Benchmarking Canada's Economic Performance

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ABSTRACT

While Canada's economic record over the past decade or so is enviable, GDP per capita remains distinctly below US levels, reflecting a sizeable productivity gap. Among the impediments to faster growth are the taxation of capital and restrictive regulations in certain sectors. Canada's experience raises the general question of why it is difficult to implement reforms, even when the barriers to improved performance are known. Peer pressure based on sophisticated benchmarking, as takes place under OECD auspices in the context of the multilateral Going for Growth surveillance, helps overcome some of the political economy hurdles standing in the way of reform. A related issue is whether GDP is a reasonable proxy for well-being, and hence an appropriate metric for policy purposes. It turns out that it is, notwithstanding its shortcomings and even if other indicators need to be considered as well alongside GDP.

THIS ARTICLE SETS OUT THE OECD framework for assessing overall economic performance, situates Canada's performance compared with its OECD partners and draws some policy lessons.

Canada often stands out as one of the best in the class, but there are areas where it can do even better. Adjustment is needed because at the end of the day Canada faces the same challenges as most OECD countries, namely raising productivity growth and keeping fiscal and social policies on a sustainable path as the population ages. More idiosyncratically, Canada will also have to cope with a dramatic upsurge in oil revenues and endeavour to avoid "tar sands" disease.

The barriers to even better economic performance in Canada raise the issue of why it is so hard to implement reforms, even when these barriers are known. A related question is whether GDP is a reasonable proxy for well-being, and hence an appropriate focus or target for policy.

Definition and Drivers of Economic Success

For the sake of simplicity, economic success can be defined as maintaining high standards of living over time and the OECD as a "convergence club" where members who are less successful can emulate best practices.

Obviously, no single summary statistic can give due credit to all the dimensions of living standards, not to mention a wider concept such as well-being. And GDP per capita in this regard is certainly a crude and imperfect measure. But recent OECD research, reviewed later in the article, suggests there is probably no superior alternative to GDP, at least for the purpose of economic surveillance.

1 The author is the OECD Chief Economist. This text is based on a speech with the same title given at a Finance Canada seminar on April 24, 2006 and on a presentation entitled "Well-being and Reforms in Advanced Countries" given at the OECD-Conference Board of Canada conference "Tackling Canada's Future Prosperity: New Directions for Success" held in Ottawa, Ontario on April 25, 2006. Email: jean-philippe.cotis@oecd.org.

Table 1
Growth in Canada and other Selected OECD Countries

Fastest growing 1996-2005 (average annual rate of change)							
Real GDP per capita		**Real GDP**		**Labour productivity[1]**		**Output gap in 2005[2]**	
Ireland	5.9	Ireland	7.4	Korea	3.3	New Zealand	1.0
Korea	3.7	Korea	4.4	Ireland	3.1	Ireland	0.5
Spain	2.7	Spain	3.6	Sweden	2.0	**CANADA**	0.0
Sweden	2.5	Australia	3.6	US	2.0	US	0.0
UK	2.4	Mexico	3.6	UK	1.7	Australia	-0.2
CANADA	2.3	**CANADA**	3.3	Australia	1.7	Sweden	-0.3
Australia	2.3	US	3.3	**Total OECD**	1.7	UK	-0.5
US	2.2	New Zealand	3.3	Mexico	1.4	**Total OECD**	-0.7
Netherlands	2.0	UK	2.8	Japan	1.4	Spain	-0.8
Mexico	2.0	**Total OECD**	2.7	**CANADA**	1.3	Japan	-0.8
New Zealand	2.0	Sweden	2.7	New Zealand	1.2	Italy	-1.4
Total OECD	1.9	Netherlands	2.3	France	1.1	Euro area	-1.6
Euro area	1.7	France	2.2	Germany	1.0	France	-1.8
France	1.6	Euro area	2.0	Netherlands	1.0	Germany	-1.9
Germany	1.2	Germany	1.3	Euro area	0.8	Netherlands	-3.0
Japan	1.0	Italy	1.3	Italy	0.1		
Italy	1.0	Japan	1.2	Spain	-0.5		

1 Per worker, for the total economy.

2 Comparable output gap estimates are not available for Korea and Mexico.

Source: OECD, *Economic Outlook* No. 79 database.

This is why GDP per capita takes centre stage in our assessment. We are obviously interested in both GDP levels and growth. But we also pay great attention to short-run resilience, that is, how well economies remain on track when hit by unforeseen adverse shocks. Here sound economic structures are those that perform equally well in the short and long term.

The OECD has accumulated a wealth of material on the determinants of growth and found, unsurprisingly, that the quality of economic policies is key (OECD, 2003). Looking at past experience, it seems indeed that success has much to do with stability-oriented macro policies and growth-friendly structural reforms.

Taking stock of economic performance over the past decade, what is really striking is the emergence of a group of successful economies scattered all around the world (Sweden, Ireland, Australia, New Zealand, the United Kingdom, Canada). They share the same sort of performance: strong long-term growth, in the range of 3 to 7 per cent a year, and a surprising resilience to shocks. Basically, these countries sailed through the global slowdown unruffled, following the ICT downturn.

They also share many similar characteristics: open product markets, flexible labour markets, strong financial development, generally sound fiscal policies and inflation targeting frameworks in the area of monetary policy. These features did not emerge spontaneously. Indeed, many of these countries were often derided as lame ducks. And most of them faced grave crises over the 1980s and early 1990s, leading to drastic, back-to-the-wall type, economic reforms.

These countries have provided a vivid example of successful economic management. They

have also confirmed the validity of a number of empirical findings, namely:

- Fiscal discipline is essential for sustainable growth.
- Price stability is associated with stronger and more stable growth.
- Open product markets are good for innovation, investment, productivity and employment.
- Financial development enhances resilience and long-term growth, in particular by easing credit constraints on innovative firms.
- Flexible labour markets and wage formation processes are key to reaching full employment and stabilizing the economy.

Of course, we thought we already knew all that intuitively. But we have now accumulated considerable empirical evidence, based on cross-country econometric analysis, as well as a number of eye-catching success stories, including Canada's.

On the other side of the Atlantic, though, many OECD countries will have to face the double challenge of curing old wounds and adjusting to new struggles. At least Canada has put itself in the privileged situation where it has mainly to look forward to new challenges. And it is certainly well placed to meet them. However, this should not lead to complacency.

The OECD Perspective on Canada

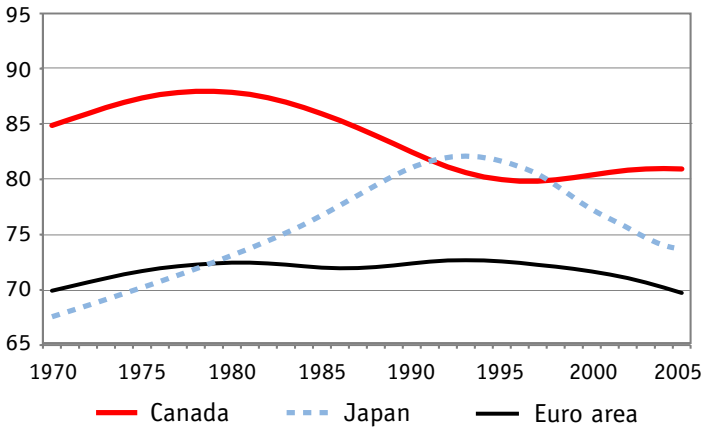
Canada's economic performance

Canada's performance over the past decade has been good (Table 1). Witness the improvement of Canada's position vis-à-vis the US economy since the mid-1990s (Chart 1). This contrasts with the widening performance gap observed in other major economies, notably the large continental European countries and Japan. The Canadian catch-up, however, mostly took place during the second half of the 1990s.

Chart 1

Trends in GDP per capita in Canada

Trend GDP per capita relative to the United States, based on 2000 PPPs and 2000 prices[1]



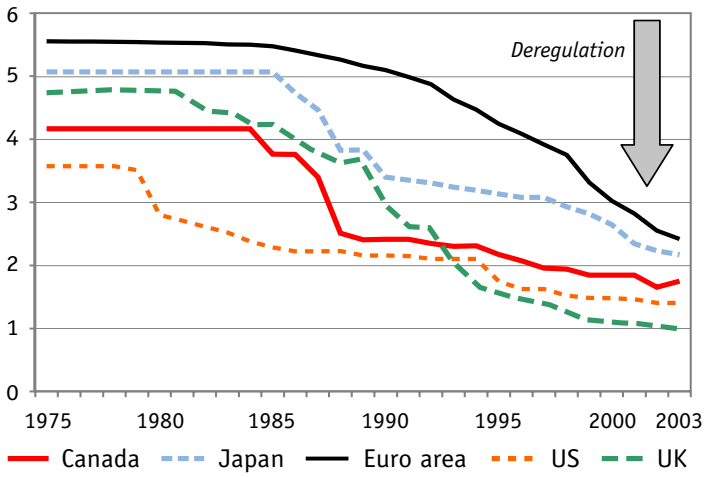
1 Trend calculated using a Hodrick-Prescott filter (smoothing parameter set to 100) over a period including projections through 2012.

Source: OECD, *Annual National Accounts*; OECD, *Economic Outlook* 78 database.

Chart 2

Trends in Regulatory Stance in Selected OECD Countries

Composite indicator of anti-competitive regulatory stance across seven network sectors[1]

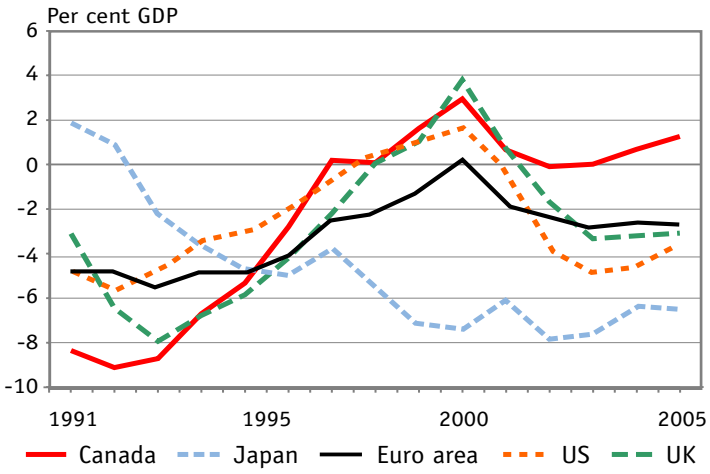


1 The indicator ranges from 0 (least restrictive) to 6 (most restrictive).

Source: OECD.

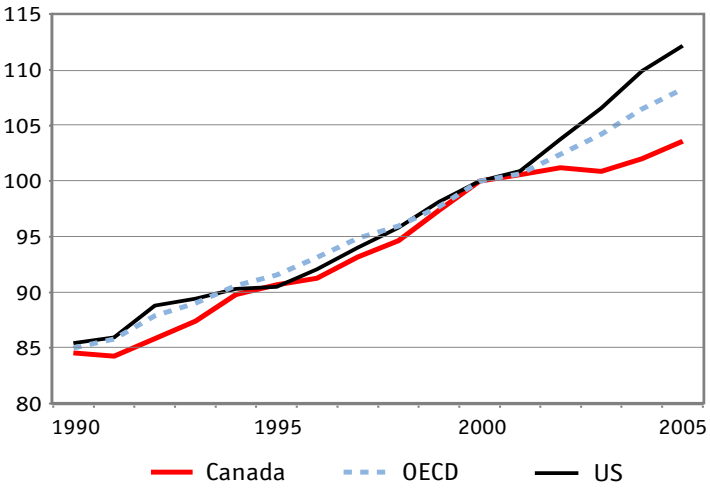
Canada's growth record is well known and widely admired. Equally enviable is Canada's remarkable resilience. This can be assessed in various ways. One is simply to look at the evolution of the output gap over time. In the case of Canada, the gap is currently small and has been

Chart 3
Trends in Government Fiscal Balance in Selected OECD Countries
Government net lending



Source: OECD, *Economic Outlook* 79 Database.

Chart 4
Labour Productivity in Canada, the United States and the OECD
Per worker, 2000 = 100



Source: OECD, *Economic Outlook* 79 Database.

small in recent years. More sophisticated econometric analysis points in the same direction, showing that after a shock, Canada tends to adjust more rapidly than many other OECD economies (Cotis and Coppel, 2005 and Duval, 2006).

These results reward a number of comprehensive structural reforms that took place in Canada starting in the late 1980s, in particular in various network sectors (Chart 2). The reforms also include the Free Trade Agreement (FTA) with the United States, and its extension as the North American Free Trade Agreement (NAFTA); the improvements in the framework for and conduct of macroeconomic policy; the introduction of the Goods and Services Tax; the move to inflation targeting; and the efforts deployed since the mid-1990s to consolidate public finances (Chart 3).[2]

However, somewhat disconcertingly, living standards in Canada measured in GDP per capita terms still remain about one fifth below US levels, even though in terms of subjective happiness measures Canadians do, if anything, consider themselves slightly better off than their neighbours to the South.[3] The living standards gap stems from lower Canadian productivity and the productivity gap has widened over the past few years.[4]

The second half of the 1990s was a period of high expectations for Canada, which seemed to share fully in the US productivity take-off. These hopes have been disappointed, however, in recent years.

Productivity growth has reverted to a low ebb, making the late 1990s upswing look like a cyclical rather than a lasting phenomenon (Chart 4). South of the border, the expected cyclical slowdown in productivity did not materialize during

2 For details, see the past *OECD Economic Surveys of Canada*.

3 The World Values Survey reports that in 1999-2001 95 per cent of Canadians classified themselves as very/fairly happy, compared to 92 per cent of Americans. The mean happiness score was 8.2 out of 10 in Canada versus 8.0 in the United States. The mean life-satisfaction score was 7.8 out of 10 in Canada versus 7.7 in the United States.

4 While there is an on-going debate in Canada about the magnitude of the Canada-US productivity level gap, it remains that by all estimates the productivity gap contributes to a significant portion of the living standard gap between the two countries (Baldwin *et al.*, 2005, Isgut *et al.*, 2006, and Institute for Competitiveness and Prosperity, 2006).

the first half of this decade, in a context where employment and capital formation were swiftly adjusted to reduced orders. All in all, average labour productivity growth in Canada since the mid-1990s has been almost one percentage point lower than in the United States, with developments since 2000 accounting for all of the weaker performance.

To some extent, Canada's labour productivity weakness may be related to lower investment in machinery and equipment, particularly in information and communication technologies (ICT), not least compared with the United States. Canada is not a major ICT producer and appears to have a slower rate of ICT diffusion. More generally, the productivity problem reflects the fact that multifactor productivity growth/technical progress has fallen behind (Chart 5).

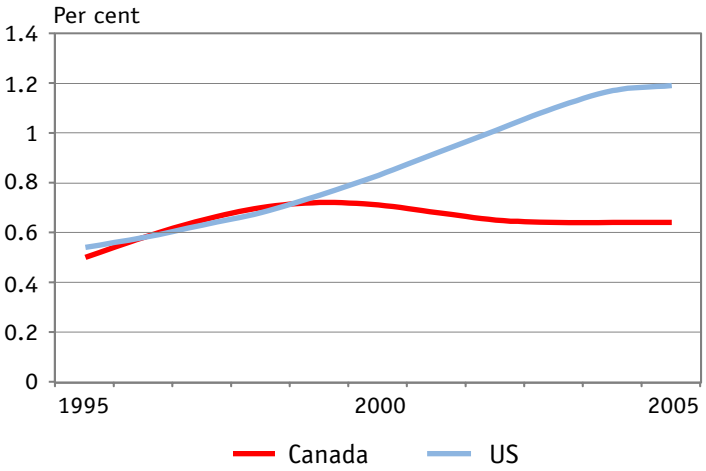
Another and perhaps more transient reason for slowing productivity may stem from the commodity price boom enjoyed by Canada. Indeed, higher energy and raw material prices offer the natural resource industry a strong incentive to start exploiting less productive deposits (Rao *et al.*, 2005). That said, the adverse impact of this factor on living standards is offset by the gains associated with improving terms-of-trade on account of higher commodity prices (Kohli, 2006).

Of course, consistent measurement of productivity across countries is not straightforward. But the key issue is that going forward, population ageing and falling labour force growth will amplify the reliance on higher productivity growth to lift living standards.

Barriers to boosting productivity in Canada

Against this background, what may be holding the Canadian economy back from achieving stronger productivity gains? The focus here will be on areas where Canada needs to improve, but keeping in mind of course Canada's many strengths.

Chart 5
Trend in Multifactor Productivity Growth in Canada and the United States



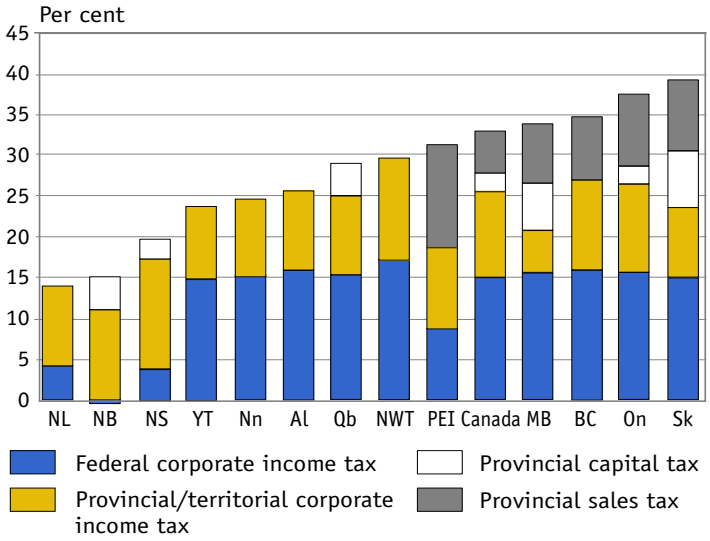
Source: OECD, *Economic Outlook* 79 Database.

Indeed, Canada scores especially well in a number of areas:

- Low barriers to entrepreneurship. Canada ranks second lowest among OECD countries after the United Kingdom.
- A well-educated population, even if performance is comparatively less favourable when it comes to continuing education and training. In 2002, Canada had the highest share in the OECD of 25-54 year olds with post-secondary or tertiary education.
- A flexible labour market that has delivered a high employment rate. In 2005, Canada had the sixth highest employment rate among OECD countries.

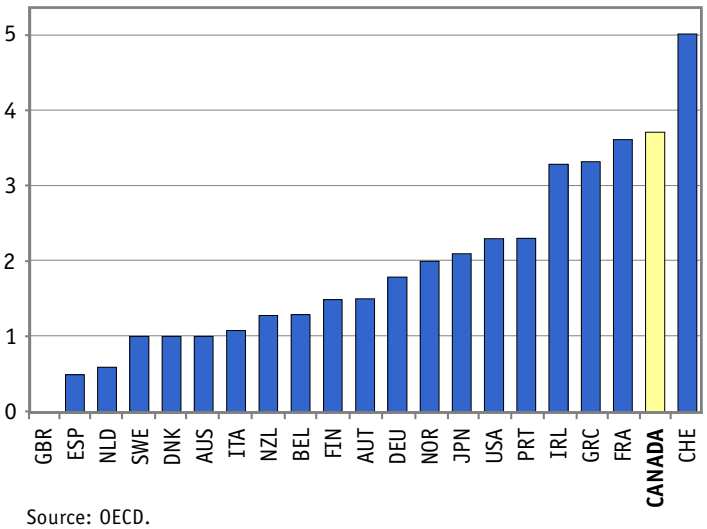
Switching now to areas where improvement is needed, it first needs to be stressed that productivity growth depends on getting the overall business environment right. It is an essential requirement for both encouraging and enabling firms to make productivity-enhancing decisions. Indeed, if the fundamentals do not allow businesses to flourish, then specific programs and policies ostensibly designed to help business will not do much good.

Chart 6
Marginal Effective Tax Rates on Investment by Province or Territory in 2010



Source: Finance Canada, *Tax expenditures and evaluations*, 2005.

Chart 7
Electricity Regulation across OECD Countries, 2003
The indicator ranges from 0 (least restrictive) to 6 (most restrictive)



Source: OECD.

Canada needs to improve its taxation of investment. It had the highest marginal effective tax rate (METR) on capital in the OECD in 2005, although it has fallen to third place, behind Germany and the United States in 2006 (Mintz, 2006). Even when all the tax changes that are in the pipeline are finally phased in, Canada's tax rates will still be relatively high. The most egregious METR components are provincial capital taxes and provincial sales taxes (PST) on capital goods (Chart 6). Particularly problematic here is the fact that the implied tax rates discourage ICT investment even more than other types of investment, as provincial taxes raise costs more for short-lived assets.

Nonetheless, even at the federal level, there seems to be scope for base broadening and rate cutting. One important base-broadening measure would be to tax all businesses at the same corporate tax rate regardless of size. Taxing small businesses less to help them grow may sound very appealing, but the evidence is that it just does not work. With few exceptions, small Canadian firms stay small (Hendricks *et al.*, 1997). Indeed, why try to grow bigger if one will just be taxed at a higher rate?

Canadian firms are more likely to be very small (20 employees or less) than in the United States, and there is also a lower share of large firms (100 employees or more).[5] This matters because large firms are able to exploit economies of scale, and do more innovation and training than smaller ones. So discouraging firm growth via the tax system damages overall productivity growth. Trying to redress the balance through Canada's plethora of government programs to help small businesses seems to be a distinctly "second-best" set of policies.

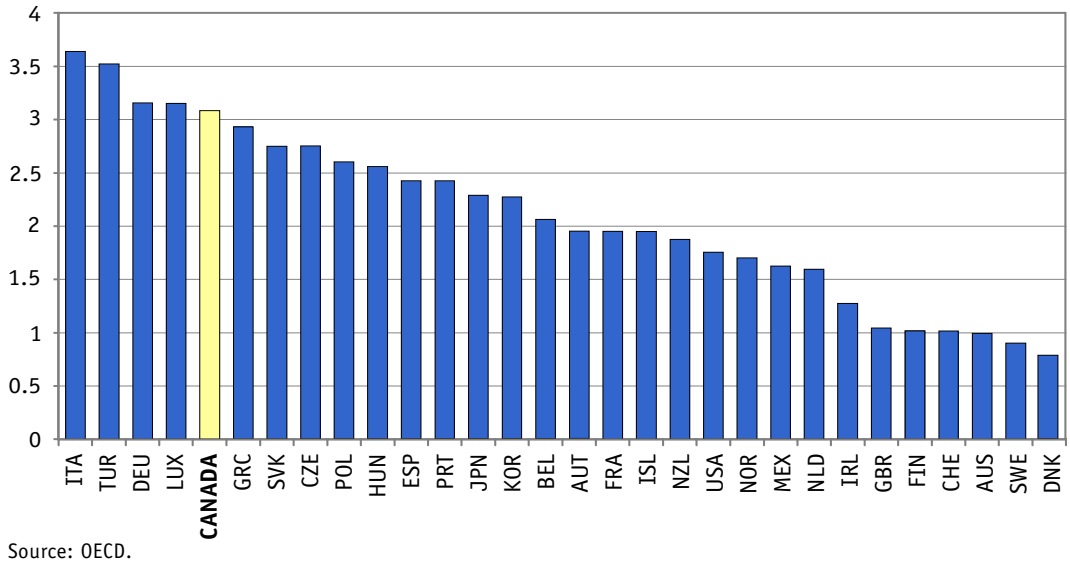
Turning to product market competition, many areas work well, but some of the exceptions are glaring. Looking at electricity, some provinces are a long way from having a well-functioning market. Indeed, Canada ranks second highest among OECD countries in the restrictiveness of electricity regulation (Chart 7). Europe provides counter-examples showing that this need not be (IEA, 2005).

5 Excluding enterprises with no employees (OECD, 2006a).

Chart 8

Summary Indicator of Regulation in Professional Services, 2003

The indicator ranges from 0 (least restrictive) to 6 (most restrictive)



Source: OECD.

Professional services in Canada do not score well here either (Chart 8). Again, the provinces still need to finish their work on removing barriers to inter-provincial trade in services. This is closely linked to compliance with Chapter 7 of the labour mobility requirements of the Agreement on Internal Trade, which affects over 50 different occupations.

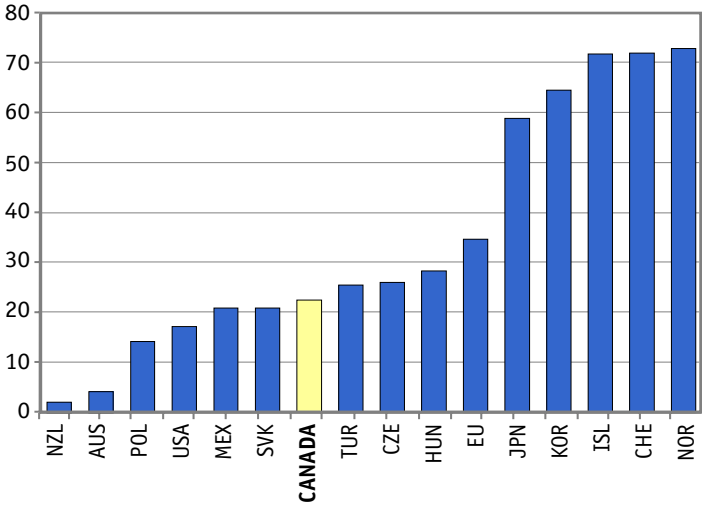
Agriculture is another area where competition is distorted. Canada's average producer support estimates do not look too bad, though they could be better (Chart 9).[6] But when you zoom in on the details, the picture becomes worse (Chart 10). The provincial supply management systems in dairy may not have a high budgetary cost, but the consumer pays dearly and efficient resource allocation is compromised.

While agricultural support has come down over the years, overall agricultural subsidies as a share of GDP in 2005 were around 25 per cent higher than in 2000. This is moving away from a level playing field for business.

Chart 9

Producer Support Estimates

Average 2002-04. Per cent of value of gross farm receipts



Source: OECD.

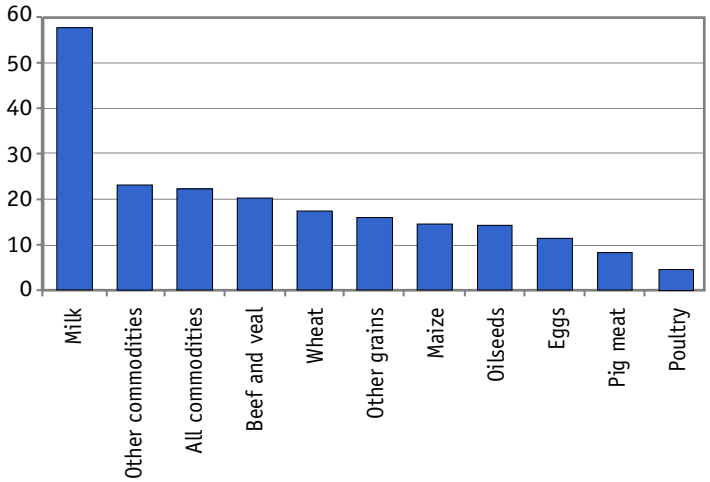
Turning to foreign direct investment (FDI), restrictions remain in particular in two network

6 The producer support estimate is an indicator of the annual monetary value of gross transfers from consumers and taxpayers to support agricultural producers, measured at farm gate level, arising from policy measures, regardless of their nature, objectives or impacts on farm production or income.

Chart 10

Producer Support Estimates by Commodity

Average 2002-04. Per cent of value of gross farm receipts



Source: OECD.

sectors: air transport — dominated by protection for Air Canada — and telecommunications (not including broadcasting). Canada has the most restrictive barriers to FDI in telecommunications and the second most restrictive in air transport among OECD countries. These restrictions retard the opportunities for greater competition, sharper management and technology transfer through FDI. They penalize the consumer and raise the cost of doing business by making it harder for producers to connect with suppliers and markets.

Overall therefore, there is considerable room for improvement in product market competition.

Last but not least, well-functioning banking systems and securities markets matter for economic growth because they channel funds efficiently between savers and investors. The size of the financial sector in Canada, defined as total loans to the private sector and security market capitalization relative to GDP, is not much more than half that of its US counterpart. Canada in 2000-03 had the fourth lowest share of cross-border loans in total domestic borrowing among OECD countries and foreign banks have low penetration of the domestic loan market (Chart 11).

In itself, this cannot tell us whether competition from foreigners is weak — it may simply reflect the efficiency with which the Canadian financial sector is serving its clients. Indeed, foreign ownership restrictions in the banking sector were eliminated in the mid-1990s. But there are domestic constraints limiting concentration of ownership and maintaining a political step in the process of approving bank mergers. This works against large new players, foreign or domestic, entering the market. Hopefully, both these issues will be carefully examined in the upcoming review of the Bank Act.

Fragmented securities markets prevent scale economies from being realized. And they impose higher transaction costs on securities issuance and investor protection. Yet despite extensive discussions, the provinces are still unable to reach agreement on either a single market regulator or a "passport" system. It seems that compromise will be necessary, and the sooner the better, since delay is costly.

Understanding the Barriers to Structural Reforms

Stepping back from the specifics of the Canadian case, poor economic performance is widely recognized as being largely rooted in insufficient reforms in labour, product and financial markets. Still, the economic reform process has been painfully slow in many of the laggard countries. And somewhat ironically, less progress has been achieved on average in those that were most in need of reform, such as large Continental European ones.[7]

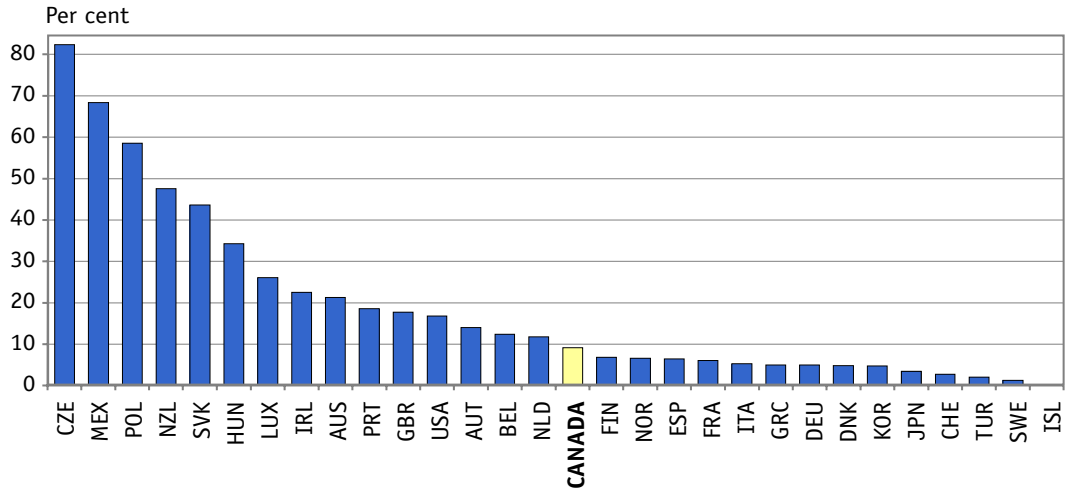
So the key issue is not just *whether* reforms improve economic performance but also *why* it is

7 Also, in the key field of labour market reforms for instance, the interests of so-called "insiders" have rarely been affected. In France and Germany for instance, the strictness of employment protection legislation for regular contracts is virtually where it was two decades ago.

Chart 11

Foreign Banks' Penetration of Domestic Loan Market

Average 2000-03, local claims in local currency only



so hard to implement them. There are at least three types of obstacles to reform. First come well-known political economy factors. Second, there are moral philosophy considerations. That is, many people tend to assess policy actions according to criteria that differ drastically from the simple welfare criterion typically used by economists. Third, well-being and happiness are much broader concepts than GDP per capita. This distinction has become acute in affluent Western societies over the recent past. Therefore, it is sometimes held that certain reforms could well boost GDP per capita but without enhancing well-being.

Against this background, sorting out what belongs to evolving social preferences and true economic deficiencies is essential. This is where hard-headed economic analysis based on indicators has a role to play. In 2005, the OECD embarked upon such an exercise with its new *Going for Growth* series. It aims mainly to identify areas of "instrumental inefficiencies." That is, dysfunctional policies in need of repair, regardless of normative preferences about what a good society should be like. And indeed, there is much room for reducing such "instrumental inefficiencies" in most OECD countries, be it to boost labour productivity or to raise labour utilization. And this could be achieved without jeopardising other government objectives such as social cohesion or environmental quality.

So, because changes in GDP per capita may not coincide with changes in well-being, it is essential to focus hard on analysing the quality of underlying policies. This also warrants digging into the well-being issue and looking at how changes in GDP relate to various measures of well-being. The main conclusion is that higher GDP per capita is strongly correlated with many other dimensions of welfare, such as self-sufficiency, health, equity, or the ability to solve political conflicts in a peaceful manner. However, it is much more loosely related to other dimensions of welfare such as social cohesion.

Obstacles to structural reforms

A major obstacle to reform has to do with political economy considerations. Structural reforms have three unfortunate characteristics. First, their costs materialize upfront while their benefits are typically gradual and/or deferred. Second, their costs tend to be concentrated on

well-organized groups while benefits usually accrue to groups with little lobbying power. Third, their costs are easy to identify while their benefits arise through indirect and complex mechanisms. All in all, reforms are often daunting tasks and many of them fail to come through despite their merits.

The OECD Economics Department has recently undertaken empirical studies of the political economy determinants of structural reforms. The analysis covers labour and product market reforms across the OECD area and spans the past three decades. Among the key drivers of reforms are factors over which governments have little control, or that they would not wish to exploit, for instance, the occurrence of major crises, such as the early 1990s crises that triggered reforms in Australia, Ireland, Sweden and, of course, Canada.

Country size is another such factor. It may not be a coincidence that top reformers have been small open economies, such as Denmark, Finland, the Netherlands or New Zealand. Small countries are price takers in world markets. And with lower rents in product markets, there is also lower public support for institutions aimed at capturing these rents. Also, the pay-off to reforms is more frontloaded in small countries, because a given gain in competitiveness has greater effects on aggregate demand than in a large country. At a more basic level, small open economies are also more aware of the changes in structural policy settings that are needed to cope with changing external conditions such as globalization and rapid technological change.

Crises or country size are largely exogenous factors. But governments can go some way towards removing obstacles to reforms. For instance, a sound structural budget balance usually appears to facilitate reforms. This could reflect an enhanced ability to finance compensatory measures for reform losers or to offset any negative effects on aggregate demand that structural reforms may have in the short run, particularly in the labour market area. Against this background, the poor state of public finances in a number of European countries does not bode well for reform prospects.

Governments can also exploit complementarities across policy areas. Many of the top reformers actually have "bunched" their reforms into packages or implemented them in sequence. By spreading the net gains from reforms more evenly across the population, such a strategy may help overcome resistance to change.

In particular, there has been a fairly strong cross-country relationship between the intensity of labour market and product market deregulation over the past decade. And product market liberalisation typically preceded labour market reforms.

This suggests that reforms in both fields are complementary. It also suggests that product market deregulation could pave the way for subsequent labour market reforms. First, reducing product market rents may progressively curb public support for rent-seeking labour market institutions. Second, lower "excess profits" would benefit real labour income through lower prices. Such income support could help to alleviate any income losses generated by labour market reforms. In the same vein, financial market deregulation should also facilitate the implementation of labour market reforms.

A final word on political economy factors: peer pressure also plays a role. OECD analysis shows that the strength of reforms in trading partners facilitates product market reforms at home. Supranational constraints imposed by international agreements are also beneficial. A case in point is the European Single Market Program, through which remaining barriers to trade and foreign direct investment (FDI) have been removed. This finding is in fact

reassuring for the OECD, given that peer pressure is the only tool at our disposal to influence national policies.

Removing political economy barriers certainly helps to undertake reforms. Still, in a number of OECD countries, reforms appear to face much stronger resistance than can be explained by political economy factors alone. At a basic level, this is confirmed by the weak explanatory power of our econometric analysis of reform drivers. Something else seems to be going on.

There is in fact a second set of obstacles to reform, which belong to the realm of moral philosophy. From this standpoint, at least three different approaches exist to assess the normative properties of a given policy action:

- The first one is consequentialism, which holds that whether an act is morally right depends only on the consequences of that act. The paradigmatic specie of consequentialism is utilitarianism, whose classic proponents include Smith, Bentham and Stuart Mill.
- The second approach is the deontological one, which emphasizes the internal character of the act itself. What makes an action right or wrong for deontologists is the principle inherent in the action. If an action is not inspired by a sense of duty, then it is wrong, even if its consequences may well be positive from a consequentialist standpoint. For instance, deontologists may not support a free-market economy in which competition and greed seem to prevail over altruism and cooperation.
- The third approach is that of the Aristotelian school of thought, which regards the achievement of virtue as the primary purpose of human life. Searching for the "good" arouses esteem from others as well as self-esteem. Adam Smith actually stressed the role of esteem in economic and social life. Despite his consequentialism, he harbored reservations as to the greed that underlies the functioning of the invisible hand.

One characteristic of economists is that they are more versed in consequentialism than the rest of society. Agricultural policy reform is a case in point. Replacing price support mechanisms with direct subsidies to poor farmers makes much sense from a consequentialist/utilitarian standpoint. It can even be designed in such a way that it is Pareto-improving, so no one loses (poor farmers, consumers, tax payers). Yet, it is unclear whether poor farmers actually support such a reform. Trading a major cut in farm output for an increase in direct payments may not be deolontological for a farmer who sees cultivating his land as his duty. It is not virtuous either: drawing most of one's income from public charity would undermine self-esteem.

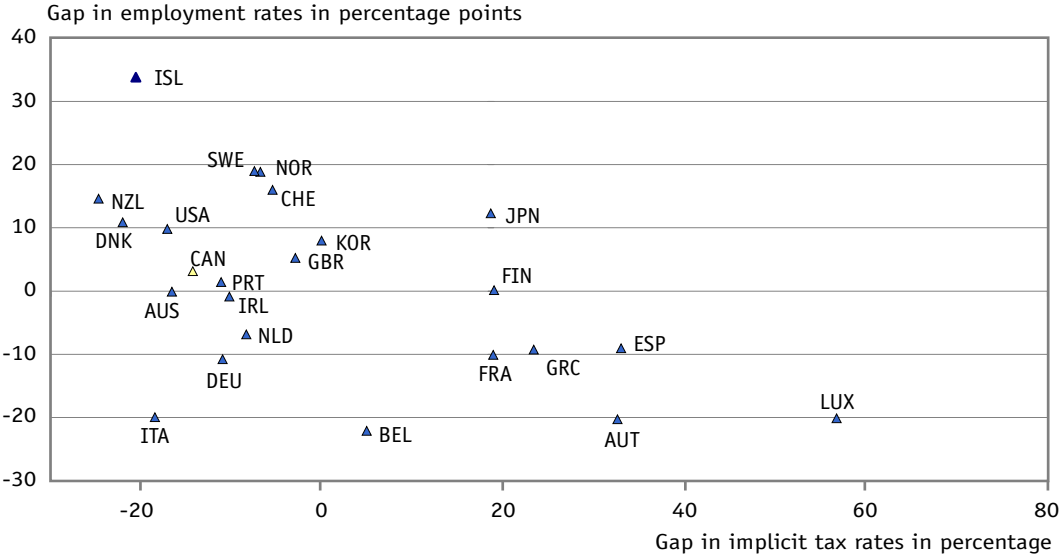
Employment protection legislation is another area where moral philosophy considerations may hinder structural reform, over and above the effect of political economy factors.

Finally, another potential obstacle to reform relates to the relationship between GDP per capita and well-being in affluent societies. This relationship seems to weaken beyond certain levels of GDP per capita, at least according to cross-country surveys of life satisfaction. So, the argument goes, why bother to undertake reforms if these merely increase GDP per capita without improving well-being? This is a major concern for the OECD, since our mandate is to achieve cross-country convergence in welfare levels.

Focusing on "Instrumental Efficiency": *Going for Growth* Surveillance

In the absence of any widespread agreement about welfare measurement, governments should at least achieve "instrumental efficiency". That is, whatever their normative preferences about the good society, they should try to set policies at the efficiency frontier.

Chart 12
Implicit Tax and Labour Force Participation of Older Workers, 2005



1 Gap in implicit tax rates in pension systems and early retirement schemes as legislated in 2005. The calculations refer to a typical "early retirement route" as discussed in Duval R. (2003).

Source: OECD.

For example, employment policies in the United States and Denmark differ considerably from one another, reflecting differences in social preferences. A higher degree of social protection is provided in Denmark, but the fiscal cost is correspondingly higher. Still, employment policies are close to the efficiency frontier in both cases, not least because both achieve high employment rates.

This is why our *Going for Growth* series primarily focuses on "instrumental inefficiencies", taking normative preferences as given. *Going for Growth* involves a new type of benchmarking surveillance, based on a set of policy indicators selected for their link to economic performance. We use them in our diagnoses — alongside in-depth OECD expertise — to identify policy priorities and derive recommendations for each OECD member.

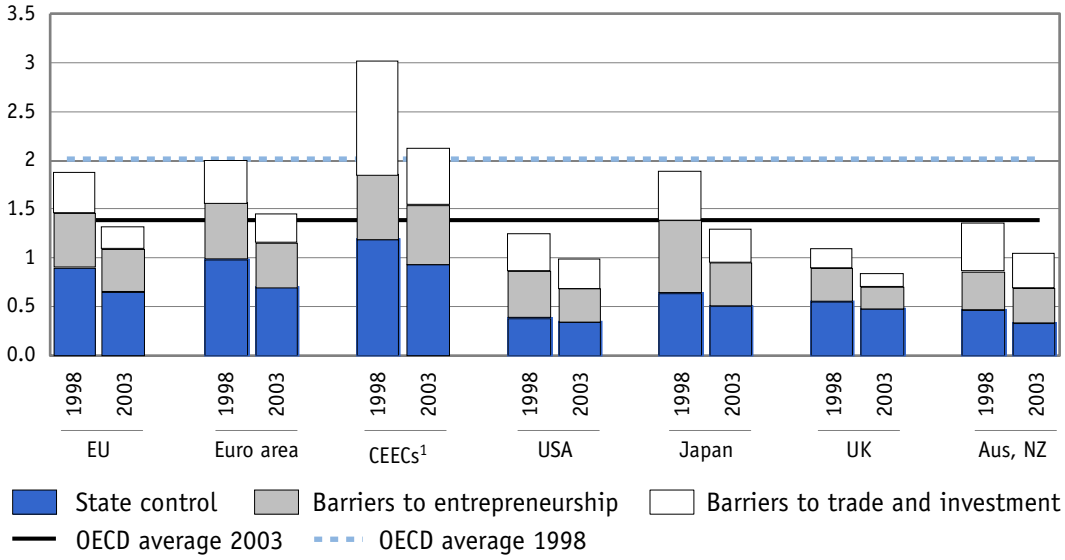
The measure of performance that remains central in *Going for Growth* is GDP per capita, measured at purchasing power parity exchange rates. Whether this is a reliable indicator of overall welfare remains an open question, which is revisited later in this article.

Assuming for the moment that GDP *per capita* is a reasonable proxy for well-being. GDP *per capita* is broken down into labour utilization and labour productivity. These components are in turn subdivided. For instance, labour utilization is broken down into the rate of employment — *i.e.* the share of persons at work — and the number of hours worked per person employed.

Besides these performance indicators, policy indicators have been designed, dealing with labour and product markets for instance. These indicators are selected because they have a documented link with performance. In the case of the labour market indicators for example, they encompass the stringency of employment protection legislation, the implicit tax on continued activity, the tax wedge on labour income, and the tax wedge on unskilled labour.

In this type of surveillance, a country comes under criticism only when performance looks weak and underlying policy indicators look bad.

Chart 13
Trends in Product Market Regulation in OECD Countries



Note: The indicator ranges from 0 (least restrictive) to 6 (most restrictive).
1 Central and Eastern European countries.
Source: OECD.

Consider the low employment rates of persons in their fifties recorded in some Continental European countries. They are a problem only insofar as they reflect misguided policies rather than a stronger preference for leisure. Using public funds to lure people into leaving the labour market prematurely is precisely an example of such bad policies. Econometric analysis shows that lifting the disincentives that curtail participation beyond a certain age could substantially boost employment (Chart 12).

Another example relates to productivity rather than labour utilization. The notion here is that barriers to entry and other regulations inhibiting competition tend to hold back productivity and output growth.

So, how can progress achieved toward more growth-friendly policies be accessed? On the product market front, regulation has become less restrictive all across the OECD (Chart 13). But much remains to be done, in particular within the European Union. Unfortunately, new initiatives to raise labour utilization have been scarcer. In particular, too little has been done to reduce the implicit tax on work for the so-called ageing workers.

Lastly, a new area was brought into the picture in this year's *Going for Growth* report, namely innovation, which is one of the main engines of long-run growth.

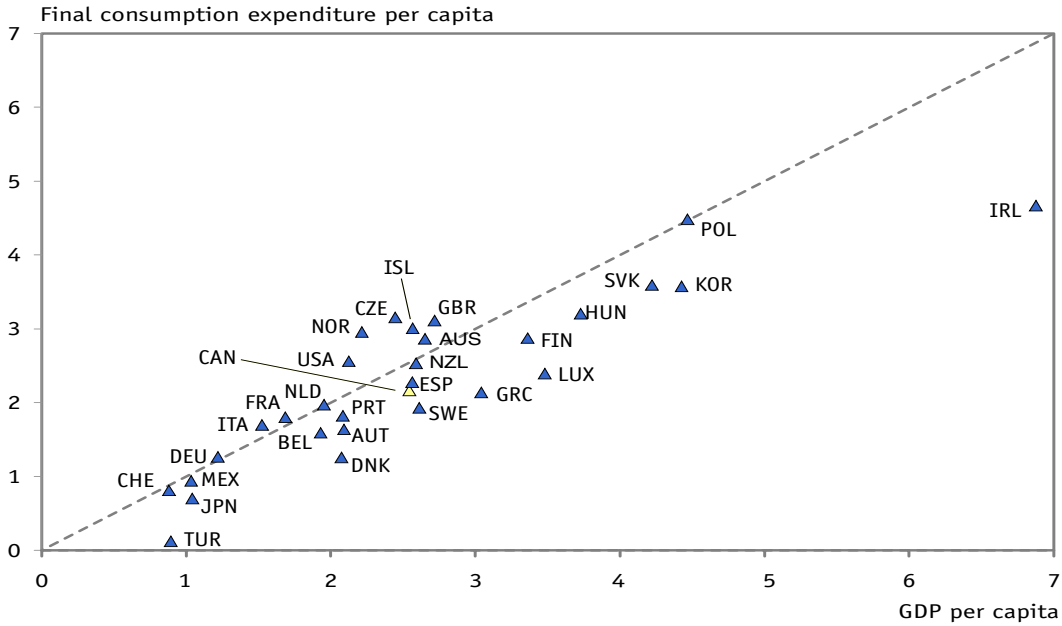
The policy indicators used here embrace the so-called framework conditions, for instance regulations affecting competition in product markets, and also more specific policies, notably R&D performed in public institutions (universities and government laboratories) or public support for private sector R&D. Performance is measured using input-oriented indicators such as business R&D intensity or more output-oriented ones such as patents.

We have documented econometrically that changes in product market regulations and the strength of intellectual property rights have spurred R&D performance in all the countries

Chart 14

GDP and Final Consumption Expenditure across OECD Countries

Average annual per cent growth rate between 1994 and 2003



Source: OECD, *National Accounts of OECD Countries, 2005* and OECD, *Economic Outlook,* No. 76 and Duval (2003).

we looked at. This was particularly conspicuous in the star Nordic performers. Even more importantly, performance has been shaped by factors such as the capacity to absorb and exploit foreign knowledge, or broad financial and economic conditions.[8]

All in all, *Going for Growth* is striving to identify what part of international differences in GDP *per capita* stems from inadequate policies and, as such, reflects differences in welfare.

Is GDP a sufficient performance statistic?

As an indicator of well-being, GDP suffers from many shortcomings. It does not incorporate environmental degradation, nor the value of leisure. Neither does it take into account the influence on well-being of income distribution. By using GDP *per capita* as the only indicator of well-being, one risks being reductionist.

It is important to avoid such a bias. As already mentioned, one way to do so is to consider lower levels of GDP per capita as a problem only inasmuch as they reflect policy deficiencies rather than differences in societal choices.

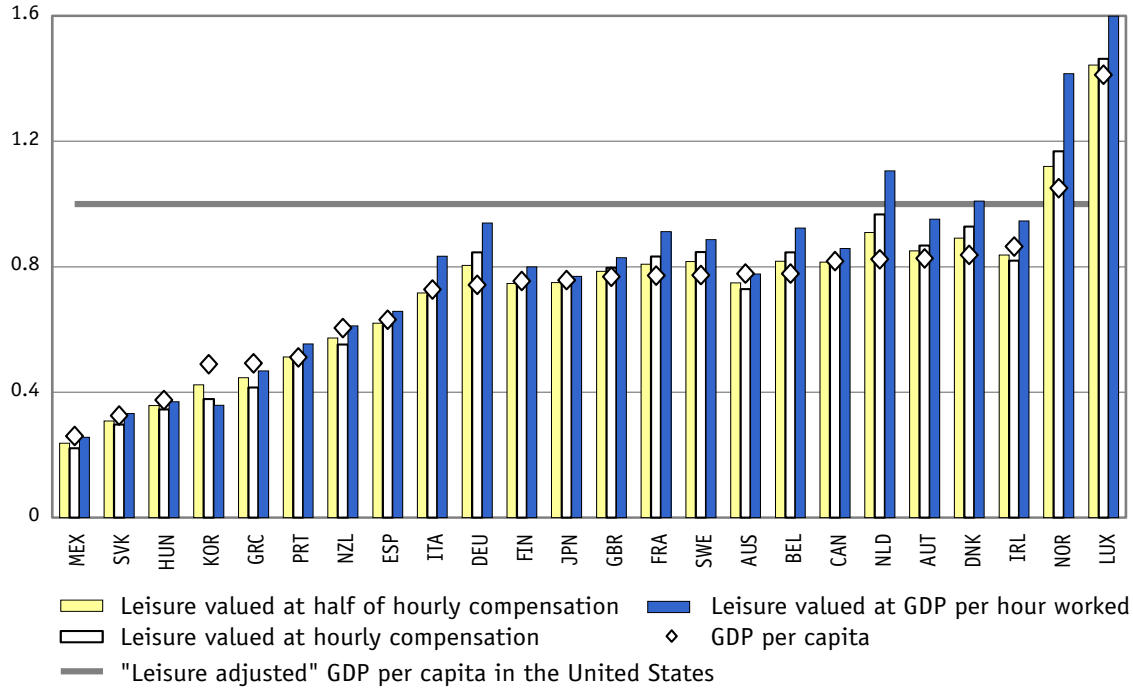
An alternative way to go is to scrutinize indicators of well-being other than GDP. Moving beyond GDP and production, consider income and consumption-based indicators, which better capture living standards (Chart 14). As it turns out, they do not alter the picture provided by GDP indicators much, nor do indicators which net out capital depreciation.

8 This extension to innovation came with many caveats. Indeed, the status and interpretation of some of the indicators are somewhat ambivalent. For instance, R&D intensity measures inputs rather than the productivity and success of innovative activity. Another example relates to patents. On the one hand, they can be a *sine qua non* for innovators to reap the benefits from their efforts, and therefore a powerful incentive to innovate. On the other hand, they can be filed to undermine potential competition or with a view to launch predatory lawsuits.

Chart 15

Taking into Account the Value of Leisure Time

Relative to the United States, as of 2001

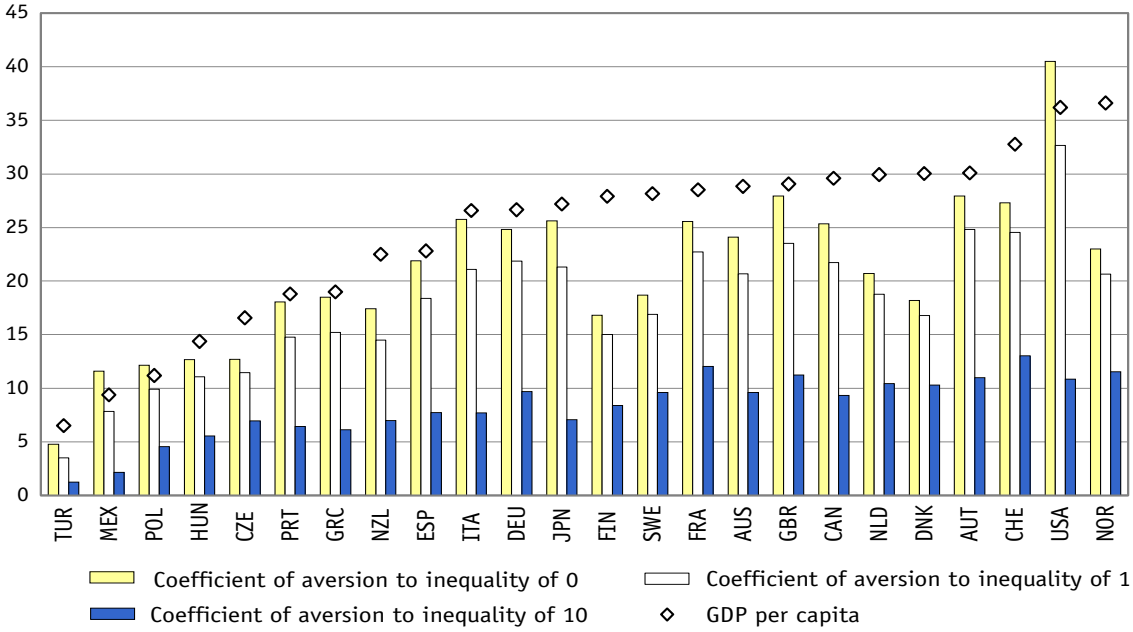


Source: OECD, *National Accounts of OECD Countries, 2005* and OECD Productivity database.

Chart 16

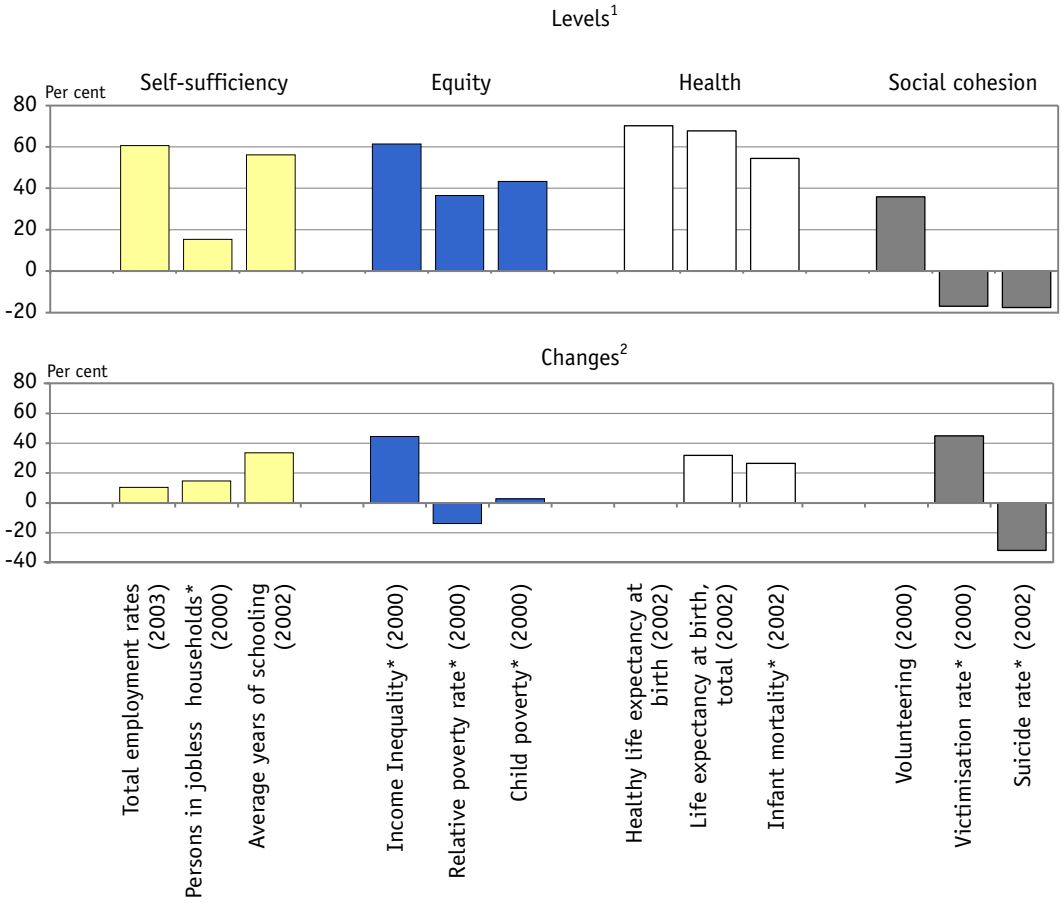
Factoring in Aversion to Income Inequality

2002 observations



Source: OECD, *National Accounts of OECD Countries, 2005* and OECD questionnaire on income distribution and poverty.

Chart 17
Correlation between GDP per capita and Other Social Indicators in OECD Countries



1 Where higher values of the indicators denote worse social outcomes (e.g.,infant mortality, denoted with an asterisk) correlations with per capita income are shown with the opposite sign.

2 Changes between the first half of the 1980s to around 2000.

Source: OECD *Society at a Glance* and Boarini *et al.*(2006).

Going one step further, one can adjust GDP and income per capita for leisure time or aversion to income inequality. Valuing leisure does not alter countries' ranking that much (Chart 15).[9]

In contrast, an extremely strong degree of aversion to income inequality can flatten out the distribution of "adjusted GDP per capita" and change rankings more significantly (Chart 16).

There is also an obvious case for broadening the scope of the indicators to include social ones. We have done this, focusing on four main categories, which reflect self-sufficiency, equity, health and social cohesion (Chart 17). Concretely, for self-sufficiency, we have looked at indicators such as the proportion of people living in households where nobody has a job, or the average number of years of schooling. These factors affect the ability of individuals to earn a decent living. Regarding equity, we have looked at indicators such as child poverty rates or gender wage gaps. For health, we have focused *inter alia* on "healthy" life expectancy at birth or the potential number of years of life lost as a result of accidents or preventable dis-

9 The quantity of leisure time is estimated by deducting from the time-endowment of each worker a common estimate of the time devoted to personal care and unpaid activities and country-specific OECD estimates of annual working hours per worker.

eases. Finally, regarding social cohesion, our key indicators comprise participation in community activities or suicide rates.

When looking at all these indicators, we had two questions in mind:

- Which dimensions of well-being go together with high GDP per capita?
- Which ones would complement and nuance the picture provided by GDP statistics?

Simple correlations suggest that self-sufficiency, equity and health tend to be stronger in countries where GDP per capita is high. Other social cohesion indicators such as suicide and victimisation rates seem uncorrelated to GDP. Also, it may well be that, starting from already high GDP per capita levels, additional growth yields diminishing returns in terms of improved well-being.

A *tour d'horizon* of welfare indicators would be incomplete without subjective measures of well-being. These measures are not always well correlated with each other, nor with GDP per capita. Strikingly, survey results show most people in most OECD countries rate themselves as fairly happy to very happy, irrespective of their income level. There is only a weak tendency for the richer countries to report higher levels of life satisfaction. But countries with the lowest level of happiness also have below-average GDP per capita. It also seems that subjective measures denote relative rather than absolute well-being.

All in all, social and subjective indicators clearly add valuable information to that conveyed by GDP. But many of them are narrow, capturing only one dimension of well-being. And all have practical drawbacks, including availability, measurement, and cross-country comparability problems. Hence, in the end, the least imperfect and most timely summary statistic of well-being remains GDP per capita. But obviously, other dimensions of welfare should be borne in mind as well. These conclusions reinforce our choice to go beyond simple GDP per capita statistics and look carefully too at the quality of policies.

One last remark on the relation between well-being and GDP: growth has externalities, both negative and positive. A prominent example of the former pertains to the environment. But then, richer societies can and typically do spend more on the mitigation of environmental stress. Less obviously perhaps, GDP growth may also have positive political externalities: insofar as conflicting claims on resources are easier to solve in an expanding economy, growth may facilitate pluralism and democracy.

Conclusion

When all is said and done, benchmarking Canada's economic performance against other OECD countries helps one understand more clearly how and why the country has done so well in recent years and deserves its accolades. It also points to a few remaining weak spots that need to be tackled. Happily, Canada's strong track record on economic performance, its resilience, and its proven ability to adjust suggest that it should be able to deal with them without too much economic pain. Nonetheless, as our analysis of the political economy of reform has shown, other, non-economic, considerations can stand in the way. We are continuing to work on our understanding of the various barriers to reform so that we can provide more relevant policy assessments and recommendations. We are also improving the depth and extending the range of our benchmarks, now that we have seen how this work can be used to provide an important backdrop to our country-specific analysis and bolster the case for reform.

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