Chapter 1. Macroeconomic background

This chapter gives an overview of the main macroeconomic trends up until 2017. The purpose of this overview is to provide background information to help understand tax revenue trends as well as tax policy changes. Tax policy reforms are closely connected with economic trends: tax revenues are affected by changes in macroeconomic conditions and economic trends themselves are key drivers of tax reforms.

Macroeconomic trends

This chapter provides background information on macroeconomic conditions up until 2017 in order to help understand tax revenue trends and tax policy changes. It covers recent trends in growth, inflation, productivity, investment, the labour market, public finances and inequality. Tax policy developments are closely connected with economic trends: tax revenues are affected by changes in the macroeconomic conditions and these developments themselves are key drivers of tax reform.

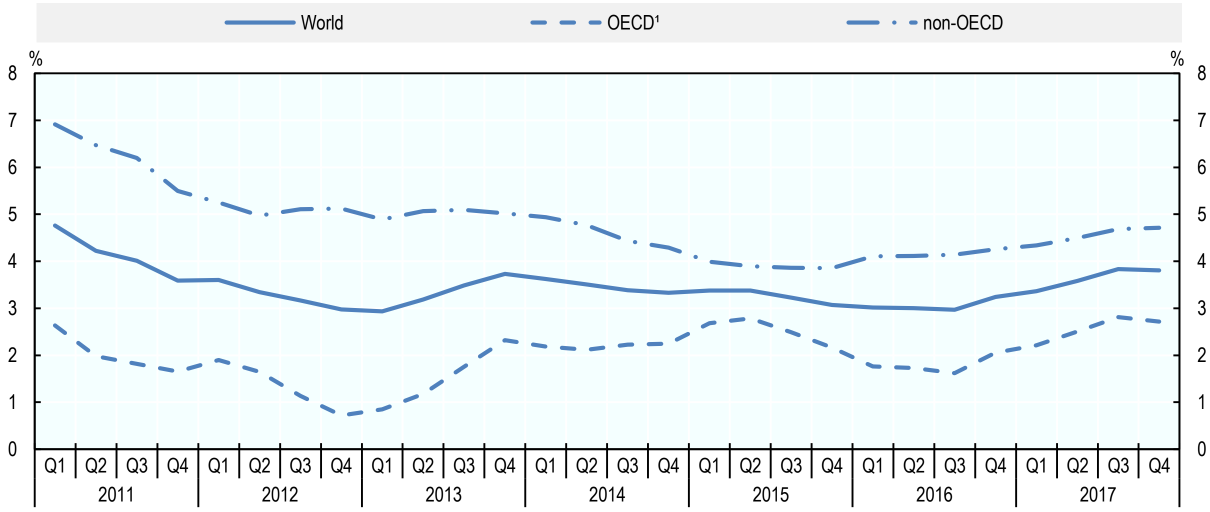
Global growth picked up in 2017 and became increasingly broad-based

Global GDP growth is estimated to have been 3.7% in 2017, the fastest pace since 2011, albeit still below the longer-term average of around 4% seen in the two decades prior to the financial crisis (Figure 1.1). The long awaited lift to global growth, supported by policy stimulus, was accompanied by solid employment gains and an upturn in investment and global trade. Whilst welcome, the cyclical improvement in consumption and investment remained short of that achieved in past upswings (Figure 1.2). Per capita GDP growth improved in the majority of OECD economies in 2017, but shortfalls in the years after the crisis have yet to be overcome (OECD, 2018[1]). The lingering effects of prolonged sub-par growth after the financial crisis also continue to be reflected in subdued productivity and wage developments.

The global cyclical upturn became increasingly broad-based in 2017, with output growth picking up in both OECD and non-OECD countries (Figure 1.3). Amongst the advanced economies, fiscal and monetary support as well as the rebound in global trade helped to underpin growth in the euro area and Japan as well as in many other small open economies strongly connected to the major economies via value-chain linkages. Growth also rebounded in the United States, with accommodative monetary policy, strong asset prices gains and steady real income growth supporting domestic demand. OECD GDP growth picked up to 2.5%, around 0.7 percentage points higher than in the previous year. The rebound in global trade and strong policy-driven infrastructure investment in China contributed to the upturn in the EMEs, boosting external demand elsewhere, especially in Asia and in many commodity-exporting economies. Growth also picked up in India in the latter half of 2017, as the earlier drags from demonetisation and the introduction of the goods and services tax began to fade.

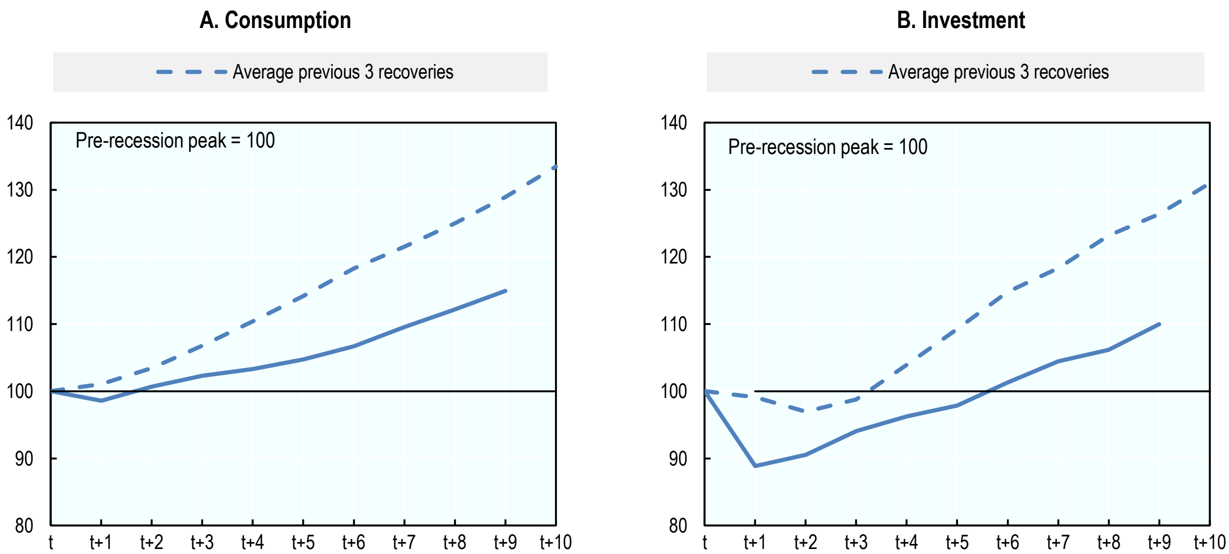
Figure 1.1. Real GDP growth

Year-on-year percentage changes



1. GDP measured using purchasing power parities.
2. With growth in Ireland computed using gross value added at constant prices excluding foreign-owned multinational enterprise dominated sectors.
Source: OECD Economic Outlook 103 database.

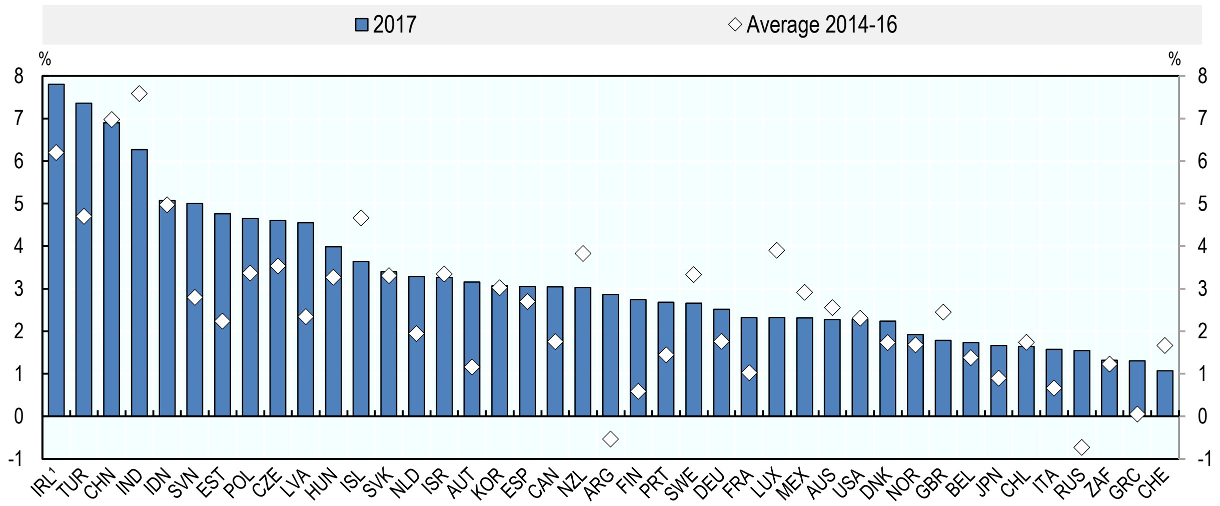
Figure 1.2. The recovery of consumption and investment in OECD countries



Note: Aggregate data for the OECD economies. Consumption is total consumers' expenditure and investment is total gross fixed capital formation. The average of the past three recoveries is an unweighted average of developments after 1973Q4, 1980Q1, 1990Q3 and 2008Q1. Series scaled to equal 100 in these quarters. All data are at constant prices.
Source: OECD Economic Outlook 103 database; and OECD calculations.

Figure 1.3. Real GDP growth in OECD countries

Percentage changes



Note: With growth in Ireland computed using gross value added at constant prices excluding foreign-owned multinational enterprise dominated sectors.
Source: OECD Economic Outlook 103 database; and OECD calculations.

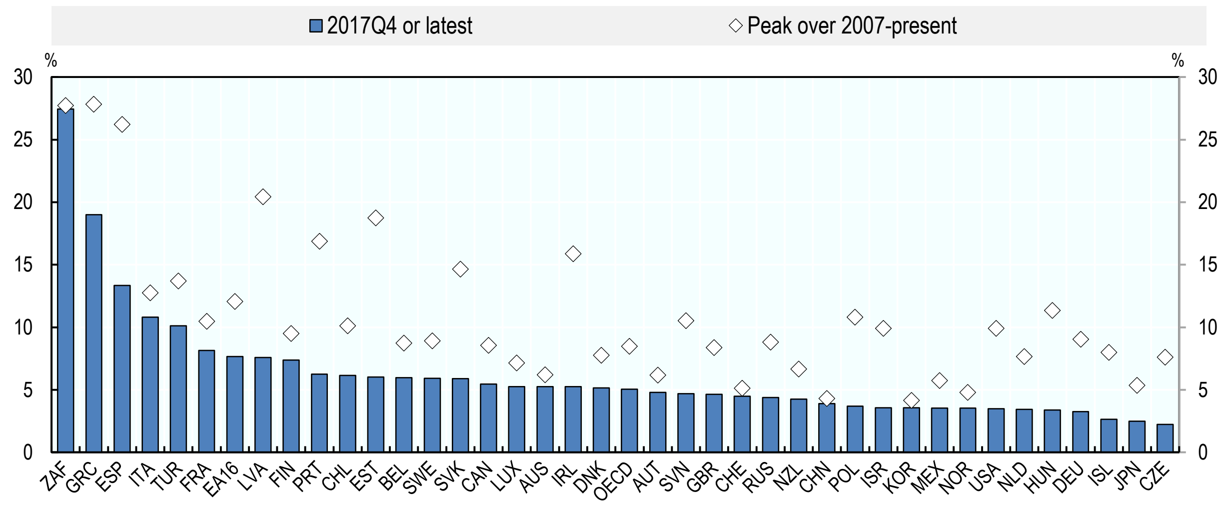
Labour market conditions continued to improve but the recovery in employment remained uneven

Labour market conditions continued to improve in 2017, with further declines in unemployment rates (Figure 1.4) and solid employment growth (Figure 1.5, Panel A). In the OECD as a whole, the harmonised unemployment rate fell to 5.5% by the end of 2017, marginally below the pre-crisis level. However, the level of unemployment remained elevated in some countries, particularly in some southern countries in the euro area (Figure 1.4). Long-term (over one year) and youth unemployment, and the number of involuntary part-time workers, still remained elevated. As of 2017, long-term unemployment represented 31% of total unemployment on average in the OECD economies (compared to under 25% in 2007), peaking at 73% in Greece and 59% in Italy. The large share of long-term unemployed people carries the risk of a rising number of discouraged workers - people who drop out of the labour force and experience skills attrition. Youth unemployment has declined from post-crisis peaks but still remains above pre-crisis levels in many OECD countries.

In most advanced economies, employment and labour participation rates are now above the level prior to the crisis, although the United States is a notable exception (OECD, 2017[2]) (OECD, 2018[1]). However, many OECD countries still have a high rate of involuntary part-time work compared with the pre-crisis level (OECD, 2017[3]). Wage growth generally remained subdued in the major economies, despite tighter labour markets (Figure 1.5, Panel B), in part reflecting weak productivity growth and low price inflation. However, some signs have emerged in early 2018 that wage pressures have begun to strengthen in several OECD economies (OECD, 2018[1]).

Figure 1.4. Unemployment rates in OECD countries

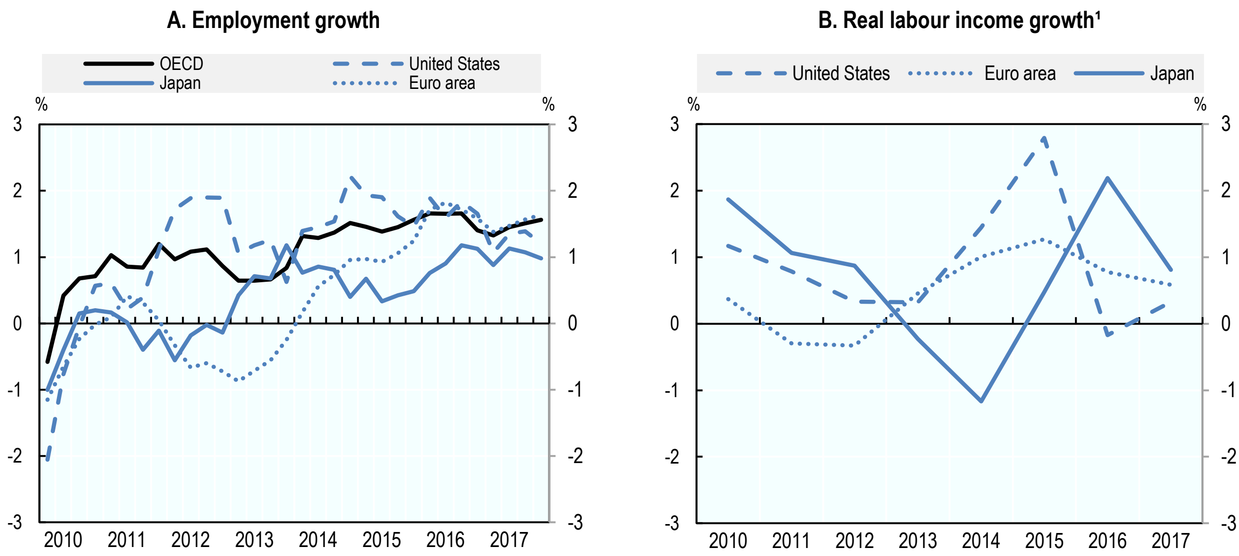
As a percentage of the labour force



Source: OECD Economic Outlook 103 database; and OECD calculations.

Figure 1.5. Employment and real income growth

Year-on-year percentage changes



Note: Labour income per employee deflated by the private consumption deflator.
Source: OECD Economic Outlook 103 database; and OECD calculations.

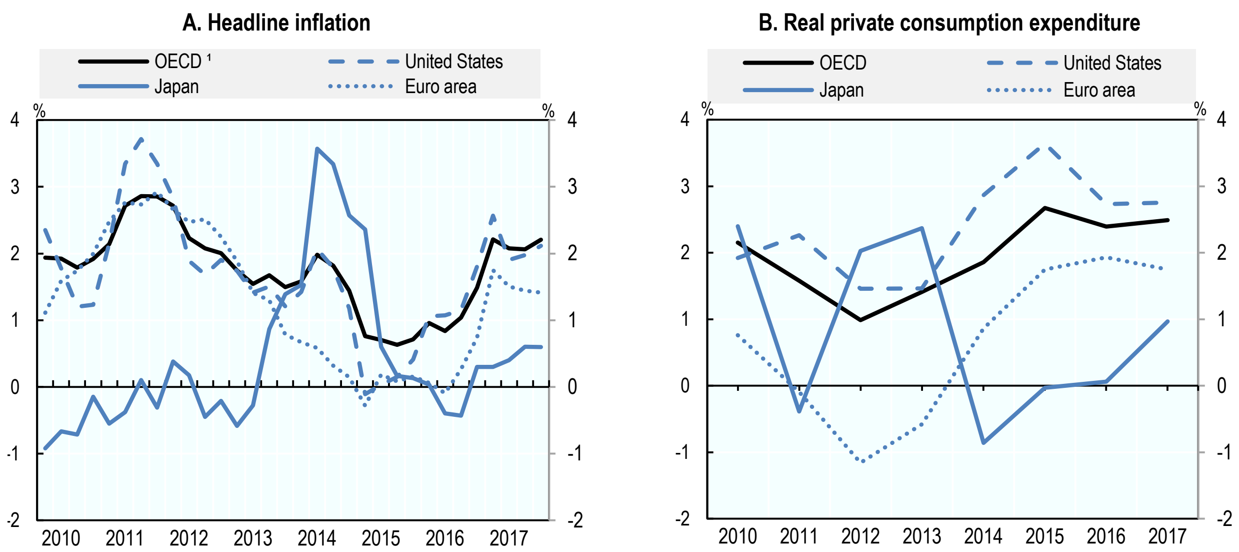
Subdued wage growth has checked consumption growth and inflation

Private consumption growth remained broadly unchanged in the major economies and for the OECD area as a whole in 2017 (Figure 1.6, Panel B) in spite of the broader upturn in output growth. Cross-country differences in consumption growth since the crisis remain closely associated with differences in real income growth, especially labour incomes (OECD, 2016[4]). Although rising employment has supported household incomes, subdued real wage growth contributed to modest household income growth in 2017 in most advanced economies, which partly explains the moderate pace of consumption growth.

Headline inflation was pushed up during the course of 2017 by a significant rebound in commodity prices during the latter half of the year. This reduced household purchasing power, at least temporarily. However, underlying inflation (i.e. excluding food and energy) generally remained subdued in the major OECD economies and below official medium-term objectives. Oil prices were boosted by strong demand, and the extension of production restrictions in both OPEC and selected non-OPEC members until the end of 2018. In turn, higher prices helped to improve the growth outlook for commodity producers and the revenue raising capacity of governments in commodity-exporting economies. Metals prices were supported over the year by both temporary supply shortages in some producing countries and strong demand, especially from China. Commodity-importing economies faced rising import costs and input price inflation in the latter half of 2017.

Figure 1.6. Real private consumption expenditure growth and inflation

Year-on-year percentage changes



Note: OECD aggregate is computed based on different indicators: United States: price index for personal consumption expenditure; euro area members and United Kingdom: harmonised index of consumer prices; and other countries: national consumer price index.
Source: OECD Economic Outlook 103 database; and OECD calculations.

Stronger investment growth is now supporting the broad-based recovery, but productivity growth remains low

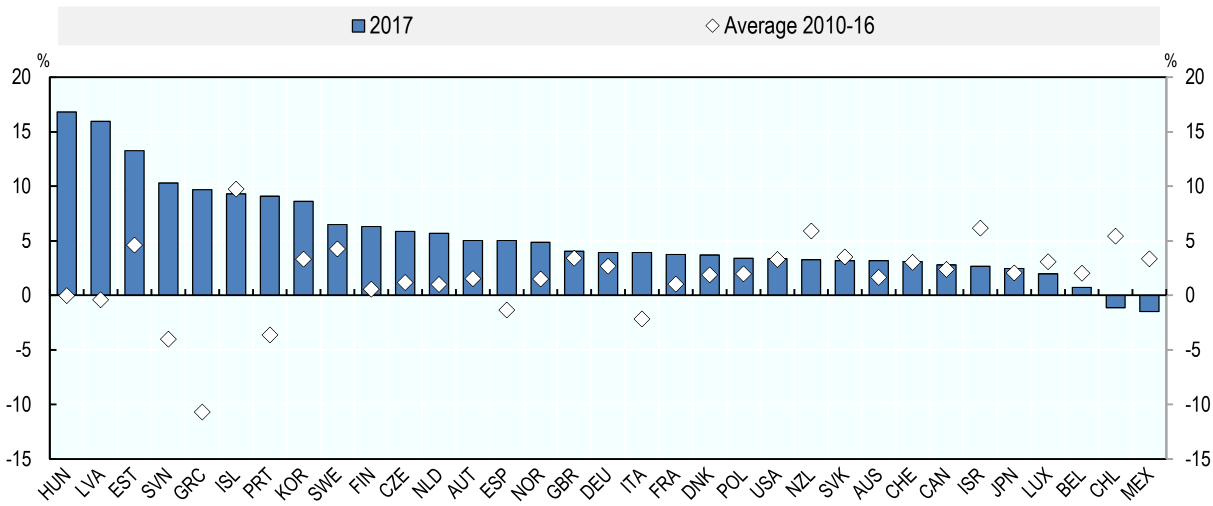
After having been subdued for a long period, fixed capital investment recovered in 2017, with the private investment growth rate outpacing its average since 2010 in many OECD economies (Figure 1.7). Total investment in the advanced economies rose by 3.6%, with business investment rising by 4½% (from under 2½% in 2016). Nonetheless, the investment upturn remained weaker than necessary to help bring growth of the productive capital stock back to pre-crisis norms, limiting prospects for productivity growth (OECD, 2017[2]). Factors holding back investment include diminished long-term growth expectations, a lack of business dynamism in some economies and uncertainty (OECD, 2018[1]). Resources trapped in unproductive firms (Andrews, Criscuolo and Gal, 2016[5]), and a slowdown of new reforms aiming to improve product market competition (OECD, 2018[6]) have also damped incentives to invest. Nonetheless, the recent upturn in investment suggests that some of these constraints may have begun to ease.

Global foreign direct investment (FDI) inflows declined by 18% in 2017 (OECD, 2018[7]). FDI inflows fell by over one-third in the OECD countries, largely reflecting lower inflows into the United Kingdom and the United States (two of the main host economies for inward FDI), but rose slightly in the non-OECD G20 economies. Despite the lower level of new inflows, the aggregate stock of inward FDI in the OECD economies rose further in 2017, to over 40% of GDP, representing over three-fifths of the estimated global inward FDI stock.

In spite of stronger output growth in 2017, labour productivity growth remained sluggish, reflecting slow growth in productive capital per worker and in the diffusion of new ideas and technology embodied in new equipment. Labour productivity growth in OECD countries since the crisis has generally fallen significantly below that seen in the decade prior to the crisis, checking future potential growth (Figure 1.8). Moreover, in the post-crisis period, there has been relatively weak growth in multi-factor productivity, which reflects the efficiency with which inputs are used (OECD, 2015[8]). Productivity gaps between firms have widened as frontier firms have continued to make gains but laggard firms have under-performed, contributing to rising inequality (Andrews, Criscuolo and Gal, 2016[5]). These trends have led to low income growth for many households, particularly at the bottom of the income distribution, which has in turn held back aggregate consumption growth.

Figure 1.7. Gross fixed capital formation growth in OECD countries

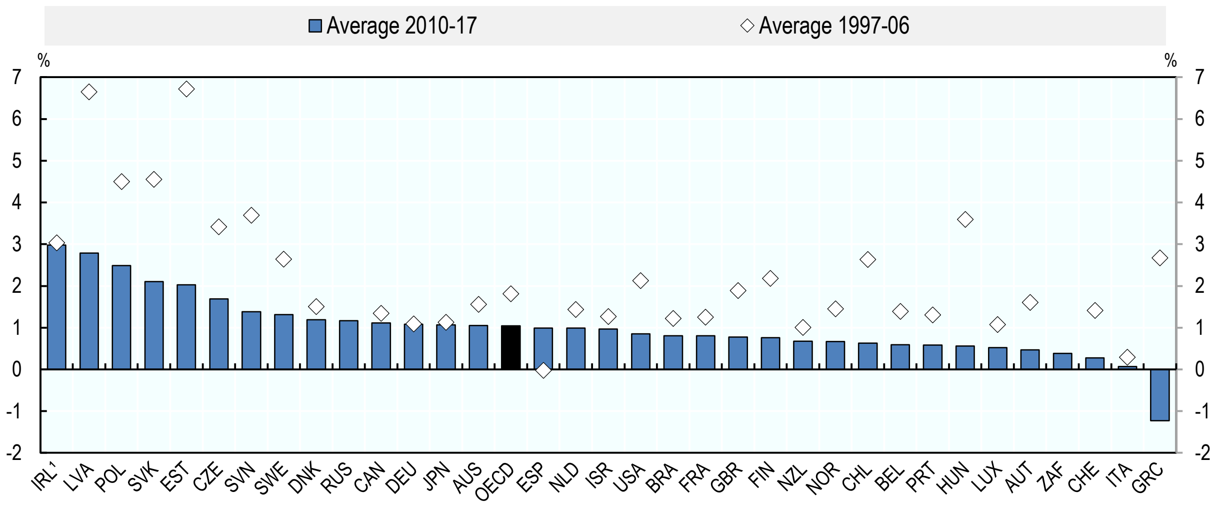
Percentage changes



Source: OECD Economic Outlook 103 database; and OECD calculations.

Figure 1.8. Labour productivity in OECD countries since the crisis

Percentage changes



Note: With growth in Ireland computed using gross value added at constant prices excluding foreign-owned multinational enterprise dominated sectors.
Source: OECD Economic Outlook 103 database; and OECD calculations.

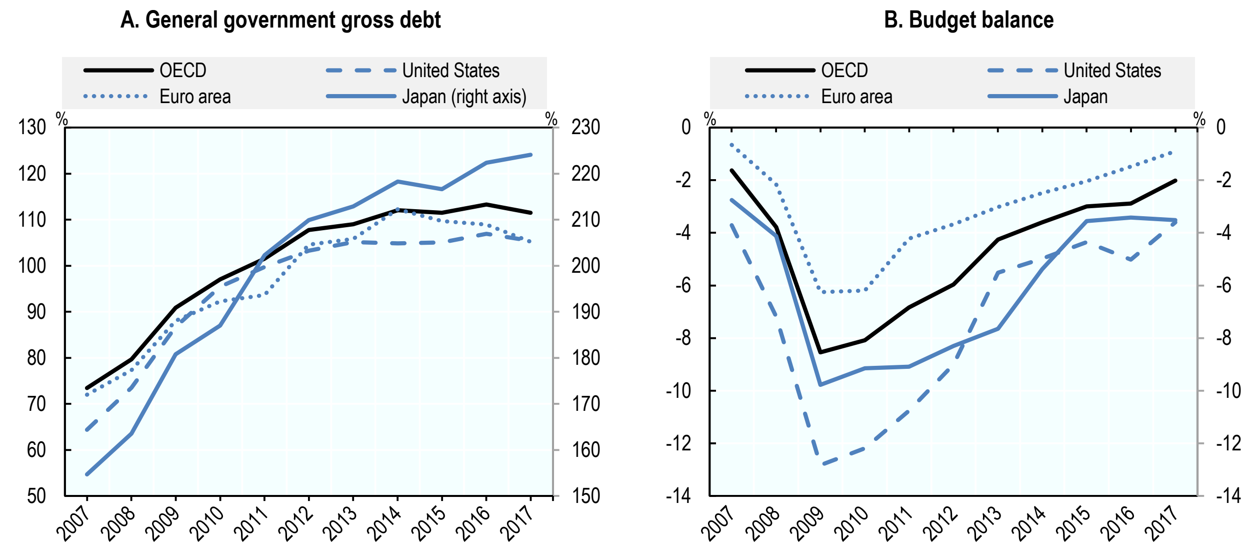
Budget balances have improved and public debt ratios have stabilised or fallen in many countries

After rising rapidly in the aftermath of the financial crisis, general government gross debt as a share of GDP has stabilised in the OECD area at a high level. The aggregate OECD gross debt-to-GDP ratio stood at about 111% in 2017, up from 97% in 2010 (Figure 1.9, Panel A). The debt to GDP ratio has declined in the euro area over the past three years, but much of this is accounted for by a sharp decline in Germany. Across the OECD, there were wide differences between countries in 2017, with gross general government financial liabilities ranging from 13% of GDP in Estonia to 224% in Japan.

The overall budget balance as a share of GDP improved further in the majority of OECD countries in 2017 (Figure 1.9, Panel B). For the OECD countries as a whole, the budget deficit dropped to 2% of GDP in 2017 from 8.5% at the height of the crisis in 2009. There was a wide difference between OECD countries in 2017, with general government budget surpluses in Germany and Korea (between 1-3% of GDP) and sizeable deficits in the United States and Japan (around 3½% of GDP). Stronger nominal growth and lower unemployment have contributed to the improvement in fiscal positions in recent years, adding to the effects from past fiscal consolidation. The overall fiscal stance, reflected in the year-on-year change in the underlying primary balance[1], became mildly expansionary in 2017, by about 0.1% of GDP in the median OECD economy. Further expansionary fiscal measures are being implemented in the majority of OECD countries in 2018-19 (OECD, 2018[1]), particularly the United States.

Figure 1.9. General government gross debt and budget balance

As a percentage of GDP

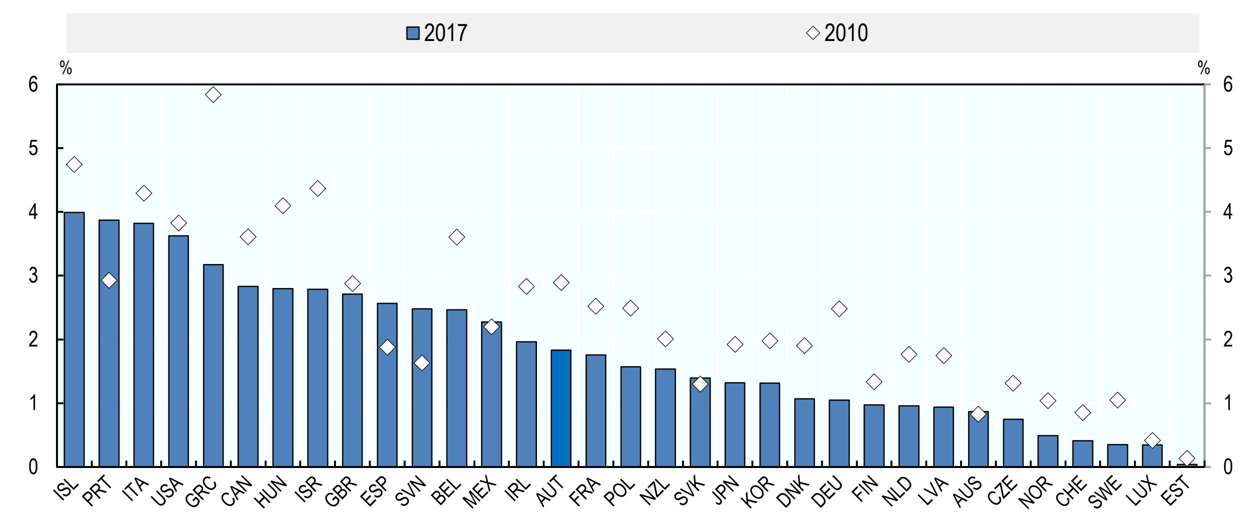


Source: OECD Economic Outlook 103 database; and OECD calculations.

Government bond yields have remained very low by historical standards in many OECD countries, despite a gentle upturn from mid-2016, reflecting expectations of continued accommodative monetary policy for some time and low term premia. Thus, a significant share of outstanding government debt was still trading at negative yields in 2017. As shown in Figure 1.10, gross government interest payments as a share of GDP generally remained below levels seen following the crisis in OECD countries, despite higher debt levels, increasing fiscal space in many countries.

Figure 1.10. Gross government interest payments in OECD countries

As a percentage of GDP



Source: OECD Economic Outlook 103 database; and OECD calculations.

Income inequality remains high in many OECD countries

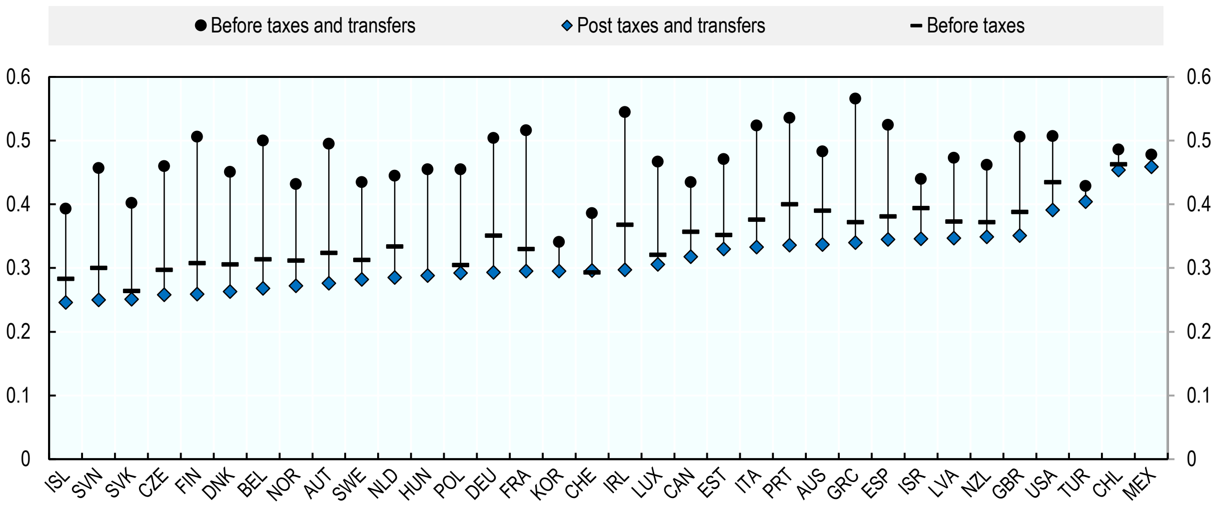
Inequality in many OECD countries remains high by historical standards. High income inequality compounds the drag on economy-wide household spending from weak income growth, as the higher-income households in which income growth has been concentrated typically have a lower marginal propensity to consume. While cross-country patterns of income inequality depend to some extent on how inequality is measured, the most widely used measure is the Gini coefficient (OECD, 2017[9]). On this basis, inequality of market incomes (before taxes and transfers) has remained broadly stable since the financial crisis on average in OECD countries, but the extent of the change in market income inequality since 2010 has varied widely across countries (Figure 1.11).

On average in OECD countries, taxes and transfers reduce income inequality by slightly over a quarter; over two-thirds of this reduction is due to transfers and the remaining portion due to taxes (Causa and Hermansen, 2017[10]). There are considerable differences amongst countries, with the highest redistribution in Finland and the weakest in Mexico. The impact of redistribution is even higher if non-cash transfers from governments, such as education and healthcare, are taken into account (OECD, 2016[11]). After taking into account redistributive policies, around half of the 33 countries for which data are available reported an increase in disposable income inequality between 2011 and 2015 (Figure 1.12). The extent of redistribution via taxes and transfers has declined in many OECD countries since 2010, in part reflecting the upturn in the business cycle and declining unemployment. Other contributing factors may include some reduction in transfers as part of fiscal consolidation and reduced progressivity of the tax system.

At the aggregate OECD level, the pace of disposable household income growth has also differed across different parts of the income distribution in recent years. The incomes of those in the top 10% of the distribution have risen faster than average (median) incomes and those at the bottom end of the income distribution (Figure 1.13). Thus, many households have seen little growth in real disposable incomes over the past decade. In around half of the major emerging market economies, disposable income inequality has decreased since the mid-2000s, including in Brazil, Turkey, South Africa and China (OECD, 2017[9]) (OECD, 2017[12]). However, it has increased in India and Russia.

Figure 1.11. Market income, post-transfer and disposable income Gini coefficients

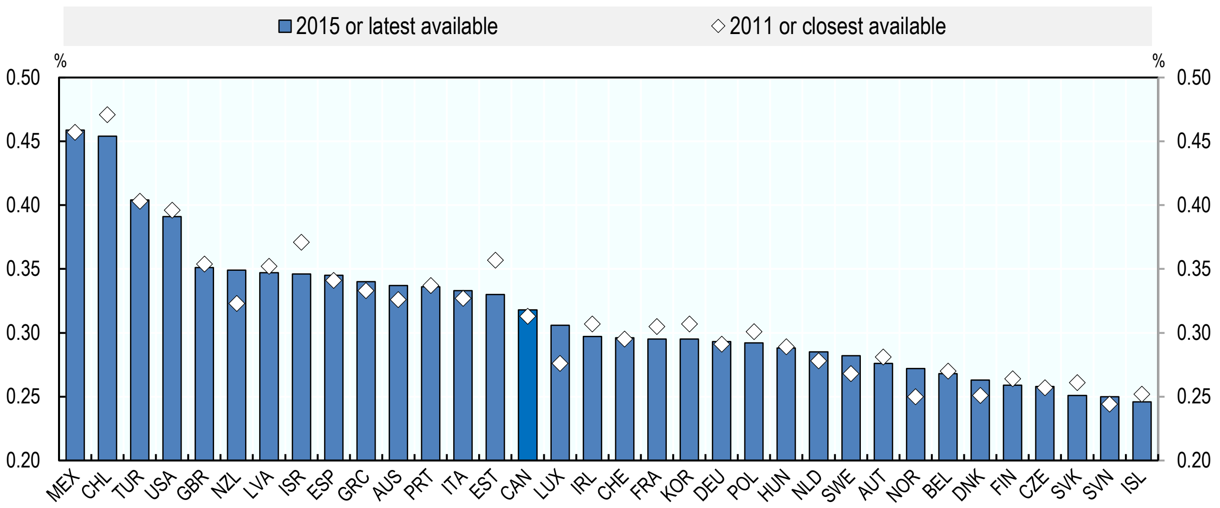
2015 or latest, for total population



Source: OECD Income Distribution Database (IDD).

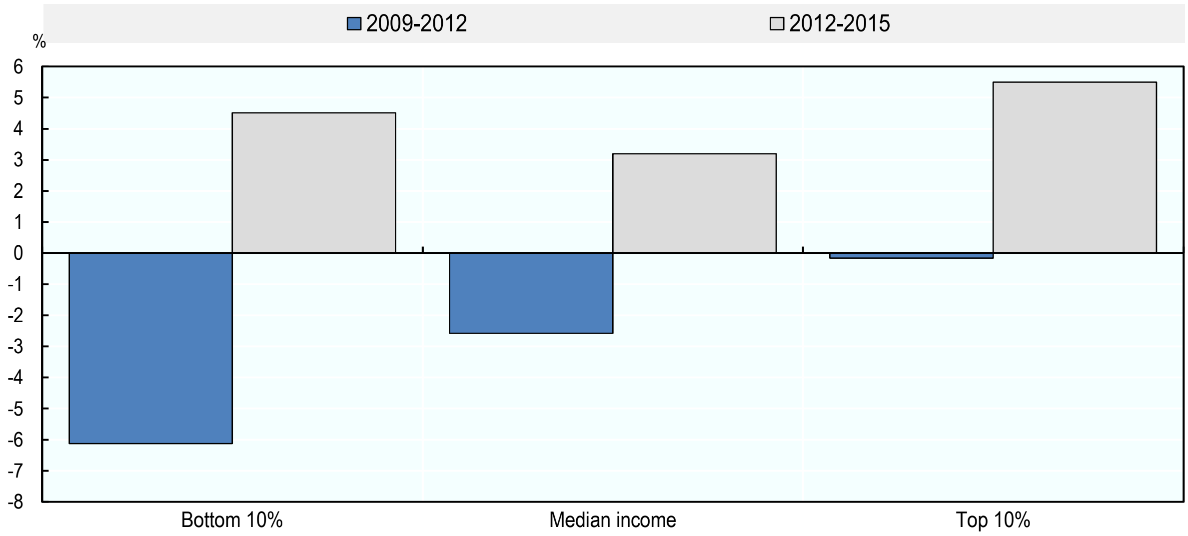
Figure 1.12. Disposable income Gini coefficients

Total population



Source: OECD income Distribution Database (IDD).

Figure 1.13. Household real disposable income growth



Note: The income series are averages of 17 OECD countries.
Source: OECD Income Distribution database (IDD); and OECD calculations.

Notes

[1] The underlying primary balance is the fiscal balance excluding net interest payments and adjusted for the economic cycle and for budgetary one-offs.

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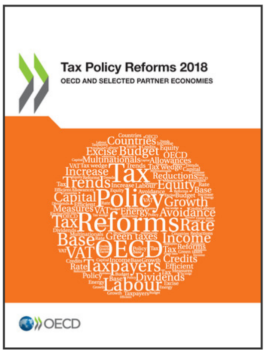
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