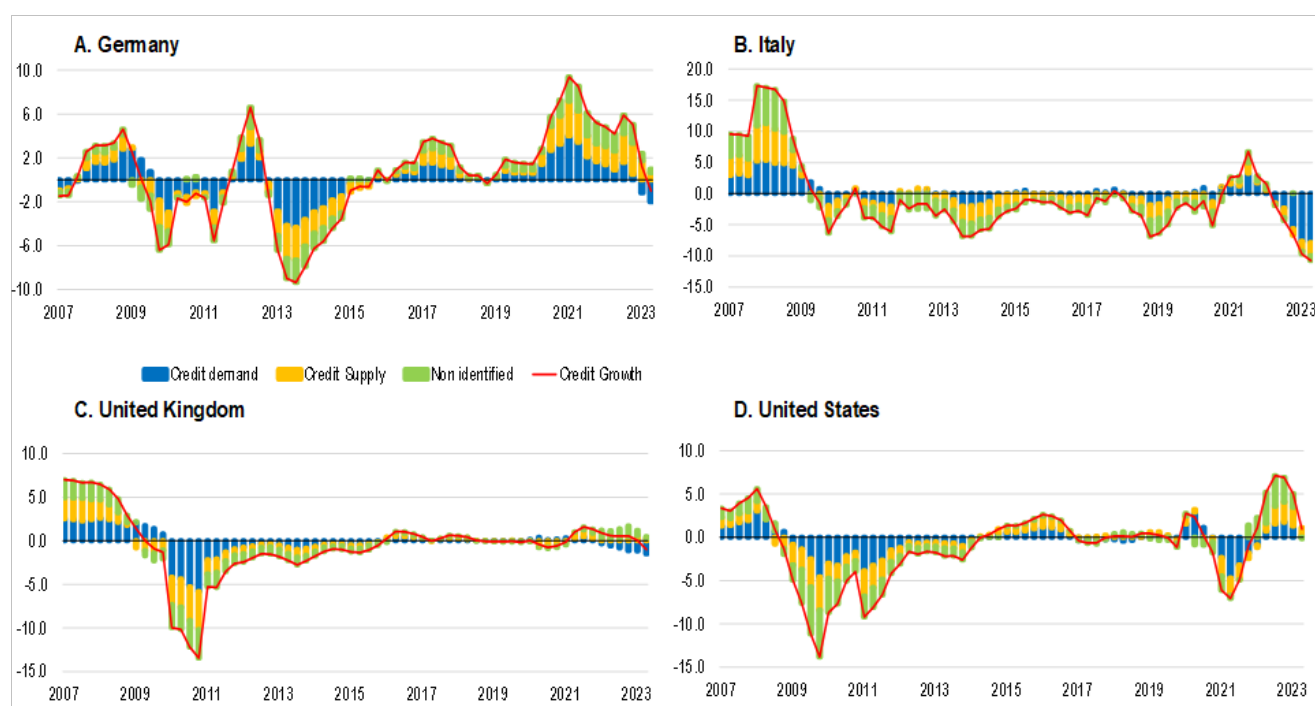
Source: Bank of England, European Central Bank, Federal Open Market Committee and OECD calculations.

[1] The VAR for each country is estimated by Bayesian techniques, with shocks identified by sign restrictions based on standard theoretical models (Gambetti and Musso, 2017). Aggregate supply shocks are assumed to drive real GDP and inflation in opposite directions; aggregate demand shocks move real GDP, inflation, policy rates, bank lending rates and credit growth in the same direction; positive (i.e., rate-

increasing) monetary policy shocks negatively affect both GDP and inflation; and expansionary credit supply shocks are assumed to lead to an increase in output, inflation and (due to the central bank policy reaction) policy rates but make bank lending rates and credit growth move in opposite directions. The VARs are estimated with one lag and sign restrictions are imposed on impact only (first quarter).

**Figure 2. Contributions of demand and supply shocks to credit growth in the period 2007-2023**

Decomposition of year-on-year percentage change of credit growth relative to its long-term trend



Note: See note to figure 1.

Source: Bank of England; European Central Bank, Federal Open Market Committee; and OECD calculations.

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# Higher defence spending will add to the pressures on the public finances

Category: Public finance, Uncategorized  
written by oecdecoscope | December 19, 2023



by Mauricio Hitschfeld, Álvaro Pina and Enes Sunel

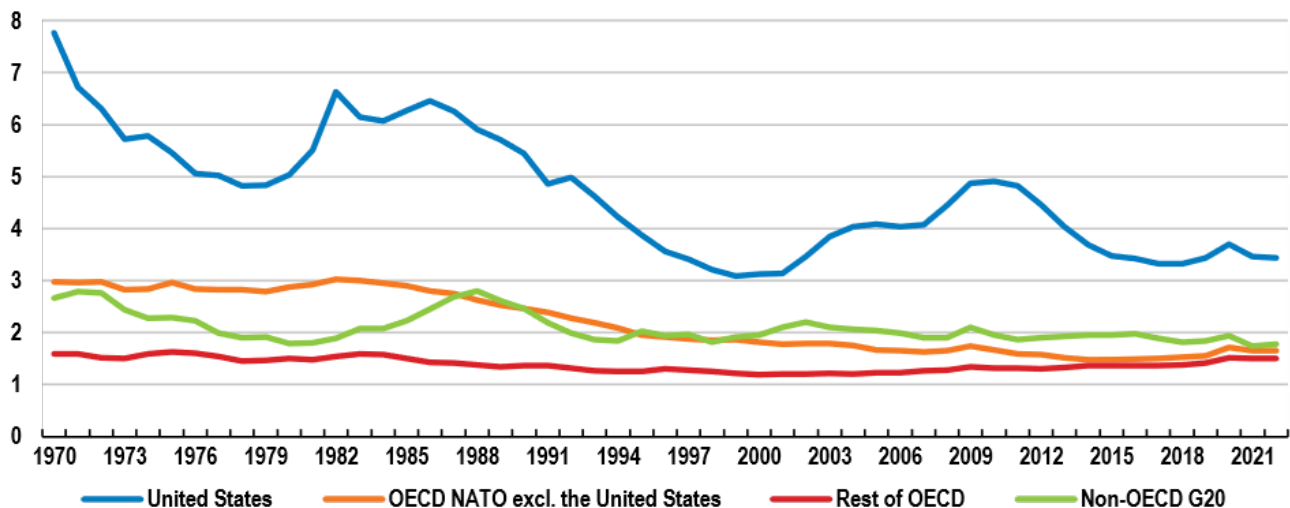
For several decades the 'peace dividend' enabled governments to reduce the share of defence spending in total public expenditure, creating space to help meet demands for

additional public expenditure on social protection and health. Growing geopolitical tensions are prompting reassessments of this strategy, with several countries announcing plans to increase defence spending over the next few years. These plans, which are already being implemented in some countries, will compound the rising pressures on the public finances from ageing societies, the climate transition and rising debt-service costs, as noted in the September 2023 OECD Interim Economic Outlook.

Across G20 countries as a whole, defence spending relative to GDP has declined in the past 50 years, from an average of about 3.8% in the 1970s to 2.4% in the 21<sup>st</sup> century. However, there have been marked differences across countries. US defence expenditure fell particularly sharply, from 6.0% of GDP in the 1980s to an average of 3.9% of GDP since the turn of the century (Figure 1). In relative terms, the gains from the end of the cold war were even larger for other OECD countries who are longstanding NATO members, with their joint spending declining from 2.8% of GDP in the 1980s to 1.6% of GDP since the year 2000. Military spending in non-NATO OECD members such as Australia, Japan and Mexico has in general been lower and more stable over time.

**Figure 1. Global defence spending has declined since the 1970s**

Defence spending, per cent of GDP, current prices



**Note:** OECD and NATO based on current membership. Aggregates show averages weighted by GDP at market prices in USD. Their composition changes over time due to data availability. Saudi Arabia is excluded from the non-OECD G20 aggregate due to the very high volatility of its defence spending.

**Source:** Stockholm International Peace Research Institute; and OECD calculations.

The reduction in spending has also been more modest in non-OECD G20 economies, a highly diverse group of countries. For instance, defence spending in China has become the second largest in the world in absolute terms, but relative to GDP is estimated to be close to the G20 median. Russia's spending in per cent of GDP has remained internationally high since the mid-1990s, particularly over the past decade.

Many OECD countries have begun to raise defence spending as a share of GDP over the last 2-3 years. There have been particularly strong increases in Greece and some Central and Eastern European countries, including Finland, Latvia, Lithuania and Poland, but also in many economies in Western Europe, partly reflecting military aid to Ukraine.

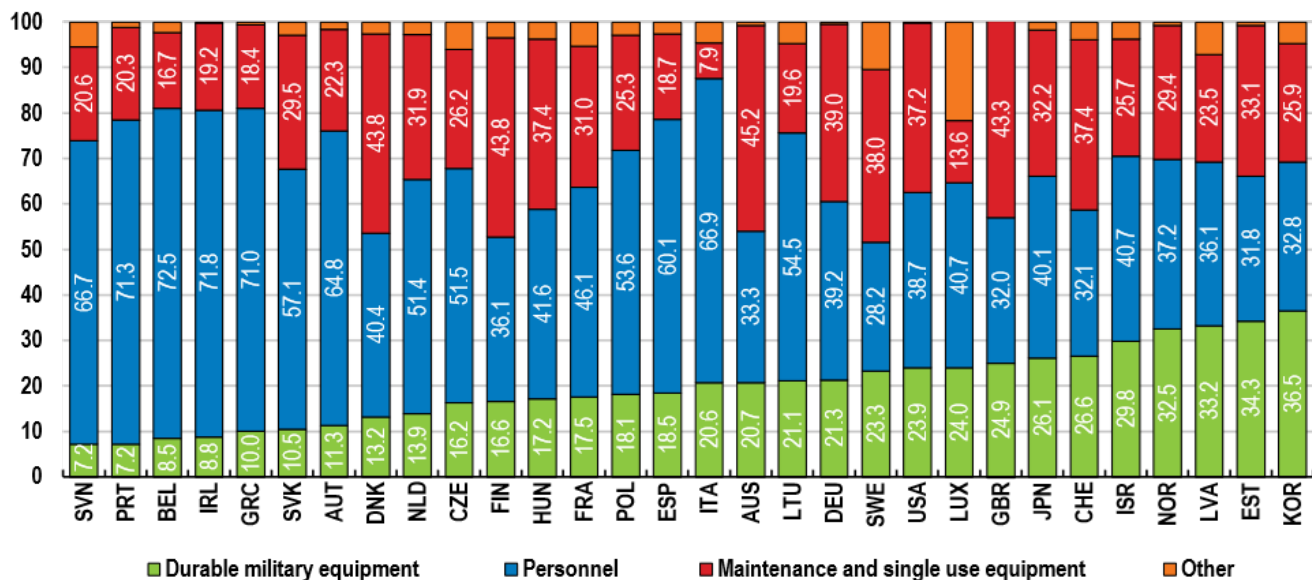
Further spending increases, sometimes sizeable, are likely in the coming years. France, Germany and Japan have started to implement detailed medium-term plans for that purpose, aiming

at increases of about 0.4% of GDP, 0.7% of GDP and 1% of GDP respectively. In other countries, a long-term target exists that implies higher defence spending (for instance, 2% of GDP in Canada and Italy, as per NATO commitments, and 2.5% of GDP in the United Kingdom) but medium-term plans to reach these levels have not yet been released. In contrast, the two OECD G20 countries where military expenditures as a share of GDP are highest, the United States and Korea, do not currently plan to further increase that share. Non-OECD G20 countries have in general not increased defence spending as a share of GDP in the recent past (Russia is an exception), nor have they announced plans to do so in the medium term.

As with other areas of public spending, improvements in the efficiency of defence spending could help to contain the budget costs of achieving the intended improvement in military effectiveness. Options to enhance efficiency may differ across countries given, among other factors, the variation in the composition of defence spending (Figure 2). The average share of defence budgets spent on investment in equipment in the countries shown is 20% and on personnel costs 48%, with an average 29% devoted to maintenance and single-use equipment and 4% to other spending items, but there are large differences between countries.

**Figure 2. The composition of defence spending differs substantially across countries**

Shares in total defence spending, per cent, 2012-21 average, current prices



**Note:** Durable military equipment corresponds to gross fixed capital formation (GFCF), personnel to compensation of employees and maintenance and single-use equipment (such as ammunition) to intermediate consumption. Since GFCF is often volatile, a 10-year average is considered. Values for Korea correspond to the 2012-20 average.

**Source:** OECD Classification of the Functions of Government (COFOG) database; and OECD calculations.

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# How widespread has the rise in unit profits been?

Category: Inflation, Uncategorized

written by oecdecoscope | December 19, 2023



By **Geoff Barnard** and **Patrice Ollivaud**, OECD Economics Department

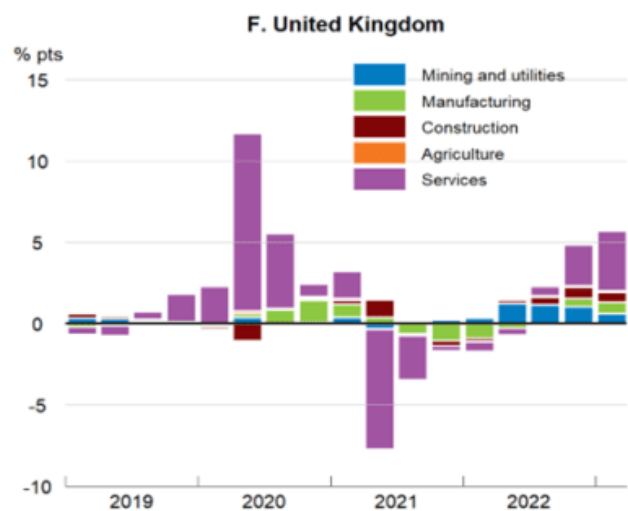
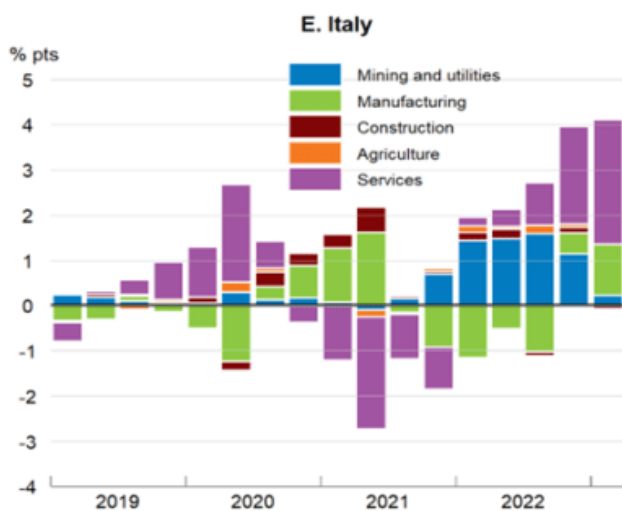
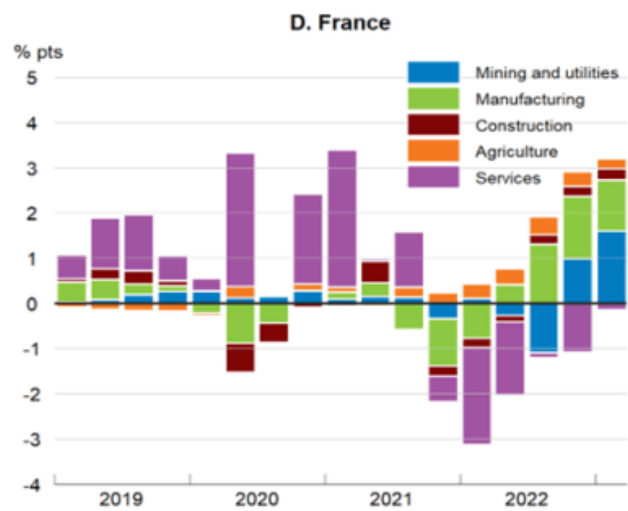
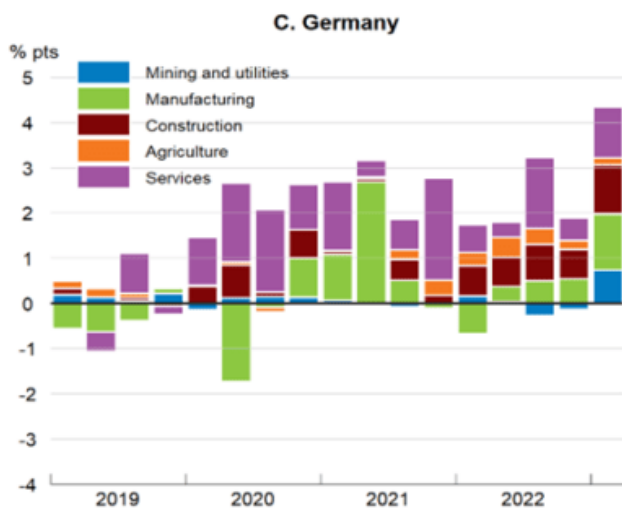
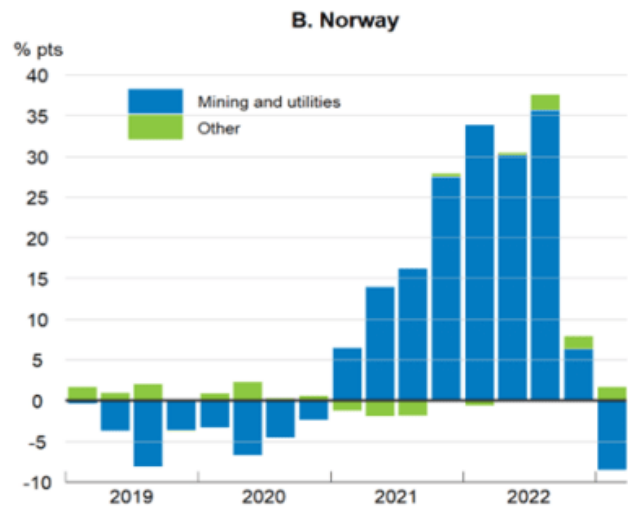
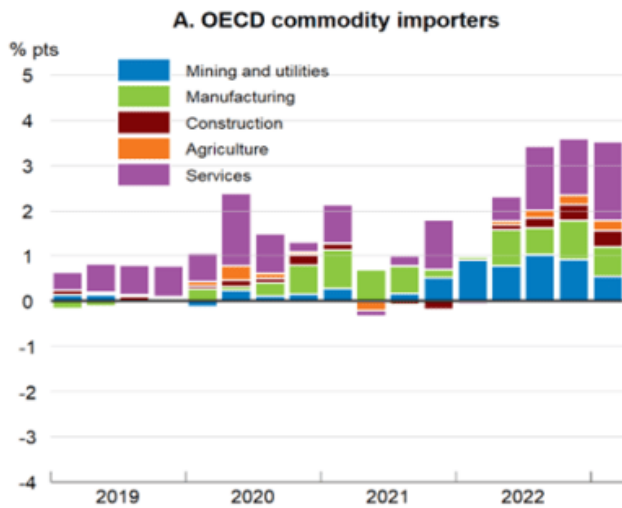
In an earlier post on this blog, the decomposition of GDP inflation (year-on-year increases in the GDP deflator) into contributions from unit profits, unit labour costs and unit net taxes across a range of OECD economies was discussed, drawing on an exercise described in the most recent OECD Economic Outlook (OECD, 2023). While informative, the economy-wide picture of unit profits leaves open the policy-relevant question of whether the increase in profits has been widespread across the economy or concentrated in only a few industries.

To get insights about where and by how much profit margins may have increased as inflation rose, information is needed on how an economy-wide increase in profits is distributed across firms. One approach is to use firm-level data. The evidence from this work is mixed. Colonna *et al.* (2023) find that margins rose in the United States and in non-tradeable sectors in Germany, and returned to pre-pandemic levels in Italy after an earlier decline. Weber and Wasner (2023), using US firm-level data, argue that rising prices after the first phase of the COVID-19 pandemic were mainly the result of market power and implicit agreements between large firms. In contrast, Glover *et al.* (2023) suggest that the rise of mark-ups in the United States during 2021-22 was due to firms anticipating future cost increases rather than an increase in monopoly power or higher demand. And Bijmens *et al.* (2023) find no evidence of a widespread opportunistic raising of profit margins in 2022 among firms in Belgium.

Another possible angle is to look at profits by sector. Doing this for the 13 OECD commodity-importing economies that produce timely data on a comparable basis, and computing unit profit as value added minus labour compensation, suggests that a disproportionate part of the observed increase of unit profits in 2022 came from mining and utilities: that is, mining and quarrying together with electricity, gas and water supply (Figure 1, Panel A). This sector accounts for only about 4% of the average economy but more than 40% of the rise of unit profits in 2022 as a whole in this group of commodity-importing countries. For these countries, this likely corresponds mainly to electricity and gas supply, including renewable electricity producers, who did not suffer from higher costs as fossil fuel prices soared, but benefited from higher retail prices. On the other hand, this effect was far from uniform across countries. Neither Germany nor France (Panels C and D of Figure 1) had a large increase in mining and utilities unit profits until late in 2022 or early 2023, when fossil fuel prices were turning down. In the case of the United Kingdom (Panel F), most of the increase in unit profits' contribution to GDP inflation from negative values in early 2021 to above 5% in the fourth quarter of 2022 corresponded to a swing in unit profits in services, although other sectors, including mining and utilities, also contributed.

**Figure 1. Mining and utilities account for a substantial share in the increase in unit profits**

Contribution of unit profits to year-on-year GDP inflation



Note: Unit profits based on estimated sectoral gross operating surplus in current values. The latter is computed as sectoral output minus sectoral compensation and an estimate of unit taxes (based on the value at the macroeconomic level in percent of GDP applied to sectoral GDP) and reconciled so that

the sum across sectors equals the macroeconomic level. OECD commodity importers correspond to a simple average of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Spain, Sweden and the United Kingdom.

Source: OECD Quarterly National Accounts database; and OECD calculations.

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On a quarterly basis, the contribution of other sectors to the rise of unit profits in the group of commodity-importing countries as a whole gradually increased through 2022 and into the first quarter of 2023, with stronger effects from both services and (through end-2022) manufacturing. Considering the small share of agriculture in the economy (less than 2% for the euro area), the contribution of unit profits in this sector to the overall unit profit contribution to GDP inflation is also notable. Thus, while the increase in unit profits (and thus the contribution to inflation) has been widespread across sectors in commodity-importing OECD economies, and while the details vary significantly across individual countries, the disproportionate rises in mining, utilities and agriculture suggest some strong sector-specific effects.

Among OECD commodity exporters, there is only one country, Norway, with the necessary sector data on a comparable basis, so this is the only source of information on sectoral developments of unit profits for this group of countries. As expected, the bulk of the large increase in unit profits in Norway in 2022 came from mining and utilities (Figure 1, Panel B), with the contribution of unit profits to GDP inflation plummeting from 2022Q4 because of the global fall in energy prices.

Overall, there is evidence from available cross-country sectoral profit data that the surge in energy prices and the

associated increase in the profits of energy and utility providers over 2021-22 played an important role in the widespread rise in the aggregate contribution of unit profits to GDP inflation. The strong rise in international food commodity prices also appears to have helped push up unit profits in agriculture in many countries, although the small size of that sector means that the impact on economy-wide profits was generally limited. The sectoral data indicate, however, that the size, timing and distribution of the increase in unit profits, and thus of their contribution to GDP inflation, varied quite widely across OECD economies – no single story fits all countries.

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# Corporate taxation can support business investment, but details of the tax system matter

Category: Tax,Uncategorized

written by oecdecoscope | December 19, 2023



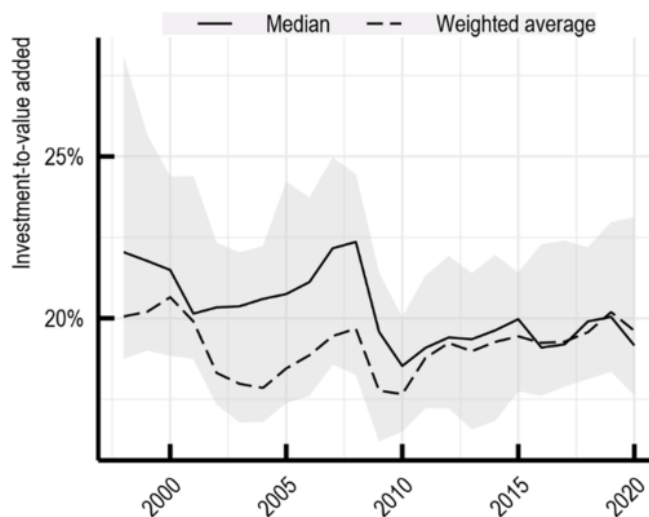
By Tibor Hanappi, Valentine Millot and Sébastien Turban, OECD Economics Department

Business investment has been weak in OECD countries since the global financial crisis (GFC). What can be done to boost it?

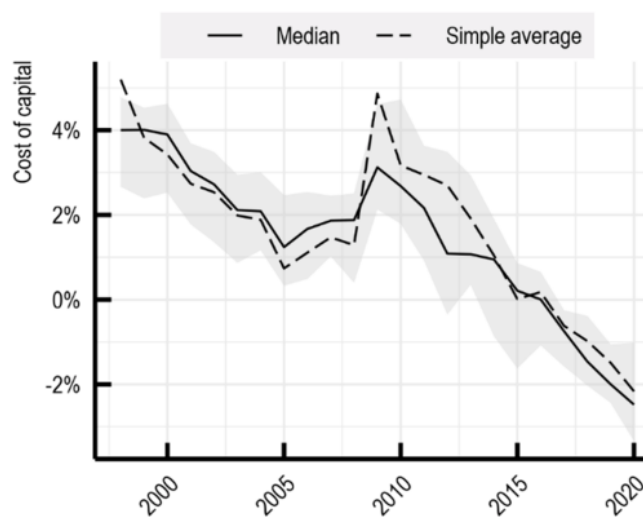
One potential lever is to modify corporate taxation to reduce the cost of capital, which is usually considered as a key investment determinant (Feld and Heckemeyer, 2011<sub>[3]</sub>; Vartia, 2008<sub>[4]</sub>; Schweltnus and Arnold, 2008<sub>[5]</sub>). However, as can be seen in the figure below, while the cost of capital has steadily fallen, reflecting the secular decline in global interest rates and cuts in statutory corporate tax rates (STR), business investment rates have not increased and real investment has barely caught up with its pre-GFC trend. These observations suggest that either the sensitivity of firms' investment to the cost of capital has declined, or the desired level of investment for a given cost of capital has fallen

because of other factors. In turn, they raise questions about whether and which changes to corporate tax systems can stimulate business investment.

**A. Investment intensity in OECD countries**



**B. Cost of capital in OECD countries**



**Note:** Panel A: Investment intensity is computed as the ratio of gross fixed capital formation over gross value-added in business sectors (Sectors B through N according to the ISIC Rev.4 classification, excluding Real Estate). Panel B: The cost of capital corresponds to the rate of return on a marginal investment required for an investor to break even after tax. It is computed based on the formula from Hanappi (2018<sub>[4]</sub>), the fiscal parameters from Spengel et al. (2020<sub>[5]</sub>), long-term sovereign interest rates and changes in the GDP deflator as a proxy for inflation. Trends and changes in the cost of capital, but not levels, are robust to replacing sovereign bond yields with a stable premium for corporations. In both panels, the shaded area corresponds to the interquartile range across OECD countries.

**Source:** Hanappi, Millot and Turban (2023), "How does corporate taxation affect business investment? Evidence from aggregate and firm-level data", *OECD Economics Department Working Papers*, No. 1765, OECD Publishing, Paris.

Aggregate trends hide heterogeneity in investment responses to taxation. Indeed recent analysis has shown that the sensitivity of firm investment to corporate taxation tends to

be heterogeneous across different types of firms (Federici and Parisi, 2015<sub>[6]</sub>; Zwick and Mahon, 2017<sub>[7]</sub>; Fuest, Peichl and Siegloch, 2018<sub>[8]</sub>; Kopp et al., 2019<sub>[9]</sub>; Millot et al., 2020<sub>[10]</sub>). As such, a more nuanced assessment of the implications of corporate taxation on investment and growth is needed.

Our new paper (Hanappi, Millot and Turban, 2023) aims to fill this need. We bring together country-industry and firm-level data on investment, as well as detailed data on the cost of capital and its tax component, to analyse how the tax sensitivity of investment has evolved over time and how it differs across firm and investment characteristics. Finally, we also disentangle key parameters of the corporate tax system to analyse the potential impacts of different tax designs.

### **The tax sensitivity of investment has weakened since the GFC and varies across firms and tax parameters**

Our estimations at the industry and the firm level confirm previous findings that business investment tends to respond negatively to increases in corporate taxation as measured by forward-looking effective tax rates (ETRs) (see Hanappi (2018<sub>[4]</sub>) for details on the methodology to construct those ETRs). However, the analysis shows that the tax sensitivity of investment fell after the GFC, suggesting that lower ETRs increase investment less now than they did in the past.

We also find that firms that are large, are part of multinational groups, have a large proportion of intangibles in their total fixed assets, or are highly profitable, have all become less sensitive to taxation compared to other firms after the GFC. The fact that these firms have become less sensitive could largely explain the aggregate trends, as investment tends to be highly concentrated among a small number of big firms, usually belonging to multinational groups.

Finally, our paper highlights significant heterogeneity in

investment responses to different corporate taxation parameters. Increases in effective taxation delivered through non-profit taxes (i.e. business taxes levied on bases other than corporate income, such as real estate or corporate wealth) have a stronger negative impact on business investment than corporate income taxes (CIT). As for the CIT, “equivalent” changes (i.e., those resulting in the same effective marginal tax rate) in the STR and in capital allowances are associated with different investment responses, depending on the initial level of STR and allowances.

### **What are the implications for corporate tax policy?**

Corporate taxation can support business investment, but the bang for the buck may have fallen, and details of the tax system matter. The results from the empirical analysis call for a more nuanced and granular approach to corporate tax policy. Beyond headline statutory tax rates, a variety of measures can be considered to support investment effectively, accounting for heterogeneity in tax sensitivity.

Potential policy options include:

- Eliminating or reducing non-profit taxes on domestic and international businesses, which are likely to generate larger adverse effects on investment than taxes on profits.
- Limiting cuts in the headline corporate income STR; which can be relatively costly compared with other corporate tax policies, as they lower the effective tax rates for all firms regardless of their tax sensitivity.
- Considering the use of targeted CIT instruments to support specific investments, provided that a coherent policy rationale and a strong institutional framework exist. Differences in effective tax rates across assets and firms can be justified when there are positive externalities. However, decisions to implement targeted

measures should also account for the costs of the induced distortions, potentially increased compliance costs and administrative burdens for taxpayers and tax authorities.

- Making use of more generous capital allowances to reduce ETRs where they are expected to induce strong investment responses. Higher STRs, combined with more generous capital allowances, are likely to be less distortive as the CIT would be largely levied on economic rents. Moreover, such policies would likely be less affected by the Global Minimum Tax under the Global Anti-Base Erosion (GloBE) Rules due to the exclusion of a fraction of the value of assets and payroll from the base of the minimum tax.

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Read more on the new paper: *How does corporate taxation affect business investment? Evidence from aggregate and firm-level data* in the direct link here.

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