September 27, 2013

GUIDANCE NOTE ON JOBS AND GROWTH ISSUES IN SURVEILLANCE AND PROGRAM WORK

EXECUTIVE SUMMARY

This note provides operational guidance to staff on Jobs and Growth issues in surveillance and program work, building on the Board paper "Jobs and Growth: Analytical and Operational Considerations for the Fund" (hereafter, "Board paper"). Jobs and Growth issues can be defined broadly as issues relating to GDP growth, employment, and income distribution.

The Board paper noted that work on these issues needs to be consistent with both the Fund's mandate and its areas of expertise. On a number of structural issues, especially related to labor market reforms and social protection schemes, the Fund would need to effectively collaborate with other institutions with greater relevant expertise.

The note provides guidance on improving analysis and policy advice in four key areas that were identified in the Board paper as showing scope for improvement:

- Enhanced examination of macro-critical domestic policies to ensure that they are directed toward keeping the economy operating broadly at capacity, consistent with available fiscal and monetary policy space.
- More systematic analysis of the growth and employment challenges and the identification of the most binding constraints to inclusive growth and jobs to provide more tailored and relevant policy advice.
- More systematic integration of policy advice on reforms of tax and expenditure policy to encourage (i) higher labor force participation, including by women; (ii) stronger job creation; (iii) progress in reducing inequalities in income distribution; and (iv) more effective protection for the most vulnerable.
- Enhanced advice on labor market policies based on currently available empirical evidence, and greater collaboration with international institutions, such as the World Bank, the OECD, and the ILO on the impact of these policies on growth, productivity, job creation, and inclusion.

Application of this guidance by staff will need to reflect country circumstances.

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I. INTRODUCTION

1. **This note provides operational guidance to staff on jobs and growth issues in surveillance and program work,** building on "Jobs and Growth: Analytical and Operational Considerations for the Fund," which was discussed by the Executive Board on March 31, 2013. The Executive Board broadly agreed with the analysis presented in the paper and supported its recommendations. While acknowledging the growing importance of jobs and growth issues for the Fund, Executive Directors emphasized that work on these issues needs to be consistent with the Fund's mandate and its areas of expertise.

2. **The note provides guidance on strengthening analysis and policy advice in four key areas that were identified in the Board paper as showing scope for improvement**:

- Enhanced examination of macro-critical domestic policies to ensure that they are directed toward keeping the economy operating broadly at capacity, consistent with available fiscal and monetary policy space.

- More systematic diagnostic analysis of the growth and employment challenges and the identification of the most binding constraints to inclusive growth and jobs to provide more tailored and relevant policy advice.

- More systematic integration of policy advice on reforms of tax and expenditure policy to create conditions to encourage (i) higher labor force participation, including by women; (ii) stronger job creation; (iii) progress on reducing inequalities in income distribution; and (iv) more effective protection for the most vulnerable.

- Enhanced advice on labor market policies based on currently available empirical evidence and greater collaboration with international institutions, such as the World Bank, the OECD, and the ILO, on the impact of these policies on growth, productivity, job creation, and inclusion.

3. **There is no "silver bullet" for how best to promote growth, jobs, and inclusion, and economists' understanding of these issues is limited**. Challenges vary across countries and there are limits to the existing knowledge of what drives growth, and therefore employment, more generally. In line with this, the debates about the determinants of income distribution, the impact of income distribution on growth, and the scope for redistribution are not fully settled. Thus, this guidance note will be updated from time to time to reflect the evolving state of knowledge.

4. **Policy advice on how countries can reach their goals on growth, jobs, and inclusion will need to be mindful of complementarities and trade-offs.** Depending on circumstances, there may be complementary or trade-off between the goals of promoting growth, employment, and income distribution. In the presence of a trade-off, staff's policy advice in surveillance and program contexts should generally prioritize growth. In most circumstances, this will help address employment challenges as well, although sometimes additional efforts such as enhancement of labor market policies may be needed, too. Further, efforts to address income inequality may be

desirable where a high degree of inequality risks undermining growth in the longer run, or where addressing inequality is an important goal of country authorities. Reducing poverty is a particularly important way of addressing inequality, including because the poor are more likely than others to be unable to invest in human or physical capital, with attendant negative effects on growth and welfare. When recommending measures to support a more equal income distribution, staff and policy makers need to be mindful about preserving the incentives that underpin individuals' willingness to expend effort.

5. Policy advice should also be mindful of countries' cyclical position. For countries facing a recession, providing advice to promote recovery should be the first priority, and policies need to focus on aggregate demand management within available fiscal and other macroeconomic space. Further, where reforms to remove structural bottlenecks to growth are needed, staff should take into account that the benefits of structural reforms often take time to materialize, and that some reforms can have adverse short-term effects, which may need to be countered through other policy actions. For example, in an environment of depressed aggregate demand, certain labor market reforms (such as reductions in unemployment benefits and employment protection) could temporarily have a negative impact on employment and growth.

6. The note is organized as follows. Section II lays out when staff should include discussion of jobs and growth issues in surveillance and program work, and which broad issues they should discuss. Section III, after highlighting the main growth challenges across countries, provides guidance on the substance of advice on a range of aspects of jobs and growth. A Supplement offers country examples.

II. WHEN TO DISCUSS JOBS AND GROWTH ISSUES

7. The Fund's work on jobs and growth issues needs to be guided by its mandate. An important source of the mandate on jobs and growth is Article I. The Article lists as a purpose of the Fund "to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy. Article I further lists as a purpose to assist members in correcting "maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." Annex 7 of the Board paper provides further explanations.

8. Implications for jobs and growth work in surveillance are as follows:

Growth

- In every Article IV consultation, staff should examine whether domestic policies are directed toward keeping the member's economy operating broadly at capacity, consistent with available fiscal and monetary policy space.

- Staff should also examine whether domestic policies are directed towards fostering a high and sustainable growth rate of potential GDP where this significantly influences prospects for domestic stability. These prospects are likely to be affected in a range of circumstances, including but not limited to situations where weak (potential and therefore eventually actual) GDP growth could result in unfavorable debt trajectories, deteriorating financing conditions, adverse affects on financial sector stability, rising unemployment, or increasing income inequality. When reviewing the impact of policies on potential growth, staff may be selective in focusing on recent developments and on the most relevant and/or recently changed policies.

Job Creation and Income Distribution

- Staff should examine issues related to job creation and income distribution if they have a bearing on domestic stability. If staff finds such an influence, they should discuss how job creation and/or income distribution could be influenced to enhance stability. As regards income distribution, the link may not be easy to ascertain given the as yet limited understanding of the effect of income distribution on growth. This said, the empirical evidence generally supports the view that high degrees of inequality impede growth, at least over the medium and long term.[1],

- Further, to the extent that job creation and better income distribution are important objectives for a member country, in advising on policies to preserve and strengthen domestic stability, staff should help the member achieve these objectives. To determine whether issues of job creation and income distribution are important objectives for a member country, staff should screen for indications that this might be the case, as well as enquire with the authorities, ahead of every Article IV consultation.[2]

- Finally, staff should discuss issues related to job creation and income distribution upon the member's request, even if there is no clear link to domestic stability. While this is not a mandated obligation, staff's willingness to discuss the issues will help build traction. To ensure that the authorities are aware of the possibility to request advice on job creation and income

[1] Researchers have studied growth over long periods of time (e.g., Persson and Tabellini (1994), Perotti (1996), Alesina and Rodrik (1994)), the level of income across countries (e.g., Easterly (2007)), and the determinants of the duration of growth spells (Berg et al., (2012)), and have generally found that higher inequality is associated with slower and less durable growth. The few exceptions to this finding (notably Forbes, 2000, and Banerjee and Duflo, 2003) tend to pick up ambiguous shorter-run correlations. (Also, Aghion et al., 1999 criticize Forbes, 2000 on a number of econometric grounds, and Halter et al., 2010 make the case that the difference in time horizons drives differences in views on the inequality-growth relationship.) The finding that higher inequality is associated with slower and less durable growth may reflect a number of effects. For example, parts of the population with little wealth or low income may be unable to invest in human capital or productive activities, particularly if imperfections in financial and other markets constrain their ability to borrow, resulting in underinvestment by the poor and consequently lower growth. The resulting underinvestment by the poor may also explain why more unequal societies experience lower social mobility, which might in turn act as a disincentive to individual effort and thus reduce growth further.

[2] Such early consultation with the authorities is also called for by the management implementation plan for the IEO evaluation of the role of the Fund as a trusted advisor. The goal is to enhance the value-added of Article IV consultations for country authorities.

distribution, staff should signal to country authorities their willingness to these issues ahead of every Article IV consultation.

9. Implications for jobs and growth work in the context of Fund-supported programs are as follows:

- In helping a member country conceive an economic program, staff should help the member analyze likely program effects on growth and employment, and, at least where relevant for growth and stability, on income distribution. This kind of analysis will be particularly important where a large macroeconomic adjustment is envisaged. Staff reports involving requests for Fund-supported programs as well as their corresponding program reviews should discuss these issues where relevant.

- When assisting the authorities in designing an economic program, staff should enquire about their goals for growth, employment, and income distribution, and support the inclusion in the program of measures that can be expected to achieve these objectives subject to consistency with the primary program goals.

- PRGT-financed programs need to devote particular attention to poverty reduction. Thus, PRGT program requests should be explicit on how they advance the country's own poverty reduction and growth objectives, cross-referencing any existing Poverty Reduction Strategy where relevant. Where feasible and appropriate, policy measures to mitigate adverse impacts on the most vulnerable should be included in program design. For example, some program conditions, such as increasing VAT rates, are likely to affect the vulnerable, and could be accompanied with measures to protect the poor, for instance, strengthening social safety nets and targeted transfers.[3]

- All program-related conditions need to be of macro-critical importance for achieving the program goals or for monitoring program implementation. The requirement of macrocriticality aims to ensure parsimony in conditionality. Whether a measure attains the level of macrocriticality needs to be determined on a case by case basis.

10. In all this, staff should collaborate closely with other institutions, such as the World Bank, the OECD, and the ILO, in line with their respective areas of expertise. Broad jobs and growth questions to be discussed in surveillance and program work are identified in Tables 1 and 2.

[3] Where feasible and appropriate, mitigating adverse impacts on the most vulnerable is desirable in programs under the Fund's General Resources Account as well.

Table 1. Broad Questions on Jobs and Growth Issues in the Surveillance Context

Are domestic policies directed towards keeping the member's economy at capacity?	Are domestic policies directed towards fostering high and sustainable potential GDP growth?	How can job creation be influenced to enhance stability?	How can income distribution be influenced to enhance stability?
• What is the state of the business cycle? • Are fiscal and monetary policies appropriately countercyclical and sustainable? • Are other policies, e.g., macro-prudential policies, appropriately adjusted to the state of the business cycle?	• What are the country's key specific growth obstacles? • How do ongoing structural reforms relate to these obstacles, are they critical for promoting growth, and how could they be made more effective? • What other important structural reforms could be enacted to accelerate growth of potential GDP? • When and under what conditions would these reforms likely deliver growth dividends? • What adverse short-term effects of structural reforms on growth, employment, and income distribution are to be expected and how can they be mitigated? • Can others be consulted, such as World Bank or the OECD?	• To what extent is unemployment structural, and to what extent is it cyclical? • What are the country's key employment challenges? • How do existing policies affect job creation? How do they address the identified challenges? • How could job creation be strengthened? • What would be the implications of these policies for domestic stability? • Can other multilateral organizations, such as the ILO, be consulted to optimize policy advice?	• Is the observed income distribution interfering with domestic economic stability? • How do existing policies affect the country's income distribution? • If there is a case that more equal income distribution might be desirable, how could income distribution be made more equal? • Are there trade-offs in equity enhancing vs. growth stabilizing policies and could policies be recommended which are both growth enhancing and equity promoting? What are the authorities' views on these? To what extent should lower growth be accepted? • Can other multilateral organizations, such as the OECD, provide advice on such policies? According to OECD (2012), examples for policies yielding both growth and equity benefits include measures to • Facilitate the accumulation of human capital • Increase social mobility in education • Reduce labor market dualism • Promote the integration of immigrants • Foster female labor market participation.

Table 2. Broad Questions on Jobs and Growth Issues in the Program Context

How will the program affect growth, employment and, where relevant, income distribution?	What are the likely impacts of proposed policy measures on jobs, growth, and inequality?	Are program related conditions macro-critical?
• Consider appropriate elements from Table 1. • What are the authorities' goals on growth, employment, and income distribution? • How can the needed macroeconomic adjustment be achieved with minimal damage to growth, employment, and income distribution, taking into account the authorities' goals to the largest extent possible? • Are proposed fiscal and monetary policies consistent with program goals, and what are likely effects on growth, employment, and income distribution? • Is the income distribution that is likely to result from the program consistent with strong and sustainable growth? • How large is the cyclical vs. structural component of unemployment and do the proposed measures appropriately take this into account? <u>In PRGT programs additionally:</u> • Are the authorities' policies consistent with poverty reduction? • Are measures included in the program directly and sufficiently supporting the poor? • Should advice on appropriate poverty reduction strategies be sought from other multilateral organizations, such as the World Bank?	• Are the proposed policy measures likely to have adverse social outcomes? • Are there alternative measures which are consistent with program goals, but have smaller negative impacts? • How large are the growth, unemployment and, where relevant, distributional costs vs. benefits of implementing the policy measure? • How are these cost and benefits distributed over time? Do long-term benefits balance the short-run costs? • Can policy measures be included to mitigate short-term impacts on the poor?	• How acute are adjustment needs? • May a slower pace of adjustment be sufficient to achieve program goals? • Are all structural conditions needed to achieve the program goals? • Are there any measures which put the ownership of the program at risk? If yes, are there alternative measures?

III. GUIDANCE ON THE SUBSTANCE OF SURVEILLANCE AND PROGRAM WORK

11. Fund advice to member countries needs to take into account country-specific growth, employment, and distributional challenges in addition to country characteristics. These challenges are shaped by the megatrends of technological progress, globalization, and changing global demographics (see the Board paper for a detailed description). Advice needs to be tailored and allow countries to take advantage of the opportunities that arise from the megatrends, while mitigating their adverse impacts. In all this, the Fund needs to focus on areas within its mandate and comparative advantage vis-à-vis other international institutions.

12. Advice should be tailored to the conjunctural context, with a focus on macroeconomic stability. For countries facing a recession, providing advice to promote recovery should be the first priority, and policies need to focus on aggregate demand management within available fiscal and other macroeconomic space. To determine priorities, staff should therefore ascertain carefully which phase of the business cycle a country is in at any given time. Further, where reforms to remove structural bottlenecks to growth are needed, staff should be aware that the benefits of structural reforms often take time to materialize, and that some reforms can have adverse short-term effects, which may need to be countered through other policy actions. For example, in an environment of depressed aggregate demand, certain labor market reforms (such as reductions in unemployment benefits and employment protection) could temporarily have a negative impact on employment and growth (see also sections III.B and III.D).

13. The following gives guidance towards more systematic analysis of these challenges, the systematic integration of fiscal policy reforms, and the enhancement of labor market advice as well as to operational aspects.

A. Adapt Advice to Different Jobs and Growth Challenges

14. This section provides pointers to the most relevant jobs and growth challenges across countries. Further information, including relevant literature, is available through the Surveillance Toolkit for Jobs and Inclusive Growth (see Box 1). Key questions to consider in the context of different jobs and growth challenges are listed in Table 3.[4]

[4] Some considerations for one country group could also be applied to other groups. This applies to all discussions and policy recommendations by country groups in this guidance note.

Jobs and Growth Challenges in Advanced Economies

15. Beyond addressing any near-term cyclical challenges, such as boosting aggregate demand in the aftermath of the Great Recession, advanced countries need to tackle longer-term issues. Many advanced countries are now at a stage in their structural transformation where labor is increasingly reallocated from high-productivity manufacturing to lower-productivity services (OECD, 2012; ILO, IMF, OECD and World Bank, 2012). Hence overcoming barriers to increased productivity growth in services is one of the key structural challenges facing advanced economies. New sources of growth may also be needed in some countries, for example where earlier models based on financial services and construction have proved unsustainable.

16. Many advanced countries also face challenges to long-term growth stemming from population aging. This challenge needs to be addressed through structural reforms that gradually increase labor supply, including of women where relevant, and ensure adequate buffers to counter future increases in health and pension related expenditures.

17. Further, many advanced countries face growing inequality. Fund research has found that technological change has been a main driver of inequality and that financial globalization has contributed as well, particularly where it led to balance of payments or banking crises, while trade globalization has tended to lower inequality (Jaumotte et al., 2013). Overall, however, the debate about the drivers of inequality is not yet settled.

Jobs and Growth Challenges in Developing Economies

18. Jobs and growth issues in developing countries are complicated by a list of factors: a much smaller proportion of workers are employed in formal jobs than in advanced countries; there tends to be significant underemployment, and thus a prevalence of working poor; labor markets tend to be fragmented; and mobility is more limited. Many developing countries are also facing a demographic bulge with large increases in the working age population, creating both challenges and opportunities. Thus, in these countries, job creation strategies need to be focused on creating the conditions for higher investment by the private sector (quality infrastructure including in agriculture, well functioning financial intermediation, and strong institutions of governance), equipping workers with basic education and job relevant skills, and protecting the working poor who are most exposed to shocks (including from weather cycles and other natural disasters).

19. Many developing countries still face the challenge of strengthening growth through structural transformation and diversification (World Bank, 2012). For many developing countries and even some emerging markets, structural transformation needs to occur through more rapid reallocation of labor from agriculture to industry and services, where TFP growth is higher. Reallocation across sectors needs to be complemented by the movement of labor out of lower-productivity firms in manufacturing and services into higher-productivity firms within those sectors. Reallocation both across and within sectors will require significant physical capital accumulation, investment in human capital, and equal access to education and health services. However, these processes take time, limiting the extent to which structural transformation can absorb labor from agriculture in countries with large shares of agricultural employment in the medium term. In such cases, raising the productivity in agriculture is an important medium-term goal for poverty reduction and growth. Another driver of rapid growth in developing countries is diversification. Imbs and Wacziarg (2003) document that higher incomes per capita are associated first with diversification, and then with reconcentration, in production and employment.

20. In addition, many developing countries face high and growing inequality. In rapidly growing countries, this may reflect rapid structural change, in line with Kuznets' theory of rising inequality in earlier stages of development. In others, high inequality may instead reflect a lack of economic and political inclusion and market imperfections that allow an elite to capture large rents. Some extent of income redistribution, including by removing privileges that lead to capture by a few, is therefore likely an important prerequisite for accelerating growth in these countries.

Jobs and Growth Challenges in Other Country Groups

21. Several country groups face particular challenges:

- *Middle-income countries:* IMF (2012a) acknowledges that the latest slowdown in Asia could possibly reflect the middle-income trap some countries in the region are starting to face. IMF (2012b) Chapter 4 investigates growth episodes in low- and middle-income countries in recent years and documents increased growth resilience due to improved policy and lower incidence of shocks. Berg and Ostry (2011) find that a more equal income distribution can contribute to prolonging a growth spell, hence underscoring the need for policymakers to pay attention to income inequality not just for its own sake but to also in their quest to ensure sustainable growth. Aiyar et al. (2013) document a higher risk for a growth slowdown for middle-income countries than for other countries and identifies the macroeconomic determinants of this slowdown that are amenable to policy interventions.

- *Low-income countries, particularly in Africa:* Studies (e.g., IMF, 2012c) have focused on the factors behind growth differentials between African countries and other developing and low-income economies, as well as the drivers of growth take-offs and growth-spells. While there is evidence that episodes of growth take-off have occurred under different sets of initial economic conditions, several factors have been typically identified as potential constraints on sustained growth, including factors related to: (i) institutions; (ii) macroeconomic, social, and political stability; (iii) trade and financial openness; (iv) education; (v) saving and private investment; and (vi) inequality.

- *Resource-rich developing countries:* Fund staff reports, case studies (e.g., Sala-i-Martin and Subramanian, 2003; Limi, 2006; and Aydin, 2011) and cross country analysis (Arezki et al., 2011; Arezki et al., 2012; and IMF, 2012d and references therein, and Lundgren et al., 2013) identify the following main interconnected areas of interventions to support sustained development in resource-rich developing countries:[5]

- *Transforming depleting resources wealth into a portfolio of other assets*, including human capital, domestic public and private capital, and foreign financial assets. While avoiding an unsustainable consumption path is key, some frontloading of public spending can improve welfare as future generations can be expected to be wealthier. The savings rate out of resource flows should be, other things equal, higher when resource inflows are short-lived and increase when time to depletion is closer.

- *Avoiding boom-bust cycles that stem from volatility in natural resource prices*. In countries with a long resource horizon, the core focus should be on managing the impact of resource price volatility, and fiscal rules based on the "structural primary balance" can help de-link spending from the volatile revenue swing. In countries with a short resource horizon, more focus should be on the exhaustibility of revenue, and fiscal targets based on the non-resource primary balance are particularly helpful.

- *Improving institutional quality and governance*. Given capacity and absorption constraints in resource rich developing countries, it is critical to strengthen institutions, especially public financial management systems, and to enhance transparency of both resource revenue and fiscal spending. The more limited the country's capacity, the more of the windfall should be saved in an asset development fund while investment capacity is built domestically. Governance should also be strengthened to ensure investment into most profitable projects.

- *Fragile states* face particular challenges such as pervasive institutional weakness and often elevated levels of violence. IMF (2011a) provides suggestions for how the Fund can best assist these countries. It calls for (i) an explicit consideration of the political context to improve the prospects of reform, (ii) a well-tailored pace of macroeconomic adjustment, (iii) close collaboration with donors, and (iv), given the typically low capacity of these countries, for a strictly prioritized and gradual agenda of key structural reforms.

- *Small states* often exhibit high government wage bills, high levels of state intervention, not fully developed financial sectors, heavy reliance on trade tax revenues, and the use of fixed exchange rates. Many of them also face slow growth, high levels of public debt, and the risk of natural disasters. While pointing to the heterogeneity across small states, IMF (2013a) gives the following policy guidance:

  - High public debt levels require fiscal consolidation accompanied by structural reforms and, in some cases, more exchange rate flexibility.

[5] See IMF (2012d) for detailed suggestions on enhancing Fund policy analysis and advice on both short-run fiscal rules to manage revenue volatility and long-term fiscal sustainability.

  - In many countries, stability risks arising from large and concentrated financial sectors call for an enhancement of the legal and supervisory infrastructure and, in many cases, the reduction of domestic public debt.

  - Macroeconomic vulnerability to natural disasters can be reduced by: (i) identifying and integrating natural disasters into the macro frameworks, (ii) ensuring sufficient fiscal and external space and flexibility to redeploy spending rapidly and mitigate BOP shortfalls, (iii) exploring how to promote insurance coverage, (iv) strengthening cooperation among multilateral institutions, (v) improving transparency to ensure effective use of disaster assistance, (vi) using reconstruction to pursue growth-enhancing structural reforms, and (vii) preventing a weakening of external competitiveness.

- *Countries with low labor force participation among women or other demographic groups:* In countries where the gender gap is of particular importance, the Fund can analyze the impact of low female labor force participation on economic growth to better inform the dialogue with the authorities about policies aimed at enhancing opportunities for women (see IMF (2013b) for an analysis of the gender aspects of jobs and growth).[6] For instance, the Fund can assist its members in reviewing tax codes to identify and remove provisions that discourage second earners, and could provide other policy options to boost the labor supply of women, such as child care. In developing countries, female labor force participation can be enhanced through equal access to health and education services, legislation allowing women to participate in the labor market on an equal basis, and the removal of bottlenecks in infrastructure and transportation. Similarly, in countries with limited opportunities for older workers, analysis could focus on removing disincentives for labor force participation by the elderly, including though pension reforms. More generally, Fund analysis and advice with regard to fiscal policies should where relevant take into account the potential impact of measures on under-represented groups, including women, older workers, and the young. Specifically, the Fund can assess whether tax regimes and the allocation of public resources contribute to better opportunities for these groups.

[6] As one example, in Japan, staff recommended targeted employment measures and deregulation to increase female labor force participation in order to alleviate the impact of an ageing population and a higher dependency ratio on growth and fiscal stability (IMF, 2012e).

Box 1. Surveillance Toolkit for Jobs and Inclusive Growth

The Fund's working group on "Jobs and Growth" has compiled a toolkit designed to facilitate country teams' access to guidance notes, relevant literature, results of research projects, models, and guidance on data issues.[1] The toolkit aims to (i) transfer 'best practices' to desk economists and improve their capacity in the areas of growth, employment, and income distribution and (ii) act as a catalytic hub for Fund staff working on these issues.

The toolkit is structured along the three pillars of growth, employment, and equality and poverty. It leverages work already under way at the Fund and builds on the expertise of partner institutions, such as the World Bank, OECD, and ILO. In each of its three sections, the toolkit lists diagnostic and policy questions to help teams frame their country-specific analysis. Each of the three pillars builds on a set of modules:

- *Specific indicators.* For example, the growth section lists relevant indicators to measure different aspects of growth (such as supply and demand contributions, growth cycles, and growth potential), while the employment section includes indicators measuring employment and unemployment, wages and productivity, and institutional labor market characteristics. Different indicators measuring poverty and inequality are included in the third pillar of the toolkit.
- *Data sources.* The data sources sections of the three pillars provide links to external databases related to growth analysis; labor market and employment data; and the assessment of equality and poverty, facilitating both country-specific analysis and cross-country comparisons.
- *Analytical tools.* The analytical tools provided in the three sections serve, for example, to analyze production diversification; calculate country-specific employment-growth linkages; project labor market variables; calculate poverty and inequality measures; and generate growth *incidence curves*.
- *Case studies and analytical papers.* The selection of papers provides examples of recent Fund work in the area of jobs and growth, papers issued by other organizations, and influential academic work on each topic.

[1] The toolkit also includes a blogs section that allows staff to keep up with ongoing debates. The toolkit is available at http://www-intranet.imf.org/jobsandinclusivegrowthtoolkit/Pages/default.aspx.

Table 3. Key Questions on Specific Jobs and Growth Challenges

Take Account of the Business Cycle

- Identify the country's position in the business cycle.
- In case of recession/recovery, focus on boosting aggregate demand with due regard to fiscal and other space.
- Should aggregate demand management be accompanied by structural reforms, and which reforms would be most useful?
- How long would the benefits of the structural reforms take to materialize? Are there short-term adverse effects and how can they be mitigated?

Address Country Specific Challenges

Advanced Economies Challenges

- What are the key bottlenecks to growth, jobs, and equity?
- What are the key barriers to increased productivity growth?
- Is population aging an issue?
- Identify structural reforms that address, or get around, the key bottlenecks.
- Identify any adverse impacts of needed structural reforms and propose measures to mitigate them.
- If aging is an issue, consider how the growth of health and pension expenditure can be limited while maintaining adequate health and pension insurance. Also identify other needed adjustments, such as policies to raise productivity and labor supply.

Developing Economies Challenges

- What is the share of work in the formal market and how many people are poor though working?
- Is there discrimination in the access to productive resources?
- What are the problems and opportunities posed by the demographic transition?
- What are the main external shocks and who is most affected by them?
- In which sectors are growth and employment concentrated? How can diversification be achieved?
- How can a shift from unproductive to productive activities be achieved?
- Is the given income distribution helpful in fostering growth?
- Focus on job creation strategies: Find strategies to increase private sector and human capital investment.
- Advise on policies to provide equal access to productive resources for all parts of the population: Propose tackling infrastructure and transportation bottle necks, deepening financial inclusion, and providing access to education and health care.
- Advise on measures (such as targeted transfers) to limit the exposure of the most vulnerable to external shocks.

Middle-Income Challenges

- Identify the major risks to remaining in the "middle-income trap" and develop a strategy for avoiding it.
- What are the policy lessons from other MICs and would similar policies work given the specific country characteristics?
- Can a more equal income distribution help prolong the high-growth episode and which are appropriate policies to generate redistribution?
- Do high public sector wages negatively affect job creation in the private sector?

Low-Income Challenges

- Are current growth policies consistent with the aim of poverty reduction?
- Do privileges held by a minority undermine growth?
- In cooperation with other institutions: What is the role of institutions, stability, education, and trade and financial openness in boosting growth?

Low Labor Force Participation in Certain Groups

- What are the growth and stability implications of a part of the population (for example women) limiting their participating in the labor market?
- What are the disincentives for these groups to join the labor market and how can they be removed?
- Would a different tax regime help (see section III.C)? What other measures could help (e.g., better access to childcare)?
- See IMF (2013b).

Fragile States and Small States

- Identify institutional weaknesses: How do they affect proposed macroeconomic and structural policies?
- What is the political context?
- Are there opportunities for "quick wins" and what are key structural reforms?
- Do high public wage bills, government intervention, and reliance on trade tax revenues undermine growth or limit fiscal space for growth promoting policies?
- Collaborate closely with donors.
- See IMF (2011) and IMF (2013a).

Resource-Rich Developing Countries

Advise on:

- Transforming depleting resources wealth into a portfolio of other assets (e.g. human and physical capital)
- Policies to avoid boom-bust cycles
- Improving institutional quality and governance
- See IMF (2012d).

B. Focus Structural Reforms on Key Constraints and Address Any Adverse Short-Term Effects

22. Staff is encouraged to try to identify some of the key constraints to growth, possibly in cooperation with other institutions, and focus on reforms that will remove or get around those constraints. Identification of key constraints is a recommendation of the growth diagnostics framework proposed by Hausmann, Rodrik, and Velasco (2006). The framework is presented in Annex 1. A number of Fund country reports and papers have applied the framework and could serve as a reference for staff. For example, Moore and Vamvakidis (2007) use the framework to examine the constraints that affect potential growth in Croatia and policies that can influence them. Lledo (2008) carries out a growth diagnostics exercise to identify governance, finance, and regulatory issues as key constraints to a thriving private sector in Mozambique, consistent with a benchmarking exercise against better-performing comparator countries. Rungcharoenkitkul (2012) combines the growth diagnostics approach with a quantitative model to identify the infrastructure gap as one of the biggest impediments to higher growth and calculate the growth dividend of its mitigation in Cambodia.

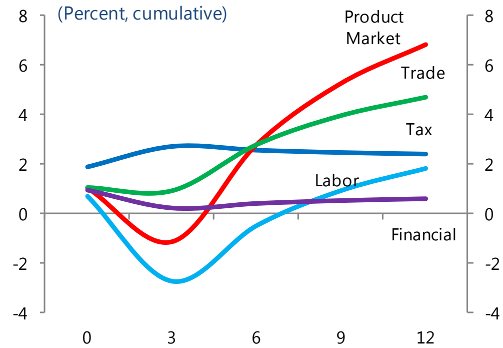
23. Staff should be mindful of uncertainties regarding the timing and size of the effects of structural reforms on growth, and aim to counter any potential adverse short-term effects (Box 2). The experience of countries with high and sustained growth suggests that there are a variety of ways in which reforms can be combined to deliver growth. In addition, it is advisable to exercise caution in linking projected increases in growth to specific structural reforms and to allow for the fact that effects may accrue only after substantial and hard-to-predict delays. Also, staff should assess the potential adverse short-term effects and consider how these could be countered.

Box 2. Impact of Structural Reforms on Productivity and Growth

Evidence on the growth impact of structural reforms is mixed. Results are not always precise, and small specification or measurement changes can result in starkly different conclusions (Levine & Renelt, 1992). Moreover, to the extent they often focus only on successful episodes, many studies have been potentially muddied by selection bias—there have been over 80 cases of sustained growth accelerations since 1950, but cross-country regressions reveal little about their underlying cause and they are not always correlated with reform episodes (Hausmann et al., 2005). Indeed, detailed case studies accounting for political and implementation constraints suggest that reforms made in response to immediate pressures, and with a lack of electoral support, are often less successful (Tompson & Dang, 2010).

Reform benefits only accrue over time, with sometimes adverse or uncertain near-term prospects. Although cumulative returns over the long horizon are typically positive, the near- to medium-term payoff for some reforms, such as labor and product market reforms, can be negative, particularly when economic activity is already depressed (IMF, 2004, IMF, 2006, Barkbu et al.,2012, Bernal-Verdugo et al, 2012, Bouis et al., 2012). Tax-system reforms by contrast, offer substantial benefits even in the short run.

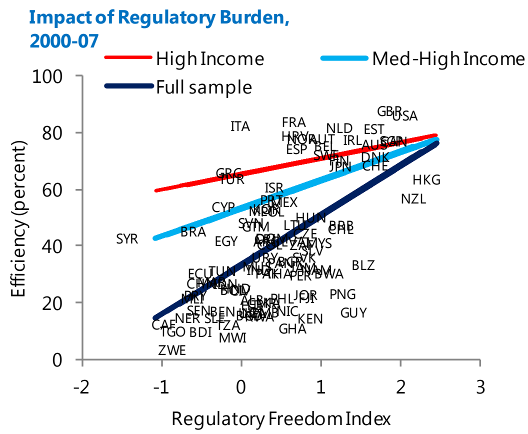
Response of Real Percapita GDP to a 1 s.d. Increase in Reform indicator
(Percent, cumulative)



Source: WEO (Apr 2004)

Product market reforms tend to have the largest impact on growth. Product market reforms (PMR), such as reforms of rules affecting market access, seek to promote competition and can increase productivity. Estimates suggest that, for OECD countries, the average change in PMR over 1998-2003 likely led to a 9 percentage point increase in GDP per capita after 10 years. This contrasts with much smaller impacts from labor market reforms (see table). Human capital reforms also contribute sizeable contributions to output, although these effects tend to have a much longer lag. For example, reforms to the quality and quantity of education in OECD countries between 1995 and 2004 increased GDP per capita by 3.7 percentage points but would take 50 years or longer to have their full effects (Barnes et al, 2013).

The impact of structural reforms on growth can be assessed using the country's distance to an estimated global best-practice frontier. The first step is to gauge each country's output relative to an estimated global best-practice frontier, taking into account the country's factors of production (physical and human capital, labor, etc). This approach not only provides a transparent assessment of each country's catch-up potential, but is also motivated by the recent growth literature, which notes that the effectiveness of different types of reform will depend on a country's proximity to the frontier (Aghion & Durlauf, 2007; Prati et al, 2013). The frontier can be estimated using statistical techniques,[1] or can be approximated instead by identifying an *ex ante* global leader, which then serves as a benchmark.[2] Having identified the best-practice frontier, the gap between this benchmark and a country's actual performance serves as an indicator of country-level "efficiency"—a country lying on the frontier can be deemed to have an efficiency level of 100 percent. The second step is to examine the link between the efficiency measure and various indicators of structural reform. In one staff study (Tiffin, 2013), the reform effort is proxied by movements in the Fraser Institute's regulatory liberalization index, which captures the extent of regulation in the labor, product, and credit markets. The results suggest that less-burdensome regulations (represented by a higher index score) are typically associated with greater efficiency (see chart). This effect is particularly pronounced for low- and middle-income countries, where catch-up gains are more readily available, but it is still significant even for the subset of high-income countries. In a middle-income country, for example, a one standard-deviation improvement in the reform index is associated with a 9½ percentage point increase in efficiency. For a high-income country, the impact is around 5 percentage points. It should be noted here that some regulations may reflect a conscious tradeoff between efficiency and equality, but the details of this tradeoff – and the availability of Pareto improvements – are likely to be country specific. Depending on the country in question, a rough estimate of the impact of reform on TFP can then be added to factor-of-production projections to arrive at a forecast for potential growth. Staff studies have also investigated "headwind" factors that may delay the payoff from reform. Looking mainly at high-income countries, high debt levels, exchange-rate rigidity, or low levels of human capital seem to slow the pace at which countries converge to the frontier. Other staff studies have stressed that growth payoffs may depend critically on the sequencing of reforms, particularly for developing economies (IMF, 2008).



As an alternative, staff simulations have also drawn on structural macroeconomic models to estimate the impact of reform. In this approach, economic inefficiency is viewed as the result of limited competition and economic rents. So, an improvement in efficiency is modeled formally as a reduction in the markup between marginal costs and prices. In this regard, GIMF is well suited for the analysis of structural reforms, owing to the explicit presence of monopolistic competition in both product and labor markets (see Lusinyan & Muir, 2012, and IMF 2013c). Analogous to the frontier approach above, modeling structural reform in this manner often entails calibrating the gap between a country's markup parameters and those of a world leader (or regional average), and then assuming that (part of) this gap is closed over a pre-specified time period. The pace of improvement is based either on the experience of others, or is simply assumed ex ante. The frontier and modeling approaches both have benefits. The former is less technically demanding and provides an intuitive framework that can be applied across a broad range of income classes. The latter approach, on the other hand, provides a more complete set of projections (output, prices, exchange rates, etc) and may allow for a richer discussion of policies—including a more finely crafted representation of the reform package under consideration, as well as the potential impact of offsetting monetary or fiscal measures.

Study	Country Sample	Estimated Impact on Growth
Product market reforms		
Barnes et al. (2013)	OECD	9 ppt increase in GDP per capita after 10 years due to the change in product market regulation implemented by OECD countries on average between 1998-2003
Bayoumi et al. (2004)	Euro area and US.	8.6 ppt level increase in GDP in the long run by reducing the price mark-up in the euro area to US levels.
Cincera and Galgau (2005)	9 EU countries	0.6 ppt increase in labor productivity and 2.7 ppt increase in employment growth from reforms to increase the firm entry rate.
Salgado (2002)	20 OECD	0.2-0.3 ppt increase in TFP growth in the long run, weak results in the short run from product market reforms implemented over 1985-1995.
Tang and Verveij (2004)	EU	1 ppt level increase in GDP from a 25% reduction in administrative burdens.
Labor market reforms		
Barnes et al (2013)	OECD	0.9 ppt increase in GDP per capita after 10 years due to the change in labor market policies implemented by OECD countries on average between 1996 and 2006.
European Commission (2010)	EU	0.3 ppt increase in potential output in the long-run from a 1% tax shift from labor to VAT.

[1] A pre-specified best-practice production function can be estimated parametrically, using techniques such as stochastic frontier analysis (see Tiffin, 2006, or IMF, 2013d), or the frontier can be instead identified non-parametrically, using techniques such as data envelope analysis (see Mattina & Gunnarson, 2007, or Ramanathan, 2005).

[2] See IMF, 2013e.

C. Advise on Fiscal Policies for Higher Growth and Employment and a More Equal Income Distribution

24. Fiscal revenue and spending policies have important effects on growth, employment, and income distribution. In some cases, a certain fiscal policy may support growth, employment, and equality. In others, however, there may be trade-offs. It is therefore important that staff assess the impact of fiscal policies on all three target variables (growth, employment, and, where relevant, income distribution), and recommend policies that promote the overall best outcome, taking into account sustainability requirements and country preferences. In many cases, it will be possible to offset undesired outcomes by designing appropriate structures of taxation and spending. For example, the impact of a high uniform value added tax on the purchasing power of lower-income groups can be offset through targeted transfers (provided there is sufficient administrative capacity for targeted transfers). This said, there may be limits to what can be achieved in some circumstances. In particular, there may be limits to the extent of income redistribution that can be achieved while also maintaining growth. Research on these limits is ongoing at the Fund. Its results will be reflected in future versions of this guidance note.

Fiscal Policy to Support Growth

25. Fiscal policy can help boost growth by contributing to macroeconomic stability over the short- and long-term and improving the supply side capacity of the economy. The role of fiscal policy as a tool for macroeconomic demand management is not examined here.[7] In some cases, policy reforms that boost growth can potentially have unintended adverse effects on equity. However, appropriate policy design (for example, better targeting of spending to the poor) can allow countries to strengthen growth while preserving equity.

26. Expenditure reforms in advanced countries:

- *Reforming public sector wages and social welfare benefits*. Countries where public sector wages are above those prevailing in the private sector should focus on containing these outlays. Reducing public sector employment and the wage bill can boost growth by putting downward pressure on the equilibrium wage in the private sector (Ardagna, 2004). Reforms of social welfare benefits that link the receipt of social benefits to work (in work-benefits) or participation in effective active labor market policies (ALMPs) can also increase incentives for labor force participation. Greater use of means-testing (which affects less than 10 percent of social benefit spending in the OECD) can create fiscal space while preserving benefits for those most in need (Adema and Ladaique, 2009).

- *Containing increases in age-related spending*. This is necessary to avoid placing an even heavier burden on more productive spending. Health and pension spending consumes close to half of government non-interest spending. Over the 2013-30 period, pension spending is expected to rise by 1½ percentage point of GDP (unweighted; weighted average, 1½ percent of GDP), while

[7] The options examined here, including in Table 4, are not meant to be exhaustive. Further country-specific analysis would be needed to design the appropriate policy mix.

health spending will rise by 1½ percentage points (unweighted; weighted average, 2¾ percent of GDP, see Clements et al., 2012a; Clements, et al., 2012b; IMF, 2013g). Reform of age-related spending will thus need to be a necessary ingredient in advanced countries' fiscal structural reforms in coming years.[8] Pension reforms that help increase the number of years worked, such as raising the retirement age, will also have a salutary effect on growth (Karam et al., 2010) while helping contain projected spending increases. Reforms of age-related spending will need to be designed in a manner that maintains adequate levels of protection against poverty. For example, pension reforms that reduce benefit levels should be carefully assessed in terms of their impact on poverty; in some cases, benefits for low-income pensioners may need to be maintained in light of equity objectives. On health care, reforms to slow the growth of public expenditure should be designed to maintain the access to basic health care services for low-income groups. For example, the poor may need to be exempted from reforms that attempt to rationalize the use of health services by raising copayments (Clements et al., 2012b).

- *Preserving spending on public investment that addresses infrastructure bottlenecks*. The empirical literature suggests that fiscal adjustments focused on cuts in wages, subsidies, and transfers, rather than public investment are the least damaging for long-term growth (Hauptmeier et al., 2006; Kumar, et al., 2007; and Gemmell, et al., 2009).[9]

27. Tax reforms in advanced countries: Changes in the composition of tax revenues can help foster stronger economic growth. Income taxes and social contributions have the most adverse effects on growth, followed by consumption taxes, while property taxes have the lowest output impact (Arnold 2008).[10] [11] At the same time, the design of a tax also matters for its impact on growth (IMF, 2013g). For example, improving the design of corporate tax systems can reduce vulnerability to crises (and, in turn, their impact on growth) by reducing the bias toward debt financing (Keen, Klemm, and Perry, 2010; IMF, 2013g). In addition, targeted tax relief can boost labor supply including for low-income workers and secondary earners (typically women) (IMF, 2012f). Eliminating distortive tax expenditures and reducing tax evasion should also be considered, as these help raise revenues in a more "growth-friendly" way than rate increases. Furthermore, there is scope for a greater use of corrective taxes. Energy taxation can correct prices that are below the levels that would fully capture externalities such as the effects of energy consumption on greenhouse gas emissions (Clements et al., 2013). Increasing these taxes can increase welfare and help avoid the need to raise other taxes that could impinge on economic efficiency. Finally, appropriately-designed financial sector taxes may either offset distortions from the value-added tax (VAT) exemption of financial services (Financial Activities Tax) or internalize externalities from excessive risk taking (Financial Stability Contribution; see IMF, 2010).

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[8] This is true of some emerging market economies as well.

[9] Policies should take into account, however, that some types of spending that are classified as public consumption, such as spending on public employees in education and health, help boost growth through their effects on building human capital. Policies should also take into account the effects of cuts in transfers on income distribution.

[10] The literature remains contentious, however, as differing specifications can lead to different results (Xing, 2012).

[11] A shift in taxation from social contributions to consumption taxation may increase inequality and require offsetting measures to maintain equity objectives. See IMF (2012f).

28. Expenditure reforms in developing countries: Reforms should focus on improving both the composition and efficiency of public spending. [12]

- *Reallocating spending toward productive activities*: Spending should be reallocated away from unproductive activities toward those that can support the development of human and physical capital. Spending that should be examined for rationalization includes energy subsidies, which disproportionately benefit upper-income groups and retard growth (Arze del Granado et al., 2012); the government wage bill, especially where public sector wages are high relative to the private sector and public sector employment is high; [13] and social benefits where these disproportionately benefit upper-income groups. The empirical literature suggests that reallocating this spending toward education, health, and public investment could have positive effects on growth (Baldacci et al., 2008; and Arslanalp et al., 2010).[14]

- *Replacing generalized subsidies with more targeted income assistance*. This helps allocate resources to their most productive use while maintaining protection for the poor. A challenge for many countries in this respect is energy subsidy reform. Clements et al (2003), drawing on country experiences, identifies six key elements of successful energy subsidy reform: (i) a comprehensive reform plan entailing clear long-term objectives, an impact analysis, and consultation with stakeholders; (ii) an extensive communications strategy, supported by improvements in transparency; (iii) appropriately phased price increases; (iv) the improvement of state-owned enterprise efficiency; (v) institutional reforms that depoliticize energy pricing; and (vi) targeted measures to protect the poor from the price increases.

- *Improving efficiency*: Many countries could improve their delivery of essential public services to support growth by improving the efficiency of spending. In health, for example, at least 20-40 percent of spending is typically wasted (World Health Organization, 2010), and there is scope for substantial gains in health indicators at current levels of spending (Grigoli and Kapsoli, 2013). The link between public investment and growth can also be strengthened in many countries by improving project selection and implementation (Gupta et al., 2011). Other reforms in public financial management (PFM) that improve the quality of budget formulation, execution, and reporting can also be helpful in improving the efficiency of spending by ensuring that public funds are spent as intended.

[12] We define efficiency here in terms of the ability of the government to provide a given level of goods and services at the minimum cost.

[13] Reducing the public sector wage bill and reallocating a larger share of public spending can also help increase growth in low-income economies (Gupta et al., 2005).

[14] For a survey of the empirical literature on public spending and growth in developing economies, see Gemmell et al. (2013).

29. Tax reform in developing countries: Tax reform, including with a view to raising a higher volume of taxes, is essential to finance higher levels of productive and pro-poor spending while maintaining a sustainable fiscal position.[15] As in advanced economies, tax reform can also boost growth by making the tax system more efficient.[16] The efficiency objective can be met in principle with low and relatively uniform tax rates imposed on broad tax bases. For example, the VAT should have a single rate with exemptions limited to the extent possible. The base for corporate income tax should also be broadened by rationalizing tax incentives. Furthermore, greater emphasis could be placed on raising revenues from property taxes. Improving tax and customs administration could also help raise revenue without raising tax rates and improve the efficiency of the tax system.

Table 4. Potential Fiscal Policy Measures to Support Growth

	Advanced Economies	Developing Economies
Tax Policy	• Improve the composition of tax revenues in light of the effects of different taxes on growth (from low to high impact on growth: property tax, consumption taxes, and income taxes and social contributions). • Reform corporate taxes to reduce bias toward debt financing. • Adopt targeted tax relief to boost labor supply. • Eliminate distortive tax expenditures and reduce tax evasion. • Enhance use of corrective taxes (such as energy taxes). • Reform financial sector taxes to offset distortions (from VAT exemptions) or internalize externalities from excessive risk-taking.	• Limit VAT exemptions to the extent possible. • Rationalize tax incentives in corporate tax system. • Raise tax revenues from property taxes. • Improve tax and customs administration. • Enhance use of corrective taxes (such as energy taxes)
Expenditure Policy	• Reduce the wage bill where public sector wages exceed prevailing wages in the private sector. • Link the receipt of social benefits to work or participation in effective ALMPs. • Enhance use of means-testing. • Contain increases in age-related spending. • Preserve spending on public investment that addresses infrastructure bottlenecks.	• Reduce untargeted energy subsidies. • Contain government wage bill and employment where they are high relative to the private sector. • Reallocate spending toward education and health, and toward public investment where this addresses infrastructure bottlenecks. • Improve the efficiency of public spending—examine opportunities to deliver services with lower level of inputs (including employment). • Improve project selection and implementation in public investment. • Implement other PFM reforms.

[15] See IMF (2010b) for further discussion on revenue mobilization in developing economies.

[16] The empirical literature on the effects of the level and composition of taxes on growth in developing economies is mixed. Much of it finds that the effects are insignificant (e.g., Adams and Bevan, 2005). More recently, Acosta-Ormaechea and Yoo (2012) find that increasing the share of income taxes (and reducing the share of consumption taxes) in total tax revenues reduces growth in middle-income economies. The effect is insignificant, however, for low-income economies.

Fiscal Policies to Support Employment[17]

30. A key element of a jobs strategy is to put in place tax and social benefits structures that support employment. Taxation and spending affect employment by influencing labor demand by firms and labor supply decisions by individuals. Empirical estimates suggest considerable responsiveness of workers and firms to these incentives in advanced countries (Bassanini and Duval, 2006; and Chetty et al., 2011). Elasticities of labor supply are especially high for low-skilled workers, women, and older workers. Given the wide divergence in labor market challenges, job strategies should take into account both short- and medium-term objectives. Where unemployment has risen sharply in the wake of the crisis, an immediate priority is to support employment growth. Options include lowering labor taxes and enhancing active labor market policies (Table 5). Fiscal policy measures to foster higher labor force participation will affect employment only in the medium to long run, but should not be delayed. Examples of these policies include child-care subsidies and tax policies that do not discourage second earners. Countries with tight fiscal constraints should prioritize reform options that are budget-neutral or can provide budgetary savings, such as reforms that link the receipt of social benefits to job search requirements.

31. Reforms should favor approaches that mitigate trade-offs between employment and equity. This can include the use of in-work tax credits and benefits that increase incentives to work and active labor market policies (ALMPs)**.** Some reforms that seek to increase incentives to work (such as cuts in social benefits) can increase wage dispersion because of their relatively stronger effects on unskilled labor. If these reforms are successful, however, they can increase employment, offsetting the effect of greater wage dispersion on inequality at the household level.

[17] For a broader discussion see IMF (2012f).

Table 5. Potential Fiscal Policy Measures to Increase Employment

	Expenditure Policy	Tax Policy
Policies to increase labor demand	• Implement hiring and wage subsidies. • Introduce employment support schemes. • Implement public work programs.	• Reduce labor taxes (fiscal devaluation: shifting from labor to consumption taxes). • Lower business taxes.
Policies to increase labor supply or facilitate matching	• Expand effective ALMPs. • Tighten eligibility criteria and job search requirements for social benefits. • Reduce the duration and level of social benefits when too high. • Increase child-care subsidies. • Increase effective retirement age. • Strengthen rules for disability pensions when too high.	• Reduce labor tax wedge, targeted to: • Older workers (earnings tax credits). • Low-skilled workers (tax relief to and in-work tax credits).
Policies to increase female labor force participation	• Strengthen financed parental leave schemes. • Provide greater parity in maternity and paternity leave. • Improve access to child-care. • Increase expenditures on female education and infrastructure. • Link child benefits to labor force participation to give incentive to rejoin the labor market.	• Reduce labor tax wedge, targeted to secondary earners (mostly women) by replacing family with individual taxation. • Give tax credits to low-wage earners.

Source: IMF (2012b), IMF (2012f).

Fiscal Policies to Reduce Income Inequality[18]

32. **Fiscal policy has played a key role in reducing income inequality in advanced economies, but has become less redistributive since the mid-1990s**. Over the past two decades, fiscal policy has ensured that inequality of disposable income in OECD countries is about one-third lower than inequality of market income (defined as income before taxes and government transfers), primarily as a result of transfers (such as child benefits and public pensions) and income taxation. The redistributive impact is higher when in-kind transfers for education and healthcare are included. However, since the mid-1990s, disposable income inequality has increased more than market-income inequality due to reduced generosity of redistributive benefits and the diminished progressivity of income taxes.

33. **Advanced economies could reinforce the redistributive role of fiscal policy in several ways**. These include greater reliance on wealth and property taxes, more progressive income taxation, removing opportunities for tax avoidance and evasion, better targeting of social benefits, and the reallocation of public spending to programs that strengthen the human capital of the poor, such as education and job training programs.

[18] A forthcoming Board paper (IMF, 2013h) will focus on income inequality and fiscal policy. See also Bastagli, Coady and Gupta (2012) for a broader discussion.

34. In developing economies, fiscal policy has had much less impact on income inequality. This, in turn, reflects their lower levels of taxation and public spending and the use of less progressive tax and spending instruments.

35. Developing economies could implement fiscal policies that enhance redistribution, while also promoting growth and fiscal sustainability. On the tax side, the focus should be to broaden tax bases through reduced tax exemptions, closing loopholes, and improving tax compliance, rather than raising tax rates. Revenue constraints are likely to remain tight, however, and fiscal resources will continue to be needed to finance spending that enhances growth, such as public investment that addresses infrastructure bottlenecks. This implies that greater emphasis will need to be placed on improving the progressivity of public spending through, for example, eliminating general price subsidies for energy (IMF, 2012g); ensuring that education and health expenditures are targeted to meeting the needs of the poor, rather than providing subsidized services to upper-income households; and putting public pension systems (which highly favor upper-income groups in developing economies) on sound financial footing, while adjusting fiscal spending in line with national poverty reduction and development strategies.

Table 6. Potential Fiscal Policy Measures to Reduce Income Inequality

	Advanced Economies	Developing Economies
Tax Policy	• Remove opportunities for tax avoidance and evasion. • Increase reliance on progressive taxes (such as income and property taxes).	• Broaden tax base by reducing tax exemptions, closing loopholes, and improving tax compliance.
Expenditure Policy	• Improve targeting of social benefits. • Reallocate public spending to programs that strengthen the human capital of the poor, such as education and job training programs.	• Increase reliance on targeted social expenditures to meet the needs of the poor. • Eliminate universal price subsidies for energy. .

Source: Bastagli et al. (2012).

D. Strengthen Advice on Labor Market Policies

36. Staff should ensure that advice on labor market policies reflects the state of knowledge and is evidence based about which combinations of labor market institutions work well. This means advice should aim for labor market policies that enable both “micro-flexibility” (allowing for the continuous reallocation of workers to jobs needed to sustain growth) and “macro-flexibility” (allowing the economy to adjust to macroeconomic shocks) while providing adequate protection for workers (see Box 3). Staff should thus discuss with country authorities whether employment protection and mandated benefits provide sufficient micro-flexibility; whether minimum wage arrangements, the tax wedge, and the collective bargaining structure provide sufficient macro-flexibility; and whether workers benefit from adequate protection. In developing countries, at a minimum staff should discuss whether labor market regulations “stay on the plateau,” i.e. avoid extremes of excessive worker protection with the result of hindering labor reallocation across sectors or of near-complete disregard for worker protection (World Bank, 2012, and Betcherman, 2013).

37. Staff should also ensure that advice on labor market policies takes account of the issues discussed in the preceding section on structural reforms, namely time spans needed for reforms to become effective and potential adverse short-term effects. In this context, it will be important that advice on labor market issues be mindful of the macroeconomic context. For example, reforms aimed at limiting labor market duality by, among other things, paring back employment protection for those benefitting from excessive protection, may result in large increases in unemployment if aggregate demand is depressed.

38. Further, as previously stressed, in analyzing labor market conditions and developing policy options, staff should always determine the extent to which unemployment is driven by cyclical factors and to which it is driven by structural factors. This is to better integrate analysis of the business cycle and labor market outcomes and to avoid potentially costly mistakes that can result from misdiagnosing the cause of high unemployment. Box 4 provides guidance on this and points to a recently developed resource staff should use. Staff may also wish to consult the Surveillance Toolkit for further resources on labor market issues.

39. A Fund-wide effort is underway to improve the availability and quality of labor market data for the most populous countries, and to maintain an inventory of data sets assembled by Fund staff. The initial data sets compiled under this Fund-wide project will be made available by end-2013. Staff are also encouraged to probe international and national data sources and to try to iron out inconsistencies in the data to the extent possible.

Table 7. Advice on Labor Market Policies

<table>
<tr><th colspan="3">Enable Both Macro-flexibility and Micro-flexibility</th></tr>
<tr><th></th><th>Advanced Economies</th><th>Developing Economics</th></tr>
<tr><td>Macro flexibility</td><td>Minimum wage: combine a low minimum wage with well targeted social transfers.
Tax wedge: strengthen the connection between taxes and corresponding benefits; shift to other taxes when the tax wedge increases labor cost in demand shocks.
Collective bargaining structure: combine national and firm level bargaining.</td><td>Minimum wage: minimum wage compresses wage distributions and reduces earnings inequality; pay attention to negative employment effects of minimum wage on specific groups (youth, women, and workers in small firms).
Labor unions and collective bargaining have limited role given the large informal labor markets.</td></tr>
<tr><td>Micro flexibility</td><td>Protect workers through unemployment insurance rather than high employment protection.
Generous unemployment insurance should have ALMPs in place and effective.
Employment protection should be limited, linked to employment length, and without threshold effects.</td><td>Protect workers, not jobs; enhance education and job related skills.
Pay attention to negative employment effects of employment protection legislation (EPL) on disadvantaged groups.
Avoid stringent EPL as it would slow down structural transformation and the speed of adjustment to shocks.
Given informality and incomplete enforcement, mandated benefits would have small employment effects.</td></tr>
<tr><th colspan="3">Take Account of the Macroeconomic Context</th></tr>
<tr><td colspan="3">Be aware of uncertainties of the timing and size of the effects of reforms.
Address the potential adverse short-term effects of reforms.
Take account of overall economic conditions in assessing the effects of reforms.
Take account of institutional settings in assessing the effects of reforms.
Take account of macroeconomic policies in assessing the effects of reforms.</td></tr>
<tr><th colspan="3">Take Account of the Business Cycle</th></tr>
<tr><td colspan="3">Differentiate between cyclical and structural labor market developments (see the IMF template for labor market analysis in the Surveillance Toolkit).
Develop policy advice while considering the cyclical and structural factors in the labor market.</td></tr>
</table>

Box 3. Macro and Micro Flexibility in Advanced and Developing Economies

Blanchard, Jaumotte, and Loungani (2012) recommend distinguishing between 'macro' and 'micro' flexibility as a basis for providing more targeted advice on the design of labor market institutions.

Advanced Economies

Macro flexibility: The institutions that appear to matter most for *macro flexibility* are the minimum wage, the tax wedge (which can affect primarily the average level of unemployment and labor force participation), and the collective bargaining structure (which can affect not only the level but also the responsiveness of unemployment). More substantial redistribution can be achieved through a combination of a low minimum wage and well-targeted social transfers (including negative income taxes). The empirical evidence suggests that, within a range, minimum wages have either small negative effects or no effect on aggregate employment.

Micro flexibility: The evidence suggests that to help *micro flexibility*, workers should be protected mostly through unemployment insurance rather than high employment protection—the so-called "flexicurity" model of Nordic countries. Unemployment insurance can be generous, but only if ALMPs are in place and effective. There is a role for employment protection, but it should be limited, linked to the length of employment in the firm, and without threshold effects. High employment protection levels are associated with high unemployment durations.

Developing Economies

Research suggests that formal labor market institutions in developing countries have modest impacts on aggregate employment, reducing income inequality for those that are covered by them but deepening labor market duality (Betcherman, 2013).

Macro flexibility: Minimum wages have either small negative effects or no effect on aggregate employment. But for specific groups of workers (youth, women, and workers in small firms) the effects on employment are negative. Non-compliance because of large informal sectors or weak enforcement may explain small effects. As for the impact on wages, virtually all studies that estimate the wage effect find that formal-sector wages rise with higher minimum wages. Somewhat surprising has been the observation that increases in the minimum wage often raise, rather than depress, wages in the informal sector. The empirical research is also consistent in demonstrating that the minimum wage compresses wage distributions and reduces earnings inequality. Labor unions and collective bargaining: The role of labor unions and collective bargaining in developing countries is limited by the large informal labor markets. Data on union influence is also scarce. As a result, while some studies find significant union wage premiums, there is no conclusive evidence.

Micro flexibility: Results for employment protection legislation (EPL) tend to be inconclusive, but some suggest negative employment effects, in particular on new hiring of some disadvantaged groups (e.g., young workers). While the evidence on the impact of job security rules on levels of employment and unemployment is inconclusive, the effect of EPL on labor market dynamics is much clearer. More stringent EPL is associated with smaller labor market flows in response to different states of the labor market, and therefore slows down structural transformation and the speed of adjustment to shocks and results in higher incidences of long-term unemployment. Mandated benefits, such as unemployment benefits, are less common in developing countries. There has been little research, but informality and incomplete enforcement are likely to result in small, if any, employment effects.

Box 4. Understanding the Growth-Employment Links and Differentiating Between Cyclical and Structural Unemployment

The growth-employment links may be tighter than it appears. There is a tendency to assert that there is a 'disconnect' between (output) growth and labor market developments, e.g. by showing that real GDP growth for a group of countries over some time period is only weakly correlated with employment growth or unemployment rates. This apparent disconnect is then used to argue that countries need a 'jobs strategy' in addition to a 'growth strategy'. Ball et al. (2013a) show that, for 20 OECD countries, the relationship between output growth and unemployment is quite strong, though the responsiveness of unemployment to output growth does vary across countries. A follow-up study for a large group of emerging and developing economies finds that the relationship is also strong in many of these economies (Ball et al, 2013b). The policy implication of these findings is that it is worth first investigating whether weakness in labor markets is simply due to poor short-run output growth, before advocating more intrusive structural remedies. Bakker and Zeng (2013) use this approach by first showing the primary role of output growth in driving employment growth in EU countries and then looking for structural factors that can explain the residuals from the output-employment relationship.

Fund staff (Abdih et al, 2012) have developed a labor market template that allows desks to analyze and project labor market indicators, including cyclical and structural unemployment, for any country with sufficient data coverage. The template uses *Excel* to generate inputs in the form of user-customized employment and output data for Fund member countries (see the case study for Algeria). Specifically, the template produces the following:

- Estimates of employment-growth elasticities: these estimates are produced using a variety of econometric methods including individual country time-series regressions and panel data estimation methods. Estimation is performed by means of an easily executed program written using the Stata econometrics package. (Crivelli, Furceri and Toujas-Bernate, 2012 provide evidence on the determinants of employment-growth elasticities.)

- Medium-term labor market outcomes table: after the appropriate elasticity has been selected, a table of possible labor market outcomes is provided in Excel, with four different scenarios that the user may adjust as needed.

- Projection charts: using the elasticity estimate, projected future growth, and other parameters previously customized by the user, two charts are provided in Excel: employment growth projections for the period of interest under a range of elasticities, and unemployment rate projections under baseline and reform assumptions.

Ideally, short- and medium-term desks' projections of unemployment and other labor market indicators could be regularly included in staff reports and possibly program documents and complement the set of tables and indicators typically reported. The table below presents a possible example on how to report key labor market projections.

	Projections 1/						
	2011	2012	2013	2014	2015	2016	2017
Real GDP Growth (%)	…	…	…	…	…	…	…
Labor force (millions) 2/	…	…	…	…	…	…	…
Employment (millions)	…	…	…	…	…	…	…
Unemployment rate (%)	…	…	…	…	…	…	…

Source: Country X authorities and Fund staff estimates.

1/ Projections based on employment-growth elasticity estimates (period x-2011).Source: Fund staff estimates (or Ball et al. 2013a, 2013b).
2/ Country X authorities; and Fund staff (ILO-Laborsta, ILO-KLIM) projections.

E. Advise on Financial Sector Inclusiveness to Decrease Poverty and Improve Distributional Outcomes

40. More varied and accessible financial services not only boost overall growth, but also reduce poverty and inequality. Financial systems serve a vital purpose, offering savings, credit, payment, and risk management products to people with a wide range of needs. Without inclusive financial systems, individuals must rely on their limited savings to invest in their education or become entrepreneurs, and small enterprises must rely on their limited earnings to pursue growth opportunities. This can contribute to persistent income inequality and slower economic growth. A well-developed financial system can allow a society to invest in more productive projects, promoting diversification and dampening cyclical fluctuations (Acemoglu and Zilibotti, 1997). Better and cheaper services for saving money and making payments and access to insurance products also allow poor households to avoid the cost of barter or cash transactions, cut the costs of remitting funds, and provide the opportunity to accumulate assets and smooth income against shocks.[19]

41. Staff should ensure that advice on financial inclusion takes account of heterogeneity across developing country financial systems. Lessons from cross-country experiences on broadening financial access and enhancing financial inclusiveness suggest the following directions:

- Develop information and market infrastructure to lower the costs and risks of expanding access to financial services. The literature shows a positive correction between credit information sharing and credit availability, especially to small and medium enterprises (SMEs).
- Limit excessively intrusive public sector interventions to avoid distortions (IMF 2012h).
- Prioritize enhancing access to funding and financial services for SMEs. Lack of SME access to finance reflects market failures and is a key constraint to job creation, particularly in developing countries.
- Enhance property rights and contract enforceability. Beck and Demirguc-Kunt (2006) find SMEs in particular benefit from a stronger legal environment.
- Encourage competition in a strong regulatory environment. Removing barriers to entry in the financial service sector and enhancing transparency would expand the sector and increase credit availability. Strong regulation and supervision including an appropriate bank resolution mechanism need to be in place when the financial sector is opened up to greater competition.
- Support the introduction of new financial tools and products (including credit cards, pensions, mortgages, and micro-loans) to promote a wider range of services.
- Investigate the issue of financial repression to safeguard the store-of-value function of money and therefore private sector savings and deepening.

[19] IMF (2009) provides guidance for surveillance of financial sector issues.

42. The creation of a development bank (DB) with funding clearly established in the state budget is a significant step to transparent development funding. A comprehensive legal framework and an operational framework for DBs are essential. In assessing proposals, staff should ensure that the principles for internal and external oversight are codified in the DB's legislation and internal regulations.[20] At a minimum, the authorizing law and respective procedural legislation should:

- Define the permissible activities, including the mission, method of funding;
- Define the government's responsibilities in providing initial and additional capital;
- Identify the agency responsible and the criteria for evaluating the institution's performance in meeting its goals;
- Grant authority to the supervisor to set and enforce binding prudential standards;
- Address fit-and-proper criteria for the management bodies, clarify their fiduciary duties, and the division of responsibilities between the oversight function (board of directors or supervisory board) and the operational management function;
- Define policies governing the accounting and auditing, including the valuation and disclosure of off-balance sheet positions and guarantees;
- Define public accountability and regular reporting obligations.

43. Deposit taking and non-deposit taking micro-finance institutions (MFI) have also proven to be effective in financial deepening in many countries. In the case of deposit-taking MFIs, it is essential to have appropriately strong supervision to ensure public confidence in the financial sector. Staff should ensure that advice on MFIs takes into account that most of the above cited legal framework, supervisory responsibilities and prudential requirements would also apply to the MFIs. Some control over non-deposit taking MFIs should also exist. The level of control would largely depend on the number of MFIs and their scope of operations. It is important to recognize that if private funding is the source of funds for lending operations, those sources have a vested interest in good governance. Oversight may be limited to registration/licensing and consumer protection.

44. Deposit insurance is an important component of any financial system safety net. Other components include a lender of last resort and prudential regulation and supervision. Deposit insurance needs to be well constructed, properly designed and well implemented, as risks - especially of moral hazard - are high. Core Principles for Effective Deposit Insurance Systems offer additional information on desirable features of deposit insurance framework.[21] Whether establishing

[20] See Fiechter and Kupiec (2004); Ratnovski and Narain (2007); and Scott (2007).

[21] See Basel Committee on Banking Supervision and International Association of Deposit Insurers Core Principles for Effective Deposit Insurance Systems, Basel 2009. https://www.bis.org/publ/bcbs156.htm

or reforming a deposit insurance system, staff should ascertain that pre-conditions exist on which to base the deposit insurance system. These preconditions include (i) ongoing assessment of the economy and banking system; (ii) sound governance of agencies comprising the financial system; (iii) strong prudential regulation and supervision; and (iv) well-developed legal framework and accounting and disclosure regime.

F. Collaborate, Reach Out, and Take Advantage of Training Opportunities

Collaborate Closely with Other Institutions in Line with Respective Mandate and Expertise

45. Staff should collaborate with other institutions as appropriate, in line with respective mandates and areas of expertise. The Fund with its traditional focus in macroeconomic (fiscal, monetary, and exchange rate) and financial policies has a key role to play in advising on macroeconomic demand management. The Fund can also advise on fiscal policies to help boost growth and employment. Further, it can advise on fiscal policies to reduce income inequality. Labor market policies are another area where Fund staff often have some expertise. To improve policy advice and avoid duplication, staff should seek to collaborate with other institutions such as the World Bank, the OECD, and the ILO.

- The World Bank has expertise in a wide range of areas relevant for developing countries, including labor market policies, financial sector issues, social safety nets, health, education, and utilities. Expectations for collaboration between the staffs of the two sister institutions are laid out in the *Joint Management Action Plan on Bank-Fund Collaboration in Middle- and Low-Income Countries*. Under the plan, Bank and Fund country teams working on middle-income and low-income countries where both institutions are active should consult each other regularly to develop a joint understanding of a country's macroeconomic challenges and the macroeconomic policies and structural reforms needed to address them, and to agree the division of labor in helping the country design and implement these policies and reforms.[22]

- The OECD has particular expertise in labor market policies and other areas of structural policies and their effects of growth.

- The ILO has expertise in several areas such as labor market institutions, tripartite labor relations, and social protection.

- Other bodies such as research institutions may also be able to share expertise of value to the Fund's work, and staff are encouraged to seek collaboration with them. For example, the Center for International Development at Harvard University conducts research on growth that may be of help.

[22] Detailed guidance is available at http://www.imf.org/external/np/pp/2007/eng/092007.pdf

Conduct Outreach on Jobs and Growth Issues

46. Sustained efforts are needed to raise awareness of the Fund's efforts to help countries reach their jobs and growth goals, as well as to enable the Fund to keep learning from the perspectives of external partners. It is therefore important in surveillance and program contexts to ensure an ongoing dialogue with social partners, including labor unions, the business community, civil society organizations, academia, and the public at large. A key goal of outreach is to explain how the Fund's policy advice and, where applicable, financial support, will help countries reach their jobs and growth goals and benefit all parts of society. For this, staff should lay out a longer-term vision and strategy, explain why any policy measures that may impose costs on some are needed as a part of the strategy, and present the measures will be taken to shield the most vulnerable from these costs.

47. Outreach to labor unions can be particularly important, especially where adjustment of wages or of labor market policies is needed. Successful outreach with labor unions has included early consultations with labor unions on possible Fund-supported programs before reaching agreement with country authorities and during program reviews; and regular interactions with labor unions as part of Article IV consultations in various countries. Strong relationships with unions may also help tripartite agreements between governments, employers and employees to support job-focused growth.

Stay Abreast of Fund Research and Take Advantage of Training Opportunities

48. Staff is advised to stay abreast of Fund research, positions, and guidance on these issues, which are not discussed further in this note. The literature on the determinants of growth, employment is still evolving, and there is no "silver bullet" answer as to the best policies to promote them. The economic developments since the start of the global financial crisis which prompted a rethinking of many aspects of macroeconomic policies are only one example demonstrating the necessity of keeping up with the current state of the art.

49. Fund staff should take advantage of training provided on jobs and growth issues. The ongoing RES/SPR Jobs and Growth Seminars are open to all staff and feature external and internal speakers. ICD is expanding its internal training offer of seminars and courses on jobs and growth issues, taught by academics at the forefront of the field. The Surveillance Toolkit provides material for self-directed learning on jobs and growth issues.

Annex I. Growth Diagnostics

1. Growth policy: balance between complexity and simplicity. A growth strategy consists of identifying and implementing reforms that address the market distortions that prevent the best use of an economy's resources. The debate on the efficient design of growth policy oscillates between the dual need of simplicity and complexity. On one extreme, the Washington Consensus provides a set of principles (property rights enforcement, macroeconomic stability, openness, good governance) that could guide reform strategies, but fails to sufficiently acknowledge country specificities and second-best interactions of different reforms. On the other hand, reform strategies that take into account such complexities require a level of information that is generally unavailable. The efficient design of growth policy, therefore, needs to strike the right balance between complexity and simplicity.

2. What is growth diagnostics? Growth diagnostics is an approach that has been proposed by Hausmann, Rodrik and Velasco (2008) to identify growth policy priorities for a given economy.[1] The underlying idea of the approach is to focus on the most binding constraints to the growth of an economy, so as to reduce the complexity of a reform strategy while taking into account the underlying economic environment. The rule of thumb of the growth diagnostics approach is as follows: focus on reform priorities based on the size of their direct effects on an economy. Intuitively, if the direct effect of a reform is large, then such effect will likely outweigh second-best interactions. This strategy, therefore, permits to abstract from costly information on the full list of required reforms and their interactions. Rather, the policy problem for the economist is to identify the most binding constraints to growth for a given country or region.

3. A conceptual framework. Hausmann, Rodrik and Velasco (2008) offer a conceptual framework to guide the growth diagnostics exercise. The starting point, is the prediction of endogenous growth theory that in equilibrium the rate of growth of an economy, g, is given by the following condition:

$$g = \sigma[r(1 - \tau) - \rho],$$

where σ is the intertemporal elasticity of substitution, r is the rate of return on capital, τ is the tax rate and ρ is the opportunity cost of funds. In turn, the private return on capital r is itself endogenous and given by

$$r = r(a, \theta, x),$$

with a being the level of total factor productivity of a country, θ an index of externalities in production and x the availability of complementary factors in production, such as infrastructure or human capital. This conceptual framework narrows down the set of potential distortions of an economy and helps organizing the policy questions. Specifically, it indicates that growth can be inefficiently low because of:

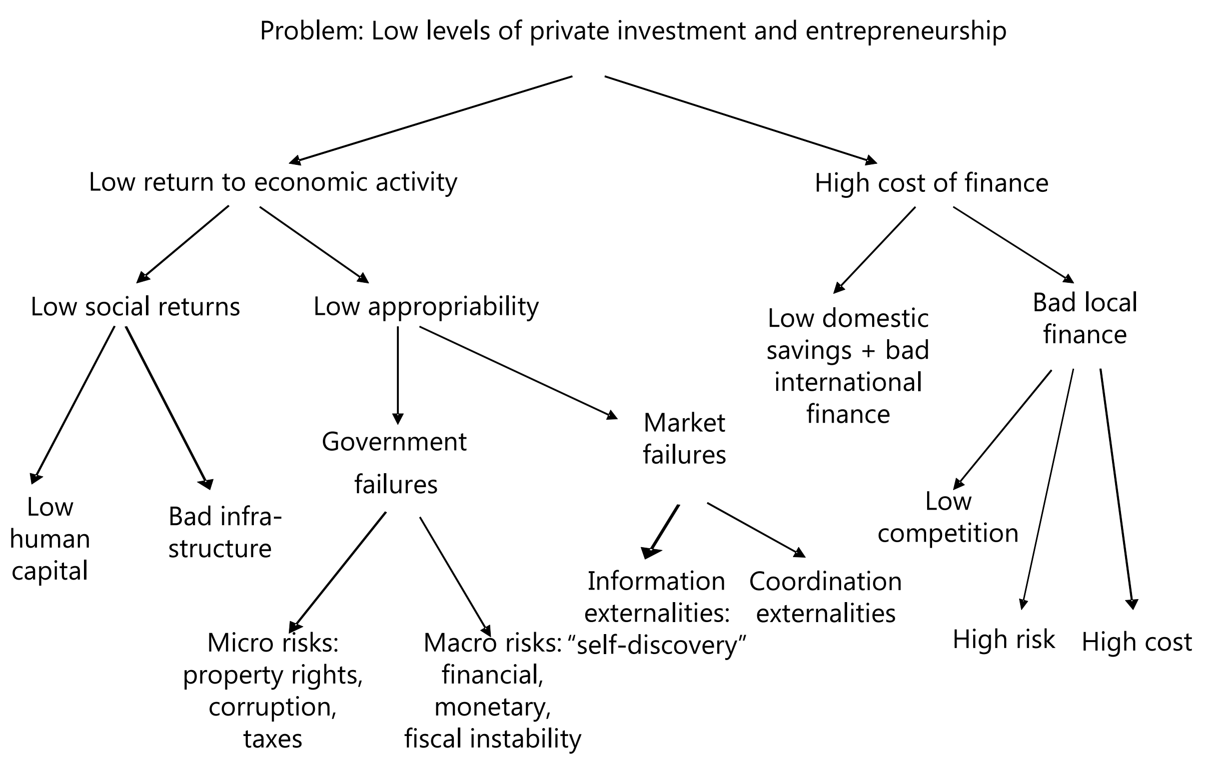
[1] See also Hausmann, Rodrik and Velasco (2006).

- *High costs of financing domestic investment (high ρ).* This, in turn, may depend on the inability to attract investment from abroad (e.g., high country risk, excessive capital account regulation) or bad conditions in the local financial market (e.g. financial repression, excessively low saving rates).

- *Low private return to domestic investment (low $r(1-\tau)$).* Low returns may result from high τ (high taxes or poor property rights); high θ (large externalities and coordination failures); low a (constraints to identify comparative advantage and to acquire technology); or low x (inadequate human capital and infrastructure)

4. The figure below summarizes the reasons for a poor growth performance and helps organize the diagnostic analysis, as discussed below.

A Growth Diagnostic Decision Tree



5. Growth diagnostics in practice. Hausmann, Klinger and Wagner (2008)[2] provide a simple guidebook to set up a growth diagnostics exercise. Their approach can be summarized by the

[2] Hausmann, Klinger and Wagner (2008) also discuss some of the criticism of the growth diagnostics approach, including Aghion and Durlauf (2007) and Dixit (2007).

following three steps: describing the growth process, identifying the constraints, and positing and verifying the constraints.

Step 1: Describing the growth process

6. Growth diagnostics starts from the analysis of the long-run growth performance of a country. This is generally done by looking at GDP per capita over an extended period of time and by benchmarking the performance of a country across time and across similar countries (e.g. countries that are geographically close, that have similar export structure, etc.).

7. The long-run performance of a country can also be indirectly assessed by looking at other correlates of growth. Economic theory indicates that an acceleration in productivity growth is associated with a broader socio economic transformation, such as decline in fertility, increase in female labor force participation, higher educational attainment and urbanization. Looking at the relative position of a country on these different dimensions, therefore, provides useful information of its growth process.

8. Finally, it is important to be aware of a country's general (current and past) macroeconomic conditions: the evolution of investment, consumption, income distribution across regions and different social groups, composition of output and exports. This analysis will help framing the investigation in a particular country in light of its macroeconomic environment and growth history.

Step 2: Identifying the constraints

9. The identification of the relevant constraints proceeds sequentially, as if we were moving down a decision tree (see Figure). First, the diagnostic exercise attempts to identify whether the main problem affecting the economy is inadequate return to investment (low $r(1-\tau)$) or insufficient access to finance (high ρ). Questions that can guide the analysis are: Is the shadow price of finance high? Do movements in the financial constraint map into changes in investment and growth? What constraint are agents trying to overcome? The essential point is to consider a wide range of evidence in an eclectic way, as the nature of the questions demands. Information could be gained by looking at relevant economic variables (e.g. lending rates) and surveys of local agents (e.g. business community). Microeconomic or anecdotal evidence, such as the analysis of how firms use their retained earnings or of what characterizes successful entrepreneurial activities, may also provide useful information.

10. Once we have identified the main problem affecting the economy, the second action to pinpoint the constraint(s) is to assess the specific distortion underlying the lack of adequate finance or the low return on investment.[3] We discuss these two cases separately. Assume first that the previous analysis indicates that financial constraints are the relevant ones (the right-hand side of Figure). Such constraints may result from inadequate access to (foreign and/or domestic) savings or from inefficient financial intermediation. Indicators of the first are a high

[3] Note that there may well be countries where both a lack of access to finance and low return on investment constitute large problems. In this situation, the diagnostic exercise moves down both sides of the decision tree.

sovereign risk, high credit rating or high lending rate, while financial intermediation problems may be signaled by a wide spread between deposit and lending rates.

11. Assume now that the main problem facing the economy is a low return on investment. This problem can be tied to three sets of factors (shown in the left-hand side of Figure). A first factor is that returns are difficult to appropriate because of high taxes, poor institutional quality or policy uncertainty. These constraints can be detected by looking at the tax system and at governance indicators such as rule of law, control of corruption, political stability or economic policy risk. A second factor is the lack of adequate complementary inputs, namely infrastructure or human capital. Measures of their shadow or effective price (e.g. returns from higher education, costs of transportation or telecommunication) may provide an indication. A third factor is finally the presence of coordination failures and other externalities. As these market failures are likely to affect the comparative advantage of a country, the export composition and sophistication will provide an indirect measure of their relative importance. Benchmarking of similar countries and anecdotal evidence can be useful to assess the relevant type of market failure.

Step 3: Positing and verifying the syndrome

12. The above two steps provide an indication of what are the likely constraints to economic growth in the country under analysis. However, a diagnosis should also include a consistent causal story of the facts that have been observed; that is, the economist may use the available evidence to posit a "syndrome". This additional step offers an opportunity to verify the robustness of the diagnosis of the previous two steps. In facts, the story proposed as the ultimate cause of the evidence observed should have other testable implications that can be confronted with the data and, therefore, corroborate or reject the diagnosis.

13. From diagnostics to therapy. The diagnostics analysis can be useful to prescribe a set of policy interventions and reforms that can restore or accelerate economic growth. Clearly the policy space is large and the appropriate policy mix depends on a number of considerations that go beyond the diagnosis of the problems and have to do with the therapy that can address them. Moreover, an effective therapy will have to take into account political economy constraints, as inefficiencies are likely to be in areas where the cost of reform are concentrated on a narrow special interest and the benefits diffused. However, the diagnostic exercise supports the reform process in two ways: i) it provides essential information on reform areas with larger returns; ii) it indicates a "menu" of options to policymakers that can be useful to overcome political economy constraints.[4]

[4] There are a number of studies that apply the growth diagnostics approach to specific countries and show how this approach can be useful in providing policy advice for reform. Several of these studies can be accessed at http://go.worldbank.org/HXX29AT3X0 and at http://www.hks.harvard.edu/fs/drodrik/GrowthDiag.html

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