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OECD Economic Outlook: A more pragmatic approach to economic policy at a time of crisis

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Key findings

- The first issue of the 2020 OECD Economic Outlook provides a full picture of the economic hardship caused by the COVID-19 and measures taken against the epidemic spread, and the grim outlook for the next eighteen months. In the case of a comeback of the virus before the end of the year, and new confinement measures, **global GDP will fall by -7.6% in 2020, only to recover to 2.8% in 2021**. The situation is particularly dire for the OECD and the euro area, where GDP could fall by -9.3% and -11.5%, respectively. The crisis is bound to leave long-lasting scars, bringing average real income per capita in the OECD area back to 2013 levels. In the case of a complete control over the virus diffusion from now to the end of the year, the GDP loss will be slightly more contained, but still very significant.

- In this context, the OECD recognises the **unprecedented fiscal and monetary effort** taken by governments in fighting the recession, and urges them to maintain expansionary policies as long as needed. Contrary to well-entrenched stances on the nature of public debt, the publication opts for a pragmatic view, acknowledging that government deficits are bound to skyrocket in order to combat the crisis in the short term, but that this does not pose a threat to debt sustainability, as long as economic growth is secured.

- The report does not dwell extensively on the longer term structural reform agenda. However, it does refer to traditional **supply-side reform** recipes, built around the trade-competition-labour flexibility tryptic. The TUAC has questioned over the years the ability of such reforms to deliver expected results in terms of GDP growth, let alone inclusive growth, as advocated by the OECD, in the absence of a wage-led growth model.

- Also, while soliciting governments to maintain **free trade and investment flows**, the Economic Outlook does not question whether any of the existing features of globalisation should be revisited, such as the excessive corporate and market concentration, or the race to the bottom in terms of labour and environmental standards.

15, rue La Pérouse – 75016 Paris – France
Tél. (33) 01 55 37 37 37 – tuac@tuac.org

- On **tax reform**, the Economic Outlook offers fairly novel views (compared to some of its past recommendations) by suggesting to make systems more progressive by focusing on tax distributional effects, as well as increasing carbon taxes while reducing fossil fuel subsidies. Concerning digital taxation, the OECD explicitly calls for a minimum taxation, raising the bar and the expectations for the on-going "Pillar II" tax negotiations.

- The messages on the **conditionality to business support** are mixed. On the one hand, the Economic Outlook agrees that support should be conditional to job preservation, while avoiding dividend payments and CEO compensations. On the other, it warns against excessive public support, particularly to unviable firms. However, at this time it could be overly complicated for governments to distinguish between business with liquidity problems and those that are just not competitive on the market. An overly prudential support policy could therefore do more harm than good. The issue of record high corporate debt predates the COVID-19 crisis, and should be carefully addressed. In the absence of intervention, the risk of a financial crisis is real. If liquidity injections prove insufficient, public equity stakes in private companies could be a solution, although the OECD is not clear yet on the exact conditions. According to the TUAC, another privatisation of gains and mutualisation of losses at the expense of the public sector, as it was the case in 2008, must be avoided.

- When it comes to **labour markets**, the renewed focus on non-standard forms of employment, and the need to design inclusive social safety net measures to preserve jobs and incomes of most exposed workers, is welcome. However, it fails to recognise that the COVID-19 crisis hit a structurally precarious labour market, which albeit painfully recovering employment levels since the global financial crisis of 2008, has not delivered job quality and resilience. Therefore, new optics are not only needed when addressing the role of the public sector as a key economic actor in the economy, but also in acknowledging that traditional structural reforms, including labour market flexibilisation, have not delivered sustained and inclusive growth, and that a new paradigm is required to this end.

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The deepest recession since the Great Depression

The latest OECD Economic Outlook (2020) provides a daunting picture of the global economy. Countries are slowly navigating their way through the COVID-19 pandemic, which the OECD depicts as both a «global public health crisis without precedent in living memory» and «the deepest recession since the Great Depression in the 1930s».

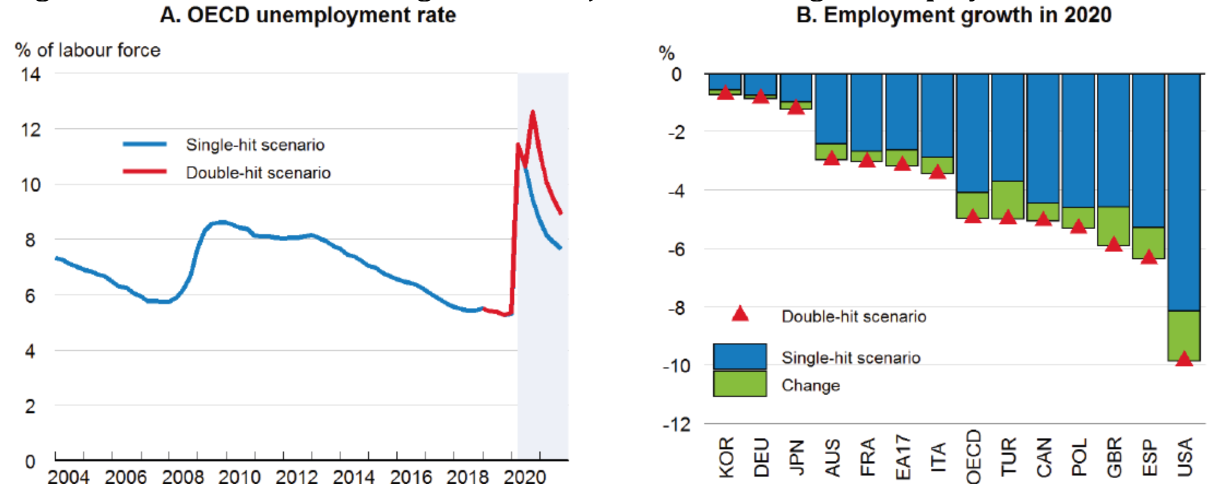
This year's economic outlook is therefore particularly uncertain, as the speed and shape of the recovery will depend largely on how the general health situation evolves. If the coronavirus gradually fades away and confinement and lockdown measures are lifted, the economic recovery will be smoother than in the well-possible case of a revival of the pandemic before the end of the year, with a stop-and-go recovery scenario.

GDP and unemployment forecasts, another lost decade?

Given the circumstances, the OECD provides two different growth scenario, in case of a single-hit (the current containment measures are assumed to successfully overcome the viral pandemic) and double-hit recession (The current easing of containment measures is assumed to be followed by a second, but less intensive, virus outbreak taking place in October/November). In both cases, the GDP fall at the end of 2020 will be sharp and outpace growth levels for 2021, indicating that the concentrated fall in GDP in the first half of 2020 will not be re-absorbed for the foreseeable future. In particular, world GDP will fall in 2020 by -7.6% (-6%) in the double-hit (single-hit) scenario, only to recover by 2.8% (5.2%) next year. The situation is particularly harsh for the OECD (-9.3% and -7.5% in the respective scenarios) and the euro area (-11.5% or -9.1%).

Unemployment in the OECD area is bound to almost double from record low levels in 2019, 5.4%, to 9.2% in 2020, only to withdraw to 8.1% in 2021 (Figure 1). As was the case after the global financial crisis of 2008 and onwards, the risk of unemployment becoming structural is very high, pushing millions of workers permanently out of job, while putting those in work under further employment and wage pressure.

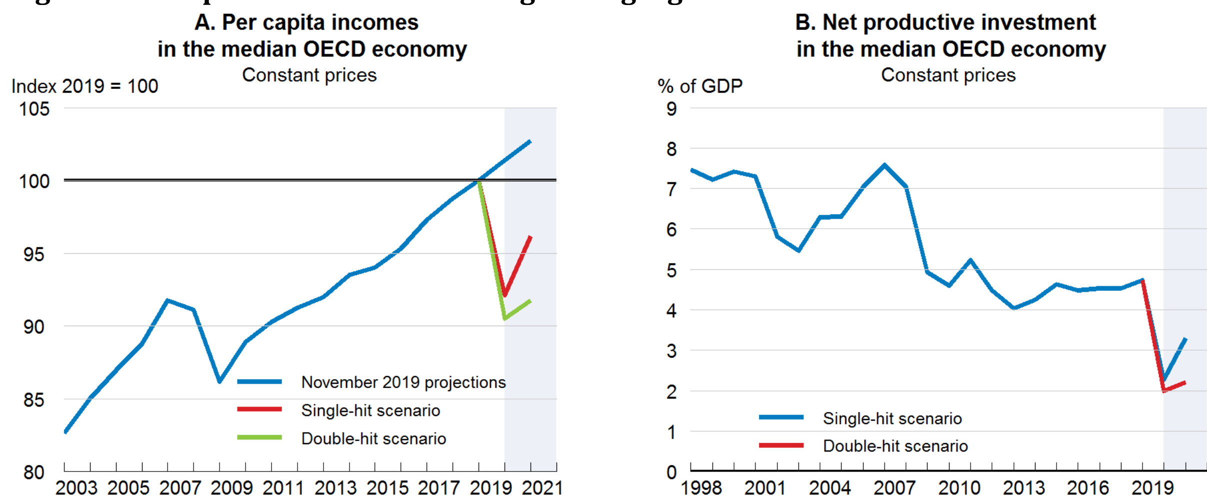
Figure 1 - The crisis is resulting in sizeable job losses and high unemployment



Source: OECD Economic Outlook 107 database, https://doi.org/10.1787/888934140202.

According to the Economic Outlook, real income per capita in the OECD area is bound to recoil to 2013 (2016) levels in the double-hit (single-hit) scenario. Perhaps the most telling, and alarming graph of the report is the one exposing the dramatic fall in income per capita expected under both scenario, and compared to the 2008 crisis (Figure 2). It also shows the continuing erosion both in public and corporate investment, despite the massive quantitative easing programmes implemented after 2008.

Figure 2 - The pandemic will leave long-lasting legacies



Source: OECD Economic Outlook 107 database, https://doi.org/10.1787/888934140259.

Fiscal and monetary response: a much welcome call for sustained support

The OECD acknowledges the prompt public countercyclical intervention enacted in order to preserve the economy. Expansionary fiscal and monetary policies allowed to increase quickly health expenditure in order to fight the COVID-19 pandemic, but also secured liquidity to businesses, preserved jobs where retention schemes were reinforced and

social safety nets, particularly unemployment benefits. Consequently, government deficits for 2020 skyrocketed and public debt is bound to rise considerably.

The Economic Outlook does not only support the need for such policies in the face of a fragile recovery, but calls for a prolonged fiscal and monetary intervention. According to the OECD, «extensive fiscal, monetary and financial policy responses will help underpin household incomes, employment and firms' cash-flow, and minimise longer-lasting scars for the economy» (p. 39), particularly in a prolonged crisis scenario.

It is important to highlight a remarkable OECD move from traditional stances on the containment of public debt as a priority government goal, towards a more complex vision of what makes a debt "sustainable" beyond its ratio to GDP. In particular, given the risk associated with a prolonged recession and in the context of an accommodative monetary policy, «a one-off shock to the level of debt may not on its own endanger debt sustainability when economies recover: what matters is the dynamics of the debt that must be controlled. In the aftermath of the crisis, an excessively quick fiscal consolidation could stifle growth excessively, as some OECD countries experienced after the global financial crisis» (p. 50).

In other words, as long as public debt accumulates at a lower rate than GDP growth, its sustainability is assured, while it is clear that GDP growth is directly tied to the fiscal stimulus that governments will be injecting in the economy. This is in direct contrast to the austerity stances that characterised many OECD economies after the global crisis of 2008, and prolonged the so-called European sovereign debt crisis, which was in most cases aggravated by a downward spiral of public expenditure cuts in the hope to reduce the debt-to-GDP ratio in euro area countries. This is a lesson that many governments must yet acknowledge, before turning an externally-triggered recession – the COVID-19 – into a self-prolonged depression.

The "mounting threat of a reversal in globalisation"

Dealing primarily with the urgency of the crisis, the report does not dwell extensively on the longer term structural reform agenda. However, it does refer to the OECD Going for Growth publication, which traditionally provides at its core a supply-side reform recipe built around the trade-competition-labour flexibility tryptic. The TUAC (2019) has questioned over the years the ability of such reforms to deliver expected results in terms of GDP growth, let alone inclusive growth, as advocated by the OECD, in the absence of a wage-led growth model. Indeed, while the latest OECD report does not question the established reform priority settings, it does acknowledge that past decades' experience show how these reforms can harm growth, particularly if introduced at a time of recession and without adequate fiscal and monetary support to counteract their negative effects.

However, the Economic Outlook expresses concerns about the preservation of the current globalisation model, soliciting governments to «keep trade and investment flowing freely to prevent the mounting threat of a reversal in globalisation» (p. 53) and refrain from introducing export restrictions on essential goods. Yet, there is no question

whether any of the existing features of globalisation should be revisited, such as the excessive corporate and market concentration, or the race to the bottom in terms of labour and environmental standards. The only conceded opening, in the convoluted language of a «regulatory flexibility» (assumingly to traditional rules of free market competition, p. 54), is to national industrial policies to support innovation and to partially revisit the current structure of global supply chains, which has manifested its limits at the peak of the COVID-19 emergency.

A call for a review of the tax policy mix

In contrast with some of its past structural reform recommendations, the report offers fairly novel views, by OECD standards, on tax reform, when it «calls for a comprehensive review of countries' tax mix, taking into account growth considerations, as well as inclusiveness and sustainability, which may have a greater weight in fiscal policy-making after the crisis» (p. 52). A COVID-19 tax paper issued in April gave already the hint of a change of heart occurring at the OECD (see TUAC, 2020a). Now, the Economic Outlook calls for «revisiting the taxation of capital», «making the system more progressive where necessary» and, in a break with past recommendation, does not necessarily call for the usual increase in VAT and other consumption taxes, as «room for manoeuvre may be limited but should be explored where possible». Importantly, «whilst care should be taken over the distributional effects, the use of carbon taxes should be increased, and fossil fuel subsidies reduced».

In an allusion to the parallel OECD base erosion and profit shifting (BEPS) negotiations, concerning digital taxation, the OECD explicitly states that «ensuring that multinational enterprises pay a minimum tax would strengthen revenue raising capacity and could be seen to contribute to fair burden sharing» (p. 52). The principle of a minimum taxation may be trivial for anyone believing in fair taxation; for the OECD, however, such proposition is ground-breaking, and raises the bar and the expectations for the on-going "Pillar II" tax negations on digitalisation.

Mixed messages about public support to businesses, without ignoring the risks of the corporate debt bubble

The report addresses at length the impact of the crisis on businesses and the implications for current government support programmes (*Issue Note 2: Corporate sector vulnerabilities during the COVID-19 outbreak* & *Issue Note 3: Assessment of government crisis programmes to support businesses*).

The messages on the conditionality to business support with respect to employment, dividend payments, CEO compensations, are mixed. On the one hand, the Economic Outlook agrees that «the design of transfers and subsidised loans to corporations should ensure that firms preserve jobs when possible and do not divert resources toward exclusively private interests (e.g., to boost CEO compensation or dividend payments)» (pp. 87-88), and that «these restrictions are important to prevent moral hazard and support employment» (p. 93). Yet, it warns elsewhere that «they may turn out to be costly

and ineffective if support is provided to non-viable firms» (p. 49), making sure that «public support does not contribute to resource misallocation, for instance by propping up unviable firms» (p. 88). According to the authors, these restrictions could result in increased cost of refinancing debt and hence «weaken businesses' financial flexibility to invest in a manner that would sustain an economic recovery» (p. 93). However, it might be very difficult to assess clearly firms' viability in the early stages of the recession. Furthermore, recent evidence for Italy suggests that despite the generous liquidity injections provided under the Italian governments' emergency plan, the share and of so-called "zombie firms" that would unduly benefit from it remains very contained, compared to healthy businesses[1].

The Economic Outlook raises important alarms bells about the pre-crisis corporate debt bubble in the making. Well before COVID-19, the OECD documented how levels of private corporate debt were piling up at record levels (2020). Since 2008, non-financial corporations bond debt reached USD 13.5 trillion worldwide. Thanks to low interest rates, corporations were able to increase their leverage ratios while preserving credit ratings. However, 52% of issued bonds are rated BBB, which is the bottom line demarcating investment from non-investment grade bonds. Since 2010, approximately 20% of newly issued corporate bonds were below this line, up to 25% when considering bonds issued in 2019 only.

A deterioration of market conditions, spreading from stocks to bonds, could still lead to a significant share of corporate debt to fall under stress, bringing the private sector debt bubble to collapse. As current central bank and government support measures are targeted primarily to investment grade securities, leveraged firms with high-yield rate bonds, i.e. riskier, are likely to be left in the cold. The size of the phenomenon, between the United States and the euro area, is estimated at USD 4 trillion. The OECD analysis suggests that with current support plans in place, the proportion of highly leveraged firms, either «at risk» or «distressed», would rise considerably, to over 70% in the United States and over 40% in Europe.

Is government equity investment in private firms the answer? The report does not offer clear indications. Outright nationalisation and state-ownership have never been a preferred route for the OECD. Instead, the report elaborates on solutionssuch as «the use of retractable preferred equity» (p. 98), without delving into the practical conditions for rescued private operators. As such, the risk of another privatisation of gains and mutualisation of losses, at the expense of the public sector, could not be excluded. On a positive side, the report stresses that any government equity programme should rest upon «environmental, social and governance considerations toward sustainable finance. OECD principles for corporate governance, competition, and responsible business conduct» - we are told - «could help shape constructive behaviours during this exceptional period of government involvement, to support competitive markets as businesses exit temporary programmes» (p. 100).

[1] Schivardi, F. and G Romano, 2020, *A simple method to compute liquidity shortfalls during the COVID-19 crisis with an application to Italy*, mimeo.

At the frontline of the crisis: non-standard forms of employment

The OECD analysis delves into specific aspects of the labour market under the COVID-19 crisis (*Issue Note 4: Distributional risks associated with non-standard work*). One of this is the impact of the current recession on non-standard workers, i.e. part-time workers, self-employed and workers hired on fixed-term contracts.

Sectors that are most affected by lockdown measures, including in particular tourism, restaurants, entertainment activities and other services, roughly account for 40% of employment in OECD economies. Up to half of the workers employed in these sectors are subject to non-standard forms of employment, making them particularly vulnerable to the recession and less likely to be covered by traditional social safety nets. This is a conservative measures, as informal employment, which is particularly important in these sectors, is not accounted for.

This poses concrete challenges to the effectiveness of traditional and reinforced employment support measures across OECD countries at the time of COVID-19. For example, only one third of OECD countries has compulsory sickness insurance for self-employed workers, while application of short-time work schemes to non-standard workers is limited when not formally excluded.

The Economic Outlook recommends to ease access and expand coverage of paid-sick leave, short-time work schemes and unemployment benefits to non-standard workers. Yet, it fails to provide a dynamic picture of the phenomenon, which could highlight how the progressive flexibilisation and dualisation of the labour market across OECD economies has led to a rise of non-standard forms of work. This has not only hindered the quality of jobs across the OECD, but has made employment more fragile in face of unexpected shocks, such as the COVID-19.

While the OECD has long advocated the need to tackle the issue of a "dual" labour market, this has most often translated in reforms aimed at increasing labour mobility for all, rather than security, with increasing systemic risks to the countries. Indeed, the Economic Outlook suggests that structural sectoral changes brought by the current recession will require, in the not so distant future, a re-allocation of workers from declining to expanding sectors, accompanied by active labour market measures to smooth such transition. Yet, a more granular analysis of the working population, both at the demographic and sectoral level, would be required in order to assess properly the feasibility of such policy recommendations.

Flattening the unemployment curve

Correlating the depth of the GDP fall to the rise in unemployment across OECD countries, the Economic Outlook (*Issue Note 5: Flattening the unemployment curve?*) highlights how measures aimed at preserving existing jobs, such as short-time work schemes, have proven very effective at containing unemployment in the short run. This is particularly true in comparison to countries with highly flexible labour markets, such as the United

States. This outcome was also highlighted in the recent TUAC note on unemployment forecasts and the importance of collective bargaining (2020b).

According to the Economic Outlook, «searching for suitable jobs in terms of wage and non-wage attributes, such as location, working time or employer amenities, is costly for workers, as is the search of employers for suitable workers. Preserving existing jobs reduces such costs of matching employers to employees and may thereby promote a quicker labour market recovery as activity rebounds. To the extent that the COVID-19 shock is temporary and does not require a major reallocation of resources, freezing the existing allocation of resources by preserving existing jobs may also promote longer-term growth of employment and productivity by limiting the loss of firm-specific human capital» (p. 120).

Therefore, excessive layoffs do not only represent a dramatic professional and human cost to workers, but can also hinder firms' productivity levels once the economy starts recovering. Also, the OECD finds that opting for unemployment benefits may incentivise businesses to opt for firing workers instead than bearing the partial costs associated with job retention schemes. This is however an aspect that the OECD has not adequately reflected on other occasions, particularly when discussing "excessive" employment protection legislation.

It is true that «the challenge for policy makers is to find the right balance between measures to promote the preservation of jobs that are viable in the long term and the reallocation of workers in unviable jobs» (p. 124). Some of the suggested approaches can smooth this dichotomy, providing trainings to workers or allowing them to take up a new or second job without immediately losing the right to unemployment benefits or the protection of a job retention scheme. However, other tools such as the progressive removal of social benefits to incite workers to look for other opportunities should be weighed carefully against the risk of removing social protection too early, at a time when the uncertainty related to the duration of the health and economic crisis is still overwhelming. The enormous danger is to leave millions of workers uncovered before they stand a real chance at re-employment, undoing the protection provided in the first weeks of the COVID-19 emergency and definitely pushing our economies down the cliff.