



Doc. 13019

14 September 2012

The activities of the Organisation for Economic Co-operation and Development (OECD) in 2011-2012

Report¹

Committee on Political Affairs and Democracy

Rapporteur: Mr Jean-Marie BOCKEL, France, Group of the European People's Party

Summary

The Parliamentary Assembly of the Council of Europe, enlarged to include the delegations of national parliaments of the Organisation for Economic Co-operation and Development (OECD) member states which are not members of the Council of Europe, as well as the European Parliament, is once again considering the activities of the OECD.

The Assembly has sought to make the debate more political to enable the enlarged Assembly to focus more on a political assessment of the work of the OECD. Therefore the Committee on Political Affairs and Democracy presents this year a report which pays particular attention to responses to the eurozone crisis and to support activities for the political developments in the Arab world.

1. Reference to committee: Reference 3845 of 9 March 2012.



Contents	Page
A. Draft resolution	3
Appendix – Modification of the Rules of Procedure for enlarged debates of the Parliamentary Assembly on the activities of the OECD	6
B. Explanatory memorandum by Mr Bockel, rapporteur	7
1. Introduction	7
2. The economic prospects and the policy responses	8
2.1. A modest recovery of growth and persistent high unemployment	8
2.2. Rising inequality	9
2.3. Economic policy responses	10
3. The sovereign debt crisis	11
4. The OECD and co-operation with the countries of the Middle East and North Africa (MENA)	12
5. A financial transaction tax?	14
6. The role of rating agencies	14
7. Conclusions	14
Appendix 1 – Financial transaction tax – Benefits and drawbacks	16
Appendix 2 – Credit rating agencies: issues and initiatives	18

A. Draft resolution²

1. The Parliamentary Assembly of the Council of Europe, enlarged to include the delegations of the national parliaments of the Organisation for Economic Co-operation and Development (OECD) member States which are not members of the Council of Europe, as well as a delegation of the European Parliament, is once again considering the activities of the OECD. The enlarged Assembly has reviewed the activities of the OECD in 2011-2012 in the light of the reports by the organisation and the report prepared by the Committee on Political Affairs and Democracy.

2. Following the reform of the Assembly's structures and working methods, which came into effect in January 2012, the Committee on Political Affairs and Democracy is now responsible for presenting the report. The Assembly has sought to make the debate more political and the enlarged Assembly also attaches importance to focusing on an assessment of the work of the OECD not only from an economic perspective, as it did in the past, but also from a political perspective. In this respect, the present report focuses on responses to the eurozone crisis and on support activities for the Middle East and North Africa region (MENA).

3. The enlarged Assembly notes the background of the world economy against which the activities of the OECD have been conducted in 2011-2012. Major challenges are facing the world economy: while growth is stagnating or becoming negative, the risk of a financial disaster is increasing. The sovereign debt crisis and the measures taken to resolve it are having a severe impact on the countries in the eurozone's periphery, while economies seem to be weakening all over the world.

4. The OECD Secretary-General has highlighted four areas of policy action for member and partner countries' governments to respond to the interlinked policy challenges related to a hesitant recovery: "go structural", "go social", "go green" and "go institutional". Many countries are confronted with high unemployment, growing inequality ("go social"), high budget deficits and public debt. New sources of growth and measures to strengthen competitiveness need to be identified, including innovation, green growth, knowledge-based assets and skills ("go structural" and "go green") to put OECD economies back on a strong, inclusive growth path. Restoring household and business confidence in markets, governments and institutions ("go institutional"), addressing long-term challenges related to rapidly growing populations in emerging and developing economies, tackling issues such as ageing in many developed countries, resource scarcity, climate change and global development, also have to be added to the policy "to-do" list to which the OECD contributes with its advice and recommendations. It is in this context that the OECD Ministerial Meeting – "All on board: Policies for Inclusive growth and jobs" – launched the initiative "New Approaches to Economic Challenges" (NAEC), which aims to draw lessons from the crisis, looking at trade-offs between different policy objectives and revisiting, where necessary, the analytical framework in order to develop a strategic policy agenda for inclusive growth.

5. One of the most important consequences of the crisis has been the sharp rise in unemployment, especially youth unemployment. In this respect, the enlarged Assembly would remind the governments concerned that, according to recent research by the OECD, in periods of excess capacity, it is important to have in place policies that support job creation, avoid long-term unemployment and help the most vulnerable, in particular the youth, with targeted programmes and investment in skills and education. Active labour market policies and taxation reforms aimed at reducing levies on labour and shifting them towards consumption or environmental protection, can have relatively speedy effects on employment and help to support investment.

6. However, rising inequality began long before the financial recession, and the slackening of growth has heightened its political resonance. According to recent research by the OECD, the growth of inequalities is due primarily to a considerable broadening of wage-derived income. While the opening of markets and technological progress have allowed productivity and growth to be increased, the least skilled workers have been the least able to grasp the opportunities thereby created. Since the mid-1990s, taxation and welfare systems have become less redistributive. The OECD places emphasis on improving the skills of the workforce to combat inequalities and a Skills Strategy was accordingly put before the member countries at the Ministerial Meeting in May 2012 to ensure that the necessary investments are supported by the development of appropriate skills. A review of taxation systems, combined with targeted programmes for the most vulnerable in welfare systems and reforms to reduce labour market segmentation, also seem necessary.

7. In the same vein, the enlarged Assembly considers it relevant to endorse the International Labour Organization's recent call for action on the youth employment crisis, aggravated by the global financial and economic crisis, which represents a challenge to the prosperity and cohesion of our societies. In this respect, youth employment measures and policies have to take into account that, even if education and training are

2. Draft resolution adopted unanimously by the committee on 10 September 2012.

essential for young people to enter the labour market successfully, better skills do not automatically translate into improved labour market outcomes and more jobs. Consequently, it is important to develop programmes specially focused on fostering youth access to decent and productive work and promoting youth entrepreneurship, with the aim of contributing to reinstating growth in a sustainable and fair manner.

8. The enlarged Assembly notes with interest the OECD's forecasts of an upturn in activity in 2013, at both global and European level. Decisions at political level are vital to bring this about. This should start with consolidation measures within the eurozone that are bolder than those taken to date, within a credible medium-term framework, as well as structural pro-growth reforms. Otherwise, Europe runs the risk of plunging into a spiral of bank busts, defaults and negative growth – a calamity that could jeopardise the entire European project.

9. The causes of the sovereign debt crisis are multiple: low interest rates and easy access to credit led households, private companies, the banking sector and governments to become over-indebted; the lack of regulation of financial markets meant that banks neglected to manage their risks and became over-extended over the last 20 years. Government and banking sector debt reached untenable levels, triggering a crisis of confidence and, in some countries, a liquidity crisis. In the summer of 2011, financial markets began to question the ability of some European governments to finance their public borrowing, in part due to the increasing likelihood of their having to bail out their private banking sector.

10. In this regard, the enlarged Assembly notes that the current crisis was also caused by the fact that legal measures were taken too late to prevent excess risk-taking by financial institutions, and therefore emphasises the importance of ensuring the effectiveness of the national and international regulatory framework, in particular the early warning mechanism for financial risk, in order to make the operations of financial institutions fair and reasonable. Further, the enlarged Assembly appreciates the OECD's efforts to present the policy direction of financial regulation through its initiative "New Approaches to Economic Challenges", and calls for the OECD to continue providing its member countries with the necessary expertise.

11. The enlarged Assembly welcomes the measures that the eurozone members have been adopting in order to cope with this situation, such as the new financial support mechanisms (the European Financial Stabilisation Mechanism and the European Financial Stability Facility), created in May 2010, and the Treaty on Stability, Co-ordination and Governance in the Economic and Monetary Union, which should come into force in January 2013. This new treaty, aimed at providing enhanced policy co-ordination and surveillance within the eurozone, gives the European Commission and the Council the right to examine national draft budgets and, if necessary, suggest amendments, and makes the Commission's recommendations binding under the Stability and Growth Pact.

12. On top of the economic, employment and social difficulties, there are now doubts about the public's acceptance of adjustment processes. In the economic report on the eurozone which it published in May 2012, the OECD recommends a range of measures in line with the guidelines recently adopted at European level and which are designed to address the sovereign debt crisis combined with targeted measures to invest in the skills and education of people and targeted support for the most vulnerable. The enlarged Assembly urges the governments concerned to make sure that the impact of the process is socially balanced and shared fairly throughout all sections of society so as to reduce inequalities. Public acceptance depends on this.

13. The enlarged Assembly welcomes the valuable contribution made by the OECD to the consensual view and the agreements reached at the Rio+20 Conference aimed at achieving sustainable development, through its Green Growth Strategy. The OECD sees it as a practical and flexible approach that assesses economic and environmental policies together, in a way that points to an economic recovery based on the sustainable use of natural resources, efficiency in the use of energy and valuation of ecosystem services, which is compatible with economic growth, job creation and poverty eradication. At the same time, the enlarged Assembly recalls that these types of initiatives and efforts should contribute to States' fulfilment of, and further commitment to, international environmental obligations.

14. The Assembly recalls its [Recommendation 2002 \(2012\)](#) and [Resolution 1885 \(2012\)](#) "The young generation sacrificed: social, economic and political implications of the financial crisis", [Resolution 1884 \(2012\)](#) "Austerity measures – a danger for democracy and social rights" and [Resolution 1886 \(2012\)](#) on the impact of the economic crisis on local and regional authorities in Europe. All these texts, adopted during the June 2012 part-session, point to a reorientation of the programmes to combat the crisis in order to promote economic growth while protecting the most disadvantaged groups of the population, in particular young people. The Assembly welcomes the path-breaking work of the OECD in this field and encourages it to continue to search for concrete policy solutions.

15. In June 2012, the Assembly also adopted [Resolution 1888 \(2012\)](#) on the crisis of democracy and the role of the State in today's Europe, which analysed the relationship between governance and the crisis, as well as the dangers to democracy linked to certain measures taken in response to the crisis. Its conclusions, pointing out that that Europe needs sound States based on strong democracies that can ensure proper representation and increased participation of its citizens at local, regional, national and transnational levels, could constitute valuable input to democratic deliberation in other OECD and non-OECD countries.
16. Also during the June 2012 part-session, the Assembly adopted [Resolution 1892 \(2012\)](#) on the crisis of transition to democracy in Egypt and [Resolution 1893 \(2012\)](#) on political transition in Tunisia, which were follow-ups to its work on the recent political developments in those countries. It recalls once again its [Resolution 1831 \(2011\)](#) on co-operation between the Council of Europe and the emerging democracies in the Arab world, and it confirms its readiness to share its experience in democratic transition to facilitate their political transition.
17. Therefore, the enlarged Assembly welcomes the OECD's decision to enhance its co-operation programme with the Arab countries following the recent political developments. It notes that the OECD's approach of enabling Arab countries to benefit from its expertise regarding reform, tapping into the expertise of its member States and creating the conditions for regional co-operation is very similar to that advocated by the Parliamentary Assembly in [Resolution 1831 \(2011\)](#). It calls on the OECD to co-ordinate and proactively contribute to various appropriate projects.
18. It is crucially important, from the perspective of promoting global economic growth, that the OECD strengthens dialogue not only with its member States, but also with non-member countries that hold prominent positions in the world economy. In this regard, the enlarged Assembly hopes that the process towards full membership of the Russian Federation in the OECD will progress and include relevant democratic elements; it encourages the OECD to strengthen its relations with major partners, to expand its membership, and to continue to make proposals to major partners for the promotion of sound economic growth.
19. Finally, the enlarged Assembly appreciates the OECD's leading role in formulating various policy initiatives, such as job creation, improvement of the development policy, promotion of free trade and other policy issues referred to in preceding paragraphs. The enlarged Assembly also invites the OECD to provide the participants of the enlarged debate, at or by the next debate, with information regarding its policy initiatives on the issues to which this resolution refers.
20. Lastly, the enlarged Assembly resolves to amend the Rules of Procedure for enlarged debates of the Parliamentary Assembly on the activities of the OECD (see Appendix) to take account of the reform of the Parliamentary Assembly's structures and of the new apportionment of tasks among its committees.

Appendix – Modification of the Rules of Procedure for enlarged debates of the Parliamentary Assembly on the activities of the OECD

1. The Rules of Procedure for enlarged debates of the Parliamentary Assembly on the activities of the OECD are modified as follows:

- 1.1. in Section I on “General Principles”, replace paragraph 1 with the following paragraph:
- 1.2. *“Parliamentary debates on the activities of the OECD shall be held on the basis of an agreement between the Parliamentary Assembly of the Council of Europe and the national parliaments of OECD member States which are not members of the Council of Europe and with the approval of the OECD Council”;*
- 1.3. in Section II on “Participants”, replace sub-paragraph 1.2 with the following sub-paragraph:
- 1.4. *“delegations of the national parliaments of OECD member States which are not members of the Council of Europe”;*
- 1.5. in Section IV on “Use of languages and documents”, delete paragraph 6;
- 1.6. in Section VI on “Amendments and sub-amendments”, replace paragraph 3 with the following paragraph:
- 1.7. *“The President of the Parliamentary Assembly shall decide on the admissibility of amendments and sub-amendments, which must be signed by at least five members and tabled in accordance with the deadlines set out in Rule 33.6 of the Rules of the Procedure of the Assembly”;*
- 1.8. in Section VIII on “Voting”, delete paragraph 2;
- 1.9. in Section IX on “Procedure in committee and examination of the report in reply to the OECD activity report”:
 - 1.9.1. in paragraph 1, replace the words “The Parliamentary Assembly committees concerned by OECD matters may hold meetings” with the words “The Parliamentary Assembly committee responsible for preparing a report on the activities of the OECD may hold meetings”, and delete the footnote;
 - 1.9.2. replace paragraph 2 with the following paragraph:
 - 1.9.3. *“At meetings of the Parliamentary Assembly committee in question, delegations of the national parliaments of the OECD member States which are not members of the Council of Europe shall be allocated the following numbers of votes:*
 - United States of America, Japan and Mexico: 4 votes*
 - Canada and Republic of Korea: 3 votes*
 - Australia and Chile: 2 votes*
 - New Zealand and Israel: 1 vote”;*
 - 1.9.4. consequently delete Appendix 2 to the Rules of Procedure;
- 1.10. delete Section X on “Liaison meetings”;
- 1.11. in Section XI on “Special guests and parliamentary observers”, in the title and paragraphs 1 and 2, replace the words “special guest(s) and parliamentary observer(s)” with the words “special guest(s), parliamentary observer(s) and partner(s) for democracy”;
- 1.12. in paragraph 4 of Appendix 1:
 - 1.12.1. replace the words “special guest or permanent observer status” with the words “special guest, permanent observer or partner for democracy status”;
 - 1.12.2. at the end of the paragraph add the following: “Morocco: 3; Palestinian National Council: 1”.

B. Explanatory memorandum by Mr Bockel, rapporteur

1. Introduction

1. In June 2011, the Parliamentary Assembly decided on certain reforms to its structures and a new division of tasks. Accordingly, the new terms of reference of the Committee on Political Affairs and Democracy state that “[t]he committee shall prepare reports on the activities of the Organisation for Economic Co-operation and Development (OECD) and the European Bank for Reconstruction and Development (EBRD). For the preparation of the reports and the debates in the Assembly, the committee maintains relations with the OECD and the EBRD, and with parliaments of non-member States participating in these debates.”

2. The reform having come into force in January 2012, the Committee on Political Affairs and Democracy appointed me rapporteur on the activities of the OECD in 2011-2012.

3. The debate on the activities of the OECD, in which the Secretary-General of that organisation participates, takes place on the basis of special rules, in the framework of an “enlarged assembly” composed of the Parliamentary Assembly of the Council of Europe and delegations from the national parliaments of non-European member States of the OECD: Australia, Canada, Chile, Israel, Japan, Korea, Mexico, New Zealand and the United States of America, as well as from the European Parliament.

4. In the past, other Assembly committees presented, on a more or less regular basis, contributions to the report and draft resolution. Given the more political orientation that the Assembly wishes to give to the debate, it seems to me that this procedure could be streamlined by eliminating “obligatory” contributions but leaving committees that so wish the possibility of requesting to deliver an opinion whenever necessary.

5. The report on the activities of the OECD used to be adopted provisionally in June and sent to the delegations of non-European OECD member States so that they would have time to prepare amendments which, together with those from other contributing committees, were then added to the draft resolution just before its adoption by the committee in the course of the October part-session. This procedure seems too cumbersome.

6. In the debate on the reform of the Assembly, some members of the then Committee on Economic Affairs and Development proposed that the reports on the activities of the OECD (and of the EBRD) should be prepared by the Committee on Social Affairs, Health and Sustainable Development (which inherited other remits of the Committee on Economic Affairs and Development) and not by the Committee on Political Affairs and Democracy, to which Mr Robert Walter replied: “[t]he logic in putting this with the Political Affairs Committee is that the work of these two institutions is basically political. It is the scrutiny of these institutions that we are talking about ... and this fits very logically with the Political Affairs Committee”.³

7. The Assembly reports on the activities of the OECD should therefore focus more on a political assessment of the work of the institution and not so much on its activities in the economic field as in the past. Accordingly, I propose that, for this year, the report focuses on responses to the eurozone crisis and on support activities for the Arab Spring, two items on which our committee was already active.

8. On 18 April 2012, I went to the OECD and met Mr Yves Leterme, Deputy Secretary-General, accompanied by Mr Luiz de Mello, Deputy Chief of Staff of the Secretary-General, and Mr Andreas Schaal, Counsellor in the Office of the Secretary-General. I also met Mr Jean-Luc Schneider, Deputy Director of the Economics Department. We discussed relations between the OECD and the Parliamentary Assembly following the reform of the Assembly in general, and in particular my report. On 23 May, I attended the presentation on the “Economic Outlook” in the framework of the OECD Forum and Ministerial Meeting.

9. Following our contacts with the OECD, the Committee on Political Affairs and Democracy approved the following programme during the April 2012 part-session (Strasbourg, 23-27 April):

- 30 May, Paris: the committee holds a first discussion on a preliminary draft report, with the participation of Mr Yves Leterme, OECD Deputy Secretary-General;
- during the June part-session (Strasbourg, 25-29 June): the committee agrees on a draft report, which is then sent to the delegations of non-European OECD member countries, which are asked to send their comments in writing in time to be included in the report (mid-August);

3. CR 24, 24th Sitting, 22 June 2011.

- 10-11 September, Helsinki: the enlarged committee approves the report, in which the contributions have been incorporated (delegations of non-European OECD member countries and a representative of the OECD are invited); the draft resolution should include the necessary changes to the special rules of procedure;
- 2 October, Strasbourg: the enlarged committee adopts a position on any amendments and organises the traditional dinner with delegations of non-European OECD member countries and OECD staff;
- 3 October, Strasbourg: enlarged Assembly debate on the activities of the Organisation for Economic Co-operation and Development (OECD) in 2011-2012 with the participation of the Secretary-General of the OECD and delegations of non-European OECD member countries.

10. During last year's debate, the enlarged Assembly adopted an amendment to the resolution encouraging the OECD to explore avenues for introducing a global tax on financial transactions. In our contacts with the organisation, we sought its opinion on the role of rating agencies in the context of the sovereign debt crisis in Europe. The OECD, to which I convey my thanks, sent me its thoughts on both questions, which I refer to in parts 5 and 6 of this report and are reproduced in the appendices.

11. Finally, the proposed amendments to the rules of procedure for the enlarged debates of the Parliamentary Assembly on the activities of the OECD presented in the appendix to the draft resolution take account of the reform of the Assembly's structures and of the new distribution of tasks among its committees. My concern has been to simplify the procedure while retaining the possibilities for participation by the delegations of the national parliaments of OECD member States not belonging to the Council of Europe. On the strength of its experience in this year's debate, the Committee on Political Affairs and Democracy may subsequently decide to adjust certain details.

2. The economic prospects and the policy responses

2.1. A modest recovery of growth and persistent high unemployment

12. In its May 2012 Economic Outlook, the OECD lets us glimpse a gradual resumption of activity in terms of averages in the OECD countries, but with strong disparities between member States.

13. In the United States, the recent indicators seem more positively oriented, particularly in the sector of household consumption with an increase in consumer credit. The real estate market continues to impede recovery, but the level of prices seems to be settling and sales have steadied, as well as new construction. With a still very accommodative monetary policy and gradual improvement in the structure of private sector debt, gross domestic product (GDP) growth should gradually gain strength to register a rate of about 2.75% at the end of 2013. The OECD stresses, however, that with unchanged legislation, expiry of the measures to grant tax relief and extend welfare benefits would entail a considerable budgetary restriction in 2013 (in the region of 4% of GDP) which would be liable to plunge the US economy back into recession.

14. The eurozone is in virtual recession, with activity stagnating in the first quarter of 2012 following a slight contraction at the end of 2011, and the OECD does not expect a significant upturn in activity before 2013. As well as the risks engendered by the sovereign debt crisis and the problems besetting the banking sectors, budgetary consolidation and deteriorating labour market conditions are likely to be a lasting drag on growth. This average overview nevertheless reflects starkly contrasting national situations. Italy, Spain, Portugal and even more so Greece have seen activity decline, and the outlook remains negative up to the end of 2013. Conversely, in Germany a strong rebound was observed at the beginning of 2012, following a slump in the fourth quarter of 2011, and growth should pick up to attain a rate of 2.25% at the end of 2013. In Japan, growth also seems to be taking off again after slackening at the end of last year, with budgetary policy and the reconstruction effort helping to boost activity.

15. All in all, based on the OECD's forecasts for 2013, average growth over the five years since the onset of the crisis will have been barely over 1% per annum in the United States and approximately zero in Europe, with weak average growth in Germany (1%) and France (0.5%), flat growth in the United Kingdom, substantially negative growth in Spain and Italy and cumulative declines in activity of 7% in Ireland and Portugal and almost 20% in Greece.

16. In opposition to this, the risk of sluggish demand in the OECD zone having a significant impact on emerging economies does not seem to have materialised. The expected slowdown in China remains very moderate and the Chinese authorities have reacted swiftly to bolster activity. The contribution of the major emerging market economies (the "BRICS": Brazil, Russia, India, China, South Africa) to global growth is

expected to remain high. The eastward and southward “shift in wealth” should therefore continue in 2012/13, with emerging economies now accounting for nearly half of the total global GDP compared with just over a third in the early 1960s. With the difference in potential growth rates, in the region of 1.5% in Europe and just over 2% in the United States, compared with 7% to 9% in China and India, this trend is bound to accelerate. According to OECD forecasts, China's GDP will thus exceed that of the United States in 2017, even though the per capita income differential will remain considerable.

17. In this context of underutilised production capacity, unemployment remains high, standing at 8.5% for the OECD zone as a whole in March 2012, that is 2.5 percentage points above its pre-crisis level with a near 14 million rise in the number of unemployed. Once again, it is the situation in Europe that is the most worrying, with a further decline in the employment level since mid-2011, whereas the United States has recorded an incipient fall of unemployment for some months. In certain European countries, the decline appears particularly marked, with the unemployment rate more than doubling in five years in Denmark, Spain, Estonia, Greece, Iceland and Ireland (admittedly with widely differing levels between these countries). At the same time, the duration of unemployment has lengthened considerably in some countries. The proportion of unemployed workers who have been jobless for more than a year now exceeds 30% of total unemployment in the United States, the highest level since the Second World War, 43% in Spain and even above 60% in Ireland. New labour market entrants have been particularly hard hit, with a near 9% fall in employment among 15 to 25 year olds. Among older workers (55 to 64 year olds), however, employment has risen, no doubt reflecting the impact of pension scheme reforms. Lastly, the level of skills has had a strong impact on employment, which among the low-skilled has fallen by over 8% since the downturn, whereas among the higher-skilled it has risen by over 9%. The level of unemployment should be barely stabilised in 2012, with an average rate of 8% for the OECD countries, before easing slightly in 2013. The improvement will be mainly confined to the United States, whereas the unemployment rate would remain unchanged at 11% in the eurozone.

2.2. Rising inequality

18. Rising inequality began long before the financial recession, but the slackening of growth has heightened its political resonance. That is why the OECD has conducted recent analyses to determine the causes of this development and explore the possible responses to it. The first determination made is that the trend, commencing initially in certain English-speaking countries, since the beginning of the 21st century has affected most OECD countries including the more traditionally egalitarian ones such as Denmark, Germany or Sweden. Only a small number of countries record comparative stability (Belgium, France, Hungary) or a reduction of inequalities (Greece, Turkey). A downward trend is also observed in Mexico and Chile, but starts from far higher levels than in the midstream OECD countries. Moreover, the change in income distribution works to the benefit of a small slice of the population. In the United States, for instance, the proportion of household income going to the top 1% rose from 13% in 1990 to 18.5% in 2008. The share of the top 0.1% has increased fourfold in 30 years to represent, in 2008, some 8% of aggregate pre-tax income, compared to 4%-5% in Canada, the United Kingdom and Switzerland, and almost 3% in Australia, France and New Zealand.

19. The growth of inequalities is due primarily to a considerable broadening of wage-derived income. While the opening of markets and technological progress have allowed productivity and growth to be increased, the least-skilled workers have been the least able to grasp the opportunities thereby created. That is why the OECD places emphasis on improving the skills of the workforce to combat inequalities, making it possible to reduce wage dispersion at the same time as increasing the employment level. A “road map” was accordingly put before the member countries at the ministerial meeting in May 2012 to ensure development of skills. Although they count for less in aggregate income, capital yields also helped accentuate inequalities, particularly in the Scandinavian countries.

20. Meanwhile, taxes and transfers now lower inequality by about 29%; more than in the mid-1980s, but less than in the mid-1990s. In fact, the statutory marginal rates of taxation on the highest incomes have been significantly reduced, decreasing from 60-70% in the early 1980s to about 40% on average by 2010. The increase in the GDP proportion of spending on social transfers reflects an increase in the number of beneficiaries, not an improvement in benefits, whereas the generally proportional welfare contributions have only a limited redistributive effect.

2.3. Economic policy responses

21. This persistent climate of weak growth makes the necessary consolidation of public finances extremely tricky. Most European countries are nevertheless pursuing a rationalisation strategy that involves both raising revenues and cutting spending. In countries such as Greece, Hungary, Italy and Portugal, there are plans to reduce the budget deficit by about 5% of GDP over the period 2011-13 and by up to 7% in Spain after programmes that were already extensive during the two previous years (over 10% in Greece). On average for the eurozone, the adjustment is projected to be 1.5% of GDP in 2012 and a further 1% in 2013, with a similar-sized reduction in the United States and stability in Japan, mainly due to reconstruction spending. Despite this major effort, however, gross debt will continue to grow in the United States up to 2013, and would barely stabilise in 2013 in the eurozone to verge on 100% in 2013 and exceeding 220% in Japan, up by 30 to 50 GDP points since the start of the crisis in most countries, with a much more severe deterioration in countries like Greece and Ireland.

22. To compensate for the budget tightening – and in the absence of inflationary pressures – the monetary authorities have pursued a highly accommodative policy, with official interest rates at near zero and central banks announcing or already implementing asset purchase programmes. While emphasising the need for continued accommodative monetary policies, the OECD also notes their inherent risks. Liquidity provision at very low rates and at long maturities could lead financial market participants to take excessive risks as in the past and increases the danger of resource misallocation by keeping non-viable institutions afloat, while asset purchase programmes may weaken central banks' balance sheets. The OECD accordingly stresses the urgency of tightening supervision to ensure that the banks clear doubtful debts off their balance sheets and see to their necessary recapitalisation, including, if required, by injection of official capital. Structural reforms also need to be undertaken for the major financial institutions to cease receiving the authorities' *de facto* guarantee, if the risk of the financial system sustaining a systemic collapse is to be averted, either by separating retail and investment banks or via increased obligations regarding reserve levels.

23. All in all, calibrating macroeconomic policies looks extremely tricky. While stressing that rationalisation of public finances is an indispensable goal, the OECD recalls that the strategies must accommodate the effect of the budget deficit reduction measures on growth. If a good many countries take action at the same time in the same direction, the effect is inevitably amplified. That is why the OECD states that, if activity in Europe proved less sustained than forecast in the budgetary projections, it would be fitting, in many cases, for the automatic stabilisers to be allowed to operate. In view of this risk of budgetary rationalisation and weakening of growth forming a vicious circle, additional measures of support to activity are under discussion in Europe, for example by providing a common guarantee for the issue of government loans to recapitalise the banks and make it easier to absorb bad debts. Another option might be to increase the resources of the European Investment Bank.

24. But it will also be necessary to tackle the problems of competitiveness besetting growth in many OECD countries, which are partly responsible for the friction between the European countries. A fresh effort for structural reforms, notably in the services industry and sheltered sectors, could create employment and at the same time generate tax revenues. The OECD's recent study, based on an analysis of thirty years of structural reforms, shows that while the benefits of such reforms typically take time to fully materialise, their impact in the short term is, contrary to popular belief, seldom negative and may even be quite rapidly positive in some cases. It appears from this study that, in periods of excess capacity, it is important not to reduce unemployment benefits and job protection in order to avoid impeding growth, and not to sacrifice active labour market policies. Conversely, taxation reforms aimed at reducing levies on labour and shifting them towards consumption or environmentally damaging activities can have relatively speedy effects on employment and help to support investment. Their negative impact on equity needs, however, to be compensated with measures targeted at low income earners. The OECD has undertaken considerable work on environmentally related taxation and green tax reform, and how to reform environmentally damaging subsidies which can both benefit the environment and contribute to fiscal consolidation. Likewise, reducing the entry barriers for the retail trade and professional services can enhance the employment component of growth. In that regard, the OECD notes that responsibility for adjustment rests with the countries having a large current account surplus as well as with the countries that carry a deficit. While the latter are to restore their competitiveness and increase their productivity through greater flexibility of the commodities and labour markets, those with a surplus should move towards an increase in wages and consumption. But, the organisation points out, while the adjustment seems to be under way in the countries with deficits, little has been done as yet in those with surpluses.

3. The sovereign debt crisis

25. The main topic of concern in Europe remains the sovereign debt crisis, however.

26. The causes of the crisis are multiple and mutually reinforcing. In many countries, low interest rates and easy access to credit without regard to ability to repay led households and governments to become over-indebted. The lack of regulation of financial markets meant that banks neglected to manage their risks and became over-extended in the last twenty years. The authorities failed to grasp the opportunity afforded by faster growth in the years leading up to the crisis to put public finances on a sounder footing. On the contrary, some governments reduced fiscal pressure and relaxed control of spending. The downturn in activity and the need to support the banking system led to a further deterioration in the health of public finances. Government and banking sector debt reached untenable levels, triggering a crisis of confidence and, in some countries, a liquidity crisis. The close links between the banking sector and public finances created ripple effects between budgetary stability and the stability of the banks. This spiral was particularly pronounced in Greece, Ireland, Portugal and Spain, which were forced to seek assistance from the European Union, other eurozone countries and the IMF in order to meet their commitments and give them sufficient room for manoeuvre to adjust their public finances. In order to cope with this situation, new financial support mechanisms (the European Financial Stabilisation Mechanism and the European Financial Stability Facility) were created in May 2010, with a combined lending capacity of 500 billion euros.

27. In the summer of 2011, the market began to question the ability of some European governments to finance their public borrowing. The loss of confidence over sovereign debt had knock-on effects on the funding and solvency position of banks which had large exposures to sovereign debt and were explicitly or implicitly reliant on government support. This fed back into the credibility of governments, as the likelihood of their having to bail out their banks increased. The loss of confidence impacted on governments' financing costs while interbank market conditions tightened and banking share prices fell, prompting the banks to speed up their debt repayment and reduce the amount of funding they supplied to the economy. In an effort to break this spiral, a series of measures were approved at the European summit in October 2011. A plan to restructure the Greek debt was agreed, which aimed to halve the country's debt burden and bring it back down to 120% of GDP. This voluntary exchange of bonds helped pave the way for Greece to receive a further €100 billion in public funds by 2014. At the same time, the lending capacity of the European Financial Stability Facility and the European Financial Stabilisation Mechanism was increased to reach €700 billion. A number of measures were introduced to deal with the banks, requiring them to raise their capital ratios to 9%, after marking down their sovereign bond holdings to market prices, from June 2012.

28. According to the European Banking Authority, banks would need to increase their capital reserves by some €106 billion, to be raised initially from the private sector and, if necessary, through a loan from the European Facility. Banks which failed to meet the new capital target would have to cut dividend payouts and bonus payments. The third part of the plan focused on enhancing policy co-ordination and surveillance within the eurozone under the Treaty on Stability, Co-ordination and Governance in the Economic and Monetary Union. This treaty should come into force in January 2013 after ratification by the member States. According to this new treaty, member countries must introduce balanced budget requirements. The Excessive Deficit Procedure is being strengthened, giving the European Commission and Council the right to examine national draft budgets and, if necessary, suggest amendments.

29. These measures were welcomed as a crucial step towards restoring confidence in States and in banking systems and bringing about the change of governance needed to ensure consistent policies across the eurozone. The Greek debt restructuring was approved by the country's creditors, the European Central Bank (ECB) provided the necessary liquidity to the banking sector and countries such as Italy, Portugal and the United Kingdom agreed new budgetary consolidation programmes and structural reforms. The respite was short-lived, however, and tensions escalated once again in June 2012. On top of the economic difficulties, there are now doubts about the public's acceptance of the adjustment process. In any event, additional measures might be needed to boost confidence, ensure a continued orderly deleveraging by the various players and enhance the stability of the eurozone. In the economic report on the eurozone which it has just published, the OECD recommends a range of measures in line with the guidelines recently adopted at European level and which are designed to address the sovereign debt crisis, including:

- in Greece, voluntary restructuring of its debt, recapitalisation of banks and a viable programme of official support;
- if necessary, an increase in the capacity of the eurozone "firewall";
- recapitalisation of the banking sector, as recently decided, drawing on public funds if necessary and avoiding excessive deleveraging so as not to hamper lending to the economy;

- the establishment in July 2012 of the European Stability Mechanism as a permanent crisis mechanism with robust capital and governance structures.

30. These measures should be coupled with prudent macroeconomic policy, an ambitious programme of structural reforms, and the introduction of rigorous budgetary procedures and enhanced supervision of financial institutions.

4. The OECD and co-operation with the countries of the Middle East and North Africa (MENA)

31. Since 2005, the OECD has been pursuing a MENA-OECD Initiative on Governance and Investment for Development with Arab countries. This programme, which is being conducted in co-operation with international organisations active in the region, aims to provide Arab reformers with OECD support in their efforts to modernise public governance and improve the environment for entrepreneurs, by creating a platform for dialogue and sharing of experience between Arab leaders and OECD experts, as well as a new forum for regional co-operation between Arab countries.

32. The areas for co-operation were decided by the Arab countries, which have chosen to focus on policy areas that are seen as having the greatest potential for creating conditions for more sustained economic growth and job creation in order to cope with rising unemployment, and build confidence. In the field of public governance and State reform, the chosen themes were budgetary reform and the management of public finances; human resource management and integrity in the civil service; e-government and administrative simplification; regulatory quality, public service delivery and public-private partnerships. Later, this list was extended to include “cross-cutting” areas such as gender equality and water resource management. In the field of investment and the business environment, the focus has been on investment policies and promotion, SMEs, entrepreneurship and human capital development, competitiveness, action against corruption, corporate governance and socially responsible corporate behaviour.

33. In pursuing this initiative, the OECD employed working methods used in activities with member States, based on peer-to-peer exchanges and open dialogue with due regard for the specific features of individual countries and drawing on rigorous analyses. This approach, specific to the OECD, had already proved successful in the 1990s in co-operation with central and eastern European countries starting out on the road to democracy and a market economy. In each area, the activities were conducted in working groups comprising practitioners from OECD and Arab countries, and co-chaired by a MENA country and a member country of the OECD. In addition, the SIGMA programme (Support for Improvement in Governance and Management), a joint initiative of the OECD and the European Union, which provides technical assistance to countries wishing to reform their public administrations in line with EU standards and good practices, likewise began operating in the region.

34. Thanks to the work done in these working groups, Arab countries have been able to benefit from the OECD’s experience in conducting reform and to tap into the expertise of its member States. It has also led to a greater awareness of the differences but also the similarities that exist between Arab countries and paved the way for regional co-operation, with those countries which are most advanced in their respective fields leading the way in the reform process. The Arab countries have also developed co-operation at national level, in areas of more specific interest to them, through in-depth exchanges of experience, North-South and South-South transfers of expertise and peer reviews. As a result of this work, a number of Arab countries have chosen to sign up to OECD instruments or to set common standards, in particular as regards the fight against corruption. A number of them have also established regional centres to train their civil servants and disseminate best practices. The OECD Secretariat has drawn all this experience together in a progress report on public governance reform in the MENA region (2010), which provides an original collection of common data that countries can use to gauge their progress and follow up their reforms.

35. Among the various country-specific co-operation activities, the Initiative to Support the Palestinian National Authority deserves a special mention. The Palestinian National Plan is designed to lay the foundations for a State based on the internationally recognised principles of good governance and the rule of law, on which to build infrastructure and the economy. One of the main themes chosen by the Palestinian National Authority within the framework of this co-operation is capacity building in the field of regulatory policy, so as to improve the rule of law and create a more secure legal environment for citizens and businesses. The aim is to increase the capacity of staff in the legislative and regulatory process and to bolster regulatory institutions. The co-operation is also about achieving greater integrity, with an assessment of existing systems and, in particular, the code of conduct for public officials. The third area is e-government which, given the

limited mobility of the Palestinian population, is a particularly important factor in better access to public services, the simplification of administrative procedures, more transparent regulation and, hence, anti-corruption efforts.

36. Since 2011, the Arab Spring has prompted the OECD to step up its co-operation programme with the Arab countries, but also to re-examine it in order to consider how best to respond to the new circumstances. At the ministerial meeting in May 2011, OECD ministers reiterated their commitment to this co-operation, saying that “governance reform plays a prominent role in supporting economic growth and development”, and asked the OECD to develop proposals for further work in this area. At the same time, the G8 countries launched the Deauville Partnership and likewise asked the OECD “to deepen this collaboration aimed at improving policy frameworks for investment and governance and advancing the structural reform agenda”.

37. They further highlighted the relevance of “the accession to and implementation of international instruments in the fight against corruption, such as the United Nations Convention against Corruption (UNCAC) and the OECD Convention on Combating Bribery in International Business Transactions, and other related instruments on government integrity and transparency”. With its knowledge of good practices and its experience with peer-to-peer exchanges, the OECD was invited to participate in the International Financial Institution co-ordination platform. The OECD is also involved in the co-ordination network set up with the United Nations, the Arab League and the Union for the Mediterranean.

38. In order to better meet the needs of Arab countries in the new political context and ensure that the projects undertaken were relevant, the OECD conducted in-depth consultations with government officials from the participating countries, but also with private sector and civil society actors and international organisations active in the region (including the World Bank, the United Nations Development Programme (UNDP) and the Arab Administrative Development Organization (ARADO)). These consultations showed that the MENA countries were all eager to pursue co-operation with the OECD, taking the view that the “OECD method” was very helpful for countries embarking on reform. By drawing on OECD members’ experience and standards, each country could advance at its own pace, developing high-quality institutions. The Arab countries also pointed out that co-operation networks on specific themes, which did not exist in the region, fostered greater regional integration, one of the keys to future growth and development.

39. The OECD countries and MENA countries thus jointly decided to strengthen and deepen co-operation in the existing regional networks, by refocusing their priorities slightly. The chosen themes relate mainly to:

- promoting clean and efficient governments, by addressing, for example, the risks of corruption, in particular at the interface between the public and private sector, in key areas such as public procurement, by setting up anti-corruption agencies and institutional mechanisms such as codes of conduct, and achieving greater efficiency and transparency in the management of public funds;
- strengthening democratic governance and open government, by looking at how to establish more participatory policy-making processes, through consultation procedures and the use of ICT tools to facilitate participation;
- promoting regional development so as to foster sustainable growth and reduce disparities between territories and between categories of the population;
- creating a better business climate for jobs, by focusing for example on SMEs, access to finance and competition policies to support both entrepreneurs and consumers;
- promoting business integrity, corporate governance and responsible business conduct, using OECD instruments;
- promoting gender equality, with, for example, the setting up of a think tank to combat legal discrimination and promote women’s integration in the economy, drawing, *inter alia*, on the OECD-MENA Women’s Business Forum.

40. At the same time, as part of the Deauville Partnership, Egypt, Jordan, Morocco and Tunisia have presented development plans, which will be implemented with the help and financial support of the G7 and international financial institutions, and for which the OECD intends to provide assistance in its areas of expertise. As well as the public and corporate governance projects, the OECD is planning to conduct analyses highlighting the links that exist in these countries between economic performance and structural policies, so as to prepare the ground for strategies and plans that are both prudent and reform-oriented.

41. In the realm of development assistance, the Arab Co-ordinating Group Institutions (ACGI) and the OECD Development Assistance Committee (DAC) held a special High-Level Partnership Dialogue in London on 4-5 July 2011. It was the first time in more than twenty years that the two donor communities had met at

senior level. The event – which was also attended by key multilateral institutions and distinguished international experts – took place against the backdrop of historic political change in the Middle East and North Africa region. Discussions focused on how the international development assistance community could best support the message for dignity, freedom, self-determination and social justice taking root and spreading across the region. They also addressed sequencing issues and broader policy coherence concerns. The concluding statement reaffirmed the commitment to a renewed partnership across the two donor communities, and acknowledged the centrality of closer co-operation in the MENA region and beyond.

42. In order to help improve co-ordination and avoid duplication, in 2011 the DAC conducted a survey of donors' ongoing and planned support programmes in the area of governance to countries of the Middle East and North Africa following the Arab Spring. The survey revealed three broad priority funding areas: (i) humanitarian assistance in the short term; (ii) facilitation of democratic transition, including gender equality and human rights in the medium term; and (iii) support for a move towards longer-term economic development and democracy to address unemployment and poverty issues. Responses also indicated that development agencies, along with their foreign ministries, have been reflecting collectively on strategic, cross-governmental responses and working towards enhanced partnership and engagement agreements as part of facilitating political dialogue. The preliminary survey results were distributed to the above-mentioned Joint ACGI-DAC High-Level Partnership Dialogue. An update on existing efforts, remaining challenges, and recent demands one year after the Arab Spring is under way since August 2012.

5. A financial transaction tax?

43. During the debate last year, the enlarged Assembly adopted an amendment to the resolution, urging the OECD to explore the options for introducing a global financial transaction tax (FTT). The OECD has submitted its analysis in response (see Appendix 1). I note that the organisation, “while not supporting a general FTT”, suggested that governments consider introducing a financial transaction tax limited to over-the-counter (OTC) derivatives transactions, even though “the best option would probably be a regulatory solution that forces OTC trades onto regulated exchanges”. I also note that the Canadian delegation does not support the idea of a financial transaction tax. Our colleague Hermine Naghdalyan has prepared a report on “Restoring social justice through a tax on financial transactions” for the Committee on Social Affairs, Health and Sustainable Development ([Doc. 13017](#)).

6. The role of rating agencies

44. The role of rating agencies has been widely criticised in Europe in the context of the sovereign debt crisis and we therefore sought the OECD's opinion on the matter. The OECD acknowledged (see Appendix 2) that the role of rating agencies had become increasingly pro-cyclical. The organisation also indicated that principles are being developed by the Financial Stability Board (FSB), which start from the basic idea that banks, market participants and institutional investors should be expected to make their own credit assessments, and not rely solely or mechanically on external ratings. It also notes that despite the increased regulatory activity, key issues still remain to be resolved but these are not often within the power of law makers.

7. Conclusions

45. Some time ago, the *Economist* magazine wrote that “something is very wrong with the world economy. That something is a combination of faltering growth and a rising risk of financial catastrophe. Economies are weakening across the globe. The recessions in the eurozone's periphery are deepening”.

46. The most recent OECD Economic Outlook, published in June 2012, set out projections under which growth overall would remain subdued with a muted and possibly bumpy recovery in OECD economies and emerging economies continuing to make a substantial contribution to overall demand. The main risk factors included a failure of policy makers to address key issues, particularly the financial and economic stability of the euro area as well as its low growth potential. So far, the most severe downside risks have been avoided but there are increasing signs of the real economist cost of the euro area crisis in terms of weak demand and rising unemployment. Prospects have weakened since June in the United States, across most emerging economies and notably in euro area countries under market pressure.

47. While much has been undertaken in terms of reform in Europe since the beginning of the crisis, the OECD economic surveys of the European Union and euro area indicate substantial unfinished business in terms of the creation of a banking union and structural reforms to boost growth and competitiveness. These

include in particular measures to complete the single European market, but also employment-oriented labour market reforms. The OECD has argued for an efficient firewall and supported the strategy of the ECB to take all the necessary measures. In order to restore competitiveness and growth, the OECD supports European governments in defining an ambitious reform agenda including new sources of growth like innovation and green growth, deregulation, labour and product market reforms, social policies and the necessary investment in skills and education.

48. It is up to Europe's politicians to deal finally and firmly with the euro. Coming up with a credible solution, following the strong actions outlined by the ECB, does not guarantee a smooth ride for the world economy; but not coming up with a solution could guarantee an economic disaster. It is against this background that the enlarged Assembly's debate on the activities of the OECD is taking place this year.

49. During its June 2012 part-session, the Assembly adopted [Recommendation 2002 \(2012\)](#) and [Resolution 1885 \(2012\)](#) on the young generation sacrificed: social, economic and political implications of the financial crisis, [Resolution 1884 \(2012\)](#) on austerity measures – A danger for democracy and social rights, and [Resolution 1886 \(2012\)](#) on the impact of the economic crisis on local and regional authorities in Europe. All these texts point to a reorientation of the programmes to combat the crisis in order to promote economic growth while protecting the most disadvantaged groups of the population, in particular young people.

50. The dangers to democracy posed by the crisis were highlighted during the debates on these reports. If, on the one hand, it is for each country to decide on the measures which better suit its situation, on the other hand, European solidarity is essential and a sharing of certain competencies, including budgetary competencies, among the States in the euro area, seems inevitable.

51. The OECD's recommendations to "go structural", "go social", "go green" and "go institutional" seem to define an effective and adequate policy mix for a way out of the crisis. The Assembly may wish to discuss concrete policy actions along those lines.

52. In June 2012, the Assembly also adopted [Resolution 1888 \(2012\)](#) on the crisis of democracy and the role of the State in today's Europe, which analysed the relationship between governance and the crisis, as well as the dangers to democracy linked to certain measures taken in response to the crisis. It concluded that Europe needs sound States based on strong democracies, a topic on which the OECD has also put quite some of emphasis in its recent work. Sound institutions and strong governance system were seen as the basis to build confidence for businesses, workers, households and citizens ("go institutional."). The enlarged Assembly suggests a future report, based on the present resolution, on the OECD's work in the area of public governance. An important step in this direction could be the OECD contribution to the Parliamentary Assembly report on the impact of the economic crisis on local and regional authorities in Europe, currently under preparation.

53. Also during the June 2012 part-session, the Assembly adopted [Resolution 1892 \(2012\)](#) on the crisis of transition to democracy in Egypt, and [Resolution 1893 \(2012\)](#) on political transition in Tunisia, which followed up its work on the Arab Spring. It recalls once again its [Resolution 1831 \(2011\)](#) on co-operation between the Council of Europe and the emerging democracies in the Arab world, and it confirms its readiness to share its experience in democratic transition to facilitate the political transition in these two States.

Appendix 1 – Financial transaction tax – Benefits and drawbacks

(Information provided by the OECD)

Objectives of a financial transaction tax

The financial crisis has revived support for a financial transaction tax (FTT) and such a tax is now under consideration by several countries, notably in Europe. Supporters of an FTT usually aim at raising revenue from the financial sector and increasing financial stability by preventing bubbles and reducing the risk of financial market crashes. The ease of collecting revenue with an FTT is also often stressed. Opponents typically stress the distortion that such a tax is likely to create, mainly by reducing liquidity and increasing the cost of capital. It should be noted that, since most taxes are associated with distortions, the real issue is not whether an FTT creates distortions, but whether they are worse than for other taxes. This section provides a brief overview of the benefits and drawbacks of a general FTT (drawing on previous work for the OECD *Economic Outlook 71* and for the OECD's Committee on Financial Markets.)

Benefits of a general FTT

- **Revenue-raising motive:** a moderate financial transaction tax applied to a broad range of financial assets could raise non-negligible amounts of revenue, provided transactions do not leak outside the jurisdiction imposing the tax. Transaction tax is easy to levy on exchange traded instruments, but more complex for over-the-counter (OTC) trades. For example, the United Kingdom stamp duty – a 0.5% FTT on the trading of shares registered in the United Kingdom – raises roughly 0.3% of its GDP, with only an estimated 20% of share-trading on the London Stock Exchange being subject to this duty. There are, however, other ways of raising additional revenues from the financial sector that may be less distorting, such as removing the VAT exemption of financial services, developing alternative financial activities taxes on value-added and taxes based on the balance sheet of financial institutions. The latter would also provide incentives to financial institutions to reduce the size of their balance sheets, which would contribute to financial stability.
- **Financial stability concerns:** whilst possible social benefits and risks emanating from high frequency trading (HFT) are poorly understood, HFT is widely believed to have caused the May 2010 “flash crash”. Even a very small FTT could strongly reduce HFT.

Drawbacks of a general FTT

- **Turnover and liquidity:** FTT reduces turnover and liquidity in markets, thereby potentially affecting market efficiency. This helps explain why many existing analogues to an FTT, such as the United Kingdom stamp duty on share transactions, exclude many transactions from the tax base. There is little evidence that an FTT – as sometimes claimed – can help to increase the efficiency of price finding in markets.
- **Displacement of financial activity:** FTTs may drive activity to other countries that do not levy such taxes, an effect that may be particularly large for countries with less important financial markets. For shares and bonds, such migration of activity could, however, be largely mitigated by administrative measures. The use of derivatives could also increase if they can be used to avoid FTTs, underlining the need for carefully designing FTTs to avoid undesired consequences.
- **Cost of capital and investment:** by increasing transaction costs, FTT may raise the cost of capital. To the extent that monetary policy reacts to the changed outlook by lowering interest rates, an FTT may change relative interest rates by effectively decreasing the cost of capital for less liquid, and raising it for more frequently traded financial assets. An FTT raising the same amount of revenue as a corporation tax from future investment projects will, for a given distribution of potential investment returns and provided profits are not shifted abroad in response to a higher corporate tax, impose a higher effective tax rate on marginal investment projects.
- **Asset prices changes:** capitalising the increased transaction costs associated with an FTT into the value of assets, such a tax tends to reduce the value of assets. However, if the change in cost of capital is mainly relative, the effect on asset prices might also turn out to be just relative. Under those circumstances, an FTT may result in a decrease in the price of the most frequently traded assets, while raising the price of the less liquid ones.

Evaluating the effects of a general FTT

All in all, a moderate financial transaction tax applied to a broad range of financial assets could raise non-negligible amounts of revenue. It may also have moderate benefits for financial stability by reducing the risk of crashes, even if the effect of an FTT on volatility is unclear. Such effects may, however, depend on other policies and structures in place.

In any case, an FTT would not have prevented the global financial crisis, and more generally does not solve the problem of financial bubbles: many countries have experienced housing market bubbles in spite of housing transaction taxes of several per cent. To achieve given revenue, an FTT may have a more negative effect on investment than some other forms of taxation, but such relative effects are difficult to assess. An FTT would also likely reduce market liquidity and change relative costs of capital. Its effective incidence and, therefore, overall distributional impact is complex and hard to predict. Finally, an FTT would not only fall on bad, but also on good financial transactions.

Against this background, the OECD's Expert Committee on Financial Markets has in the past expressed a negative opinion of FTTs, even though it was open to a financial activity tax, which would be levied on the balance sheet of financial institutions. Nonetheless the experience of a large number of countries that have used FTTs – including the United Kingdom, Switzerland, Hong Kong, Singapore and Taiwan – suggests that modest and well-implemented FTTs are feasible without causing major financial market distortions.

A specific FTT on OTC derivative transactions

While not supporting a general FTT, the OECD Secretariat suggested governments consider introducing a financial transaction tax limited to OTC derivatives transactions which is different from a general FTT.⁴ The best option would probably be a regulatory solution that forces OTC trades onto regulated exchanges, as proposed by the Financial Stability Board (FSB), but as long as such a solution has not been implemented, the rationale for considering a transactions tax in the form of a regulatory charge to be applied to the over-the-counter (OTC) derivatives market is as follows:

- The OTC market is already characterised by a high degree of illiquidity, so the standard objection that FTT has a negative impact on liquidity may not apply or matter.
- The charge would raise the cost of derivatives, resulting in higher bid/ask spreads in the OTC markets to cover the additional cost. This would reinforce the demand for standardisation, clearing and trading on exchanges, and help to reduce the trend towards less socially useful derivative activity.
- The incidence of the charge would fall more on active trading of a short-term gambling/churning nature in those institutions where such trades were concentrated, rather than on longer-term final-user hedging in the corporate sector. It would thereby lengthen the holding period of derivative products. In OTC markets, where assets are rarely traded, taxing transactions is also fairly similar to directly taxing the stock of assets, which is an attractive feature as it makes the tax somewhat more similar to a financial activities tax.
- Accumulating at least part of the revenues in an insurance fund would help to underwrite the solvency guarantee of central counterparties.

4. A. Blundell-Wignall and P. Atkinson, "Global SIFIs, derivatives and financial stability", *OECD Financial Market Trends*, Vol. 2011, Issue 1, www.oecd.org/dataoecd/62/10/48299884.pdf.

Appendix 2 – Credit rating agencies: issues and initiatives

(Information provided by the OECD)

The issues

Credit rating agencies (CRA) have been strongly criticised for their failures in rating collateralised debt obligations (CDOs) prior to the financial crisis. Their rating of sovereign debt has also become a controversial issue in the European Union/euro zone, with frequent calls by the European Parliament for a European CRA Foundation⁵ and bans on some sovereign ratings, the latter strongly advocated by the European Commission.

The analytical issues are complex since they involve market expectations about the probability of future events. CRAs are not agencies but rather normal commercial companies, so that business models and incentives are equally important as regulation to market outcomes.

Several issues stand out:

- The market is a natural oligopoly due to the importance of reputation that can only be obtained with a track record. Thus competition is weak. Under these conditions new entrants might compete by raising ratings (in other words, potentially a race to the bottom) and lowering fees. This is said to have happened when Fitch entered the United States market.
- Aggravating the situation is the “issuers pay” method of remuneration which means that issuers can search for ratings as happened with CDOs prior to the crisis.
- Conflicts of interest are potentially important since CRA also advise companies about how to achieve better ratings.
- The information they release is open to all and so is in the nature of the public good. It is also used by regulators and investors alike and might contribute to sudden price movements (the cliff effect) and procyclicality.
- Methodologies are proprietary in nature only the results being observed by users. It is not necessarily bad but can lead to problems.

Regulatory response

In response to earlier problems such as Parmalat and Enron, the issue of oversight of CRAs was taken up by the International Organization of Securities Commissions (IOSCO) in 2006 and again in 2008 via a strengthening of voluntary codes. The OECD Principles of Corporate Governance also addressed the issues surrounding CRAs in the 2004 revision. The United States, the European Union, Canada and Australia have all recently introduced mandatory registration and oversight. The United States and the European Commission have both reacted in ways that reflect their different starting points. The United States has favoured civil litigation by removing protection of CRA and by changes to the market structure through lower barriers to entry. Public enforcement and regulation have been favoured in Europe.

In addition, a number of financial regulators have moved to change the way in which ratings are used. Work is under way both in the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) to reduce, where possible, the mandated use of external ratings by the financial sector. The BCBS is working to address adverse incentives arising from the use of external ratings in the regulatory capital framework, while the FSB is developing general principles to reduce authorities’ and financial institutions’ reliance on external ratings.

The principles being developed by the FSB start from the basic idea that banks, market participants and institutional investors should be expected to make their own credit assessments, and not rely solely or mechanically on external ratings. The latter cannot be ensured by law alone, but requires appropriate incentives. The design of regulations and other official sector actions should support this basic aim.

5. Fitch is located in the United States but is French owned.

Overall assessment

Despite the increased regulatory activity, key issues still remain to be resolved but these are not often within the power of law makers:

- Barriers to entry by new ratings companies remain to be addressed together with the danger that increased competition can sometimes lead to a reduction in ratings quality. Registration and oversight are only a partial response.
- Local presence requirements by the European Union (in other words ratings done in a third country must be endorsed by a CRA registered in the European Union regardless of the issuer) will discourage new competitors since local presence is expensive.
- The issuer pays principle needs to be reconsidered and broadened to include the trading platform.
- Many issues concern the use of ratings by investors such as the “cliff effect”, when all leave a security when a rating is changed. This also leads to procyclicality in financial investment and in prices. However, a solution goes far beyond regulation since it needs to address incentives facing institutional investors.
- Removing reference to ratings in financial market regulation is a positive step. However, private investors will undoubtedly continue to use them as a basis for action, something that is outside the control of law makers.
- Banning ratings would not remove uncertainty from the market, especially for sovereign debt. Journalists are often more important in moving markets than CRAs.
- Auditor rotation is one thing, CRA rotation is quite another. CRA rotation may discourage new entrants. The European Parliament is now scaling back proposals on such rotation.