Making Reform Happen

LESSONS FROM OECD COUNTRIES

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Foreword

Structural reforms are at the heart of OECD work. Over the years we have collected and analysed data, peer reviewed the policies of member countries, identified best practices and given recommendations. We have worked with both member countries and non-members to advance their reform agendas and have developed strategies for designing the most effective policies concerned with, among other things, growth, development, jobs, taxes, education, competition and, most recently, innovation. The potential for structural reforms to enhance long-run productivity and growth performance has been highlighted by a large and growing body of OECD work, much of which has been showcased in successive editions of our *Going for Growth* publications. Increasingly, though, governments now tell us that effective politics is not only about "where to go" but also about "how to get there". We have heard ministers ask "how to reform and to be re-elected" and "how to reform and to perform".

In response to these signals, in 2007 we started to look systematically at the political economy of reform and to discuss this dimension in our committees and our Centres of Government working group. Almost all OECD countries face medium- and long-term structural challenges in the context of global imbalances, climate change and population ageing. The current financial and economic crisis has underscored the relevance of governments' capacities to realise structural reforms, and the need for better regulation, more jobs and fiscal consolidation point clearly in the same direction. To put it bluntly: a crisis is a terrible thing to waste.

While the content of reforms may differ from country to country and from domain to domain, the institutional and process aspects are possibly even more country-specific. We do not pretend that political economy of reform is a subject that lends itself to "one-size-fits-all" toolkits. On the other hand, we have been involved in so many reform attempts across the decades that it is worthwhile to identify which lessons could be drawn and to focus on how we can best support our members in making reform happen. This has resulted in more alert support, including country-specific reports, seminars and projects on the realisation of reforms.

In the analytical strand of this work, a chapter in the 2007 edition of *Going for Growth* has been followed by two major companion studies. The first – *The Political Economy of Reform: Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries* (2009) – describes and analyses more and less successful reforms in three major policy domains. The second – this publication – presents cross-country lessons about the conduct of reforms in nine key areas: fiscal consolidation, tax, environment, labour market (pensions included), health, education, public administration, competition and regulation. An interim synthesis was released in 2009. We hope that this report can serve as a "palette" for policy makers who face the challenge of crafting and implementing structural reforms – a collection of "colours", instrumental in realising reforms, which deal with issues like communication, evidence, institutions, timing, costs and benefits, and engaging stakeholders. Yet we offer it as a "palette" rather than a "toolkit", for we know well that successful reform is more of an art than a science. For that purpose we accompany the launching of this report with a brief policy note.

In the meantime, we recognise that process dimensions are the subject of increasing discussion in our committees, so we expect that effective ways to realise reforms in different areas will be on our agendas in the coming years. From our findings it is clear that successful reforms often build on earlier failed attempts. By sharing experiences, exchanging views, comparing practices, we can learn from each other to speed up and sustain reform efforts. This can contribute to governments' responses to the challenges of structural reforms beyond the current crisis.

This volume was prepared under the overall direction of Deputy Secretary-General Aart de Geus, with the participation of the members of the OECD's "Making Reform Happen" network; though they are too numerous to mention by name, their important contribution to this work is gratefully acknowledged. Special thanks are due to Beatriz Pont of the OECD's Education Directorate for her work in getting the entire project under way and to Cheonsik Woo of the Organisation's Secretariat, who took over co-ordination of the project from her. The individual contributions presented here were edited for publication by William Tompson, assisted by Cheonsik Woo. Financial and in-kind support for this work from the Korean Development Institute is gratefully acknowledged.

Angel Gurría, Secretary-General of the OECD

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Executive summary

Since 2007, the OECD has undertaken a substantial and growing body of analytical work under the aegis of its "Making Reform Happen" (MRH) project, which seeks to better understand both the obstacles to reform that governments face in different policy domains and the most effective ways of overcoming them. This volume presents some of the findings that have so far emerged from ongoing work within the context of MRH. Its principal aim is to see how an understanding of past reform experiences may be of use to policy makers seeking to design, adopt and implement reforms in the years to come. The chapters that follow examine the particular challenges to reform and explore possible ways to meet those challenges in nine different fields of public policy: competition and market opening; pensions and labour markets; tax policy; environmental protection; education; health care; public administration; regulatory policy and fiscal consolidation. They reflect the experiences of the OECD and its member countries in each domain, with reference to both OECD-wide trends and specific cases, in the belief that a better understanding of past successes and failures should enhance prospects for better design and implementation of future reforms.

Despite the wide range of issues areas and countries covered, the conclusions that emerged from the chapters collected here suggest that such cross-country comparisons can be fruitful.

- They highlight evidence of institutional and policy convergence in some domains. This suggests that the scope for cross-country learning and policy/institutional transfer is considerable, despite wide variation in individual country contexts.

- The MRH work points to broad lessons for policy makers undertaking reforms – lessons that appear to hold good across a wide range of countries and issue areas. While policy makers may at times need both toughness and political cunning when advancing contentious reforms, OECD experience suggests that successful leadership is often about winning consent rather than securing compliance. This makes effective communication, underpinned by solid research, all the more important. Other cross-cutting themes concern the respective roles of leadership and institutions, questions of timing and sequencing of reforms, and strategies for dealing with the opponents of policy change.

- A further set of lessons that emerge are more "domain-specific", addressing the specific challenges that arise in conjunction with different kinds of reform.

The importance of such reform lessons is all the greater in the wake of the global financial and economic crisis. As OECD governments confront the challenge of trying to restore public finances to health without undermining a recovery that in many areas may remain weak for some time, they will need to pursue a careful mix of fiscal policies and growth-enhancing structural reforms. Designing, adopting and implementing such a policy mix will require the crafting of effective reforms and effective strategies for implementing them. A number of the studies presented here thus explore the particular challenges associated with reform after the crisis and the role of the OECD in meeting those challenges.

Chapter 1

Reform beyond the crisis

by William Tompson*

This chapter draws out some of the principal lessons that emerge from reform experiences in OECD countries. It seeks to identify both common patterns across policy domains and factors that appear to be specific to particular types of policy reform. The chapter begins with a consideration of the challenge of cross-country policy learning in an environment characterised by broadly similar reform challenges but widely differing reform contexts, a fundamental issue that confronts all the authors in this collection, as well as officials and policy makers in OECD countries who seek to learn from each other's experiences. The discussion then turns to some of the cross-cutting lessons for policy makers that nevertheless seem to be emerging from the "Making Reform Happen" work. The chapter goes on to deal with specific policy domains, highlighting some of the main points that emerge from the individual chapters in this book. A further section explores the meaning of these findings in light of the global economic and financial crisis and looks at the challenge of reform after the crisis. The final set of issues addressed concerns the implications of these findings for the work of the OECD.

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Over the last few decades, OECD countries have implemented policy reforms in a wide range of domains, with a view to enhancing living standards by raising labour utilisation and productivity, increasing the resilience of the economy to shocks and improving welfare by addressing social concerns such as equity and environmental quality. Despite a broad consensus on the need for reforms in many fields, their depth, scope and timing have differed considerably across both countries and issue areas. Indeed, the reform process has often stalled or been thrown into reverse. The political and technical challenges involved in actually realising reforms are enormous.

In an effort to help governments meet these challenges, the OECD has since 2007 undertaken a substantial and growing body of analytical work under the aegis of the horizontal project "Making Reform Happen" (MRH), which seeks to better understand both the obstacles to reform that governments face in different domains and the most effective ways of overcoming them. In parallel with this work, the OECD has been strengthening its capacity to provide analytical and other support aimed at helping individual governments identify the most effective ways to realise reforms. Though undertaken prior to the global economic and financial crisis, both these strands of MRH work have taken on a new urgency in the wake of the crisis, since OECD governments now face the challenge of trying to restore public finances to health without undermining a recovery that in many areas may remain weak for some time. This will require a careful mix of fiscal policies and growth-enhancing structural reforms.

This volume presents some of the findings that have so far emerged from ongoing work within the context of MRH.[1] Its principal aim is to see how an understanding of past reform experiences may be of use to policy makers seeking to design, adopt and implement reforms in the years to come. The chapters that follow examine the particular challenges to reform and explore possible ways to meet those challenges in a number of distinct policy areas, including labour- and product-market regulation, tax and budgetary policies, education, health care and environmental policy. Two further chapters offer analyses of how to build "reform capacity", by changing the way public administrations work ("reforming the reformers") and putting in place institutions and processes for generating high-quality regulation. These are all areas that have seen considerable reform activity in recent years and that remain high on the policy agendas of most, if not all, OECD members.

The individual chapters that follow have been prepared under the aegis of the OECD directorates active in the areas covered, and most have been discussed in the relevant OECD committees. They reflect the experiences of the OECD and its member countries in each domain, with reference to both OECD-wide trends and specific cases, in the belief that a better understanding of past successes and failures should enhance prospects for better design and implementation of future reforms. The focus in each instance is on the political economy of reform – that is, on the political factors that facilitate or hinder the adoption and implementation of reforms that would be likely to improve performance in a given domain. In other words, the initiatives examined in this volume are broadly considered to have been "good" reforms, as opposed to straightforward policy failures, although that should not be taken to imply that the reform designs were in all cases unproblematic, let alone perfect.

Common challenges and diverse contexts

Would-be reformers face common problems arising from the heterogeneity of agents…

At the root of many of the obstacles to reform lies the central problem of political economy: the heterogeneity of agents. If all citizens had similar activities, endowments and preferences, then most policies would affect all alike, and it would be relatively easy to devise and implement optimal policies – at least, if governments had perfect information, so that it would not be possible for individuals to free-ride. The problem is not merely that agents' economic endowments are unequal but that they are often different in kind and held in forms that are highly context-specific.[2] Many workers have skills that are firm- or even job-specific, and many firms are invested in capital and equipment that may be of value only for pursuing certain activities in particular locations. Such human or technological capital may be difficult to redeploy in response to a changing environment. The different endowments and/or preferences of different groups mean that many reforms will have a differential impact on them, sometimes substantially altering the relative value of different types of human and physical capital. Even socially beneficial reforms may therefore contradict the interests of many, largely because of distributional consequences that may be unrelated to the core aims of the reform. This heterogeneity finds expression in the political process, not least because it structures the incentives of politicians seeking election.

When it comes to policy reform, there is thus a twofold challenge. The first is to design reforms that will enhance aggregate welfare, even allowing for the costs that reform may impose on some agents. The second is to devise strategies for securing adoption of such reforms that prevent the opponents of change from blocking reform, but that also address their legitimate concerns about its distributional consequences. Given the technical, economic and political complexity of the issues and interests at stake in many reforms, this seemingly straightforward set of challenges can in reality prove dauntingly complex, particularly in situations characterised by imperfect information, distributional uncertainty and low levels of trust.

A good deal of theoretical and empirical work also points to the significance of two other factors:

- Loss aversion: there is evidence to suggest that agents tend to prefer avoiding losses to acquiring gains and that they will therefore run greater risks to avoid loss than to acquire gains. In most situations, this tends to make agents more risk-averse than a standard expected-utility approach would imply.[3]
- Endowment effects: the "endowment effect" is a shorthand label for the fact that that people often value a good or service more once their right to it has been established. This reinforces their tendency to attach a higher value what they already hold, simply because they already hold it. The result, again, is often a tendency to over-estimate the costs and/or under-estimate the benefits of change relative to the status quo.[4]

...but these problems take on different forms owing to the heterogeneity of institutions

Yet if it is the heterogeneity of agents that underlies the principal obstacles to reform everywhere, it does not follow that one can identify any "one-size-fits-all" formulae for overcoming the obstacles to reform or even identifying the most urgent reform priorities. This is because the heterogeneity of institutions and economic structures across countries ensures that the challenges facing would-be reformers vary widely across both time and space. It is important to acknowledge at the outset that virtually all of the contributions to the OECD MRH project emphasise the need for both reform design and strategies for reform adoption to reflect the specific institutional and cultural context of the country. Even where common problems can be identified in different countries, the specific features of the constitutional order, the political conjuncture, the structure of the policy process and other facets of the context for reform mean that simple, unaltered "transplants" of policies and institutions from one environment to another rarely take root. Some degree of adaptation is usually required. This must be borne in mind when trying to draw lessons from reform experiences across countries.

Nevertheless, the evidence suggests that such cross-country comparisons can be fruitful. First, for all their institutional, political and economic differences, OECD countries face a large number of common challenges, as is clear from the chapters that follow. These include devising policies to promote greener growth, pursuing fiscal consolidation in the wake of the global crisis, addressing the longer term fiscal and other consequences of population ageing, enhancing quality while controlling costs in fields like health care and education, spurring innovation, and adapting regulatory and other arrangements in the face of technological change in sectors like telecommunications. Moreover, in many of these policy domains, member countries have increasingly adopted common approaches, even if the specific institutions and policies still vary considerably from one jurisdiction to another. For example, the focus of labour-market policies over the last two decades has shifted increasingly from an emphasis on passive income support to activation.[5] Michael Wise's chapter highlights the degree of policy convergence with respect to various aspects of product-market regulation and competition policy (Chapter 2). In other areas, like pensions and public administration reform, policy tends to be highly path dependent,[6] as is clear from the chapters in this volume by Vincenzo Galasso (Chapter 3) and Claire Charbit and Camila Vammalle (Chapter 8).[7] Paul Ekins and Roger Salmons also find considerable evidence of path dependence in their chapter on environmental policy reform (Chapter 5). While governments confront common problems, the solutions adopted are to a great extent dependent on past choices. Yet even in these domains, the sectoral chapters presented here, as well as previous OECD work on the political economy of reform, point to important similarities in reform processes.

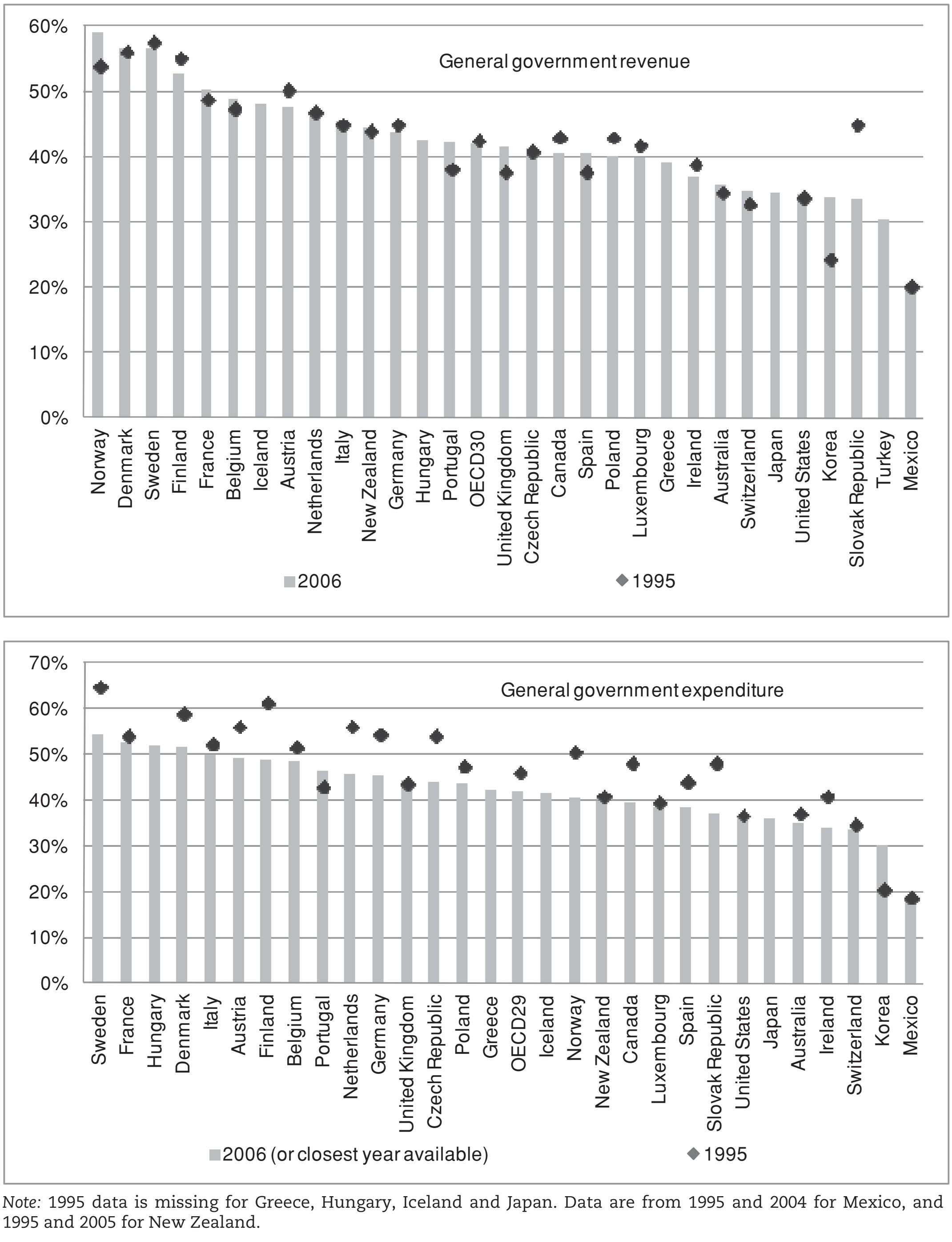
Perhaps most interesting of all is the evidence of a degree of institutional and policy convergence in the OECD area in some domains. To be sure, there is little or no evidence of convergence in constitutional structures or party systems, and there is still considerable diversity in the institutions of OECD welfare states.[8] Contrary to what some theorists of globalisation have predicted, there is little evidence of any convergence in levels of taxation or public expenditure either (Figure 1.1). However, there are clear indications of a certain amount of convergence at the level of "second-order" institutions concerned with economic governance. Faced with common challenges, OECD countries have gradually identified a number of institutions that, with appropriate modifications, appear to support sound macroeconomic and structural policies in a wide variety of settings.

In terms of macroeconomics, the most visible development has been the rise of independent central banks, which are now the rule in developed countries.[9] While one cannot point to such a dramatic convergence in fiscal institutions, Robert Price's chapter draws attention to the relatively rapid diffusion not only of fiscal rules but also of independent bodies charged with monitoring adherence to rules-based fiscal frameworks and, in some cases, with performing some of the technocratic functions associated with budget preparation (Chapter 10). OECD (2009a), moreover, highlights the gradual spread throughout the OECD area of a range of budgetary practices and procedures, including medium-term budgeting, performance-oriented budgeting and more rigorous rules governing budgetary transparency. Michael Wise emphasises the trend towards stronger general competition law regimes and stronger competition authorities, while Gabriella Meloni underscores the growing popularity of independent regulators for network sectors and well institutionalised arrangements for public consultation over policy, as well as practices such as regulatory impact analysis (RIA) (Chapter 9).[10] These and other examples suggest that the scope for cross-country learning and policy/institutional transfer is considerable, despite wide variation in individual country contexts.

One cannot always specify with precision the degree to which institutional change is a cause or consequence of reform. For example, while central bank independence (CBI) does tend to be associated with better inflation performance, many analysts incline to the view that CBI is neither a necessary nor a sufficient cause thereof; both Posen (1993) and Eijffinger and De Haan (1996) suggest that low inflation depends more on the strength of the political coalition supporting price stability, which is the key determinant of both inflation outcomes and the degree of CBI. However, to the extent that institutions represent "frozen preferences",[11] they may help consolidate reforms and make it harder for opponents to reverse them, as several chapters in this volume suggest. For example, Robert Price finds that the reform of budgetary institutions tends to follow the first stages of fiscal consolidation but that, once in place, fiscal rules and independent fiscal bodies help to maintain discipline. The experiences of OECD countries in fields as diverse as pension reform, product-market regulation and the reform of public administration also point to the potential of dedicated "reform institutions" to help initiate and sustain reforms.

Figure 1.1. **General government revenue and expenditure in OECD countries, 1995 and 2006**

% of GDP



Note: 1995 data is missing for Greece, Hungary, Iceland and Japan. Data are from 1995 and 2004 for Mexico, and 1995 and 2005 for New Zealand.

Source: OECD National Accounts Statistics for all, except Turkey; for Turkey, the Ministry of Finance Revenue Administration.

Managing the process: some general lessons

Although the MRH review of OECD experience does not yield any universal "toolkit" for reformers, or even suggest that such a toolkit exists, it does point to a number of striking regularities in the way reform processes unfold, which suggest that, despite the wide variety of challenges and circumstances they face, policy makers contemplating reforms need to address a certain number of basic questions in the early stages of reform design (Box 1.1).

Box 1.1. **Urgent questions: a reformer's initial checklist**

While neither the MRH work nor the political economy literature in general can yield any universal formulae for reform success, the research undertaken to date and summarised in this section suggests that policy makers should bear in mind the following questions when designing both policy reforms and strategies for their adoption and implementation:

1. Do the authorities have a clear mandate for change?
2. What more can be done to demonstrate the need for change and/or the desirability of the proposed solutions to the public and key stakeholders?
3. How strong is the evidence and analysis underlying the arguments for reform?
4. Are institutions in place that can manage the reform effectively, from design to implementation, or is there a need to create/strengthen such institutions?
5. Does the reform have clearly identifiable "owners", in terms of both politicians and institutions responsible for taking it forward?
6. What is the expected timeframe for design, adoption and implementation?
7. What is to be the strategy for engaging those threatened by reform? Can they be persuaded to support it? To what extent can/should their objections be overridden? Should they be compensated for their anticipated losses – and, if so, how and to what extent?

Among the major themes to emerge from all strands of the MRH analytical work to date are the following.

Elections matter: it pays to have a mandate for change

It is important to have an electoral mandate for reform. This is one of the strongest findings to emerge from the studies that have fed into the present synthesis. Reform "by stealth", via the quiet adoption of a series of seemingly technical changes, can sometimes yield progress, but it has severe limits. Major reforms for which governments have not previously sought public approval tend to succeed only when they generate visible benefits very rapidly, which structural reforms generally do not. Crises may create opportunities for such "reform surprises", as governments are forced to change policies rapidly in response to an emerging situation, but unless the pay-offs are quick, the sustainability of such reforms tends to depend on the government's ability to make the case for reform in terms of longer term goals. It is therefore important that governments undertaking reforms in the wake of the global financial and economic crisis avoid the temptation to treat the crisis as a *force majeure* situation that obviates the need to do the hard work of persuading stakeholders and voters of the need for change. The evidence suggests that an electoral mandate appears to be most important in respect of reforms that are all-encompassing (labour markets, pensions, environment), including those that affect basic public services (health care, education, public administration). The electoral salience of product-market reforms, by contrast, appears to be lower in most cases.[12]

Effective communication, underpinned by solid research, can help secure such a mandate

The importance of meaningful mandates makes effective communication all the more important. Successful reforms have usually been accompanied by consistent co-ordinated efforts to persuade voters and stakeholders of the need for reform and, in particular, to communicate the costs of non-reform. Where, as is often the case, the costs of the status quo are opportunity costs, the challenge is all the greater, because the cost of opportunities forgone tends to be politically "invisible". Where reforms are more or less all-encompassing (*e.g.* pensions, labour markets), communications efforts need to be directed at the voting public, while in other domains, the key focus may be primarily (though not exclusively) on directly affected stakeholder groups. Clear communication of the long-term objectives of reform is particularly important in a crisis: where reforms are undertaken in response to crises and other exogenous shocks, there is often a lack of clarity about their aims. That said, communication should not be confined to "marketing" the reform: real engagement with stakeholders also involves listening to their concerns, and may well result in some modification of reform proposals. This can improve the quality of policy, as well as prospects for reform adoption.

This points to the need for policy design to be underpinned by solid research and analysis. The MRH review of OECD members' experiences suggests that an evidence-based and analytically sound case for reform serves both to improve the quality of policy and to enhance prospects for reform adoption. If reform advocates can build a broad consensus among experts and the public concerning the merits of reform, they are likely to be in a stronger position when dealing with the reform's opponents. This is particularly important in those instances in which a reform must be negotiated with stakeholders who are suspicious of change. However, the challenges involved in evidence-based policy making vary across policy domains.

Successful reform also requires strong institutions and leadership…

The foregoing challenges, in turn, are more likely to be met where appropriate institutions exist, capable of supporting reform from decision to implementation. The impact of economic analysis, in particular, depends to a significant extent on the source: research presented by an authoritative, non-partisan institution that commands trust across the political spectrum appears to have a far greater impact. Building such institutions can take time, as their effectiveness depends on their reputation, but where they exist, their prior analysis appears to have enhanced the prospects for reform in particular areas. Yet institutions capable of providing expertise and advice are not all that is needed. Effective institutions are often required to guide and monitor implementation. Gabriella Meloni's chapter highlights the need for institutional coherence and co-ordination at all levels of government and for a well articulated and well-designed policy process, while Claire Charbit and Camila Vammalle address the critical issue of improving the quality and efficiency of public administration.

Leadership is critical. Virtually all of the assessments prepared so far in the context of MRH point to the importance of strong leadership – whether by an individual policy maker or an institution charged with carrying out the reform. Much of the work also points to the importance of government cohesion in support of the reform. If the government is not united around a reform proposal, it sends out mixed messages, and opponents are able to exploit its divisions; defeat is usually the result. Cohesion appears to matter more than such factors as the strength or unity of opposition parties or the government's parliamentary strength. That said, the call for strong leadership should not be read as endorsing a top-down approach to reform or suggesting a preference for unilateral action by the executive. While unilateral reforms are sometimes the only way forward and reformers may need both toughness and political cunning when dealing with opponents, the experiences highlighted by the chapters in this volume suggest that successful leadership is often about winning consent rather than securing compliance. This is particularly the case where those directly affected by a reform will play a role in implementing it.

…and takes time

Partly for these reasons, successful structural reforms take time. The more successful reforms examined in the MRH analyses generally took several years to prepare and adopt, and they often took far longer to implement. By contrast, many of the least successful reform attempts were undertaken in haste, often in response to immediate pressures: when it comes to policy reform, more haste can indeed make for less speed. Reforms of pension, health-care and education systems, in particular, often have relatively long gestation times, involving a considerable amount of careful study and consultation, as well as very long implementation periods. Much the same is true of reforms to public administration. Thus, while crises may provide opportunities to press ahead with reforms, the ability to make good use of such opportunities may depend on the work that has already been done to prepare a reform. It is often said that governments must seize the opportunities created when crises, scandals or other events create an opening for reform. However, to make the most of those opportunities, reformers must be ready even before they arise.

A final cross-cutting lesson, which is hardly surprising in view of the foregoing, is that successful reform often takes several attempts. Many of the biggest reform successes analysed in the secretariat's work followed earlier setbacks, and less successful reform attempts can often be seen in hindsight to have helped set the stage for subsequent, sometimes far-reaching reform initiatives, often by deepening policy makers' understanding of the problems involved.

It pays to engage the opponents of reform and may be necessary to compensate them

To a greater or lesser extent, all the chapters in this volume address the question of how to deal with the opponents of reform. While the nature and intensity of opposition to reform varies across issues and countries, there are some broad themes that appear to emerge in almost every context. First, reform experiences in OECD countries suggest that it pays in most circumstances to engage those who will be most directly affected by reform. Inclusive, consultative policy processes are certainly no guarantee against conflict when sensitive reforms are under consideration, but over time, such an approach seems to pay dividends, not least by creating greater trust among the parties involved, which may make the expected losers from reform more willing to rely on commitments to steps that will mitigate the cost of reform for them. Secondly, it is important to recognise that concessions to potential losers need not compromise the essentials of the reform: they may indeed be coherent with its overall logic, improving the prospects of particular groups that will be affected by the reform without contradicting its overall aims. The individual chapters illustrate the possibilities for such "reform-consistent compensation" in such areas as pensions, labour- and product- markets, taxation and public administration reform. Broader trade-offs may be possible, when complementary reforms in different domains are undertaken in such a way as to allocate both costs and benefits more equitably.

The question of whether, when and how to compensate those who will lose out as a result of reform emerges in virtually all the chapters. The literature on structural reform devotes a great deal of attention to the question of when and how the losers from reform might be compensated, whether by exempting them from the reform, at least for some period, or via some sort of alternative compensation. Failure to compensate may reinforce opposition to reform, but excessive compensation may be costly or may simply blunt the effects of the reform itself.[13] In a repeated game, it may also reinforce opposition to future reforms, as the perceived weakness of the government encourages agents to push for maximum concessions. The most common compensation strategies involve "grandfathering" rents and long transition periods, both of which are discussed later and in the chapters to follow. Concessions in the form of "side payments", such as adopting policies in other domains that might offset the cost of reform for some groups, are employed less frequently, though examples of such bargains are discussed in a number of chapters.

The extent and nature of compensation for "reform losers" depends on a number of factors

A number of considerations come into play when issues of compensation arise. First, there is often a value judgement to be made about the rents that agents are losing as a result of reform. If these are widely seen as unjustified (arising from, for example, the abuse of market power), there may be a well-founded reluctance to compensate, other than perhaps by phasing the reform in over some period. Where, on the other hand, there is a strong sense that agents did have some entitlement to the benefits they will lose, some compensation may be necessary. Reforms that affect what are considered to be "acquired rights" are likely to be particularly difficult to execute in the absence of compensation. It is not always clear, though, what constitutes an "acquired right". The issue is most straightforward in respect of contribution-based benefits or labour contracts. In other cases, it may depend on how the existing policy regime is organised and conceptualised. This, in turn, reflects not only the specific legal, cultural and institutional norms prevailing in a given country, but also the organisational and other resources of the groups that stand to lose. Other things being equal, the argument for compensation is stronger where subsidies or economic rents are capitalised into the value of assets. This is the so-called "taxi medallion problem" highlighted by Koromzay (2004). Current asset owners in such situations have typically acquired assets or made investments in good faith in an environment in which asset prices already reflected the rents generated by status quo policies (and in some cases, they were encouraged by those policies to do so). The true beneficiaries were those who held the assets when the policy-induced distortions were created.

The case for compensation is also likely to depend to some extent on the options the losers have for mitigating their losses – or even benefiting from reform – in the absence of compensation. This depends in large part on their pre-reform endowments and position. As a rule, either generous compensation or long transition periods are likely to be needed for agents who cannot readily adapt to the measures being implemented. The argument for long phase-in periods in respect of pension reforms, for example, rests largely on the fact that there are strong arguments against imposing substantial changes on current pensioners or older workers, for whom it may be too late to adjust their savings or labour-market behaviour. The owners of capital are, *ceteris paribus*, able to adapt to reform more easily than other agents, except perhaps in cases where reform risks leaving them with stranded investments. They can adjust their portfolios in response to policy changes and thus reap at least some portion of the benefits of a growth-enhancing reform. Indeed, if well functioning financial markets bring forward in time some of the benefits of reform, then the owners of capital may start to reap the benefits of reform even before they begin to pay the price.[14] Wealthier agents are also better able to cope with the costs of non-reform in many situations, having recourse to a wider range of adaptive strategies in response to sub-optimal policies and institutions. This puts them at an advantage in any conflict about how the costs of reform will be allocated. This is likely to matter more where the distributional consequences of reform depend on the specific measures adopted and are relatively easy to anticipate – *e.g.* in connection with labour-market reforms and pension reforms rather than, for example, financial or trade liberalisation.

Sectoral perspectives on making reform happen

This section turns from the most general, cross-cutting issues to some of the more sector-specific conclusions that are suggested by the various contributions to this volume. Its organisation follows the structure of the book as a whole, reflecting a broad – and admittedly imperfect – distinction between the various roles that the state plays in an economy. Generally speaking, the policy domains covered here fall into three groups:

- Fields like competition policy and the regulation of labour and product markets, in which the state's role is primarily that of "referee", regulating the activities of autonomous agents, who choose and pursue their own ends, and resolving disputes between them.

- Areas like education and health care, in which the state is engaged in the direct provision of services to citizens.

- Activities concerned with the functioning of the state itself in its performance of both rule-application (regulatory) and task-fulfilment (service provision) functions. The chapters in this volume by Meloni (on regulatory policy) and Charbit and Vammalle (on public administration reform) are chiefly concerned with these domains.

Of course, these distinctions are somewhat rough and ready, and there is in fact considerable overlap among them. Health-care policy, to take but one example, may concern the direct provision of some services as well as the governance of markets for the provision of others. Pension reform, too, may involve both governance of markets and direct administration of public schemes. Moreover, in many instances, reform itself may involve altering the state's role in a given field, as when a public administration reform results in the outsourcing of services that the state bureaucracy previously provided to itself or when sectors in which goods or services have been provided by state-owned monopolies are opened up and turned into contestable markets with private players. Many pension reforms involve changing the balance between public and private sources of pension income. Finally, when it comes to environmental policy, in particular, the reform agenda may involve policies to address environmental externalities in all of these fields. Nevertheless, these three broad categories are worth bearing in mind, because, as will be seen, they do tend to present somewhat different challenges for reformers.

International pressure and technological change have been key drivers of product-market reforms

The experiences of a number of OECD countries suggest that reforms of product-market regulation can play an important part in governments' response to adverse shocks. Deregulation can speed up the needed reallocation of resources, and, by reducing the cost of doing business, provide a fiscally neutral way of giving some relief to an enterprise sector under pressure. Efficiency-enhancing reforms to network industries and other non-tradable sectors can be particularly attractive at such a time. Nevertheless, simply persuading stakeholders and the public that the overall assessment of costs and benefits favours such reforms can be difficult, largely because the costs of the status quo in respect of product-market reforms are often hidden from the electorate. It is often clear who will pay the price for a reform – which firms are likely to come under pressure and which jobs may be at risk – whereas it may not be at all obvious who is paying for the status quo. It is difficult to identify firms that have never entered the market, sectors that have not developed or the workers whom they would have employed. However, experience suggests that a determined effort to quantify the costs of the status quo and the potential benefits of reform, and to communicate these to stakeholders and the public, can be crucial elements of success.

At the same time, successful product-market reforms typically include transition arrangements designed to ensure that the producer or consumer interests affected do not experience abrupt changes in economic conditions. As noted above, the most difficult problems tend to be those that arise when the rents resulting from anti-competitive regulatory policies have been capitalised into asset prices: current asset owners may not have profited from the old policies, but it is they who will be hurt by reform. Reform may make it impossible for some investors to earn an economic return on investments undertaken in good faith on the basis of the previous policy regime (so-called "asset stranding"). Since employer-employee relationships usually involve an element of relationship-specific investment that is lost in the event of a separation, stranded assets problems can affect labour as well. Where they arise, direct compensation or some other form of transitional assistance may be required if reformers wish to avoid extremely long phase-in periods.

As Michael Wise observes in Chapter 2, market-opening reforms are an area in which the last few decades have seen a significant degree of convergence among OECD countries. The trend towards stronger competition regimes and institutions is widespread, as is the tendency to open up more and more previously protected sectors to competition. This has come about not least because it is a field in which both international competitive pressures and international organisations and agreements have played a very large role in driving policy change, often in conjunction with major crises. In a world of increasingly free trade, both direct competitive pressures and the increasing focus of international trade negotiations on non-tariff barriers tend to put pressure on anti-competitive regulatory regimes. Reform thus typically begins "at the border", with foreign trade liberalisation, and gradually extends into more and more sectors and policies "behind the border", many of which are judged to be trade-related. Wise also observes that some of the sectors in which insider interests have been most successful in resisting market opening are non-tradables, where such external pressures are weak or altogether lacking. The role of technological change in driving policy reform is also important, though somewhat ambiguous. On the one hand, there is little doubt that technological change has been a powerful driver of reform in sectors like electricity and telecoms, in part by turning formerly non-tradable sectors into tradable ones or creating new possibilities for introducing competition in activities previously characterised by a high degree of natural monopoly. The opening of such markets to competition has often, in turn, spurred further innovation. On the other hand, the technical complexities involved in the creation of well functioning markets in sectors like electricity have sometimes created additional obstacles to reform. While the technical problems are real enough, it is also the case that protected insiders can use them to resist reforms that would in fact be quite feasible.[15]

Labour-market reforms have too often targeted "outsiders"

The global crisis that erupted in 2008-09 has highlighted the peculiar challenges posed by labour-market reform in many OECD economies. The 2009 meeting of the OECD's Council at Ministerial Level emphasised the need for re-employment measures and other reforms to counter the tendency for cyclical unemployment to become structural, including more effective and, in some cases, expanded active labour-market policies (ALMPs). However, reform of the "core" of the labour market is likely to be much harder in the near term. The evidence suggests that, although high levels of unemployment tend to increase the pressure for labour-market reform, a sharp rise in unemployment increases the likelihood that any reform will leave regular workers on indefinite contracts (labour-market "insiders") largely untouched. Since the value of employment protection rises with unemployment, regular workers, who tend to be the most organised segment of the labour force, have even greater reason to resist any weakening of employment protection legislation (EPL) during a cyclical downturn. Because EPL tends to impede job destruction as well as job creation, governments may hesitate to relax it in a recession, for fear of even greater job losses. Consequently, labour-market reforms in recessions tend to focus on labour-market "outsiders" – new entrants, those on irregular contracts, the unemployed and others on benefit. While reforms aimed at activating outsiders can be beneficial, the crisis has underscored, and perhaps even exacerbated, such labour-market "dualism" in many countries, as labour-market outsiders have borne the brunt of the adjustment, while insiders have in some cases secured significant real wage increases.

However, the experience of labour-market reform in OECD countries also seems to suggest that a sharp downturn can often be the right time to initiate a reform: given the lags involved in the policy process, labour-market reforms designed and adopted in the middle of a contraction are often implemented in a recovery, when an improving job market can make implementation easier. In short, the most promising time for reform seems to be immediately after a recession.[16] Moreover, in both labour and product markets, such reforms can facilitate the smooth reallocation of resources towards more dynamic sectors. Advancing such reforms may require significant concessions to organised labour on other issues. Galasso, in Chapter 3, shows that these concessions need not compromise the economic logic of reform: in some cases, it is possible to package reforms in such a way that agents will accept reforms they find threatening if these are bundled with reforms from which they stand to benefit. For example, there is a general tendency for unemployment benefits and employment protection to operate as substitutes in many countries – relatively few OECD countries combine very generous unemployment benefits with high levels of EPL. A reduction in EPL may therefore be combined with increased generosity of unemployment benefits where these are relatively ungenerous; in principle, both reforms might be desirable. Such a trade-off will, of course, depend on whether or not there is fiscal space for such concessions. Galasso also shows that labour markets are not so easily reformed by the sort of gradual, divide-and-rule approach that has often succeeded when reforming public pensions. Whereas pension reform in many countries has advanced by changing one segment of the pension system at a time, the same approach to labour markets has often simply led to deepening segmentation of the market.

Pension reforms

Pension reform appears to be an area in which public communication of reform messages is especially important – and potentially effective. As recently as the mid-1990s, some studies of the political economy of pension reform in the developed world suggested that it could only proceed by "stealth", with governments adopting technical changes with a minimum of publicity in an effort to shore up the financial sustainability of pension systems without ever revealing the far-reaching nature of the changes they were making (see, *e.g.* Pierson, 1994, 1996). In fact, it seems to have become easier in the last 20 years to win public acceptance of the need for – and, perhaps, the inevitability of – the reform of general pension systems, even if the urgency of reform has sometimes been questioned. This reflects in no small measure the impact of public discussion of research on the implications of lower birth rates and longer life expectancies, in particular, for public pension systems.[17] There is also an understanding in many countries that the current crisis has put even greater pressure on the finances of pension systems, making reform even more of a priority. While the distributional issues remain difficult, agreement on the need for reform is now widespread, and much has already been done.

Pension reform experiences in OECD countries highlight the importance of many of the general lessons identified above, including the need for careful study and consultation, the risks associated with excessive haste, and the importance of public communications and clear electoral mandates. It is a domain in which unilateralism appears to be a particularly unpromising strategy: almost all major reforms are preceded by intensive consultation and negotiation, sometimes over very long periods. In addition, successful reform strategies have often involved relatively long transition periods, which effectively exempt large groups from implementation of the reform. Despite the widespread perception in many countries that pension reform proposals represent a threat to retirees and older workers, current pensioners are rarely affected by pension reforms and workers approaching retirement usually experience only minimal change.[18]

In part, this is because trade unions and political parties tend to be oriented towards the interests of older cohorts, but there are also good economic arguments for long transition periods. Sharp swings in pension policy can be costly to contributors making career/savings choices for the long term, and the microeconomic benefits of pension reform depend in part on the clarity and stability of the link between contributions and benefits. The costs of pension reform thus tend to be borne chiefly by younger cohorts. Since it is they who will lose out if the system proves unsustainable over the long term, and since they have longer to adjust their savings behaviour, this tends to be politically acceptable.

Pro-growth tax reform

Although there is now broad agreement on a number of basic principles underlying pro-growth tax reform, implementation of such principles has, to date, been patchy. With public budgets in many OECD countries now under severe strain, however, such principles are more important than ever in guiding tax policy. Pressure for fiscal consolidation will compel many countries to seek new revenues in coming years, and the impact of this process on growth will depend largely on their success in identifying the revenue sources that are least distorting and least damaging to growth. To some extent, the difficulty of pursuing pro-growth tax reforms hitherto has reflected resistance to pro-growth tax reforms on other grounds, such as simplicity, equity or ease of administration. The need to make trade-offs among various goals is one of major challenges confronting any comprehensive tax reform. However, resistance to reform also reflects the fact that, while tax reform is in principle an "all encompassing" reform (the tax system affects everyone), it is relatively easy, and often electorally advantageous, for policy makers to opt for tax policy changes that serve the interests of particular constituencies (often swing voters). The benefits of such measures are effectively targeted – and visible to the beneficiaries – while the costs are spread over all taxpayers and are consequently less visible. A further concern in the present environment is that the growth of budget deficits in many countries will make it difficult to pursue pro-growth tax reforms that result in significant revenue losses in the short term; this makes any uncertainty regarding the impact of reform on taxpayer behaviour all the more important.

Bert Brys's overview of tax reform experiences in the OECD area in Chapter 4 points to a number of ways in which these and other challenges can be addressed:

- The framing of tax reform debates is critical: by considering the tax system as a whole (or even the tax-and-benefit system, when the taxation of labour income is at issue), rather than focusing on isolated elements, policy makers can better communicate the issues and trade-offs involved to the public, as well as address issues like vertical equity, which are best conceived as properties of the entire system rather than of specific taxes. This points to the potential for advancing reforms via broad packages that remove distortions in the system while spreading both benefits and adjustment costs widely; the losers from some measures may be winners from other elements of such a package.

- Since tax reform is likely to be a lengthy and complex process, articulating broad aspirational reform goals can help to clarify the meaning of reform for agents, while also making it easier to resist special interest lobbies. If reforms are to be bundled, such goals can help give "shape" to the package, increasing the likelihood that it will constitute a coherent reform rather than a ragbag of unrelated measures. Potential opponents' fears may also be allayed somewhat if the statement of reform goals includes acceptance of some *ex ante* constraints on reform, such as revenue neutrality.

- There is often a role for independent bodies charged with assessing the likely impact of proposed reforms in terms of such issues as taxpayer behaviour, revenues, vertical and horizontal equity, and ease of administration. Such a body could also provide analyses of the status quo, not least via the provision of transparent reporting of, *e.g.* the level of tax expenditures. In this connection, Brys notes that even the structure of the policy process – who gets to weigh in on reform proposals and at what stage – can be important.

- Finally, Brys notes that the timing of implementation can be critical. Changes in business taxation, in particular, can have devastating effects on firms if they are not phased in appropriately – sudden changes in the treatment of, *e.g.* debt-financed investment may otherwise push many firms to the brink of insolvency.

Economic and scientific uncertainty can make environmental policy reform particularly difficult

One of the most commonly cited "stylised facts" about the difficulty of structural reform is that the costs tend often to be incurred up front and concentrated on a few agents, while the benefits take longer to materialise and are generally more diffuse.[19] As is clear in Chapter 5 by Paul Ekins and Roger Salmons, this generalisation seems to be particularly true for environmental policy. Many environmental reforms are concerned with addressing the externalities generated by economic activity, and this means, almost by definition, that some actors will be deprived of sometimes substantial income in order to bring environmental benefits to all. Moreover, when it comes to issues like climate change, the full benefits of reform will not be felt for a generation or two. Reform debates are often complicated further by concerns about the impact of reform on competitiveness, its consequences for the less well off, and the problems that arise when the income streams eliminated by a reform have already been capitalised into asset prices – as, for example, when environmentally damaging farm subsidies have been capitalised into land prices.[20] At the extreme, environmental reforms can result in "asset stranding," which occurs when reforms leave companies or individuals stuck with investments that they would never have made if they had anticipated the change in the legal-regulatory regime and from which they cannot hope to earn an economic return in post-reform conditions. Reform may, in essence, render the assets worthless. Compensation of investors may thus be in order, provided they have not yet recovered the cost of the asset and cannot do so via sale or alternative use.

Scientific uncertainty often presents a further challenge, as it implies that the evidence put forward to support the case for reform will often be contested, and those threatened by policy changes will try to generate more "favourable" evidence to introduce into the debate. Debates over the science underlying certain environmental policy reforms are also affected by disagreement concerning such issues as the appropriate techniques for monetising environmental values and the proper limits of cost-benefit analysis. Consequently, the choice of analytical technique is often highly politicised. In many countries, a widespread attitude of mistrust towards government adds to the difficulty, since official claims about the need for reform are likely to meet a sceptical reception by much of the electorate. Finally, environmental reform is often complicated by the devolution of responsibility for issues across different levels of government (*e.g.* water management). It can also be highly path dependent, since past policies and infrastructure investments may dictate to some extent the menu of options available to policy makers.

Recent policy reforms in OECD countries suggest a number of lessons about how to address the particular challenges involved in environmental policy reform. First, as in other domains, engaging stakeholders and the public is crucial. Second, while research alone is no "fix" for politics, there is no substitute for a solid, evidence-based case for reform when dealing with stakeholders and voters. Public acceptance of a degree of scientific consensus does matter. Where, as is often the case, implicit or explicit subsidy regimes contribute to environmental externalities, transparency about the size and allocation of subsidies can help. Third, path dependence implies that the selection of policy instruments depends to some extent on existing institutions and regulatory regimes. Policy makers need to consider, for example, how easily a given legal system can cope with the introduction of instruments like tradable permits. Efforts to ensure that environmental policy changes are compatible with the broader institutional and regulatory environment are more likely to succeed where governments create institutions or processes that permit a whole-of-government approach to environmental regulation. In many cases, these considerations also point to the need to rely on a mix of policy instruments to address multiple market failures.

Concerns about competitiveness and the distributional consequences of reform are often finessed via partial and/or temporary exemptions from certain provisions, transitional support and long phase-in periods. At times, reform may be facilitated by the adoption of offsetting policies to ensure its tax neutrality, either by recycling the revenues raised by an environmental tax back to firms according to some rule or by cutting other taxes on industry, such as labour taxes. However, care must be taken that such measures are de-linked from the original polluting activity and do not lock resources into activities that should be curtailed or abandoned. Partial exemptions are sometimes used, as well, particularly to give relief to companies facing international competition. However, this can blunt the effectiveness of the reform; such exemptions may also be linked to binding targets for environmental performance, but the evidence suggests that this tends to have a limited effect. In some cases, it may be possible to achieve environmental objectives without radically and suddenly increasing the tax burden on firms: the environmental impact of an emissions tax, for example, will depend on the tax paid on marginal emissions, not the average tax per unit emitted. There may thus be some scope for phasing the tax in or designing it in such a way as to avoid unduly penalising investment decisions made before it was adopted.[21] Finally, if permit trading is to be introduced, it may prove politically necessary – though it is not economically desirable – to issue at least some portion of permits free of charge to major polluters ("grandfathering") (see Chapter 5 for more detail). If this is done, governments should seek to transition gradually towards reliance on auctions.

Reformers in education and health care face a number of common challenges

Chapters 6 and 7, by Gregory Wurzburg and Jeremy Hurst, suggest that governments seeking to reform health-care and education systems are likely to confront a number of common challenges, connected largely with the fact that both involve a great deal of direct service provision by the public sector, though there tends in most countries to be more private provision (even if publicly financed) in health care than in education.

- Both are characterised by an unusually high degree of path dependence. Health-care and education systems are both large and complex, and they have evolved in very specific ways in different national contexts. The question of what is feasible or desirable thus depends to a great extent on the institutions and policies already in place, as well as on the available physical infrastructure and human capital. Past policies also help shape public attitudes concerning what citizens have a right to expect from public health-care and education systems, which are often part of an implicit but nevertheless fundamental "social contract".

- The provider interests in both fields, who tend to be very well organised, generally command greater public trust than do politicians. Voters may be dissatisfied with health-care or education systems, but they tend to trust medical professionals and educators, who therefore have enormous power over the reform process. Some observers argue that they often act as *de facto* "veto players" when it comes to reform in their respective domains. Moreover, because effective implementation requires their co-operation, public sector providers can often undermine or even sabotage the implementation of reforms they oppose, at times turning their opposition *ex ante* into self-fulfilling prophecies *ex post*.

- It can be hard to make the case for reform on grounds of policy outcomes, because there is no consensus about how to assess outcomes in health care and education. This is partly due to the complex mix of goals to be pursued in both fields (equity, efficiency, quality, choice, cost-containment, etc.), but it also reflects the lack of reliable, generally accepted indicators concerning the quality of health-care and education outcomes and their value. Evidence-based reform is difficult where the evidence base is either lacking or contested. One consequence of this is that isolated facts or bits of data, or the emergence of a single high-profile study, can have a disproportionate impact on policy debates.

- Policy in both fields tends to be characterised by very long lags between conception and implementation. It can take years to design and adopt a reform, and it may be a decade or more before its impact is really felt.[22] This constitutes a potential disincentive for elected politicians contemplating reform, since no government is likely to remain in office long enough to receive credit for the benefits of the reforms it initiates.

- There is much less agreement about what constitutes "best practice" in these two fields. In some policy domains, one can identify a broad consensus on certain essential elements of a sound policy framework, even if there are disagreements about the details of implementation. In health care and education, however, there is no such model of best practice against which to assess individual policy regimes.

There are also more specific challenges in each field. In many countries, policy reform in education is complicated by the difficulty of co-ordinating reform across different levels of government and across multiple regional and local jurisdictions. This can also be a problem in health care, but it is typically less of an issue than in education. Sequencing is also a key issue in many education reforms, since retraining staff is often required. In the case of health care, many of the problems facing would-be reformers arise from the asymmetries of information which exist between patients and providers, and between governments, managers and providers. Health-care professionals and pharmaceuticals producers hold much of the knowledge about the benefits or potential benefits of health care. Insurers, governments and managers tend to be knowledgeable about the costs. Insured patients may be ignorant of both. The political economy of health-care reform is also shaped by the size and concentration of the actual or potential economic rents involved, which ensure the mobilisation of powerful lobbies when those rents are threatened.

Despite the presence of this formidable array of obstacles, many OECD countries have undertaken education and health-care reforms in recent years. Their experiences suggest a number of lessons concerning how governments tackle these challenges.

- Major changes are very rarely imposed on medical professionals or educators: successful reforms tend to be negotiated and to involve sometimes substantial appeasement of the major stakeholders. Health-care reform, in particular, has tended to be expensive in most countries – even if it is expected to help contain costs over time, it often involves expensive concessions in the short term. This suggests that it will be very difficult to reform where the crisis has brought about a marked deterioration in public finances.

- This process of negotiation means that reforms tend to involve extensive study and long preparation times: these are not domains in which "big bang" reforms, such as might be used to open a heavily regulated market, are likely to succeed.

- More and better data and analysis, including international comparisons, are often helpful, though a great deal depends on the level of consensus that exists regarding the value and meaning of such evidence.

- The need to engage the professions being reformed, coupled with the long time horizons involved, also means that reforms in health care and education may benefit from the creation of reform institutions to facilitate consultation and to support reform implementation. The existence of such institutions may also give coherence to a reform process that is likely to involve a large number of mutually reinforcing changes in discrete parts of the system over an extended period. A well-established and credible reform institution may also help to counterbalance the influence of provider interests in these domains.

To "reform the reformers" it is usually necessary to win their co-operation

As Claire Charbit and Camila Vammalle make clear in Chapter 8, public administration reform raises many of the same challenges, in terms of scope, scale and complexity, as reforms in health care and education, including path dependence, long time lags, co-ordination among different levels of government (especially but not only where reforms are directed at greater decentralisation) and the need to win the support of public sector stakeholders who will be directly affected by reform. It is also a domain in which it can be difficult to make an evidence-based case for change, because of the difficulty of evaluating the quality and efficiency of public services/public administration. In addition, there is rarely much social demand for public administration reform; while citizens are often dissatisfied with public sector inefficiency or the quality of public services, the issue of "internal" changes in public administrations usually tends to be of low political salience, and generating public demand for reform may itself be one of the first challenges that would-be reformers have to tackle. At the same time, however, voters may react strongly and negatively to measures that are perceived to violate a basic consensus about the boundaries and obligations of the state. Privatisation and the outsourcing of functions previously performed by public bureaucracies can be seen as violations of the kind of tacit "social contract" discussed above. Finally, public administration reforms confront policy makers with the problem of "reforming the reformer", since the public administration must, in effect, design and implement its own reform, imposing measures on itself that many officials may dislike.

Many of the lessons that emerge from recent experience with public administration reform pertain directly to the challenges identified above:

- Among the key elements of successful reforms have been efforts to raise citizen awareness of, and support for, reform, often via public debates and consultation strategies, and steps to compensate civil servants, financially or otherwise (*e.g.* via improved working conditions or opportunities for career development). Public understanding and support may be easier to obtain if changes in public administration are accompanied by complementary reforms that are more visible and more popular, such as e-government reforms, which can enhance both citizen voice and the quality of public service delivery.

- Extensive consultation with the officials affected by reform, whether they are elected or not, is also important, since civil servants and local politicians are more likely to accept – and even to take ownership of – a reform if they are clear about its underlying values and goals, and their role within it.[23] Civil servants' support can also be won – or their opposition reduced, at any rate – by complementary reforms that offer them benefits. While direct concessions such as higher pay may sometimes play a role, steps to improve working conditions, increase job satisfaction or invest in public officials' professional development may all be entirely consistent with the goals of reform while also fostering support for it among officials.

- Governments may also reduce uncertainty, and therefore opposition to reform, by accepting a degree of incrementalism, allowing reform to proceed in stages, with adequate provision for feedback and adjustment along the way. However, sustaining such an incremental reform over an extended period requires consistent leadership; public managers' perception of political support for public administration reforms appears to have a direct influence on their implementation (see Yang and Pandey, 2009).

- Given the likelihood of government turnover, this points to the need for independent, permanent organisations for steering reform, especially after the initial stages; otherwise, there is a great risk that incrementalism will give way to inertia and reforms will stall. Since such institutions need broad authority across the state administration, centres of government often have a key role to play here.

- Charbit and Vammalle also identify a role for international organisations in helping to generate knowledge, citizen awareness and support through the sharing of knowledge and information, policy evaluation and the promotion of co-operation among national administrations. By providing international benchmarks and channelling peer pressure, they can increase incentives for reform.

Progress in all domains can be enhanced by institutionalising better policy processes

Gabriella Meloni's chapter on enabling regulatory reform looks not so much at the substance of policy reform as at the policy process (Chapter 9). Yet the issues addressed in her chapter are crucial to enabling governments to devise and realise effective, efficient reforms in a variety of domains. Here, too, moreover, there are indeed substantive reforms at stake. Their effects are potentially very far-reaching indeed, even if they are, from the perspective of most economic agents, not so immediately visible or relevant. In no small measure, this reflects a gradual evolution in the understanding of regulatory reform in the OECD area: what was once seen as an essentially episodic reform (a one-off set of interventions aimed at deregulation) is now understood as an ongoing process that is increasingly integrated into policy making and that comprises a mixture of deregulation and reregulation.

The chapter identifies a number of features that characterise the institutions and processes associated with producing high-quality regulation. The first is the articulation of a clear and well-structured general policy framework. While this depends greatly on the specific institutions and traditions of any given country, it is critical that the roles and competences of the actors are clearly defined; that the system is structured as to make a "whole-of-government" approach to reform feasible, by taking into account interactions among institutions; and that there is a strong commitment to a regulatory culture that favours information sharing, trust and co-operation, as well as an explicit high-level commitment to the regulatory reform agenda. In exploring the preconditions for achieving these factors and the various institutional forms that may emerge in different countries, Meloni identifies a number of areas where there has been a degree of institutional convergence. These include growing reliance on independent regulators, more institutionalised and explicit procedures for consultation with stakeholders in the course of policy making, the growing popularity of "reform-advocacy" bodies and the spread of regulatory impact analysis, particularly since the mid-1990s. The chapter also explores the kinds of institutions evolved in different countries to address problems of multi-level governance in the field of regulatory reform. The institutional convergence observed, though far from complete, is impressive, and it suggests that OECD countries with widely differing institutions, political systems and legal cultures do reach for similar solutions when faced with similar reform challenges.

This sort of diffusion of institutions and policies is clearly facilitated by co-operation in international forums. Drawing on a large and growing body of research in this field, Meloni argues that international organisations may act more effectively as agents of durable reform when they focus on education, teaching and exchange of national experiences rather than seeking to use "hard" forms of conditionality to impose policy reform from the outside. Hard conditionality can be successful in some domains and in some circumstances, but the evidence suggests that it has been broadly ineffective in most arenas, not least because it is rarely successful in establishing domestic agents' "ownership" of reform processes – and it often results in policy prescriptions that are ill adapted to local conditions.

Fiscal consolidation tends to be easier to sustain if fiscal rules and institutions are strengthened

Robert Price's analysis of the political economy of fiscal consolidation in Chapter 10 comes at a timely moment, as the past couple of years have witnessed a dramatic deterioration in the state of public finances in the OECD area. Drawing on a large body of empirical and theoretical work, including a study of 85 fiscal consolidation episodes in the OECD area over three decades, Price finds convincing evidence that fiscal policy processes in many countries are characterised by deficit bias: fiscal policy tends to be far more counter-cyclical in downturns than in upswings, with the result that many countries have experienced a secular rise in public debt and cyclically adjusted deficits. The chapter analyses the market failures and political economy factors that underlie this bias. Fortunately, the empirical record suggests that there is a direct relationship between the size of the initial deficit and the scale of the ensuing consolidation: in short, countries reform more when they are in deeper fiscal trouble. The most successful are those who base their adjustment largely on structural reductions in public spending. While most consolidations involve a mix of revenue- and expenditure- side measures, a considerable body of research suggests that consolidation has a greater chance of being sustained if based on spending restraint, particularly with respect to government consumption and transfers.[24] A focus on expenditure is more likely to correct the biases that led to the deterioration in the fiscal position in the first place (von Hagen, Hugues Hallett and Strauch, 2002). Policy and long-term interest rates are also more likely to fall when consolidation involves structural spending cuts, which may be why Giudice, Turini and Veld (2004) find that consolidation episodes based on expenditure restraint have generally been associated with better growth performance than those relying chiefly on revenue increases.

In general, significant consolidations do not begin with changes to fiscal institutions. The first steps are typically aimed at immediate savings and they are often rather *ad hoc* in character. However, consolidating governments often come to re-examine rules-based frameworks and institutions later on, in an effort to sustain the gains they have made in fiscal adjustment. Overall, the most effective combination appears to involve both structural budget-balance targets and nominal expenditure ceilings. Debrun *et al.* (2008) find that policy tends to be less pro-cyclical where the rules for setting budget-balance targets and expenditure ceilings explicitly address the macroeconomic stabilisation function of fiscal policy, as well as debt/deficit management. The fiscal frameworks in many successful consolidation episodes built prudent macroeconomic assumptions into the budgetary process. Mechanisms that increase the political costs of breaching the rules can also help a great deal. This implies a need for rules to be simple and transparent, so as to facilitate public and media monitoring, as well as assessment by independent authorities. These considerations point to two advantages of spending caps. First, they can allow individual spending ministers to be held accountable for breaches. Secondly, they are arguably more transparent – and thus easier to explain and to monitor – than all but the simplest unadjusted balanced budget rules (which are likely to be too crude to be desirable).

Such frameworks are only likely to work to the extent that elected politicians "take ownership" of them. Some countries have sought to discipline politicians by adopting constitutionally entrenched fiscal rules, but Ljungman (2008) finds that rules need not be enshrined in law to be effective, provided there is real political commitment to them. In the absence of political support, the legislative status of a rule cannot ensure its effectiveness. Giving the fiscal rule a higher legislative status is thus more likely to be a way for politicians to signal their commitment to fiscal discipline than a real mechanism for binding themselves in future. The crucial challenge is therefore to establish broad and enduring support for a stable, transparent and effective fiscal framework.

As noted above, recent years have witnessed growing interest in "fiscal councils" or other non-partisan agencies that perform at least some of the technocratic functions in the budget process, often in the context of implementing a fiscal rule. These can be devices to signal government commitment, as well as forces for discipline in their own right. For example, the Fiscal Policy Council in Sweden assesses whether fiscal policy objectives, including long-run sustainability, the budget target, the expenditure ceiling and counter-cyclicality (or at least avoidance of pro-cyclicality) are met. An analysis by the European Commission (European Commission, 2006) found that fiscal performance was better in countries with at least one national institution other than government and parliament providing inputs into the fiscal policy process such as forecasts, analyses or recommendations. Delegation of forecasting responsibilities also seems to have helped correct optimistic biases in the projections underlying public budgets. Debrun and Kumar (2007) likewise find a strong relationship between the *de jure* influence exerted by non-partisan agencies and their impact on fiscal performance, especially where there are formal guarantees of independence. The presence of fiscal councils appears to contribute both to the emergence of fiscal rules and to their effective enforcement.

The challenge of reform after the crisis

Structural policy should form an important part of a strategy for exit from the crisis

The world economy continues to grapple with the aftermath of the deepest and most widespread recession in over half a century. The collapse of world trade and the sharp output contraction recorded in almost all OECD countries, allied to a major slowdown in the major non-OECD economies, are without precedent since the Great Depression. The initial policy response in most countries was largely focussed on fiscal and monetary easing and, in some countries, on the stabilisation of banking systems disrupted by the financial crisis that helped trigger the recession. Given the severity of the downturn, it is hardly surprising that the salience of structural policy receded somewhat. However, OECD governments are now faced with the challenge of sustaining the recovery from the crisis. This will require finding a combination of structural policies that enables them to shore up public finances without choking off growth. Structural reforms can facilitate the pursuit of both goals, by enhancing growth potential on the one hand and, in many cases, reducing the pressure on public budgets on the other.

It is critical to keep long-term goals in view when navigating a course out of the crisis (see OECD, 2009b). While the events of 2008-09 have clearly had an impact on immediate policy priorities, focusing attention on the need for, *inter alia*, better regulation of financial markets, they have done nothing to diminish – and in some cases they have increased – the major reform challenges that governments already faced in a range of domains, from pensions to environmental policy. Moreover, as noted above, most of these reforms will take considerable time to design, adopt and implement; policy makers should be wary of seeking – and should avoid appearing to promise – "shortcuts" to strong growth and fiscal sustainability. Governments will also need to be exceptionally sensitive to the distributional consequences of fiscal and structural policies going forward. While issues of equity are never unimportant, they have taken on a new significance in many countries, owing to the perception that many of the early measures adopted to address the crisis have transferred resources to interests and groups that helped bring it about, particularly the financial sector.

The challenges ahead will be all the greater, because many structural and fiscal emergency measures adopted in 2008-09 in an effort to cushion the immediate impact of the crisis could undermine long-term growth if they are retained over the medium-to-long term. Strategies are needed for unwinding such measures once the recovery is assured. While the increased government presence in the financial sector in many countries is the most obvious example of this problem, an array of extraordinary product- and labour-market interventions will also need to be phased out. If prolonged, they risk delaying needed adjustment and weakening any future recovery. Finally, it is important to note the potential of the current crisis to act as a catalyst for reforms aimed at ensuring that the recovery and future economic growth are consistent with sustainable development.[25]

There is good evidence that crises often act as spurs to reform…

A large body of research on policy reform suggests that crises can create significant reform opportunities, both by demonstrating the unsustainability of the status quo and by disrupting the interest coalitions that have previously resisted reform. Moreover, there are good empirical and theoretical grounds for believing that crises also increase agents' willingness to accept the risks of change. In normal circumstances, when immediate losses do not threaten, the combination of loss aversion and the endowment effects discussed above tends to lead individuals to overestimate the risks and underestimate the benefits of reform. Yet these same factors mean that agents will often take greater risks to check possible losses than they would to realise potential gains of equal size. Faced with a crisis that threatens their existing endowments, therefore, they may become less risk-averse.[26] Different types of crisis tend to be associated with different types of reform: trade and labour-market reforms are most likely to be prompted by sharp falls in growth and income, financial reforms tend to follow bouts of high and especially volatile inflation, and fiscal crises tend to favour tax reforms.[27]

OECD work broadly confirms the importance of this crisis-reform link. However, it also suggests that sound public finances tend to be associated with more reform. Indeed, the link between healthy public finances and structural reform progress is one of the most robust findings to emerge from recent work. Both the case-study work and the econometric results across a wide range of specifications point to this conclusion.[28] While pressure on public finances often constitutes an important motivation to attempt reforms, it can make them harder to adopt and implement. Many reforms involve upfront fiscal costs, while the benefits are realised only later. A severe fiscal squeeze may make it harder to assume these costs, even if the reform is projected to save money in the long run. In addition, a weak fiscal position makes it harder to find resources to provide adequate compensation or transition arrangements for those who will lose from reform. Finally, governments with limited political capital may opt to focus on fiscal consolidation rather than structural reform. This is a particularly relevant concern, given the recent deterioration in many OECD countries' public budgets.

…but the impact of the recent crisis on the politics of reform is hard to foresee at this point

The impact of the present crisis on prospects for reform is thus ambiguous: the crisis may strengthen the case for pursuing some reforms, but the fiscal situation will constrain governments' ability to do so. As and when the nascent recovery becomes self-sustaining, many OECD governments will be under enormous pressure to pursue fiscal consolidation in order to address concerns about long-term fiscal sustainability. Such pressures will constitute a powerful argument in favour of reforms to public pension systems and other entitlements, as well as health care; however, governments will have to show considerable ingenuity in creating the fiscal space needed to bear the short-term costs of such reforms. Reforms will also need to be presented as desirable on long-term, structural grounds and not merely as unavoidable cuts in public expenditure. Experience of past reform attempts in some OECD countries suggests that reforms justified chiefly as responses to fiscal pressure may be difficult to sustain when that pressure eases.[29]

There is one other potentially important respect in which the current crisis may affect the politics of reform differently from previous crises. Public trust in market-oriented policies has been damaged by the widespread perception that the downturn is the product of under-regulation of the financial system and that the response has required active, large-scale direct intervention by governments in markets. In the short term, at least, the crisis may put advocates of market liberalisation in whatever policy domain, on the defensive. In any case, while the crisis has hardly invalidated prior understandings of many reform challenges, in some fields, such as financial regulation, it has called into question many positions that were previously held to be well-established "policy orthodoxy". In many areas, it must be admitted that there is no generally agreed understanding of what constitutes "best practice" policies. This may, however, have the advantage of compelling would-be reformers to make the case for regulatory or other reforms more rigorously and persuasively, on the basis of careful, context-specific evidence and analysis, rather than relying on an implicit assumption that the case for, *e.g.* opening product markets or relaxing labour-market regulations is self-evident.

Reform-minded governments can take some consolation from another finding to emerge from the secretariat's MRH work: current growth performance has little impact on governments' ability to reform. The econometric results and the case-study evidence alike are consistent with the conclusion that macroeconomic performance is important in determining whether and when reform initiatives are attempted, but it appears to have little, if any, impact on governments' success in adopting and implementing those initiatives that they do undertake. Granted a government is prepared to put forward a reform proposal, its prospects for success do not appear to be strongly linked to the business cycle. If a government is ready and able to press ahead with a reform, there is unlikely to be any reason to wait for a more politically "auspicious" time in the economic cycle.[30] That said, the scale of the challenge facing policy makers may in itself cause governments to postpone some reforms that were being prepared before the crisis: government capacities are limited and are at present focussed, for obvious reasons, on the response to the recession. In addition, the current situation has highlighted some new priorities, as well as reinforcing old ones, so there may well be a need to reshape reform agendas and reconsider specific reform objectives in light of the new situation.

Finally, it is worth noting in this context that, while the current crisis has implications for all the policy domains covered in this volume, there are other sorts of crisis that arise. What constitutes a "crisis" can often depend to some extent on the policy area in question. While labour- and product-market reforms, as well as some trade, tax and social insurance reforms, may be prompted by recessions and financial crises, in other fields a sense of crisis may be provoked not by a macroeconomic shock but by the appearance of new data or information, which exposes problems previously not well understood or changes ideas of what is acceptable. The first Programme for International Student Assessment (PISA) scores, for example, generated a sense of urgency about education reform in some countries. Economic crises can provide an impetus to public administration reform, but they may also prompt organisational innovations that are at odds with the thrust of reform: for example, while many public administration reforms tend towards greater organisational diversity and decentralisation, crises often trigger increased centralisation.

The challenge of reform and the role of the OECD

The OECD can facilitate cross-country policy learning

The experiences reviewed in connection with the MRH project confirm that the case for reform is strengthened by the availability of internationally comparable data and analysis. In a number of policy domains, the OECD is in a strong position to provide these. It can also promote awareness of emerging policy challenges, stimulating evidence collection and knowledge sharing, as well as providing potential tools for reform. The importance of such knowledge sharing is all the more evident in light of the fact that successful reforms often take several attempts. Yet each such attempt may take years, raising the question of how governments can limit the number of "false starts" and accelerate reform progress. The evidence suggests that cross-national studies and international policy dialogue can speed up the process of "policy learning", enabling governments to learn from one another and thus avoid repeating one another's policy errors. OECD work on disability benefit policies since the early 1990s well illustrates the potential of this type of cross-national exchange to make policy reform easier (see Prinz and Tompson, 2009). Such learning is particularly valuable at a time when OECD governments confront a range of global challenges, from ageing to the environment, that may take decades to tackle.

The involvement of national officials and experts in OECD discussions, in turn, helps to create and sustain "communities of practice" at the international level, networks of experts who then exchange ideas and experience, and influence policy debates within their respective countries by framing both policy problems and potential solutions for decision makers (Haas, 1992). As shared understandings of what constitute "best practice" emerge in a given domain, such networks help to diffuse them, bringing about a degree of policy convergence. Often OECD evidence and analysis is mediated via domestic institutions, be they state institutions such as the CPB Netherlands Bureau for Economic Policy Analysis or the Australian Productivity Commission, independent research institutes and think tanks or key responsible experts serving in government. These bodies, in turn, feed their own research and analyses not only into domestic policy debates but also, via formal and informal channels into the work of institutions like the OECD. This means that OECD influence on national policies is often diffuse and difficult to pin down with precision. However, as the research surveyed in the latter part of Gabriella Meloni's chapter suggests, such "soft power" can be very effective over time, not least because it is more likely to lead to local ownership of reform initiatives than the exercise of stronger forms of co-ordination, such as aid conditionality. This, in turn, increases the likelihood that cross-national learning will be adapted to local circumstances when policies are devised. It also adds to the legitimacy of reforms.

Peer review and benchmarking can stimulate reform debates

Peer review of macroeconomic and structural policies has long been at the heart of OECD work, and the crisis has underscored its importance as a mechanism for cross-national learning and policy dialogue. The events of 2008–09 have demonstrated more starkly than ever how fuzzy the line between the domestic and international spheres has become in a globalised world. Now more than ever, we know that our neighbours' policy errors can cost us dearly. Indeed, for some countries, the experience of the crisis was rather like waking up with a severe hangover because the neighbours had gone on a drinking binge: having pursued responsible macroeconomic and structural policies, they found themselves overwhelmed by a crisis not of their own making. This experience has highlighted, among other things, the potential value of peer review of economic policies. If the domestic policies of a state's trading partners can affect it so directly, then they are of more than just academic interest.

While OECD recommendations and data are cited frequently in some national-level policy debates, the evidence suggests that the impact of OECD work is most apparent when countries see their performance or policies in comparative context: benchmarking often signals to electorates or elites that institutions or situations that they may have come to regard as normal may be quite unusual by international standards and that outcomes they may regard as satisfactory are unimpressive when seen in an international context. The impact of PISA scores on education reform debates in many OECD countries provides a vivid illustration of this point. Appropriate benchmarking, where possible, can act as a powerful stimulus to domestic reform debate, but benchmarking exercises should be undertaken with great care, since their value and credibility depend on the quality of the underlying data and analysis. Current OECD work on measuring trade restrictiveness is particularly relevant at present, given the need to resist protectionist pressures arising in response to the crisis.

The OECD can also play a key role in helping countries meet one of the reform challenges implicit in the findings reported earlier: the challenge of sustained incrementalism. One of the striking features of the sectoral analyses prepared under the auspices of MRH is the extent to which reform success in many domains requires commitment to a series of discrete but co-ordinated reforms over periods that are likely to exceed the lifetime of most governments. While "big bangs" may work for trade or competition reforms, they are unlikely to be suitable for most of the reform tasks facing governments in fields like health care, education, environmental protection or public governance. The OECD thus has a role to play in supporting those domestic institutions that exist to help sustain coherent policy reform over extended periods. Peer reviews of policy can often help in this respect.

As a multi-dimensional organisation, the OECD is also able to bring evidence and experience from different domains together, so as to ensure that discussions of economic, social, environmental and governance issues fertilise one another. At a minimum, this should help ensure policy coherence – policies should not contradict one another. At times, it can do more than that, creating opportunities to identify potential complementarities among reforms, where co-ordinated pursuit of multiple mutually reinforcing reforms may increase the benefits generated by each.[31] This is particularly important with respect to policies aimed at fostering more environmentally friendly growth, which require careful analysis from a wide range of perspectives. The breadth of the OECD's remit also puts it in a good position to contribute to the design of pension and labour-market reforms that are "in sync" with one another, so that benefit and pension reforms designed to enhance labour supply and promote longer careers are accompanied by labour-market policies that address the particular needs of older workers. This multi-dimensionality is a crucial consideration in the current conjuncture, owing to the need to maximise the synergies – and minimise the trade-offs – between policies designed to meet the immediate crisis and those focused on longer term goals. Thus, the OECD's *Going for Growth 2009* outlines a number of fiscal and structural measures that could yield a "double dividend", addressing both the short-term impact of the crisis and the need to enhance long-run growth potential (OECD, 2009c). The Organisation is also working on "green growth" and innovation strategies, bringing together approaches common to all OECD countries. Likewise, ongoing work on regulatory reform in response to the crisis considers the implications of policy change for competition policy and macroeconomic management, as well as financial market development.

Notes

1. This is not the OECD's first foray into the field of political economy. The work presented here builds on previous OECD work on the political economy of reform carried out by the Economics Department (see Duval and Elmeskov, 2005; Høj *et al.*, 2006; and Tompson, 2009). However, the present volume encompasses a much wider range of policy domains.
2. Inequality of endowments alone could create some conflict, of course, but potential solutions are easier to devise where all actors' claims are identical, like those of the shareholders in an enterprise issuing only one class of common stock.
3. For the classic statement, see Tversky and Kahneman (1991).
4. This is about more than preferring "a bird in the hand to two in the bush", because it allows for the discounting the alternatives according to their perceived likelihood. For more on the endowment effect, see Kahneman, Knetsch and Thaler (1990).
5. Initially, this affected mainly "ordinary" unemployed workers, but recent years have seen increasing attention to activation of older workers, the disabled and other groups that may require more support in order to maintain labour-market attachment.
6. Broadly speaking, "path dependence" refers to the extent to which – and the mechanisms by which – the set of decisions one faces in a given situation is limited by past decisions, even though the past circumstances that gave rise to those decisions may no longer be relevant.
7. For more on the path dependence of pension policy, see Tompson (2009).
8. Chapter 3 addresses some of these differences. See also Boeri *et al.* (2006).
9. See Goodman (1991) and Eijffinger and De Haan (1996) for overviews of this trend.
10. In the broad sense of the term, things like fiscal rules and regulatory impact analysis are also, of course, "institutions" (see North, 1990). We distinguish here between institutions (organisations) and practices or policy regimes largely to reflect common usage outside the academic literature.

11. Shepsle (1986) argues that institutions represent the "frozen" preferences of those who created them.

12. Housing markets (whether rental or owner-occupied) are an important exception, since policy changes can have huge implications for large numbers of households. See Tompson (2009).

13. Some object to generous compensation in principle, seeing it as tantamount to buying out rent-seekers when the elimination of rents and the move away from a "rent-seeking society" is the essence of economic reform. For sharply differing perspectives on the desirability of such an approach, see Bates (1994), Williamson and Haggard (1994); Koromzay (2004); and Delpla and Wyplosz (2007).

14. See Buti *et al*. (2008) for evidence that they can.

15. For examples of this, see Tompson (2009), especially Chapters 17 and 18.

16. See the econometric evidence in IMF (2004); OECD (2006); see also the Spanish, German, US and Dutch labour-market reform episodes reviewed in Tompson (2009).

17. Some of the earliest and most influential studies drawing attention to looming pensions problems were produced by the OECD; see van den Noord and Herd (1993); and Roseveare *et al*. (1996).

18. There are exceptions: the 1992 Italian pension reform, some changes to Polish pensions in the early 1990s, and the 1977 and 1983 US Social Security reforms.

19. See IMF (2004) for evidence confirming this view.

20. Current farmers are not the most likely beneficiaries of such subsidies, but they are the ones who will be hurt if the subsidies are eliminated.

21. OECD (2005) describes the attempt to introduce such a tax in France.

22. These lags may be even longer in education than health care.

23. The findings of the MRH review in respect of goal clarity and communication adequacy are supported by other recent research; see Yang and Pandey (2009).

24. For examples, see Alesina and Perotti (1996); Alesina and Ardagna (1998); von Hagen, Hugues Hallett and Strauch (2002); Ahrend, Catte and Price (2006); Guichard *et al*. (2007).

25. This potential was the focus of the "Declaration on Green Growth" adopted by the OECD Council Meeting at Ministerial Level on 25 June 2009.

26. Crises may also induce a switch in equilibrium behaviour: if the payoffs from non-cooperative behaviour deteriorate sufficiently, previously antagonistic agents may opt to co-operate in undertaking a reform.

27. On the link between crisis and reform, see *inter alia*, Williamson (1994); Rodrik (1994), Martin and Scarpetta (1998); Drazen (2000); IMF (2004); and Boeri *et al*. (2006).

28. See Duval and Elmeskov (2005); Høj *et al*. (2006) and Tompson (2009).

29. See Tompson (2009), especially on the Swedish sickness insurance reforms of the early 1990s and the attempt to reform the farmers' social security system in Poland in 2003-05. Williamson and Haggard (1994) report a similar finding in respect of developing countries.

30. There may, however, be economic reasons to hold back on some reforms, while pressing ahead with others, since reform sequencing can be important.

31. Policy coherence is largely seen as a constraint, whereas the notion of policy complementarities highlights the potential to realise positive benefits from co-ordinated reforms. See Braga de Macedo and Oliveira Martins (2008).

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Chapter 2

Opening markets to competition

by Michael Wise*

This chapter offers an overview of OECD experience in the field of product-market reform and seeks to identify lessons that may assist policy makers in advancing such reforms where unnecessary restraints on entry or competition remain in place. It begins with a summary of market-opening reforms in the OECD before turning to look in greater detail at reform experiences in respect of both internationalisation (foreign trade and foreign investment) and domestic liberalisation. This is followed by a look at the process of product-market reform, including interactions with interest groups, consumers and other stakeholders, the creation of effective institutions to drive and implement reforms, and the complementarities that can be realised when reforms are pursued in a co-ordinated fashion across a number of domains. The major lessons that emerge from this analysis are then summarised in a brief conclusion.

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Competition-oriented structural reforms aim to remove barriers to trade and investment, to strengthen the protection of competition in general and to promote competition in particular sectors through liberalisation, restructuring, privatisation and regulation. Most OECD countries have undertaken the principal reforms described in this chapter, but constraints and problems persist. The motivation for market-liberalising reforms is usually to stimulate lagging growth and improve competitiveness by making the economy more efficient and productive. Such reforms often follow financial or economic crises that expose weak economic performance. They try to address rigidities and protections that stall recovery and constrain growth. In different ways, these reforms seek to improve the functioning of markets, through competition to the extent feasible, and thus to reduce costs and raise productivity. Equally importantly, more competitive markets give consumers lower prices, more choices and better service.

OECD market-opening reform experiences

The basic principles supporting market liberalisation have become generally accepted, and major reforms of trade, investment, competition and market regulation have been achieved in most OECD countries. But the task is not finished, and some have challenged the economic, political and philosophical foundations of liberalising policies in response to the global crisis that erupted in 2008-09, pressing for emergency measures that would stall or reverse such policies. Moreover, the underlying cause of many of the problems that market-opening reforms seek to address is the quest for advantage over rivals and protection from competition, and that quest will persist. If reform has eliminated the most obvious ways to use government power to gain advantages and protections, interested parties will resort to alternatives.

"Reform at the border" has achieved a great deal, but much remains to be done

Trade reform has historically sought to reduce tariff levels, to stimulate trade by making importing more profitable, and to remove discriminations, quotas and licensing requirements that divide international markets and protect domestic firms from competition. Most OECD countries had accomplished these basic reforms by the late 1980s. Barriers to investment typically take the form of procedures for screening or authorising foreign investors, or rules that bar or limit foreign investment in designated sectors or activities. In the OECD area, most barriers to investment were lowered or eliminated along with liberalisation of trade. However, less obvious constraints remain in place. Removing these non-tariff trade barriers and remaining restrictions on foreign investment is a current challenge. Regulations or investment controls that benefit or target particular sectors may amount to restraints on trade or investment. Sectors and functions that are still most commonly affected by such restraints include services, resource extraction, agriculture and intellectual property. Restrictions on foreign investment most often apply to sectors such as electricity, transport, telecommunications and finance. These include, perhaps not coincidentally, some of the service sectors that are often objects of competition-promoting regulatory reforms.

Reforms "behind the border" have focused on competition law and enforcement

Stronger competition laws and more active enforcement, to cement and protect market liberalisation, were part of many market-opening reform programmes in the 1980s and 1990s. The sector-specific nature of many trade and investment restraints was addressed in important competition-law reforms that strengthened the application of general principles of competition policy and reduced or eliminated exemptions and exclusions. Another important step has been to make enforcement independent of political influence. Investment-related decisions about mergers and acquisitions still test the appropriate degree of independence of competition agencies. Competition policy, too, now faces the challenge of resisting calls for retrenchment and relaxation of enforcement rigour, advocated to protect firms in the economic downturn. Extending competition to regulated sectors has been the most obvious reform of domestic product markets. This important programme of regulatory reform is closely linked to competition law and enforcement, because the tactics that once-regulated actors use to maintain their power may violate both the new competition-promoting sectoral regulation and the general competition law. Making reforms work well requires allocating jurisdiction appropriately between general competition law enforcement and regulators charged with overseeing particular sectors.

Market-oriented reforms have tended to follow a common pattern

A logical sequence connects the reforms of policies pertaining to trade, investment, competition and market regulation. In most OECD countries, the process began with manufacturing trade liberalisation, often driven by external developments and commitments. Financial market and foreign direct investment (FDI) liberalisation have tended to come next, followed by the opening of domestic product markets and service sectors. Labour-market reform (which is beyond the scope of this chapter) typically comes last, in part because labour-market institutions are less directly affected by competitive pressures from abroad. However, the disappearance of the rents arising from past protection of product markets sometimes reduces the ability of producers to carry on living with the costs of highly protective and inflexible labour-market policies and institutions, thereby generating reform "spillovers" from product to labour markets.[1] This sequence has been observed in a large number of OECD countries, with Australia representing perhaps the clearest and most sustained example (Box 2.1).

Box 2.1. **Market-opening reform sequence: the Australian experience**

Slow growth in output and productivity and increasing inflation and unemployment prompted a major shift in economic policies beginning in the 1980s, including comprehensive fiscal, monetary and labour-market reforms. The authorities had long believed that major reform was needed to reverse deteriorating economic performance, but an earlier liberalisation effort, in 1973, had been poorly prepared and badly timed, and its apparent failure stalled reform for some time. To stimulate competition, tariffs and industry support were cut and import controls were eliminated. Trade reform was unilateral; the political constraints were overcome without resorting to claims that change was compelled by international obligations or agreements. Capital market liberalisation and a floating exchange rate policy were adopted in the early 1980s, in part to bring some relief to those hit by trade liberalisation (the dollar fell after its float, bringing relief to the tradables sector). Deregulation and restructuring of airlines and shipping began in the 1980s. In 1991, the traditional telecoms monopoly was replaced by duopoly in fixed service and three firms in mobile service, and the sector was opened up completely in 1997 (although the historical incumbent was not fully privatised nor subject to full vertical separation of functions). In 1995, Australia consolidated enforcement of general laws about competition, consumer protection, procurement and access to essential facilities in a new, independent Australian Competition and Consumer Commission, whose new leadership adopted a vigorous enforcement posture. The National Competition Policy, agreed in 1995, led to a comprehensive review of state and national regulations to eliminate unjustified anti-competitive effects. Deadlines for review and reform were particularly important for energy and transport sectors, which are state responsibilities. In electric power, from 1993 to 2003, states phased in separation of functions and opening of markets to retail competition, leading to an integrated market in the eastern part of the country. In natural gas, there is competition in open-access regimes now in most states. State-level reforms in rail include vertical separation, corporatisation and third-party access.

The logic of the sequence reflects both economic and political economy factors, and runs more or less as follows:

- The easiest way to stimulate competition and efficiency quickly is to bring more products and players into the market; lowering barriers to trade and investment is therefore the natural first step. External liberalisation, moreover, can often foster further reform: by bringing new products and actors into the market, trade and FDI liberalisation stimulate competition and destabilise entrenched interests that may be upholding other rigidities in domestic markets.

- To ensure that firms actually compete in the new conditions, collusion and monopoly must be prevented to the extent possible and must be punished where they nevertheless occur, so a strengthening of competition policy in domestic markets is required.
- To reduce tradable firms' costs and help them succeed in the new, more competitive environment, and to obtain benefits of competitive markets domestically, regulations that unnecessarily perpetuate monopolies and cartels must be reformed; many of the most important problems here are in non-tradables, especially network sectors. This points to the need for extending reforms into non-tradable sectors. Australia, for example, found that opening the borders to trade and investment in order to introduce competition led to demands for more flexibility and greater efficiency in "upstream" non-tradable sectors, so as to help tradables producers under pressure to meet that competition by improving productivity.
- To open opportunities and reduce the rents due to market power, official monopolies and quotas and licenses that restrict entry should be repealed.
- To discourage politically motivated intervention and stimulate efficiency, liberalising reforms may include corporatising and privatising government-run commercial and utility operations.

A common theme of these reforms is to end sector- or firm-specific special deals and discriminations, sought and obtained by rent-seeking pressure groups, and to favour instead the general application of uniform rules governing market conduct.

The external dimension: trade and foreign direct investment liberalisation

Crises and other shocks have helped to spur external liberalisation…

While a number of drivers can be identified in connection with specific product-market reforms, there are two factors that have frequently played a particularly important role in spurring reform: crises and the requirements of various international agreements or other undertakings. Of course, reform in virtually any domain is often spurred by dissatisfaction with the status quo – institutions and policy settings are not revised if they appear to be working well – and in a number of cases, severe economic distress has prompted wide-ranging reforms of market regulation. Thus, many OECD countries undertook reforms after the second oil shock at the end of the 1970s, when the need to address structural rigidities and to correct the policy errors committed after the first oil shock were both widely recognised. In some instances, this process was driven primarily from within by governments seeking to reverse what was regarded as evidence of a long-term deterioration in performance; New Zealand and Korea (Box 2.2) represented two of the most striking examples of such a policy shift in OECD countries following the second oil shock. Ireland followed suit somewhat later, with a reform programme that ultimately involved a radical shift in the entire approach to economic policy. However, their experience was not unique, as unilateral liberalisation, particularly in the field of foreign trade, was chosen by a number of countries inside and outside the OECD. In a number of OECD countries, including Australia and Sweden, deep recessions at the beginning of the 1990s prompted wide-ranging programmes of market-oriented sectoral reforms, not least because steps to reduce the regulatory burden on entrepreneurs – which would be desirable at any time – offered a way for cash-strapped governments to reduce the cost of doing business at little or no cost to the budget. At the same time, reforms to cut costs and raise efficiency in non-tradable sectors also provided some relief to tradables producers, who depended on those sectors for inputs and who were then under intense pressure.

Box 2.2. **Unilateral liberalisation: New Zealand, Korea and Ireland**

New Zealand

New Zealand initially responded to the second oil shock with more of the kind of state intervention that had long characterised its economic policies, including a blanket freeze on all prices and wages for almost three years. The evident failure of these policies and the arrival in power of a new government set the stage for a dramatic programme of economic reform and financial deregulation. Major reforms included privatisation of state assets, revamped labour-market legislation and fundamental changes to fiscal and monetary policies. Competition-promoting reforms opened markets, ended price controls and reduced tariffs, subsidies and protected monopolies. Laws that curtailed competition in finance, transport, dairy products and petrol were repealed. The general competition law was overhauled in this process. The body whose previous function had been deciding about price controls was transformed in 1986 into a streamlined Commerce Commission to enforce the new competition law. After a decade of adjustment to these widespread changes, during which resources and employment shifted among sectors, some aspects of the reforms in labour and product markets were amended in the late 1990s.

Korea

Following the second oil crisis and the recession of 1980, Korea began a long-term programme of economic liberalisation and macroeconomic stabilisation to replace policies of targeted credits, tax benefits, import protection and promotion of selected industries. Limits on foreign investment were reduced, banks were privatised, interest rates were deregulated and tariffs were cut. At the outset, in 1981, Korea replaced price control regulation with a comprehensive competition law. The Economic Planning Board was abolished, and the competition enforcement agency, the Korea Fair Trade Commission, became formally independent in 1994. Reforms intensified following the financial crisis of 1997, further reducing trade barriers and liberalising restrictions on inward foreign investment. Regulatory reform priorities included repealing most exclusions from the competition law and eliminating or revising regulations that constrain competition and enterprise. Financial sector regulation was strengthened and consolidated in new institutions. In telecoms, reforms had begun in the 1990s, and the sector is now open to competition. In transport, rate controls were lifted in the 1990s and entry conditions have been eased. The electric power industry has been restructured, but open access and competition are being introduced more slowly.

Ireland

In the face of a major economic crisis in the mid-1980s, Ireland discarded its traditional policies of protection and moved toward greater flexibility, foreign investment and trade. Fiscal reforms improved the public balance sheet, and the public agency charged with rescuing domestic manufacturers was closed down. Liberalisation of airlines and road freight began in the 1980s. Public procurement was liberalised and most remaining state-owned commercial enterprises were privatised in the 1990s. The economy benefited from EU support funds and then from the EU Single Market Programme, as Ireland's policy environment made it an attractive base for foreign firms entering to compete in the larger European market. A general competition law was adopted in 1991, to replace the National Prices Commission, but there was no public enforcement authority until 1996.

The connection between crisis and reform seems particularly strong with respect to the reform of trade and market regulation; crises provide an opportunity to eliminate the most obvious constraints on competition. By contrast, in times of crisis, labour-market reform is likely to be harder, because people who feel threatened will not easily be persuaded to give up what they believe are protections.

The greatest push towards liberalisation of policies towards FDI in the original 24 OECD member countries took place in the 1980s. At the end of the 1970s, numerous restrictions remained in force, and member countries' future policy stances were still somewhat uncertain. At that time, comprehensive systems made authorisation compulsory for both inward and outward direct investment, while countries also imposed restrictions limiting foreign participation or channelling it into certain sectors of their economies. Sometimes too, countries clamped down on investment financing, be it local or foreign, laid down requirements as to nationality or place of residence for managers and directors of the companies concerned, and restricted purchases of commercial real estate. Public or private monopolies also closed important sectors to competition (OECD, 1992, based on OECD, 1982). An OECD survey of controls and impediments affecting inward investment in OECD member countries undertaken at the beginning of the 1980s found little movement towards reform. By the end of the decade the situation was transformed. A later OECD assessment could conclude that "no one can fail to be astonished by the extent of member countries' progress since the beginning of the decade towards greater liberalisation and the removal of restrictions and obstacles to direct investment flows to and from other countries and, more significantly still, in their broader regulatory approaches to such investment" (OECD, 1992). The recession at the start of the decade prompted member countries to start removing obstacles to inward investment, and the spectacular internationalisation of the world economy and the need to be competitive encouraged them to go as far as possible in removing such obstacles. Learning the lessons from policy responses to the first oil shock in 1973-74, OECD member governments opted to confront structural rigidities in their economies through privatisation, deregulation and FDI liberalisation (Box 2.3).

Box 2.3. **Liberalisation of foreign direct investment: representative experiences**

Within the broad trends, there were some country-specific aspects of FDI reform:

- In Australia, Canada and New Zealand, reforms aimed to return to the open door policies of the 1950s and 1960s and away from the restrictiveness and controls of the 1970s. Their policy reversals in the 1970s had responded to perceived high levels of foreign control, particularly in Canada.
- Within Europe, the move towards a Single Market drove the process of liberalisation. Capital movements were liberalised as of 1990, and the Single Market came into effect in 1993.
- Spain and Portugal radically revised their policies towards FDI as part of the process of accession to the European Communities (EC). Although Spain relaxed rules on the acquisition of minority shareholdings by foreign investors to some extent in the 1980s, it was not until it joined the EC that regulations governing capital movements were overhauled and exchange controls relaxed. Portugal adopted a new code on foreign investment in mid-1986.
- The Nordic countries responded to enhanced European integration by initiating reforms of their FDI regimes. These governments controlled foreign company activities by keeping a close watch over the use of land and natural resources. The authorities' powers were broad and long-standing, and thus the liberalisation process that began towards the end of the 1980s signalled an important, substantial policy shift.
- Japan eliminated exchange controls in 1980 and began to liberalise the FDI regime in 1985.
- The United States, already relatively open to foreign investment, allowed for greater foreign participation in the transport sector in the 1980s.

…which has also been supported by international institutions and agreements

External factors have tended to play a larger role in the reform of foreign-trade and foreign-investment regimes than they have in most other domains, although external pressures have also been important in driving sectoral reforms in fields like telecom (OECD, 2007). There are, of course, a number of different mechanisms at work. Successful liberalisation abroad, for example, may in itself serve as a source of inspiration. However, the main external drivers appear to involve international institutions and agreements. While there are numerous examples of unilateral trade liberalisation, trade barriers are often easier to lower in the context of an international process, be it negotiations under the aegis of the General Agreement on Tariffs and Trade (GATT) / World Trade Organization (WTO), the creation of the EU Single Market or the conclusion of bilateral or regional free trade agreements like the North American Free Trade Agreement (NAFTA). While there may be good economic grounds for favouring unilateral liberalisation in principle, the reciprocal concessions involved in "tit-for-tat" trade negotiations often make it easier to win the domestic political battle for freer trade. Historically, therefore, an internationally co-operative approach to liberalisation has been an important force for structural reform. Accession to bilateral agreements, multilateral conventions, international organisations and customs unions that promote freer trade is often taken to represent accomplishment of these goals and reforms, or at least commitment to them. For some countries, such as Mexico (Box 2.4), trade reform was linked to accession to GATT.

Box 2.4. **Mexico: crises, international commitments and political obstacles**

The debt crisis of 1982, followed by the sharp drop in oil prices in 1985, combined to strengthen the hand of reformers by demonstrating that the *status quo ante* was no longer an option. The return to stable economic growth – albeit slow by the standards of the 1970s – and the rapid internationalisation of the Mexican economy helped to sustain and even accelerate liberalising reforms. Trade reforms came first. Mexico acceded to the GATT in 1986, before the first wave of reforms of FDI regulations. The early reforms of FDI regulations relied on administrative changes that did not alter the underlying legislation. They were top-down measures orchestrated by reform-minded technocrats in the executive branch. These were later consolidated in a new Foreign Investment Law in 1993. International agreements, principally NAFTA, have been employed partly to promote further liberalisation and partly as a means to consolidate existing reforms and to make them irreversible. OECD accession helped to ensure that liberalisation under NAFTA was extended on an *erga omnes* basis, particularly in the banking sector.

The reform process has slowed down since the early 1990s. The banking crisis of 1995 weakened the reformist faction within government by calling into question the results of a decade of reforms, which had not managed to put an end to the boom-and-bust cycles of the past. Some exceptions to the general slowdown have been the banking sector, where the need for capital infusions led to substantial liberalisation, and some specific sectors such as ports, airports and railways. Mexican FDI regulations are still relatively restrictive by OECD standards. The slowdown has several possible explanations:

- Multiparty democracy has made reforms more difficult. The parliament and the judiciary are stronger, as are opposition parties and their political supporters. These developments make change more difficult, though their impact should not be exaggerated. Even in a one-party regime, different factions contend and ministries may have different agendas.
- Arguments for reform are no longer as persuasive as they were. The deep crisis in 1994-95, together with a perceived rise in income inequality and only weakly visible improvements in economic efficiency as a result of previous reforms, imply a weakening of support for future reforms.
- The nature of the necessary reforms has evolved. The first round of reforms could be achieved by presidential decrees. Second-generation reforms require more emphasis on building appropriate institutions better suited to the new regulatory environment. They also require more work on consensus building and public consultation.

Reforms "at the border" can help to consolidate domestic reforms

Reform of foreign trade and investment regimes has a longer-term effect. Bringing in new products, capital, management and market players makes market changes durable. FDI liberalisation in OECD member countries often follows trade liberalisation. For example, Mexico became a signatory to the GATT in 1986, before embarking on extensive liberalisation of FDI restrictions. Exchange controls and financial markets are often reformed first. A precondition for FDI liberalisation was the removal of exchange controls in OECD countries, beginning in the United Kingdom in 1979 and encompassing almost all member countries over the next decade. Governments concluded that such controls were ineffective as a means of maintaining economic independence. Instead, improved management of the economy in general, and of monetary policy in particular, enabled the authorities better to anticipate and cope with the balance-of-payments problems that had been associated in the past with the lifting of exchange controls.

Regional integration and international commitments have sometimes helped to lock in reforms and to promote further liberalisation in policy domains that might seem quite far removed from foreign trade or the regulation of foreign investment. Globally, the requirements of membership of the WTO now extend well beyond the "frontier" issues of tariffs and quotas, and affect numerous purely "domestic" policy settings. Within Europe, the Single Market programme, the Directives on the Liberalisation of Capital Movements and various sectoral initiatives substantially liberalised FDI within the European Community. New EC members have had to align their FDI policies with those of the rest of the European Community. Joining the EC spurred reforms in Spain, Portugal and the more recent entrants from Central and Eastern Europe. Mexico proposed a free trade agreement with the United States after it had already begun to reform its FDI regime, but substantial work remained to be done. OECD accession had a very significant impact on the degree and form of capital liberalisation undertaken for the most recent entrants. Accession negotiations led to pressure for further reforms and also encouraged the new OECD members to extend liberalisation undertaken at a regional level on an *erga omnes* basis. Both in the case of NAFTA for Mexico and Association Agreements with the European Union (EU) for the new Central European members, the introduction of *erga omnes* principles of extension of liberalisation measures to all OECD countries has been a positive force in advancing liberalisation (OECD, 2002) (Box 2.5).

Box 2.5. **Transition opportunities and international commitments**

Liberalisation of the rules governing foreign investment in Central and Eastern Europe is inseparable from the transition to a market economy. The discrediting of the previous policy regime meant that there was little legacy of rent seeking which might obstruct the opening to foreign investors. The need for western capital and expertise was also keenly felt. As a result, these countries have achieved a level of openness to FDI comparable to, and sometimes exceeding, that of older members of the OECD. There was, nevertheless, scope for further liberalisation in individual sectors, which was encouraged by accession to the EU and the OECD.

These four countries (the Czech Republic, Hungary, Poland and the Slovak Republic) generally had few sectoral restrictions on foreign investors by the time of accession. They had each signed association agreements with the EU before joining the OECD. The attitude adopted towards foreign ownership of land and certain other natural resources has constituted a special case, due in particular to the political complications created by restitution rights to assets confiscated by the communist regimes and geo-political considerations dating from the 1940s. Thus, all four countries were reluctant at the time of accession to fully liberalise the acquisition of land by foreign investors, and they lodged reservations accordingly under the Codes of Liberalisation, although the purchase of real estate necessary for business establishment was generally freed.

Certain commitments were nevertheless undertaken as part of OECD accession. Hungary removed restrictions on foreign equity participation in insurance companies, and the Hungarian authorities committed not to apply similar restrictions in banking and financial services to OECD-based investors pending their abolition. As part of Poland's accession in 1996, the Polish authorities committed to remove the incorporation requirement for all enterprises and to liberalise further real estate acquisitions related to FDI. Members also encouraged them to abolish the authorisation requirement for foreign acquisitions of shares in enterprises holding a share of a Polish insurance firm.

The impact of crises and international institutions can be mutually reinforcing

The example of Korea demonstrates how two critical factors – international agreements and financial crises – can interact to accelerate an ongoing process of incremental reform. Prior to the financial crisis and OECD accession, FDI had played a relatively minor role in Korean development, largely because policy makers focused on encouraging capital goods and technology imports instead of FDI. Korea maintained significant restrictions on inward FDI, with certain sectors of industry fully closed to incoming greenfield investment and others partially closed, sometimes in combination with joint venture obligations.[2] By the early 1990s, the perceived weakness of Korea's technological base, combined with international pressure and the prospects of joining the OECD, all contributed to a change in direction. The government promulgated a five-year foreign investment plan to liberalise a series of sectors. Successive plans were then introduced annually to foster further liberalisation. When Korea joined the OECD at the end of 1996, it undertook to accelerate and broaden the scope of its original FDI liberalisation plans. In the end, the Asian financial crisis then led to reforms going far beyond the commitments undertaken at the time of OECD accession.[3] These were complemented by privatisation and trade reforms designed to increase competition within the domestic economy. Liberalisation was partly intended to attract foreign capital as a counter-cyclical measure in a crisis situation, but it was also based on the desire for structural improvements in the Korean economy by enhancing competition and introducing principles of corporate governance. As a result of these crisis-induced policy changes, FDI inflows into Korea were 12 times higher in 1999 than five years earlier.

Reforms "behind the border": competition law and sectoral reforms in the OECD

Competition law reform laid the basis for many sector-specific reforms

Reinvigorating competition law and reducing support and protection for inefficient incumbents are often co-ordinated with trade-related reforms and reform of product-market regulation. The enthusiasm for free-market policies that often motivates liberalising reforms also prompts and supports improvements in competition policy. In practical terms, preventing collusion and monopoly secures the benefits of the stronger competition that the other reform measures are meant to encourage. Many countries improved general competition laws and enforcement agencies in connection with market liberalisation and regulatory reform programmes (Table 2.1). A few, such as Italy and Mexico, took the occasion of reform to enact their first general law on competition. Improvements include clearer prohibitions of anti-competitive conduct, stronger sanctions against violations, more powers, resources and independence for the enforcement authority and fewer exclusions and exemptions from the law. The goal of strengthening competition law is usually non-controversial, although parties that expect to be targets, such as incumbents in regulated monopolies and the beneficiaries of trade and investment protections, often resist the particulars.

Competition law enforcement also supports reform of product-market regulation (PMR). Would-be entrants and potential customers blocked by exclusionary or discriminatory tactics complain about these abuses to the competition authority. This means of seeking change has often been used in telecommunications, but competition agencies have also reviewed complaints about restraints and abuses in all of the historically monopolised sectors, including postal services, electric power, natural gas and transportation. Nevertheless, the competition authority may have little power to resolve these disputes, if legislation creates sectoral exclusions from its jurisdiction or legal rules give precedence to other laws or regulations instead of the general competition law. The role of competition authorities in may sometimes be limited to advocacy and advice about changing other regulations. Some jurisdictions, such as

Australia, the Netherlands and New Zealand, incorporate this support into the institutional structure, by assigning responsibility for economic regulation of network sectors to the competition authority.

Table 2.1. **Competition law strengthening in reform**

Country	Year
Australia	1994
Canada	1986
Czech Republic	1991
France	1986
Hungary	1984
Ireland	1993
Italy	1990
Mexico	1993
Netherlands	1997
New Zealand	1986
Poland	1990
Spain	1989

Product-market regulation reforms have made significant but uneven progress since the 1970s

Product-market regulation reforms have been underway since the 1970s or early 1980s in some OECD countries with the United States and the United Kingdom leading the way in a number of sectors (Box 2.6). Since the 1990s, significant market-opening PMR reforms have been pursued by virtually all OECD countries. As a general rule, reforms in road freight, air transport and telecommunications came early and went further; by comparison, reform has been slower or less extensive for gas, water, electricity, postal services and rail transport. The OECD indicators that cover regulation of these sectors reveal the variations in timing and scope of reform in member countries (Figure 2.1). While reforms in some domains have been driven largely by the liberalisation of foreign trade and investment, technological change has also played an important role in many sectors, particularly where it has revealed efficient alternatives to traditional vertically integrated monopoly structures in sectors previously regarded as "natural" monopolies.[4] In other cases, reform has been prompted, at least in part, by a desire to attract fresh investment that public authorities are unable or unwilling to provide. The inevitable limitations of regulation and of public enterprise management have in many cases led to over- or under-investment and to distortion of costs and prices. Finally, policy makers in one jurisdiction have been prompted to explore reform options by observing reform in other jurisdictions. Comparison of experiences across markets may change ideas about what is technically or economically feasible and discredit claims that supposedly excessive competition must be curbed by regulations that authorise and enforce cartels, limiting entry and fixing prices.

Box 2.6. **Product-market regulation reforms in the United States and the United Kingdom**

United States

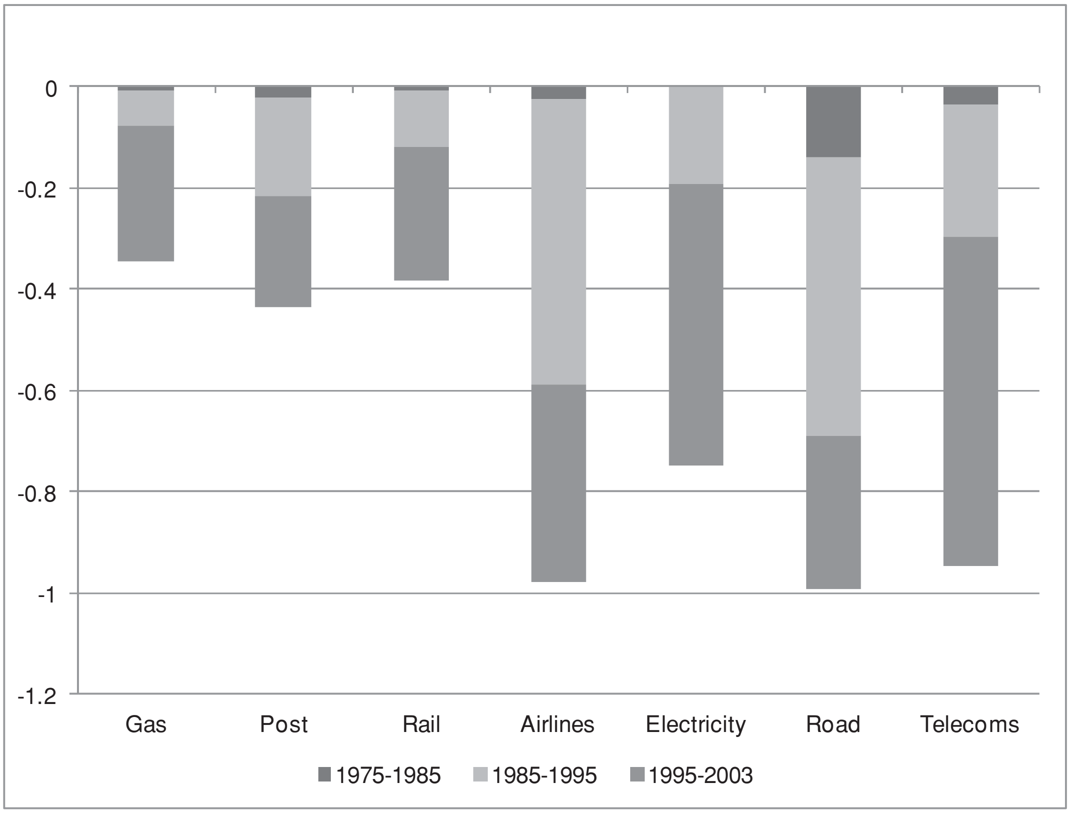
Basic changes in competition and regulatory policies began in the mid-1970s, motivated by stagflation and the first oil shock. Unusually, the programme was launched with sectoral deregulation, and trade and investment reforms such as NAFTA came much later in the process. Airline deregulation, removing economic controls on prices and entry, started in 1978 and was completed by 1983. Rate and entry controls on interstate trucking were repealed in 1980 (and on within-state trucking, in 1994), along with most rate and service controls over rail freight. In the natural gas market, reforms that began in the late 1970s ended price controls and moved the industry toward a system based on regulated open-access pipeline transport. In telecoms, vertical separation of the traditional monopolist was ordered in 1982 and completed in 1984. This major restructuring was the outcome of antitrust enforcement; since then, 1996 legislation set a new regulatory framework governing the evolution of competition in this industry. In electric power, the principles for competition-based reform were set by legislation in 1992 and by federal regulatory order in 1996; reform has been pursued in different degrees by many states. Financial services were opened to larger-scale competition from 1980 to 1994, through steps such as letting banks offer higher interest rates and permitting interstate operations. These sector-level reforms were accompanied by the emergence from the late 1970s of a consensus for efficiency-based enforcement of the well-established general competition laws. Merger control guided by economic analysis concentrated on large horizontal combinations, while improvements in enforcement methods, such as the leniency programme for uncovering cartels, produced very strong sanctions against price-fixing and bid-rigging.

United Kingdom

Along with major changes in labour, monetary and fiscal policies, the reforms that began in the early 1980s included privatisation in electricity, gas and telecoms in order to encourage market forces and enterprise. Monopolies were ended formally in 1982 for gas and telecoms and in 1990 for electric power; however, the industries' structures remained non-competitive. Competition in these sectors developed in stages through the 1990s. In telecoms, a new regulator was set up in 1984 and licences were issued for cable TV and competing cellular networks. The duopoly approach to the sector was rejected in the early 1990s; accounting separation and price-cap regulation were applied to the still-dominant incumbent in the middle of the decade, and in 2000 the local loop was unbundled. In gas, negotiated access and provision for privatisation were in place in the 1980s, by 1990 there was retail competition for large customers, by 1995, structural vertical separation, and by the late 1990s, full retail competition. In electric power, structural separation and privatisation in 1990 were followed by creation of a pool-based market and then full retail liberalisation in the late 1990s. In gas and electric power, the changes revealed risks of market power that were addressed through new legislation in 2000-01. Improvements in the general competition law and enforcement structure came later in the reform process, through legislation in 1998 (effective in 2000) and more comprehensive changes in the Enterprise Act 2003.

Figure 2.1. **Timing and scope of industry-level product market reform, 1975-2003**

% change in the indicators



Note: The total bar indicates the percentage reduction in regulations over 1975-2003, broken down into three sub-periods.

Source: Conway, Paul and Giuseppe Nicoletti (2006), "Product Market Regulation in the Non-Manufacturing Sectors of OECD Countries: Measurement and Highlights", *OECD Economics Department Working Papers*, No. 530, DOI: *http://dx.doi.org/10.1787/362886816127*.

Most transport sectors have been opened up…

Trucking reform often has often come early in the reform process. There is no economic rationale for limiting entry and controlling prices, that is, for regulations that authorise and enforce a cartel to provide this service. However, the large number of voting individuals with a stake in the regulated industry often constitutes a political obstacle to reducing its monopoly rents. Trucking liberalisation in the United States offers insights into regulatory capture and the value of a federal system's inter-jurisdictional perspectives and powers. After interstate trucking service was almost completely liberalised and the national regulator was abolished, the last step was to pre-empt local regulation of intrastate service. That step was taken to end the irrational result of parochial sectoral regulation. For reasons having to do with nothing but their historical development, FedEx was treated like an air carrier but its competitor, UPS, was treated like a road carrier, and state-level sectoral regulations were being applied to protect each client sector against competition from the other.

Taxis are another common example of a well-organised interest that has moved the government to guarantee and manage its cartel. In contrast to trucking, however, taxi services have often managed to sustain their protections long after most other transport sectors have been opened up. A structurally atomised industry with easy entry and exit, taxi service ought to be highly competitive, but licensing regulations typically limit the number of entrants and fix their prices. The cartel's resulting market power is measured by the market price of the licenses needed to join it. The medallion value, which capitalises the monopoly rent, often represents the operator's *de facto* retirement savings. Compensating the loss of that value in order to overcome resistance to reform looks like rewarding or bribing the cartel; however, the individuals who receive compensation usually are not the ones who created the cartel: the monopoly rents have been capitalised into the value of the medallions before the current owners bought them. The compensation may in fact be much less than the estimated total value of the monopoly. After the Irish taxi market was liberalised, unexpectedly and almost overnight (which led to a four-fold increase in number of taxis in Dublin), the government set up a transition "hardship fund", for one year, to compensate some losers of medallion value. Yet payments averaged only about EUR 1 000 and totalled much less than the estimated pre-reform values.

Air transport liberalisation has gradually eliminated national monopolies, while moving more cautiously to undo agreements that have divided international markets. In addition to liberalising entry and pricing, reform has usually entailed privatisation and regulatory measures to protect competition. Vertical separation in this sector is not an obstacle, since virtually every aspect of the provision of airline service can readily be contracted out. Some "essential facilities" bottlenecks still restrain competition, though, such as access to operating slots at high-volume airports. This points to the desirability of vertical separation to cut the ties between airline ownership and airport operation. In contrast to sectors like electricity, it is difficult even to argue that the combined ownership of infrastructure and operating entities can yield economies of scope, so nothing is lost by enforcing vertical separation. A common competition problem in the post-reform industry is preventing incumbents' predatory responses to new entrants. General competition law rules might apply to this conduct, but some countries have also considered specific rules tailored to abusive practices of this sector.

Ocean shipping's worldwide system of authorised cartels is yielding, slowly, to liberalising reforms. Shipping conference agreements that control capacity and rates have long been protected by explicit antitrust exemption in many jurisdictions. Some of these exemptions date from the mid-20th century, when the United States tried to prosecute conference cartels as violations of the antitrust laws. As more countries embrace market-oriented policies and active competition law enforcement themselves, these exemptions are being narrowed or, as in the European Union, repealed.

…though rail reform has proved difficult

Railway reform must overcome obstacles of compensating labour and providing adequately for infrastructure investment. American and Canadian experiences in freight railway liberalisation, which started in the 1980s, show that private ownership and operation in competitive conditions can achieve higher productivity and lower prices. One driver of reform was increasing competition from a liberalised trucking sector – a classic example of the kind of positive spillovers that successful PMR reforms can generate. The United Kingdom liberalised both freight and passenger rail service in the early 1990s. New operators improved efficiency and rail traffic grew significantly, reversing decades of decline. However, rail reform is complicated by the network properties of the industry, and in the UK case, the system's provision for infrastructure management did not attract enough investment to correct the problems created by decades of under-investment prior to the reform. Service quality declined and safety became an increasing concern. Moreover, the contracts negotiated by the historical operator were not clear enough to avoid opportunistic behaviour by the new operators; conditions deteriorated and undermined popular acceptance of this reform. The UK experience points to the crucial importance of reform design when opening up network sectors.

In continental Europe, rail reform has been limited. The industry is dominated by passenger transport, although the European Commission has made freight transportation a priority in order to achieve environmental targets and to reduce trade costs. The rail freight sector still has monopoly features. Infrastructure is publicly owned and managed, and private operators can pay a fee to use the network. However, competition is largely theoretical. In Germany, for example, where rail freight has been liberalised longer, the market shares of the new entrants are only 6-8%. The large historic national rail operators seem to prefer partnership strategies rather than challenging each other in new markets. Technical problems of network interoperability also inhibit moving outside of traditional national markets. Since 1997, when the first relevant EC Directive was approved, the process that would allow a train operator licensed in one state to operate across Europe has still not been completed. Technical harmonisation of standards and working practices has not overcome the need to comply with national standards and other administrative barriers to entry.

Technological change has facilitated telecoms reform

Telecommunications reform has been wide and deep, driven primarily by technological change. Alternatives such as microwave transmission, cellular phone systems, cable TV and later the Internet, broadband and Wi-Fi displaced the traditional monopoly paradigms of landline telephony and broadcast television and radio. Pressure for reform came first from makers and marketers of alternative technologies, along with their customers, usually businesses. Reform has restructured and usually privatised the historic monopoly telecoms firm (or ministry) and liberalised entry into the sector. The new entrants into liberalised markets often include foreign firms in the same sectors, as once-national firms that have lost their local monopolies and are threatened with loss of business at home try to recover it elsewhere by buying parts of other once-national monopolies. To allow competition to develop quickly, without waiting for entrants to install new facilities (or requiring them – inefficiently – to duplicate existing facilities that have monopoly features), reformers have often permitted entry by firms that would use some of the incumbent's capacity. Thus reform also has frequently involved mediating disputes and enforcing rules about the terms and prices of access to the incumbent's lines and switches. The principal obstacle has been resistance from the incumbent and its allies. Employees have sought to keep the advantages of government employee status, which has probably been a larger worry than loss of jobs overall, since most post-reform telecommunications sectors have experienced significant increases in total employment as markets have expanded. The historic monopoly's resistance to market entry, through protracted controversies about the terms and price of access, has been a more persistent obstacle to reform.

Power-sector reform has proved more difficult

Electric power reform has been slower and later to arrive. Reform here also seeks to eliminate inefficiencies that result from defects in the regulation of privately owned utilities or management methods of public enterprises. Here, too, technical change played an important role in triggering reform, although technological developments were less dramatic in power than in telecommunications. The spread of small, low-cost gas turbines in the 1980s made it more likely that real competition in generation could be realised: the economies of scale in power generation were falling to a fraction of what they had been. The increasing efficiency of long-distance transmission further weakened the traditional argument for integrated monopoly based on economies of scale, raising the prospect of decentralised production across a common delivery network (White, 1996; Quiggin, 2001). On the other hand, technology can present an obstacle to reform, or at least a complicating factor, because the physics of energy production requires tight co-ordination of operations throughout the system (Box 2.7). This creates complex contracting and marketing problems for a vertically un-integrated industry, which a successful reform plan must solve. While it is, in principle, possible to introduce competition in the contestable segments of the electricity sector – power generation and retail supply – *without* unbundling the incumbent, the very technical complexity of the sector makes this particularly difficult. Where the operator of the transmission and distribution networks remains an important player in the generation or supply markets, enforcing a non-discriminatory third-party access regime in respect of transmission and distribution is likely to prove very difficult. This points to the need for vertical separation of the natural monopoly transmission and distribution networks from the competitive activities of generation and retail marketing, thereby removing any incentive for the grid operator to deny access to others. Horizontal separation of the incumbent's generation and marketing assets creates competitors at the levels of production, wholesaling and retailing.

Box 2.7. **Economic implications of the physical properties of electricity**

Many of the technical challenges for policy makers trying to create electricity markets derive from three peculiar physical properties of electricity: it cannot be stored economically, apart from water stored in reservoirs available to hydroelectric generators; demand tends to be inelastic in the very short term, as most consumers lack the information or the means to react rapidly to changes in price; and supply and demand must balance at all times. Electrical imbalances at any point within an interconnected transmission network can have immediate and severe repercussions throughout the entire network. In addition, policy makers must consider the binding nature of generator and network capacity constraints when they emerge. The challenge of balancing supply and demand in real time across the whole network is magnified by the dynamic nature of flows on interconnected transmission systems, which follow the path of least resistance determined by the constantly changing interaction between generation and load, rather than contract paths. As a result of these factors, electricity markets can be quite volatile and may be particularly susceptible to the exercise of market power. For example, a generator who knows he must be dispatched to keep the system in balance is well placed to abuse his position. Electricity's attributes also give rise to the need for centralised or co-ordinated system operation and dispatch to manage reliability. It is these considerations that underlie the need to create a number of special institutions to regulate and operate electricity markets, as well as to prepare fairly complex rules governing electricity trading.

Source: Tompson, William (2009), *The Political Economy of Reform: Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries,* OECD Publishing, DOI: *http://dx.doi.org/10.1787/9789264073111-en.*

One of the major concerns underlying opposition to market reforms in electricity is the fear in many situations of potential "stranded" assets.[5] Stranding tends to be mostly in generation assets and supply contracts, due to the existence of high-cost facilities that will not be profitable in more competitive conditions. Compensation may be arranged through accelerated write-offs of assets or subsidised by transition charges on reform beneficiaries. Would-be entrants at the generation stage may support reform because they expect to receive subsidies that are provided to promote environmental or supply-security policy goals. Industrial and large commercial customers have backed reform more strongly than household consumers, who have been slower to seek out competitive alternatives to their traditional suppliers. Households often do not imagine competition for this service, and they place a high value on stability and security of supply. Making prices vary with hourly and seasonal changes in cost would make even household consumers more cost-sensitive, and here technology will promote reform with the introduction of time-of-day metering and automated controls. Environmental policy goals also encourage consumers to take advantage of competitive alternative providers, since one of the dimensions in which electric power can be differentiated is the generation technology.

Some lessons can be learned from reform successes and failures. In England and Wales, vertical separation enabled competition to deliver cost reduction; by contrast, in Scotland, where the incumbent was not vertically restructured, there was no post-privatisation improvement in efficiency (Newbery and Pollitt, 1997). In Scandinavia, there is a well-established multi-jurisdiction market and power pool, but in continental Europe, reform has been slow. One reason is that potential benefits were masked by the effects of rising fuel prices. Congestion and interconnection failures between networks have thwarted efforts to integrate and open the continental European market. California's electricity reform also underscores the importance of good policy design. In an effort to ensure that consumers would quickly perceive reform and restructuring as a success, California's reform legislation reduced and capped retail prices. Thus, when wholesale prices then rose sharply, due to a shortage of generating capacity, higher-than-expected gas prices and manipulation of the post-reform energy markets, power companies were bankrupted. Blackouts, a state takeover and extraordinary price increases followed, and the debacle discouraged reform efforts in other states.

Other network sectors have also undergone significant reform

Natural gas reform appears to be easier in jurisdictions that produce gas, such as the United Kingdom and the United States, than in those that import it. Some countries that must import all of their gas (often from virtually a single source) evidently doubt that competitive markets could deal adequately with the supply-security dimension. As a technical matter, experience shows that competition is feasible not only for well-head production, but also for long-distance transport. Network economies remain important for final delivery to smaller consumers, so this service typically remains a monopoly, but other segments of the market are contestable. The need for reform became clear after the 1970s energy crises, which disrupted fuel markets and encouraged customers to search for alternatives to higher-priced oil. In the United States, jurisdictional competition demonstrated the disparities. Interstate sales were on different prices and terms than sales within the state where gas was produced, because they were subject to different regulatory regimes. Artificial devices to redefine sources and uses of gas in order to take advantage of one regime or the other highlighted the irrationality of the complex regulations then in force and showed the likely benefits that would follow from reforming them. Customers demanded reform in order to eliminate cost advantages that their competitors enjoyed because their suppliers of fuel or feedstock were under a different regulatory regime. The stranded costs of supply contract commitments that had been undertaken under the old regulatory regime were compensated by transition charges. In the United Kingdom, the reform experience showed that privatisation alone was not enough to improve efficiency. British Gas was privatised in 1986, but benefits were not observed before the full liberalisation when new producers and traders could enter and compete against British Gas. The appearance of a bulk market for gas was followed by a sudden increase in demand and lower prices.

Postal reform is slowed by concerns about preserving universal service and the jobs of a large number of public employees. Job losses are clearly a concern for those representing postal workers' interests, but concerns about the status and employment conditions of postal employees are also a factor, particularly where postal employees are classed as civil servants. Prospects for cost savings drive reform, which appears inevitable as technology erodes the traditional monopoly service. Private, competitive entry at the profitable fringes, for documents and package delivery, revealed inefficiencies and unexploited opportunities. Postal volumes are shrinking as customers routinely use the principal competitive alternative, the Internet. In the European Union, the scope of the legal monopoly is gradually shrinking, pursuant to EC liberalising directives. Liberalisation has attracted new entrants, but their collective market share is typically 10% or less. Nevertheless, the impact of the *threat* of competition is sometimes enough to make a big difference: the Swedish postal monopoly, for example, has lost very little market share since its monopoly was ended in the early 1990s, but its own efficiency improved very rapidly during the first years after liberalisation (Tompson, 2009).

Non-tradable services can be particularly difficult to open up

Professional services, historically organised as authorised cartels, have embraced competition reluctantly. Like taxi services, these sectors tend to be structurally atomised, with relatively low barriers to entry (apart from those erected by regulatory authorities and professional bodies) and exit. However, they are usually subject to pervasive regulation controlling entry, recommending or fixing prices, protecting the exclusive exercise of specific functions and prohibiting or restricting advertising and the formation of commercial business structures. There is little evidence that these restrictions improve consumer welfare; on the contrary, restrictions have been correlated with higher prices and less innovation, without improving quality (Conway, Janod and Nicoletti, 2005). However, the beneficiaries are particularly well organised to resist change, particularly where the professions themselves are self-regulating, and they are often successful in persuading the public that they need the protections in order to protect consumers from exploitation by poor service providers.

The process of product-market regulation reform

Reforms that aim to introduce competition in previously monopolistic sectors must isolate and then regulate the monopoly function (if one remains), liberalise entry into other functions and support the competitive entrants into these functions as they are getting established. Where it would improve efficiency or reduce distortions of competition, government commercial operations may need to be corporatised or privatised. Where the sector is a cartel enforced by law, reform to eliminate the cartel may also need to address "essential facility" natural monopoly features, such as capacity-limited airports, and risks of consumer injury, such as from unqualified providers of professional services.

Proper sequencing and co-ordination of the phases of reform is critical

At the heart of many reforms of previously monopolistic sectors – and especially when these concern network industries – lies the vertical and horizontal restructuring of the monopoly concern. "Vertical" separation, to isolate the monopoly function of the legacy incumbent and operate it independently of functions that could be competitive, simplifies regulation of the monopoly operation and encourages competition elsewhere. This is the most straightforward and effective way to reduce the incumbent's incentive for anti-competitive exclusionary behaviour. Although separating the operations within the enterprise is a necessary first step, the incentive to exclude competition is reduced much more by separating the operations' accounts, legal structure or ownership. "Horizontal" division of the assets in the incumbent's competitive functions creates the possibility of competition much more quickly than waiting for entrants to invest in new assets. Technical feasibility is a significant precondition, and restructuring must weigh the risk of losing productive or operational efficiencies or incurring higher-than-anticipated transaction costs.

In many cases, corporatisation of the monopolist is a necessary prerequisite for the more effective degrees of vertical and horizontal restructuring. Even for the monopoly functions that may remain with a single state-owned entity, transforming a historically bureaucratic or administrative organisation into a corporation and cutting its ties to government policy can create incentives to improve efficiency, not least by increasing financial transparency and managerial accountability. However, even such a modest initial step may meet fierce resistance, since – even in the absence of privatisation – corporatisation may be seen as a threat to the freedom of action of the concerned's managers[6] or the status of its workers as civil servants.

Privatisation is often one of the core aims of reform, but privatising a monopoly without regulating it just puts the rents into private hands rather than the public purse. Though typically regarded as an element of a "liberal" reform, privatisation can serve either to impede or to facilitate market opening. If fiscal concerns loom large in policy makers' calculations, they may prefer to privatise a monopoly intact, even if none of its functions have the character of a natural monopoly (*i.e.* even if there are no impediments to horizontal unbundling and the introduction of competition).[7] If a concern is to be privatised with monopoly functions intact, careful work must be done to ensure an adequate regulatory framework is put in place. Privatisation projects may also discourage or prohibit participation by foreign investors in order to protect local interests, potentially undermining the effectiveness of reform. Conversely, however, foreign firms may be encouraged to buy the privatised assets precisely in order to accelerate reform and attract investment. In general, privatisation should follow rather than precede the design of a new regulatory framework for the sector, lest asset-allocation contests get caught up in – and influence – debates about the regulatory framework.[8]

Creating competition requires permitting competitors to enter markets and functions that had been legally protected monopolies. To make this entry realistic and create competition quickly, regulation must ensure non-discriminatory access by third parties to any remaining monopoly "essential facilities". On the other hand, rules requiring access and setting the price to be paid for it must permit enough profit to support long-run investment in infrastructure. Where monopoly is inevitable, exploitation of market power must be curbed by public provision of the service or regulatory oversight of the provider.

The agencies that apply the rules to promote competition must be independent from influences that would try to preserve protections and discriminations, and they must have enough resources and legal powers to ensure compliance. Setting up a separate regulator for each liberalised sector promotes continuity and technical familiarity, but it runs a risk that regulation of a "client" industry could sustain protections rather than discourage them. A system of common rules applied across several sectors is less vulnerable to myopia or to forum-shopping opportunism. Co-ordination of actions and policies among regulators and with the competition authority is important, to avoid duplication and ensure consistency.

Resistance to reform often stems from concerns about its distributional effects

The usual sequence of liberalising reforms corresponds to some extent to the relative difficulty of making them happen. Opening markets to competition by expanding trade and investment while strengthening domestic competition policy have generally been faster and easier tasks than restructuring network industry monopolies and reforming regulation that protects domestic cartels. Although most OECD countries have made considerable progress in sectoral regulatory reform, there are few sectors or jurisdictions in which it could be said that the task is completed. All these reforms face certain common political economy challenges and responses.

Trade, investment and sectoral regulation situations involve the same interest-group dynamics, often involving the same sectors and firms, which have sought protection from competition through any or all of these measures. Thus, the situations present similar risks of anticompetitive, inefficient sectoral exclusions and special protections. Because the restraints often benefit a particular sector or firm, its privileges and discriminations are vulnerable to challenge on grounds of both efficiency and equity, and reform can be easier where its advocates are successful in deploying both lines of argument.

Distributional uncertainty constitutes a source of resistance to reform in many situations. Reform inevitably creates the risk of leaving someone worse off than before, at least in the short run (Calabresi, 1991). The problem is that, while identifying losers from market-opening reforms is rarely difficult, identifying potential winners can be hard. Indeed, if the status quo is sufficiently restrictive, many of the potential beneficiaries of reform may not yet exist, let alone be identifiable. This is because new entrants, or even new sectors, may emerge only as a result of the reform. However, the greater difficulty often lies in persuading the public of the consumer interest in more competitive markets because:

- Individuals may resist a reform that would benefit them as consumers if it could impose costs on them as employees.
- Conflicting interests between different consumers may also complicate reform. For example, extending utility service outside of developed areas may require a large investment, but those who are already served may object to the higher rates needed to pay for expanding the network to serve the less well-off. They might even employ the rhetoric of pro-competitive reform to justify keeping their own

rates lower. Moreover, consumers who benefit from cross subsidies for such things as local transport, power, postal service or telecommunications, will not want to lose them.

- Where the effects are mixed and to some extent uncertain, so that not all individuals know for sure where they will stand post-reform, it can be completely rational for a majority of the public to reject a change that would improve the welfare of the majority (Fernandez and Rodrik, 1991). One way to overcome this hurdle would be to identify more clearly those who will gain from the change, to reduce uncertainty and thus encourage potential winners to support reform.

- There may be other reasons why individuals might not support changes that would make them better off. For some, relative position matters. They will be reluctant to back a reform that leaves them better off in absolute terms but worse off in relative terms.

- "Status quo bias" is now a well-established empirical reality: individuals often place an unrealistically high value on what they already have (Kahneman, Knetsch and Thaler, 1991). In other words, they discount potential gains more heavily than potential losses, making them more risk averse than they would be if their aim were simply to maximise their expected utility. Proponents of reform faced with such individuals need to show that the net benefit of change is both large and clear.

Consumer uncertainty about outcomes can thus be an obstacle to success. Even where they are confident that they stand to benefit from greater efficiency, individuals might regard the likely pay-offs as too small to prompt active support for the reform, while the risk to reliability from changing the familiar, traditional system may look large. Consumers in most countries were indifferent, if not hostile, to early telecoms reforms, viewing them as complicating their lives by forcing too many choices. Change requires designing and explaining regulation that overcomes the information gap and consumers' sometimes rational status quo bias. Costs of information and organisation explain some consumer apathy about reform. The per capita benefits from better regulation can be so small that it would be irrational for any individual consumer to pay attention to them, even if those benefits are large in aggregate. Thus, documenting actual experiences of large and visible consumer benefits from reforms, in the form of wider choice, better service or lower prices, can show that the promised benefits will be worth the trouble. The consumer perspective can also be a useful check: if it is hard to show how a proposed reform benefits citizens as consumers, the supposed reform may be ill-advised.

Those threatened by reform are more likely to mobilise than its potential beneficiaries

One of the more troubling findings of research into the political economy of reform is that the losers from reform are more likely to mobilise than are the potential winners (Olson, 1965; Tompson, 2009). As noted in the previous section, this is in part due to the greater difficulty of identifying the potential winners, but there are other factors at work. First, the costs of reform often tend to be upfront and relatively concentrated, while the benefits are longer-term and more diffuse. In such a situation, one would expect potential losers to mobilise much more readily than potential winners, even if their discount rates are identical. Secondly, there is reason to believe that their discount rates will *not* be identical. The literature on endowment effects and loss aversion suggests that people discount potential future gains more readily than expected future losses. Thus, given equal resources and similar positions, potential losers will be quicker to mobilise in order to resist losses than winners hoping to realise gains (Rodrik, 1994; Drazen, 2000). Thirdly, the interests that resist reform are usually better placed to organise themselves for that purpose, since they represent the incumbent interest in a sector. These include the managers, investors, employees and officials of the enterprises that enjoy protections from competition and advantages from discriminations and cross-subsidies, as well as any favoured customers who would lose privileged access to services in the event of reform. As beneficiaries of the status quo they will often, though not always, dispose of greater organisational, political and financial resources.

Nevertheless, some of the winners from market reform may also be easy to identify and organise to affect policy. These may, for example, include developers of new technology or competitive offerings that aim to "cherry pick" the incumbent's business at points of inefficiency, as well as their customers who would gain. Industrial and commercial customers clearly understand their interest in lower costs and greater competition, at least among their suppliers and customers. Reforms may therefore be relatively easy in sectors producing intermediate inputs to other industries, as the "downstream" sectors can constitute a pro-reform constituency. The reform of sectors producing for final consumption, by contrast, can be harder, as households may worry about quality and distribution and will usually have little incentive to mobilise. Even if they are aware of the benefits of reform, their impact on individual households may be small as to create only the weakest of incentives for citizens to mobilise in support of change (Tompson, 2009). The relative shares of final and intermediate consumption affected by the reform thus help explain outcomes. Industries where reforms are deeper tend to be those accounting for a larger share of firms' inputs and a smaller share of household consumption. Economy-wide pressures for reform are stronger when these are likely to affect production costs. This suggests a sequence, coping first with producers of intermediate inputs before moving to reforms that affect final consumer products.

Compensation of potential losers may well be required for reform to proceed

To overcome opposition and accelerate the implementation of reform, the reform programme may need to provide some way to compensate those whom change will make worse off. Adjustment assistance may be offered to sectors affected by trade liberalisation. Reforms of regulated sectors may set up transition arrangements for relationship-specific labour, for amortising the lost value of stranded assets and for reforming obsolete contracts. If government operation of utility functions has subsidised other functions or social benefits, the authorities will need to find new sources of revenue. Parties threatened with the loss of subsidised universal services may demand that reforms deliver an equivalent. Compensation may be necessary to overcome opposition. Compensating the loss of pre-reform asset values, through accelerated write-offs or other transition funding arrangements, can be simpler than compensating larger groups such as labour interests. Providing for compensation through broad-based programmes and social safety nets is generally preferable to distorting the details of a reform (Landy, Levin and Shapiro, 2006). Thus in Australia, sensitive sectors or regions that were considered unusually likely to resist changes received adjustment help. It may be important to call attention to the compensation being provided, though, particularly if the regulation that is being reformed had provided similar protections, implicitly or explicitly. If the cushion or compensation is not linked to the reform, the apparent absence of compensation could undermine support for change.

Advancing reform also requires persuading consumers of its potential benefits

Not all difficulties of reform can be explained simply as conflicts over competing interests. Difficult choices between competing values can also slow the process. Even a well-informed public may not accept that it would benefit from reform. A preference for security and stability, or a claim that fairness is more important than efficiency, can argue against proposals to change the status quo. Many consumers may believe that regulations which some propose to reform are protections that should be preserved intact. Reform advocacy may thus involve educating consumers about where their interest lies while understanding the importance of protecting their other values, perhaps by devising ways to do so more efficiently and with fewer distortions.

Persuasion may also be necessary to overcome doubt among members of the public whether advocacy of less or different regulation is consistent with advocacy of consumer interests and protections. For example, groups representing consumers have sometimes objected to changes that would lead to lower prices or more open entry on the grounds that product or service quality would decline. A "key fact", presented clearly when the public is ready for the message it conveys, can be decisive. The early experience of reform in the United States illustrates how a pro-reform consensus can form around basic concepts. In the economic conditions of the mid-1970s, with low growth and high inflation, the public was ready to be persuaded to change. Arguments about economic regulation could be reduced, convincingly, to the simple point that prices were too high, and restrictive regulation was one of the reasons (Noll, 1989). An illustration from the airline industry made the point irrefutable: rates for service within states were a fraction of the rates for comparable interstate service that was subject to federal control of rates and entry. Thus the first major reform project was liberalisation of airline service and abolition of the sector's economic regulatory agency.

Obtaining broad support for reform depends on assuring the public that "reform" is not a euphemism for eliminating protection against injury and monopoly. Lowering barriers to trade and removing constraints in product markets, if successful, can facilitate further, more difficult reforms. To overcome objections from special interests and scepticism from likely beneficiaries, effective advocacy should combine a clear message, based not just on theories but also on key, compelling facts illustrating the likely effects of reform, with honest acknowledgement of the costs as well as the benefits.

Regulation may seek to correct market failures due to monopoly power, asymmetric or incomplete information, external effects and elements of public goods provision in particular sectors. Whether a regulation deals with these risks effectively requires a cost-benefit assessment of the regulation and of alternatives to it. If reasons such as these supported establishing the regulation, and those underlying conditions are still a matter of concern, then proponents of reform will need to persuade stakeholders and the public that reform would still deal with those concerns adequately. Reluctance to back reform may contain an element of sceptical conservatism. Consumers may accept the public interest justification for regulation, and they may suspect that those who call for reform have other agendas, which are inconsistent with the public interest. Among those who lobbied hardest for reform of California's electric power system were traders who anticipated profiting from defects in the reform plan, "By cloaking their preferred policies in the free market rhetoric of hired experts, these rent seekers promoted inefficient market design that maximised their capture of transaction cost profits" (Landy, Levin and Shapiro, 2006). Consumers may thus want to know more about the motivations of those who claim to speak on their behalf.

The California experience also highlights the importance of not *over*-selling the benefits of reform (Tompson, 2009). Failure to deliver promised benefits can undermine future reform efforts, and unfulfilled promises of benefits from market reform can produce cynicism and scepticism, even if reforms bring positive results overall (Battaglio, 2007). California's experience with a poorly designed electric power reform illustrates this risk. The breakdown of the reform owed much to decisions that were taken in an effort to ensure that it brought palpable improvements quickly. In the end, however, promising immediate benefits in order to overcome political resistance proved to be reckless, and when the design failed, reform momentum was lost.

Yet if the benefits of reform are realistically assessed and credibly presented, market-opening reforms can be mutually reinforcing. Demonstrated benefits from one reform can make the next one easier to adopt. In connection with Australia's National Competition Policy reform programme, the Productivity Commission not only made initial estimates of likely overall improvements in economic performance, but also published follow-up analyses to measure the impact of reforms after they were implemented, concluding in 2005 that better productivity following reforms in energy, water, telecommunications and transport boosted Australia's gross domestic product (GDP) by 2.5%. Post-reform improvements in prices and services in regulated sectors are widely reported and cited to support reforms in others.

Leaders can promote reform over the resistance of better organised beneficiaries of rents and privileges if the voting public believes strongly enough that they will benefit. Demonstrations and arguments that credibly reduce uncertainty about the magnitude, timing and assignment of the benefits and of the costs of reform are vital to success. Clear understanding among stakeholders of the problems and of the solutions – including transparency about their costs as well as their benefits – is necessary, both to launch reform and to maintain momentum through the phase when costs may loom larger than benefits. This is likely to involve more than simply "communications as marketing"; on the contrary, the communications efforts that support reform initiatives will need to involve real consultation with stakeholders and the public, rather than one-way public relations exercises. Effective consultation strengthens the legitimacy of the reform and also provides feedback that may be valuable in avoiding potential pitfalls and improving reform design.

The creation of strong, credible reform-oriented institutions can facilitate progress

OECD experience points to the potential of a number of different types of institutions to help advance market-oriented regulatory reforms. Regulatory reform councils or commissions, such as the "Better Regulation" group in the United Kingdom and the regular regulatory reform commissions in Japan and Korea, have made major contributions to the reform of market-restraining regulation in many countries. Membership in these groups is often *de facto* representative of the business, labour and public interest groups that would support or oppose reform. Among OECD countries, the most effective standing institution supporting market-opening reforms has probably been the Australian Productivity Commission (Box 2.8). It provides impartial, well-researched analysis of costs and benefits, along with advice and recommendations. The commission's process of public consultation and feedback gives the government an opportunity to gauge likely reactions and thus reduces the risk of reversals.

Competition enforcement agencies and policy offices have also been important institutions supporting market reforms. Their analysis and advocacy can fill an information gap and serve as surrogate or virtual "organisations" representing consumer interests. To improve consumer welfare where consumers themselves are rationally ignorant of their own interests,[9] competition enforcement agencies can take action on consumers' behalf, promoting changes that will produce large-scale, though diffuse, benefits, for which supporters of reform can later claim some political credit. Enforcement can demonstrate likely benefits while stigmatising rent-seeking interests, challenging them to justify resistance to change. Competition advocacy can educate consumers about the effects of reform and motivate them to support it, providing an alternative to formal organisation as an avenue of political influence. Advocacy and enforcement can call attention to issues and motivate coalition-building and public support in conditions where theory predicts that opponents of reform would successfully organise to defeat it. Giving the competition authority an explicit mandate to promote competition, or even to propose further reforms, can thus have far-reaching consequences, as the Italian experience demonstrates (Box 2.9).

Box 2.8. **Australia's Productivity Commission**

The Australian Productivity Commission (PC) is a major source of innovative policy analysis and advice. It is unique among OECD countries for its standing function. Its charter is to improve the productivity and economic performance of the economy, taking into account the interests of the community as a whole, having regard to environmental, regional and social dimensions; not just the interests of particular industries or groups. The PC is an advocate for reform and an authoritative source of advice on reform opportunities and strategies for policy implementation. Importantly, the scope of the commission's work covers all sectors of the economy, including the public and private sectors and Commonwealth as well as State and Territory responsibility.

The Productivity Commission was created by an Act of Parliament in 1998. The evolution of this institution embodies the links among policies about trade, regulation and competition, as well as the evolution of Australian policy. The Productivity Commission replaced three standing economic research and advice agencies: the Bureau of Industry Economics, the Economic Planning Advisory Commission and the Industry Commission. The Industry Commission, which had been created in 1989, had in turn evolved from the Industries Assistance Commission, which in 1974 had replaced the Tariff Board, established in 1922.

In the conduct of its reviews the commission operates independently under the powers of its own legislation. Its independence is formalised by law. The large majority of its inquiries and studies have a regulatory dimension. Key factors that have been vital to its success are a strong analytical tradition, independent commissioners, skilled staff and transparent processes. The chair and the commissioners are appointed by the Governor General. The Productivity Commission has 180 professional and support staff. The processes of inquiry are public, allowing the opportunity for the participation of interested individuals and groups, and the final inquiry reports must be tabled in Parliament within 25 sitting days of the Australian Government receiving the report.

The Productivity Commission produces four main outputs:

- public inquiries and research studies requested by the Australian Government;
- performance monitoring, benchmarking and other government services to government bodies;
- competitive neutrality complaints and advice; and
- supporting research and annual reporting on productivity performance, industry assistance and regulation.

The outputs are delivered through public inquiry and research reports, staff research papers, public conferences and seminars. The commission produces an annual reporting series (the "blue book") on the performance of government services.

The commission models the economic costs and benefits of alternative policy options and it may make recommendations on any matter that it considers relevant. The range of topics is wide, covering rural and regional policies, network industries, sectors such as automobiles, gambling, textiles, pharmaceuticals, performance benchmarking of Australian regulation and annual reviews of the regulatory burden on business.

Box 2.9. **Competition agency advocacy and Italy's *Bersani* reforms**

Nearly 400 sector studies and advocacy filings by the Italian Competition Authority, over a period of 15 years, laid the foundation for the wide-ranging *Bersani* reforms of 2006 and 2007. The reforms mirror recommendations from the authority's repeated findings about issues arising from sectoral regulation. Italy's original competition law, from 1990, required the new Antitrust Authority to draft advocacy reports on public procurement, retail trade and concessions. These reports were important in influencing subsequent reform.

Professional services: rules setting minimum fees and banning advertising were repealed, and controls on multi-disciplinary practices were relaxed. In 1997, a sectoral inquiry by the Competition Authority called attention to these constraints, and in 2005, the latest in a series of advocacy reports on liberalisation of professional services, analysed potential measures in detail.

Retail distribution: limits on promotional sales were dropped, and approval of new store locations should not impose requirements about minimum distance from others or range of products supplied. These steps bolster a 1998 reform that made it easier for small shops to open up. In 1993, one of the Competition Authority's first reports, in response to a specific instruction in the then-new Competition Act, was about issues in retail distribution. Later advocacy reports backed up the 1998 reforms and called attention to how regional governments were implementing those reforms.

Bakeries: bakeries no longer need special authorisation to relocate, and they may sell other food products for immediate consumption. In 2002, an advocacy filing by the Competition Authority called for such reforms.

Pharmaceutical products: pharmacies no longer have a monopoly on selling "over the counter" products, retailers may discount the prices of those products, and a wholesale distributor may now run a pharmacy. In 1997, a sector inquiry by the Competition Authority questioned restraints on pricing and on entry by wholesalers, and more recent advocacy filings dealt with other aspects of these regulations.

Taxicabs: limits on the number of taxi licences were lifted, and other aspects of regulation by municipalities were made more flexible, to promote new entry. In 1995, the Competition Authority issued an advocacy filing about competition problems in this sector, and it returned to the topic with a filing in 2004.

Insurance: exclusive distribution arrangements and mandatory minimum prices were prohibited. In 2003, a sector inquiry by the Competition Authority showed that exclusive contracts raised entry barriers.

Finally, agencies that embrace both consumer protection and competition responsibilities can enjoy a unique advantage in promoting regulatory reform. They can credibly contend that their advice to promote competition is consistent with protecting consumers. Increasing competition should benefit consumers directly; thus, the ultimate goal of much economic regulatory reform is fundamentally a consumer-protection goal. Where a single agency has both consumer-protection and competition responsibilities, this point may be easier to communicate convincingly. Experience confirms the value of this connection. An International Monetary Fund (IMF) study of conditions affecting the success of broad-based reforms found that reforms began sooner and proceeded farther in Australia, Canada, New Zealand, the United Kingdom and the United States (IMF, 2004). In each of these countries, there is an agency that combines responsibilities for competition with enforcement of rules to protect consumers against unfair practices in the marketplace.

Product-market reforms can reinforce one another

As noted earlier, the usual sequence of market-liberalising reforms – trade, investment (and foreign exchange), competition, sectoral regulation – follows a logic of competition policy. Thus, market opening is typically followed by reforming regulation of product markets, in order to improve efficiency in the new, more competitively challenging environment. Product-market reform has gone farthest in sectors where the economic argument for controlling price and entry has been weakest, or where technological development has undermined traditional justifications for regulation. These factors explain why, in infrastructure services, reform of airline services, road freight and telecommunications has been more successful, while reform has been slower in product markets such as electric power and railways, where the economic arguments are more complex. Theory prescribes a sequence of sector reform steps that is not always followed in practice. It would be better to separate monopoly elements from competitive functions and set up the regulator, to oversee the monopoly element and promote competition in the others, before privatising the incumbent and liberalising entry and pricing. However, privatisation often comes too early in the process (usually for fiscal reasons), and entry is invited before regulations are in place to counter the incumbent's strategies for excluding competition. The experience of OECD countries suggests that strengthening general competition laws and enforcement advances the market-opening agenda and can catalyse sectoral reforms. This goal is usually unobjectionable and widely supported, so it might be packaged along with more controversial proposals.

Synergies and sequencing among policies can reduce the need to promise compensation. Where the scope of reform is broad, and the pace and plan are deliberate, individuals and businesses will have a clearer idea of the potential benefits and risks, and it may be easier to persuade them that the benefits will be greater. Phasing changes so that at least some of the benefits are clearly in place before the costs begin to bite could facilitate the process. Co-ordinated, even simultaneous, reform in many markets can help overcome resistance. Targets cannot complain they are being singled out, and each may reap some benefit from reforms to others, compensating for his own apparent losses. However, the design of reform should be alert to the risk that parties will use tools in one policy area to counter changes in another. For example, an industry might not resist trade reforms, because it has lobbied successfully for investment protections or an antitrust exemption. Sector-specific constraints on investment may represent just such a trade-off. Their likely effect on the success of sectoral reforms is ambiguous. Restraints on investment in reforming sectors might eliminate some of the most likely new entrants from contention. But putting these restraints into a reform package might deflect opposition to any change, leading to a second-best situation that is nevertheless an improvement.

Conclusion

The consumer interest in market opening is, in principle, direct and obvious. More competition in markets should encourage higher output, greater choice and lower prices. Labour-market reform, which is typically most difficult, may become easier after product-market reform. On the one hand, if stronger competition reduces market power, there is less rent available to be claimed through protective labour-market arrangements. On the other hand, a more competitive market creates more opportunities for efficient firms to enter and expand, which can translate into more opportunities for employment, reducing the incentive to demand inefficiently strong protection for current jobs. Nevertheless, product-market reforms in sectors that remain heavily regulated may become even harder as other sectors are liberalised, and the difficulty is due mainly to labour-market issues there (OECD, 2007). Loss of protections in other sectors increases the value of the privileges that remain, thus increasing the incentive for those who enjoy them to resist change.

Making market-opening reforms happen requires effective communication and consultation with stakeholders and the public, strategies for addressing the concerns of those who stand to lose out as a result of reform, institutions that are capable of sustaining wide-ranging, coherent and consistent programmes of competition-promoting reform, and a readiness to effectively use the reform opportunities that arise as a result of exogenous shocks, such as crises, and international undertakings. Important steps include:

- identifying likely beneficiaries of reform, such as customers and potential new entrants, and enlisting their support;
- educating the public with salient facts about the costs of the status quo and the benefits of reform, particularly by showing how higher productivity can mean more resources for compensating losers and for cushioning the impact of other reforms;
- facilitating the inevitable bargaining among organised interests, to promote outcomes that address the legitimate concerns of potential losers but are nevertheless consistent with the public interest;
- taking advantage of the opportunities that may be presented by crisis situations, which can destabilise relationships among established interests and create openings to negotiate new ones;
- establishing effective "reform institutions" in the form of commissions or other bodies tasked to pursue regulatory reform or empowering competition authorities to promote competition and consumer protection, as well as to enforce existing competition law;
- making the most of the reform "leverage" offered by involvement in international organisations and negotiations; and
- easing the transition to the new arrangements by compensating losers and dealing with such problems as stranded assets, capitalised rents and sunk costs.

Notes

1. On the "typical" sequencing of reforms, see IMF (2004); Brandt, Burniaux and Duval (2004); Banks (2005); Berger and Danninger (2006); Høj *et al*. (2006); and Landy, Levin and Shapiro (2006).
2. The acquisition of an existing Korean enterprise by a foreign investor was prohibited. A large number of firms were designated as defence-related companies, where inward foreign investment was subject to prior approval. There were also aggregate foreign investor ownership limits in state-owned enterprises put up for sale in successive privatisation programmes. Moreover, the administrative procedures and approval processes confronting foreign investors were lengthy and cumbersome (OECD, 2002).
3. A new legal framework for FDI was introduced in late 1998 to reshape and streamline the previous administrative approach to FDI. Of the 52 sectors previously prohibited or restricted to foreign investors, 30 were opened partially or completely. Much of the liberalisation of FDI rules covered the service sector: finance, telecommunications, broadcasting and maritime and air transport.
4. In the usual classification of market failures that should be corrected by regulation, a "natural monopoly" is a market that could be fully served at the lowest total cost, given the technology available and the scope of the market, by a single operator. Natural monopoly has long been considered typical of network utility and transport industries. Other conditions and policies that are invoked to justify regulatory intervention in markets include information failures and asymmetries, under-supply of public goods and redistribution.

5. When legislative or regulatory changes in market conditions leave companies or individuals stuck with investments that they would never have made if they had anticipated the change in the legal-regulatory regime, possibly rendering previously valuable assets worthless, the assets in question are said to be "stranded". In such situations, it is common to compensate investors, provided that: (i) the cost of the asset has not yet been recovered; and (ii) it cannot be recovered by sale or alternative use.

6. In a very real sense, greater transparency will, *ceteris paribus*, reduce their discretion.

7. See, for example, water privatisation in South Australia, as discussed in Tompson (2009), Chapter 18.

8. On the one hand, it is generally not desirable to have new asset owners lobbying the authorities to ensure regulatory arrangements that will favour them. On the other hand, neither should those acquiring assets via privatisation then face *ex post* surprises in the form of regulatory arrangements that may be less favourable than they had been led to expect *ex ante*.

9. Consumers may be said to be rationally ignorant when the cost of educating themselves on an issue exceeds the potential benefit that the knowledge would provide to the individual consumer.

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Chapter 3

Advancing pension and labour-market reforms

by Vincenzo Galasso*

This chapter aims to isolate the factors that may impede the adoption and implementation of reforms to pension systems and labour-market institutions, and to identify the conditions, sequencing and packaging of successful reforms. The chapter begins by setting the economic and political scene for implementing pension and labour-market reforms. It briefly discusses the factors that make such reforms necessary and, in some countries, more or less unavoidable. The perceptions that individuals in these countries have of the economic risks and their attitudes towards the feasibility of reforms are also analysed. In an effort to take stock of reform processes so far, the main pension and labour-market reforms implemented (or attempted) in OECD countries are then reviewed. The analysis of these reforms (or reform failures) is crucial to identifying the main elements leading to a successful reform process. Previous research on the political economy of reforms has identified several economic and political factors that may be decisive for success. These are summarised next, focusing on empirical testing of the relevant theories. Finally, in the light of these results, the chapter ends with a brief outline of feasible reform strategies.

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This chapter aims to isolate the factors that may impede the adoption and implementation of reforms to pension systems and labour-market institutions, and to identify the conditions, sequencing and packaging of successful reforms.[1] To this end, it draws heavily on the existing theoretical and empirical literature on the political economy of reform. It makes sense to combine these two policy domains in a single discussion, since changes in pension systems can have a tremendous impact on agents' labour-market incentives and labour-market policies can likewise encourage or discourage early exit into retirement by older workers. Retirement reform is, in essence, an aspect of labour-market policy. Moreover, some pension reforms effectively require complementary changes to labour-market institutions: measures aimed at promoting longer careers and later retirement often need to be accompanied by labour-market policies that take better account of the needs of older workers. At the same time, however, the evidence suggests that it may be particularly difficult to pursue pension and labour-market reforms simultaneously.

Understanding the need for reform

Long-term factors underlie the need for pension and labour-market reforms

Retirement systems and labour-market regimes are persistent institutions that affect most individuals in society, albeit in different ways. Reforming them thus entails large distributional effects, since it typically generates winners and losers. Theoretically, the electoral cost (or benefit) of retirement and/or labour-market reforms should depend on the magnitude of the reform's impact on the winners and losers, and on their relative political influence. However, these reforms are typically associated with large costs concentrated on relatively few, easily identifiable and politically relevant groups (such as labour-market insiders and cohorts or sectors enjoying unusually generous pension arrangements), and yield individually small benefits that are spread out across large numbers of individuals, who may be difficult to identify *ex ante*. Pension and labour-market reforms may thus lead to large electoral backlashes.

Nevertheless, politicians may choose, or find themselves compelled, to commit their electoral or political "capital" to reform. This motivation for reform may reflect ideological positions,[2] a desire to secure economic opportunities for the country, external constraints (such as the need to comply with international undertakings), or an economic crisis that reveals the cost of the status quo. The last motivation has proved particularly relevant when persistent policies and institutional arrangements have coexisted with very dynamic environments. In fact, while some institutions, such as the unemployment benefit system, often act as automatic stabilisers, frequent adjustments are needed to fine tune them in response to evolving economic conditions. However, the most fundamental challenge to these institutions may come from their perceived unsustainability over time in a changing economic environment.

Population ageing constitutes the main challenge to existing pension systems

In many countries, the need to reform pension systems is largely a consequence of the financial sustainability challenges brought about by population ageing. In much of the OECD area, pay-as-you-go (PAYG) pension systems have been put under stress by a combination of falling fertility rates and a generalised increase in longevity. The share of elderly individuals in the populations of OECD countries has risen quite substantially during the last decades, and this trend is expected to continue to increase in the future (Table 3.1). In some countries, this phenomenon has been fairly dramatic: between 1980 and 2007, the proportion of elderly increased from 13.4% to 19.9% in Italy, from 13.1% to 18.6% in Greece, from 10.2% to 17.3% in Portugal, and from 10.9% to 16.7% in Spain. Over the same period, public pension spending in Italy grew from 10.5% to 14.0% of gross domestic product (GDP).

Table 3.1. **Share of population aged 65 and over in selected OECD countries, 1980, 2007, 2020 and 2050**

	1980	2007	E88 (2020)	E09 (2020)	Δ (2020)	E88 (2050)	E09 (2050)	Δ (2050)
Austria	15.5	16.9	19.4	19.4	0	21.7	28.2	6.5
Belgium	14.4	17.1	17.7	19.5	1.8	20.8	25.7	4.9
Denmark	14.4	15.3	20.1	20.1	0	23.2	24.5	1.3
Finland	12	16.5	21.7	22.4	0.7	22.7	26.1	3.4
France	14	16.4	19.5	20.2	0.7	22.3	25.6	3.3
Germany	15.5	19.8	21.7	22.8	1.1	24.5	31.7	7.2
Greece	13.1	18.6	17.8	21.1	3.3	21.1	31.5	10.4
Ireland	10.7	11.1	12.6	13.3	0.7	18.9	23.7	4.8
Italy	13.4	19.9	19.4	22.7	3.3	22.6	32.6	10
Netherlands	11.5	14.5	18.9	19.8	0.9	22.6	26.6	4
Portugal	10.2	17.3	15.6	20.1	4.5	20.6	30.1	9.5
Spain	10.9	16.7	17	18.8	1.8	22.9	32.1	9.2
Sweden	16.3	17.4	20.8	20.8	0	21.4	24.7	3.3
United Kingdom	14.9	16	16.3	18.3	2	18.7	23	4.3

Note: E88 (2020) = forecasts for 2020 carried out in 1988; E09 (2020) = forecasts for 2020 carried out in 2009; Δ (2020) = difference between the 2000 forecasts carried out in 2009 and in 1988. The same relationships apply for E88 (2050) and E09 (2050).

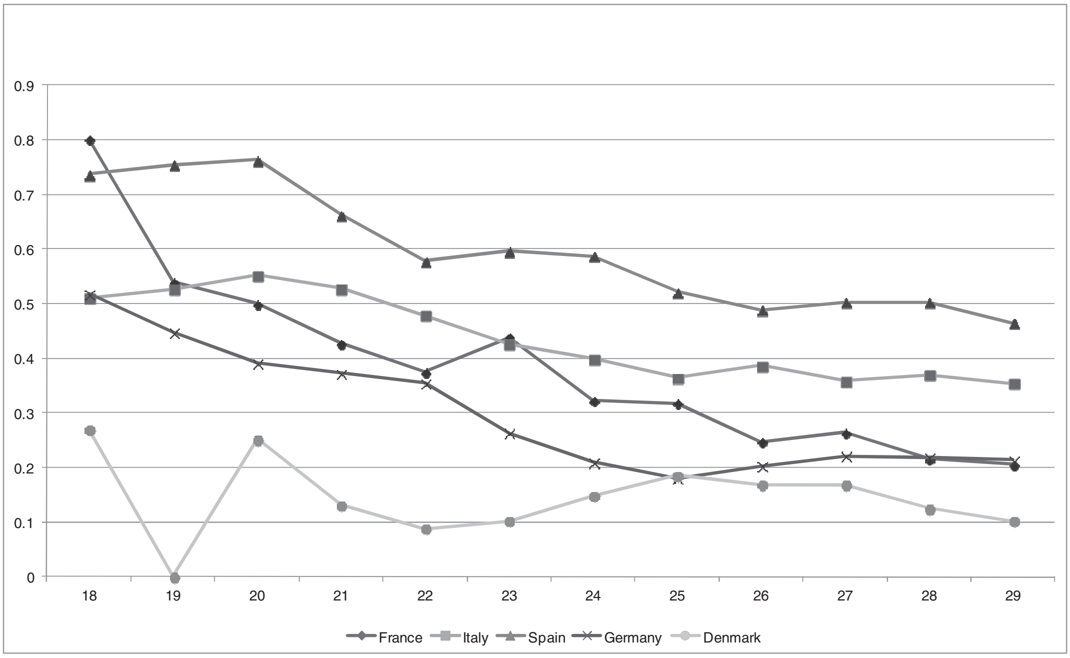
Source: OECD (1988), *Ageing Populations: The Social Policy Implications*, OECD Publishing; European Commission (2009), *2009 Ageing Report: Statistical Annex*, European Commission Directorate-General for Economic Financial Affairs, Brussels.

Public awareness of ageing trends has also grown over time. The expected shares of the elderly in the 2020 population which were projected in 1980 differ substantially from the most recent (2009) forecasts (Table 3.1). The differences in forecasts for 2050 are even larger, ranging from +1.3% in Denmark to +10.4% in Greece. Increased awareness of the magnitude of the ageing process and of its effects on the financial sustainability of public pension systems has played an important role in setting the stage for pension reforms in many OECD countries in the last two decades. In addition, financial crises have sometimes threatened the short-term solvency of some PAYG pension systems, thereby requiring an immediate policy response.

Labour-market dualism is driven by both efficiency and equity concerns

The case for labour-market reform reflects a number of concerns. On efficiency grounds, there is a widespread consensus among economists on the need for structural labour-market reforms in some countries to make the allocation of labour more efficient and increase participation rates. Furthermore, in some countries characterised by strong employment protection legislation (EPL), such regulations have given rise to a sort of "labour-market dualism", involving a clear separation between (senior) workers on regular permanent contracts and workers on temporary or other non-standard contracts – typically young people, females, poorly educated individuals or migrants. This is both inefficient and inequitable. The magnitude of this effect is displayed in Figure 3.1, which shows the percentage of temporary contracts for young workers by age in five countries. In Spain, most young workers are on temporary contracts. Furthermore, this temporary employment status is quite persistent, as young workers have found it increasingly difficult to move into permanent jobs. In fact, while three out of four 18-year-olds in employment are on temporary contracts, almost half remain in temporary jobs at the age of 29. By contrast, only one 29-year-old out of ten is on a temporary contract in Denmark. These wide differences in labour-market outcomes may help explain the different pressures for reforming labour markets across countries. However, since large shares of temporary workers are typically associated with a high levels of employment protection, which themselves reflect the political clout of labour-market "insiders", greater pressure for reform is often matched by greater resistance, and hence a higher electoral cost. Moreover, it is often the case that even labour-market outsiders are reluctant to support the relaxation of EPL. If they still hope to become insiders, they may focus on changing their place in the system rather than changing the system itself.

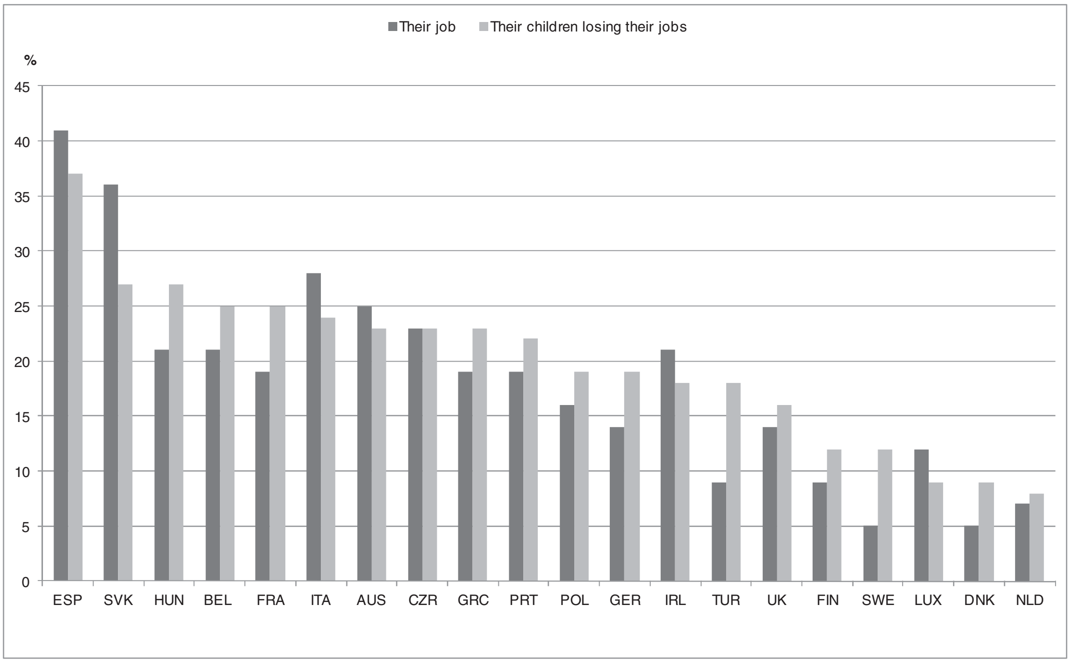
Figure 3.1. **Proportion of workers in temporary employment, by age, 2008**



Source: OECD (2008), *OECD Employment Outlook 2008*, OECD Publishing, DOI: *http://dx.doi.org/10.1787/empl_outlook-2008-en*.

Despite this apparent gridlock, windows of opportunity to reform highly regulated labour markets sometimes open up. Individuals' perceptions of the probability of losing their jobs (or their children losing jobs) can serve as a proxy measure for the demand for security (or insurance) against unemployment risk. Figure 3.2 shows how such perceptions vary across different European countries. Unsurprisingly, given dual labour-market dynamics, individuals are more concerned about their children losing jobs in Spain, France, Italy, Portugal and Greece than in the Nordic countries. However, individuals in the Mediterranean countries are also highly concerned about losing their own jobs – despite the high degree of employment protection enjoyed by regular workers. Regular workers' demand for more job security may open the way to reforms aimed at reaching a more balanced labour market, for instance by relaxing EPL in exchange for better income protection against unemployment risk (Boeri, 2009).

Figure 3.2. **Concerns about job security in selected OECD countries, 2008-09**



Source: Eurobarometer, 2008.

Taking stock of reforms

Pension reforms have involved later retirement, more pre-funding and less generous benefits

Although in most OECD countries, the initial introduction of public pension systems dates back to the beginning of the last century, or to World War II, the large expansion of public spending on pensions has mainly occurred over the last three decades. This rise in spending has largely reflected demographic shifts. As the fraction of retirees in the total population increases, the total amount of resources transferred from working generations to the elderly has to increase, even if the generosity of individual pension benefits remains constant. In fact, the generosity of benefits was also increased in many countries in the 1970s and early 1980s, most often as a result of reductions in the number of years of contributions required to be eligible for a full old-age pension, straightforward increases in the pension replacement rate and the introduction of generous early retirement schemes (often in a misguided attempt to relieve labour-market pressure at times of high unemployment). However, the political mood changed from the mid-1980s, thanks in large part to a wider recognition of the future financial strains facing unfunded pension systems during the demographic transition, and the economic distortions implied by these large welfare programmes. Several pension reforms – typically involving parametric rather than structural measures – were therefore proposed. Some of them were adopted and implemented, albeit often with long transition periods, whereas others met fierce public opposition and had to be withdrawn.

Recent pension reforms have pursued three main objectives: (i) raising the effective retirement age, mainly by reducing the incentive to retire early; (ii) curbing pension benefits in order to keep the financial sustainability of the system under control, by modifying the benefit formulae and by indexing benefits to prices (rather than wages); and (iii) increasing the use of private pensions in an attempt to modify the public-private mix in the provision of retirement income, by providing tax incentives for private pension contributions. Examples of reforms aimed at postponing retirement age include those in France (2003), Germany (1992, 1997 and 2003), Italy (1992, 1995 and 2004), and the United Kingdom (1986). Increases in effective retirement ages were pursued by legislating rises in statutory retirement ages and by altering the formulae for benefit adjustments so as to reduce the incentives to retire early. Figures 3.3 and 3.4 show that Italy and Sweden, and to a lesser extent Belgium, France and Germany, were particularly effective in reducing the incentives for early retirement, as measured by the implicit tax on continuing to work, both for workers aged 55-59 and for those aged 60-64.

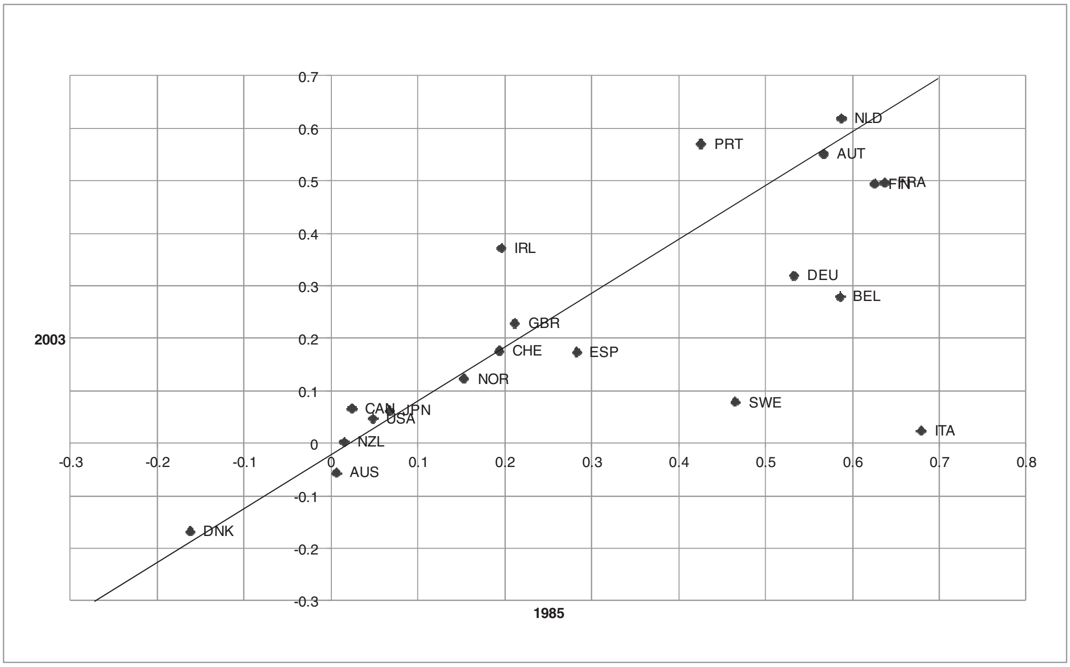
Reform measures leading to the development of private second pillars (occupational pension funds) and third pillars (individual funds) were also widespread. In Germany, the 2001 Pension Reform Act increased the fiscal advantages of saving in private pension funds. In Italy, the 1992 Amato Reform established occupational schemes, and special tax treatment for non-mandatory funded pensions was introduced in 2000. In 2004, the investment of the end-of-career severance payment (the so-called "*trattamento di fine rapporto*") into occupational pension plans was strongly incentivised. In France, the 2003 "Fillon reform" introduced tax-deductible, voluntary individual pension plans (*plans d'épargne individuel pour la retraite*), which were intended to provide workers with fiscally advantageous saving instruments for retirement income. Even in the United Kingdom, despite the existence of a well-developed second pillar, the 1986 Pension Act allowed for opting out of part of the state pension system into personal pension funds.

More comprehensive measures have also been introduced that radically modify the nature of the system. In Italy, the 1995 Dini reform completely redesigned the architecture of the Italian social security system; Sweden, too, adopted a structural pension reform in the mid-1990s, as did Poland a few years later. In each of these countries, defined-benefit schemes were abandoned in favour of a combination of notional defined contribution (NDC) schemes and funded arrangements, though the balance between the two varied substantially from country to country. The NDC schemes, which constituted the largest part of the reformed systems, continued to be financed on a PAYG basis, but individuals' pension benefits were directly linked to their lifetime contributions to the system. This contributive aspect is only "notional", since contributions are not in fact invested in assets. Italy also eliminated its so-called "seniority pensions" (*pensione di anzianità*), which allowed workers to retire well before the official retirement age, provided that they had contributed for a certain number of years.[3] Poland eliminated many – though not all – of the privileged early-retirement regimes that applied to specific groups and sectors. In both countries, the elimination of such arrangements was implemented over a long transition period. Finally, additional norms were introduced to advance the harmonisation process across various pension regimes and to provide fiscal incentives for individuals to invest in private retirement savings.

Labour-market reforms are increasingly driven by the need to tackle labour-market dualism

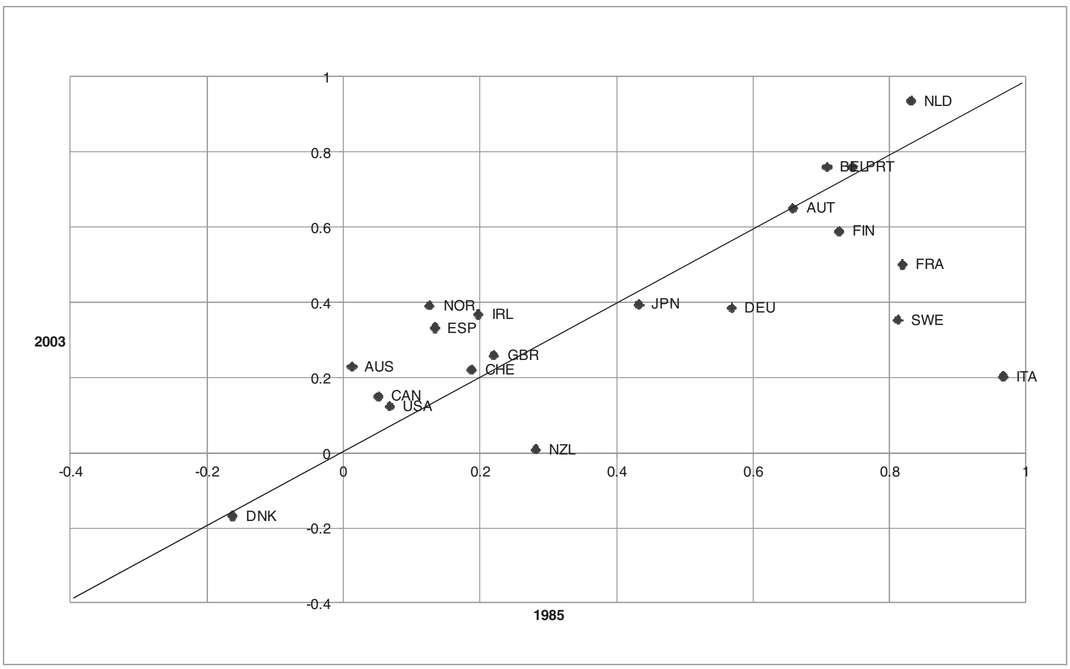
Labour-market policies and regulations respond to many fundamental needs of workers, such as providing insurance against the income risk associated with unemployment, protecting individuals against discriminatory dismissals, and maintaining the employability of temporarily unemployed workers. Yet, the development of these policies over the past decades has contributed to a polarisation in the labour market. In particular, EPL aimed at protecting workers against the risk of dismissal has induced a segmentation between insiders, who are highly protected, and outsiders, such as the unemployed. Furthermore, large differences in the strictness of EPL between regular and temporary contracts have created dual labour markets in many countries, where the outsiders are a large group, mainly composed of (young, unskilled and predominantly female) temporary workers.

Figure 3.3. **Changes in the implicit tax on continuing to work for workers aged 55-59 in selected OECD countries, 1985 and 2003**



Source: Duval, Romain (2003), "The Retirement Effects of Old-Age Pension and Early Retirement Schemes in OECD Countries", *OECD Economics Department Working Papers*, No. 370, DOI: *http://dx.doi.org/10.1787/308728704511*.

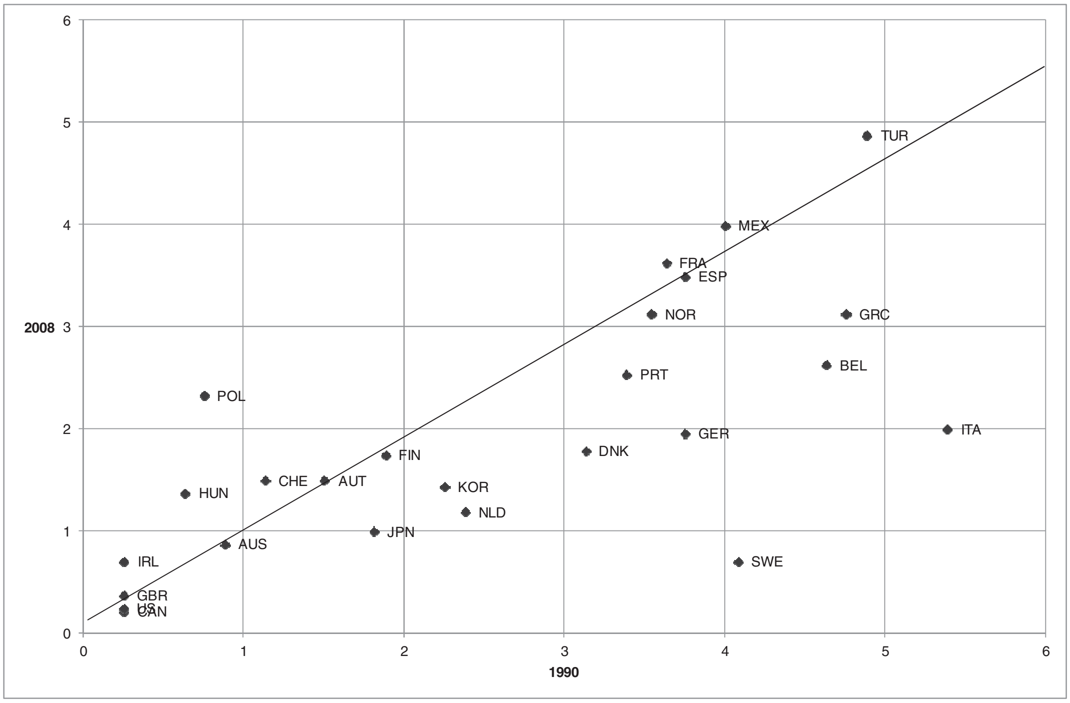
Figure 3.4. **Changes in the implicit tax on continuing to work for workers aged 60-64 in selected OECD countries, 1985 and 2003**



Source: Duval, Romain (2003), "The Retirement Effects of Old-Age Pension and Early Retirement Schemes in OECD Countries", *OECD Economics Department Working Papers*, No. 370, DOI: *http://dx.doi.org/10.1787/308728704511*.

Over the past two decades, several countries have implemented labour-market reforms (for a comprehensive analysis, see OECD, 2006). Some reforms were aimed at modifying the labour-market prospects of outsiders, that is, workers with temporary contracts and the unemployed with low employment probability. These measures typically featured a reduction in the strictness of EPL for temporary workers, and more targeted active labour-market policies for groups experiencing particular problems with labour-market attachment. The first major reform of temporary contracts took place in Spain in 1984, although Portugal had already liberalised the use of fixed-term contracts in 1976. In Spain, the maximum duration of temporary contracts was extended to three years, and little or no termination compensation was offered to temporary workers. The effects of this reform on the labour market were substantial: in the decade following its introduction, the share of temporary contracts in total employment in Spain increased from 11% to 33%. In 1997, temporary contracts represented 96% of the annual job-creation flow. Similar reforms took place in other countries, notably in Italy in 1997 and 2003, in Sweden in 1996-97, and Germany in 2003 (Figure 3.5).

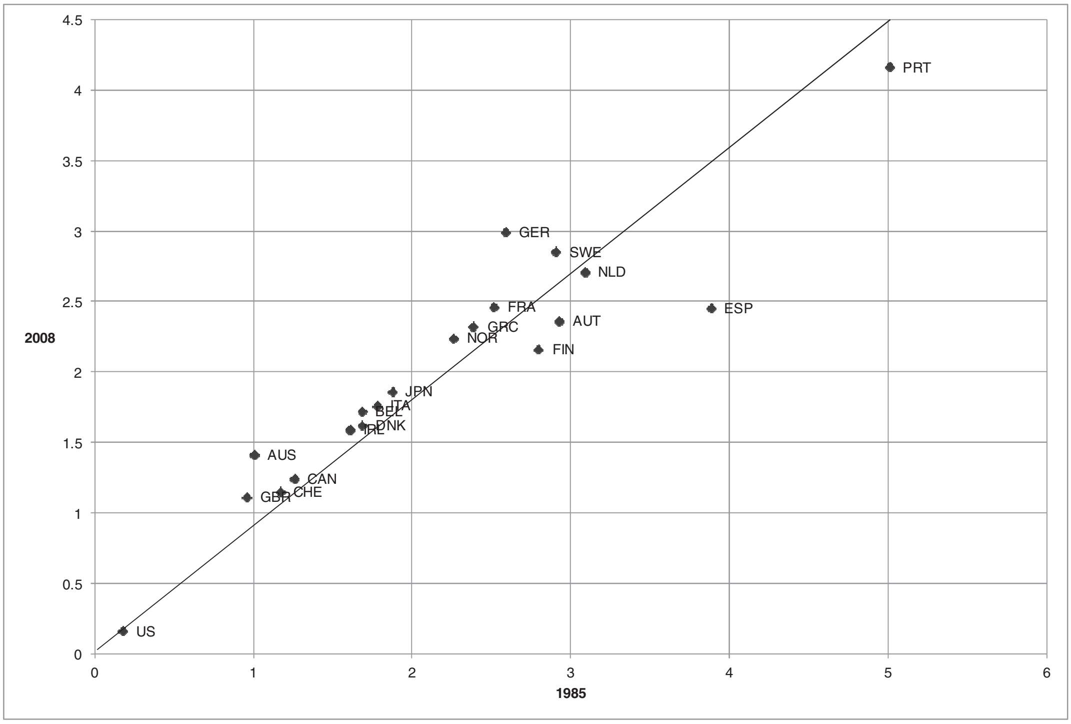
Figure 3.5. **Changes in employment protection legislation strictness for temporary contracts in selected OECD countries, 1990 and 2008**



Source: OECD Employment and Labour Markets database.

This flurry of reforms of temporary contracts was not matched by corresponding reforms affecting permanent contracts. In fact, labour-market insiders (regular workers on permanent contracts) have been virtually unaffected by reform measures in almost all countries – with the notable exceptions of Spain, Portugal and, to a lesser extent, Finland (Figure 3.6). Between 1989 and 1991, several restrictions on layoff legislation were phased out in Portugal, and the length of the decision process and was reduced. In particular, the list of circumstances leading to individual dismissal for economic reasons was broadened, and individual dismissals due to failure to adapt were reintroduced. At the same time, the use of fixed-term contracts was restrained. In 1994, the use of temporary contracts in Spain was restricted to temporary causes only, and the cost of individual dismissals for regular contracts was reduced. Soon after, in 1997, in an attempt to promote the creation of permanent employment, a new "permanent employment promotion contract" was introduced for a four-year trial period; it was available for young (up to 30 years old) and older (above 45) unemployed individuals and for those temporary workers whose contract was transformed into a permanent one.[4] Together with the cancellation of administrative authorisation and the introduction of "objective" reasons for layoffs in 1994, this measure significantly reduced the cost of separation for these new contracts.

Figure 3.6. **Changes in employment protection legislation strictness for permanent contracts in selected OECD countries, 1985 and 2008**

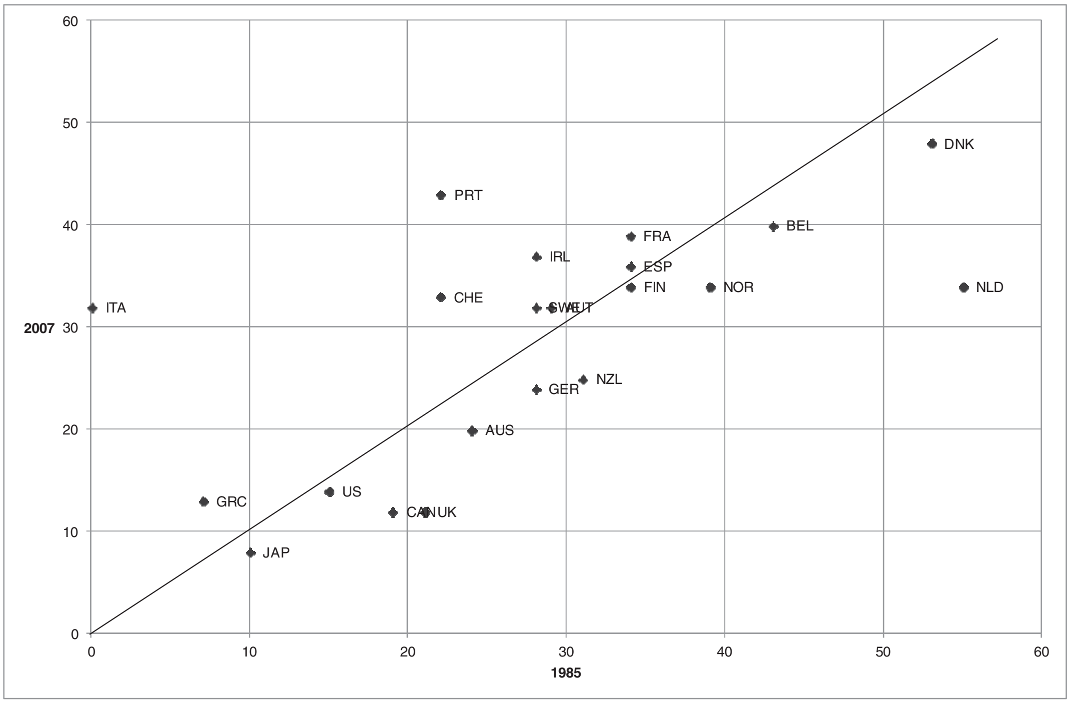


Source: OECD Employment and Labour Markets database.

Labour-market reform often involves adjustments to a range of policies

Other measures modified the generosity of unemployment benefit systems, both in terms of duration and level of benefits, as well as the scope of active labour-market policies (ALMPs). On these issues, reform strategies differed widely across countries. Italy and Portugal increased the generosity of unemployment benefit schemes, while the Netherlands reduced it (Figure 3.7). Between 1994 and 1999, Denmark substantially modified its previously very generous unemployment benefit scheme, using a compensation strategy involving stricter benefit rules but more investment in ALMPs (Box 3.1). A further attempt to reduce the cost of the Danish unemployment benefit system failed in 2001. Reforms in a number of countries aimed at increasing the effectiveness of ALMPs, although overall spending on active policies in the OECD area actually fell as a share of GDP after the mid-1990s (OECD, 2006). For instance, in the Netherlands, in 1991 public employment services (PES) were obliged to inform the institutions in charge of unemployment benefits of insufficient job-search efforts by benefit claimants, and refusal of a suitable job offer became grounds for complete and permanent loss of unemployment benefits. Subsequent legislation gave local authorities more responsibility for providing income support but also a more active role in monitoring compliance with activation obligations. Similar ALMP reforms aimed at enhancing job placement efforts, and monitoring of work availability was strengthened in several other countries (OECD, 2006).

Figure 3.7. **Changes in unemployment benefit replacement rates in selected OECD countries, 1985 and 2007**



Source: OECD Employment and Labour Markets database.

Box 3.1. **The Danish reform of unemployment benefits in the 1990s**

Denmark during the mid-1990s tightened the rules governing eligibility for unemployment benefits, reduced benefit duration and strengthened activation incentives. The maximum duration of benefits was reduced from nine years to four. A "duty" of activation was introduced after one year (or six months for those under 25). Previously, training periods and subsidised job offers were not usually proposed before the end of an initial period of 2.5 years, and unemployed workers could use participation in these programmes to renew their benefit entitlement. The minimum contribution period was increased from 26 weeks to 52 weeks (26 for workers under 25 years of age). Yet, the level of benefits remained unchanged at 90% of the previous wage, with a ceiling at approximately EUR 1 500 per month. However, training, sabbatical and parental leaves were introduced to promote job turnover between employed and unemployed people.

Source: OECD Benefits and Wages database.

Additional labour-market reforms affected labour costs through changes in wage-setting institutions and the taxation of labour earnings. With respect to wage setting, there has been a trend across OECD countries to decentralise wage bargaining, often via the use of clauses that allow firms to opt out of the sectoral agreements and to bargain at firm level. Rather than stemming from the direct action of the government, these changes have typically been the result of a concerted approach involving the government and the social partners. Few changes have occurred to the existing minimum wages, although they have often been reduced in relative terms by governments that have allowed their growth rate to lag that of the average wage (OECD, 2006). Many OECD countries have reduced statutory income tax rates (particularly the top and basic rates), while broadening tax bases (Alt, Preston and Sibieta, 2008). As a result of these measures (and the use of fiscal drag), the tax-to-GDP ratio has largely remained constant, except in Germany and Japan, where the burden of income tax has fallen significantly.[5]

Labour-market regulation can complement or substitute for income-support schemes

As Boeri (2009), observes insurance against the income risk of unemployment and activation incentives can be seen as complements, while unemployment benefits and EPL can be seen as substitutes, inasmuch as both provide insurance against job losses. These interactions among labour market programmes give rise to at least two configurations of policies and institutional settings associated with rather positive labour-market outcomes. OECD (2006) identifies two groups of countries that have achieved relatively strong employment performance with very different policy mixes: a first group of "market-reliant" economies, which includes most Anglo-Saxon countries, and a second group of "other successful countries", including many Nordic OECD members. A third group, consisting of continental and Mediterranean countries, has exhibited poorer labour-market performance. This suggests both that the particular combination of policies pursued matters but that there may nevertheless be different roads to success. Early examples of co-ordinated reforms include the United Kingdom in the 1980s, where a new legal framework governing union activities was introduced together with changes in EPL and minimum wages, and New Zealand from the mid-1980s into the 1990s, which underwent the liberalisation of financial, product and finally labour markets. More recent examples of such "packaging" include reforms in Spain and Finland. In Spain, relaxation of the strictness of EPL was associated with an increase in the degree of redistribution achieved through unemployment benefits. Finland also reduced the level of employment protection for regular workers while adjusting the design of its unemployment benefit system to make it more redistributive.

Economic and political factors that affect the implementation of reforms

Both pension and labour-market reforms tend to provoke resistance

A large body of literature has developed to explain the demographic, economic and political determinants of the creation of public pension systems and their rapid expansion.[6] However, these arguments are not necessarily helpful in explaining the adoption of reforms aimed at scaling down pension schemes. Far from being a mirror image, the politics of retrenchment would seem very different to the politics of welfare expansion (Pierson, 1994). Increases in the coverage and generosity of the welfare state are typically popular policies, which provide resources to large groups. Furthermore, these policies are persistent (Coate and Morris, 1999; Conde-Ruiz and Galasso, 2003; Hassler *et al.*, 2003), as they create a constituency of beneficiaries (retirees and welfare recipients) and bureaucrats, who will support the maintenance of these systems in the future. Welfare retrenchment, by contrast, is generally unpopular, imposing losses on specific, sometimes large, groups (such as would-be early retirees), while creating only diffuse and uncertain gains.

The introduction of more stringent employment protection legislation and the increase in the generosity of unemployment benefits or active labour-market policies are often controversial, due to employer concerns about EPL and, in many countries, the growing distinction in the labour market between insiders and outsiders. Once established, these policies prove remarkably persistent, since they create a substantial constituency of actual (in the case of EPL) or potential (in the case of unemployment benefits) beneficiaries, who tend to oppose reducing the level of security provided by these programmes. As shown in Figure 3.6, this is particularly evident in the case of EPL, where the beneficiaries are most often well-organised insiders. Yet, persistence is also a notable feature of unemployment benefit policies, where the main recipients are outsiders (Figure 3.7). This may because generous unemployment benefit schemes are also supported by the employed, who want such insurance.

A growing body of literature has analysed the political and economic factors shaping labour market institutions and of reform. These theoretical contributions have mainly focused on the importance of electoral constraints in the struggles between insiders and outsiders. Most of this work has concentrated on studies of individual policies,[7] such as EPL or unemployment benefits, without exploring possible complementarities among them. Yet reform packages that change different policies at the same time allow for compensation of losers and may enhance the political feasibility of labour-market reforms (Boeri, Conde-Ruiz and Galasso, 2009).

Crises can help break resistance to reform

The political economy literature on structural policies strongly suggests that economic crises may facilitate the adoption of reform measures (Drazen, 2000; Drazen and Easterly, 2001). In general, a deep crisis calls for quick reactions, which typically include the adoption of expansionary policies, unless fiscal conditions preclude this. However, structural reforms may also be promoted if existing institutions or regulations are, at least partially, recognised as having contributed to the deterioration of economic conditions, and if changes in these institutions and regulations are expected to facilitate recovery and raise potential output. Crises often raise the cost of maintaining the status quo, while also imposing a sense of urgency about reform.[8] These combined effects weaken the resistance of the coalitions supporting the status quo, which may in some instances be destabilised by the advent of the crisis. Yet crises may also hinder some reforms, as individuals are likely to be less willing to compromise rents or benefits unless alternative compensations are provided. This is particularly true of EPL: the value of employment protection rises in times of rising unemployment.

Thus, labour-market reforms may be promoted by economic crises that worsen labour-market outcomes, hence inducing more unemployment, lower employment and greater segmentation between workers with regular and non-standard contracts. In countries featuring rigid labour markets, periods of high unemployment, especially among the young, may call for reforms aimed at improving the functioning of the labour market. However, any increase in flexibility can be seen as imposing adjustment costs on workers already suffering from adverse economic conditions (Bean, 1998). Hence, winning acceptance of reform from labour-market insiders is likely to prove exceptionally difficult in crisis conditions, unless significant compensatory measures are designed. If the crisis has also hit public finances, the fiscal space to do this may be lacking. As a result, reforms adopted in crisis conditions are often targeted at labour-market outsiders, who are less well organised and less able to resist reform than the regular workers who constitute the core of the labour market. Nevertheless, if a crisis serves to increase awareness of the inefficiency of existing labour-market policies, political support for reform may be stronger after the crisis, when the economic recovery is getting under way and there is more room for designing compensatory packages (OECD, 2006).

Economic and financial crises may also create opportunities for pension reforms, particularly when the earlier failure to reform unfunded pension schemes in response to demographic trends may have contributed to severe fiscal problems. In deep recessions, the fall in pension contributions, which are typically linked to the total wage bill, may even jeopardise current payment of pension benefits, unless compensatory transfers from the general revenues are used. Crisis may thus require a reduction in pension spending and yet make the associated reform measures, such as an increase in the retirement age or a reduction in pension benefits, less palatable to those who will be affected. The availability of early retirement schemes, in particular, offers an easy exit for older workers who wish to withdraw from the labour market in response to a downturn.

Reforms are easier to execute in good times, but political support for them is often weaker then

Paradoxically, the reform of such schemes may actually be easier in a buoyant labour market, where older workers have better prospects, but it may take a crisis to create a sense of urgency about the need to reform them. This is true of reforms generally: the implementation of reforms under good economic conditions simply presents a different set of difficulties. Economic and financial conditions may grant more room for manoeuvre, and the empirical evidence suggests that the costs of reform tend to be lower in a growing economy. More resources may be available for designing better compensation packages, such as more generous unemployment benefits in exchange for more flexibility on the labour market, or to pursue more costly reform measures (such as pre-funding in pension reforms). Yet in absence of a crisis, the reform process may lack the necessary political momentum. This is because politicians may be unwilling to risk political capital to promote reforms with uncertain or only long-term economic gains, particularly in advance of electoral competitions (Saint-Paul, 2002).

Monetary policy may help reduce adjustment costs in response to reforms

There are several reasons why monetary policy – and, in particular, its use to target a fixed exchange rate – may affect the adoption of structural reforms. Relinquishing control over other aspects of monetary policy in order to maintain a fixed exchange rate – or giving such control to an external authority, such as the European Central Bank – prevents a country from using monetary policy to accommodate negative shocks. This should create incentives to pursue structural reforms, such as greater liberalisation of labour and product markets, in order to enhance market-based adjustments (Bean, 1998; Duval and Elmeskov, 2005; and Obstfeld, 1997). In short, the loss of one adjustment mechanism implies a need for greater flexibility of other mechanisms in responding to shocks. Joining a single currency, such as the euro, may also provide an additional channel for promoting reforms, because the use of a single currency increases price transparency and thus makes comparisons in international markets easier, thereby facilitating trade.[9] This increase in international competition may make it harder for domestic monopolists to protect local markets (and rents), thereby creating pressures to deregulate product markets. To the extent that product-market liberalisations reduce the rents available to be shared between workers and firms in protected sectors, this may in due course give rise to pressure for liberalisation of the labour market as well (Blanchard and Giavazzi, 2003).

However, relinquishing monetary policy authority, in particular by joining the euro, may make structural reforms harder to pursue even as it increases the need for them. Saint-Paul and Bentolila (2000) argue that the upfront cost of structural reforms in this case may increase. Since labour-market reforms with positive long-term effects often entail a negative short-term impact, they should if possible be accompanied by expansionary aggregate demand policies. This both reduces the economic cost of the reform and makes it politically easier to adopt and implement. Under the euro, however, it may be more difficult to use macroeconomic policy to offset the cost of reform, because aggregate demand is more constrained at the national level (not least by the requirements of the Stability and Growth Pact), and monetary policy is in the hands of the European Central Bank. A similar argument may apply to pension reforms. They can generate long-term savings for social security funds but may also imply short-term budget deficits, which would violate the limits imposed by the Stability and Growth Pact. The Pact provides for consideration of the upfront costs of the introduction of a fully funded system, but the allowance made may not be sufficient to avoid some impact on the deficit, and some other pension reforms that entail short-term expenditure increases may not qualify for such special consideration at all.

Reform is far easier when a government has secured an electoral mandate for it

Successful reform attempts require governments to use their political capital to circumvent the resistance coming from within the government, from opposition parties, and from crucial veto players in society (such as unions or employers' organisations). Several political and institutional features affect the government's incentives to reform and, ultimately, its reform strategy. The ideology of the policy maker, the system of political representation and the relative power of different groups of actors in the reform game (parties, lobbies, voters) have been hypothesised to be among the main political determinants of the reform process (Boeri *et al.*, 2006). Potential drivers leading policy makers to commit to reform include economic benefits (*e.g.* growth-enhancing policies), ideological motivations (*e.g.* reducing the role of the public sector for some right-wing governments, and vice versa for some left-wing governments), and political gains (*e.g.* increasing re-election probability). Potential costs are the mirror image of these benefits. These costs may be particularly relevant for structural labour-market reforms, which typically entail substantial redistribution, and hence favour specific groups of voters while damaging others. As Rodrik (1994) observes, resistance to reform can generally be expected to increase with the "political cost-benefit ratio" – the relationship between a reform's redistributive impact and the efficiency gains it yields. Thus, the greater the degree of redistribution implied by a reform, the harder it will be to realise, other things being equal.

In the political economy literature that emphasises the role of the electorate in determining economic policies and regulation (Persson and Tabellini, 2000), policy makers are typically modelled as opportunistic incumbent politicians focused on re-election or candidates drafting a political platform. In both cases, politicians have an electoral interest in adopting economic policies that serve their electoral interests. These will depend on the nature of the electoral competition: they may seek positions that are supported by a majority of the voters or those that appeal to those voters whose decisions may be most easily swayed by the policies on offer – the swing voters (Stromberg, 2008). In a system characterised by multi-party competition and complex coalition bargaining, they may adopt stances that target strategically significant minorities rather than the majority of the electorate. Whatever the motivation, the evidence suggests that winning an election on a political platform that includes a mandate to reform represents a crucial stepping stone towards implementing reforms (Tompson, 2009), although in some cases, governments have been successful in promoting reforms, which were in sharp contrast with their electoral programmes (Cukierman and Tommasi, 1998).

Once in power, politicians care about re-election (Alesina, 1988). The government's tenure of office, or the expected lag to the next election, may thus affect the reform process. If the government is approaching a general election, it may refrain from implementing structural reforms with high short-term costs, but it may be more keen on policies with short-term benefits – and vice versa for newly elected governments. Well-functioning financial markets may, however, bring forward some of the long-term benefits of reform, thereby helping reformist governments to pursue their aims (Buti *et al.*, 2008). Consideration of the electoral costs and gains from reform are remarkably well suited for broad policy measures, such as retirement and labour-market policies, which typically affect a wide range of individuals and may have large electoral effects. Pension reforms are known to be politically costly unless introduced with very long lead times, since pensioners and older workers, who are likely to feel the effects of any cutbacks that are not phased in over a long period, are "single-minded" (Mulligan and Sala-i-Martin, 1999) when it comes to pension benefits. Younger cohorts' interests tend to be more diversified, as they depend on family status, occupation, income, etc. Since population ageing also increases the relative weight of elderly voters in the electorate, pension reform is most likely to succeed when the costs can be shifted onto future generations and reforms can be phased in over very long periods. If the financial pressure for reform is such major changes affecting current retirees or older workers are required, their opposition will be very hard to overcome. In short, as retrenchment policies become economically more urgent, they become politically more difficult (Galasso, 2006).[10]

The redistribution set in train by labour-market reforms can often have both generational and gender dimensions that are politically significant: the division between labour-market insiders and outsiders typically shows an age and gender cleavage, with a majority of the insiders being male and older than the outsiders. Since older voters tend to vote more than younger ones, the generational split may tend to bias the electoral calculations somewhat against reform. Finally, the political ideology of the government can also affect its orientation towards reform. Left-leaning governments are often perceived to give greater weight to equity and redistributive concerns, while right-wing governments are more likely to emphasise efficiency.

The path of reform may be shaped by initial structural conditions and "status quo bias"

Initial conditions may be an important determinant of structural reform. On the one hand, countries with more stringent labour-market regulation, more generous early retirement provisions and more overall pension spending may be in more urgent need of reform. On the other hand, generous programmes are known to induce a status quo bias, by creating political constituencies among programme beneficiaries and bureaucrats, which will oppose labour-market liberalisation and cuts in spending on benefits. Initial conditions, such as existing institutions and labour-market policies, are also crucial in determining how aggregate macroeconomic shocks translate into labour-market outcomes, and thereby into demand for – or opposition to – reforms (OECD, 2006).

At the level of the individual, "status quo bias" is largely a reflection of the combination of loss aversion[11] and the endowment effect.[12] Individual agents are likely to overestimate the risks and underestimate the benefits of reform. At an aggregate level, status quo bias may also stem from uncertainty about the outcome. In a reform having redistributive effects, there may be uncertainty about precisely who stands to gain, even if it is expected that most people will be winners: some may expect to win and others to lose, but a third group may be unsure of their prospects. Hence, even when a majority of the population would benefit from the reform *ex post*, this majority may be difficult to identify *ex ante* and hence to mobilise in support of the reform (Fernández and Rodrik, 1991). Better information may thus play an important role in the reform process, by helping to identify potential winners from among the uncertain.

Good-quality information and analysis may also help to convince people that the proposed reform is motivated not by ideological factors but by actual economic concerns. The latter argument may be more credibly spelled out by representatives of parties that would typically be expected to oppose the reform on ideological grounds. Thus, left-wing parties may be more credible advocates of liberalisation. Faced with a reform proposal, voters cannot be certain whether it is motivated by a desire to increase social welfare or by the proponents' wish to pursue partisan objectives and serve the particular interests of its own core constituents. Given the existence of such information asymmetries, substantial policy change in a given direction may be more easily sustained if implemented by parties that would appear *ex ante* to be ideologically opposed to it (Cukierman and Tommasi, 1998).

International influences tend to be less important when it comes to labour-market reform

External pressures have been identified as crucial drivers of product-market liberalisation (Høj *et al.*, 2006; Alesina, Ardagna and Galasso, 2009; Duval and Elmeskov, 2005). This pressure may come from observed reform successes in major trading partners and the need to maintain international competitiveness through domestic reforms or from international arrangements such as the European Single Market programme. However, labour-market reforms are only indirectly affected by these channels. Increases in international competitiveness may instead put pressure to respond at home by reducing labour-market distortions and rigidities. On the other hand, the higher volatility associated with opening up to a more competitive environment may increase the demand for job security – and hence for stricter EPL – and may also induce firms to restructure, thereby generating increased demand for more generous unemployment benefits or, in the case of older workers, early retirement provisions (Conde-Ruiz and Galasso, 2003, 2004).

The choice between "bundling" and "sequencing" reforms depends on the context

Another strand of the literature emphasises the role of interactions among reform policies in securing their success, the scope for "bundling" reforms into larger policy packages and the relevance of timing and sequencing of reforms, due to possible spillover effects (Boeri *et al.*, 2006). A sequencing between product- and labour-market reforms has been proposed that requires the product market to be liberalised first, in order to reduce the rents that can be appropriated by firms and workers, and thus to minimise the resistance to labour-market reforms.[13] Sequencing reforms with a gradual approach has often been advocated as a successful strategy to gain popular support, when reform outcomes are largely uncertain and some learning is needed (as it occurred in many liberalisations in eastern Europe), or as a device to divide the opposition and construct different majorities for different reforms (Dewatripont and Roland, 1992, 1995). If the first reform steps lead to expectations of further reform, moreover, agents will begin to adjust their behaviour accordingly. This *ex ante* adjustment may reduce resistance to subsequent reform measures.[14] In some countries, such as Denmark and the Netherlands, an inclusive approach to policy making prevails, in an attempt to make crucial players, such as unions, internalise at least in part the interests of outsiders. This was done for instance by increasing the degree of centralisation of wage bargaining (Elmeskov, Martin and Scarpetta, 1998; Blanchard and Philippon, 2004), while at the same time allowing for some negotiation to occur at the firm level using opt-out clauses (OECD, 2006).

Piecemeal reforms have also been used to circumvent opposition by insiders. In the labour market, the typical reform sequence begins with the reduction of restrictions on temporary and other non-standard contracts, which gives rise to a dual labour market. Once the stock of such contracts has become sufficiently large, there may be enough political momentum to continue with reforms of the core labour-market policies and institutions. Such, at least, is the logic: in fact, OECD countries suffering from labour-market dualism have seen relatively little progress from the first step to the second – reform of the "core" labour market has been very limited indeed. The typical pension reform sequence in many countries has also unfolded in a similar fashion, beginning with private sector employees (who, though numerous, usually have less generous pension arrangements) before moving to the main public sector scheme and then to the more specific schemes that exist in the most privileged parts of the public sector (Tompson, 2009). As the reform sequence unfolds, the privileges and rents retained by the unreformed minority will look increasingly anomalous and thus ever harder to defend.

Bundling different policies into a single reform programme, which may allow the losers from one reform to benefit from others, may be possible in labour-market reforms, since, as noted above, countries choosing different institutions and policy configurations have been able to achieve positive employment outcomes. Unemployment benefits may be a close substitute for EPL (Pissarides, 2001; Blanchard and Tirole, 2003). Reforms aimed at more flexicurity may be able to exploit this substitutability (Boeri, Conde-Ruiz and Galasso, 2009). Bundling reforms may also work where with a reduction in the generosity of unemployment benefits coincides with an expansion of ALMPs.

Empirical assessment of the determinants of labour-market reforms

The empirical literature on the determinants of retirement and labour-market reforms has followed two different strands. One has focused on the analysis of case studies of attempted reforms – both more and less successful. This approach allows the researcher to gain a detailed understanding of the specific institutional, economic and political determinants of reform.[15] These details often prove crucial in implementing a successful reform. However, case studies do not necessarily lead to general conclusions and lessons for reforms that can be applied to different countries and/or reform areas. Econometric analyses are in a better position to quantify the impact of these determinants and to assess the general external validity of these results. Econometric analyses of the political economy of reforms are typically based on cross-country panel estimations using synthetic indicators of policy settings as the dependent variable. Reform measures include the OECD indicators for ALMPs, EPL strictness, unemployment benefit spending and replacement rates, spending on old age pension, social security contributions and early retirement measures, such as the implicit tax on continuing to work (Duval and Elmeskov, 2005; Høj *et al.*, 2006), as well as International Monetary Fund (IMF) indicators of financial sector, international trade, labour and product markets, and taxes (IMF, 2004). Other explanatory variables include measures of economic, demographic and political conditions. Some studies have focused on the probability of large reforms, by concentrating on large variations in these indicators (Duval and Elmeskov, 2005), while others have examined annual changes, hence analysing all reform measures.

Crises can indeed create opportunities for reform

Econometric and case-study analyses alike confirm that economic crisis stands out as an important determinant of labour-market reforms. Studies that use aggregate indicators of labour-market reform (IMF, 2004, Duval and Elmeskov, 2005, Høj *et al.*, 2006) show that increases in the output gap and higher unemployment rates are associated with reforms.[16] Not all reforms are equal, however. Using disaggregated indicators, Høj *et al.* (2006) provide evidence that the direction of reforms differs for insiders and outsiders. For instance, large increases in the long-term unemployment rate are associated with lower employment protection for temporary workers and with more generous unemployment benefits, but they have no effect on EPL for permanent workers. Hence, it appears that higher unemployment risks are dealt with during crises by introducing more flexibility for outsiders, while providing more protection for insiders and eligible outsiders through higher unemployment benefits.[17] Economic crisis affects pension reforms, as well. In particular, high unemployment rates are associated with a reduction in the implicit tax on continuing to work. This is somewhat surprising, since the introduction of early retirement provisions in the 1970s and 1980s was often justified by policy makers on the misguided grounds that such measures would “make room” on the labour market for younger workers.[18]

Some crucial labour-market reforms occurred during, or in the immediate aftermath of, economic crises that generated negative labour-market outcomes. In Spain, the seminal 1984 reform, which liberalised the temporary contracts and gave rise to the subsequent massive increase in the share of temporary workers in total employment, was passed during a period of high and persistent (youth) unemployment. Analogously, an extensive and deep reform of labour legislation aimed at increasing the flexibility of the labour market for permanent workers was launched in 1994, again in a period of deep recession.[19] An economic crisis also lay behind the reform of unemployment benefits system and ALMPs in Denmark between 1994 and 1997. At the beginning of the 1990s, the unemployment rate reached 12%, a level that threatened to jeopardise the functioning of its generous unemployment benefit system. In a country with a strong tradition of compromise and consensual policy making,[20] the crisis generated the momentum to reform the relatively inefficient unemployment system, which relied too heavily on passive benefits but lacked effective ALMPs. The reform implemented in response to this crisis tackled the integration of the long-term unemployed through both financial incentives and active policies.

Initial structural conditions are also important, particularly in conjunction with economic crises. Although retirement systems and labour-market policies have been very persistent over the last three decades, IMF (2004) finds that countries with more restrictive regulations tend to have better results when they do reform: the pay-offs are greater when structural policy settings are *ex ante* more restrictive. Høj *et al.* (2006) also find that such countries undertake more reform in response to labour-market shocks. Despite the high degree of policy persistence, countries with more rigid labour markets tend to reform more, particularly when hit by negative shocks.

Labour-market reforms are more likely to be electorally contentious than pension reforms

Although the constituency of labour-market insiders and bureaucrats may not be defined along political lines, discontent with labour-market reforms is often voiced through channels such as left-wing political parties and unions. The crucial role of these political actors stems from their ability to mobilise the public against reforms through national strikes and social protests. Street protests blocked relatively modest labour-market reform proposals in France in 1994 and again in 2006, and union resistance to reform has been powerful – though not always successful – in reaction to various liberalisation proposals in France and Italy. Even the threat of strikes may be sufficient, since employers' desire for industrial peace and wage moderation may sometimes make them reluctant to support regulatory reforms in the labour market, which they see as a lower priority (Tompson, 2009). The 2001 Rasmussen labour-market reform in Denmark failed after being rejected by both the unions and the employers' organisation. Pension reform proposals, too, have sometimes been withdrawn due to the massive opposition by unions and left parties, including the 1995 Juppé reform plan in France, the 1994 Berlusconi reform proposal in Italy and the 1997 Kohl reform project in Germany.[21]

In ageing societies, reforms of retirement schemes are particularly sensitive to political constraints. As a result, policy makers have typically refrained from unilateral action, seeking instead a broad consensus among other political forces and in the social arena.[22] The fact that all of the blocked pension reforms mentioned were undertaken unilaterally suggests that a unilateral approach to reform is not promising when it comes to pensions. The search for a large consensus may also arise from governments' desire to avoid electoral backlashes by sharing responsibility for reform (and thus the blame for its costs) with as wide a range of actors as possible. In addition, the long lead times involved in reform implementation mean that such an approach may be needed to avoid reversal of the reform following a change of government. Hence, even strong governments enjoying broad support in Parliament will face a trade-off in tackling pension reforms. In fact, while their political strength allows them to carry on reforms through the Parliament (Pierson and Weaver, 1993), it also implies a higher accountability to the electorate for their policy decisions (Persson and Tabellini, 2000).[23]

The relevance of electoral constraints also points to the fact that having an electoral mandate for reform, for instance when the incumbent government has won the previous elections on a pro-reform campaign, may significantly increase the probability of a successful reform. Pension reform experiences in France (2003), Mexico (2007) and Poland (1997-99) support this view (Tompson 2009).[24] Furthermore, the French and Mexican reforms were adopted soon after national elections,[25] during the political "honeymoon" period, when the government's electoral mandate was still relatively fresh, and they were facilitated by the weak state of the opposition, which had just suffered defeat at the polls. Likewise, a new labour-market reform was adopted in Spain in 1997, in an attempt to balance the mix of temporary and permanent contracts, which had not been largely influenced by the previous reform.[26] The conservative *Partido Popular* (PP) had run on a pro-reform campaign to obtain a mandate from the voters. Soon after winning the elections, thanks to its fresh mandate and the weakened state of the opposition, and partly helped by better economic conditions, the new government secured adoption of a reform aimed at promoting permanent employment and reducing employment insecurity, by introducing the "permanent employment promotion contract" described earlier. The reform included additional measures, such as better regulation of training, part-time and discontinuous contracts, and additional rights for temporary workers. These latter measures were strongly supported by the unions and helped to obtain their acquiescence in other elements of the reform. By contrast, the Polish 1997-99 pension reforms suggest another interesting channel through which political and electoral constraints affect reform strategy: reforms may also be approved at the end of the electoral cycle by the incumbent government facing an expected electoral defeat, in order to bind the next government's hands.[27]

Econometric evidence concerning the relevance of political institutions and electoral constraints for reform seems to confirm many of the conclusions reached in the case studies, although political variables are not found significant in explaining large reforms (Duval and Elmeskov, 2005). The ideology and tenure of the government matters. In fact, it appears that more labour-market reforms occur when a right-wing government is in power (IMF, 2004), and when the government has been in office for at least two years (Høj *et al.*, 2006). More specifically, right-wing governments are associated with less generous unemployment benefits for the long-term employed and with lower implicit taxes on continuing to work (Høj *et al.*, 2006). The political strength of the government, as measured by its relative majority in the parliament, seems also to have a positive impact on its reform effort (IMF, 2004). Countries featuring a majoritarian electoral system are found to reform more. However, Buti *et al.* (2008) do not find support for the idea that reforming governments tend to be punished by their electorate, at least in countries where well-developed financial markets help bring forward the long-term benefits of reform.

Case studies have also underlined the importance of the social partners' potential opposition to reform. Econometric evidence shows that higher union density is associated with lower employment protection legislation for temporary workers (Høj *et al.*, 2006). This is consistent with previous arguments suggesting that unions may be willing to accept more labour market flexibility for outsiders in exchange for higher job security for insiders. Greater centralisation of the wage bargaining seems more important to internalising the cost of early retirement, and thus to reforming this feature of the pension system.[28]

Reforms are sometimes sequenced so as to divide opponents

The crucial role of electoral constraints and veto players has forced politicians who were willing to undertake reforms, or compelled to do so by economic crises or other exogenous events, to adopt different strategies to pacify, overcome or circumvent the opposition to reform.

A popular design in pension policies has been to concentrate the cost of the reform onto younger generations, for whom the issue is less salient, in order to minimise the electoral backlash from older cohorts, for whom it is a first-order issue. Long transition periods for the implementation of retrenchment measures allow mature cohorts of workers and retirees to escape the cutbacks, which instead fall primarily on younger generations. In France, the 1993 pension reform restricted eligibility requirements and reduced the average generosity of pension benefits, but it had only a marginal negative effect – if any – on individuals in their forties or older. Similarly, the 1992 reform of the German pension system included measures that reduced the generosity of early retirement pensions, but this only took effect over a lengthy transition period, which effectively allowed workers in their mid-forties and older to be only marginally affected, if at all.

This "divide and conquer" strategy (Boeri *et al.*, 2006) was even more evident in the Italian pension reforms of the 1990s. The 1992 Amato reform followed a deep financial crisis, which was jeopardising the payment of pension benefits. Despite the urgency of the situation and the magnitude of the retrenchment (net pension wealth[29] was reduced by 52.9%), the reform featured very unequal intergenerational cost sharing. It did include a switch from wage- to price-based indexation of pensions, which hit current retirees and older workers.[30] In this, it was fairly unusual: many pension reforms leave current retirees totally unaffected and impose only limited costs on workers approaching retirement. Nevertheless, three-quarters of the cost of the Amato reform fell on those under the age of 45, who lost 76.7% of their aggregate pre-reform net pension wealth.[31] Indeed, those under 30 were left with negative net pension wealth. By contrast, the 45+ cohorts lost 16.8% (3.4% for the over-60s) (D'Amato and Galasso, 2002). The 1994 Berlusconi pension plan, which envisaged large reductions in the individuals' net pension wealth (around 27.5% for the workers), but a more equal cost sharing, failed. A year later, the 1995 Dini reform was milder than Berlusconi's project and featured a long transition period, which proved crucial to its unequal allocation of costs across generations. Individuals under 40 bore the full cost of the reform.[32]

In many respects, it is quite logical that the costs of pension reform be borne chiefly by younger cohorts. First, it is they who will lose out if the system proves unsustainable over the long term. Secondly, abrupt changes in pension policies can be very damaging to contributors making career/savings choices that will pay off only in the long term, and there are strong arguments against imposing radical changes on individuals' retirement schemes at a stage when it is too late for them to adjust their savings or labour-market behaviour. Thirdly, precisely because younger people have longer to adjust their career plans and arrangements for financing retirement, this inter-generational allocation of reform costs tends to be politically acceptable.[33] Indeed, the *lack* of overt inter-generational conflict is one of the most striking features of the politics of pension reform.[34] However, such lengthy transition periods may become problematic in the long run, if the younger cohorts who bore the costs of the reform begin to push for modifications as they approach retirement. The 1995 Dini reform in Italy illustrates this risk.[35] The conversion coefficients used to link pension entitlements to life expectancy when calculating pension benefits were to be updated every ten years, but this was immediately delayed. The rise in the minimum age for seniority pensions, which was negotiated at length in the early 2000s, was likewise postponed. Indeed, implementation of the reform has involved a process of continuous negotiation. This tends to generate uncertainty, which undermines the microeconomic benefits of the defined-contribution system. These depend to a great extent on the existence of a clear, stable link between contributions and eventual benefits.

Some compensation of losers may also be required

The use of compensatory measures to win the approval of left-wing parties and unions for pension policies characterised the 1993 French reform process.[36] The centre-right Balladur government combined unpopular measures with some concessions to the unions, such as the establishment of the *Fonds de solidarité vieillesse* (FSV), from which non-contributory benefits were financed. Reform measures were also restricted to private workers only, thus leaving almost 5.5 million, highly unionised, state employees untouched. Two years later, the Juppé government, which enjoyed a large majority in the parliament, tried to extend the Balladur reforms to the public sector and to modify the Constitution in order to grant parliament the right to approve the social security budget. It was forced to withdraw these plans after three weeks of massive strikes. The 2003 Fillon reform, by contrast, was adopted after the government divided the trade unions by offering concessions sufficient to bring the moderate unions on board, including confirmation of the unions' role in administering the system. It is important to note that the concessions made in the Balladur and Fillon reforms, though significant, were coherent with the overall logic of the reform. They softened its impact on particular groups, but they did not contradict its overall aims.

Many successful labour-market reform strategies begin with the recognition of the existence of two groups of individuals in the labour market: the insiders (workers with permanent regular contracts), who typically oppose any increase in flexibility, and the outsiders (unemployed and workers on temporary contracts). Reforms promoting flexibility "at the margin", that is, among outsiders only, have been implemented in many countries (OECD, 2006). In Portugal and Spain, however, this has represented the first step in a process which has led to an increase in flexibility also among regular workers. In Spain, ten years after the 1984 reform liberalised the temporary contracts, the Socialist government found itself facing a situation in which labour-market outsiders constituted the majority of the workforce. The growth of temporary employment and the rise in unemployment during a serious recession meant that, for the first time, regular workers were outnumbered by the unemployed and those on temporary contracts.[37] The government opted to stand on the side of the outsiders and launched a reform of labour legislation that also affected regular workers. The unions rejected this, even to the point of calling a general strike, but the government held firm. Having won re-election the year before on a promise to tackle unemployment, it argued that the unions' refusal to discuss reform proposals in the midst of an economic crisis left it no choice but to act unilaterally. This was a major defeat for the unions and, although they were able to blunt some of the effect of the reform via collective agreements with employers, the memory of this setback appears to have been one of the factors prompting them to co-operate with the reform process launched by the PP government elected in 1997 (Tompson, 2009). Germany and Italy implemented two-tier reforms that increased labour-market flexibility for new entrants and the long-term unemployed, while leaving conditions for insiders unchanged. However, the spillover strategy that had proved successful in Spain did not lead to more flexibility among regular workers in Germany and Italy.

Compromise and the design of compensatory schemes were the key elements of the successful strategy that led to labour-market reforms in Denmark between 1994 and 1997. In 1993, the Social Democratic Party took office and built a consensus around the need for greater financial discipline but also for policies to prevent the rise of long-term unemployment and inactivity. These latter measures were strongly supported by the unions. In the end, the reform implemented between 1994 and 1997 represented a mix of social discipline and social integration efforts, which effectively modified financial incentives and active labour-market policies in order to protect the long-term unemployed. In 2001, the newly elected Conservative government proposed a further reform aimed at reducing the cost of the unemployment insurance system. This included tighter eligibility requirements for unemployment benefits and a reduction in their generosity, to be achieved by increasing the period over which the reference wage for the replacement rate was to be calculated. The 2001 package, however, did not envisage any additional compensatory measures. Both the unions and the employers' organisation vetoed the proposals, claiming that these measures would have reduced labour-market flexibility. Analogous arguments were used to oppose a subsequent proposal to cut benefits put forward by the same government in 2004. The unions threatened to withdraw the possibility of temporary layoff from collective agreements if these measures were passed. This highlights the compensatory nature of the unemployment scheme *vis-à-vis* flexibility and suggests the existence of a high degree of complementarity between EPL and benefit reforms.

Interactions among reforms may affect their timing and sequence

Econometric evidence confirms the relevance that both case studies and the theoretical literature on political economy assign to the timing of the reform process and to the interactions between reforms across markets (*e.g.* between labour, product and financial markets) and among policies within a given market (*e.g.* between EPL for temporary and permanent workers). Using indicators for five policy areas (taxation, unemployment benefits, EPL, retirement schemes and product markets), Duval and Elmeskov (2005) find a positive association between large reforms in different areas. Additional evidence (IMF, 2004; Høj *et al.*, 2006) points to a more precise timing running from product-market to labour-market reforms. In particular, liberalisation of the product market seems to pave the way for reductions in the degree of protection for temporary workers, but not for regular workers. Høj *et al.* (2006) examine in detail the timing of reforms across labour-market programmes. They find some (weak) evidence that countries which start with a high degree of protection for regular workers tend to observe reduction in the level of employment protection for temporary workers over time. Retirement policies, as measured by the implicit tax on continuing to work, also appear to be strongly related to labour market institutions. In particular, greater strictness of EPL for regular workers is associated with strong incentives to retire early for workers aged 55-59 years. An increase in the generosity of the unemployment benefits leads to a reduction in the incentives to retire for elderly workers (aged between 60 and 64 years).

Finally, it should be noted that Tompson (2009) finds some suggestive evidence in his case studies of a negative relationship between pension and labour-market reforms. Major reforms in one domain may make reforms in the other harder. The strength of this link should not be exaggerated, but the logic seems clear: given the labour-market implications of many retirement reforms, simultaneous changes in both domains might be seen as hitting workers with a "double whammy". In many countries, moreover, unionised workers tend to be older than the workforce as a whole, and many unions also represent large numbers of pensioners. Thus, the specific constituencies of organised labour may well be particularly threatened by combined pension and labour-market reforms. This makes the Italian experience in the mid-1990s all the more remarkable, since the country did manage to adopt and implement significant reforms in both domains, albeit only after major concessions to the unions had been made in respect of both.

The fiscal position tends to matter more than the monetary stance

The econometric evidence suggests that monetary policies have little impact on labour-market reforms. Theoretical arguments suggested that relinquishing monetary policy to enter a fixed exchange rate regime, as the euro zone, could be conducive to labour-market reform. However, Alesina, Ardagna and Galasso (2009) find no evidence of a euro-adoption effect on EPL that might support this argument; instead, they find only a small increase in the generosity of unemployment benefits.[38] Duval and Elmeskov (2005) suggest that reforms may actually be promoted by an independent monetary policy, particularly in large countries, but the association is relatively weak.

Fiscal policies, by contrast, tend to play a more important role. Some empirical studies show that fiscal surpluses are associated with aggregate reforms in pension, labour and product markets (Duval and Elmeskov, 2005; IMF, 2004), while structural budget deficits are associated with less generous unemployment benefits and increases in the implicit tax rate for older workers. This association may reflect the fact that reform is easier where there is more fiscal space for compensating losers, or it may be that when public finances are weak, governments invest their (necessarily limited) political capital in fiscal consolidation rather than structural reform; Tompson (2009) identifies elements of both these factors at work in his case studies.

International influences, external constraints and imitation of best practices may also promote reforms. Several studies point to an effect of EU membership, which may proxy for more open trade, on reform indicators both at the aggregate level (IMF, 2004) and at the labour-market level (Høj *et al.*, 2006). Yet, the empirical evidence fails to identify its impact on individual policy indicators. Openness to trade is also recognised to be an important determinant of liberalisation at the aggregate level (IMF, 2004). In addition, small countries, which typically rely more on foreign trade, tend to implement more reforms (Duval and Elmeskov, 2005). However, Alesina, Ardagna and Galasso (2009) find no effect of the European Single Market, which substantially increased competition and trade among European countries, on labour-market reforms, although they find a strong impact on product-market liberalisation. Reforms in trading partners seem to promote domestic labour-market reforms, with the effect being mainly driven by changes in the unemployment benefit system and in implicit taxes on continuing to work.

Effective communication can do much to build support for reform

Several successful reforms featured large efforts by governments to provide information not only about their short- and long-term benefits but also – crucially – about the costs of maintaining the status quo. The role of information was crucial in pension reform processes in Italy (1995), France (2003), Poland (1997-99) and Mexico (2007). Greater public awareness about the true costs of the status quo can help individuals to understand and perhaps accept the need for reform, thereby reducing its expected electoral cost for the politicians. There is often a role for international organisations to play here. Early OECD work on the long-term contingent liabilities of member countries' pension systems helped give greater urgency to pension reform debates in a number of countries in the 1990s (Tompson, 2009), and the World Bank has played a key role in both making the case for change and designing pension reforms in many countries, not least in central Europe. European bodies like the Ageing Working Group of the Economic Policy Committee and the Indicators Sub-Group on Replacement Rates of the Social Policy Committee are also becoming more and more influential.

More information and more public awareness of the need for change may also foster co-operation among political parties and social partners on the most effective measures to undertake. This is perhaps easier in respect of pension reforms than in labour markets. Research by national and international institutions on ageing and its fiscal consequences has helped provide relevant information and increase public awareness. It is relatively easy to communicate the implications of population ageing and lower fertility for traditional public pension systems to the public. The notion that longer life spans and a lower ratio of workers to retirees put a strain on PAYG pension systems is fairly common sensical.[39] Labour-market reform issues, by contrast, are less well understood by most voters – particularly the costs that high levels of EPL impose.

A communication strategy aimed at informing the public at large of the costs of the status quo and of the short- and long-term benefits of reform was particularly important in paving the way for the German and Spanish labour-market reforms. Indeed, the provision of information is even more relevant in respect of labour-market policies than it is with respect to issues like pension reform, since it is generally more difficult for individuals to appreciate the negative effects of some labour-market institutions, such as very high levels of employment protection,[40] particularly during economic crises. A better understanding of the functioning of the labour market – of the costs of the status quo and of the costs and benefits of reform – may also promote co-operation between government and social partners to design feasible reform policies.

Conclusion

This discussion confirms a widely known result in the literature on the political economy of structural reform: there is no one-size-fits-all reform strategy to be applied in all countries and sectors. Changes in retirement systems and in the labour market are mostly triggered by economic and demographic factors. However, political processes and the initial structural conditions are also crucial to identifying which strategy to adopt, and ultimately for the probability of success of the reform measures.

The implications of the findings presented here for reforms following the global financial and economic crisis are mixed. Both the case studies and the econometric work support the hypothesis of a link between crisis and reform. Financial or budgetary crises stimulate pension reforms, particularly if they are severe enough to raise questions about current payment of pension benefits. In labour markets, high and rising levels of unemployment represent the main trigger. However, the evidence also suggests that strong public finances – in particular, to facilitate the financing of compensatory measures – may prove decisive in overcoming opposition to reform. The dramatic deterioration in public budgets in much of the OECD area thus suggests that reform in many domains may get harder in the years to come.

Several case studies, supported by additional econometric evidence, point to a reform sequence in which deregulation in product markets precedes changes in labour-market arrangements. It is less clear, however, that reforms of temporary contracts can eventually lead to more flexibility of permanent contracts: the Spanish experience points to such a possibility but it remains exceptional. Thus, sequencing reforms in an attempt to undermine intra-group cohesion, a strategy that has been successfully been applied in pension and other reforms, seems to be far from certain of success when reforming labour markets.

Differences in political systems, economic conditions and structural policy mixes suggest the scope for different reform strategies in different countries. Governments enjoying large parliamentary majorities and backed by a solid mandates to reform, or those facing deep economic crises, should use their power to tip the balance towards reform. Informing the electorate about the costs of the status quo may also help limit electoral backlashes. Weaker governments or governments approaching the end of their electoral mandates will find it harder to use their political capital to push for reforms. When urged to reform by crisis or external constraints, these governments may try to adopt a strategy of broadening political support by spreading the benefits onto a larger group of voters, although this may result in diluting the reform measures.

Notes

1. This chapter refrains from analysing the economic effects of structural reforms, which are assumed to be largely positive. A large body of literature has analysed the effect of structural reforms on economic performance. See, among others, Conway and Nicoletti (2006), Griffith, Harrison and Macartney (2007), Nicoletti *et al.* (2001), Nicoletti and Scarpetta (2003), Schiantarelli (2005), Bassanini and Ernst (2002), Fiori *et al.* (2007) and Scarpetta *et al.* (2002).
2. Pierson (1994) argues that the UK pension reforms of the 1980s were inspired by Margaret Thatcher's ideology. See also Jessop *et al.* (1988).
3. The minimum contribution period (MCP) varied from less than 15 years for women with children working in the public sector (20 for men in the public sector) to 35 years for industrial workers.
4. With respect to the regular permanent contract, compensations for unfair individual layoff or social charges were lower: 33 days per year of service, instead of 45, up to a maximum of 24 months' pay (instead of 42).
5. These reforms may be driven by electoral considerations, since income tax "cuts" are popular and easy to publicise, while the overall tax burden is more difficult to measure (Profeta, 2007; and Galli and Profeta, 2009).
6. See Barr and Diamond (2008), Perotti and Schwienbacher (2009), Pinotti (2009) and Galasso and Profeta (2009) for a discussion of the economic, cultural and political determinants of the introduction and initial design of these pension schemes.
7. Crucial contributions include Wright (1986) for unemployment benefit, Saint-Paul (1996, 1999a, 1999b, 2000) for employment protective legislation, and Pallage and Zimmermann (2001).
8. See Ellwood (1982), Layard (1986) and Machin and Manning (1999) on the long-lasting negative effects of crisis on earnings and human capital, particularly for the young, and Ball (2009) on the risk of unemployment "hysteresis".
9. Rose (2000) suggests that monetary unions have an extremely large effect on trade among members. See also Alesina and Barro (2002), Alesina, Barro and Tenreyro (2002), Tenreyro (2007), and McCallum (1995).
10. The Italian pension reform of 1992 (the "Amato reform") demonstrates that radical reforms affecting older workers and pensioners may be possible in conditions of extreme crisis, but once the crisis is past and the financial pressures have eased, subsequent reforms are likely to target the young, as was the case with Italy's "Dini reform" in 1995.

11. There is a good deal of evidence to suggest that agents tend to prefer avoiding losses to acquiring gains and that they will therefore run greater risks for the former than the latter.

12. The "endowment effect" hypothesises that people value a good or service more once their right to it has been established.

13. Empirical studies (Alesina, Ardagna and Galasso, 2009; Fiori *et al.*, 2007) do not find clear evidence of this sequencing. See also Blanchard and Giavazzi, 2003; Ebell and Haefke (2003); Koeninger and Vindigni (2003); IMF (2004); and Duval and Elmeskov (2005).

14. On anticipatory adjustment in respect of pension reform, see Palier and Bonoli (2000); and Palier (2007). Agents who adjust in anticipation of a reform may even put themselves in a position where they will suffer losses if it is *not* implemented, since they will have "invested" in the new system.

15. The results of the case studies discussed in this section are mainly drawn from Boeri *et al.* (2006), Galasso (2006), and Tompson (2009). See also Immergut, Anderson and Schulze (2007).

16. The empirical evidence in IMF (2004) suggests that a current economic crisis may actually hinder labour-market reforms, although a recent but past economic crisis promotes reforms.

17. It is worth noticing that these larger unemployment benefits need not compensate the outsiders for the reduction in the protection for temporary jobs, since, at least in some countries, temporary workers are not eligible for these unemployment subsidies.

18. This argument, based on the so-called "lump of labour fallacy," has been proved wrong (Boldrin *et al.*, 1999).

19. In 1993, GDP decreased by 1% and total employment by 4%, while the unemployment rate went above 20%.

20. Historically, the Danish proportional electoral system has given raise to a long sequence of coalition governments led by minority parties, with governments collaborating with both sides of the Parliament. Among the social partners, an equal tradition of compromise exists, with labour-market organisations representing both employed and unemployed workers, since unemployed workers remain members of their original trade unions.

21. For details, see Tompson (2009), especially Chapters 3 and 4.

22. Even the Reagan's 1983 reform plan in the United States benefited from the counsel of a bipartisan commission, and the 1992 Italian government engaged in lengthy discussion with the unions and the parties.

23. The 1986 Social Security Act in the United Kingdom constitutes an almost unique case study of a strong (Conservative) government – led by Mrs. Thatcher, delivering single-handedly a structural reform that largely reduced the public provision of the retirement income, while increasing the private market involvement. Although this political strategy was largely driven by ideological considerations (Pierson, 1994), and was certainly facilitated by the political crisis of the opposing (Labour) Party, electoral concerns were still present (Bonoli, 2000). Even so, it is important to note that the scheme being reformed was relatively new, so individuals' acquired rights in it were still very limited.

24. This begs the question of what leads politicians to run on a pro-reform platform and why they win.

25. Interestingly, in Mexico an attempt to reform the pension system took place before the elections and failed, while it succeeded after the elections (Tompson, 2009).

26. In 1995, the stock of temporary contract still amounted to 35% of all contracts. In spite of the 1994 reform, in fact, short-term contracts were still more convenient for the firms than permanent jobs.

27. This theoretical argument was put forward by Tabellini and Alesina (1990) and Persson and Svensson (1989) to study how strategic creation of public debt allows current voters to limit future government spending abilities. Tompson (1998) looks at it in the context of the politics of central bank independence.

28. Høj *et al*. (2006) find their measure of centralisation to be associated with a reduction in the implicit tax rates for the age cohort 55-59 years. More centralisation may, however, be accompanied by opt-out clauses that allow firm-level negotiation of part of the wage.

29. Net pension wealth is defined as the discounted value of all future pension benefits to which an individual is entitled under current legislation, minus the discounted value of all future contributions to the system. Thus, changes in the net pension wealth of an agent induced by a reform provide a measure of the costs of the reform to the individual. Estimates of the variations in individual net pension wealth induced by the Amato and Dini reforms and the plausible changes that would have been induced by the 1994 Berlusconi reform attempt are set out in Beltrametti (1995).

30. Fifteen years after retirement, the initial pension was projected to lose over one-third of its value relative to current wages. See Pizzuti (1998, p. 46).

31. That is, the present value of the promises made under legislation then in force to retirees and workers, net of the contributions that the latter would have to pay later on.

32. In 1995, the median age of the voting population was 44, and older voters tended to have higher turnout at elections than younger cohorts. Hence, the Dini reforms effectively enjoyed the support of a majority of voters, who did not bear any cost of the reform; the reform package proposed only few months earlier by Berlusconi failed to enjoy the same political support, since it featured reductions in the net pension wealth for workers over 40 (Galasso, 2006).

33. Pension benefits are essentially deferred wages. It may therefore be rational for agents to accept adjustments in entitlements – *i.e.* a reduction in the rate of return on pension savings – in return for greater confidence that benefits will be paid. See Immergut, Anderson and Schulze (2007).

34. See, in particular, Ebbinghaus (2006); Immergut, Anderson and Schulze (2007); and Tompson (2009).

35. The first cohort of individuals to be substantially affected by the Dini reform is due to retire around 2030 (Brugiavini and Galasso, 2004).

36. Bonoli (2000) and Béland (2001) highlight the role of the unions especially in the reforming of the French welfare state.

37. This interpretation was also provided by Dolado and Jimeno (2004), who investigated the evolution of the ratio of regular permanent employees relative to the active population.

38. Alesina, Ardagna and Galasso (2009) do however find that the adoption of the euro strongly induced a reform effort in the product market, particularly in the energy sector.

39. Boeri, Börsch-Supan and Tabellini (2002) show that agents who are more informed about the costs of the status quo and about the future prospects of the existing system tend to be significantly more supportive of pension reform.

40. Bassanini and Duval (2006) and OECD (2006) provide useful information on the interaction between labour-market institutions and policies (such as EPL, ALMPs, union density) and employment outcomes.

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Chapter 4

Making fundamental tax reform happen

by Bert Brys*

This chapter begins with a discussion of the objectives of tax reform before proceeding to explore the most important environmental factors that influence the reform process, focusing on the circumstances that explain when these objectives and environmental factors may become an obstacle to the design and implementation of tax policies. The second part of this chapter discusses strategies that might help policy makers to successfully implement fundamental tax reforms.

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Countries often succeed in implementing fundamental tax reforms. Sometimes, however, tax reform proposals never leave the drawing boards of studies departments or ministries of finance. In other cases, the tax reforms that are implemented have been revised to such an extent during the reform process that they no longer – or only partially – serve the original tax reform objectives. It also happens that the initial reform objectives are scaled down "pre-emptively", as policy makers anticipate the obstacles that will have to be overcome and conclude that the cost would be too high or the prospects for success too uncertain to justify risking their political capital. In order to make fundamental tax reforms happen, policy makers have to be aware of the major challenges they are likely to face during the tax reform process.

Fundamental tax reforms go beyond small changes in tax rates and provisions. They can be confined to one tax, as for instance a value-added tax (VAT) or personal income tax (PIT) base-broadening reform that finances a cut in the statutory rate of the tax, or they can involve a more complex package of tax increases and reductions. Fundamental tax reforms can be designed to be revenue neutral – either in the first year after implementation or in the following years – or to increase or decrease tax revenues. They can be systemic, involving fundamental changes in tax rules and structures, or they can be limited parametric changes in existing taxes. Examples of systemic reforms are the dual income tax reforms in the Scandinavian countries; the 2006 reform introducing an allowance for shareholder equity in Norway; the 2001 presumptive capital income tax reform in the Netherlands; the 2004 flat tax reform in the Slovak Republic; and the introduction of the alternative minimum corporate tax (IETU) in Mexico in 2008. An example of a parametric reform is the VAT rate increase in Germany in 2007, which financed a decrease in social security contributions.

Policy makers have been successful in implementing tax reforms, as can be observed indirectly from changes in the tax mix over time. Despite some significant differences in the distribution of the tax burden between tax instruments across countries, most OECD governments continue to extract the bulk of their revenue from three main sources: income taxes; taxes on goods and services; and social security contributions. On average, there has been a reduction in the share of tax revenue accounted for by personal income tax partly because of the introduction of "make-work-pay" policies targeted mainly at lower income workers and reductions in the top PIT rates in many countries in order to stimulate human capital formation, entrepreneurship and risk taking. Another recent trend in the taxation of personal income is that some OECD countries, particularly in Scandinavia, have introduced dual tax systems, which tax personal capital income at low and proportional rates, while labour income continues to be taxed at high and progressive rates. Several other countries have moved towards "semi-dual" personal income taxes. There has also been a continuously growing share of social security contributions, which are often levied at flat rates.

Corporate income tax (CIT) rates have been reduced in many countries since the beginning of the 1980s. The share of the CIT in total tax revenues, however, has increased in the majority of the OECD countries, thanks largely to base-broadening measures, increased firm profitability as a result of globalisation (at least prior to the crisis) and greater incentives for businesses to incorporate – implying that the revenue effects of lower CIT rates will partly show up in lower PIT revenues (OECD, 2007). The increasing share of the financial sector in the value added of the business sector has also played a role, although this trend may now have come to an end. A growing feature of corporate tax systems is the use of tax credits or special deductions for research and development (R&D) expenditures. These are now available in most OECD countries (Palazzi, forthcoming).

The share of taxes on consumption has declined gradually, but the mix of taxes on goods and services has changed markedly. In general, there has been a shift towards the greater use of general consumption taxes, particularly VAT (although there remains a lot of scope for further VAT base broadening in most countries) and a reduction in the revenue share of specific consumption taxes such as excise duties. The share of property taxes (on immovable property, net wealth, inheritances and legal transactions) has been approximately constant on average. There has also been growing interest in the use of environmentally-related taxes, with several countries introducing new taxes to deal with specific environmental problems.

When reforming tax systems, policy makers must try to balance the different goals that tax systems aim to achieve. This implies a need to make difficult tradeoffs. Policy makers will have to balance the efficiency and pro-growth objectives/impact of tax reforms with their distributional objectives/impact, while also taking into account the impact on revenues, tax avoidance and evasion opportunities, and the costs of compliance, administration and enforcement – bearing in mind that those costs also feed into the marginal social cost of public funds. When reforming labour taxation, they must also consider the interplay between taxes and benefits. International tax issues, questions of fiscal federalism, the transitional costs of changing the tax system and complex timing issues also have to be considered, as do complex implementation, legal and administrative issues. The design and implementation of tax reforms are also influenced by the institutional context. Finally, political economy factors will have an impact on the outcome of the tax-reform process, for instance because elected politicians may seek to use the tax system to favour particular interest groups and increase their probability of re-election. Hence, the successful pursuit of tax reform involves not only public finance considerations, but also administrative, institutional and political economy factors.

Policy makers can follow certain strategies to make fundamental tax reform happen. These strategies help them overcome or circumvent obstacles to tax reform and allow policy makers to reconcile the different efficiency, fairness and wider tax policy objectives. Even though these strategies do not offer a menu that can automatically be applied to all possible fundamental tax reforms in OECD countries, the analysis that follows will offer insights that policy makers may find useful in facing the challenging task of implementing fundamental tax reform.

The remainder of the text identifies first the obstacles to fundamental tax reform by looking at issues of policy design and afterwards at political economy and institutional factors. The chapter then presents the strategies that might help to overcome these obstacles to the implementation of tax reforms. This is followed by a brief conclusion.

Obstacles to tax reform: issues of policy design

This section identifies the main obstacles to the implementation of fundamental tax reform by looking at tax reform from a public finance perspective (see also Bird, 2004). Tax reform is not only shaped by efficiency and international tax concerns but also by questions of horizontal and vertical equity (fairness)[1] and revenue potential. Tax avoidance and evasion considerations, fiscal federalism relations and transitional tax-reform cost considerations are a key issue in the public finance analysis of tax reform as well.

Reform must balance efficiency and equity considerations…

Taxes are efficient if they distort agents' economic decisions as little as possible. However, efficiency-enhancing tax reforms may at the same time face efficiency drawbacks, which create obstacles to their effective implementation. For example, make-work-pay policies that reduce personal income tax rates and/or employee social security contributions for lower income workers tend to increase labour-force participation, but can discourage taxpayers already in employment from working more or trying to find a better-paid job. This is because, if targeted tax reductions are phased out as income increases, then lowering the average effective tax rate for those at the bottom of the earnings distribution may confront them with rapidly rising marginal effective rates as their incomes increase. A reduction in the CIT rate may increase economic growth (Johansson *et al.*, 2008), but policy makers have to consider that the overall burden on capital income cannot be too much out of line with the top PIT rate; otherwise, the self-employed will face incentives to incorporate purely for tax reasons.

A shift from direct towards more indirect taxes – a tax reform that is considered to be growth-promoting (Johansson *et al.*, 2008) – through an increase in the statutory VAT rate might increase tax evasion and cross-border shopping and might stimulate the informal sector. It might also result in pressures for wage increases, leading to inflation and a corresponding loss of competitiveness, and leading to an increase in the unemployment rate. If, however, the VAT rate increase is offset by a reduction in the direct taxation of labour, then the overall effect on competitiveness could be positive: this is because domestic producers will reap the full benefit of the cut in direct taxes, but the increase in VAT will be "shared" with foreign competitors, because exports are zero-rated for VAT purposes and imports are taxed at the same rate as domestically produced goods. A shift from direct to indirect taxes might therefore be achieved by broadening the VAT base as well as (or even instead of) increasing the VAT rate. As a general rule, there is much to be said for trying to keep most bases broad and most rates low.

Fundamental tax reforms may aim at improving equity. Some reforms, however, may be seen to benefit particular groups disproportionately, while other groups pay a disproportionate share of the costs. The adverse redistributional impact of these reforms would then reduce the tax system's equity. Distributional considerations might therefore become an obstacle to implementation. Also, because the efficiency gains from tax reform typically do not arise immediately but accrue over time, policy makers will not immediately be able to use these efficiency gains to compensate the losers from tax reform. In any case, the initial losers are not necessarily the final losers. The redistributional impact of tax reforms should therefore be assessed in a dynamic – and not a static – setting.

The question, of course, arises as to which degree governments would want to use the tax system to redistribute income. Non-tax policy measures that stimulate education, for instance, increase individuals' earning capacity and may therefore contribute to a more equal income distribution. A considerable part of income is redistributed within the same family types but over different periods in their lifecycle, for instance between periods with and without children. A reduction in the progressivity of the rate schedule compensated by a reduction in child tax credits and similar provisions, for instance, might leave many families relatively as well off when the entire lifecycle is considered.

The redistributional impact of tax reforms has to be analysed in the context of a country's entire tax and benefit system and not evaluated in isolation. This is especially true of the tax treatment of capital assets (Leape, 1990). Because taxes and tax provisions are capitalised in the prices of the assets, the current owners of tax-privileged assets are not necessarily the beneficiaries of these tax provisions. The price of owner-occupied houses, for instance, will be influenced by the presence and generosity of mortgage interest relief and the possible absence of a capital gains tax. The final incidence of these tax provisions will then depend on how the gains of the tax privileges are shared between sellers and buyers. Leape (1990) therefore concludes that whether or not one would propose preferential treatment for housing if one were designing a tax system from scratch, there is good reason to be very careful when altering or abolishing such preferences, because of the inequities that would result. This argument holds not only for owner-occupied housing but also for pensions, because pensioners no longer have the opportunity to adjust their labour-market behaviour in response to change in the PIT. These examples also point to the need for predictable and consistent tax rules as the basis for long-term private sector planning of labour, saving, investment and consumption decisions. Complex tax incidence issues might create obstacles to the implementation of reforms of other taxes as well. The CIT is levied on corporate profits, but this does not mean that capital owners will inevitably earn a lower return on their investment. Investors might simply require a higher before-tax return on their investment in order to offset the impact of the corporate tax. As a result, capital does not necessarily bear the (entire) burden of the CIT. The corporate tax might also (partly) be shifted to consumers through higher prices and/or to labour through lower wages (see OECD, 2007 for more detail).

…as well as revenue and tax-avoidance concerns

Tax-revenue considerations become an obstacle to the implementation of pro-growth tax reforms if the reforms would reduce tax revenues – in the short and/or medium term – or increase uncertainty about the level of tax revenues that governments will collect in the future. This might be the case if the impact of proposed reforms on agents' behaviour is difficult to predict. Such reforms will therefore face stronger implementation obstacles from a tax revenue perspective. Even where there is an apparent tax "giveaway" as a result of a reform, this might reflect the use of fiscal drag or restraint on the growth of public expenditure rather than tax reform windfall gains.

The behavioural response to tax reforms merits consideration in another context, as well: tax avoidance and evasion considerations might create obstacles to the implementation of fundamental tax reforms. As noted above, in-work benefits can reduce average effective tax rates while confronting those affected with steeply rising marginal effective rates. This gives workers an incentive to conceal income in order not to lose part of the in-work tax credit – by under-reporting earnings from their primary job or by taking a second job in the informal sector instead of working more in the official economy. An increase in the standard VAT rate may increase informal sector trade and cross-border shopping, and an increase in the top PIT rate will reduce work incentives and might provide self-employed businesses with a tax-induced incentive to incorporate. This strengthens the case for a general rule of trying to keep most bases broad and most rates low because base-broadening measures will usually reduce the tax compliance costs and the opportunities for agents to engage in tax-minimising behaviour and the benefits of evading taxes. The tax reform obstacles created by tax avoidance and evasion considerations will especially be minimised if the increase in tax revenues as a result of base broadening leads to a reduction in tax rates.

International rules and commitments may limit reform options

International tax rules, European Court of Justice judgments and EU directives (applicable to OECD countries that are also EU members), internationally agreed tax practices and bilateral or multilateral tax agreements can put constraints on the tax reforms that policy makers can implement. Consumption taxes, for instance, have to be levied on a destination basis under World Trade Organization (WTO) rules, and international tax agreements concluded within an OECD context imply that countries cannot engage in harmful tax practices/competition[2] and have to exchange information on request.

The financial and economic impact of foreign tax systems may also impose constraints on the tax reforms that countries might want to implement. By reducing the CIT rate, for instance, governments might try to attract foreign direct investment. However, a CIT rate reduction in the host country will simply transfer tax revenues to countries that tax their multinational enterprises (MNEs) on worldwide income but allow foreign tax credits for the corporate taxes paid at source (OECD, 2007), without changing the effective tax burden – or the investment behaviour – of the MNEs. (This argument, of course, ignores the impact of tax deferral, as MNEs can defer the taxation in their home countries until profits are repatriated.) The international tax environment also imposes constraints on the amount of tax simplification that can be achieved with respect to such taxes as the CIT. In order to protect the domestic corporate tax base, many countries implement thin capitalisation rules, transfer pricing rules, controlled foreign corporation (CFC) rules and additional anti-avoidance rules.

Fiscal federal relations may complicate tax reform

Fiscal federalism might create obstacles to the implementation of tax reform. Many countries have "tax-sharing" agreements between central and sub-national governments, which imply that sub-national governments are directly affected by reforms of shared taxes, possibly leading to financial or other compensation measures that could reduce the efficiency of the reform. Tax-sharing agreements often include complex equalisation formulae to obtain horizontal equity among sub-central jurisdictions. Tax reforms might have an impact on these formulae, possibly leading to complex negotiations and corresponding costs. The fact that some taxes might fall entirely within the jurisdiction of sub-national governments could become an obstacle to the implementation of reforms. A shift from direct towards indirect taxation, for instance, will be more complicated if direct and indirect taxes are levied by different levels of government. This is especially the case for property taxes which are often levied at the state, regional or local level, while income taxes are usually levied at federal level. A shift from income to property taxes, which could be beneficial for growth (Johansson *et al.*, 2008), would then imply an increase in tax revenues for the sub-national authorities and a fall in revenues for the national or federal level. This change might then have to be compensated by revenue transfers or changes in the tasks that have to be financed by different levels of government.

Tax reform at federal or national level requires co-ordination between the taxes levied and the tax and other reforms implemented at lower levels. For instance, if different states or regions within a country face different economic problems, it might be difficult to solve these problems only by changing the tax system at the federal level; tax reform that is good for some might not necessarily be good for all. This is, for instance, the case in Belgium, where the Flemish region faces relatively high unemployment among older workers, while the Walloon region has relatively more young unemployed. Tax measures that tackle the problems of some states or regions might then have to be accompanied by other tax changes that tackle the problems of the other regions. This could be costly in terms of tax revenues foregone. Where sub-central governments have discretionary power over rates and/or bases, special attention must be paid to prevent harmful tax competition between them, especially if sub-central tax rate and revenue reductions are automatically compensated – either partially or fully – by higher transfers from central to sub-central levels. Fundamental tax reforms therefore require that different levels of government and different regions within the country act coherently. The implementation of income redistribution policies could also be at risk if different taxes are levied at different levels of government, because, as noted earlier, distributional goals cannot be achieved on a tax-by-tax basis, but should be considered in the context of the tax and benefit system as a whole, irrespective of the level of government that levies a particular tax. This is for instance the case in countries where indirect taxes – mainly recurrent taxes on immovable property and/or VAT – are levied at the regional level while income taxes are levied at the federal level.

The transitional costs of reform must also be addressed

Additional obstacles to the implementation of tax reforms may arise as a result of the transitional costs that they entail. The implementation of a tax reform involves a period during which new rules are implemented and firms and households adjust their behaviour in response to the new tax situation. These tax-induced changes in behaviour can be highly distortionary and very costly for the agents involved. High transition costs could be expected if, for example, the CIT were replaced by a corporate cash-flow tax, which no longer permitted the deduction of interest payments from taxable corporate earnings. In the absence of transitional measures, firms that were highly leveraged might then suddenly face a sharp increase in the cost of finance, which could lead to bankruptcy for some. The corporate cash-flow tax literature shows that most of the efficiency gains from having a corporate cash-flow tax might be lost during the transition period (OECD, 2007), because the new tax rules would have to be phased in gradually in order to prevent large economic disruptions. The provisions governing the transition period might have a big impact on the final tax reform outcome. For instance, increases in consumption taxes and excise duties could give rise to an increase in the inflation rate, especially if price increases automatically led to wage increases through the wage bargaining process. Other institutional factors, such as the presence and level of minimum wages, might strongly influence the impact of tax reforms during and after the transition period.

The mere announcement of a tax reform can have an impact on agents' behaviour even before it is implemented. The impact on short-run growth might be negative if, for instance, agents postponed investment decisions until the new tax rules were in force. Problems may also arise if, on the contrary, agents rush to make the most of a tax distortion before it is removed.[3] The opposite result holds as well: the reduction or abolition of a growth-friendly provision could have positive short-term growth effects. For example, the announcement of the reduction of an investment tax credit in the near future could bring forward investment and thus stimulate growth in the short run. Similarly, the announcement of a future increase in the VAT rate, for instance, will bring forward purchases of durable consumption goods. Whether or not this is desirable will, of course, depend on the structural position of the economy at the time. Announcement effects can thus create obstacles to the implementation of tax reforms or give rise to unanticipated distortions, especially if government cannot implement the reform immediately.

The time between the announcement of a tax policy change – possibly via the setting of an aspirational tax policy goal – and the actual implementation of the reform then becomes an important factor in tax policy. The appropriate length of time will depend in part on the degree to which the reform will alter the affected taxpayers' circumstances. Changes in taxes that have a particularly "regulatory" character may have particularly pronounced "announcement effects". The announcement of new environmental taxes or higher environmental tax rates, for example, might induce businesses to invest in pollution abatement, so that they can avoid paying these taxes. Yet when it is announced and implemented in a relatively short period, there is little, if any, actual opportunity for firms to abate immediately. Experimenting with new techniques, installing new equipment, making new products and switching inputs all take time. The tax therefore is effectively levied on current emissions (which are based on historical behaviour, given the inability to replace capital assets quickly or to change processes immediately). Yet it is possible to begin realising the benefits of abatement even without levying the tax: a credible announcement that environmentally-related taxation will be implemented in the future (in a year or two, for example) can provide firms with the abatement incentives of the tax without collecting revenue – and therefore without imposing a tax burden based on pre-tax production arrangements.

The length of the transition period might therefore depend on the time that firms need to replace their existing capital stock with new machines that are less harmful to the environment. This, in turn, might depend on the actual age of the current capital stock and on whether better technologies are available or have to be developed first. Such a lead-in may also help to ease the implementation of environmental taxes where there are strong constituencies arguing against their introduction. This effect, however, depends greatly on the credibility of the government's promise to impose the tax in the future. The Swiss authorities adopted such an approach when introducing a new tax on volatile organic compound (VOC) emissions: the tax was announced two years before the government actually began to levy it (Box 4.1).

Box 4.1. **The announcement effect of an environmental tax on volatile organic compounds in Switzerland**

Volatile organic compounds (VOCs) are solvents used in industries that require quickly evaporating substances, such as paint-making and metal-cutting. Besides human health effects, VOCs also contribute to ground-level ozone formation (summer smog). In January 1998, the Swiss authorities approved a tax on VOCs of CHF 2 per kilogram (rising to CHF 3 per kilogram in 2003), but stipulated that the tax would be levied only from January 2000. The government decided to impose this two-year transition period in response to suggestions from industry as well as from the relevant state bodies that there was a need for time to develop both industry competencies and the infrastructure needed for effective administration of the new tax.

The tax has been effective, as emissions of VOCs have decreased significantly. Emissions of taxed products declined 12% during the transition period, as firms adjusted their behaviour in anticipation of the new tax. Emissions dropped a further 25% during 2001-04 when it was fully implemented. Thus the credible promise of future imposition of the environmental tax on VOCs did lead to some abatement even in 1998-2000. There were significant variations in the reactions of firms to the new charge. Larger firms generally innovated and adopted new technologies rather quickly, while smaller firms, due to financial or informational constraints, were less likely to act. The role of cantonal officials also varied. Some saw their role as facilitative and administrative; they therefore helped with information and technology diffusion. Others, by contrast, viewed their role as tax administrators only.

Source: Based on OECD (2009), "Taxation, Innovation and the Environment", December, *www.oecd.org/document/13/0,3343,en_2649_34533_44863437_1_1_1_1,00.html.*

Tax administration issues may also raise obstacles to reform

Reformers need to be sensitive to the impact of reform on the tax administration itself, from an organisational perspective, including any major changes in the tasks performed by the tax administration. These tasks include the collection of information and the identification of taxpayers, the calculation of the tax liabilities, the collection of tax revenues, the communication with taxpayers, the provision of assistance and the enforcement of the tax laws. The tax administrative approach also focuses on any additional compliance costs imposed on taxpayers. Tax administrative issues might become an obstacle to the implementation of tax reforms if change would entail additional costs to the tax administration and taxpayers. Tax reform might be costly if it necessitates organisational changes in the tax administration, the development of new (or adjustment of existing) computer systems, the training of officials or the development of new compliance-monitoring systems. The new tax rules might also lead to an increased compliance burden on taxpayers. An increase in recurrent taxes on immovable property, for example, might require extensive – and expensive – revaluation of property. Property valuations are out of date in many OECD countries, and appropriate property valuation methods are lacking in some, although there are exceptions (*e.g.* Denmark and the Netherlands).

Obstacles to tax reform: political economy and institutional factors

The political economy analysis of tax reform includes voters, political parties, lobby groups and politicians in the public finance models and analysis. The incorporation of voter preferences and the incentives facing politicians in the analysis allows a better understanding of the formation of tax policy and the role of different political institutions in shaping it (Persson and Tabellini, 2002).[4] The democratic political process is such that a number of its characteristics might create obstacles to the implementation of tax reforms. This section discusses the main political economy arguments advanced to explain why socially beneficial tax reforms are not always implemented (see also

Olofsgard, 2003). The underlying issue concerns the heterogeneity of agents discussed in Chapter 1 of this volume: if tax policies affected all taxpayers in the same way, then it would be relatively easy to devise, adopt and implement optimal tax policies. The differential impact of tax reforms on groups with different endowments and/or preferences means that even welfare-enhancing reforms may contradict the interests of many.

For politicians, the visibility of tax-policy decisions is critical

Politicians have an incentive to implement tax reforms that benefit large numbers of voters. However, they may not need to give equal weight to the interests of *all* voters, preferring instead to focus on attracting "swing voters," who are more likely to change their votes in response to a reform that favours them (Profeta, 2003). Tax reforms that benefit swing voters, though, are not necessarily in the general interest. Politicians might face incentives to reform the tax system in order to signal to particular groups of voters that they care about taxpayers' welfare. This might give rise to a sequence of incremental tax reforms that target specific groups and try to create winners without making losers. However, if piecemeal reforms are undertaken for the sake of reform and without any strategic vision to guide them, politicians might not understand or take into account the long-term implications of these measures, such as potentially negative impact on future tax revenues or the possibility that tax complexity might breed further tax complexity (Bradford, 1986). This entails the risk of making the tax system more complex without tackling the underlying economic problems and tax issues in the most efficient way. This process would seem to underlie the trend observed in various OECD countries at various times towards increasing tax expenditures. It is important to recognise, in this connection, that the visibility of tax policy changes may be highly asymmetrical: politicians may find it easy to adopt tax breaks that bring significant, visible benefits to specific groups (who are thus aware of the change and will support it), but result in an increase in the overall tax burden on other groups that is so small as to pass unnoticed. This asymmetry contributes to the incentives to increase tax expenditures and thus the complexity of the tax system overall.

In general, politicians face an incentive to enact reforms whose gains are visible at the time of the next election – and, if possible, whose costs are not. If the gains from tax reform are visible when the election takes place, politicians will maximise the probability of being rewarded for having undertaken them. This is, of course, on the assumption that individuals – regular as well as swing voters – will associate the politician(s) responsible with the benefits of the reform. Because fundamental tax reforms usually take longer to realise than incremental changes to the tax laws and are sometimes so complex as to leave voters uncertain of how to evaluate them, politicians operating with electoral time horizons in mind might prefer highly visible *ad hoc* measures to more fundamental reforms, especially when the next election is relatively close.

Tax reform visibility has other implications as well. If politicians view voters as strongly averse to increased taxation, they might want to choose forms of taxation that are less visible to the decisive (swing) voters. This partly explains why recurrent taxes on immovable property, which are highly visible, are rarely increased by politicians (Alt, Preston and Sibieta, 2008). This conjecture also seems to imply that employer social security contributions are more likely to be increased than employee social security contributions and that PIT cuts may be offset by increases in less visible indirect taxes. Another tax reform visibility example is linked to inflation. Alt, Preston and Sibieta (2008) argue that policy makers have an incentive to place greater reliance on taxes that need not be increased each year in order for revenues to remain constant in real terms. Policy makers therefore have an incentive to rely more on *ad valorem* taxes on capital and labour income and on VAT, instead, for instance, of *ad quantum* excise duties. The tax reform visibility argument offers an additional explanation for the phenomenon of "bracket creep" in many OECD countries. OECD (2008) concludes that most OECD countries do employ some form of adjustment, such as indexing tax band limits for inflation, in order to prevent large PIT burden changes as a result of inflation. These adjustments are, however, incomplete or infrequent in most countries. Because inflation might create a relatively hidden increase in the tax burden, the political process creates an incentive *not* to operate a system of full, automatic inflation adjustments ("full indexing"). Instead, the increase in tax revenues as a result of "not fully indexing" creates the opportunity for a highly visible tax reform after a number of years.

Uncertainty about the distributional consequences of reform may impede change

There can be considerable uncertainty about who will win and who will lose from a tax reform and whether (how) voters will change their voting behaviour in response. In fact, risk-averse taxpayers might vote against tax reform even if they knew that a majority would gain from the reform (Fernandez and Rodrik, 1991). This status quo bias reflects the fact that, while some of those who stand to gain or lose from the reform may be easily identifiable, the median or swing voter may not know *ex ante* whether s/he will join the winners, because the tax reform benefits will become clear only in the future. This individual uncertainty then generates a double hurdle for reforms: a reform must attract majority support both *ex ante* (to win adoption) and *ex post* (to be sustained). Olofsgard (2003) points out that this result hinges on the assumption that the winners from reform cannot credibly commit *ex ante* to compensate the losers *ex post*. As a result of this uncertainty, voters might become reluctant to vote for a tax reform that was expected to increase overall welfare.

Policy makers could also face tax reform outcome uncertainty as a result of uncertainty regarding the impact of reform on agents' behaviour, income distribution, tax revenues, etc. In the presence of high levels of uncertainty about the number of winners and losers and the extent to which they are (positively or negatively) affected by the tax reform, policy makers might become more careful in making a decision to engage in tax reform.

Other types of electoral uncertainty can hinder the implementation of fundamental tax reforms. Policy makers face uncertainty about who will be in power after the elections and whether the new government can reverse or stop a tax reform that was started before the election. Tax policy annulations or reversals might have an impact on who actually wins and loses from the tax reform. Policy makers may also be uncertain about the quality of information available concerning the likely impact of reform. They have to base decisions on the information provided by their staffs, by the research departments of state bodies and/or political parties, by the social partners and by the academic community. The greater the uncertainty about information quality and the greater the divergence between the information obtained through different channels, the harder it will be for politicians to draw conclusions and to make decisions regarding the actual implementation of the tax reform.

Uncertainty about the divergent impact of tax reform on different parties in the governing coalition (or different groups within the ruling party) might create an obstacle to the implementation of welfare-enhancing tax reforms, especially if the constituents of one of the coalition parties bear most of the costs. Ashworth and Heyndels (2001) analyse the impact of political fragmentation in OECD countries over 1965-95. They find that countries where political power is more dispersed change their tax system less frequently. When they do occur, tax reforms in such countries tend to be compensated by other changes in order to be acceptable to different parties. Hence, the more fragmented the government coalition, the harder it is likely to be for political parties to engage in fundamental tax reform.

Special interests may be very effective in influencing tax policy

An alternative political economy approach focuses on the political influence of the tax reform losers that may block the implementation of tax reform. They might exert influence either directly, through their ability to block enactment of reforms within the parliament, or indirectly, by persuading politicians to opt for the status quo instead of launching a tax reform (Olofsgard, 2003). The potential beneficiaries of tax reform are often silent in contrast to the losers. This is typical of many structural reforms: for a variety of reasons, including loss aversion and endowment effects, agents are, *ceteris paribus*, more likely to mobilise against a proposal that threatens them than in support of one that offers them benefits. In the field of tax reform, this is typically the case when tax breaks are worth a great deal to special interest groups, but their abolition would bring only a small reduction in the total tax burden for most taxpayers.

Politicians might be more willing to listen to particular special interest groups if they receive direct or indirect campaign contributions from them or if these special interest groups consist of swing voters that have an influence on the outcome of the next election (Olofsgard, 2003). Different groups of taxpayers might also face different transaction (lobbying) costs (Holcombe, 1998). As a result, tax policy reform will be biased towards reforms that are favoured by influential lobby groups, which then might create an obstacle to the implementation of tax reforms that would be welfare-enhancing overall.

Alt, Preston and Sibieta (2008) note that policy makers should be aware that the enactment of new tax expenditures and the introduction of special tax treatment for particular groups of taxpayers might create new special interest groups. The removal of the special tax treatment might then turn out to be very difficult and might give rise to additional or extended special tax treatment provisions over time. Even when taxpayers did not lobby for a particular tax measure in the first place, they may lobby for its persistence and extension, even if the result is a less efficient, less fair, more complex and less growth-oriented tax system. Ashworth and Heyndels (2001) see tax expenditures, in particular, as a tool to serve swing voters and special interest groups. The underlying rationale for this is linked to the fact that, as noted earlier, the benefits from tax expenditures can be targeted while the costs – the reduction in overall tax revenue – can be spread across all taxpayers. While there are good arguments for introducing tax expenditures in some cases, politicians that introduce tax expenditures do not necessarily internalise all tax expenditure costs. The political process might therefore lead to excessively high levels of tax expenditures which, once introduced, become very difficult to abolish.

The structure of the policy process can shape tax reform outcomes

Tax reforms may be blocked and changed, sometimes significantly, at the legislative stage (Bird, 2004). Sound tax policies might therefore lose many of the desired tax design characteristics. The growth-enhancing economic impact and/or the equity characteristics, for instance, of a fundamental tax reform might be reduced as a result of the changes made to the proposals during the parliamentary process. Tax reformers must therefore pay close attention to these critical aspects of the policy process and, in particular, to the ability of special interests to influence parliamentary behaviour.

Tax reform outcomes reflect not only the political rules of the game, but also the institutional context within which alternative tax policies can be analysed and evaluated and within which final tax policy decisions can be made (Hettich and Winer, 1999). This institutional tax reform perspective points to particular legislative rules of procedure, committee systems and other aspects of institutional design that can help or hinder the implementation of tax reforms. Much may depend on who decides to evaluate particular reforms – and when this evaluation decision is made, which tools and type of analysis will be applied in the evaluation and who will be asked to conduct it. Weingast and Marshall (1988) argue that the assignment of legislators to committees and the institutional arrangements that create agenda power for each committee are key issues in explaining tax reform outcomes. The tax reform process also depends on who has the authority to invite experts to appear before tax committees or otherwise to participate in the policy process, and who will participate in setting the future tax reform agenda. Other key factors are the institutional settings that determine how expert analyses will be submitted – and to whom – and what will be done with their evaluations. In particular, it may matter whether or not the government commits to making these evaluations and (intermediate and/or final) reports public and when.

The publication (or not) of such analyses is, in turn, linked to the reformers' communication strategy. A key objective of such a strategy might be to create public awareness of, and support for, tax reform. This might be achieved through public debates, consultation rounds involving the social partners or other representatives of civil society, etc. The ways that these communication processes are managed might have an impact on the tax reform outcome. The communication strategy of tax committees or other bodies charged with crafting reform proposals will be shaped by the rules governing their conduct: how can tax committee members communicate about the work done by the committee and who decides on these rules, etc.

Similarly, the scope for tax officials or other civil servants to provide input in the tax reform debate and/or to make reform proposals should be considered. Tax administrations, for instance, are generally able to provide good quality input in the tax-reform process, and their role, involvement and support for reform is crucial, as they will have to implement and enforce the new arrangements. Tax administrations will generally be particularly sensitive to the administrative and compliance aspects of reform, about which others may know relatively little. They can therefore identify problems likely to arise during the transition period following a reform or warn of the dangers that may exist where proposals that are economically sound in principle may be administratively very problematic in practice. For example, proposed reforms may threaten to add to compliance burdens or to create new opportunities for tax avoidance and evasion.

Strategies for successfully implementing fundamental tax reforms

This section discusses strategies to successfully implement fundamental tax reforms. These strategies aim to allow policy makers to reconcile different efficiency, equity and other tax policy objectives and to overcome the obstacles identified in the previous sections.

Reform design should be guided by a clear strategic vision and backed up by solid analysis

As a starting point, governments might try to obtain a consensus on broad, long-term tax reform objectives. These might include reducing the country's debt-to-gross domestic product (GDP) ratio, increasing domestic saving and investment, attracting foreign investment or increasing the labour supply. A broad consensus on tax reform goals will facilitate the discussion and evaluation of different tax reform proposals that attempt to realise these broad objectives. Clear communication regarding long-term objectives might facilitate the creation of a broad social consensus that favours the introduction of the most desirable tax-reform measures. When designing a reform that achieves the broader reform objectives, governments might have to find a balance between such different tax design criteria as efficiency, equity, simplicity, enforceability, revenue-raising ability, etc. Clear communication with the public about these trade-offs and the choices that have to be made might help in obtaining support for the reform.

Even in the absence of a broad strategic consensus on tax reform, governments can reduce uncertainty and begin to guide tax-reform debates by announcing aspirational tax-reform goals before presenting specific proposals. In Australia, for instance, the aspirational tax reduction goals are announced before the start of the fiscal year. The goals can be postponed in case of a worsening of the economic or budgetary situation. The setting of aspirational future tax-reform goals can also be applied to announce future tax rate increases or future shifts in the tax mix, for instance. This approach allows policy makers to set long-term tax policy goals that go beyond the current government horizon. It also creates incentives not to deviate from these goals and to resist, for instance, the pressure of certain lobby groups during or after the implementation of part of the announced tax reforms, because the government's credibility is at stake. Moreover, aspirational tax-reform goals provide a measure of predictability even where the entire reform cannot be implemented immediately. This provides agents with the opportunity to adjust their behaviour over time, which will avoid large shocks in behaviour. This reduces the costs for the agents involved and the distortionary impact of reform on the economy as a whole.

Once the broader tax-reform objectives have been set, governments can start evaluating specific reform proposals and studying the degree to which these proposals achieve the desired objectives. The evaluation of tax-reform proposals should focus on their behavioural impact, their revenue implications, their distributional impact, their implications for compliance and enforcement costs, and any tax avoidance and evasion issues that may arise. In order to be able to draw well-founded tax policy conclusions, it is important that all aspects of the proposed reform are analysed. Different types of models can assist in assessing the impact of new tax measures on revenues and welfare. Static tax policy models are simple and can provide a first indication of the effect of a reform on revenues and welfare, but do not model its behavioural impact. This is especially important in the case of reforms that are intended to increase efficiency since they "work" by changing behaviour. However, behavioural tax policy models are more complex to build and operate. They provide a more complete view of the impact of tax policy changes on revenues and economic performance, though their predictions may be subject to a wide margin of error. General equilibrium models are not based on disaggregated taxpayer information but do consider the interaction between different markets and prices as a result of the tax policy reform and are therefore useful as well.

Framing tax-policy debates may be crucial when equity issues arise

The evaluation of tax-policy reform implies addressing the impact of the tax reform on income distribution. However, policy makers should bear in mind – and communicate to the electorate – that distributional goals should not be assessed on a tax-by-tax basis. Alt, Preston and Sibieta (2008) argue that in order to pursue sensible tax policy, it is essential to see the tax system as a system rather than to consider its different elements in isolation. Disconnected tax debates may be particularly counter-productive for the implementation of fundamental tax reform. Broadening the VAT base, for example, might be difficult if the discussion of VAT-reduced rates on particular goods takes place in isolation. The framing of the debate on recurrent taxes on immovable property in isolation will likewise hinder its adoption. Alt, Preston and Sibieta (2008) argue that such framing could result from a lack of public understanding of the actual impact of different taxes and of the interconnectedness of the tax and benefit systems. Discussing tax-policy reforms in isolation could reinforce this lack of understanding by allowing the tax-reform discussion to focus on individual taxes only. Lobby groups might have an incentive to frame particular tax-policy reforms in isolation, but this approach is unlikely to be in the interest of the general public.

Advancing reform may require acceptance of some ex ante *constraints*

Accepting certain constraints up front might help governments to build support for tax reform. A government could, for example, commit to implementing only reforms that were judged to be redistribution-neutral, reforms that did not lower total tax revenues or reforms that did not change the favourable treatment of, say, mortgage interest deductions. However, explicitly accepting some upfront constraints regarding key tax objectives might imply ruling out some Pareto-improving reforms. Ackerman and Altshuler (2006) argue that it is nearly impossible to design a tax reform that relies on base-broadening measures to finance rate reductions and is nevertheless both revenue- and distribution-neutral. They argue that, although imposing up front constraints on the tax-reform process can be beneficial, the trade-off is a greater likelihood that the reform that actually is implemented will not dramatically alter the tax system. Policy makers should therefore be careful in setting strong constraints up front, because they may dictate the outcome of any reform effort.

That said, accepting constraints on the reform process might also make it easier to implement reform. The more negotiable the reform details, the higher is this incentive, and the greater the likelihood of delay (Alesina and Drazen, 1991). Thus, governments must sometimes put themselves in a situation where burden shifting across groups is impossible. This is why affirming certain constraints on the reform *ex ante* might make it easier to pursue. Common examples include the reliance of national governments on international constraints, such as those coming from the International Monetary Fund (IMF) or the European Commission, to persuade stakeholders that some measures are inescapable or on tax reform principles that were agreed upon during prior reform processes, as was the case in Norway in the early 2000s (Box 4.2).

Box 4.2. **Reforming the "split model" in Norway**

The 1992 dual income tax reform in Norway introduced a flat PIT rate of 28% on personal income. The same rate is used for corporate income. In addition to the flat rate, a progressive surtax is levied on gross income from wages and pensions above a certain threshold. Double taxation of distributed profits is prevented by a full imputation system. Double taxation of retained profits was prevented through the so-called RISK scheme.

In order to ensure equal tax treatment of wage earners and the self-employed, the dual income tax system splits the income of the self-employed into a labour income component, as a reward for work effort, and a capital income component, which is the return on savings invested. The capital income component is calculated by imputing a return – the sum of a risk-free market interest rate plus a risk premium – to the business' capital stock; the labour income component is then residually determined as total business income net of capital income. The part considered labour income is taxed according to the progressive rate schedule. The part accounted as capital income is taxed at the flat rate. This approach is also used to avoid giving active owners of closely held corporations an incentive to report their highly taxed wages as lower taxed capital income, given that at least two-thirds of owners are classified as active owners (OECD, 2006). The split model gave rise to a lot of tax-planning activities aiming to shift the amount of highly taxed labour income into lower taxed capital income. The most obvious strategem was to invite silent partners to take at least one-third of the shares in order to escape the mandatory income splitting. In many cases, the reduced tax bill alone paid for the giveaway of one-third of the shares (Riis Jacobsen, 2007).

In 2002, the government appointed an expert committee on tax reform, led by a former finance minister. The committee's mandate went beyond the income-shifting problems connected to the split model; the committee had to consider reforming the tax system in order to make it more robust in light of increased international capital mobility and the European Economic Area (EEA) agreement. Tax simplification and strengthened redistributive properties were additional tax-reform objectives. The committee's tax-reform suggestions had also to be in line with the dual income tax principles established during the 1992 tax-reform process. The committee considered several tax reforms. The least radical change it discussed was a tightening of the existing split model. Narrowing the gap between the marginal tax rates on labour and capital income, combined with a tight split model, would probably have been the easiest way to address income shifting. However, the committee had little faith in the robustness of such a reformed tax system, mainly because the problems with the former tax system were not due to the split model in itself, but arose because politicians had used the system to achieve (personal) political economy objectives that undermined its functioning. Because the committee did not believe that politicians would refrain from doing this in the future, the allowance for shareholder equity tax system was implemented (OECD, 2007).

Source: Based on Riis Jacobsen, Michael (2007), "Economic National Report – Norway; Taxation of Capital and Wage Income; Towards Separated or More Integrated Personal Tax Systems" and OECD (2006), *Fundamental Reform of Personal Income Tax*, OECD Tax Policy Studies, No. 13, OECD Publishing, DOI: *http://dx.doi.org/10.1787/9789264025783-en.*

Ex post evaluation and international dialogue may help strengthen the case for change

Ex post evaluation of tax-policy changes might provide valuable insights and offer an opportunity to learn from tax reforms that have been implemented in the past, thereby increasing the probability of better reforms in the future. Countries might evaluate *ex post* whether the tax reforms have achieved their objectives and analyse why certain objectives were or were not met. They might also assess the impact of tax reforms in terms of efficiency, equity, compliance, evasion and revenues. This will offer an opportunity to improve tax reforms that already have been implemented and might yield valuable insights for future tax reforms. *Ex post* evaluation might lead to a set of country-specific best tax-policy practices and clarify the need for specific tax policy evaluation tools and models that have to be developed. Policy makers might commit to an *ex post* tax reform review by a specific date in order to help legislation pass, as was done in the Netherlands in 2001 (Box 4.3). This commitment will also provide a motivation for evaluation. Another related mechanism is the use of "sunset clauses", which implies that tax rules have to be confirmed. This might then provide an incentive for *ex post* tax policy reform evaluation as well.

Box 4.3. **The 2001 comprehensive tax reform in the Netherlands**

The 2001 tax reform in the Netherlands reduced corporate and personal income tax rates while broadening their tax bases, shifting the burden of taxation towards greater reliance on indirect taxes and "greening" the tax system. Tax allowances were replaced by tax credits, and the wealth tax and the taxation of personal capital income were replaced by the taxation of an imputed return on capital at the individual level. This "presumptive capital income tax" aims to ensure that all forms of personal capital income are taxed equally. It prevents taxpayers from realising capital income in the form of tax-free capital gains, as was the case before 2001. Instead of a tax on the actual return on capital, a 30% proportional tax rate is applied on a notional return of 4% on the net value of the assets owned by the personal investor. A basic tax-free allowance introduced a progressive element in the presumptive capital income tax (Brys, 2006, 2009).

The reform process that resulted in the 2001 tax reform started in 1997, when the tax rules for closely held corporations were revised. This resulted in the "Taxes in the 21st Century" report that was presented to parliament in 1997. It identified the main problems with the old tax system and presented the possible contours of a new system. The conclusions of this report were afterwards integrated into the coalition agreement of the second cabinet of Prime Minister Wim Kok. The 2001 Income Tax bill and the accompanying explanatory memorandum were put forward in parliament in September 1999. Different roundtable conferences were organised and the CPB Netherlands Bureau for Economic Policy Analysis released a report called "Economic Consequences of the 2001 Tax Reform". The bill was amended several times and was accepted in parliament in May 2000. The coalition partners agreed that the 2001 tax reform would be evaluated after four years. Particular elements of the new income tax law which did not work out as planned were already reformed before the end of that period. The 269-page evaluation report was discussed in the Second Chamber of the States General (the lower house of parliament) at the end of 2005, leading to a number of tax reform adjustments.

Countries might also learn from other countries' best practices. International organisations like the OECD play an important role in offering a platform for sharing experiences and discussing international best practices. In fact, the focus in such fora should not only be on best practices, but also on countries' (partial) reform failures in order for other countries to learn and reduce the probability that they will make similar mistakes.

The potential for cross-border spillovers in connection with tax reform reinforces the case for such international engagement: the implementation of tax reforms might have repercussions for other countries and might depend on whether other countries implemented similar types of reforms. The introduction of a comprehensive business tax

(CBIT), for instance, is probably only feasible if many countries implement the same corporate tax reform at the same time; otherwise, such a reform will discourage investment in the reforming country, as the CBIT will strongly increase the cost of debt-financing at the corporate level. Small countries that increase the statutory VAT rate might simply lose revenues as a result of increased cross-border shopping, unless neighbouring countries also increased their VAT rates. Co-ordination of tax policy, especially among neighbouring countries, can therefore be important. Co-ordination might also prevent countries from engaging in race-to-the bottom tax competition or implementing harmful tax practices that would undermine the efficient working of the overall tax system. The role of international organisations in this context is important, as they play an important role in creating a forum where countries can share information and views about tax (and other) issues.

OECD work on the Model Tax Convention, on the transfer pricing guidelines, on harmful tax practices and on the international tax information exchange agreements contributes to the creation of a level playing field. The OECD's tax work avoids international double taxation but also attempts to prevent no-taxation; it reduces tax-evasion possibilities, contributes to the reduction of tax compliance costs, helps create an environment where individual taxpayers and businesses have greater certainty about the tax rules they will face and improves the tax system's equity as it helps ensure that all taxpayers pay their fair share of the tax burden. Moreover, these international tax rules help broaden tax bases, thereby creating opportunities to lower the tax rates and therefore a pro-growth tax environment. The participation of both OECD members and non-member countries in the OECD's tax work is therefore in itself part of a "making fundamental tax reform happen" strategy.

The proper timing of reform is crucial

Good reform proposals that are put forward at the wrong moment may be blocked.[5] For instance, politicians will have to decide when to bring the reform proposals to the attention of the broader public, when to explain the impact of the reform and when to implement it. New governments that have campaigned for election on a platform of tax reform can use their electoral mandates to make rapid progress. Other issues of reform timing, however, may depend more on the state of public finances than the political conjuncture. Experience shows that it might be easier to implement fundamental tax reform when a country is running budget surpluses that could absorb possible revenue losses or could be used to partly compensate the losers from tax reform. The implementation of counter-cyclical pro-growth tax reform could anticipate possible economic downturns and mitigate their impact by putting the economy on a higher growth path before the downturn hits. In short, governments face incentives to engage in fundamental tax reform when times are good. However, it might not be possible to obtain support for fundamental reform in a cyclical upswing. An economic downturn might then create an opportunity to introduce pro-growth tax reforms and put the economy on a higher long-run growth path. Recessions sometimes expose very clearly the weaknesses of the economy and thus the need for reform. As a result, taxpayers and voters might more easily accept the necessity of reforms that tackle the underlying economic problems. The problem then, however, is that the deterioration in public finances brought about by the downturn may reduce the fiscal space available for financing reforms that might involve upfront costs.

It can sometimes pay to prepare ideas for tax reform in advance and wait for a good moment to launch them into the political arena. Politicians might, for instance, try to obtain political support within their own political party and gather data that provide support for tax reform before they express their tax reform ideas in the public domain. Governments might also have an incentive to postpone the presentation of tax reform ideas until they are ready to answer the most difficult questions and respond to the most severe criticisms. Aggregate tax-reform uncertainty might create an option value to learning. Policy makers' and other stakeholders' understanding of economic problems might be improving over time, as more and better information becomes available. In that case, it may be better to defer an apparently worthwhile reform until further information confirms the tax reform gains. This might then lead to tax reforms that are implemented late, but vigorously and quickly.

There are strong arguments for "bundling" reforms into comprehensive packages…

In devising an approach to tax reform, policy makers face a difficult choice between "bundling" and "sequencing" – that is, between attempting to adopt a comprehensive tax reform more or less at once, in what is sometimes referred to as a "big bang" approach and pursuing a more incremental strategy. Both offer advantages and disadvantages, and the question of which is to be preferred depends not only on the institutional and political context, but on the goals of the reform and the obstacles that might be foreseen. In general, however, the literature seems to suggest that comprehensive reform is preferable, at least when it is possible. Recent examples of comprehensive tax reforms include those in the Netherlands, described earlier (Box 4.3) and in the Slovak Republic (Box 4.4).

Box 4.4. **The 2004 comprehensive tax reform in the Slovak Republic**

The 2004 "comprehensive" flat tax reform in the Slovak Republic aimed at improving labour market flexibility and increasing work incentives, as well as attracting more foreign direct investment, on the condition that the tax reform had to be broadly revenue-neutral. Before the tax reform, the personal income tax system had five income brackets, with marginal tax rates varying from 10% to 38%. The average production worker faced a marginal personal income tax rate of 20%. The corporate tax rate was 25%, having fallen from 40% since the end of the 1990s.

The introduction of the 19% flat tax rate on corporate and personal income – the flat rate was set below the marginal rate faced by average workers – was combined with certain base-broadening measures and with a large increase in the basic allowance – it more than doubled – in order to offset the increase in the marginal tax rates for lower income households. At the same time, the government reduced social assistance benefits, introduced additional reforms that aimed to "make work pay" and shifted the tax burden from direct to indirect taxation. The two VAT rates of 14% and 20% were replaced by a single 19% rate – setting the new VAT rate slightly below the top statutory VAT rate of 20% might have helped gaining political support for the reform – and certain excise taxes were increased.

The tax reform turned out to be broadly revenue neutral as a result of the shift from direct to indirect taxation. A comparison of the estimated tax revenues that would have been received in 2004 in the absence of reform and the revenues actually received in 2004 suggests that the decline in PIT revenues (estimated at 0.8% of GDP) and CIT revenues (a further 0.8% of GDP) was almost entirely offset by the increase in VAT revenues (up an estimated 0.8% of GDP) and excise revenues (up an estimated 0.6% of GDP).

Various elements of the 2004 Slovak tax reform tended to change the income distribution in favour of more affluent households (OECD, 2005). However, the issue of fairness in taxation cannot be separated from the issue of efficiency. As the tax reform aimed at increasing the capital stock and improving the allocation of capital, labour productivity might increase; this should raise real wages so that workers, including the low-skilled, should also benefit from lower taxes on capital over the long term. As these benefits only arise over time, an increase in the basic tax-free allowance was crucial to obtaining the lower income workers' political support for the tax reform.

For a start, bundling reforms may make it easier to address distributional issues. There are examples of "bundled" tax reforms, involving the simultaneous adoption of multiple changes in taxes (and sometimes benefits) that will mitigate the costs of reform for groups that might otherwise be hard hit by individual measures. VAT base-broadening measures, for example, increase tax revenues that can be used to compensate poorer households through increased direct benefits. This approach was followed in Chile. Alternatively, the impact of VAT base broadening could be offset by a reduction in PIT rates in the lowest personal income tax brackets or increases in the threshold at which PIT begins to bite. A statutory CIT rate reduction could be accompanied by an increase in taxes on capital income at the personal shareholder level. An increase in the recurrent taxes on immovable property or VAT could be used to finance a reduction in employee social security contributions. Bundling reforms also allows governments to allocate the benefits of reform to particular types of taxpayers, for example through direct increases in benefits or indirect tax cuts. By choosing the details of the tax-reform package, governments will increase the probability of finding sufficient political support to implement the reforms. However, the compensation of particular groups of taxpayers will only be necessary if these groups have the power to block reform or are seen as possible swing voters in the next election.[6] The potential to advance reform in combinations like these highlights the importance of viewing the tax system as a whole rather than considering individual taxes in isolation. In order to advance fundamental tax reforms, governments may need to combine tax and benefit reforms in different areas in order to achieve a balance among the broader reform objectives of efficiency, growth, equity and revenue.

While much attention is often paid to the very real difficulties of engineering a "big bang" reform, there are times when it may offer a far easier way forward than a more gradual approach. For example, a comprehensive package may be necessary in order to obtain sufficient support for fundamental tax reforms. Olofsgard (2003) points out that bundling reforms may be necessary if there are a number of potential "veto players" whose support is crucial. Martinelli and Tommasi (1997) argue that often, and particularly in Latin America, reforms are an all-or-nothing process. Gradual reforms may be impossible, whereas big bang reforms may be feasible, even if only at some opportune moments. They propose a model in which each group has veto power such that divide-and-rule tactics cannot work: each individual reform measure pleases two groups and hurts one, so every single reform will be vetoed. Yet there is a "grand reform" that corrects all distortions at once. In that case, the strategy of bundling many reforms together becomes the only politically feasible strategy. In short, in countries where many groups, agents or institutions have *de facto* veto power over tax policy, reforms might be delayed until the time when the distortions of the status quo hurt all groups, who then accept a grand reform.[7]

The comprehensive (big bang) approach to tax reform might be preferred over the incremental tax reform approach for a number of other reasons (Olofsgard, 2003). Comprehensive reform might prevent the formation of lobby groups powerful enough to stop the reform or to adjust the reform proposals in such a way that its main goals are no longer (or only partially) achieved. By acting quickly, governments might actually increase the probability that fundamental tax reforms are implemented. Olofsgard (2003) also argues that the big bang approach may also be preferred if the full tax reform package is necessary in order to realise the long-term benefits of reform or if there is a risk that the tax reform will be stopped or reversed. Tax-reform support may be withdrawn if the realisation of long-run benefits becomes uncertain because of the risk of getting stuck at a partial reform equilibrium. Finally, a good comprehensive tax reform package is, if it can be accomplished, better than an incremental approach, which runs the risk of losing focus and degenerating into *ad hoc* measures that do not lead to the fundamental change that might be needed.

As noted earlier, policy makers have a greater incentive to engage in tax reform if the gains will be visible by the time of the next election. Given the four- or five-year political cycle in most democratic societies, this implies that fundamental tax reform – especially comprehensive reforms that require more time before the benefits of reform become visible – will have to be introduced at the beginning of a government's mandate in order for the gains to be tangible by the next election.

…but incremental approaches may nevertheless be preferred in some circumstances

The attractions of comprehensive reform notwithstanding, there are circumstances in which sequencing reforms may be the desirable – or even the only feasible – strategy. In fact, even if a comprehensive approach is followed, governments could still implement the comprehensive reform on a tax-by-tax basis instead of implementing all tax reforms at once. The distinction between the adoption of a grand reform and its implementation should not be overlooked, because the greater the complexity of the changes adopted, the more likely it is that implementation will take time. Yet there are also arguments for taking a more gradual approach to the *adoption* of reforms.

Uncertainty constitutes one such argument. Dewatripont and Roland (1995) propose a model in which a major reform can be split into two smaller, complementary reforms, both of which must be implemented to realise the benefits of the complete reform. However, uncertainty surrounds the benefits of reform. Implementing the entire reform at once would produce all benefits and costs immediately. The gradual strategy, however, would introduce only one of the smaller reforms first. Once the outcome of that smaller reform was observed, the population would decide whether to implement the second reform or to return to the status quo. The costs of reversal increase with the magnitude of the reforms already implemented. Thus, the gradual strategy dominates if the first reform has a sufficiently high probability of revealing that the whole process should be stopped: this saves on reversal costs. Because of the option value of an early reversal, gradualism also facilitates social acceptance of the whole reform process, particularly if the second part of the reform is "politically difficult". In fact, the second reform will only be implemented if that the experience of the first reform suggests that its benefits will be sufficiently great. Thus, some of the *ex ante* opposition to a comprehensive reform may be quelled by proceeding in stages and providing a possibility to block the entire process at the interim stage. Dewatripont and Roland (1995) also show that reformers should first implement the reforms that have: (i) the highest expected payoffs; (ii) the highest risk for any given expected payoffs; and (iii) a high probability of revealing information about the value of the entire reform process; the first and second reform should also be complementary.

It may also pay to unbundle reforms that cannot overcome the status quo bias, and hence to spread the implementation of the (comprehensive) tax reform over time (Dewatripont and Roland, 1992). The idea is simply to divide the reform in two steps that do not harm the same voters (or interest groups). The first measure targets a sufficiently narrow group of the population and thus enjoys the *ex ante* support of a majority. Once this first reform is passed, the group that opposed it may come to support the second step, which will target voters not threatened by the first. In essence, the strategy of sequencing here aims to divide and conquer those who would unite to reject a fundamental reform if it were undertaken all at once. Moreover, if the reform sequence proceeds in a consistent way, the process as a whole will gain credibility and agents will become gradually more accepting of subsequent reforms, not least because some will start to adapt their behaviour in anticipation of the changes that are in prospect.

If, however, there is too much uncertainty about when the next step in the tax reform will be implemented, taxpayers might wait to adjust their behaviour instead of immediately anticipating the reform. Moreover, the approach does provide taxpayers with an opportunity to start lobbying against reforms that are planned for the future. A proper design of the different phases of the tax reform – which type of tax reform will be implemented when, and what are the conditions for tax reform deferral – is therefore crucial. Thus, a sequenced approach to tax reform would still benefit from the kind of overall strategic reform vision discussed above. Otherwise, there is a risk that policy will become increasingly *ad hoc* and inconsistent.

An incremental tax reform approach also makes fewer demands on scarce policy-making and administrative resources and may therefore be more likely to succeed (Bird, 2004). By first introducing relatively popular reforms, politicians might obtain a good tax reform reputation and build up support for the implementation of the more controversial measures (Olofsgard, 2003). However, Stiglitz (2002) argues that tax reform will generally be accepted if there is some kind of tax reduction in prospect. He therefore advises not to reduce the rates before the more complex issues have been put on the reform agenda. In any case, a comprehensive tax reform does not necessarily rule out the necessity for incremental follow-up measures. A big bang tax reform might create new loopholes, it might need to be corrected or amended subsequently, or it might exacerbate existing distortions that were not tackled by the original reform plan. The further "fine-tuning" of the tax reform will then require incremental tax reform.

A sequenced approach to reform may also better suit politicians with an eye on the electoral calendar. A comprehensive tax reform, even if it is implemented at the beginning of the electoral cycle, might take longer than four to five years to generate visible gains. Because politicians run then the risk of not being rewarded for the reform at the next election, they might prefer to follow the incremental approach, especially if there is a substantial probability that the next government in power will reverse the tax reform. Reforms that are more difficult to design, for which it takes longer to obtain sufficient political support and that take longer to implement might therefore be enacted first.

Whether reforms are comprehensive or incremental, some transitional arrangements may be needed

Governments may sometimes allow for "grandfathering rules" that allow the old tax rules to continue to apply to some existing situations while the new tax rules will apply to all future situations. This strategy might be considered if agents no longer have the opportunity to adjust their behaviour in response to the new tax rules because they are, for example, already retired and therefore no longer have the opportunity to adjust their labour-market behaviour. However, grandfathering rules that are not well targeted will reduce the gains that can be realised by reforming the tax system, particularly if agents are able to take actions that will lock in the old rules. Moreover, grandfathering rules increase the complexity of the tax code, which results in increased compliance and enforcement costs. They can create tax-evasion opportunities where new and old rules co-exist and they may reduce the revenues gains from fundamental tax reform. The old rules might be phased out over time, implying that after a number of years only one set of tax rules will apply. Government would then have to decide upon the proper length of this phase-out period.

Governments need to be careful not to implement transitional or other temporary policies that will in fact be difficult to reverse. The removal of special tax treatment for particular groups can be difficult, even if it was never intended to be permanent, because of pressure from those who benefit from special treatment. Temporary measures thus have a tendency to become permanent. However, the introduction of temporary tax measures can be beneficial in particular circumstances. If a government does introduce temporary measures, it might be advantageous to include the expiry date in the original legislation (sunset provision or clause). The special tax treatment can, of course, be confirmed by law for a new period of time if need be, but it will be harder to lobbyist to resist a return to the *status quo ante*. This approach signals the temporary nature of the special tax rules.

Much depends on the quality of the institutions charged with reform design and implementation

Bird (2004) discusses different strategies for "institutionalising" the process of tax reform. The recommendations in this section largely reflect the analysis in Bird (2004) and his review of McIntyre and Oldman (1975). The latter argue that countries that put in place appropriate institutional arrangements for tax reform would both improve the quality of tax reforms proposed and increase the likelihood of their adoption and successful implementation. Appropriate institutional arrangements are necessary in order to ensure the adequate drafting of the tax legislation, the collection and analysis of relevant tax and other data, proper tax-reform planning and effective communication with the broader public. They argue that better planning will increase political support through improved transparency and public understanding. It will be possible to make changes in reform proposals for political (or other) reasons more quickly, while at the same time remaining faithful to the underlying objectives and rationale of the reform. It is easier to resist politically appealing and populist arguments against reform where proposals are backed up by high-quality tax-policy analysis. Moreover, politicians introducing reforms will have more control of the process in terms of timing and presentation.

Good institutional planning of fundamental tax reform is a precondition for its successful implementation. However, it is also necessary for improving both the design of the many technical rule changes that might have to be made to accommodate tax rules to the changing environment (Bird, 2004). Moreover, good planning is also important to prevent the implementation of tax rules – or small changes to these rules – in ways that undermine the proper functioning of the tax system. Effective tax analysis departments can help reduce the uncertainty about the outcome of reform. Governments with tax reform ambitions therefore need to provide adequate resources for the development and maintenance of tax models that can provide good quality analyses of the impact of tax reform on agents' behaviour and tax revenues and by investing in the human capital of its staff. Governments might also want to share the results of this work with the broader public on a continuous basis. Tax analysis departments then have the opportunity to establish credible reputations for providing high-quality work. Fundamental tax reforms that take into account the recommendations of the tax analysis department might then become easier to implement.

Governments might also ask independent bodies to calculate the effects of tax-reform proposals on firms' and households' behaviour, tax revenues, income distribution, etc. Alt, Preston and Sibieta (2008) argue that external organisations – whether domestic or international – provide some level of scrutiny and accountability. This can help improve the draft legislation and make it more likely that the economic impact of reform proposals is fully thought through.

Policy advice could also be provided through specific tax-policy reform committees and commissions, such as the Tax Commission in Denmark, which has set a new benchmark to form a basis for the political negotiations on the 2010 tax reform (Box 4.5). The membership of such a committee may consist of academics and experienced politicians of high political stature, as well as senior officials. Their recommendations may provide valuable inputs to the tax reform process and might help sell the tax reform proposals to the legislature and the general public.

The transparency of tax reform processes can be a crucial factor

The way that taxation and public spending are perceived by the public or reported by the media may be decisive in winning public support for a particular tax reform. However, voters are typically imperfectly informed and they do not often have the information and/or skills needed to assess the effects of tax policies. Imperfect information may allow politicians to run their own agendas, which may not be in line with the preferences of the median voter.[8] At the same time, it may also induce voters and other political actors to block beneficial tax-policy reforms. A proper tax-reform communication strategy and a dialogue with business, unions and other social partners, special interest groups, academics and the broader public may help to overcome the obstacles to the implementation of fundamental tax reform. Clear communication about tax-reform objectives and measures might facilitate the creation of a broad social consensus that favours the introduction of these reforms. A proper communication strategy will also help if the impact of the tax reform turns out to be different than foreseen. It will help to point out why the outcome could not have been foreseen and to explain why the outcome differs from the expected outcome.

Box 4.5. **The 2010 tax reform in Denmark**

In Denmark, a Tax Commission was appointed in early 2008 with a former minister for taxation as chair and a number of primarily academic tax experts as members. The Tax Commission met academics, representatives of business and industry, labour leaders and OECD officials during the first six months of its work. On 2 February 2009, the Commission's presentation of its report on tax reform was broadcast live on television. Tax cuts and financing were around DKK 36 billion, corresponding to approximately 2% of GDP. Three weeks later, the government put forward proposals based on the Commission's recommendations, and on 1 March, a political agreement on the 2010 tax reform was reached. Some of the more controversial elements of the Commission report were either modified or dropped from the final proposals. The total value of the reform was also reduced to around DKK 30 billion. The changes made to the Commission proposals were mainly due to concerns about distributional issues and the burden on the business sector. However, the inclusion of some relatively ambitious and controversial elements in the Tax Commission proposal was important to the end result. It might be argued that the Commission proposal set a new benchmark for the tax system, on the basis of which political negotiations could proceed.

In structuring the tax reform, the authorities sought to balance financing and tax cuts among groups of taxpayers that were, or might be perceived as being, connected. This had much to do with the perception that the reform was fair and acceptable. First, the top marginal PIT rate was cut by 5.5 percentage points, while the tax threshold was increased. These measures were financed by cutting the tax value of interest deductions in excess of DKK 50 000, by introducing a limit to yearly tax-favoured pension savings and a tax on large pension income, and by reducing tax expenditures for business and industry. Secondly, the government followed a similar strategy by connecting a reduction in the bottom PIT rate and the introduction of "green cheques" (a standard cash transfer) with general increases in energy and environment taxes and reductions in the tax value of deductions of expenses like labour union fees and commuting expenses.

The most important issue in the public debate following the Tax Commission was the proposed reduction in the tax value of interest deduction in personal income taxation by 8 percentage points; a measure which was needed in order to finance a substantial part of the tax cuts. The government was able to implement this tax reform measure by building several safeguards into the reduction. First, the reduction of the tax value from 33.5% to 25.5% is to be phased in gradually from 2012 to 2019, while the tax cuts are taking effect from 2010. Secondly, the reduction is only effective for the interest deductions in excess of DKK 50 000 (DKK 100 000 for married couples) a year. This threshold is nominally fixed and thus will be gradually reduced in real terms. Finally, a special compensation scheme was introduced whereby individuals are to be compensated if the loss from the reduced value of interest deductions (and other personal deductions) exceeds the gain from the cuts in the PIT. Overall, the success of the reform owed much to its reliance on a rate reduction and base-broadening approach that balanced tax cuts and financing within broad income groups. The distributional analysis that underpinned the reform proposals focused not only on the immediate impact of the reform, but also on its longer-run distributional impact, which made it possible to take into account the longer-run tax reform efficiency gains. In addition, the timing of the tax cuts and financing was important in light of the international economic crisis. The emphasis on improving fiscal sustainability in light of the crisis therefore worked to implement this fully financed tax reform.

Governments might inform stakeholders of how tax revenues are spent, for example, by including such information with the tax returns that citizens must complete. This strategy might be followed at all levels of government. Such information sharing could be done on a regular basis and not only when governments plan to raise taxes. Information sharing will also help to build tax morale and improve tax compliance. Many taxpayers might lack proper knowledge of which taxes are levied and why. For instance, in many countries, a large part of the tax burden on labour income consists of social security contributions levied to finance social security benefits (pensions, unemployment insurance, health insurance, etc.). Taxpayers are not necessarily perfectly informed about the level of these social security contributions, especially when employers pay a large share on their behalf.

Transparency is also a key element of government accountability. Governments and politicians are accountable to citizens (voters) for their performance in general and for the effective and efficient use of public resources in particular. Increased government accountability will weaken political incentives to manipulate tax and expenditure policies for purposes of electoral gain. Moreover, periodic assessments of existing policies – and clear communication about these assessments – may enable governments to make well-informed decisions concerning ineffective or outdated policy measures that need to be eliminated and to strengthen and update those that are retained. This need for periodic reviews, including tax expenditure reporting (Box 4.6), has been reinforced by the fiscal imbalances resulting from the international financial crisis.

Box 4.6. **Tax expenditure reporting**

Fiscal information is critical to the overall transparency of tax policy. Yet substantial gaps often exist. In general, governments provide sufficient documentation regarding taxes collected and direct spending, mainly through the budget documentation. However, the publication of comprehensive information on spending through the tax system (tax expenditures)[1] is an area for potential improvement in many OECD countries (OECD, forthcoming). Many have no provision for systematic reporting of tax expenditures. Tax expenditures (TEs) have a significant effect on overall tax burdens and also on the budget (due to the tax revenue forgone). They also reduce fiscal flexibility, due to the opportunity cost of the revenue forgone. At the same time, TEs contribute to the growing complexity of the tax system and thus tend to raise administration and compliance costs. In contrast to direct spending programmes, tax provisions are not generally submitted to periodic scrutiny and they may be largely "invisible" to the electorate at large. However, like any other tool for achieving policy goals, TEs can be put to good use or abused.

Many OECD and non-OECD countries produce and publish regular tax expenditure reports, which include a list of their main tax provisions and estimates of the cost of such reliefs in terms of tax revenue forgone. Some governments even bring TEs into the budgetary process. However, systematic and periodical assessments of the effectiveness and efficacy of TEs are still the exception rather than the rule in most of the OECD. Greater transparency of and accountability for TEs might be ensured by reporting better information on their rationale, objectives and performance. If properly designed and implemented, a TE report makes tax expenditures more transparent by providing information on the government's use of public resources and whether these measures are achieving their intended purposes and designed in the most efficient and effective manner. A TE report also encourages accountability by enabling policy makers, voters and other political actors to evaluate individual tax expenditures – in terms of their net social benefit and distributional impact – and to make well-informed decisions about whether to eliminate or continue them. Finally, a TE report contributes to the management of budget allocations and the overall fiscal position by estimating the opportunity cost of these reliefs in terms of higher taxes, reduced spending and/or higher deficits.

1. A tax expenditure can be seen as a public expenditure implemented through the tax system by way of a special concession (exclusion, exemption, allowance, credit, preferential rate or tax deferral) that results in reduced tax liability for certain groups of taxpayers (Altshuler et Dietz, 2008).

That said, talk can be cheap (Olofsgard, 2003), and one-line slogans may catch the public's attention but are not necessarily a reflection of the truth. Tax-reform discussions are complicated and cannot always be summarised in short, pithy statements. Governments that want to introduce complicated tax reforms will therefore have to adapt to the modern media landscape which seems to provide less opportunity for deep analysis and discussions. Tax-reform discussions within parliaments are therefore still very important. Dialogue on the substantial tax reform measures with business, unions, etc. also helps to signal the quality of the reform and the reform intentions of the policy makers involved.

Co-ordination of reform across levels of government is important

Sub-central governments in many countries are seeking additional resources for improving the services they provide; channelling these demands into the path of fundamental tax reform is a policy challenge. This strategy could help sharing the burden of tax reforms between the different levels of government, making the implementation of reforms more politically acceptable. Many obstacles to do so could be envisaged, but a justification of tax reform based on the need to be closer to citizens could actually contribute to the success of the tax-reform process.

It is clear that fiscal federalism could complicate matters, but it may also provide new opportunities to have a more globally efficient tax system. For instance, the assignment of a country's taxing powers to the appropriate institutional level might imply that taxes could be reformed in a more efficient and equitable way. Blöchliger and Petzold (2009) have discussed the criteria for assigning particular taxes to different government levels. They write:

> *The conditions for a sub-central tax to be growth-enhancing are the same as for a national tax, but some additional constraints apply to make a "good" sub-central government tax. There is quite a broad consensus on what makes an effective sub-central tax mix. As a basic principle, sub-central government should rely on benefit taxation,* i.e. *taxes that provide, for households or firms, a link between taxes paid and public services received (Oates and Schwab, 1988). The criteria derived from this principle include: sub-central government taxes should be non-mobile and non-redistributive (to avoid tax erosion), non-cyclical (to avoid sub-central government running stabilisation policy through debt and deficits), should not be exported to other jurisdictions (to avoid distortions in the tax burden), and the tax base should be evenly distributed across jurisdictions (to avoid strong disparities and/or the need for huge fiscal equalisation systems). Based on these criteria, the property tax would occupy an even more prominent place in the sub-central than in the central tax mix, particularly for local governments (King, 2004). Sub-central personal income taxes would lose out because of their redistributive properties, and sub-central consumption taxes, especially sales taxes, would lose because they divert taxes among jurisdictions. Sub-central corporate income taxes come last: corporate tax revenue is mobile, highly cyclical, geographically concentrated and tends to shift the tax burden to non-residents.*

In assigning particular taxes or discretionary powers on rates and/or bases fully or partially to sub-central governments, it is important to avoid stimulating regions to compete in a harmful way. A compromise must be achieved between the possible gain in efficiency as a result of a higher level of tax decentralisation and the need for a coherent and non-distortionary tax distribution. Discretionary control over a particular tax base could also have important trade-offs between efficiency and compliance/administration costs for the whole tax system. Discretionary control over tax rates may be provided within tax bands; that is, states/regions are given the freedom to change rates within these bands. This should ensure that the overall links between taxes levied at different levels are maintained, *e.g.* that CIT rates are not reduced too far below the top PIT rate or that taxes on owner-occupied housing are not too far above or below the tax burden on other investment opportunities, at the cost of limiting the sub-central discretionary powers on taxes.

The co-ordination of tax reforms between different regions is important. There is a need for different levels of government to act coherently. Any tax reform must take into account existing taxes at the federal and sub-central level and shared tax agreements. This implies that the impact of tax reforms on other regions or levels of government is considered. Governments should create appropriate institutional settings that allow for tax reform evaluations across levels of government and regions. There might also a need for mechanisms that allow for inter-regional compensation, for instance if particular federal tax reforms have a positive impact on some, but a negative impact on other regions.

Successful reform requires strong leadership

The implementation of fundamental tax reforms might require a political champion who can create circumstances that are favourable to their implementation. A political champion will recognise when there is a tax reform momentum and use this opportunity to introduce a tax reform. Bird (2004) states that the essential requirement for successful tax reform is a strong political will exemplified by one or more political champions who are prepared to put their reputations on the line. Their involvement will very likely increase the support for fundamental tax reform. In order to obtain sufficient political support for fundamental tax reforms, politicians may want to identify the winners and losers and the degree to which voters will win or lose as a result of the tax reform. Clear communication about winners and losers might be especially important for the implementation of fundamental tax reforms if many taxpayers think they will lose while they effectively will not (or not as much as they expect). In fact, the need for providing good quality information becomes more important the higher the costs for taxpayers to collect information.

Another strategy that may help introduce fundamental tax reform is to focus on the inequities of the current tax system. This may persuade voters that tax reform is necessary. For instance, levying reduced property taxes on out-of-date housing values will imply that some taxpayers that are entitled to be taxed at the reduced rate cannot benefit from this provision. Focusing on this inequity, politicians might build support for reassessing the property values of all houses. Here, too, the quality of information available to politicians and the public may be critical to prospects for "selling" the reform. Detailed reporting of the cost of tax expenditures, for example, may strengthen the case, on equity and other grounds, for reforms aimed at simplifying income taxation, in particular.

In the absence of sufficient political support, politicians may want to adjust the original tax reform proposals in such a way that political support increases. For example, a larger part of the tax reform benefits could be allocated to the losers from reform or they could receive offsetting benefits through the reform of other policy measures. Compensation will, however, only be necessary if the tax reform losers have the political clout to block reform or are considered to be the swing voters in the next election. It may also be warranted on equity grounds, if there is a widespread public perception that the benefits they may be losing were in some sense justified. The compensation of losers will divert the benefits of reform towards particular groups of voters. Compensation packages might then reduce the overall tax reform gains. Policy makers might therefore have to trade off the benefits of compensating losers in order to obtain sufficient political support against the costs as a result of the reduction in the overall tax reform gains for society. If too many voters will have to be compensated in order to be able to implement the tax reform, it might even be more beneficial not to implement the fundamental tax reform.

Barbaro and Suedekum (2006) argue that symmetric tax reforms – the same individuals gain and lose as a result of the fundamental change in the tax mix – are easier to implement than asymmetric tax reforms where the winners and losers are not the same individuals. An asymmetric cut in tax privileges might hurt a relatively small group of taxpayers strongly while a large group will be affected positively. Assuming a revenue-neutral tax reform, their gain might be small and have therefore no impact on their voting behaviour. The group of taxpayers that loses substantially faces a strong incentive to lobby hard against the reform. However, if the benefits and costs of tax reform are diffuse, there is a lower probability that new interest groups will be formed. Barbaro and Suedekum (2006) therefore conclude that tax reforms that share the burden of forgone privileges evenly among many groups or, alternatively, compensate losers for their losses, have the greatest probability of being implemented.

Politicians might try to link explicitly the abolition of a tax expenditure that is inefficient and beneficial only to some taxpayers with the introduction of tax measures from which most taxpayers will gain. This strategy might make the silent majority awake because they explicitly gain if the new tax policy is introduced, though it is likely to remain the case that the gains of the many will, at an individual level, be small compared to the losses of the minority.

Making fundamental tax reform happen in light of an economic crisis: concluding remarks

Strategies to overcome the obstacles to fundamental tax reform are of special interest because of the global financial and economic crisis. On the one hand, it is sometimes argued that the crisis might facilitate tax reform. The political economy obstacles to reform might be easier to overcome during a crisis, especially because of the increased pressure to raise more tax revenue in order to restore public finances and because of the pressing need to put economies back on a high-growth path. Olofsgard (2003) argues that a crisis might make the implementation of tax reform more likely, because it undermines the power of vested interests and it might imply that opponents of reform may change their perspective because they start to gain from reform as well. He argues that a crisis might create a sense of urgency, opening a "window of opportunity" for fundamental tax reform that would otherwise have been blocked. Harberger (1993) argues that a severe crisis may be necessary in order to convince policy makers that their view of what is "good" tax policy may not be entirely correct, that there are other alternative tax systems available and that fundamental tax reforms are necessary.

On the other hand, the crisis might make fundamental tax reform even more difficult to implement, especially because large groups of taxpayers have been, and will be, strongly affected by the crisis. The analysis in this chapter might therefore be helpful to explain why some countries are able to engage in fundamental tax reforms in times of a crisis while other countries face more difficulties in doing so, providing insights that might be useful to all countries in implementing fundamental tax reforms in the future.

Notes

1. Horizontal equity from a tax perspective implies that taxpayers in an equal situation should be taxed in an equal manner, as they have the same ability to bear the tax burden. The tax policy objective of vertical equity prescribes that taxpayers with better circumstances should bear a larger part of the tax burden as a proportion of their income. Vertical equity thus implies that the distribution of after-tax income should be narrower than the distribution of before-tax income, or that the average tax rate should be increasing in income (OECD, 2006).
2. More information on the definition of such practices can be found on the website of the OECD's Centre for Tax Policy and Administration: *www.oecd.org/ctp* under the heading "harmful tax practices".
3. In 1988, for example, the UK government's announcement of changes to the rules governing mortgage interest relief at source, which were to take effect only four months later, triggered a rush to complete mortgage deals before the change entered into force. As a result, an already over-heated housing market was pushed still further, only for the boom to end in a house-price bust a short time later.
4. Of course, tax is only one issue among many determining voters' choices and it is by no means always the most salient, although elections may sometimes turn on major tax reforms.
5. Countries that have successfully implemented fundamental tax reform in the past would not necessarily have been successful given different (economic, budgetary, political, etc.) circumstances. Likewise, countries that have not been successful in implementing fundamental tax reforms in the past may successfully implement them in the future.
6. At least this is what standard voting models seem to imply. Policy makers may of course also provide benefits or tax reductions to taxpayers purely on equity grounds, for instance, even if they know that this will not (strongly) affect these taxpayers' voting behaviour.

7. In contrast, when the executive is sufficiently powerful to exploit divide-and-rule tactics *à la* Dewatripont and Roland (1992), as discussed later, then the gradual strategy might allow an earlier start to the reform process.

8. In some cases, however, imperfect information might allow policy makers to introduce controversial tax reforms that are in the general interest.

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Chapter 5

Making reform happen in environmental policy

by Paul Ekins and Roger Salmons*

This chapter seeks to identify lessons that may be of use to policy makers seeking to advance environmental policy reform. Owing to the breadth of this field, it considers reforms in a number of environmental policy domains that are relevant to a number of different OECD countries. They include energy and climate change, water allocation and pollution, waste management, agriculture and fisheries. In many OECD countries, these environmental topics have been the subject of policy reform rather than just incremental change, but the reforms that have been so far implemented are far from complete, so they provide a suitable study focus for this chapter.

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The discussion which follows considers the full range of environmental policy instruments available to policy makers, but it is especially concerned with the challenge of implementing economic policy instruments. Policy reform (as opposed to incremental change) in the environmental arena almost always requires the use of economic instruments, albeit often in conjunction with other instruments. This may be due to the central place in environmental economics of the concept of the "externality", with the advice that this should be "internalised" into the price, and the most obvious and often the most efficient way to this is through an economic instrument. It is probably also due to the fundamental role played by prices in a market economy. While it is possible to conceive of fundamental change coming about without the influence of market forces, in reality this very rarely occurs, and the most direct way of influencing market forces is through changing prices.

The chapter proceeds as follows. The first major section lays out the major issues that affect receptivity or opposition to environmental policy reform. Unusually, perhaps, for a discussion of the political economy of policy reform, it begins with a look at the role of evidence and analysis – reflecting the fact that much of the pressure for environmental policy reform arises not from the complaints of agents currently suffering the consequences of the status quo, but from forward-looking scientific analyses of the impact of human activities over a long time horizon. This is followed by a relatively simple sketch of other influences on behaviour and the policy process and a look at environmental policy processes. Five cases of environmental policy reform are then analysed in some detail in order to assess the impact of some of the factors that appear to explain the success, or failure, of environmental policy reforms. The case studies cover five environmental policy areas, and a range of different policy instruments. In each case, the main drivers for reform are identified together with the institutional context; the main features of the reform are described and the outcomes summarised; and the key factors explaining the implementation and success of the reform are isolated.[1] The chapter then addresses directly the major factors facilitating or impeding reform, with particular reference to the case studies, but drawing also on the wider literature on environmental policy reform. This synthesis is followed by a brief conclusion.

Context and instruments

Scientific uncertainty often reinforces resistance to reform

The availability and robustness of evidence – data and information – are crucial and often problematic factors in environmental policy making. Environmental systems are complex, providing special problems in the policy arena for the generation of the information itself; for the public awareness and understanding of it; and for confidence about the outcomes of environmental policy. Successful environmental policy making relies on robust environmental information systems. The provision of such systems can be expensive, and the relevant costs need to be taken into account in the consideration of policies in different areas. In complex areas of policy making, where the stakes are high, it is to be expected that much of the evidence itself will be contested by stakeholders for whom it is inconvenient, and considerable efforts will be made to generate "evidence" which is more convenient for the interests concerned.

Evidence needs to be analysed and interpreted, and there is a wide range of possible analytical techniques. The natural economic choice of analytical technique is cost-benefit analysis (CBA). However, the use of CBA in environmental policy raises a number of difficult issues (Foster, 1997). Quantitative analytical techniques in general, and CBA in particular, find it difficult to adequately treat the ethical dimension of environmental policy making, which may make them controversial or inappropriate. Issues where this dimension is prominent may be more amenable to participatory and deliberative forms of analysis (Stagl, 2006), which may in turn lead to what Zerbe and Dively (1994) have called a "cost-oblivious" model of environmental decision making. For example, environmental regulations for safeguarding human health are often formulated with regard to maximum permissible health impacts. Agents in breach of these regulations cannot defend themselves by showing that the benefits derived from so doing exceed the costs of the damage incurred, however great the margin between cost and benefit. Similarly, a policy discourse conducted in terms of rights and responsibilities may have little place for the balance between costs and benefits. Widely held ethical norms of this kind may become entrenched in institutions which become part of the cultural landscape, and which may be difficult to change. Indigenous land rights are one example which may have significant environmental implications. Absolutist views on the conservation of biodiversity may become similarly institutionalised.

Moreover, the idea that all important environmental impacts can be expressed in terms of monetary costs and benefits may be challenged. For example, possible intrinsic values of species, the intergenerational implications of discounting, or the possibility of valuing long-term effects on behalf of future generations, are all issues that have been raised in this context. Even if it is accepted that CBA may be appropriate in a particular context, there may be conflict over the means of valuation to be employed. Many environmental impacts are not immediately expressed in monetary values, and the techniques of monetisation that need to be used to generate such an expression may themselves become the focus of conflict and confuse rather than clarify the various arguments around policy reform. When generally accepted, however, the results of CBA are valued, and can be very influential in policy formulation, because they have a claim to social optimality and can therefore reduce the need for further analysis. Given the uncertainties involved in CBAs of complex issues, different interests may seek to generate and promote different CBAs of the same issue (see *e.g.* Lesser, Dodds and Zerbe, 1997). Moreover, most CBAs take an aggregate view of costs and benefits, and do not distinguish between different distributional outcomes, so even an uncontested CBA method may not be acceptable to those for whom distributional outcomes are important.

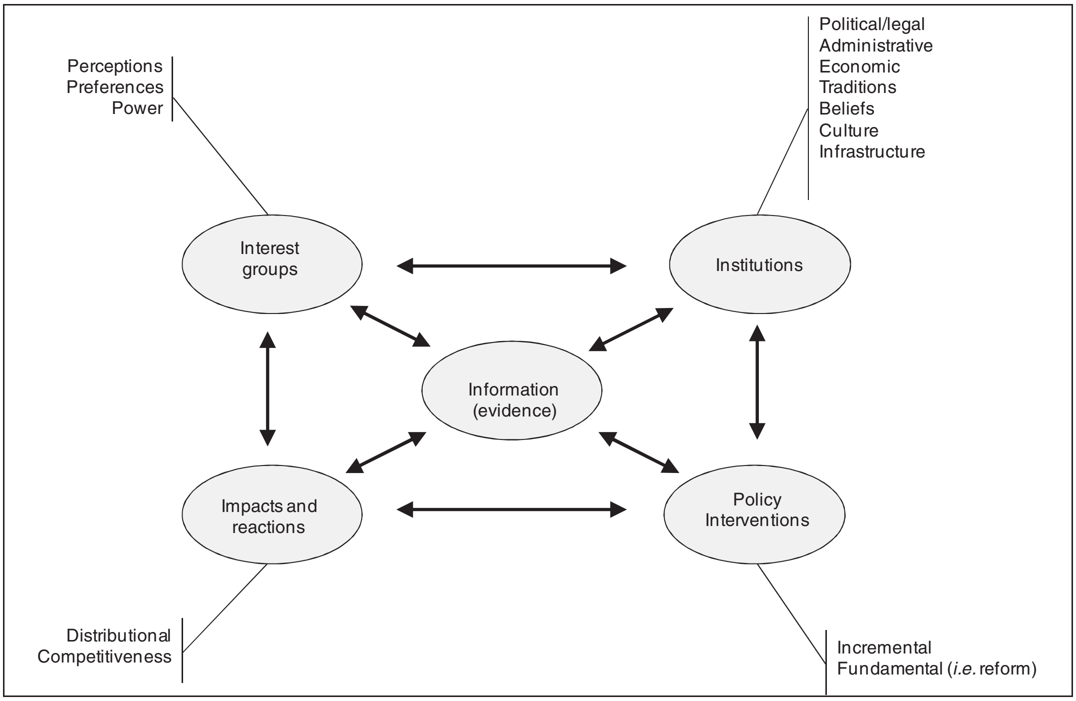
The choice of analytical technique, therefore, is far more than just a technical decision. Clearly it needs to be technically appropriate and robust, but it also needs to secure public acceptance. Any policy-making situation with significant distributional impacts is likely to be hotly contested, and it can be a major barrier to reform if the analytical approach and results become a major focus of debate, rather than the policy itself.

Agents' views of environmental policy reform also reflects institutions, interests and incentives

The crucial interactions between the influences on behaviour and policy formulation may be illustrated as in Figure 5.1. The elements of the web it depicts are inter-related and interactive, and all of them need to be addressed simultaneously for any desired policy reform to be successful. Each of the influences on behaviour which drive these interactions will be briefly discussed in turn.

Relevant information is at the centre of all the interactions between policy makers, interest groups and institutions. Each contending group will present information which justifies its favoured approach as evidence, and will seek media amplification of those aspects of the information which it regards as particularly supportive of its position. It is to be expected that the validity of the information will be contested by all those who find it unfavourable to their point of view. The general mistrust of government means that even those policy makers who seek to promote the public interest will find that the information they generate is likely to be received sceptically and scrutinised for evidence of personal interest.

Figure 5.1. **Influences and interactions in the policy-making process**



Institutions have political, legal, economic and cultural expressions that may include deeply embedded traditions and belief systems. Because they often arise from, or reflect, deep social and cultural norms, institutions can be very resilient and, if they are opposed to the policy reform being considered, they can act as formidable barriers to it. At the same time, because they are often resilient and long lasting, society can change round institutions so that they become anachronistic, such that with the right impulse they can be swept away quite quickly. Those seeking policy reform need to become adept at institutional analysis, identifying those elements supportive of, or hostile to, the reform in question, and work to strengthen the more supportive elements and weaken the more hostile ones. Box 5.1 uses the experience of the United Kingdom in greenhouse gas mitigation policy to illustrate the kinds of institutional reform that may be required in order to facilitate widespread change in relation to a complex and pervasive environmental problem.

As the physical manifestation of important institutions, infrastructure tends to be systemic and long lasting, and to facilitate or discourage certain types of behaviour, which then may become habitual and difficult to change, especially when they coincide with powerful individual preferences (which may be why the infrastructure was constructed in the first place). For example, a strong preference for personal mobility has led some industrial societies to construct good roads, but poor public transport networks. This reinforces dependence on private motor cars, which will in turn make policies intended to reduce that dependence costly or unpopular. Such policy is likely to require the provision of alternative infrastructure to facilitate a mode switch.[2] Simply maintaining infrastructure is expensive; drastically changing it can be much more so. It is therefore helpful when policy reform is aligned with cycles of infrastructure renewal, so that the new infrastructure appropriate to the reform can replace the old at the end of its life.

Box 5.1. Institutional reform for the reduction of greenhouse gas emissions in the United Kingdom

The United Kingdom has engaged in significant institutional reform in order to address the challenges of reducing greenhouse gas (GHG), and especially carbon, emissions:

- *Departmental organisation in central government*: in 2008 a new government department was created, the Department of Energy and Climate Change (DECC), out of the climate change division of the Department of Environment, Food and Rural Affairs (DEFRA) and the energy group of the Department of Business Enterprise and Regulatory Reform (BERR).
- *Cross-government co-ordination*: the Office of Climate Change (OCC) was set up in 2006 to support analytical work on climate change and the development of climate change policy and strategy across a number of government departments, including DEFRA, BERR, the Foreign Office and the Departments of Transport, International Development and Communities and Local Government. Its role following the creation of DECC is not clear.
- *Legislation*: the Climate Change Act has adopted a statutory GHG emission reduction target for 2050 (80% below 1990's level by 2050) and provides for the adoption of statutory five-yearly "carbon budgets" from 2008 to define the trajectory to meet the targets.
- *Independent advice*: the Committee on Climate Change (CCC), a non-departmental public body, was set up in 2008 in order provide advice on the carbon targets and budgets. It recommended the 80% reduction target (which was then put into the legislation) and has recommended the first three carbon budgets, which are awaiting the government response.

An important purpose of these institutional changes has been both to ensure that all arms of government are aware of, and respond effectively to, the high-level commitment to reduce GHG emissions, and to place external pressure on the political process to develop and implement the strong policies that will be necessary to meet the targets. With the exception of its Kyoto target, which will be quite easily met, the UK government does not have a good record in meeting targets relating to climate change mitigation – its targets for 2010 for carbon emission reduction, combined heat and power (CHP) and renewable electricity generation seem very likely to be missed by a large margin. It remains to be seen whether this new institutional architecture is able to improve on this performance.

From an environmental policy point of view, it may be considered encouraging that few people actually have inclinations to destroy the environment for the sake of it. There is therefore no strong preference in this direction that needs changing. However, it is unfortunately also the case that few people actually seem to value the environment very highly for itself, and therefore there are few inhibitions about impacting negatively on the environment when this occurs as a side effect of an activity or experience for which people have a strong inclination. Because people's inclinations can have strong roots in their values, and because expressed inclinations often get transformed into habits, they can be very difficult to change.

Institutions are the organisational equivalent to inclinations. Like most people, organisations do not usually engage in environmental degradation for its own sake. However, organisations have purposes, and an important purpose for commercial organisations, at least, is making profits. It is unfortunately rarely the case that, other things being equal, taking care of the environment enhances profitability, while not taking care of it may very often do so. Where taking care of the environment involves additional costs, commercial organisations may be expected to oppose policies that encourage or force them to do so. They may often frame their arguments in terms related to the wider interests of society, such as jobs or international competitiveness, and these arguments will have a certain force. However, environmental economic theory is quite clear that organisations (and individuals) should not do more damage at the margin than the marginal benefit generated by their activities. Where their operations cause damage to those who are not benefiting from them, they may come under pressure to pay compensation or to cut back their operations further. Whether this occurs will then depend on the relative power of the competing interests, because not all social interests are expressed equally powerfully.

A very important purpose of policy reform is often to change agents' perception of their own self-interest by altering the incentives they face so as to increase the costs of environmentally harmful action (for example, an environmental tax), to reward environmentally-friendly behavioural change (a subsidy), or to introduce penalties for certain behaviours (a regulation). The form and nature of the incentive to be introduced is the subject of instrument choice, which is discussed in the next section.

The choice of instruments depends on the kind of policy challenge to be addressed

Different kinds of policy instrument may be needed to bring about different kinds of behavioural change. Jordan, Wurzel and Zito (2003) employ a four-category typology of policy instruments:

- Market-based instruments include "emissions trading, environmental taxes and charges, deposit-refund systems, subsidies (including the removal of environmentally-harmful subsidies), green purchasing, and liability and compensation" (EEA, 2006). These instruments aim to affect incentives and interests directly. Sometimes, as with emissions trading schemes, these instruments also require new institutions.

- Regulatory instruments seek to define legal standards in relation to technologies, environmental performance, pressures or outcomes. These instruments impose penalties on actors who fail to meet the standards, and therefore also affect incentives, though less directly than market-based instruments. They also normally require new institutions to administer and enforce the regulations.

- Voluntary agreements between governments and producing organisations may be accepted by the latter in order to forestall the introduction of regulation or market-based instruments (see ten Brink, 2002 and OECD, 2003a for comprehensive discussions). The penalties associated with failing to keep to the agreement affect incentives. These instruments also often require quite complex institutional arrangements to monitor their effectiveness.

- Information-based instruments like eco-labels may be mandatory or voluntary. These instruments obviously seek to provide information to promote behaviour change.

As noted in OECD (2007a), in complex policy situations where there are a number of influences on behaviour, it may be necessary to introduce a package of different instruments in order to enhance their overall effectiveness. The theoretical rationale for instrument mixes derives from the fact that "most environmental problems are of a multi-aspect character" (OECD 2007a). Environmental impacts from the same substance or activity may vary across space (*e.g.* ecosystem, medium, topology, human population) and time (*e.g.* season, weather). It is also the case that environmental issues interact, so that, for example, water-security policies may need to include policies for the adaptation to, and mitigation of, climate change, as well as the provision and protection of water resources.

Multiple instruments may also be required to correct multiple market failures. For example, an economic instrument that affects prices will not be effective if consumers are not aware of prices, or the means by which they can respond to price increases.[3] That said, instrument mixes are not always either necessary or efficient (OECD, 2007a). As a general rule, though, environmental policy reform (as opposed to incremental change) is likely to require some mix of policies, and some effort should be expended to examine the rationale both for the different instruments to be put into the mix, and for their combination. Some of the relevant issues are considered in the brief case study of the UK waste policy presented in the next section.

Case studies in environmental policy reform

Water effluent charges in the Netherlands[4]

By the late 1960s, the Netherlands was suffering from a substantial deterioration of surface water quality, with the load of organic pollutants causing acute oxygen problems. Large amounts of heavy metals, pesticides, hydrocarbons, and organic chloride compounds were being discharged, causing deterioration of water quality, sediment pollution and the loss of indigenous species. The problem was serious enough to jeopardise the use of water resources for human activities.

The Netherlands has a long-established and robust institutional framework for water management, based on a system of regional water boards, comprising elected members who represent the different categories of stakeholders. Though supervised by the provinces, the water boards have a high degree of operational and financial independence. Traditionally, the boards were responsible for flood protection (*e.g.* dykes, etc.) and water quantity management (*e.g.* drainage and irrigation), with these activities being financed by a water board charge levied on the beneficiaries of these services.[5] However, from the 1950s, they had started to get involved in water-quality management. Water policy was (and still is) the responsibility of the Directorate-General for Public Works and Water Management (Rijkswaterstaat [RWS]),[6] and the 12 provinces. The Rijkswaterstaat was responsible for the management of state waters, while the provinces were responsible for the management of regional waters, but in all cases, the responsibilities had been delegated to the water boards. Within the Rijkswaterstaat, the Institute for Inland Water Management and Waste Water Treatment (RIZA) played a significant role in the national supervision of industrial pollution, conducting research and providing advice on water-pollution control.

In response to the deteriorating environmental conditions, the Pollution of Surface Waters Act (PSWA) was introduced in 1969, coming into force in the following year. The PSWA was the country's first law on water-pollution control. It defined institutional responsibilities for water-quality management and introduced two pollution-control instruments – discharge permits and wastewater-discharge levies. The water boards were reorganised on hydrological principles (to reflect natural watersheds and river systems) and were made responsible for the quality of local waters; while the RWS was given responsibility for state waters (principally the Rhine and the North Sea). A system of levies was introduced for all discharges to surface waters and to the sewerage system – payable either to the local water board or to the state. While it was not a formal objective at the time of their introduction, it was foreseen that the charges might incentivise dischargers to reduce pollution loads. The objective of the levy was to recover the cost of surface water quality management and wastewater treatment rather than to reflect the marginal damage caused by the discharges. However, the levies conformed to the "polluter pays principle" in that they applied to all discharges and were based on the actual pollution load.[7] The funds generated by the state water levy were used to provide subsidies for industrial companies that reduced pollution loads.

The introduction of PSWA had a significant impact on water-pollution levels in the Netherlands. From 1970 to 1987, pollution of oxygen-binding substances was reduced by 80%, in spite of increased economic activity. Reductions were especially significant for companies discharging to state waters, reflecting the earmarking of revenues for pollution-control subsidies and the supporting activities of RIZA. Between 1970 and 1989, over 70% of industrial investments for water-pollution control were financed by subsidies provided from the state levy. Furthermore, the outcome was more cost-efficient than in neighbouring countries (*e.g.* Denmark) because more pollution was controlled at the source, reducing the need for costly end-of-pipe treatment at public sewerage plants.

The introduction of effluent charges under the PSWA in the Netherlands was highly successful – both in terms of its environmental effectiveness and its economic efficiency. There are a number of factors that seem to explain the success of the reform compared to contemporary initiatives in other European countries:[8]

- The existing institutional framework for water management – with its stakeholder involvement and tradition of "user charges" for flood protection and water-quantity management – was highly conducive (with minor amendments) to the introduction of effluent charging.
- The absence of prior legislation on water-pollution control meant that the effluent charging system was not compromised by having to work alongside other existing instruments. The charges applied to all emissions – both to surface water and to the sewerage system – and were based on actual emissions.
- The charges were set at a sufficiently high level to provide a meaningful economic incentive for pollution control. This was reinforced by the use of the state revenues raised to subsidise investment in pollution control.
- The provision of support and information on pollution control technologies by RIZA significantly reduced the transaction costs for industry.

Water reform in Australia[9]

Prior to the 1980s, the emphasis of water policy in Australia was on engineering solutions and on increasing water supply to address shortages. The development of irrigation was linked to policies explicitly intended to promote rural settlement. Water was often over-allocated and was typically supplied below cost, providing little incentive for conservation. Furthermore, cross-subsidisation between sectors resulted in an inefficient allocation between competing uses. During the 1980s, increasing scarcity, rising supply costs and pressure on state budgets led to a number of state-level initiatives to improve the management of municipal water utilities and irrigation networks. However, there were disagreements between the states involved and by the early 1990s, it was clear that the Murray-Darling Basin (MDB) was suffering increasing environmental degradation, with reduced water flows, more frequent droughts and significant impacts on water quality and biodiversity.

While environmental and resource management considerations played their part, the main driver for reform in the water sector was a wider drive to improve the economic efficiency of infrastructure sectors and utilities, in order to improve the competitiveness of tradable sectors. This drive was underpinned by a belief in the benefits of introducing rational pricing for scarce resources and the development of competitive markets in these sectors. These principles were largely reflected the recommended template for water reform.

Responsibility for water issues in Australia is vested in the state and territory governments. Water is state property and entitlements to use it, usually tied to land ownership, were granted as statutory rights under state legislation. The role of central government was (and still is) very limited. In practice, the states typically devolved a great deal of authority over water to local water districts and catchment management authorities, which tended to be dominated by irrigators. Consequently, farmers had considerable influence over the administration of water policy and catchment management. The complexity of the issues involved, and the lack of immediate signs of crisis at that time, meant that the public was not much engaged in the reform debate, which was largely confined to academic experts, representatives of the affected interest groups – chiefly the irrigated agriculture sector – water utilities and public officials involved in water policy. While the farming lobby's principal concern was with the security and predictability of water entitlements, there was also a strong commitment to keeping prices down. There was a fear that increased water prices could leave the sector with a potentially huge "stranded asset" problem.[10]

The Water Reform Framework (WRF) was adopted by the Council of Australian Governments (COAG) in 1994. The objectives of the reform were to ensure that water prices reflected the full cost of resources; to eliminate cross-subsidies and make other subsidies transparent; to separate regulatory functions from water provision; and to introduce trading in water rights in order to increase allocative efficiency. In addition, a temporary cap was imposed on diversions from the MDB at 1993-94 levels. The framework document was only ten pages long, comprising a set of general principles, targets and incentives. It did not address the details of implementation, which were left to the states. In the decade following the introduction of the WRF, significant progress was made with respect to urban water reform, with most urban water authorities introducing consumption-based charges for households and firms. Cross-subsidies were reduced or eliminated, and both individual water consumption and the unit supply cost of water fell in urban areas.

Some progress was made with respect to rural water. The states' legal frameworks were adapted and harmonised to facilitate the development of water markets. Water-access entitlements were converted to a system of tradable ownership entitlements, with most of the new entitlements being separated from land ownership rights.[11] However, differences remained between the states' regulatory regimes and their respective definitions of water rights. While amendments were made to state legislation in order to remove obstacles to water transactions both within and between jurisdictions, a number of limitations on permanent transfers, transfers between catchment areas and transfers of irrigation water to other uses remained in force. Several states prohibited or capped the ownership of water rights by persons not owning or occupying land, or restricted the proportion of entitlements in any given catchment that could be held by non-farm users, reflecting a fear that water rights might be bought up for speculative purposes. As a result, water markets were often inaccessible to urban users. The volume of trades was relatively low. In 2004-05, the total volume of trades was 1 300 gigalitres representing 7% of total consumption and 4% of total entitlements. Of this, three-quarters were temporary intrastate trades, while only 0.4% involved permanent transfers between states. Administration of the cap on diversions from the MDB proved highly problematic, due in large part to differences in the management rules applied by the states. Information on diversions was neither reliable nor homogeneous across jurisdictions, while data on historical water use was of a poor quality. Furthermore, with the exception of bulk diverters, the states had little capacity to regulate water supply to licence holders when restrictions were imposed.

While some progress was made in implementing the WRF, it was slow and uneven, with the achievements falling short of the original reform objectives. As a result, a new water reform initiative (NWRI) was launched in 2004 in an attempt to address some of the issues that had hindered progress.[12] There would appear to be a number of reasons for this:

- The WRF was very general, with no real consideration of detailed implementation issues. While this facilitated initial agreement, it resulted in problems at the implementation stage. Furthermore, the lack of specific targets or commitments made it difficult to impose penalties on states if they pursued policies that were at odds with the objectives of the framework.

- There was a weak constituency for reform. The case for reform rested on the need to ensure long-term sustainability of water use, to reduce environmental damage and to improve the economic efficiency of water allocation. However, these benefits were diffuse and poorly understood by the public, as were the costs of inaction. In contrast, most individual consumers were clearly worse off under the reform than they had been previously. This was particularly the case for those intensive water users who were already actively engaged in the water-policy arena.

- The vesting of responsibility for water management with the states, together with a requirement for unanimity, made every state a *de facto* "veto player". Since none was under pressure from a strong pro-reform lobby, co-operation proved difficult in the absence of a crisis, particularly in respect of the MDB, where there were sharp conflicts of interest between up- and down-stream states.
- The domination of catchment-management authorities by local irrigator interests diluted the environmental effectiveness of the reform.
- In the rural sector, water entitlements were perceived as acquired rights. Many had been held for long periods and had provided the basis for significant investments. Consequently, there was considerable resistance to any reductions in volumetric entitlements.
- The potentially serious knock-on effects of water reform on rural communities – many of which existed as a direct result of past irrigation policies – meant that there was strong resistance from agricultural and other rural interests, who had considerable political muscle.
- There was a lack of consensus on some of the basic scientific questions. In particular, there was considerable uncertainty surrounding the sustainable levels of water abstraction, making it difficult to produce authoritative estimates of the benefits of reform (or the costs of non-reform). This allowed opponents to challenge the scientific case for reform.
- Practical difficulties in measuring water use and in assessing the impact of water diversion on other users made reform implementation exceptionally complex. This was particularly true for water trading, where the impact of a transaction on third parties may depend not only on the volume traded, but also the locations of the buyer and seller, and any change in the use of the water.

Waste management reform in the United Kingdom[13]

In the 1980s and early 1990s, waste management was a very low environmental priority in the United Kingdom. Practically no household waste was recycled or composted in the 1980s, and by 1995-96, this proportion had only increased to 6% (DEFRA, 2007a), with the vast majority of the rest land-filled, because that was the cheapest option. While recycling proportions were higher in the industrial, commercial, construction and demolition sectors, this was a result of market forces, rather than policy, and data on waste from these sectors were not systematically collected until 1998-99 (DETR, 2000). In 1994, the European Union (EU) agreed the Packaging and Packaging Waste Directive (94/62/EC), which mandated recycling targets for different kinds of packaging waste. These were revised in 2004 to an average of 60% for overall recovery of packaging waste and 55% minimum and 80% maximum recycling of it by 2008.[14] This EU challenge to UK policy was reinforced in 1999 by the passing of the EU Landfill Directive (99/31/EC), with targets to reduce the quantity of biodegradable municipal waste land-filled, with reference to that produced in 1995 to 75% by 2010, 50% by 2013 and 35% by 2020.

The UK policy responses to these EU targets and obligations have been manifold. The first, generalised response to the Packaging Directive was the landfill tax, introduced in 1996 at GBP 7 per tonne of active waste and GBP 2 per tonne of inactive waste. These rates were set to be equal to the estimated externalities of landfill, but the rates were soon raised above. The two specific measures focused on packaging have been the Producer Responsibility Obligations (Packaging Waste) Regulations introduced in 1997 and the Packaging (Essential Requirements) Regulations introduced in 2003. Both are periodically updated. These placed an obligation on companies above a certain size to recover a certain proportion of their packaging, and established a system of tradable Packaging Recovery Notes through which this obligation could be discharged (see Salmons, 2002 for details). Under the influence of these policies, the recycling and recovery rates of packaging waste increased from 28% (recycling) and 33% (recovery) in 1998 to 55% (recycling) and 60% (recovery) in 2005 (DEFRA, 2006), although the overall recovery rate was still being reported as 59% in 2007 (DEFRA, 2009). However, unless the policy is blown off course by the downturn in recyclate markets due to the recession, it seems likely that the EU packaging waste targets for 2008 will have been met.

Households in the EU are little affected by the packaging legislation, but the municipal waste stream was very much the target of the Landfill Directive, and the United Kingdom's very low recycling, and high proportion of land-filling, was a major problem in the light of the targets. Some UK local authorities (LAs) are both waste-collection and waste-disposal authorities, but the majority do one or the other, a split responsibility that impeded the search for alternatives to landfill until the 2003 Waste and Emissions Trading Act compelled LAs in "two-tier" areas to adopt joint municipal waste-management strategies. In the Household Waste Recycling Act (2003), LAs were required to separate out (individually or together) at least two types of waste by 2010. LAs are liable for the landfill tax, but are not currently permitted to pass on to households an incentive for waste reduction by charging them according to the amount of waste they generate.[15]

The organising framework for the central government's response to waste-management responsibilities has been the Waste Implementation Programme (WIP), set up in 2003 and concerned with local authority funding, the delivery of waste-management infrastructure, the development and deployment of new waste technologies, the generation of appropriate data and research, encouraging waste minimisation and the spread of best practice in kerbside collections of recyclables, and increasing awareness of waste issues. Much of WIP is implemented through an arms-length body, the Waste and Resources Action Programme (WRAP). LAs have been the recipients of considerable central government funding (much of which they have in any case paid through the landfill tax) to establish and maintain kerbside recycling schemes. Expenditure on waste collection and disposal (including the landfill tax) rose from GBP 1.65 billion in 2001/02 to GBP 2.44 billion in 2005/06 (DEFRA, 2007b). In return for this funding, LAs have been required to meet recycling targets or, since 2007, annual performance standards, which in 2007 required that at least 20-30% of municipal waste is sent for recycling and composting in 2007-08 (HMG, 2007). Another innovation in England[16] was the introduction in 2005 of the Landfill Allowances and Trading Scheme (LATS), whereby waste disposal authorities are given allowances for land-filling biodegradable municipal waste (BMW), which they may trade. The quantity of allowances will decrease in order to meet the targets in the Landfill Directive. BMW in England in 2007/08 decreased by 8.4% from the previous year, with all LAs surrendering adequate allowances, and had already met the Directive target for 2009/10. Trading, however, was thin, with only five LAs buying allowances from other LAs (EA, 2008). In addition to statutory instruments, the government has also entered into a number of sectoral voluntary agreements and "sector plans" to encourage business sectors to produce less waste (DEFRA, 2007b).

The overall policy approach seems to have been reasonably effective. Up until 2000, municipal waste had been growing by 3.5% per annum, but over 2002-07, its growth was only 0.5% per annum. The proportion of recycling and composting of household waste increased fourfold between 1996/97 and 2006/07, reaching 31% in 2007, while the recycling of packaging waste doubled between 1998 and 2006. Only 62% of municipal waste was land-filled in 2005/06, down from 82% in 1998/99, and with the quantity between 2000/01 and 2006 falling from 80 to 65 million tonnes. Residual household waste decreased by 22% from 2000/01 to 2006/07. However, in 2005, the United Kingdom still had the second highest proportion of landfill, and second lowest proportion of waste recovered, among the EU15 (DEFRA, 2007a), so it is clear that while the instruments of policy reform may now be in place, their work is still far from completed.

A number of factors appear to underlie reform progress in this area:

- UK waste management policy was almost wholly focused on the management of landfill sites, until EU Directives obliged it to address the recycling, recovery and minimisation of waste.
- The resulting UK waste policy is a good example of a complex mix of instruments that includes economic instruments (landfill tax, LATS, recycling subsidies), regulation, voluntary agreements, and information (development of new data systems, waste-awareness programmes).
- Reform required or brought about substantial institutional change, including co-operation between waste collection and disposal authorities, and the creation of a waste-management trading scheme.
- The landfill tax was calculated to reflect the environmental externalities of landfill, but it was soon recognised that this was neither high enough to drive the necessary investment in alternative waste-management technologies, nor to provide the revenues needed to subsidise kerbside recycling schemes. The tax is now nearly six times its original rate.
- An obstacle to the effective operation of the landfill tax in respect of household waste is that LAs are currently not allowed to charge households according to the amount of waste they produce. A small number of pilot schemes have been permitted to explore how such charging might work, but no LA has yet established such a pilot because of extensive negative press coverage of the idea. This was triggered by the installation by some LAs of microchip technologies for weighing waste in LA-required waste bins, before plans for variable charging had been discussed in the communities concerned. The charges were widely labelled "stealth taxes" and the microchips called "bin spies".

Agricultural subsidy reform in New Zealand[17]

In the early 1980s, New Zealand was suffering severe economic problems. The unemployment rate had risen to 7%; inflation was running at around 20%; real gross domestic product (GDP) growth per capita was only around 1%; the fiscal deficit had ballooned to 9% of GDP; government net debt had risen to 41% of GDP; the chronic current external deficit was having negative implications for the exchange rate and the country's credit rating had collapsed. The deteriorating economic situation was not sustainable and the government had no choice but to embark on a far-reaching and substantive programme of economic reforms.

The agriculture sector was a primary target for reform. Over the previous two decades, there had been a gradual acceleration in production grants and subsidies. Programmes that had initially been narrowly focused had rapidly expanded to include a range of production-related measures, fertiliser subsidies, loans to farmers at below-market rates, generous tax rebates, and lucrative incentives for land development. At its height, there were around 30 different forms of assistance to farmers. By 1984, these subsidies were causing severe distortions in the sector, with significant excess supply, inflated agricultural land prices and distorted production decisions.

From 1984, government assistance to the agricultural sector was virtually eliminated – in some cases almost overnight. Minimum price schemes for wool, beef, lamb and dairy products were abolished. Tax concessions for farmers were withdrawn, as were free government services. Land-development loans, fertiliser and irrigation subsidies, and subsidised credit were reduced and then phased out from 1987, as were assistance for flood control, soil conservation and drainage schemes. As a result, the Effective Rate of Assistance (ERA)[18] fell from 123% in 1983 to around zero by the 1990s.

The economic and environmental effects arising from the removal of the subsidies were broadly positive. The economic indicators for the agriculture sector have improved across the board since the subsidies were eliminated. The removal of the subsidies caused a dramatic reduction in the size of the national sheep flock and a major restructuring of the meat-processing sector. However, the sector became much more efficient and profitable, with both production quantities and export revenues increasing. Moreover, other sectors benefited significantly from the elimination of subsidies. There has been a significant switch into horticulture and viticulture, with production and exports of apples, kiwifruit and wine all rising sharply. Overall, the agricultural sector was compelled to become much more flexible, responding more effectively and efficiently to price signals by switching to new or different types of production. Reform also encouraged the rural sector to diversify into other activities, such as rural tourism and eco-tourism, placing it on a more sustainable footing in terms of income. The removal of subsidies caused a 50% fall in the real price of farmland by 1988 – reflecting the previous capitalisation of subsidies into land prices – but within seven years, they had recovered to 86% of their 1982 value.

While the objectives of reform were economic rather than environmental, the removal of the subsidies was broadly beneficial for the environment. The elimination of fertiliser subsidies led to a reduction in phosphate leaching from hill country pasture catchments; the reduction in the national sheep flock yielded benefits for erosion control, water quality and methane emissions; and the removal of land-development subsidies led to a substantial decline in the felling of native forest. While these benefits were partly offset by the impacts of increases in other agricultural activities, the overall environmental impact was positive.

There were social costs in the rural sector. Rural incomes declined during the 1980s, although this was not due entirely to the removal of subsidies. Many small rural firms went out of business and a large number of farm labourers were made unemployed. There was a knock-on impact on many small rural towns in the mid-1980s, as people left in search of employment elsewhere. This resulted in the contraction of public services such as schools and local hospitals. However, there was no widespread rural collapse – only around 1% of farmers left the industry, while the overall rural population rose slightly between 1981 and 2001. Despite these social impacts, little use was made of transitional assistance measures. In part, this was due to the speed of the reforms, which meant that it was not possible to conceive and implement measures in time. However, mainly it was due to the state of the government finances, which precluded any significant expenditure on support measures. Some assistance was provided in the form of debt rescheduling in 1986-87 and with farm debt restructuring. In addition, expert help was provided to help farmers with the development of business plans and credit mediation.

The reform of agricultural subsidies in the mid-1980s transformed the performance of the sector and was broadly beneficial for the environment. While there were negative social impacts, the effect on rural communities was not as great as had been feared. There would appear to be several factors that might explain this success:

- The sense of impending economic crisis in the early 1980s forced the government to take drastic action. Subsidies could no longer be afforded.
- There was a general consensus among the main political parties on the need for reform – both in agriculture and the wider economy.
- The Labour government that initiated the reforms did not have a significant rural constituency and hence did not stand to lose much support as a result of the reform of agricultural subsidies. Consequently, it was better able to resist the opposition from the rural lobby.
- The reform was implemented to an agreed and transparent timetable – with farmers being given clear signals about the depth, breadth and pace of change.
- The reform of agricultural subsidies was part of a wider economic reform programme that included measures which reduced factor input prices. Thus,

while the main farmers' organisation was unhappy about the removal of subsidies, it strongly supported the wider reform process, which eased the pressure on farmers by lowering production costs.

Fishery subsidy reform in the European Union[19]

EU fisheries subsidies were first introduced in 1970 with the objective of supporting and encouraging fish production. In particular, they were aimed at promoting capital investment in larger and more efficient fleets, and at adapting production and marketing conditions. As a result, there was a threefold increase in the engine power of the fishing fleets over the next 17 years and the fishing industry became increasingly capital-intensive and technologically productive. This was a major factor in the depletion of fish stocks over the following decades. By 2001, less than 20% of the 113 Northeast Atlantic fish stocks assessed by the International Council for the Exploration of the Seas were within safe biological limits.

Since their inception, subsidies have been provided primarily through a series of EU structural funds intended to promote the development and structural adjustment of the fisheries sector. Initially, financial assistance was provided under the European Agriculture Guidance and Guarantee Fund (EAGGF). This was superseded in 1993 by the Financial Instrument for Fisheries Guidance (FIFG), with the European Fisheries Fund (EFF) taking over in 2007. The agreement of structural funds – and hence the reforms to fishery subsidies – is subject to a lengthy, bureaucratic and political process, involving a number of different elements of EU governance.[20] Due to their political sensitivity, proposals to reform fishery subsidies have been subject to intense and lengthy Council negotiations between the responsible ministers from the respective member states.

Over the last decade, the fishing industry and environmental non-governmental organisations (NGOs) have both been increasingly engaged in the development of fisheries policy, including the issue of subsidy reform. This has been facilitated through the opening of the Commission Advisory Committee for Fisheries and Aquaculture (ACFA) to NGOs in 1999; and the establishment of regional advisory councils (RACs) in 2004. More specifically on subsidies, a series of stakeholder conferences were held at the EU level in advance of the EFF proposal, involving industry, NGOs and governments.

In recognition of the role of subsidies in the build up of over-capacity, and hence over-fishing, there has been a shift in focus towards balancing fleet sizes to available fish stocks. In particular, the most direct forms of capacity-enhancing subsidies have been phased out, with assistance being redirected to provisions for vessel decommissioning, transitional support measures and environmental projects. Under the FIFG, the emphasis evolved towards achieving a sustainable balance between resources and their exploitation. The FIFG agreement for 1999-2006 introduced environmental safeguards, provisions for environmental projects and the involvement of environmental interests. In particular, it included provisions for the adjustment of fishing effort, reducing the excess capacity of the fishing fleet, early retirement schemes and individual compensatory payments for individuals made redundant as a result of vessel decommissioning, and the development of marine-protected areas. In 2002, amendments to the FIFG under the Common Fisheries Policy (CFP) reform included the phasing out of subsidies for vessel rebuilds and the making available of extra funds for vessel scrapping.

The reforms have broadly been carried over into the EFF, the objectives of which are to support the CFP so as to ensure exploitation that is compatible with economic, environmental and social sustainability; promote a balance between resources and fishing fleet capacity; strengthen the competitiveness of the sector; foster protection of the environment and natural resources; and encourage the sustainable development in areas with activities in the fisheries sector. While the reforms to the subsidy regime have changed the nature of the assistance provided, they have not reduced the magnitude of the support. Indeed, the EU allocation to fisheries subsidies via the FIFG for the EU15 for 2000-06 was double the contribution for the previous period.

While there have been some significant changes to the nature of the financial assistance provided to the fisheries sector since subsidies were introduced in 1970, it has been a gradual process. A number of factors have supported the reform process:

- A major factor driving reform under the FIFG and the EFF was the strong political leadership provided of the then Commissioner for Agriculture, Rural Development and Fisheries, Franz Fischler, who was instrumental in securing the phase out of subsidies for constructing new vessels in 2002.
- Increasing attention to environmental integration strengthened the case for reform.
- The involvement of the environmental NGOs in the development of fisheries policy has played an important role in raising the public profile of fisheries subsidy issues.

However, there have also been a number of factors that have held back the reform process:

- The subsidy regime has been in place for over 35 years and has become an entrenched part of the fisheries management regime. When the financial periods have ended, there has been a presumption that subsidies would be renewed rather than removed, with no active reconsideration being given to the ongoing rationale for them.
- The enlargement of the EU has been a major factor inhibiting subsidy reform. The ten new member states that joined the EU in 2004 were poorer than the existing EU15 and had high expectations of support for their fishery sectors.
- Economic pressures resulting from rising oil prices and falling revenues as a result of the decline in fish stocks resulted in heavy lobbying by the fishing industry to maintain subsidies.

Lessons of policy reform: the institutional context

The importance of appropriate institutions to support reform is difficult to exaggerate

It is important to consider the institutional context when designing policy reform. If it is to be successful, either the reform must take account of the existing institutional framework, or the framework must be adapted to support the desired reform. An appropriate and conducive institutional framework is a key factor in determining the success of an economic instrument. This was highlighted in the first case study, in which the well-established institutional framework for water management in the Netherlands was highly conducive to the successful introduction of effluent charges. In contrast, the different management traditions in Denmark, France and Germany complicated the use of similar economic instruments in those countries (Andersen, 2001). Experience with water-trading initiatives suggests that successful trading regimes tend to be built on pre-existing institutions and are integrated into traditional regulatory regimes. This may entail tradable permits being combined with other policy instruments (taxes, charges, environmental quality objectives, etc.) in order to form instrument mixes for more effective water management (Kraemer, Interwies and Kampa, 2002). However, as the Australian case shows, the construction of new regimes on the foundations of the old can lead to unforeseen complexities when trying to define property rights and organise markets. Governments should consider how existing institutions could be used to facilitate the implementation of a new policy instrument – in particular, an economic instrument. This may require that they be modified or altered on an incremental basis (Andersen, 2001).

The legal system, in particular, may not be readily compatible with the use of certain policy instruments, or may even prohibit their use. For example, in countries where they apply, such legal principles as the equality of citizens in the eyes of tax law, non-transferability/sale of administrative permits, non-appropriation of *res communis* and the individual's right to a healthy environment might present major obstacles to the use of tradable permits, or impose significant restrictions on the design of systems. In France, for example, principles underlying tax law have complicated attempts to introduce an emissions tax. In addition, administrative authorisations are emanations of the state's sovereignty. As such, they do not confer any right that can be upheld against the state or transferred to other economic agents via a monetary transaction (OECD, 2001b). In the United Kingdom, local authorities are not allowed (outside the recently permitted pilot schemes) to introduce variable waste charging which has been effective in reducing waste generation in other countries (*e.g.* OECD, 2007a). Even if there is no incompatibility with fundamental legal principles, existing regulations or regulatory approaches may not be conducive to the introduction of tradable permits. This would be the case, for example, where existing regulations prescribe the technologies that must be used, rather than the limit for emissions. Furthermore, to the extent that they remain in force, other regulations may impose obligations that compromise the efficiency of a trading system.

As the Australian case illustrates, water ownership and allocation are subject to many different laws and regulations in different jurisdictions, making it difficult to ascertain the ownership of water. Furthermore, differences between the legal and economic definitions of water resources have hindered the development of water trading. Consequently, there is a need for clear legal definitions that match their economic counterparts, and a clear initial assignment of property rights to water resources (Kraemer, Interwies and Kampa, 2002). There may also be legal obstacles to the introduction of water pricing, or restrictions on tariff structures. In Hamburg, for example, significant legal changes were required before water pricing could be introduced: rent laws had to be amended to allow the water company to enter into contracts with tenants, while the building code and related laws were changed to make meter installation obligatory (OECD, 2003b). In France, the January 1992 Water Law prohibits the inclusion of any non-volumetric (*i.e.* fixed charge) element in tariff structures (OECD, 1999).

There may be benefits in making broad changes to the legal framework within which environmental policies are introduced, rather than making piecemeal amendments to facilitate specific policy interventions. In Sweden, a new framework law – the Environmental Code – was adopted in 1999, with the aim of simplifying and modernising the legal structure underpinning environmental policy, and making it more transparent. In addition to spelling out general principles relating to the environment and consolidating previous legislation, the code introduced ambient quality standards and clarified the role of environmental impact assessment. In addition it introduced new institutions, including environmental courts as well as environmental sanctions (OECD, 2007b).

The "institutionalisation" of previous policy interventions may impede reform

Past policy interventions can become "institutionalised", either in terms of physical infrastructure, or asset values, or stakeholder expectations. This can result in significant resistance to reforms. The separation between waste-collection and waste-disposal authorities in the United Kingdom was a significant barrier to the increased recycling of waste before the two kinds of authorities were forced to implement joint strategies. In Australia, the subsidised water prices under past water policies designed to encourage rural settlement had caused the development of agriculture based on a large-scale irrigation infrastructure. Consequently, there was strong resistance to the removal of subsidies under the Water Reform Framework. Where agricultural subsidies have been provided for a long period, they may be capitalised into agricultural land values. This was evident in New Zealand, where the removal of the subsidies caused a 50% decline in the price of agricultural land within four years (Vitalis, 2006). While this did not prevent the implementation of the reforms in this particular case (see the case study), the potential decline in land – and other asset – values is likely to be a cause of significant opposition to reforms in other settings. In the European Union, a major obstacle to reform of fishery subsidies is the fact that they have been in place for over 35 years and have become an entrenched part of the fisheries management regime. Consequently, when financial periods have ended, there has been a presumption that subsidies would be renewed rather than removed, with no active reconsideration being given to the ongoing rationale for subsidies (Brown, 2007).

Devolved responsibility for environmental management can complicate reform

In line with the principle of subsidiarity, responsibility for environmental management issues is being increasingly decentralised to state and/or local governments, with functions being devolved to the most appropriate level to address problems in the most effective and efficient way (OECD, 2008a). While this may be advantageous for "day-to-day" management, it can cause problems for the implementation of major policy reform. This is a particular issue in the case of water management, where jurisdictional differences have inhibited the introduction of integrated water management and the development of water-trading systems (Kraemer, Interwies and Kampa, 2002). In Australia, the divergence in practices and regulations among the states has hindered the introduction of interstate water trading. Furthermore, a requirement for unanimity has made it difficult to introduce integrated management of water systems covering multiple jurisdictions, such as the Murray-Darling Basin (OECD, 2008b).

Stakeholder involvement and consultation are essential

Open and inclusive decision-making processes, with active stakeholder involvement in the formulation of environmental policies are crucial if reforms are to be implemented successfully (OECD, 2008a; Ridgeway, 2007). In several countries, consultative bodies to the national governments have been established to provide strategic advice on environmental and sustainable development issues. These include representatives from civil society, industry and trade unions. In particular, Green Tax Commissions, with participation from relevant ministries, affected industries, trade unions, environmental organisations, etc., have proved a useful way to build communication between stakeholders on environmental tax reform (OECD, 2008a).

Participatory decision making can play an important role in overcoming resistance to water pricing and water trading. (Kraemer, Interwies and Kampa, 2002). In Hamburg, for example, the potentially contentious reforms to the rent laws to allow the extension of water metering to all households was resolved with a high degree of acceptance through consultation and participation of all levels of government and of political and social leaders (OECD, 2003b). Similarly, experiences with the reform of environmentally harmful subsidies demonstrate the importance of including diverse stakeholders and opinion makers, in order to gather information and ensure the resilience of policy decisions. Public consultation, joint decision making and partnerships have been integral to reform efforts (Ridgeway, 2006, 2007). By contrast, attempts to prepare for variable waste charging by introducing weighing technology into waste bins without either informing or consulting with the public triggered a media backlash.

Institutions also matter for the implementation of environmental policy reform

Institutional factors affect not only the design and adoption of environmental policy reforms but also their implementation. In particular, a great deal may depend on the choice of agent responsible for implementation and the existence of institutions to support/facilitate adjustment. This is particularly true for the implementation of economic incentives, such as environmental taxes. In particular, substantial consideration should be given to the interests of agents, and appropriate incentives should be designed to encourage them to act in accordance with the purpose of the policy. The existence of an appropriate institutional network that can provide information, skills and know-how can lower transaction costs for the targets of an environmental tax. In the Netherlands, for example, the provision of support and information on pollution-control technologies by RIZA significantly reduced the transaction costs for industry (Andersen, 2001).

Dealing with those threatened by reform

Distributional and competitiveness concerns can present obstacles to reform

Industrial competitiveness and income distribution concerns are often cited by policy makers as major obstacles to environmental regulation – particularly in relation to the use of economic instruments – and the reform of environmentally harmful subsidies (OECD, 2006a). In addition, fears about the social consequences and structural dislocation for particular regions or communities (*e.g.* rural communities) have impeded subsidy reform and the introduction of water trading (Ridgeway, 2006; Kraemer, Interwies and Kampa, 2002). All environmental policy interventions create winners and losers – at least from an economic perspective. While compensation of the losers may not be necessary for reasons of economic efficiency, it may be justified on equity grounds (*e.g.* protecting low-income households or other vulnerable groups), or for reasons of political feasibility where the losers have the power to block (or compromise) the intervention (OECD, 1995), as was the case in the Australian water reforms, in particular. When designing reforms to existing subsidies, appropriate measures should be included (*e.g.* transitional support) in order to ensure that they are equitable and politically feasible (OECD, 2006a).

Competitiveness concerns should be addressed without compromising the reform

Opposition to environmental policy reforms on competitiveness grounds is likely to be particularly intense where firms face strong international competition (OECD, 2008a). To a certain extent, competitiveness concerns may be allayed by providing better information on the actual competitiveness impacts of policies, and through a well planned and transparent phasing-in of the policy to allow for adjustments (OECD, 2008a). Gradually phasing in an environmental tax can soften the immediate impact and give firms time to adapt in order to reduce the impact on production costs (OECD, 2006b). Partial exemptions may also be used to reduce the impact of an environmental tax for companies subject to international competition. In Sweden, for example, energy taxation rates are differentiated; with higher rates for households and service sector companies, lower general rates for industry and further reductions for energy-intensive industries (OECD, 2007b). However, this undermines the environmental effectiveness and economic efficiency of the tax (OECD, 1995). In theory, this could be addressed by making the exemption conditional on achieving a specified level of environmental performance, as in the United Kingdom, where energy-intensive firms can receive an 80% discount on the Climate Change Levy (CCL) if they enter into binding agreements with quantified performance targets. There has been some dispute about the stringency of these targets, with some claims that they represent no more than business as usual, but there is also evidence that the intensive negotiating process to agree CCAs revealed previously overlooked emission abatement opportunities (Ekins and Etheridge, 2006). Thus, greater emissions reductions were achieved than might have resulted from paying the full rate of tax alone.

Alternatively, the revenues raised by the environmental tax can be recycled back to all firms according to some rule, so that the overall impact is neutral. However, care should be taken to ensure that the recycling mechanism is de-linked from the original polluting activity, in order to minimise the negative impacts on both the environmental effectiveness and the economic efficiency of the tax (OECD, 2008a). One option is to reduce other taxes on industry; in particular, labour taxes. This form of environmental tax reform (ETR) has been used in Germany and the United Kingdom, where revenues from the introduction/increase of industrial energy taxes have been used to reduce employers' social contributions.[21] However, while this is revenue neutral in aggregate, energy-intensive sectors with relatively low labour inputs are net losers and may still suffer negative competitiveness impacts. An alternative option is to recycle the tax revenues based on output. This approach was adopted in Sweden in relation to the NO_x charge for the energy production sector because of fears that generators might relocate to Denmark. Under the Refunded Emission Payment (REP) scheme, energy producers face a charge per unit of NO_x that they emit, but receive a refund based on how much energy they produce. The overall impact on the sector is neutral and almost half of the generators receive more back in subsidies than they pay in charges. Because of this, most companies are fairly positive about the tax (OECD, 2007b).

In the case of permit trading systems, "grandfathering" permits free of charge may alleviate industry fears regarding competitiveness. However, it is the opportunity cost of permits (*i.e.* the price at which they could be sold) that determines the impact on production costs and hence competitiveness. Consequently, in the absence of other market failures, while the method of permit allocation will have distributional implications, it should not make any difference to the impacts on competitiveness. In practice there is likely to be some impact, depending on the competitive structures of permit and product markets, and the degree of imperfections in the capital and financial markets (OECD, 1995, 2001b, 2008c).

International co-ordination of actions to create a "level playing field" can also help to reduce competitiveness impacts arising from the introduction of environmental taxes or the removal of subsidies (OECD, 2008a). However, this need not be a necessary condition. As was seen in the case study, New Zealand's experience with reforming agricultural subsidies shows that it is possible to take significant unilateral action without suffering any long-term loss of competitiveness (Vitalis, 2006).

Equity concerns should be addressed at the policy-design stage

Concern is often expressed over the potential distributional implications of environmental taxes and charges such as water pricing. Failure to address these concerns early in the policy process can fuel opposition (OECD, 2006b). Undesirable distributional outcomes can be mitigated by providing exemptions, or reduced tax rates, for vulnerable groups (*e.g.* low-income households, pensioners, single parent households). However, this would reduce both the environmental effectiveness and/or the economic efficiency of the tax. Consequently, it is likely to be preferable to use direct compensation measures to alleviate the impacts (*e.g.* increased social security payments). Relief can also be provided through the income tax system – for example, by increasing basic personal allowances or introducing tax credits (OECD, 2006b, 2008a).

In relation to water pricing, a range of measures can be (and have been) used to alleviate hardship while still maintaining incentives (OECD, 2003c):

- Where increasing-block volumetric tariffs (IBT) are used, a number of consumption blocks are defined, with a low (or zero) charge applied to the first block and increasing charges for successive blocks thereafter. However, because they are based solely on consumption levels, IBTs do not address all equity concerns. For example, the average water price paid by large low-income households can still be higher than that paid by smaller high-income households (OECD, 1999).

- This can be addressed by relating either the fixed-charge element of the tariff or the initial IBT block to the needs of households in some way. For example, the size of the initial block could be based on the size of the household and an allowance for essential water use per person. Such an approach has been adopted in Flanders (OECD, 1999).

- Under tariff innovation approaches, completely new tariffs are introduced and customers are allowed to choose between tariffs – sometimes subject to qualifying restrictions. This approach can be particularly useful as a transition mechanism during the introduction of water metering and pricing. Some tariff packages may be offered only to particular groups, such as those in receipt of social security benefits (OECD, 1999).

- Target-group approaches can include both price reductions and income supplement schemes targeted at specific households. In Australia, for example, Sydney Water provides a range of residential safety nets. In the United States, there are examples of low-income and disabled households receiving rebates based on income, percentage discounts on water bills, waivers of fixed charges and fixed allowances (credits) on bills (OECD, 1999).

Transitional support measures can address regional/structural impacts of reform

When removing/reforming environmentally harmful subsidies, it may be necessary or desirable to provide some transitional support. However, it is important that such measures facilitate change rather than delay it and that they be carefully planned, truly transitional and well targeted (Ridgeway, 2007):

- Reforms can be phased in over time, in order to allow a more gradual adaptation, as has been done in the United Kingdom to cushion the impact of reforms to Less Favoured Areas payments under the EU Common Agricultural Policy (CAP) and the reforms to the CAP Single Payment Scheme.

- Capacity-building support can be provided to enhance the competitive ability of the sector or locality; to promote economic diversification and development of alternative income sources; or to support innovation and adaptation of production processes. The CAP "Pillar 2" measures are an example of such an approach.

- Time-limited compensation payments or one-off payments can be provided to those who will lose out from the reform (Dwyer, 2007).

Experience to date with reforms to EU agricultural suggests that capacity-building support is the most effective approach. The more innovative CAP "Pillar 2" measures appear to have been particularly important as tools to support effective adjustment. The case for "cushioning aid" is less clear, although when combined with adjustment aid, it may provide valuable breathing space for some of those affected by reforms (Dwyer, 2007). However, as the New Zealand case study illustrates, it is possible to implement fundamental reforms without significant transitional support. Subsidies to the agricultural sector were virtually eliminated over a very short period. Due to the speed of the reform and the severe constraints on government finances, minimal transitional support was provided, although the farm sector did gain from radical reforms going on elsewhere, which mitigated the impact of subsidy reform (Vitalis, 2006). This illustrates the potential of packages of complementary reforms to reduce the need for direct compensation of losers from reform.

Stakeholder involvement can help overcome resistance to reform

The creation of a common understanding of the problem at hand may help to overcome industry resistance to environmental policy reforms. One way to build such an understanding is to involve relevant stakeholders in policy formulation, for example through broad formal consultations when new policy instruments are being proposed. A good example of this was the close consultations with the industry and other stakeholders which, together with extensive *ex ante* impact assessments during the policy formulation phase, were crucial for the eventual adoption of the European Commission Regulation on Registration, Evaluation, Authorisation and Restriction of

Chemicals (REACH) (EC 1907/2006) (OECD, 2008a). Both the fishing industry and environmental NGOs have been increasingly involved in the development of EU fisheries policies – including subsidy reform. The involvement of the fishing industry has been important in changing its positions, and in making governments aware of how and why those positions have evolved. For example, the industry approach in some member states is now geared more towards obtaining a level playing field and supporting a phase out of capacity-enhancing subsidies. What is less clear is how the industry's involvement has actually influenced the development of reforms. However, both industry and NGOs believe that they had some influence (Brown, 2007).

Timing and interaction among reforms

Various catalysts can drive environmental policy reform

There have been a number of different catalysts for environmental policy reform. These include external crises, fiscal, economic or environmental (*e.g.* agricultural subsidy reform in New Zealand), wider policy reform initiatives (*e.g.* water reform in Australia), and changes to the general political context (*e.g.* fisheries subsidy reform in the EU). Reforms may also be facilitated by a change in political orientation (Ridgeway, 2006). While an external crisis may make it possible to drive through fundamental reforms out of necessity, such circumstances do not facilitate the careful planning and implementation – in particular, the need for transitional assistance (Vitalis, 2006). Consequently, it may be better to exploit windows of policy opportunity that may enable governments to initiate reforms, rather than waiting for a crisis. This was the case for example in Sweden, where a confluence of political forces was a major factor driving agricultural policy reforms (OECD, 2006a). It may also be easier to introduce reforms – particularly reforms to existing subsidies – in an economic upswing. However, the potential downside of attempting to time reforms in this way is that it may delay action (Ridgeway, 2006).

Environmental reforms may be easier to implement if combined with other policy reforms

New environmental taxes may be more politically acceptable, and hence easier to implement, if they are applied to broad tax bases or introduced as part of broader fiscal reform (OECD, 2006b). For example, the Norwegian CO_2 tax introduced in 1991 was combined with reduced taxes on incomes in "remote" areas. Similarly, the ecological tax reform (ETR) initiated in Germany in 1999 used the revenue from increased energy taxes to reduce pension insurance contributions for employers and employees (OECD, 2008a). A similar approach has been adopted in the United Kingdom, where revenues from the Landfill Tax and the Climate Change Levy have been used to reduce employers' national insurance contributions. However, while revenue recycling might mean that the reform is revenue neutral in aggregate, there are still likely to be winners and losers. Revenue recycling does not necessarily guarantee the political acceptability of the reform – it will depend on the relative political power of the different sectors and/or businesses affected. The sequencing and pace of complementary reforms is also important. For example, while the elimination of farm subsidies in New Zealand was accompanied by a lowering of tariffs on farm inputs, the latter proceeded at a slower pace. The resultant short-term hardship for the sector could have been avoided with better co-ordination of the respective reforms (Vitalis, 2006).

The role of evidence and international organisations in supporting reforms

Information and evidence can play a key role in building support for reform

The absence of a constituency for reform can be a major factor undermining prospects for its successful adoption or implementation. This can often reflect uncertainty about, or a lack of understanding of, the severity and causes of an environmental problem or the benefits of action (OECD, 2008a). This was the case, for example, with the Water Reform Framework in Australia, where the economic and environmental benefits of the reform were diffuse and poorly understood by the public (OECD, 2009). The general public's willingness to accept a new environmental policy instrument depends to a large extent on their awareness and understanding of the environmental problem being tackled, and whether the proposed instrument is seen as making a significant contribution to reducing the problem (OECD, 2008a). Consequently, it is advisable to provide correct and targeted information to the public on the causes and impacts of environmental problems (OECD, 2006b) and on how the proposed policy instruments work (OECD, 2001b). One way to do this is through involving relevant stakeholders in the policy formulation process – for example, through broad formal consultations or working parties preparing new policy instruments. Green Tax Commissions, comprising participants from relevant ministries, industrial organisations, trade unions, environmental organisations, etc., can provide a useful means for fostering communication between stakeholders and building a constituency for change (OECD, 2006b). Environmental NGOs can also play an important role in raising public consciousness of environmental issues, as in the case of EU fisheries subsidy reform (Brown, 2007).

Transparency about existing subsidies can be important in communicating the benefits of reform

Greater transparency about the size and beneficiaries of environmentally harmful subsidies and their economic, environmental and social impacts can play an important role in selling the benefits of reform. In particular, an understanding of the actual and opportunity costs of subsidies can help to build coalitions for reform and neutralise opposition to change (Ridgeway, 2007). In agriculture, significant work has been undertaken to identify the beneficiaries of subsidy payments – in terms of income levels, farm structures and geographic location – and the cost of subsidies to consumers and taxpayers. This has provided a powerful motivation for change and has helped influence decision makers in some countries (OECD, 2006a).

The global nature of many environmental problems requires international co-operation

Many environmental issues are either global in nature or have an important global dimension. In addition, there is now a general recognition among policy makers that there are strong interactions and dependencies between environmental, economic and social issues. In response to these facts, a complex institutional architecture of international environmental governance has evolved. The international governance structure comprises both intergovernmental and non-governmental institutions and organisations, with the latter including both business and civil society organisations. The institutions may be usefully classified along two separate dimensions (see Table 5.1). Along the first dimension, a distinction can be drawn between purely environmental international institutions and those which consider environmental issues among others. Along the second, the institutions can be distinguished in terms of their status and function.

Table 5.1. **Classification of international institutions**

	Environmental (including energy)	Multi-dimensional
Informational/advisory/policy support	International Energy Agency European Environment Agency International Panel on Climate Change	OECD
Operational/policy-driven	United Nations Environment Programme	Bretton Woods institutions: International Monetary Fund World Bank United Nations institutions: Commission for Sustainable Development UN Development Programme UNCTAD *et al.*
Legislative	Multilateral environmental agreements	European Union World Trade Organization

The European Union exerts a major influence on national policy reform in member states through the various environmental directives that have been passed into EU law. For example, directives on package waste and the land-filling of biodegradable municipal waste have acted as significant drivers of UK waste-policy reform that has resulted in the implementation new economic policy instruments.[22]

In 2001, it was estimated that there were in excess of 500 multilateral environmental agreements (MEAs), of which 60% had been agreed since the Stockholm Conference in 1972. About 65% were regional, and 40% were concerned with the marine environment (UNEP, 2001). Among the more important global MEAs are the United Nations Convention on the Law of the Sea (1982); the Convention on International Trade in Endangered Species (CITES) (1973); the Convention of Biological Diversity (CBD) (1992); the Rotterdam Convention (1998) on prior informed consent; the Stockholm Convention (2001) on persistent organic pollutants; the Vienna Convention for the Protection of the Ozone Layer (1985) and its Montreal Protocol (1987); and the UN Framework Convention on Climate Change (UNFCCC) (1992) and its Kyoto Protocol (1997). However, there are still major unresolved issues to do with legislative priorities at the global level, most importantly perhaps between the relative standing of MEAs and World Trade Organization (WTO) agreements, were they to conflict. This issue was on the agenda of the Doha Round of trade negotiations, which currently appears to be at an impasse.

The environmental influence of the operational and policy-driven organisations is broadly proportional to the budgets they deploy. This makes the International Monetary Fund (IMF) and the World Bank the most influential. However, their policy interventions are not always perceived to be environmentally positive. It is not surprising therefore that those who wish to strengthen global environment governance often advocate an increased budget and role for the United Nations Environment Programme (UNEP), or a completely new World Environment Organisation (WEO) along the lines, perhaps, of the WTO.[23]

The influence of information-generating bodies depends on the salience of the issues they address

The Intergovernmental Panel on Climate Change (IPCC) is probably the most influential of the information organisations, because of the global concern about climate change and the political attention this is generating. Global scientific efforts to raise the profile of other environmental issues (for example, the Millennium Ecosystem Assessment, or the Natural Resources Panel) have had a much lower impact. This prominence, however, can be a source of vulnerability as well, as became clear in late 2009 and early 2010, when the soundness of IPCC reports and the scientific basis for its work came under widespread attack.

The multi-dimensional nature of the OECD makes it ideally placed to provide insights from across the policy spectrum to aid the implementation of environmental policy reforms. The advantage of a multi-dimensional organisation such as the OECD is that it is able to explicitly connect its environmental work with relevant non-environmental issues with a view to drawing out the broader policy implications which may be important for policy reform to be implemented. However, it is necessary for such an organisation to keep its approach to information generation and interaction with its members fresh to ensure continuing influence. The OECD has been assessing member countries' environmental policies for a number of decades, in an effort to help governments improve the effectiveness of their policies, to the exchange of experiences and the transfer of information about successful policies among countries, and to increase the accountability of governments. The main influence of OECD work might be in the general propagation of a homogeneous discourse in different fields of policy making, including the use of market-based instruments, internalisation of external costs and promotion of cost-benefit analysis. A strength of the OECD is its capacity to mobilise governmental actors and promote environmental policy integration within governments. It is important that OECD show enough flexibility to accommodate national circumstances, while at the same time providing a rigorous and transparent analytical framework, in order to remain influential (Lehtonen, 2009).

Conclusion

It is not easy to generalise about the kinds of institutions that are most likely to support policy reform. Generating understanding about the appropriate institutional framework to drive reform forward and how to design that framework with reference to the institutions that already exist (which may be obstructive to reform) is a crucial element of reform design. The appropriate institutions will depend on the issue, the context, the reform being proposed, the existing institutional framework and a host of country-specific factors. However, the foregoing analysis has underscored the need for strong institutions when it comes to dealing with information and communication. Policy reform requires, first and foremost, public understanding of the need for it. For complex issues, such as many environmental policy areas, the messages have to be complex enough not to misrepresent the issue, and simple enough to be widely comprehensible. The other prime considerations in communications in support of reform are transparency (the messages and measures must be clearly related to the purpose of the reform) and consistency (the messages and measures must be seen to be complementary and mutually supportive). During the implementation phase, adequate *ex post* analysis will only be possible if the criteria and indicators against which the reform will be evaluated have been defined *ex ante*. This requires foresight and budgets projected into the future at the time of the reform, which are often not forthcoming.

The most common means of identifying losers from environmental policy is through modelling of different kinds. This can be expensive and therefore requires that budgets are set aside for it. There are many techniques for engaging those affected by reforms in the political processes that lead up to their adoption. Given that losers from reform are often more concentrated, vocal and politically well organised than winners, this may be unavoidable, as well as desirable. Compensatory measures are sometimes an appropriate response to distributional impacts from reform, but they need, if possible, to be implemented in a way that does not compromise the efficiency or effectiveness of the reform.

A distinction has been drawn between legislative, operational and informational institutions. Clearly legislative institutions play a key role in reforms, as with EU Directives in relation to the environmental policies of member states. Of the informational organisations, the IPCC has probably been the most effective, because it is focused on an area of fast-moving science that has a very high political profile. However, this has at times left it politically exposed. The OECD, though less prominent in environmental debates, brings strengths of its own to the environmental reform process. Its multi-dimensional focus allows it to bring evidence and experience from one area in order to fertilise discussions of another. However, informational organisations always run the risk of becoming or being perceived as "talking shops", so it is important for such organisations to maintain a comparative advantage in innovatory ideas, analysis and insights.

Notes

1. All of the information in these case study summaries is taken from previously published descriptions and/or analyses of the respective reforms. No new information has been gathered or analyses undertaken.

2. The London congestion charge was a good example of this, because all the revenue from the charge had to be spent on improving public transport in London. Even so, similar provisions failed to win acceptance of congestion-charging schemes in Edinburgh and Manchester.

3. Such a situation is not uncommon in respect of energy markets, in which consumers are often unaware that they can save money either by switching their energy supplier or by installing relatively simple energy-efficient technologies.

4. The information for this case study is taken from Andersen (2001), RIZA (2002) and Lazaroms and Poos (2004).

5. This was not a user charge in the strict sense, as it was not based on the provision of an individual service. However, the allocation of the costs to different stakeholder groups was proportional to the benefits that they received from the services.

6. Part of the Ministry of Transport, Public Works and Water Management.

7. For simplicity, a standard load of three pollution units is assumed for all households. However, this can be reduced on request to one pollution unit for single-person households.

8. Andersen (2001) compares the experiences of using economic instruments to control water pollution in Denmark, France, Germany and the Netherlands.

9 The information for this case study is taken from OECD (2008b) and OECD (2008c).

10. When legislative or regulatory changes in market conditions leave companies or individuals stuck with investments that they would never have made if they had anticipated the change in the legal-regulatory regime, possibly rendering previously valuable assets worthless, the assets in question are said to be "stranded". In such situations, it is common to compensate investors, provided that: (i) the cost of the asset has not yet been recovered; and (ii) it cannot be recovered by sale or alternative use.

11. The separation of water entitlements from land ownership rights was an important factor driving later reforms.

12. The NWRI and the subsequent Water Act 2007 successfully addressed many of the issues. For a comprehensive review of these reforms, see Young (2010).

13 This case study summarises, supplements and updates information from OECD (2007a).

14. There were specific recycling targets for different materials; see BERR (2009).

15. Some pilot schemes to permit them to do this have been sanctioned by the government, but have not yet been taken up by the LAs because of the political controversy generated by the issue of variable waste charging, which has received extensive hostile media coverage.

16. Waste is a devolved issue, so that Scotland, Wales and Northern Ireland make their own arrangements,

17. The information for this case study is taken from Vitalis (2006).

18. The ERA measures net government assistance to an industry by comparing the difference between the value-added by the assisted sector to the value-added generated by the same, but unassisted sector (at the world or reference price). It takes into account not only support directed at an industry, but the amount of support indirectly received or the tax paid by the

industry because the government has subsidised or taxed a supply industry (definition provided in OECD, 2001a.)

19. The information for this case study is taken from Brown (2007).

20. Proposals are prepared by the responsible Directorate-General (DG) (currently DG Fisheries and Maritime Affairs). After discussion with other relevant DGs (and checking by the Legal Service), the proposal is submitted to the College of Commissioners for approval. If there is (majority) agreement, the proposal is then sent to the Council of Ministers and to the European Parliament for their consideration.

21. In Germany, the revenues were used to reduce both employers' and employees' social contributions.

22. The Packaging and Packaging Waste Directive (94/62/EC) and the Landfill Directive (9931/EC).

23. See Biermann and Bauer (2005), and Bauer and Biermann (2004) for the arguments, and see France Diplomatie (2006) for a French government proposal for a United Nations Environment Organisation.

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Chapter 6

Making reform happen in education

by Gregory Wurzburg*

This chapter discusses factors that influence education reform. It starts by describing the features of the education sector that are shared with other areas of public policy and those features that set education apart. This is followed by three case studies that examine in detail the implementation of education reforms in Denmark, Finland and Portugal. The final section draws on both the case studies and the larger literature on policy reform to identify some conclusions about what drives – or impedes – the implementation of education reform.

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The challenge of education reform

Reform is complicated by uncertainty about its costs and benefits and by the long time lags involved

Implementation of education reform is influenced by many of the same factors that influence implementation in other sectors. There is uncertainty about the size and distribution of benefits. But uncertainty is a particularly vexed issue in education reform because of the range of actors (including students, parents, teachers, employers and trade unions) who have stakes in education outcomes. Uncertainty about costs is problematic because education infrastructure is large and implicates multiple levels of government, each often trying to minimise or shift the costs of reform. The potential cost of earnings foregone during tertiary education and further training for adults is another source of uncertainty.[1] To some extent, these challenges are typical of the obstacles facing reformers in many domains. However, assessing the relative costs and benefits in education is rendered particularly difficult by the large number of intervening variables that influence nature, size and distribution of benefits of reform. In short, it is rarely possible to predict clear, identifiable links between policies and outcomes, especially given the time lags involved.

The issue of loss of advantages or privileged positions is of particular importance in education reform, because the vast structure of established (usually public) providers implies the existence of extensive vested interests. The resistance of provider interests to reform may well be more acute in education than in other sectors (except, perhaps, for healthcare) for a number of reasons:

- Teachers are generally viewed positively by the public, even if there is great dissatisfaction with education systems. They often command greater public trust than politicians, so their resistance to reform, will be particularly effective.
- The implementation of reforms is often impossible without the co-operation of the providers. They can easily sabotage reforms in the implementation phase, while blaming policy makers for having attempted misguided reforms in the first place.
- Teachers in many OECD countries are well organised, with strong, politically active unions.

Timing is relevant to education reform in two senses. First and most obviously, there is a substantial gap between the time at which the initial cost of reform is incurred, and the time when it is evident whether the intended benefits of reforms actually materialise. This makes reform a thankless task when elections take place before the benefits are realised. This, too, is a factor that complicates the politics of reform in many domains, but again, it seems to be of exceptional importance in education, where the lags involved are far longer than is typical of, for example, labour- or product-market reforms. Timing can be important also with regard to the sequencing of different components of reform, if one element – curriculum reform, for example – requires prior reforms in pre-service and in-service training in order to be effective.

Some obstacles to reform are particularly acute in education

Because of these factors, resistance to education reform is often the issue uppermost in the mind of reform-minded decision makers. However, there are aspects of education that differentiate it and the challenges of reform from other areas of public policy. The education environment is in certain respects qualitatively different from that faced by policy makers in other areas, first because of the sheer scale of the education enterprise:

- Public spending on institutions alone (excluding financial support for students and families) is greater than 5% of gross domestic product (GDP), and one of the biggest areas of public spending outside transfers (OECD 2009b).
- Educators are one of the largest occupational groups in the workforce; in 2007 instructional staff comprised, on average, some 4.0 % of employment in OECD countries,[2] a fact that reinforces the power of teachers' unions.
- Virtually everyone has experienced education. Completion of upper secondary education is approaching universal levels, participation in early childhood education and care is increasing, converging on the patterns established in some leading countries where it too is universal. Participation in higher education is becoming a mass phenomenon, and increasingly adults participate in some form of "lifelong learning".
- Education is widely present and visible. Virtually every community has a school it can call its own, and higher education and training institutions are more and more part of the local landscape and part of the workplace.

As a consequence, interest in the status quo appears to be more broadly and deeply vested in education than in other areas of public policy. Even small reforms can involve massive reallocations of resources, and touch the lives of millions on both the client and provider sides. This rules out "reform by stealth" and makes it essential to have consensus, or at least broad political support.

However, the pressures for change in education are strong and growing

However, there are strong countervailing forces that intensify the pressure to depart from the status quo because the stakes in the outcomes of education are important and, by every indication, growing. At a micro level, education plays an important part in determining employability and earnings, and at a macro level, it is associated with higher levels of productivity and output growth.[3] The emergence of the knowledge society and the upward bias in skill requirements in the labour market only increases the importance of education. Inversely, the cost of underperformance and underinvestment in education also is rising. The effect is two-fold. First it broadens the circle of those who feel they have direct stakes in the outcomes of education beyond parents and students to employers and virtually anyone with a stake in social and economic welfare. Secondly, it makes them more demanding.

Strategies to overcome resistance to education reforms are similar in certain respects to those adopted in other areas. Reform is more easily undertaken in "crisis" conditions, although the meaning of "crisis" may be somewhat different in education. The exogenous shock involved is likely to be something that radically and abruptly alters perceptions of the system rather than an event that suddenly affects its ability to function. For example, the release of a highly publicised report on disappointing education outcomes or performance may engender a sense of crisis, not because educational outcomes have suddenly changed, but because assessments of those outcomes have. Publication of *A Nation at Risk* (National Commission on Excellence in Education, 1983) riveted public attention on shortcomings in US education and raised questions about the impact of earlier reforms on the quality of education (see Colardyn, 2009). The release in December 2001 of the first OECD Programme for International Student Assessment (PISA) results (OECD, 2001) sent shock waves through Denmark because they undermined the widely shared but unsubstantiated view that Denmark had one of the best education systems in the world. PISA provided robust evidence that instead the system was merely mediocre – close to the OECD average – and fairly inequitable. After considerable soul-searching and an expert review by the OECD, the Danish government launched a far-reaching reform of primary and lower secondary education (OECD, 2004a). "Crisis" often takes other forms in education. It can be the slow-building, but relentless, pressures imposed by demographic forces. For example, the prospect of abrupt demographically induced declines in numbers of upper secondary school graduates forced the government of Finland, only a few years after it created a new polytechnic sector, to launch ambitious reforms to reduce the number of tertiary institutions and overhaul their governance and financing. In Germany, shrinking age cohorts forced some *Länder* to merge education tracks at the secondary level (*Realschule* and *Hauptschule*). In Portugal urgent questions about the adequacy of tertiary education arose in the 1990s because of the lagging growth in tertiary enrolments juxtaposed with the increasing demand of the emerging knowledge society for higher-level skills and competencies.

Internationalisation is also exerting pressure on education systems to reform. In the United States, there is now unprecedented interest in trying to benchmark the school performance of individual states to international standards. After literally decades of bitter and inconclusive debate over the pros and cons of national or federal standards for judging education outcomes, 46 of the 50 states have agreed to sidestep the issue and begin benchmarking performance to international standards using PISA (McNeil, 2008). Internationalisation of student flows has intensified competition for students. One consequence in Europe has been to stimulate the comparatively rapid and voluntary pursuit of the Bologna Process to simplify the degree structure of European universities, making it easier for students to compare universities in different countries and move from one university to another, and for graduates to be more mobile in European labour markets. Internationalisation of higher education led to the aggressive merchandising of higher education in developing countries that pushed OECD countries to support an initiative by the OECD and the United Nations Educational, Scientific and Cultural Organization (UNESCO) to establish international standards regarding trade in education services (see OECD 2004b, 2005).

The complex governance of education systems makes co-ordination of reforms particularly important

As in other sectors, co-ordinated reforms in discrete parts of the system have proven to be mutually reinforcing. This was the case in Scotland when the government, intending to initiate sweeping reforms to curriculum, testing, and leadership, started with an overhaul of teacher training, induction and pay. The success of reforms to curriculum and testing were seen as hinging on prior reforms that would have an influence on who teaches and how they are trained (OECD, 2008b).

However, insofar as education systems involve multiple levels of government, implementation of "comprehensive reform" may be difficult to co-ordinate across the different levels of the administration, and across multiple regional and local jurisdictions. This problem was encountered in Denmark where it has been difficult to synchronise national reforms to strengthen national testing with the pre- and in-service training of municipally employed teachers (Nusche, Wurzburg and Naughton, 2010). The United States shares with other federal systems (Austria, Australia, Canada, Germany, Switzerland and the United Kingdom) a different kind of problem in attempting to address the problem of weak schooling performance that has been viewed with alarm for more than half a century. Though the federal government can require states to set quality standards as a condition for receiving federal money for education, it cannot determine what those standards are (OECD, 2007a). It was only in 2009 that state school officials and governors agreed on the principle of establishing national, common, core standards in English language and mathematics.[4]

More generally, there are several important features of education systems that distinguish them from certain other areas of public policy:

- *Specific capacity constraints*. Overcoming resistance to reform is wasted effort if systems do not have state-of-the-art knowledge, professional know-how and adequate institutional arrangements to support dissemination of information and lessons about the new tasks and responsibilities inherent in the reforms. Successful reform may require significant investment in staff development, or clustering reforms to build up collateral capacity in related institutions.

- *General capacity considerations*. In the knowledge society, the increased importance of human capital is reflected in the increased demand for education at preschool through to tertiary education, although in some countries declining birth rates have dampened the effect of rising participation rates. Internal and international migration can add to the challenge of anticipating and responding to changes in demand for education.

- *Complex governance*. Education systems extend from local schools and independent universities to national ministries. The responsibilities of institutions and different levels of government vary from country to country, as do the relative importance and independence of non-public providers. Reforms need to take into account the respective responsibilities of different actors. Some reforms, particularly those related to strengthening accountability for the performance of the education system, may only be possible if responsibilities can be reallocated.

- *Greater availability of performance data*. There has been an explosion of information on the performance of education systems, down to the level of the individual classroom and student as obtaining, managing and accessing information has become cheaper. A political trend towards increasing accountability for public services has spurred greater interest in benchmarking performance – locally, nationally, and internationally. This has extended the frontier of knowledge and permits more "evidence-based" policy making. However, though the increased information has resolved some issues, much is also hotly contested, and the newly available evidence often raises new questions.

Though not unique to education, these factors need to be considered when addressing the challenge of education reform.

Education ministries have been on the front line of some of the most visible and often controversial public policy reforms on issues related to improving quality, to the status of teachers, to strengthening accountability, to managing capacity in the face of declining demographics and rising participation rates, and controlling and financing the cost of mass participation in higher education. Education policy makers know only too well the difficulty of securing the financial base for expanding tertiary education, whether by reallocating away from other areas of public expenditure, or imposing student fees. Schooling reforms that entail more testing of students often encounter resistance from teachers concerned about crowding out of time for teaching; reforms to advance or delay vocational studies may be resisted by parents who are sceptical about whether promised benefits will materialise.

Additional reform lessons emerge from international exchanges of experience with education reform

In September 2008, the OECD Education Policy Committee met at chief executive level to discuss why some reforms succeed and others fail, how to persuade parents, teachers, and politicians to support reforms, and what changes the minds of stakeholders who initially resist reforms or their implementation. In their meeting hosted by Korea's Vice Minister of Education, Science and Technology, senior policy makers shared and compared their experiences with the process of formulating and implementing reform in four areas: improving school outcomes; tertiary education; the introduction and use of information and communication technology (ICT) in education; and whole-of-government strategies for lifelong learning. Several recurrent themes emerged out of the discussions:

- Policy makers need to build consensus on the aims of education reform and actively engage stakeholders, especially teachers, in formulating and implementing policy responses.

- Reforms can capitalise on external pressures as part of building a compelling case for change.
- All political players and stakeholders need to develop more realistic expectations about the pace and nature of reforms to improve outcomes.
- Reforms need to be backed by sustainable financing.
- There is some shift away from reform initiatives *per se* towards building self-adjusting systems with rich feedback at all levels, incentives to react and tools to strengthen capacities to deliver better outcomes.
- Investment is needed in change-management skills in the education system. Teachers need reassurance that they will be given the tools to change and recognition of their professional motivation to improve outcomes for their students.
- Evidence can be used more effectively to guide policy making, combining international benchmarks with national surveys and with inspectorates to provide a better diagnosis.
- Evidence is most helpful when it is fed back to institutions along with information and tools about how they can use the information to improve outcomes.
- "Whole-of-government" approaches can include education in more comprehensive reforms. These need effective co-ordination and overall leadership across all the relevant ministries.

The lessons emerging from the discussions of education chief executives were broadly consistent with those gleaned from earlier OECD work. But it also was apparent in the discussion that the usefulness of broad lessons can be severely constrained by country-specific circumstances related to institutional arrangements. For example, the role PISA results played in education debates in federal systems such as Germany and the United States was different from the role they played in more centralised systems, such as in Denmark or France, because in federal systems, the federal government has no direct role in education provision. The applicability across countries of lessons is constrained as well by differences in the nature of external shocks and pressures, and how they are transmitted through a system. For example, the fall of the Berlin Wall triggered very severe shocks in Finland because of its unique status as an important western portal for trade with the then Soviet Union, and then amplified by the timing of the event (more on this later). Portugal was particularly sensitive to the skill bias of technological change that became evident during the early 1990s, because the educational attainment of the population was so low. The impact of the current financial and economic crisis on school expenditure is influenced by issues as distinct from each other as the importance of local funding, and the capacity and willingness of different levels of government to engage in deficit financing.

Because country-specific circumstances are important determinants of how policy is implemented, case studies of country-specific experience remain an important source of insight into why some reforms are implemented successfully and some are not. This also limits the usefulness of generic lessons about how to make reform happen. The next section examines education reform in three countries. The first case study deals with evaluation reform in Denmark, the second with the introduction of a polytechnic sector to the Finnish tertiary education system, and the third with broad tertiary education reform in Portugal. Each of the cases describes the background to the reform and outlines its main features, results and outcomes to date. Then each examines the role played by four levers that are found in cross-country and cross-sectoral analysis to have an influence on the trajectory and pace of reform, the degree to which reforms are implemented and the impacts that reforms finally have on policy and practice.

Denmark: introducing a culture of evaluation

The emergence of new evidence provided a shock to the system that led to reform

Until recently, education decision makers and stakeholders in Denmark had very limited means for gauging education performance. The first results of PISA published in December 2001 were a jolt to Denmark and its education community, because they filled a void in evidence of system performance. The PISA results were surprising not because they were particularly bad – Denmark scored slightly below the OECD average on reading and slightly above on math and science – but because they were at odds with the widely shared, but poorly substantiated, belief that Danish schools were equitable and ranked among the best in the world.

The absence of systematic and comprehensive evidence made it difficult for the Ministry of Education to detect and prioritise problems of underachievement and for parents and local governments to gauge how effectively their schools were working. PISA had a large, perhaps disproportionate impact, because it suddenly shed light on issues that, until then, had been invisible at a system level. Subsequently the Danish government embraced recommendations from an OECD review[5] that argued for "a culture of evaluation".[6] In the wake of the publication of PISA results and the subsequent OECD review of the Danish *Folkeskole* (the elementary and lower secondary education system), and following further debate among stakeholders in Denmark, the Danish authorities in 2006 adopted amendments to the *Folkeskole* Act that led to a range of measures to expand and improve information on performance of Danish education. Three critical elements[7] were:

- the requirement that each student have a "personal education plan";
- the requirement that each municipality prepare an "education quality report" on the schools in its jurisdiction; and
- the introduction of mandatory national testing every year from years two through eight of the *Folkeskole*.

In addition to these measures, the government adopted an initiative called "promoting a culture of evaluation" to encourage various actors to follow performance more closely and take steps to improve performance where needed. Collectively, these measures constituted an ambitious and promising framework for obtaining, analysing, and using feedback on the functioning and performance of the *Folkeskole*. The ultimate effectiveness of that framework however depends on how well the individual components of evaluation and assessment are implemented, and whether and how the information from evaluations and assessment is used within municipalities, schools and classrooms.

Systems for tracking and improving student performance have been strengthened

Two elements of the framework appear to be working well. The most successful has been the "personal education plan" that teachers are now required to prepare for every student.[8] The law requires that the plans set out learning targets for each student, and, taking into account the results of examinations and evaluations that measure proficiency and performance, that they be adjusted accordingly. On the basis of discussions with teachers, parents, students, and school leaders that were conducted as part of an OECD review of migrant education in Denmark,[9] it would appear that the plans have been widely implemented and are broadly supported. Teachers find them to be useful for organising diagnostic and performance-measurement information into a transparent tool for gauging performance and progress. They also find the plans to serve as a useful basis for discussions between educators about the different learning needs of students and the effectiveness of different approaches to teaching. Teachers as well as parents expressed the view that the plans provided a "neutral" or "evidence-based" agenda for parent-teacher meetings. Some migrant parents found this to be particularly important as a way of getting around the difficulty of relying entirely on oral communication for the parent-teacher meetings.[10]

The second element of the ministry's overall strategy for establishing a "culture of evaluation" in the *Folkeskole* is the "education quality report" that each municipality is now required to submit. The purpose of the report is to provide a structure that allows municipalities to address the question of how well they are carrying out their obligation to provide education that meets the "common objectives" established by the *Folkeskole* Act. The education quality report is intended to describe the municipality's school system (number of schools, enrolment levels, number of staff, overall administrative arrangements), the schools' academic level (as measured by school leaving examination results, other examination results, national test results when the testing regime is in place), the measures the municipal board has taken in order to evaluate the academic level, and the steps the municipal board has taken in response to the previous quality report.[11] The reports appear to have great potential as a tool to drive a more systematic approach to the collection and analysis of information on a broad range of dimensions of performance, including how well schools are meeting the needs of migrants. As such, the quality reports serve two purposes: first as an accountability tool for judging whether municipalities are meeting their obligation to take care of primary and lower secondary education; and secondly as a tool for guiding strategies to improve the quality of education.

The personal education plans and the municipal education quality reports appear to be complementary approaches for systematically tracking and improving performance at a student and classroom level, and at a more systemic school and municipality level. They have the particular strength of being non-targeted measures that make it easier to identify students with low levels of performance and bring in to play appropriate remedies at the level of the classroom as well as the school and municipal level.

The third element of the framework was to consist of mandatory national testing from year two to year eight. This element was voted by the parliament in 2006 and is supposed to be implemented in 2009; however it has been put off to 2010 and may be delayed until well after that. Among other consequences, the delay in establishing the system of mandatory national testing will deprive the municipal education quality reports of the means for benchmarking school performance – locally or nationally.

The full implementation of these approaches and realisation of their potential depends on education professionals having the capacity to use the tools appropriately. Here the record is mixed. Authorities at the level of the municipalities recognise the need to obtain better data and evidence and build up capacity to use it. The municipalities began to take steps to improve information on performance and support school improvement where evidence showed that performance was lagging. In 2007, Local Government Denmark (Kommunes Landsforening [KL]), the association of the 98 municipalities in Denmark together with the Danish government and Danish regions launched a project to determine what kinds of indicators were needed in order to monitor the state of the *Folkeskole* in Denmark. KL reports that most municipalities now have experts on evaluation or at least have persons who have had some training in the field, so as to help schools with the development of personal education plans and the preparation of education quality reports (both requirements of the legislation outlined above). Additionally KL has set up a partnership on the *Folkeskole* involving 34 municipalities for the purpose of improving learning outcomes of students. This initiative is intended to provide teachers and school leaders with technical assistance and guidance for the purpose of developing assessment and evaluation practices in the classroom and at the level of the school that will help educators better identify students in difficulty, to better diagnose the sources of their problems, and develop personal education plans accordingly. As part of this process of building up technical know-how and capacity at the level of KL and individual municipalities, KL is also turning to municipalities in other countries for relevant experience (see, for example, KL, 2009).

It has been important to engage practitioners in an ongoing process of reform

Within schools, the introduction of the personal education plans has attracted the support of teachers because the plans align well with the "whole child" approach that has long been part of the *Folkeskole*. The plans also do not require teachers to have high levels of proficiency in complex evaluation and assessment techniques. The in-service training in teaching Danish as a second language includes training in formative assessment to help teachers better identify and diagnose the learning needs of migrant students. The evaluation consultants in the municipalities also provide training and support for teachers.

In addition to the formal requirements for the personal education plans and the municipal education quality reports, Danish educators increasingly turn to practitioners for ideas on how to improve education for migrants and more generally, thus overcoming a tendency noted in the 2004 OECD review for teachers to be "modest about their successes and … [hesitant] to claim that what they are doing is special" (OECD, 2004a). One example is a study funded by the Ministry of Internal Affairs and carried out by the Ramboll Corporation in 2006 to identify, document and evaluate examples of what teachers consider to be successful strategies for meeting the learning needs of migrant students. Reports on good practice, quality development, student composition and municipal support and co-ordination are available on a website for stakeholders to consult.[12] Another initiative is the Task Force for Bilingual Students that was established in 2008 by the Ministry of Education in co-operation with the Ministry of Refugee, Immigration and Integration Affairs to assist municipalities in improving the quality of schooling for migrant children. Staffed by the Ministry of Education and followed by a steering group of representatives from both ministries and the municipalities, the task force is working with educators and officials in five municipalities[13] to take stock of the factors that hinder integration of migrants and to develop action plans for teachers, schools and municipalities to address those factors. This increased reliance on the experience and expertise of practitioners complements academic research in the area of migrant education.

A new national curriculum is being launched in mid-2009. Among other things, the curriculum is intended to embed strategies for improving education for migrants in larger strategies for raising education outcomes overall. Rather than treating Danish as a second language as a separate course for migrants, the new curriculum will aim to integrate mastery of Danish into specific subject areas such as mathematics or history. The curriculum also will establish mandatory attainment targets for municipalities and schools. When combined with the requirements for municipalities to indicate in their quality reports how weak performance will be improved, this has the potential to reinforce not just a culture of evaluation, but a culture of continuous improvement.

As is clear from the preceding section, the past several years have witnessed important progress towards implementation of a "culture of evaluation" in schools. There is every indication from research outside Denmark that this progress will help reduce the "guesswork" and uncertainty in schooling about who is in trouble, why some students encounter difficulty in learning, and what strategies are most likely to improve performance.

Reform progress has been uneven, owing to capacity constraints and fragmentation of authority

Progress in introducing a "culture of evaluation" in Denmark has been uneven down through the different segments of the pathway between the ministry and the classroom; this reflects the differential influence of the various levers for reform at different points along that pathway. Capacity constraints at the level of the municipality and classroom appear to play a role in determining where reforms have moved ahead most and where their implementation lags. This has been most evident in the classroom, where teachers have little access to pre- or in-service training that prepares them to conduct assessment and evaluation, and to interpret their results, including the results of national testing.

School leaders have no formal training requirements in school leadership or the use of assessment and evaluation methods. Some of these deficiencies can be compensated for through expertise provided by evaluation consultants employed by municipalities (the level of government responsible for delivering schooling). But not all municipalities have such consultants. The effect of these constraints has been mitigated by the fact that at least two elements of the reform – the use of the personal education plan and the municipal quality reports – can be implemented in more or less complex forms. Both are essentially platforms whose precise use is influenced to some degree by the capacity of the individuals completing them. If/as their continuing implementation becomes more demanding in terms of the kind of criteria that are included and the kind of supporting evidence required, capacity constraints may become more binding.

The implementation of reforms to strengthen the "culture of evaluation" has been hampered to some degree by the fact that responsibility is fragmented at critical points of the implementation process. This makes it difficult to ensure that all the needed elements are being dealt with correctly and at the right time. The provision of pre-service and in-service training needed to equip teachers and school leaders to collect and use evaluative evidence is a case in point. Though the ministry may mandate testing, *e.g.* it is up to an independent advisory body to determine what teachers need to know in order to carry out testing and use information obtained from testing; then it is up to autonomous teacher-training institutions to decide how much and what kind of training to provide. There is also limited room for manoeuvre in using financial resources to incentivise behaviour. The municipalities finance school-related spending, including that for in-service training. Even if the ministry imposes new demands on teachers by requiring personal education plans to be completed for all students, the decision of whether to train is made at the local level (frequently in the school). Though the ministry may allocate extra financial resources to help defray the costs of implementation, such resources cannot be ring-fenced and how they are spent is ultimately a matter of local discretion.

Stakeholders have reacted more favourably to some elements of reform than others

To all appearances, the degree to which the various facets of the "culture of evaluation" have been implemented has been influenced strongly by the reaction of parents of students and teachers. Anecdotal evidence suggests that the personal education plans have been popular with both parents and teachers. For parents, it provides a vehicle for structuring discussions with teachers about the progress of their children that, for some, is less threatening than a parent-teacher meeting with nothing in writing and no clear reference points. Some migrant parents have been strongly supportive of this as a way of reducing the reliance on oral communication alone (a challenge for those encountering language barriers). The teachers have welcomed the plans for similar reasons. They also have welcomed them because the plans accommodate a comparatively unstructured form of assessment that is more in line with what was done before. Because it is in writing, it also facilitates interaction with other teachers on questions about learning difficulties encountered by particular students and the comparative effectiveness of different teaching styles. However, progress on national testing has been hampered by strong resistance. Though the parliament voted in 2006 to require a system of mandatory national tests from year two to year eight in the *Folkeskole* by 2009, this programme will not be implemented on schedule. The mandated testing is a sharp break with the past when most examinations were voluntary (even the school leaving examinations were voluntary until recently). Moreover, many teachers see the tests more as tools for imposing accountability than as tools for improving schools and learning.

International influences have been critical

External evidence in the form of internationally benchmarked education performance measures (*i.e.* PISA) has been critical in stimulating and shaping the initiatives to strengthen the culture of evaluation in Danish education. This evidence was influential in two ways. First and most obviously, it filled a vacuum in credible evidence on performance of the Danish education system. In doing so it established to the satisfaction of most that the *Folkeskole* was underperforming and in need of repair. Secondly, it made it possible to benchmark Danish education outcomes against those of other countries, including countries to which Danes wished to be compared. Although PISA was not the first source of international evidence suggesting that Danish schools were not as successful as widely believed,[14] it provided the first results that were robust and fully internationally comparable. However, PISA results alone did not drive the reforms; they served as a catalyst to spark a reform debate. The content of reform was subsequently shaped by a policy review carried out by the OECD. That review, the first to use PISA, also drew on other sources of information to identify strengths and weaknesses of the *Folkeskole* and propose strategies for capitalising on its strengths and overcoming its weaknesses. Even then, the OECD did not provide a blueprint. Rather it set a broad direction that was subsequently refined and further adapted to the particularities of the Danish situation.

Finland: introducing polytechnics into the tertiary education sector

A severe economic shock triggered a debate on the need to expand, and refocus, tertiary education

In the late 1980s, Finland's exports, though increasingly high-tech, were dominated by paper and wood products, and Nokia was a town best known for its tyres and rubber boots. There were signs of strain in the economy. The effects of the near jobless growth that was endemic to parts of Europe were compounded by regulatory and structural changes that were being undertaken to modernise the Finnish economy and its place in the European Free Trade Association (EFTA) and the Nordic region. In November 1989, the Berlin Wall came down. This put an abrupt end to Finland's unique status as a prime portal for western trade with the Soviet Union, and tilted the creaking economy into a brutal and deep dive. Growth plunged, then turned negative; unemployment rose. In 1990 GDP was shrinking at an annual rate of 6%. A Presidential Commission was established to referee consultations and develop a plan for recovery. It concluded that, among other things, the future should be in more than forest products, rubber boots and truck tyres. In that climate, investment in human capital was seen as a good hedge against risk and uncertainty.

The government agreed to double higher education enrolments by the end of the century. But this goal posed a dilemma. University education at the time was academic, long and expensive. There was a perceived need for shorter and less academic programmes of study, with greater emphasis on advanced technical subjects that would leave graduates ready for jobs in the knowledge economy already emerging in Finland and elsewhere. There was a widely shared view that the universities would be too slow to implement the necessary changes and that the needed reforms would be too costly or require too much bargaining to be implemented. It was concluded that a more expeditious strategy for achieving the desired changes in the content and delivery of tertiary education was to create something new.

In 1991, the parliament passed a law to create, on a pilot basis, a new professionally oriented polytechnic sector, the *Ammatikorkeokoulu* (AMK). The new institutions were to build on a pre-existing network of 250 post-secondary vocational institutions. The establishment of the polytechnics called for instituting new governance structures based on municipalities or foundations owning the institutions, direct financing from the Ministry of Education and Research, and upgrading the teaching staff. It was intended that polytechnics offer advanced studies ending with a bachelor's degree, a degree that until then was not awarded by universities, but which was fully consistent with the degree structure of many of the Anglo-Saxon countries and which foreshadowed the structure encouraged by the Bologna Process at the end of the 1990s. In the mid-1990s, new legislation was adopted making the 22 pilot institutions permanent; the total number eventually grew to 29. By the end of the century, tertiary enrolments had more than doubled; all of the net increase in enrolments that occurred since the beginning of the decade was in the new sector.

The reforms set in train a large-scale restructuring of tertiary education that is still ongoing

In 2002, an OECD team of experts released a report broadly praising the quality of the new AMK and the greater degree of differentiation that the AMK injected into tertiary education in Finland, including the possibility of a professional degree at master's level. The OECD experts endorsed the more locally oriented governance structure of the AMKs,[15] and supported changes in financing arrangements to link central government funding more directly to performance and less to student enrolments, as well as to enhance the capacity of polytechnics to respond to demands of local and regional development (OECD, 2003a). Three years later, in a progress report to the OECD Education Committee, the Finnish authorities reported that polytechnic applications and enrolments continued to grow and that polytechnic graduates continued to fare well in the labour market. The authorities reported that important reforms had been introduced to enhance autonomy, link financing more closely to performance, formalise a professional master's level degree, and strengthen research and development (R&D) in polytechnics.

However, the good news about the early success of the AMK was overshadowed by an internal government analysis that in the latter half of 2005 warned of a deep long-term decline in tertiary education enrolments driven by declines in the number of young people.[16] This was followed by a more far-reaching study by the Economic Council of Finland in 2006 that, on the one hand, underlined the importance of the past contribution of education and R&D to Finland's long-term economic performance, but, on the other hand, argued for restructuring and better focusing of resources in the sector by creating strategic centres of excellence. The report proposed detailed guidance on rationalisation of the tertiary education sector that involved consolidation and the closing of some institutions, and concentrating resources and streams of studies (Prime Minister's Office, 2006). This prompted a new round of reflection about the scale and structure of tertiary education in Finland, and questions about the affordability of a large number of differentiated institutions (29 polytechnics and 23 universities). Over the following years, some consolidation occurred, with a number of polytechnics and universities being consolidated, but with the differentiated structure being retained. This latest round of administrative and legislatively mandated changes culminated in the Universities Act of 23 June 2009, which increased the administrative and financial autonomy of universities and was associated with the consolidation of three universities in the Helsinki region into one. In the meantime, the universities implemented a number of changes in the structure of some of their own programmes, introducing bachelor's degrees in engineering.

The rapid pace and large scale of the transformations that occurred in tertiary education in Finland over the past two decades belied long-standing resistance to such reforms. As early as 1981, the OECD recommended that Finland diversify the structure of its tertiary education system by introducing a parallel system of polytechnics based on a shorter degree programme (most university study terminated in a master's degree at least). The purpose of the proposed change was to raise and diversify the qualifications of the Finnish labour force (OECD, 1982). The ministry concluded at the time that the proposal was not "practicable" inasmuch as Finland had just completed reforms to strengthen vocational education, including at the post-secondary level (OECD, 2003a). But there also was stiff resistance among university professionals who warned against the risk of "academic drift" in the proposed polytechnics and resented the prospect of increased completion for tertiary education resources. Small and medium-sized enterprises (SMEs) also expressed misgivings about the reforms, worried about whether a flood of polytechnic graduates would unnecessarily inflate job requirements and salaries (see OECD, 2003a).

The tertiary education landscape in Finland today is profoundly different from two decades ago. The creation of the polytechnic sector broadened the scope of studies that students could undertake, and introduced gradations of depth of specialisation and application that had not existed before. It responded effectively to strong societal demand for tertiary education; in view of Finland's continuing transformation as a knowledge society, the creation of the AMKs also met (if it did not proactively help shape) economic demand for more advanced skills. Finland today has one of the highest rates of participation in tertiary education in the OECD. Moreover, notwithstanding the universities' earlier resistance to the creation of the polytechnics, the universities themselves have changed and engaged as well in a separate process of reform.

The creation of the polytechnics in Finland has been a relatively smooth process of reform that achieved its objectives, generated substantial and observable positive outcomes, and appears to have had positive collateral impacts on the universities. Has this been the result of chance or some unobserved characteristics of Finnish society and Finnish government? Or has this been the result of a manageable process of "making reform happen" that has lessons for public policy reform in other countries? The following discussion examines the polytechnic reform in Finland through the prism of the four levers of reform that have been found to be effective in other situations.

Political leadership was important in advancing reform

A critical element in the foundation of the successful polytechnic reform was the strong role that the Ministry of Education and Research could play in setting the direction of reform, and creating incentives and means for various stakeholders to support it. The ministry controlled financing of the post-secondary vocational institutions, as well as universities, and was in a position to steer policy regarding enrolment levels in different courses of study and duration of studies. The ministry had influence as well over student-support schemes. It was able to employ these tools to good effect by nesting the reforms in a fairly coherent long-term strategy for institutional development that was in turn synchronised with the trajectory of economic development.

The Economic Council in the Prime Minister's Office was another key element of the institutional arrangements in Finland that favoured polytechnic reform. Its report in 2006 recommending rationalisation of the tertiary sector simultaneously intensified the pressure for further restructuring while also providing fairly detailed guidance as to the direction that such restructuring should take.

The reform created few losers and a substantial number of winners in a relatively short time

One of the striking aspects of the reform to establish the polytechnic sector was the fact that there were very few stakeholders who lost much in absolute terms, and many stakeholders who gained considerably. The big winners in the reforms were students who had been unable to find spots in universities or were unable to find the particular stream of studies in technical areas in which they were interested. The reforms, in increasing capacity and broadening the diversity of what was on offer, generated a high level of satisfaction among incoming students. The principal "losers" were the heads of the 250 or so post-secondary vocational institutes that were transformed into a much smaller number of larger institutions. But the staffs in the institutions were for the most part able to continue employment in the larger institutions so long as they pursued the necessary studies to raise their qualifications to at least the master's level.

Finnish universities were one set of stakeholders whose active resistance might have slowed development of the polytechnics and undercut their legitimacy. In fact, serious organised resistance on their part never materialised. There are a few possible explanations. Inasmuch as the polytechnic sector was created by shifting resources from the pre-existing post-secondary vocational education sector (thus minimising net new expenditure), the universities could hardly argue that the polytechnics were getting resources that would have otherwise gone to universities. Because of the widely held outside view that university studies were too long and academic, universities were in a weak position to argue for additional resources. In fact, the establishment of the polytechnic sector probably eased pressure on universities to make major changes in their structure and operations. After the first decade of operation, when it was clear that all net new growth in numbers of tertiary enrolments were in the polytechnic sector, it might have been argued that polytechnics were siphoning off resources that might otherwise have gone to universities. But by then, some universities were already searching for ways to adapt to a changing national and global environment. Though the consolidation and rationalisation that began in the wake of the 2006 globalisation report might have generated resistance among universities, little resistance materialised, perhaps because the sense of necessity and urgency surrounding the restructuring agenda was widely shared or perhaps because the restructuring was accompanied by increased institutional autonomy.

The timing of the reforms owed much to external factors

The timing of the creation of the polytechnics at the beginning of the 1990s and the terms under which the new system was created were closely linked to the timing of the political and economic events associated with the fall of the Berlin Wall. It did not happen earlier, because prior reforms to post-secondary vocational education had barely taken effect: the cement on what was to be the foundation of the eventual polytechnic system was barely dry. But timing was critical also because latent resistance to the creation of a larger, more diverse sector (particularly on the part of universities trying to reduce competition for scarce financial resources) would have had a greater chance of defeating the reforms. By the early 1990s, events had changed the political climate, and decisive action (as well, no doubt, as the appearance of decisive action) was needed. The government's stated goal of doubling tertiary education enrolment was a highly visible and welcome sign of a clear plan. The creation of the polytechnics promised that a doubling of tertiary enrolments would not lead to "more of the same".

The creation of the system was also complementary to other aspects of economic policy being put into place at that time to deal with the crisis. The new polytechnics provided a vehicle for enlarging and deepening the base of human capital needed to support the kind of innovation and restructuring that the government was encouraging. The prospect of expanding post-secondary education also offered the possibility of postponing the entry of upper secondary graduates into a slack labour market, which would have raised unemployment rates.

The Finnish authorities have made extensive – but selective – use of OECD analysis and advice

Finland has a long record of relying on international organisations as sources of external benchmarks against which its performance could be judged. In one comprehensive stocktaking of all the reviews of Finnish education policy that were carried out by the OECD (Rinner, Kallo and Hokka, 2004) concluded that by dint of its policy work as well as its statistical benchmarks for comparing countries, "the OECD has had a major influence on Finnish education policy." In focusing on the reviews by the OECD of higher education and the polytechnics, the authors criticised the Ministry of Education and Research for being too responsive to suggestions of the OECD. They noted that following the 1994 review of higher education (OECD, 1995a), "Finland had either already reacted to or was in the process of reacting to all the recommendations" (Rinner, Kallo and Hokka, 2004). They noted similar responses following the 2002 review of the polytechnic system (OECD, 2003a), highlighting that the ministry had taken action on "points about which the OECD had made critical comments" (Rinner, Kallo and Hokka, 2004). They conclude that though "[t]he OECD has no legal decision-making power over the education policy of its member countries … the organisation has achieved a sound political resonance at the highest level of decision making" (Rinner, Kallo and Hokka, 2004).

However, that assessment may oversimplify the manner in which outside benchmarks and international organisations have influenced the trajectory of polytechnic reform (and education reform more generally) in Finland by caricaturing it as a one-way process of OECD advice leading to policy response in countries. Jorma Julin, a former Finnish ambassador to the OECD, has implied a more nuanced relationship between OECD input and public policy in Finland:

> *The views of the OECD have always been taken seriously, even though they may have been criticised from various quarters. Numerous recommendations and good practices of the organisation have been implemented in Finland, as well perhaps not always immediately or in full measure without adaptation, but there has never been any unclarity (sic) about the direction of change. (Rinner, Kallo and Hokka, 2004)*

In the case of the polytechnics in Finland, there is clear evidence that Finnish actors set the broad direction of policy (the decision to create the polytechnics, governance and status, and timing), and then drew selectively on outside influences to help steer the debate and marshal support inside the country. There are two reasons to support this alternative interpretation of events:

- The Finnish authorities had full control over the decision to seek advice of the OECD, and over the scope of advice being sought. The 1982, 1995, and 2002 OECD reviews, which all contained recommendations related to the creation, structure, governance and financing of polytechnics, were initiated by the Finnish authorities. The "terms of reference" that guided the scope of the reviews were established by the OECD in co-operation with the Finnish authorities. The implication is that the Finnish authorities were predisposed to at least the broad thrust of the reviews.

- The Finnish authorities had full control over the decisions to implement or ignore recommendations in the review. They were selective about which recommendations they acted on and in the way in which policy was implemented. Notwithstanding the recommendations that were followed (cited earlier), the authorities ignored the 1982 recommendation to create a polytechnic sector and they ignored the 1995 recommendations to shift a part of the financing burden to students.

This would suggest that the OECD's capacity to promote reform hinges more on being able to answer incremental questions about how to reform, rather than more fundamental questions of whether and when to reform.

Portugal: tertiary education reform

Portugal has experienced a dramatic expansion of tertiary education since the mid-1970s

The 1974 revolution in Portugal marked the beginning of, among other things, an opening up of education. Until then, less than 10% of cohorts were completing upper secondary education and only 5% had university qualifications. This placed Portugal behind all OECD countries except one, usually by a wide margin (OECD, 1995b). Afterwards, participation exploded. By the turn of the century the proportion of 25-34 year-olds that had completed upper secondary education was more than three times higher than the proportion among adults who had been schooled 30 years earlier. University completion had increased more modestly, rising by 50% (OECD, 2003b). But the population growth during that time concealed the scale of tertiary expansion. Between the 1960s and the turn of the century, tertiary enrolments increased more than 13-fold, rising from 30 000 students to 400 000. In the ten years ending in 2002-03, enrolments more than doubled (OECD, 2007b). The expansion of tertiary enrolments was achieved through reforms that expanded the tertiary sector, but shifted growth to favour polytechnic and private institutions. In the 20 years ending in 2003-04, the university share of enrolments declined by 40%, while the polytechnic and private shares more than doubled. In 2007, there were 30 universities and 130 polytechnics. The private institutions were a mixture of universities and polytechnics. The expansion was financed in part by increased public outlays as well as by the introduction of modest student fees.

The dramatic expansion of tertiary education was a major accomplishment; however it was not trouble-free. Though intake and total tertiary enrolments increased dramatically, there were very high drop-out and failure rates. The 2006 OECD review (OECD, 2007b) attributed this to multiple causes. One was the general weakness in the quality of research, reflected in a comparatively low level of expenditure on R&D and small numbers of PhD researchers working in industry. It also identified serious shortcomings in teaching and learning, including long duration of studies, implying high opportunity costs, substantial differences between institutions in the quality of instruction, and weak competencies of entering students because of deficiencies in elementary and secondary education. For example, the 2000, 2003 and 2006 PISA results for 15-year-olds in Portugal have been well below the OECD average. The mean score of 474 on the 2006 survey of scientific literacy was the fourth lowest in the OECD; Portugal had comparatively few 15-year-olds scoring well, and comparatively more scoring poorly (OECD, 2007c). Moreover, though the improvements have been dramatic when judged against where Portugal was a few decades ago, they still fall short of achieving the level of tertiary education needed to stay fully competitive in a global society.

Recent reforms have shifted the focus from expanding access to raising quality

In 2007, the government shifted the emphasis of tertiary education policy from quantitative expansion to qualitative improvement. Reforms to improve quality focused on three areas: governance; education, teaching and learning; and research, innovation and internationalisation.

In the area of governance, the reforms established broad principles for the organisation and steering of the tertiary education system, laying the groundwork for the creation of a Co-ordinating Council of Higher Education (Conselho Coordenador do Ensino Superior [CCES]) that would consist of major stakeholders and provide strategic guidance for the higher education system. The reforms spell out arrangements under which institutions would have greater autonomy (including the possibility of acquiring independent legal status in the form of public foundations governed by private law) and the means for ensuring their accountability; as part of that, the reforms require the establishment of governing boards with external members. The reforms also formalise the distinction between universities and polytechnics, reinforcing the binary system and protecting differentiated choice for students.

Reforms to strengthen education, teaching and learning in the tertiary sector focus on improving access to tertiary institutions and on the quality and relevance of instruction. The Bologna Process has been the principal force guiding reforms in this area. A 2006 Act of Parliament provided the legal basis for this. Since then, new rules have been put in place governing the creation of post-secondary education programmes, providing more flexible admissions and access to tertiary education (particularly for older students), and rationalising access and provision. The latter provisions have made it easier for institutions to ensure quality by setting minimum standards of academic performance for entry to tertiary education, and setting minimum enrolment thresholds for initial degree programmes. The reforms also created the legal framework for quality assurance in higher education and established the National Agency for Assessment and Accreditation of Higher Education. The latter is responsible for the quality assurance of tertiary education institutions and courses, as well as for Portugal's inclusion in the European tertiary education quality-assurance system. In order to ensure that tertiary education was widely accessible, the reforms increased grants and social supports for students and put in place a student loan programme based on government guarantees of private bank loans to cover the direct and indirect costs of participation. Finally, measures have been introduced to begin the process of reforming academic careers. These include steps to differentiate between polytechnic and university staff, and to make it easier for polytechnic staff to facilitate the development of links with the professional world.

Reforms in the area of research, innovation and internationalisation reinforced earlier reforms to enhance capacity and quality, and to facilitate the link between Portuguese institutions and research and innovation initiatives outside Portugal. Since the late 1990s, science policies in Portugal have focused on (i) strengthening and restructuring the network of research centres throughout the country through regular systematic international evaluation, with direct impact on their funding levels; and (ii) promoting critical mass across all scientific disciplines by establishing a network of selected "associated laboratories" in the form of relatively large research consortia oriented towards thematic networks in a number of selected institutions following their international assessment. There have been initiatives to establish research consortia and otherwise strengthen links with the research institutions of Portugal. There have also been initiatives to promote integration of tertiary students into R&D activities early in their studies, and to equip them with the competencies they need to carry out research, and the transferrable skills needed to work outside Portugal.

The initial stages of implementation of the reforms have gone well

The reforms launched since 2006 have largely been implemented, thanks in part to strong political leadership from the Ministry of Science, Technology and Higher Education, but also because the reforms have managed to harness the interests of diverse stakeholders in improving tertiary education. By October 2008, all tertiary institutions had submitted their new statutes to the Ministry of Science, Technology and Higher Education, and most have been approved with minor modifications. Having passed that step, institutions started the process of naming main governing board members. Most of the various building blocks to align tertiary education in Portugal with the Bologna Process are in place. The effects of the reforms are evident as well in the way tertiary education is financed, with the private share of spending on education institutions rising from 7.5% in 2000 to 33.3% in 2006 (OECD, 2009b).

Perhaps the most concrete outcomes to be witnessed are those in the area of research, innovation and internationalisation. In 2008, science and technology spending exceeded 1% of GDP for the first time in history, and the science and technology share of public spending reached 3.6% – a one percentage point increase over 2005 and the highest level ever seen in Portugal. Scientific output as measured by internationally referenced scientific publications increased by 45% between 2005 and 2008. The number of PhD researchers increased 25% between 2007 and 2009.

There also have been concrete manifestations of internationalisation of higher education and science and technology systems. There are established examples of collaboration and partnerships with the Massachusetts Institute of Technology (MIT), Carnegie Mellon University and the University of Texas in Austin, to stimulate the integration of national institutions into scientific networks at the international level. There are other examples as well, some with industry and others with academic and research institutions.

In November 2008, the Portuguese Minister of Science, Technology and Higher Education and his staff reported to the Education Policy Committee on the follow-up to the 2006 OECD review of tertiary education in Portugal. They were congratulated for the progress they had made in formulating and implementing reforms, and the speed with which they had done so. Though the implementation process was not discussed in great detail, it appears there were a number of factors at work.

The leadership of the ministry and minister were critical, owing to weaknesses in other institutions

One point that was stressed repeatedly in the discussion between the Education Policy Committee and the minister was that the leadership of the ministry and the minister were essential in keeping the implementation process moving. This reflected the fact that there was little in the way of other institutional arrangements to initiate and support the process of reform. This lack of arrangements extended from the absence of an independent strategic steering body, to the lack of means for quality assurance, to inadequate incentives and enabling mechanisms to support institutional self-direction, to the lack of means for institutional accountability. The reforms have filled these gaps. However, it is too early to say whether the new arrangements will work as intended; if they do not, their existence may complicate any attempts by the ministry to step in and exert leadership.

It should be noted, however, that the ministry took care to ensure that the conception of the reform rested on foundations outside the ministry. The reforms were the product of an ambitious process of consultation that reached out to virtually all important stakeholders in Portugal. The reform process was also strongly influenced by outside forces and reference points. Perhaps the most important was the Bologna Process to make higher education content and degrees in Europe more compatible and comparable. Though some countries such as the Czech Republic have tended to keep the Bologna Process at arm's length (Czech Republic Ministry of Education, Youth and Sports, 2009), the Portuguese authorities embraced it as a tool to influence the technical design of the reform, and give it political momentum, by linking it to the objectives of wider access to, and clearly differentiated pathways in, tertiary education, and enhanced international mobility of tertiary graduates.

The early stages of reform created a number of winners and few losers among stakeholders

The speed with which the reforms have been enacted and the substantial progress towards implementation are a reflection of the fact that they have been structured in a way that minimises the losses suffered by the "losers" and maximises the gains to the "winners". In fact, given the starting point of a fairly centralised system, the principal "loser" is the Ministry of Science, Technology and Higher Education, because the increased autonomy of institutions is made possible by the ministry ceding bureaucratic control over spending decisions, for example. However, insofar as the ministry is ultimately responsible for ensuring the overall effectiveness of the system, even that loss is mitigated by the institutions' greater accountability to the ministry for tertiary education outcomes. Thus, the ministry is trading control over inputs for control over outcomes. The institutions are indeed under greater pressure to be accountable than they were before, thanks to the strengthened measures for quality assurance. But in return for that, they have considerably greater control in developing strategies and programmes to improve and sustain quality.

Students and academics are perhaps the stakeholders most central to the reforms. For students, the immediate effects of the reforms have been to lower the financial barriers to participation in tertiary education. Insofar as the reform strategies rely on loans to ease the cost of participation, it remains to be seen whether in the future, as loan payment obligations become due, there will be resistance from students and graduates (and possibly the Ministry of Finance, if the government is called upon to guarantee unpaid loans). It also is too early to gauge the full impacts and reactions of academics to reforms that will affect the contractual status of academics, the differentiation in the career pathways of academics in polytechnics as opposed to universities, and the conditions for awarding full professorships.

The comprehensive nature of the reform package has made implementation easier

Progress in implementation has been facilitated by the comprehensive nature of the reforms, as well as by the timing and speed of reforms. The comprehensive scope of the package made it easier to include a *quid pro quo* to offset measures that might impose costs on stakeholders. Thus, the reforms created mechanisms for making institutions more accountable for outcomes at the same time that it enhanced their autonomy. Similarly, the ministry was able to relax its control over inputs to university education by putting in place a system for quality assurance. At the same time, there are limits to how comprehensive reforms can be. The eventual impact of mechanisms to strengthen quality assurance of teaching and learning will be attenuated by the comparatively poor performance of the primary and secondary education system. Until outcomes at that level improve, the combination of increased institutional autonomy and more intense pressure to ensure that students finish studies promptly may create incentives for institutions to compete for the highest performing students, rather than attempting to enrol the students for whom the institutions can add the most value.

The speed of the more sensitive aspects of tertiary education reform appears to have been directly related to their timing. The reforms to enhance the status and autonomy of institutions, to create the Council for Higher Education, and to strengthen financial supports for students were made possible by the fact that the government's party had an absolute majority in the parliament. In formulating reforms and launching the implementation process, it would appear that the government set a pace that would allow it to lock the reforms into place between elections. Indeed, in his report to the Education Policy Committee, the minister underlined this as an important factor. However, it should also be noted that other reforms to expand participation in tertiary education and strengthen university R&D began in the 1990s and spanned different governments. These were reforms that were less sensitive inasmuch as they did not restructure stakes in existing arrangements and were carried out in a financial and economic climate that was more conducive to growth. This made it relatively easier to achieve and preserve political consensus on core principles of reform.

External influences played a significant role in shaping the reforms

The government of Portugal relied heavily on international benchmarks and external actors to help shape reforms and sustain the political force for reform. Some of this reliance on stocktaking is built into the law, which requires "periodic evaluation of the education system, including evaluation of the higher education system" (Law 38/94, 21 November; Article 9, No. 3). But the government appears to have been particularly aggressive in building in external reference points. It did this by seeking outside diagnoses and advice from the OECD, the European Network for Quality Assurance (ENQA), and the European University Association (EUA). It sought OECD input twice, in quick succession, first by participating in the analytical strand of the OECD thematic review of tertiary education, which involved the preparation of a background report by the Ministry of Science, Technology and Higher Education (OECD, 2006, 2008a). This did not involve extensive country-specific analysis of the situation in Portugal, but it situated the analysis of tertiary education in Portugal in an international context. Almost simultaneously, the government requested that the OECD carry out a peer review of tertiary education in Portugal in order to provide an in-depth analysis of strengths and weaknesses and country-specific recommendations on how to improve the system (OECD, 2007b).[17] Both exercises provided an abundance of evidence that recognised the important gains in widening participation in tertiary education, while underlining the continuing comparative weakness of tertiary education in Portugal and the urgency of enlarging and improving it. The two exercises also provided advice on how this might be done and examples of how similar challenges were met in other countries.

Beyond that, the government relied extensively on the Bologna Process. It used it as an external standard to guide the content and structure of tertiary education programmes and the degrees awarded by institutions to ensure that they were consistent and compatible with tertiary education in other European tertiary institutions. By embracing the Bologna Process, the government appears to be encouraging an outward orientation of the tertiary education community in Portugal (this includes encouraging the international mobility of Portuguese graduates), while reinforcing the notion that external benchmarks matter.

Conclusion

Education is an area in which governments exert an important influence on how individuals fit into the societies in which they live. The continuing evolution of the knowledge society, combined with forces of globalisation, amplify the importance of education by raising the stakes in education outcomes. Those outcomes exert great and increasing influence over everything from aggregate economic performance, to the level and distribution of income, to social cohesion and cultural vitality. As the stakes rise, weaknesses and mismatches in education grow into inefficiencies and inequities, making it increasingly important that governments formulate and implement reforms to ensure that education responds quickly and effectively to the evolving needs of learners and societies. But, precisely because more is at stake, the implementation of reforms can be more contentious and difficult. This is particularly true in education, where systems of provision are large and costly, and governance is complex.

Notwithstanding the importance of country-specific circumstances that influence the implementation of reforms, there are common patterns that emerge from the more in-depth examination in the case studies:

- One is the importance of external shocks or crises. The scale and complexity of education lend enormous inertia to the systems, making it particularly difficult to deviate from the status quo. External shocks, such as the release of the PISA 2000 results in Denmark, and the economic crisis the followed in Finland following the collapse of the Berlin Wall have the effect of making the status quo less sustainable by making the cost of inaction more evident, and by undermining the interests of at least some of the stakeholders, spurring them to action. Crises that make the cost of inaction more evident also can broaden the circle of stakeholders with an interest in departing from the status quo, while making it more difficult for insiders to persist with defending it. In the midst of the crisis in Finland, the proposal to establish a new polytechnic sector offered a pro-active strategy to support economic restructuring that appealed to a broad cross-section of education professionals, as well as economic actors and social partners.

- The role of external actors within countries is important as well. The Economic Council in the office of the Finnish Prime Minister appears to have played an important role in raising the importance of the country's globalisation strategy, and making the further reforms of polytechnics and universities an integral part of that strategy. This helped push tertiary education reform out of the education box, making it a broader public policy issue with a broader circle of stakeholders. This made concerted resistance by the institutions untenable.

International organisations can play a vital role in helping to make reform happen. However, it is important to appreciate the subtleties involved:

- One important role appears to be in providing external benchmarks that allow countries to judge performance – not just against their own historical outcomes, but against the performance of neighbours and competitors. The value of external benchmarks has increased with globalisation. The PISA 2000 results constituted the kind of external shock to the Danish education systems that can spark far-reaching reforms. The shock to Finland in the early 1990s came in the form of economic performance data that demonstrated not just the absolute depth of the Finnish crisis, but its relative depth, as it underwent a far greater shock than other countries. In Portugal, the rapid expansion of tertiary education (a 13-fold increase between the 1960s and the end of the 1990s), though commendable by historical benchmarks, has not led to complacency, because Portugal still performs comparatively weakly by international benchmarks.

- The policy advice that international organisations give countries is another important lever for change. The meeting of chief executive officers in Seoul (September 2008) underlined the importance of consensus as a precondition for education reform, and the impossibility of achieving reform when a major stakeholder such as teachers stands in opposition. This message was consistent with OECD work investigating policy reform in other areas. By definition, outsiders (such as international organisations) alone cannot build domestic consensus, because they are not party to it. Their role is necessarily one of providing the evidence and moral support that domestic players can use. In none of the case studies did the policy reviews by the OECD facilitate reform on issues that were not already on the agenda. The reviews had an impact when they resonated with ideas that were already in the domestic debate, and thus served to validate or raise the visibility of certain points of view. However, in the case of the Bologna Process, an external structure to guide the content of tertiary education programmes and structure of degrees has proven invaluable to Portugal as scaffolding to support reforms aimed at improving the compatibility and consistency of tertiary education in Portugal with developments outside it. However, it should be noted that such use of the Bologna Process was possible only because of the political will to do so within the country.

Notes

1. For a thorough discussion of implementation of reform in tertiary education, see OECD (2008a), Volume 2, Chapter 11, "What Next? The Challenges of Policy Implementation".

2. OECD secretariat calculations based on OECD education statistics and labour-force statistics.

3. There is a deep and broad body of human capital literature that examines the relationship between education and labour-market outcomes, starting with the groundbreaking work of Gary Becker (1964) and Theodore Schultze (1963). For a recent review of the literature on education levels and the quality of education and its relation to economic growth, see Hanushek and Woessmann (2009).

4. See *www.ccsso.org/federal_programs/13286.cfm*.

5. Following publication of the PISA 2000 results, the Danish authorities agreed that the OECD undertake a "pilot review" to draw on PISA results and other evidence to analyse school education and advise the government on how to improve the quality and equity of schooling outcomes. In their recommendations, the OECD examiners placed a high priority on "creating a culture of evaluation" – strengthening evaluation and feedback in order to close the gaps between perceptions and actual performance of the system, and strengthen the basis for improving the system (OECD, 2004).

6. For additional information on measures adopted following the OECD review of the *Folkeskole*, see OECD (2008d).

7. A fourth element, the establishment within the Ministry of Education of the Agency for the Evaluation and Quality Development of Primary and Lower Secondary Education is not included here because that was wholly subsumed in the ministry.

8. See *www.eng.uvm.dk/Uddannelse/Primary%20and%20Lower%20Secondary%20Education/The%20Folkeskole/Evaluation%20Tests%20Student%20Plans.aspx*.

9. See Nusche, Wurzburg and Naughton (2010).

10. The plans also mirror a shift found in other countries towards greater "personalisation" of learning, particularly with regard to teacher practice (see Järvelä, 2006).

11. See *www.eng.uvm.dk/Uddannelse/Primary%20and%20Lower%20Secondary%20Education/The%20Folkeskole.aspx*.

12. See *www.dettevirker.dk/temaer%20og%20cases/temaer%20og%20cases.aspx*.

13. They were chosen from a group of mid-sized municipalities (25 000-95 000 inhabitants) that had at least two schools in which migrant students comprised at least 10% of the student population; out of the 41 eligible municipalities, 16 applied. For more details, see *www.dettevirker.dk/mere%20viden/tosprogs%20taskforce/udmoentningsplan%20task%20force.aspx*.

14. An international literacy test in 1991 and an international mathematics and science survey in 1994/95 also suggested that Denmark was in the middle, not the top of the international education league. However, the reference countries were a mixed lot and failure to meet the sampling requirements undermined the robustness of the results. See OECD (2004).

15. The arrangements contrasted with the arrangements for universities: they were accountable to the Ministry of Education and Research for administrative matters, but fairly autonomous with regard to academic matters, including entrance requirements, credit transfer, etc.

16. Though the master's level "second-cycle" polytechnic degree is aimed at adults with at least three years of work experience, the total number of older students at this level would not be nearly enough to offset the decline in the number younger people enrolling in first-cycle degree programmes.

17. The Portuguese government also organised the final international conference that concluded the thematic review and launched the final publication (OECD, 2008a). This served as one more means of anchoring tertiary reform in the public debate in Portugal.

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Chapter 7

Effective ways to realise policy reforms in health systems

by Jeremy Hurst*

This chapter investigates the factors that can help or hinder the reform of health systems in OECD countries. "Reform", here, refers to changes to health systems which aim to improve their performance in one or more dimensions. The chapter is written mainly from a prescriptive point of view – what should governments do to increase the prospects for successful reforms? It is also written mainly from the perspective of economics, although a few selected references are made to political science literature. The first part of the chapter considers the need for reform in health systems. It goes on to set out a general framework for examining the determinants of success and failure in health reforms and to focus on the governance of reforming health systems, identifying some enabling and disabling factors that are likely to be partly under the control of governments. The second part of the chapter presents five case studies of the factors associated with successful and unsuccessful reforms, based on five recent OECD Reviews of Health Systems – in Finland, Korea, Mexico, Switzerland and Turkey. Two final sections discuss the findings that emerge from the case studies and draw some conclusions.

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The context for health-system reform in OECD countries

OECD countries are struggling to ensure access to quality care while containing costs

As part of a continuing process to raise living standards and welfare, all OECD countries are striving to improve the performance of their health systems. Spending on health systems averaged 8.9% of gross domestic product (GDP) in OECD countries in 2007 (OECD, 2009) and nearly three-quarters of this spending is public expenditure.[1] Recent work suggests that individuals may value gains in health status as highly as gains in GDP (Murphy and Topel, 2006), yet not all OECD citizens have access to basic health insurance and health status is distributed very unevenly across populations (de Looper and Lafortune, 2009). The work of the OECD's Health Care Quality Indicators (HCQI) group shows persistent gaps in health-care outcomes across countries. It is such shortcomings in the performance of health systems which form the basis of the case for health-system reforms. Recent analysis of OECD health data, using regression analysis and data envelopment analysis, also suggests that there is significant scope to improve efficiency in most, if not all, OECD health systems (Joumard *et al.*, 2008).

It is necessary to assess the "performance" of health systems – and their reforms – against the main objectives of health policy. OECD work on health-care systems has long focussed on access, quality, responsiveness, sustainability, equity and efficiency. This chapter focuses mainly on reforms focussing on equity and efficiency, not because the others are less important, but rather because they are rather easier to identify as explicit goals in past discussions of reforms.

Achieving efficiency involves both maximising a weighted sum of health improvements and responsiveness for given spending (achieving value for money) and finding the "right" level of health expenditure as opposed to spending on other goods and services. The latter usually manifests itself as a problem of public cost containment, although it is also possible for governments to spend too little on health care. Unfortunately, it is difficult to measure either of these concepts of the efficiency of health systems, because of the difficulty in measuring outcomes and their value.

Equity goals may vary somewhat across countries, but there is widespread agreement about pursuing equity in access to basic health care across populations, pursuing fairness in paying for basic health care and providing financial protection against catastrophic medical care costs, especially for the poor. There is also growing agreement about the importance of pursuing equity in health status itself across populations, since good health is necessary for citizens to flourish.

Health-system reform may be modelled as an iterative, circular process

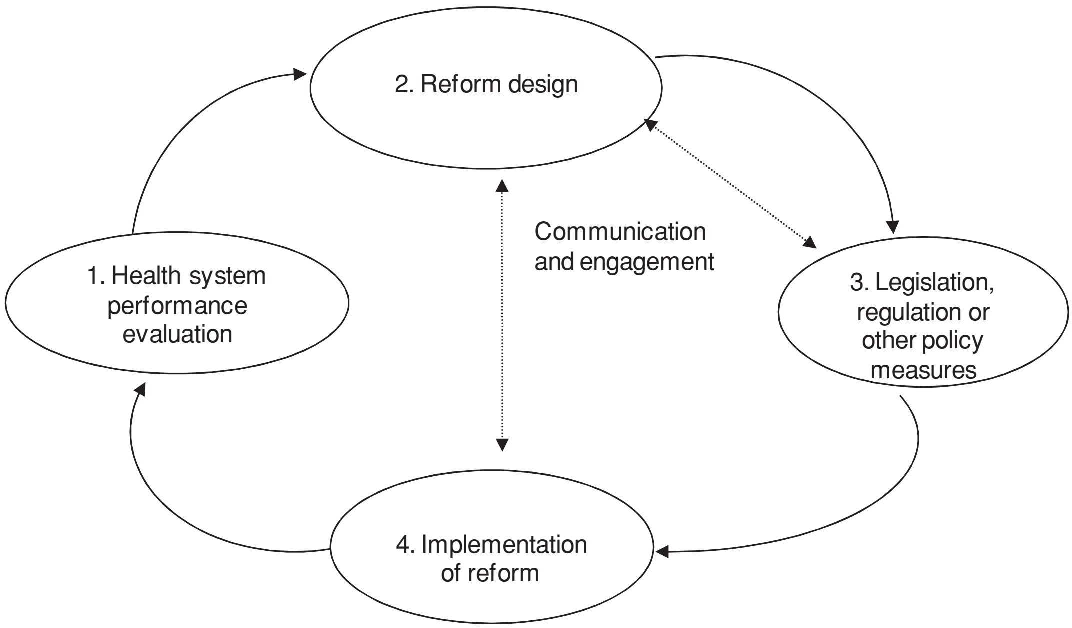
The design and implementation of health-system reforms can be thought of as a circular improvement process (Figure 7.1):

- First, evaluation of a health system's performance by the government or by other interested parties is likely to reveal shortcomings in the efficiency or equity of the system.
- Second, this diagnosis may lead the government or other interested parties to design and propose structural reforms aimed at tackling those shortcomings.
- Third, if the government is convinced of the case for reform and has adequate leadership and political authority to drive the process forward, it may seek to introduce legislation, regulation or other policy measures, paving the way for reforms.

- Fourth, legislation or regulation must be implemented by the agents concerned with the financing of the health system or with the delivery of services, if performance is to be improved.

Finally, the circle will be completed if the impact of reforms on the performance of the health system is subject to evaluation. There will be interdependence between the successive stages of reform – each can be thought of as a necessary but not sufficient condition for a successful outcome. This framework allows for consideration of two different issues: the determinants of success in the process of health-system reforms and the determinants of success in health-system outcomes. It is as possible to implement the "wrong" reforms well as it is to fail to implement the "right" ones well. Meanwhile, there may be only a limited capacity for reform and any of the four stages may act as a bottleneck in the process.

Figure 7.1. **The process of reform design and implementation in a health system**



Source: Adapted from Nutley, S. and P.C. Smith (1998), "League Tables for Performance Improvement in Health Care", *Journal of Health Service Research Policy* 3:1, January.

It is unknown, for a given set of reforms, how to fix all of the problems with a health system at one go. Moreover, it is quite common for there to be unintended or unanticipated side effects of reforms – which call for further structural changes to be made. In addition, in the longer term, changing expectations among consumers, changing technology or changing resources may precipitate a case for further reforms. For these reasons, it is appropriate to think of the process of reform and implementation as potentially continuous; thus, the four stages of the reform process may well unfold simultaneously rather than in sequence.

The obstacles to health-system reform are considerable…

Tuohy (1999) provides an illuminating analysis of the process of health reforms from a political science perspective. Based mainly on reform experience in recent decades in three countries (Canada, the United Kingdom and the United States), the analysis emphasises the difficulties which face significant structural reform of health systems. Once established, the parameters of the health-care system generate a distinctive logic that tends to govern the behaviour of the participants in the system until the parameters are changed again. The system may change dynamically according to its own logic, but only minor, government-inspired reforms are likely to be possible during these periods. Hence, Tuohy has entitled her book *Accidental Logics*. Only rarely is there sufficient mobilisation of political will and authority outside the health arena, together with a set of appropriate policies, to drive through successful changes in the parameters of the health system. Established interest groups can frequently thwart or derail such changes. Tuohy draws attention to the many occasions on which health reforms were not attempted (as in Canada in the 1990s) or failed (as in the United States in 1993). However, occasional "windows of opportunity" open for significant reforms. Tuohy also emphasises the historical uniqueness of each health system and the "path dependency" which governs its evolution. From an international perspective, policies cannot be uprooted from their national contexts – although knowledge of comparative policies can be an aid to the judgement of national reformers.

A simple, but useful, model of the political structure of the health-care system distinguishes between three main interest groups: consumers; "administrative rationalisers"; and "professional monopolists" (Alford, 1975). The consumers are often the weakest group and the professional monopolists – led by the medical profession – are often the strongest. It is difficult or impossible to implement health-system reforms – especially reforms concerning the efficiency of health-care delivery – in the teeth of determined opposition from the medical profession. Indeed, when it comes to health-system reforms, the medical profession might be seen as a strong "veto player" (see below), not least because its active co-operation may be needed to implement many reforms. The medical profession's power is especially great when, as frequently happens, doctors win support from consumers in opposing change. In general, consumers trust physicians more than they trust politicians.[2]

Both at the legislation/regulation and implementation stages, reforms are more likely to succeed if a realistic assessment has been made of any opposition to the reforms that is likely to arise. It may be that the government has sufficient power to override such opposition, though this may be far easier at the legislative stage than in the course of implementation. If not, it will be necessary to embark on communication and engagement with the interested parties with a view to persuading them of the case for change (Figure 7.1). The availability of resources to "grease the wheels of change" may aid such a process.

...but many OECD countries have undertaken substantial reforms in recent years

Nevertheless, as Docteur and Oxley (2004) have shown, many OECD countries have accumulated a significant history of health-system reforms. One well-travelled path has been the introduction of successive extensions to health-insurance coverage for different groups in the population over many years, culminating in the achievement, in most OECD countries, of universal health coverage, usually with a significant element of compulsory insurance and significant redistribution of income. This expansion of coverage has frequently led to problems with cost containment, because of the lowering or removal of financial barriers to access and the moral hazard engendered by health insurance. That, in turn, has encouraged the introduction of cost-control measures by governments, which have sometimes had distorting side effects on prices or volumes – and presumably on micro-efficiency. Despite such measures, costs have generally continued to rise because of technological improvements in medicine and the ageing of populations.

Macro-level budgetary or regulatory policies to control cost growth – such as those setting caps on budgets or freezing prices – can be powerful in restraining cost growth in health systems (OECD, forthcoming; Oxley, forthcoming). In the context of the 2008-09 economic downturn, several OECD countries are considering similar measures to cut or moderate health-spending growth. However, where these measures have been implemented in the past, they have only worked for limited periods. After an initial reduction in cost, health spending has resumed its previous trajectory. Moreover, these measures cannot be sustained in the longer term without jeopardising other health policy goals – such as equity and access.

The ongoing search for cost containment, as well as for the more elusive value for money, has led to a quest for improvements in micro-efficiency in health systems. This continues in all OECD countries. Policy makers in many OECD countries are looking for ways to reduce the rate of long-run growth of health spending by changing the mix of incentives facing users and providers (OECD, forthcoming; Oxley, forthcoming). On the demand side, examples of reforms include those aimed at better care co-ordination or encouraging self-care management and prevention. On the supply side, there is hope that linking provider payments to performance targets, accelerating the adoption of health-information systems or using tools to prioritise the adoption and use of health technologies, might, among others, have positive long-run returns. However, evidence on the cost effectiveness of such interventions is still limited and, where it exists, it is not always favourable. Some reforms of this type require significant upfront investment for gains to be expected in the long term. Changing provider's payments and incentives can also encounter much political and professional resistance.

Factors which can help or hinder health-system reform

Opportunities for major structural reform of health systems tend to be rare

Much has been written about health reforms, but little about the factors which help or hinder such reforms – especially from a prescriptive point of view. Although Tuohy (1999) describes her account of health reforms as a work of analysis, not prescription, she does draw two policy conclusions in her final remarks. The first is that because political "windows of opportunity" to secure structural changes to health systems are rare, would-be policy makers should work out their policies in advance and strike quickly when the political opportunity arises.[3] Secondly, any reforms undertaken between these windows of opportunity should "go with the grain" of the health system. In other words, acts of periodic boldness should be interspersed with long periods of ongoing prudent incrementalism. The problem, of course, is in identifying when such a window might open.

Schieber (1995) reviews the preconditions for health reform, drawing on experiences from OECD countries. Most of his analysis is concerned with evidence on the institutional determinants of the performance of OECD health systems, rather than with the determinants of success in the process of reforms. Also, his advice is aimed at developing countries rather than OECD members. Nevertheless, he identifies a number of factors which should assist reforms in any health system, including: the availability of information and research on the performance of health systems; various institutional factors which support good governance (such as a strong tax system); political leadership, especially at the top of government; and technical competence among the staff charged with implementing reforms.

The remainder of this section draws on this paper and on the literature cited earlier, to suggest a set of hypotheses about the factors likely to help or hinder health reforms. For expositional purposes, the analysis that follows is organised under headings which more or less follow the four stages in the reform cycle set out earlier:

- the availability and use of information, evidence and analysis about the performance of the health system and about the ways performance could be improved;
- political leadership and the political possibilities for the government (or governments) to promote reforms, introduce legislation and secure commitment or co-operation from other stakeholders in the system;

- the use of incentives – both sticks and carrots – to align the motivation of the main actors in the system with the objectives of policy; and
- the availability of resources to purchase improvements and "grease the wheels of change".

To some extent, these factors will be exogenous to the health-reform process. For example, policy makers concerned with health-system reform are unlikely to be able to alter the constitution of a country or change the growth rate of its GDP very much, both of which are often clear constraints on the prospects for health reforms. However, to some extent these factors will be amenable to change – that is they will be open to the exercise of good governance. For example, governments can do a great deal to build the evidence base concerning health-system performance, political processes can be used to win over the opponents of reform, and money can be raised to meet the costs from within available resources. An attempt will be made in the following discussion to identify which of the hypothesised factors will be under the influence of policy makers.

Lack of data frequently makes evidence-based policy making difficult in health care

Many of the problems faced in managing and reforming health systems arise from the asymmetries of information which exist between patients and providers and between governments, managers and providers. Health professionals hold much of the knowledge about the benefits or potential benefits of health care. Insurers, governments and managers tend to be knowledgeable about the costs. Insured patients may be ignorant about both the benefits and the costs.

Accurate diagnosis of the performance shortcomings in a health system is a necessary prerequisite for successful reforms. In the case of some problems – such as the proportion of the population lacking health insurance – the relevant data are fairly easy to obtain. Similarly, there is, in the majority of OECD countries, a significant body of evidence and analysis on the distribution across income groups of access to a variety of health services (van Doorslaer and Masseria, 2004; de Looper and Lafortune, 2009). Diagnosis of efficiency failings is much more difficult, because of the lack of health system outcome measures that could be directly linked to health resources and because several factors outside the control of health systems affect health outcomes. Recent evidence on health-system efficiency using broad health-system outcome indicators suggests that there is still much variation in efficiency within clusters of countries with similar institutional structures in health care (Joumard and André, forthcoming). This suggests that there is scope for improving health-system efficiency in OECD countries. Quality of care indicators (such as avoidable admission rates for chronic conditions, survival rates from cancers and case fatality from acute exacerbations of chronic conditions) would also permit better estimates of health-system efficiency, but are often not solid or widespread enough to enable meaningful cross-country analysis of health-system efficiency.

Perhaps as a result of this, it is possible to identify occasions when the arrival of new outcome data has transformed perceptions of the efficiency of a health system and has helped to precipitate reforms as a result. For example, until the late 1990s, UK policy makers and OECD observers believed that the health system in the United Kingdom performed well. Health status was about average for a western European country, whereas the health expenditure share of GDP was significantly below average. The combination of average health status and low spending was attributed to high efficiency in the National Health Service (NHS) and calls to increase health spending above small, annual increases were rejected by successive governments. However, towards the end of the decade, new, comparative European cancer-survival data – arguably a reasonable measure of a health outcome – became available; these data suggested that, at least in the case of cancer services, the UK health system was performing poorly compared with those in most other western European countries. It also became evident that waiting times for elective surgery were much longer in the United Kingdom than in other European countries. The resulting shock to perceptions was followed by the government's announcement of a major "NHS Plan" to reform the delivery of health services, together with a large and sustained increase in spending on the NHS. In a reversal of the previous stance, the government stated at the beginning of the NHS Plan that, "In part, the NHS is failing to deliver because over the years it has been underfunded" (Department of Health, 2000).

Nevertheless, careful ex ante *analysis and discussion can facilitate reform*

At the next stage in the reform process, success in designing reforms can sometimes be aided by appointing a commission or group to diagnose problems in the system and to propose solutions. Two examples are the Beveridge Report in the United Kingdom (Her Majesty's Stationery Office, 1942) which led to the setting up of the NHS and the influential Dekker Commission (1987) in the Netherlands, which proposed important reforms to the health system, involving the introduction of a single national health-insurance system with regulated competition. Indeed, despite Tuohy's advice about "striking while the iron is hot", it is often necessary to invest in protracted discussion and negotiation about reforms. In the Netherlands, for example, for many years after the Dekker Commission's report appeared, agreement could be reached only on incremental changes. It was nearly 20 years before the final decisive legislative step was taken towards a version of managed competition, in 2006; implementation of these reforms is still under way. This may be an alternative strategy when political windows of opportunity for rapid strategic reforms fail to open. A distinction is sometimes drawn between open reforms, and "reform by stealth" (*e.g.* Tompson, 2009). Reforms by stealth involve making apparently technical changes to a system, perhaps over many years, which end up being as significant as a major structural reform. In some contexts, it is argued that this is the only feasible way to proceed. However, it is a strategy very vulnerable to reversal if the political mood swings, and can lead to incoherent, semi-finished reforms. Moreover, given the direct involvement of health professionals in realising health-system reforms, it is doubtful that reform by stealth would get very far without attracting their attention. The quiet, incremental progress of reform over the years after 1987 might suggest that the Dekker reform was, to some extent, an example of a successful reform by stealth. However, the relatively open and inclusive nature of Dutch policy making meant that the major stakeholders were involved in bargaining and discussion of the reform throughout.

Ideally, the making of health policy should be "evidence-based". Unfortunately, the lack of outcome measurement discussed earlier, together with a lack of evaluation of many reforms, means that the evidence base for health reforms is deficient, especially when it comes to identifying ways to improve efficiency. That, in turn, allows competing ideologies to continue to flourish both within and across countries about the best ways to achieve efficiency – for example, by the public service (the United Kingdom's Beveridgean) model or by regulated markets (as in the United States) for insuring for, and delivering, health care. Nevertheless, there is a growing international literature on alternative ways to finance and deliver health services which can be used to inform the judgements of policy makers. On the whole, it is easier for the designers of reforms to follow well-worn paths. For example, many OECD countries have adopted versions of the Bismarckian model of national health insurance, which was first introduced in Germany in 1883. Similarly, a number of countries – including, most recently, Turkey – have, following an international inquiry, introduced variants of "family practitioner" services, with gate-keeping, a long-established model for delivering primary health care in some OECD countries (OECD/WHO, 2009). This has not prevented reformers from introducing some relatively innovative arrangements – such as "internal markets" for public hospital care in national health services and regulated competition among health-insurance funds within national health-insurance schemes (Docteur and Oxley, 2004).

It is desirable to consider whether reforms are politically feasible and implementable at the design stage, with a view to building in features that are likely to improve the viability and acceptability of the reforms. It is also desirable, if possible, to subject prospective reforms to cost and to cost-benefit analysis, and to estimate their distributional consequences. Cost analysis is needed to establish the affordability of the reforms or the need to find additional resources. Cost-benefit analysis is needed to check that the reforms will make the best possible use of resources, although the findings of a cost-benefit analysis are more likely to be challenged in health than in some other policy domains, owing to disagreement concerning such issues as the appropriate techniques for monetising the value of health outcomes and the proper limits of cost-benefit analysis. Nevertheless, some form of cost-benefit analysis is desirable to help identify the probable winners and losers from the proposed changes, information that may be vital for informing the political process. Finally, evaluation of the reforms – preferably independent – is vital if policy makers are to learn from experience. It is desirable to set up such evaluation in advance to establish a baseline before the changes occur. It is also desirable to focus on measuring outcomes to the extent possible. The Netherlands provides a good example, given its willingness to shine a spotlight on the outcomes of its recent reforms.

Reform is rarely, if ever, possible without strong political leadership

Successful structural reforms will require the exercise of political power or persuasion to propel the reforms through their legislative and implementation stages. As mentioned earlier, Tuohy (1999) has concluded that sufficient mobilisation of political will and authority is only rarely available to make structural reforms to OECD health systems. However, it seems likely that OECD countries differ somewhat in their capacity for health reforms, because political institutions differ in the extent to which they support the status quo or changes to the status quo, as the case may be. In the past, some important health-system reforms in OECD countries have been introduced by unelected governments. For example, following inconclusive deliberations in the Netherlands about compulsory health insurance over the four decades prior to the Second World War, social health insurance was introduced abruptly to a large part of the Dutch population by the German occupation forces in 1941 (Blanpain, Delesie and Nys, 1978). National health insurance was introduced in Korea by military dictatorships between 1977 and 1988. However, under current democratic circumstances, OECD governments will require not only a popular mandate but also the ability to win votes in their legislatures to carry out important health reforms. In a study of structural reforms in pensions, product markets and labour markets, Tompson (2009) finds that the importance of an electoral mandate to reform success varies somewhat from one policy domain to another, but that it tends to be most important in fields like pensions, where reforms have a direct and palpable effect on the rights and welfare of a large part of the electorate. Health-system reforms clearly fall into this category.

Political leadership is likely to be an essential ingredient in securing successful structural reforms to health systems. Leadership will certainly be required by health ministers. However, given the high salience of health-care provision for voters, the explicit or tacit support of prime ministers or presidents is generally required to secure overall political legitimacy for major health reforms and to help in securing public resources. The "Great Society" reforms which introduced Medicare and Medicaid to the American health system in 1965 were initiated by President Lyndon Johnson following a Democratic landslide in 1964. The major reforms to the British NHS, which introduced an internal market in 1992, were initiated by Prime Minister Margaret Thatcher during her third term in office. Most recently, the passage of major health-care reform legislation in the United States followed an election in which health-care reform was a key issue and which left the Democratic Party with control of the White House, and heavy majorities in both chambers of Congress. Yet even in these circumstances, the administration had to commit the full weight of the White House to the health-care reform battle. More recent examples of political leadership in health reforms are covered in some of the five case studies discussed in the following sections.

The number and configuration of "veto players" are crucial factors

Opposition can be expected to major reforms to any health system. Observing the lack of comprehensive reforms to the American health system, Fuchs (2009) reminds us that Machiavelli wrote in 1513, "There is nothing more difficult to manage, more dubious to accomplish, nor more doubtful of success … than to initiate a new order of things. The reformer has enemies in all those who profit from the old order and only lukewarm defenders in all those who would profit from the new order." More recently, an important political theory has been advanced which identifies variation in the number of (*de jure* or *de facto*) "veto players" in the policy process and the ideological distance between them as critical determinants of variation between countries in the capacity for reform (Tsebelis, 2002). Institutionalised processes of decision making are described and classified in terms of constellations of veto players – political actors whose agreement is required for policy changes to happen. The potential for policy change decreases as the number of veto players increases, but two other critical variables also come into play. Change is harder the greater the dissimilarity of the policy positions of the veto players and the greater their internal cohesion (where veto players are institutions or groups).

Tsebelis argues that the United States, for example, has many institutional veto players whereas the United Kingdom, under a government commanding a parliamentary majority, has only one.[4] Many OECD countries – including those with federal constitutions – split the responsibility for funding and providing health services between central and local government. Tsebelis argues that federalism increases the number of veto players. The possibility of calling referenda further adds to the number of veto players. Unitary states with constitutions that allow a central government with a popular mandate to control the legislature and the health system would seem to come out as having greater reform capacity than states with many veto players under this theory. However, in a number of such countries, the health system has become a "political football" on some occasions, with successive governments of different political persuasions introducing competing reforms which reverse some or all of the changes introduced by their predecessors. Nations where a long period of negotiation and compromise between a number of veto players has preceded reforms seem likely to make changes which have wider ownership and, consequently, greater sustainability when there are swings in the political pendulum. In any case, this configuration of veto players depends not only on the formal rules and institutions that govern policy making, but also on informal norms, conjunctural political factors and the sequence of the policy process.[5] Thus, even in a polity with a highly centralised constitution and relatively few constitutional veto points, there may be *de facto* veto players, including elements of the health professions. The power of the medical profession may be all the greater where the data limitations described above apply: it can be difficult for reformers to challenge the claims of the profession in the absence of authoritative data on quality, efficiency and other variables.

The opponents of reform are usually more likely to mobilise than its beneficiaries

Another important argument relates to the fact that the beneficiaries of reform are often diffuse whereas the losers are concentrated. Policies to improve efficiency in health-care delivery may be resisted successfully because the beneficiaries (patients) are numerous but unorganised, whereas the losers (providers) are concentrated and well organised. As noted earlier, it is likely, too, that information asymmetries will tend to favour the losers. However, policies which involve improving, say, access to health insurance may be easier to introduce – partly because there is widespread altruism among voters when it comes to social provision of access to health care, and partly because it is generally in the long-term interests of providers to co-operate in any expansion of the market.

Obstacles to reform may also emerge where health policies fall under the responsibility of different ministries and disagreements arise between them. When it comes to the level of public spending on health, there is almost invariably a tension between the Ministry of Finance and the Ministry of Health. When it comes to disease prevention involving changes in lifestyles, there is generally a need for several ministries, such as those for transport, food and agriculture, and the environment, to co-operate in the design of new policies. In these cases, successful reforms generally involve one ministry accepting budgetary costs for certain benefits which accrue to the "clients" of another.

Implementing reforms can be as challenging as adopting them in the first place

Further political problems can arise when the time comes to implement reforms. If insurers and/or providers are in independent hands, negotiations may well be required for implementation to be successful. Even if the health insurers and/or the providers are in public hands, there may well have been "provider capture". In particular, there can, under any ownership arrangements, be formidable opposition to reforms from health professionals, especially doctors, if they perceive that their professional freedoms or economic interests are threatened. Moreover, because many health reforms require, at least to some extent, the co-operation of health professionals, it may be impossible to effectively implement a reform that they strongly oppose. If their resistance is strong enough, their objections to the reform may take on the character of a self-fulfilling prophecy, as they subvert the implementation of changes whose adoption they opposed.

The quality of public administration is likely to help determine the success of reforms. In general, the chances of success may be improved in countries where the role of the Ministry of Health is focussed on "steering" the health system rather than "rowing" – that is, on guiding and regulating the health system rather than on providing services directly (Osborne and Gaebler, 1992). Otherwise, the Ministry of Health may face conflicts of interest. The quality of public management – such as hospital management – will also be important where provision is in public hands. However, to the extent that the medical profession retains its clinical autonomy, there is the possibility that public managers and doctors will clash over the implementation of reforms that are unpopular with clinicians. Also, a trap lies in wait for zealous reformers in unitary states which have control over the management of the health system. Wave after wave of reforms can lead to "reform fatigue" among managers and clinicians alike.

The use of incentives and disincentives is critical…

Successful reforms, especially those aimed at improving microeconomic efficiency, often embody changes in the monetary and non-monetary incentives facing the main actors in the health system. They may involve the judicious use of changes in cost sharing among consumers, in the incentives and opportunities facing health insurers, or in the payments and other incentives facing providers. These are large subjects which have generated a considerable literature. Reviewing this literature is outside the scope of this chapter. Suffice it to say, that although much is known about the effect of different payment and incentive systems on the volume of services demanded and supplied in various settings, less is known about their effects on the quality of care, because of the lack of health outcome and quality measures. Financial incentives may also be used by central governments to help persuade other entities, such as state or local governments, to co-operate in health-system reforms, when such entities have significant responsibilities for health care. For example, central governments may make grants available to local governments when they adopt certain reforms, or they may make matching funds available when local authorities incur expenditure on meeting national targets for the provision of certain services.

…which implies that resource constraints can be a major problem

The availability of resources can help to determine whether reforms are successful or not. There are generally net costs in the case of reforms designed to promote access, or equity of access, to health services. The design of such reforms needs to take careful account of affordability. Most countries which have achieved universal health insurance have done so step by step, starting, many decades ago with the population groups best able to afford voluntary or compulsory health insurance and ending, more recently, with those requiring large subsidies. However, in the case of Korea, affordable, compulsory national health insurance was achieved for the whole population in 1989, at a relatively early stage in the country's economic development, by setting the average cost-sharing level originally at about 50% of the average price of insured health care. Similarly, many countries which have established universal public insurance for health care have discovered that there continue to be problems concerning unequal access to public services across geographical areas. That is partly a legacy of previous inequities in health expenditure, staffing and buildings across different areas, which tend to persist. In such circumstances, it is very difficult, politically, to "level down" rather than to "level up". Hence, substantial resources and/or considerable time may be required to achieve equal access for equal need across the country.

In the case of reforms designed to promote micro-efficiency, there may well be net savings to be reaped in the long run. However, reform may still require an investment of resources in advance to allow such savings to be realised. For example, in view of the fact that labour costs predominate in health care, many reforms aim to raise the productivity of staff. However, a rise in pay rates or other monetary rewards may be needed to persuade staff to change their existing working practices. The British National Health Service Act of 1946 was only passed following 18 months of acrimonious negotiation between the health minister and the medical profession which ended with substantial pay increases.[6] Investment in information technology might also save some labour costs in the long run, but it almost certainly requires a significant investment in hardware, software, training and organisational change up front to achieve such savings.

Clearly, the reform agenda must take account of resource availability. Faster economic growth can help the pursuit of both equity and efficiency if it is combined with the right policies. However, there is evidence from some health systems that growing resources can prompt actors to relax, whereas shortages can be a spur to efficiency.[7] In the absence of growth or in a context of slow growth, it may be necessary for the promulgators of reform to find innovative ways to raise efficiency. There is also the "difficult" possibility of reallocating resources to health from other areas of government spending. These realities have to be borne in mind when considering prospects for reform in the wake of the global economic and financial crisis: the simple fact is that major health-system reforms tend to be very expensive up front, even if they promise to lead to cost savings in the end. That implies that reform will be far more difficult where public budgets are under severe strain, as the ongoing debate over health-care reform in the United States well illustrates.

Finland: improving access and managing decentralisation

The Finnish health system resembles those in other Nordic countries by offering universal coverage of a comprehensive range of health services, by being funded mainly through taxation, and by relying mainly on public provision of care. However, the Finnish system is both more decentralised and more mixed in its funding than are those of other Nordic countries. Local governments, in the shape of more than 400 municipalities, play a leading role in both the financing and provision of care. There is, however, some co-operation between municipalities over care. For example, hospital services are concentrated in 20 districts that are formally under the control of the municipalities. The OECD review of the Finnish health system published in 2005 (OECD, 2005a) concluded that it performed rather well overall. The main problems were long waiting times for many services, such as appointments with general practitioners and elective surgery. Also, it was noted that many municipalities felt that hospital funding was out of control and that there were efficiency concerns about the degree of decentralisation in the system. The report reviewed a number of reforms, some of which were ongoing and some of which were only beginning at the time of the evaluation. Two of them appear to be of particular interest to a discussion of effective ways to realise health reforms: the National Health Project and the Project to Restructure Municipalities and Services.

Progress has been made in addressing waiting times and variations in access

The National Health Project (the National Programme for Safeguarding Health Care) lasted from 2001 to 2007. It can best be described as a broad collection of incremental reforms. Probably the most important targets of the National Health Project were to reduce the variations in treatment rates across the country and to decrease excessive waiting times for appointments and treatments. The variations in treatment rates were tackled by introducing clinical guidelines on what preventive and curative treatments should be offered for the principal causes of illness. These were developed on the basis of earlier and ongoing work by the Finnish Medical Society, Duodecim, which has created an electronic database of evidence-based medicine that can be accessed both by physicians and patients in Finland. The waiting times took account of the guidelines, where appropriate, and were tackled by setting targets for maximum waits of three days for a patient to see a primary care professional, three weeks for an outpatient appointment and three to six months for recommended hospital treatments, including elective surgery. These targets were reinforced, as necessary, by extra funding (50% state, 50% municipal), by formal follow-up evaluation reviews and by conditional fines for the poorest performers. They were introduced during a period when per capita health expenditure was rising fairly briskly.

An evaluation of the National Health Programme was commissioned by the Ministry of Social Affairs and Health in 2008. Both successes and failures were reported. The best results were seen in the actions aimed at improving access to services. The number of patients waiting over six months for surgery had fallen from 60 000 in October 2002 to 34 000 by August 2005 and to 1 700 by the end of 2008. About 90% of health centres were achieving the target of seeing a primary care professional within three days. However, waiting times to see a primary care physician had increased in some parts of Finland because of difficulty with recruitment. The guidelines seemed to have had a positive effect on access and equity of access to treatment. Treatment rates for some over-prescribed operations such as cataract surgery had fallen and treatment rates for some under-prescribed orthopaedic operations had increased. The success of these elements in the reforms may be attributed to a number of factors. First, in the case of the guidelines for uniform clinical care, the guidelines had the advantage of being "owned" by the Finnish medical profession, which ensured both their authority and their clinical acceptability. In the case of the waiting time reductions, they were popular with patients, acceptable to the medical profession when motivated by the guidelines, incentivised by financial sticks and carrots and funded by a period of steady growth in health expenditure.

Efforts to streamline multi-level governance arrangements in health are ongoing

The Project to Restructure Municipalities and Services was set up in May 2005, and was still ongoing at the time this chapter was written. The OECD report had debated the pros and cons of extreme decentralisation of the governance of health care of the kind found in Finland and had recommended that some consideration be given to the regionalisation or centralisation of hospital services on efficiency grounds. The aim of the project, which covers all the responsibilities of the municipalities, is to increase the efficiency and productivity of municipalities and the services they provide. A striking feature of the project is that it involves not only representatives of appropriate ministries and local authorities, but also representatives of the opposition parties. This reflects a tradition of striving for consensus in Finnish politics. After consideration was given to three different models for reforming local government in Finland, it was decided, in 2006, to focus on a model for encouraging voluntary mergers between municipalities and services, with the help of financial incentives. Research has suggested, for example, that the minimum efficient population required to support a health centre is 20 000-30 000 people. Yet over 250 municipalities have fewer than 6 000 inhabitants. It is also believed that it is more difficult to secure continuous medical cover and more difficult to recruit staff to small health centres.

The project has had some success, in that the number of municipalities decreased from 432 in 2005 to 348 in January 2009, and further reductions have been announced. The largest government party, the Centre Party, has been in the driving seat. However, for historical reasons, small municipalities in rural areas have been Centre Party strongholds. Not surprisingly, perhaps, the Centre Party suffered considerable setbacks in the local elections of October 2008. This outcome may lead to a less radical approach to the final reforms. The progress which has been seen with this project seems to illustrate how difficult it can be to agree reforms which attempt to trade off assumed efficiency gains against other principles, such as the preservation of local democracy and the convenience of local access to services. However, a gradual, consensus-based and incentive-based approach seems to be working to bring about a more efficient level of decentralisation in Finland.

Korea: increasing equity while containing costs

Korea achieved universal health insurance coverage in 1989 following a step-by-step extension of social health insurance across different groups in the population, under successive military governments, starting in 1977. By adopting Bismarckian social health insurance arrangements, Korea followed a well-trodden path, rather like that of Japan some decades earlier. The relatively rapid achievement of universal health insurance was aided by a high rate of economic growth in Korea. However, insurance coverage is neither broad nor deep, and out-of-pocket payments still accounted for just under 36% of health expenditure in Korea in 2007 – one of the highest ratios in the OECD. This high level of cost sharing made compulsory insurance more affordable, not least because it is likely to have moderated demand. On the supply side, the majority of providers are private. Consequently, the Korean health system retains many of the characteristics of a private market, despite the universal applicability of social health insurance. Nevertheless, life expectancy at birth is above the level that might be expected given that health expenditure per capita and as a share of GDP (at 6.4% in 2006) is below the level that might be expected for a country with Korea's GDP per capita (OECD, 2009).

In 2000, Korea undertook two significant health reforms

Following the transition to democracy in Korea in 1988 and the coming to power ten years later of a progressive president interested in social protection, two structural reforms were introduced to the health system in July 2000 (OECD, 2003).

- The "Integration Reform" brought together about 370 insurance societies in one single, "National Health Insurance Corporation" (NHIC) with the aim of increasing both equity and efficiency. This reform allowed contribution rates to be unified across the population. Rates had previously been different across the population although benefits were the same. The reform also enabled there to be national pooling of risks, the exploitation of economies of scale and the creation of a monopsony in public purchasing of health care.

- The "Separation Reform" brought about specialisation in prescribing (by physicians) and in dispensing (by pharmacists), mainly with the aim of reducing the medically unnecessary use of drugs and encouraging efficiency in prescribing. Previously, physicians had been allowed to dispense drugs as well as to prescribe them, and they had earned significant income from so doing. Pharmacists had been allowed to prescribe as well as to dispense for patients who complained of minor symptoms.

Addressing equity in insurance coverage proved easier than curbing costs

The Integration Reform was broadly successful. Integration of contribution rates for employed and self-employed workers was achieved in 2000, and integration of financial accounts was completed in 2003. Administrative costs had been 6.7% of total health-insurance payments in 2000. By 2004, they had fallen to 4.3% and by 2007 to 3.3%. The reform allowed the establishment of a Health Insurance Review Agency to audit medical claims and to review the appropriateness and economy of the services provided to the insured population.

The Separation Reform appeared to be less successful in the short term, but can be judged to have been a success in the long term. The doctors were strongly opposed to the loss of their dispensing privileges and income. Although the government raised medical fees somewhat in anticipation of the reform, the physicians were not satisfied with the initial level of compensation. There followed several periods of strike action by doctors, before and after the introduction of the reform, which were met by progressive increases in fee levels. By the time the strikes were settled, fees had risen by about 40%. Also, the government had conceded the right for doctors to continue to dispense injections – and about 50% of consultations resulted in an injection.

The steep increase in fees exacerbated a deficit in the National Health Insurance (NHI) scheme, which in turn necessitated the raising of copayment rates, increases in contributions and other measures. Public spending on health per capita rose by 32% between 2000 and 2001 and the public health spending share of GDP rose from 2.2% to 2.9% (OECD, 2007). It is difficult to say how much of this increase was due to the Separation Reform and how much was due to upward momentum in the underlying deficit. However, some of the fee increases appear to have been clawed back in later years – the public health spending share of GDP was still 2.9% in 2004. On the positive side, the aim of separation was achieved and there appear to have been some significant improvements in the quality of prescribing as a result. For example, the proportion of doctors' visits resulting in prescriptions, including antibiotics, decreased from 55.7% in 2000 to 45.1% in 2002 and to 29.6% in 2008. The number of drugs per health-insurance claim fell from 5.9 in 2000 to 4.5 in 2002 and again to 4.1 in 2008.[8]

Opposition from the medical profession nearly thwarted the "Separation Reform"

Why was one reform initially more successful than the other? Both the Integration and Separation reforms had been informed by international comparisons of health policies and both had been discussed for some time prior to their introduction by the government and interested groups. The Integration reform had the support both of the rural population and the labour unions. In the case of the Separation Reform, there was also support from civic groups. There had been discussions between representatives of civic groups (patients) and the leaders of the medical profession, and an understanding had been reached that there was agreement from the profession for the reform to go ahead. However, it seemed that the then medical leadership was not fully informed of the views of the rank and file among physicians, and there was clearly outrage among ordinary doctors when the reform went ahead.[9] It seems that the government was misinformed about the likely reaction of the doctors and that, in hindsight, more communication and engagement between the government and the doctors would have been desirable. Partly as a result of this experience, the government has established a Committee for Health Insurance Policy Deliberations which brings together at regular intervals representatives from three major stakeholders – the medical providers, the insured and patient groups, and institutions representing the public interest such as the ministries of health and finance and academics.

Among the recommendations of the OECD Review of the Korean health system was a suggestion to improve financial protection in the National Health Insurance scheme by introducing an annual cap on accumulated copayments for any individual. This reform has gone ahead together with other improvements to benefits, such as adding magnetic resonance imaging and CT scanning to NHI cover (Colombo and Hurst, 2008). Such improvements in benefits were informed by evidence that out-of-pocket payments for medical services in Korea were regressive and that there were inequities in access to cancer care for low-income individuals (Kim, Lee and Hong, 2005). The improvements to benefits have been enabled partly by Korea's high economic growth rate – which averaged 3.9% between 2000 and 2005, more than twice the OECD average.

Mexico: extending insurance coverage to the poor and uninsured

The Mexican health system has consisted of a large and mostly unregulated private sector and a public sector fragmented into several vertically integrated social insurer/providers, each covering different parts of the population including two large social security organisations covering formally employed, salaried, private sector workers and government employees, respectively. There is quite a separate system of state health services for the poor and uninsured, which has not been very well funded in the past. Public governance has been split between the social security system, the federal Ministry of Health and the state governments. Until recently, those formally insured represented only about 50% of the population. Mexico has had one of the smallest public shares of total health expenditure in the OECD area (44% in 2006). Moreover, public funding per capita has been inversely correlated with indicators of need, such as infant mortality, across geographical areas (OECD, 2005b). As a consequence, access to health care has been very uneven across the population and it was estimated in 2003 that nearly 20% of the poor (those in the first income quintile) incurred health spending that pushed them below the poverty threshold (OECD, 2005b).

The Seguro Popular *has substantially extended access to affordable health insurance*

A major reform, the System of Social Protection in Health, was introduced in 2004 under the leadership of the Ministry of Health (OECD, 2005b). The main element of the reform was a new voluntary health insurance scheme, the *Seguro Popular* (Popular Health Insurance), which was designed to provide, progressively between 2004 and 2010, coverage for a package of essential interventions for the poor and uninsured. The scheme was financed by separate federal and state contributions per enrolled family and by a small, means-tested premium paid by each family. The fact that federal contributions depended on voluntary enrolment, gave the states an incentive to promote the scheme and the fact that it was aimed at the uninsured meant that extra federal resources tended to flow to the states with the lowest public health spending per capita. It was envisaged that the insured would be free to utilise any health-care provider, which meant that money would follow the patient and a step would be taken towards horizontal integration of the system. The *Seguro Popular* has grown quickly since it was first set up. By the end of 2007, 7.3 million families were signed up to the scheme and public health-insurance coverage had risen to about 75% of the population. The government increased the budget for the scheme by 21.1% in 2009 with the aim of covering 11.1 million families (ACS, 2009).

The success of the *Seguro Popular* can be attributed to several factors. The reform addressed a problem – lack of health insurance coverage in the population – the adverse financial and health consequences of which had been well documented by research and international comparisons (Knaul and Frenk, 2005). There was strong leadership from the Ministry of Health and the reform was cleverly designed to complement the existing social security system and to incentivise both families and the states to take up the scheme. There was time to pilot the reforms between 2001 and 2003 under the six-year presidency of Vicente Fox and a realistic, six-year implementation period from 2004. The reforms were successfully negotiated both within congress and with the state governments. Finally, much emphasis was put on a sustained effort to raise resources both from federal and state budgets against a difficult fiscal background. However, various challenges remain, including variability of political allegiances in congress and across the states; variability in implementation capacity at the state level; and continuing problems with fiscal capacity.

Switzerland: struggling to contain costs

Switzerland has a particular form of universal health insurance. Everybody in Switzerland is required to buy health insurance covering a package of basic health care, with the state subsidising the premiums for the poor. The insurers are private entities, but they are not allowed to make a profit on the basic package and they must operate open enrolment. Citizens have free choice of health insurer and the insurers compete mainly on service and price. The premiums are both flat-rate and community-rated: the rich pay the same rate as the poor. There is a risk-equalisation mechanism which compensates insurers with less favourable risk structures. There is a high level of cost sharing and direct payments for uncovered services and, at 40%, the private share of health spending is the fifth highest in the OECD area. On the supply side, most hospitals are owned by cantons and ambulatory care doctors are self-employed. Governance is fragmented. Social insurance is mainly a federal responsibility. The provision of health care is a cantonal responsibility. Public health is a joint federal/cantonal responsibility. There are 26 cantons and it has been said that Switzerland has 26 health systems. Also, changes to the law at a national level may be submitted to a referendum at the request of either 50 000 voters or eight cantons. Since 1974, at least nine proposals for changes to the health insurance law have been rejected in popular ballots, all with an overwhelming majority.

The Swiss system, though effective, is one of the most expensive in the OECD

The OECD/World Health Organization (WHO) review of the Swiss health system was published in October 2006 (OECD/WHO, 2006). Collaboration between OECD and WHO was requested by the Swiss authorities in order to obtain an overview of the health system both from an economic and a public health perspective. It also ensured good acceptance of the report at the national level. This was followed in 2007 by a study comparing the Dutch and the Swiss health-care systems, which share some important similarities (Leu *et al.*, 2007). The aim was to inform the ongoing reform process in both countries. According to the OECD/WHO report, the level of health status in Switzerland compares well with levels in other OECD countries. There is an abundance of modern medical care and patients are largely satisfied with the services they receive. However, these successes come at a high financial cost. At 11.6%, Switzerland has the second highest health expenditure share of GDP in the OECD area and the highest in Europe. Moreover, the rate of growth of health expenditure has been outpacing the rate of growth of GDP more than has been the case for the corresponding OECD averages (OECD/WHO, 2006).

Although there was no formal implementation process for the OECD/WHO review in Switzerland, the report is considered to be a reference document in the discussions about further health reforms. The "independent view" of the OECD/WHO experts is seen as an advantage. The report describes 6 types of reforms and makes 23 recommendations. Some of them were already ongoing or only beginning at the time of the evaluation. Two of them appear to be of particular interest: the revision process for the federal health-insurance law (LAMal); and the prevention and health promotion law project.

Despite reform efforts, costs continue to rise as a share of GDP

The last major reform to the Swiss health system was the passage of the LAMal by a narrow majority in a referendum in 1994. That had been preceded by discussions with all stakeholders, which had started in 1991. It was this law which introduced important aspects of the present system, such as universal health insurance, a uniform basic package of care, state subsidies for the poor, free choice of insurer, community rating of premiums, a risk-equalisation mechanism and the non-profit status of insurers. It was envisaged that cost containment would be promoted by regulated competition among the insurers. The successful passage of the LAMal, which was introduced by a Social Democrat administration, can be attributed to a growing consensus in Switzerland that all Swiss citizens had the right of protection against catastrophic medical expenses and the right of access to high-quality medical care. Also, in many ways the law represented only incremental change. Around 95% of citizens were already covered for health insurance voluntarily and many of the insurers were already non-profit sickness funds.

However, whereas the LAMal introduced universal health insurance, it did not seem to succeed in the aim of introducing cost containment through competition between insurers. Health expenditure has continued to grow much more rapidly than GDP. Further reforms have therefore been discussed. In 2003, a market-inspired reform was proposed, aiming at increasing competition in the system, but it was rejected by parliament. In 2007, a counter-proposal for a single health insurer and income-related premiums was also subsequently defeated at a referendum. Since 2004, the government has tried to submit to parliament a set of incremental and market-oriented reforms. Some important legislative changes have been approved as a result and will come into force in 2012, including the introduction of a diagnostic research group-based hospital-financing mechanism, the possibility of using hospitals in other cantons and the modification of the risk-compensation mechanism for insurers (to include risk adjusters based on morbidity data). Reforms which would have introduced more state control were rejected at the same time.

The project of a federal law on prevention and health promotion had already started at the time of the publication of the OECD/WHO report, which probably reinforced the process of reform. A special commission was created in 2006 and made some recommendations about the legal, financial and organisational measures which would be necessary for the reinforcement of prevention and health promotion in Switzerland. The report of this commission was distributed to members of parliament and in September 2007, the Federal Council gave the mandate to draft a law on prevention and health promotion. The first proposal was supported by three-quarters of the consulted stakeholders and by a majority of cantons. The law was adopted in the autumn of 2009. Federal leadership, associated with political consensus, is behind the successful progress towards this reform.

Considering the recent discussions about health system reform in Switzerland, especially since the publication of the OECD/WHO report, the following conclusions can be drawn:

- In general, the main reason for failure/delay in adopting reforms is the lack of political consensus. In Switzerland, two opposing ideological groups of roughly equivalent strength coexist. One group would like to have more state control while the other is in favour of introducing more competition in the health system.
- The barriers to reform include the fact that the constitution gives easily exercised veto powers to the 26 cantons and to popular opinion, through referenda.
- The main determinant of success has been leadership – usually by the federal government, although this was not sufficient for the LAMal.

Turkey: increasing quality and efficiency

The Turkish health system has been undergoing a profound structural transformation since 2003 (OECD/WHO, 2009). Prior to 2003, the system was a combination of a number of social health insurance schemes for different segments of the employed population and their dependents; a national health service providing limited services, free of charge to the population; and a social assistance programme for the poor and vulnerable (the “Green Card”). There were both overlaps and gaps in these arrangements. Moreover, there were serious problems on the delivery side, which meant that even insured people did not always get access to appropriate services. For example, primary care was generally weak, leading to over-utilisation of crowded hospital out-patient departments. There was also considerable geographical inequity in access to health services. Although health status had been improving in Turkey prior to 2003, life expectancy remained below and infant mortality above the levels found, on average, in countries with a comparable standard of living. Only limited data on outcomes are available but comparisons of patient satisfaction with primary health-care services across countries, suggest that satisfaction in Turkey was well below the average in a group of ten European countries (OECD/WHO, 2009).

The "Health Transformation Programme" sought to address both efficiency and quality of care

A major set of reforms, the "Health Transformation Programme" (HTP) was introduced by the newly-elected Justice and Development government in 2003. The main aims were to unify the existing social insurance schemes and administration of the Green Card under a single insurer, which would provide universal health insurance. A purchaser/provider split would be established and autonomy would be granted to public hospitals. A family practitioner service with capitation payments and gate-keeping would be set up throughout Turkey. There would be investment in staff and in information systems. It was planned that the HTP would be implemented during the decade 2003-13. Although Turkey has a relatively centralised administration, this reform required co-operation across several different ministries with responsibilities in the health sector including the ministries of health, labour and social security, and finance, together with the State Planning Organisation. Many of these measures were under consideration well before 2003, but a major economic crisis in 2000-01 helped to delay action. It required the election of the Justice and Development Party in 2002 with a strong electoral mandate and the renewal of that mandate in 2007, to kick start and sustain the political momentum for reform.

When an OECD/World Bank team reviewed the Turkish health system and its reforms in 2008, the HTP was half completed (OECD/WHO, 2009). Universal Health Insurance was achieved in 2008 with the unification of the social security programmes with the Green Card scheme under the Social Security Institute. The new family practitioner services had been rolled out to about 20% of the population. Public hospitals had been unified under the Ministry of Health and a performance-management scheme had been introduced to incentivise staff. The beginnings of a purchaser/provider split had been put in place although public hospitals had not yet gained significant autonomy. As a result of these and other related changes, there has been a large increase in activity, both in primary care and in hospitals. Satisfaction with primary care has risen sharply in provinces which have introduced family practitioners. Also, there was a general rise in satisfaction with the health system as a whole in the population. Although health expenditure has risen sharply, it has risen no faster than GDP. The OECD/World Bank Review concluded that, although it was too early to make a final assessment, the HTP seemed to represent "good practice" in the development and implementation of major health system reforms and preliminary indications were that it had been successful.

The Turkish experience exemplifies many of the political economy lessons identified in this chapter

Many of the conditions for successful health system reform, which were outlined in the first part of this chapter, seem to have been present in Turkey at the launch of the HTP and during the first stage of its implementation:

- Turkey had informed itself about weaknesses in the performance of the Turkish health system by international comparisons provided, for example, by OECD and WHO data.

- Reforms of the kind adopted under the HTP, had been put forward under the National Health Policy in 1990, following health-reform studies by the Ministry of Health and the State Planning Organisation, and these had been articulated further in the Seventh Development Plan, 1996-2000 (OECD/WHO, 2009). In particular, studies had been carried out of family practitioner services in a number of European countries.
- Strong leadership was shown by the new health minister.
- Because of the controversial nature, complexity and likely cost of the proposed reforms, a long period – ten years – was set for steering the reforms through the legislative process and for implementing the results.

The reform plans also took due account of the need to motivate public sector providers to support reform.

- Under the HTP, there were major reforms to the incentives facing medical specialists and other hospital staff in public hospitals with the introduction of bonus payments under the "performance-based, supplementary payment system". This linked pay to improved performance by staff. As a result, there were sharp increases in pay rates for doctors between 2003 and 2005; an increase in full-time working by previously part-time specialists in public hospitals; increases in hospital activity rates; apparent increases in productivity per physician; and large improvements in the satisfaction reported by patients with hospital services (OECD/WHO, 2009).
- The introduction of family-practitioner services (in 23 provinces by October 2008) gave primary care doctors greater pay and autonomy, and was associated with a relative shift in consultations away from hospital outpatient departments towards family practitioners and a sharp increase in patient satisfaction with primary care. Meanwhile, strong economic growth in Turkey between 2002 and 2006 helped to fund the extensions to health insurance coverage, the improvements to incentives and the increases in services (OECD/WHO, 2009).

Synthesis: what do the case studies tell us?

Although this chapter's five case studies cannot be said to be representative of the OECD area as a whole, they do help to shed some light on the factors associated with the success and failure of health-system reforms. It is striking that all five countries concerned have carried out successful health system reforms recently, despite challenges which seem to vary both with the country and with the type of reform. The depth and scope of the reform varied. Some were more systemic than others, even in the definition phase. Some countries appear to have had less capacity for pushing through health-system reforms than others. For example, in Switzerland, the constitution gives power to many "veto players" and there is polarisation of political opinion on the best way to carry out health-system reforms. This combination of circumstances makes it easy for interested parties to block proposals for reforms in Switzerland.

Expanding access is easier than increasing efficiency or containing costs

The type of reform – whether it is concerned, say, with equity of access, with cost containment or with microeconomic efficiency – seems also to have a bearing on the challenges facing reformers. Most OECD countries have already achieved universal health insurance (UHI), but in the unrepresentative sample discussed above, only two countries had achieved UHI by the early 1990s. The reforms discussed above brought UHI additionally to Switzerland in 1996 and to Turkey in 2008. Meanwhile, Mexico has made major strides towards UHI with the *Seguro Popular* since 2004. It seems that movements towards UHI have been easier to achieve politically than other health system reforms in most OECD countries – although some countries remain exceptions to this rule. Although there will be losers from such reforms (broadly speaking, those with higher incomes and those with good health). There is widespread altruism in most OECD electorates when it comes to providing everyone in the population with access to basic health care. Also, it is usually in the long-term interests of the professional monopolists and other provider and insurance interests to co-operate in any expansion of the health system.

Reforms which deliver cost containment may be more difficult to achieve. Among the countries discussed above, Finland and Korea seem to have achieved admirable control of health expenditure by different means. However, Switzerland appears to be struggling to contain costs. And although Mexico and Turkey have hitherto had comparatively modest levels of health expenditure, the recent improvements to their health-insurance arrangements have introduced some uncertainty about the future fiscal sustainability of extensions to their health systems. Most difficult of all may be achieving improvements to microeconomic efficiency. All the countries discussed above struggle with ambiguity about how to achieve microeconomic efficiency because of the lack of measures of health outcomes and quality. This has encouraged ideology to flourish in health-policy debates. In addition, it is clear that the medical profession can hold a *de facto* veto – if only a temporary one, in some cases – over reforms which challenge their professional freedoms or economic interests. This was noticeable during the implementation of the Separation Reform in Korea.

Against this background, it is possible to identify some of the factors which have helped to bring about success in health-system reforms in the countries reviewed in this chapter.

The quality of analysis and evidence supporting a reform matters

It is clear that all of the successful reforms summarised earlier were informed by diagnostic data and analysis, which often included international comparisons of health-system performance. In particular, Mexico and Turkey utilised national and international health data to help diagnose the shortcomings in access to health services, in financial protection and in health status that were tackled by the introduction of the *Seguro Popular* and the Health Transformation Programme, respectively. International comparisons have highlighted the relatively high level and rate of growth of health expenditure in Switzerland. This observation is congruent with OECD findings in other policy domains (OECD/WHO, 2009): the clearest impact of work by the OECD and other international bodies is often observed when countries are able to see their performance or policy regimes in comparative context. Such benchmarking can signal to electorates or elites that institutions or situations that they may have come to regard as normal and acceptable are in fact unusual and often rather poor by international standards.

Similarly, the designs of the reforms summarised above were informed both by national analysis and international comparisons. For example, Finland's successful clinical guidelines were developed with the help of an international medical literature. Turkey's successful family practitioner reforms were developed on the basis of prior studies of family doctor services in a number of OECD countries.

Electoral mandates can open "windows of opportunity" for reform

Several of the case studies – especially those for Korea, Mexico and Turkey – appear to illustrate occasions when newly elected administrations with strong leadership and strong popular mandates seized political "windows of opportunity" to make structural reforms to health systems. Perhaps it helped that two of these countries, Korea and Turkey, are relatively centralised states with few veto players. In the case of Turkey, co-ordination across several ministries with responsibilities in the health sector also helped advance the reforms.

Three of the case studies indicate the possibilities for achieving national legislation for health-system reforms even when the responsibilities for the governance of the health system rest mainly or partly at local government level – increasing the number of veto players. In Finland, the "Project to Restructure Municipalities and Services" has succeeded in encouraging some voluntary mergers between small municipalities, with a view to bringing about economies of scale, although at the time of writing, the final destination of these reforms remained uncertain. Despite the difficulties with national legislation in Switzerland, mentioned earlier, a major reform to the health system, the LAMal, was passed (if only by a whisker) at a referendum in 1994. In Mexico, potential opposition from some state governments to the federal government's proposal to introduce the *Seguro Popular* was disarmed by negotiation and engagement. However, variations continue to exist across the states in the capacity to implement the *Seguro Popular* effectively.

Getting the doctors on side is key

The case studies in this chapter help to illustrate how important it is to get the medical profession on side before implementing reforms that are aimed at improving the efficiency of health-care delivery. As has been mentioned, in Korea, the initial attempt to separate the dispensing of pharmaceuticals from prescribing led to a series of strikes by doctors, despite an earlier agreement to this reform by the then leadership of the medical profession. The reforms had to be rescued by a very large increase in physicians' fees – suggesting that a high price was paid for the subsequent gains in the efficiency of prescribing. By contrast, in Finland, the introduction of clinical guidelines – with a view to reducing variations in treatment levels and bringing down waiting times – was successful because the medical profession had prior ownership of work on standardising treatment protocols. In Turkey, significant prospective increases in doctors' pay, combined with new performance incentives, helped to ensure that many individual doctors co-operated enthusiastically with the reforms, despite vociferous opposition from the Turkish Medical Association.

Reform is easier where resources are available to address incentive issues

Several of the case studies reveal the use of incentives to support the reform process. Finland put in place both incentives and disincentives to encourage the attainment of waiting-time targets, with good results. In Mexico, the *Seguro Popular* was designed to encourage the poorer states to promote the scheme, because federal transfers would increase with take-up. Turkey, as has been mentioned above, introduced a powerful bonus-payment system which linked pay to performance for staff in public hospitals. It led to a rise in pay rates and it brought about a sharp increase in hospital activity and a large improvement in patient satisfaction with public hospital services. This appears to be an excellent example of meeting the rising demand for services created by improvements to health-insurance cover by raising productivity on the supply side.

At least two of the case studies illustrate the importance of raising resources to help to fund health reforms. In Mexico, the best use was made of limited fiscal capacity by sharing the funding of the *Seguro Popular* between the federal governments and the states. Private contributions to the premiums were also required – albeit at a level that would be likely to be affordable by the poor. In Turkey, the Ministry of Health succeeded in securing an increased share of public spending for the health sector during the early years of the HTP. It was also fortunate that the introduction of the HTP coincided with a period of rapid economic growth in Turkey. However, it remains a matter of concern that the HTP was only half completed when the world economic crisis started in 2008. This may illustrate one of the risks attending drawn-out, large-scale reforms.

Conclusion

Reforming health systems is a complex, multistage process. All stages in the process – diagnosis, design, legislation/regulation and implementation – must be completed successfully for the reform as a whole to be successful. In particular, successful health system reforms will require the co-operation of the professional monopolists who provide health services – especially the medical profession. The factors leading to success or failure in health-system reforms are to some extent exogenous and to some extent open to management by the governments promoting reform.

The gathering of information and evidence seems to be helpful at the diagnostic and design stages of reform. In particular, there is evidence that international comparisons of health-system performance and analyses of what works and what does not work in health institutions abroad have been helpful in most countries. The production and publication of a clear diagnosis and a compelling design for a reform has often represented a key, initial step in the process of building a consensus or majority for change.

It has been suggested that political "windows of opportunity" for making major, structural reforms to health systems in democratic countries open only rarely. Strong political leadership – including leadership by presidents and prime ministers – and the exercise of political authority seem to be indispensable for seizing such opportunities. Prior preparation – perhaps by assembling a suitable body to draw up proposals for reform – may help. At other times, reforms will need to "go with the grain" of the health system, seeking incremental improvements to its performance without attempting major structural changes. In all cases, communication and engagement between the proponents of reforms and other key stakeholders – especially those holding *de jure* or *de facto* veto power – may help to prevent such stakeholders from exercising their potential vetoes, or from conspiring to reverse the reforms after the next swing of the political pendulum. The skilful use of incentives, to help align the interests of the key stakeholders with the intentions of the reform, can contribute to success. And securing resources to fund improvements or simply to "grease the wheels of change" has often been a necessary condition for success.

Some of the experiences reviewed in this chapter suggest that there may be trade-offs between maximising the success and sustainability of health-system reforms; maximising the speed at which they are carried out; and minimising the resources that have to be invested in their implementation. It will often be possible to choose any two of these desiderata, but not all three.

In view of the relative isolation of health-care systems from one another, and the variety of institutions and ideologies that coexist in the health-care field, there would seem to be a major continuing role for the OECD in providing international data and analysis of what works and what does not work in health policy – and what are the determinants of success in health-system reforms. Advancing the collection of health-care-quality indicators would also seem to be a particular priority, given the central importance of efficiency to health-system performance and the comparative lack of indicators and benchmarks of health-care outcomes against which efficiency can be measured.

Notes

1. Total expenditure on health measures the final consumption of health goods and services (*i.e.* current health expenditure) plus capital investment in health-care infrastructure. This includes spending by both public and private sources on medical services and goods, public health and prevention programmes and administration. See OECD (2009).

2. For example, in the United Kingdom, the most recent biennial survey of public attitudes towards conduct in public life found that the proportion of respondents who said that they would trust government ministers and members of parliament to tell the truth were 27% and 26%, respectively. Trust in family doctors to tell the truth was 94% (Committee on Standards in Public Life, 2008).

3. This is consistent with the findings, in other domains, reported in OECD (2009b).

4. Just considering the legislative process, the House of Representatives, the Senate and the President all have to approve legislation (subject to over-rides) in the United States; only the House of Commons is relevant for financial matters in the United Kingdom.

5. In other words, it may be important to know who has the power to intervene at what stage.

6. Later, the minister remarked famously that, in order to broker the deal with the doctors, he had "stuffed their mouths with gold" (Baggott, 1994).

7. Fluctuations in productivity in Finnish health centres in the 1990s seem to fit this pattern (see OECD, 2005a).

8. Information provided by the Korean authorities.

9. Strikingly, this is the opposite of what "veto player" theory would suggest: it was the lack of cohesion on the part of the medical profession that created the initial obstacle to change.

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Chapter 8

Modernising government

by Claire Charbit and Camila Vammalle*

This chapter analyses a number of key challenges for implementing public administration reform. It highlights these challenges and discusses possible tools to address them, drawing on past and present reform experiences in several OECD countries. It is based on OECD analyses of public administration reforms and other literature, looking primarily at two policy domains: decentralisation and public employment reforms. The focus is on the reform process rather than the nature of the reforms themselves. The chapter is structured as follows: the first section provides a general description of public administration reforms and the general challenges faced by reformers. It briefly overviews experiences in public administration reform in the last three decades in several OECD countries. The rest of the report is organised according to the three phases of the reform process: planning, implementation and sustainability. Although these phases do not always – or even usually – unfold in such a neat sequential pattern, it is analytically useful to distinguish them in this way, since they present different challenges. For each of these phases, the key challenges for implementing public administration reforms are identified, and a set of possible tools to address these challenges are described, together with specific examples of tools some OECD countries have used to address similar challenges.

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A government's capacity to reform is a great source of comparative advantage. Implementing reforms helps to unleash the potential needed to support growth and sustainable development. But reform goes beyond enacting laws: the process of designing, introducing, implementing and sustaining reforms needs to be part of a coherent plan that takes into account a number of structural elements. It is therefore difficult to exaggerate the importance for a government's "reform capacity" of an effective public administration, possessing analytical, regulatory and administrative capacities of a high order. An efficient, effective, accountable and transparent public administration can bring higher levels of legitimacy, trust and commitment to the incumbent economic and political reform agendas, as well as improve the quality of both policy design and policy implementation. Yet public sector reforms are in many cases complex, unpopular, contested and fraught with risk. They require a long time to produce results and prove beneficial. Therefore, countries adopting reform packages are faced with the question of how to sustain the reform's legitimacy, support and impetus and to keep people's trust, while introducing necessary but often controversial policy initiatives. The experience of OECD countries shows that the complexity of public administration reform is exacerbated by the interaction of simultaneous processes in the economic and political fields (OECD, 2005).

In the wake of the global crisis that erupted in 2008-09, making public administration reforms happen has become more important than ever. History shows that such deep crises can either completely halt (or even reverse) ongoing and planned reforms, or on the contrary, can serve as the impetus to implement important reforms. In any case, the crisis has made the need for public sector modernisation more urgent, as citizens have turned to the state in search of quick solutions to complex problems. Governments must therefore be capable of acting rapidly, but not hastily, as today's decisions will have long-term consequences: for countries implementing stimulus programmes, funds can be used to promote desired outcomes such as innovation, regional development or a greener economy; and in most countries, budget deficits will soar, thus creating stronger pressures to reduce public spending in coming years. Given this context, it is all the more important for the public sector to be efficient, equitable, and forward-looking, or in a word, "agile". This crisis should thus be used as a trigger for the public administration reforms needed to achieve this goal.

The challenge of public administration reform

Public administration reform processes tend to be highly path- and context-dependent

A large consensus exists on the need for reforms to adapt governance and administrative systems to the global and knowledge-based society. One of the key issues is to design and manage processes of reform that are able to initiate a long-term dynamic of change. There are two reasons for this. First, reshaping the system of government by redistributing authority in a multi-level system of governance and redefining the relationships among the different tiers of government takes time: collective skills, legitimacies and processes of co-operation have to be built; the civil service has to be transformed in order to rationalise it and to allow it to better respond to citizens' needs; in-depth diagnoses of highly complex systems have to be performed; statuses of civil servants and career management have to be transformed; organisations and their mode of performance have to be redesigned. All of these are massive processes which take time. Secondly, the challenge is not merely to adapt the public administration to a new, but stable, situation. Rather, it is to enable it to adapt continually to an environment characterised by an accelerated pace of change in many domains.

Processes of government modernisation are also framed by severe constraints:

- They are path dependent. National systems of governance and public administration are the results of specific historical processes.

- Existing structures of governance reflect specific national compromises among various forces. They are the expression of different balances of preferences in terms, for example, of the degree of collective solidarities versus the promotion of entrepreneurship, or acceptance of differences versus the creation of collective values.

- They must be adapted to the population (diversity, size, cohesion) and economic characteristics of each country.

- They are strongly shaped by the constitutional system that frames political debate, public budgeting and legal enactment.

What is possible and works in a certain context might be impossible or undesirable in another. The concrete capacity to devolve, delegate, diversify, open to competition, and formalise public management can vary greatly from one country to another and from one level of government to another. Radical reforms based on transplanting organisational patterns that exist elsewhere are likely to fail if they are not adequately internalised or if the domestic political process "denaturalises" them. The key challenge is not how to change the in-depth nature of national systems, but rather to make these systems and institutions work better.

Public administration reforms present a range of challenges, some of which are peculiar to administrative reforms

Despite the highly context-dependent nature of public administration reform, there are some common challenges that can be identified in any public process. Thus, it is possible to learn from past and foreign experiences. This section explores these challenges, explaining why public administration reforms are often even more delicate, politically sensitive and difficult to implement than other reforms. It then shows that, despite these specific difficulties, major public administration reforms have been carried out in many countries. Public administration reforms face three general challenges, common to all reform processes:

- The scope, scale and complexity of public administration make it difficult to see what is critical to success and what is irrelevant, what is related to something and what is trivial: in short, administrative complexity makes the elements of reform somewhat intractable.

- The pace, visibility and dynamism of reform make it difficult to know what should be done to start, steer and sustain the reform: what should come first and what later, what is a necessary condition of success and what is a "nice to have", what are the potential obstacles and opportunities.

- Acquiring the *savoir faire* of reform is very difficult, principally because it is inadvisable – and impossible – simply to transplant, without modification, the approach to reform used elsewhere. It is impossible because, notwithstanding many similarities, the circumstances and conditions of reform are never the same. And, it is inadvisable because the most important condition of success is that those implementing the reform have a sense of ownership of it; the reformers' creativity and perseverance are essential and their motivation comes from feeling responsible and committed. This requires that they manage the reform in a way that aligns with their own administrative and national values, culture and practices.

In addition to the difficulties already listed, administrative reforms face four specific challenges:

- *Lack of social demand for reform*: creating citizen interest and support for public administration reform is often a challenge. Public interest in public administration reform is generally weak, because these changes are perceived as being far from the concerns of everyday life. When public administration works efficiently, citizens do not notice it. When it does not, they lose confidence in the state and in its capacity to reform.

- *Public resistance to some forms of change*: paradoxically, where public interest in public administration reform does arise, it might be to oppose it. On the one hand, citizens might resist changes that they believe touch the specific "social contract" that exists regarding the proper scope of public action (*e.g.* they may resist privatisation or the "outsourcing" of public functions to the private sector). On the other hand, a reformed public administration implies a cost to citizens, as they have to go through the process of "learning" how the "new" administration works (without *ex ante* guarantees that it will be more efficient and/or equitable).

- *The problem of "reforming the reformer"*: the public administration must design and implement its own reform, imposing on itself measures that might negatively affect some of its own constituent elements. For instance, civil servants may dislike reforms that appear to challenge or even run counter to their psychological profile (*e.g.* risk aversion) and or their personal values (*e.g.* an ethic of community service). Reforms might also affect public decision makers and/or political leaders, as decision-making power is shifted from one part of the administration to another.

- *The politics-administration nexus*: public administration and the political institutional environment are highly interdependent – reforms of one can have profound and unforeseen consequences for the other.[1]

Meeting these challenges depends largely on the quality of institutions and leadership

There are, however, a number of political and institutional factors that facilitate reform:

- Reform is easier where the governance regime is characterised by sufficient stability, clarity and authority, so that all parties involved, including civil society and public servants, know who is making the decisions, where they are being taken, and, in at least a general sense, why.

- It helps if the political institutions that must sanction the reform command the confidence of civil society. This can be particularly challenging, as creating this stability and credibility is sometimes the principal objective of public administration reforms.

- Political leaders, too, must have sufficient standing and credibility to proceed and to be assured of sufficient popular support while concentrating their political energy on the reform.

- Transparency and credible evaluation mechanisms are needed to evaluate and legitimate reforms, identifying what works and what doesn't. Strong ombudsmen and independent courts of auditors can play this role.

- It is important that the administrative leadership be seen as acting in the public interest, as interpreted by the duly elected government, and in conformity with the laws of the country, and that it have sufficient experience and capacity to be able to advise the government and motivate the public servants. In this respect, institutions such as centres of government can co-ordinate all public administrations and ensure continuity in policies and reforms.

- The team of reformers must have sufficient competence, previous knowledge and contacts, as well as access to the necessary information and methods to undertake, systematically and coherently, the planning, implementing and consolidating of the reform.

That said, because major administrative reform represents a break from the past and an acknowledgement that current practices, policies and processes must be changed, it often helps to have a newly elected government with a clear mandate for reform. As can be readily seen, many of the facilitating factors identified above may themselves be the fruits of a successful reform; in some cases, therefore, it may be possible to set in train a "virtuous circle", whereby the early stages of reform create the preconditions for further reform.

The experience of OECD countries highlights the value of a range of tools for realising public administration reforms

OECD countries have seen significant changes in public sector management over the last three decades. The goal has been to make public administration more transparent, more user-centred and more focused on performance, even though the traditional model of government as responsible for all steps in service provision provided a basis for steady recovery and strong growth in post-war Europe. Although this continues to be the model for some OECD countries, social, economic and technological developments in the latter half of the 20th century generated increasing pressure for change. In many countries, fiscal stress and financial crisis provided the main triggers for widespread administrative reform. By the early 1980s, it was becoming clear that some of the open-ended, demand-driven commitments of the traditional model were no longer politically or economically tenable. The new wave of reforms focussed on how to "make the managers manage", and on how to improve the efficiency and quality of public services. There were calls for a reduction of the role of government in the economy. Administrative reforms were characterised by a combination of increased fragmentation through horizontal structural differentiation; increased decentralisation through structural devolution; and the extensive use of contracts. Most recently, reforms have focused on dealing with the inability of elected governments to control and co-ordinate policies across ministries. There is a feeling that, as the policy arena has become more crowded, with numerous actors competing for political space, the government's ability to maintain some semblance of control has been curtailed.

In general, OECD countries have been immersed in the transition from a stage dominated by a single policy maker (at different levels of government, according to the nature of the country's institutions) to a stage with several actors engaged in policy making, implementation and the use of market mechanisms for allocating public goods and services. Increasingly, OECD countries consider that it is not only necessary to change the relationship between government, citizens and parliaments, but also the functioning of government itself. In this sense, for more than two decades, they have been adapting their models of "welfare capitalism" to a changed economic environment. As a result, there has been a radical shift in the way government works through the adoption of mechanisms that are expected to strengthen legitimacy and allow government to reform itself to better meet society's needs. They constitute a way to restore trust in government, which is both a goal of, and a condition for, successful reform.

Reform processes are not linear: reforms usually consist of several components, which might not all progress at the same speed, and reforms can sometimes accelerate or slow down due to external circumstances. Still, as reforms are long-lasting processes, it can be useful to analyse them through a three-stage framework: the planning phase (where the objective is to *start* the process on the right foot); the project management phase (where the objective is to *steer* the process in the right direction); and the sustainability phase (where the objective is to *secure* the progress made and ensure its durability). Each of these phases presents specific challenges, which can be addressed by one or more policy tools. Some of these tools can in turn be used to address several different public administration reform challenges. The mix of tools can therefore be adapted to fit the political and cultural setting. Table 8.1 summarises the possible challenges and tools available to reformers.

Table 8.1. **Public administration reform challenges and possible policy tools**

Key challenges	Possible policy tools
• Bridging information gaps and developing a clear roadmap with measurable intermediary targets and final outcomes. • Creating support for the reform: citizens and civil servants. • Building on leadership and political commitment to the reform. • Overcoming resistance to change and creating ownership feeling for reforms. • Capacity and knowledge. • Avoiding policy reversals. • Evaluating reform and assessing success.	• Independent systems of expertise and preliminary evaluations. • International organisations. • Public debates and consultation strategies. • Seize the moment: take advantage of crises. • Intermediation bodies (unions, associations, etc.). • Clear electoral mandates. • Compensating losers of reforms. • Implementing complementary reforms. • Contracts and experimentation. • Training plans and public administration schools. • Communication. • Evaluation mechanisms. • Independent and permanent institutions. • Ombudsmen and high-level committees.

Reform: the planning phase

The planning phase is very often rushed and not given enough consideration. Yet planning lays the foundations for reform, and this phase conditions the degree of resistance it will face later, and thus its chances of success. Indeed, the more effective the consultation and support-building during the planning phase, the smaller the future resistance and risk of reform reversals. The planning phase defines the motivation for reform and sets its strategic objectives, developing a vision of reform that can be applied to organisational and programme redesign and can be communicated convincingly to civil society, sub-national governments and other stakeholders. The reform plan must achieve an optimal size: it must include enough elements to constitute a critical mass without having so many that objectives conflict and project management becomes impossible.

Key challenges in the planning phase include addressing information gaps…

Reforms may be highly complex, and it may be impossible to plan all elements in advance, because they have to be implemented over an extended period and not all of the needed changes can be anticipated. Nevertheless, it is still essential to propose a plan of reform that clarifies its goals and objectives, as well as the method envisaged for implementing it, including the mechanism for amending it as needed. Rather than a plan, *per se*, what is needed is a widely shared roadmap that describes the priorities and strategy of the reform, and identifies the supporting organisation responsible for the translation of general principles into regulatory and organisational initiatives. This roadmap is all the more important, as it will allow key stakeholders to assess whether and how much they will gain or lose from the reform. Reliable and timely data are necessary to properly assess the need for reform and the expectations and positions of the key stakeholders, and thus to develop this clear roadmap. This is a real challenge in many countries, which lack robust information databases and systems (with both financial and non-financial performance data). Indeed, one of the objectives of public administration reforms might actually be to create such information systems.

…and building support for reform

Creating citizen interest in public administration reform is another key challenge, especially in countries where the involvement of civil society in reform processes is traditionally weak. Top-down policy-making approaches are generally at odds with citizens' demands for greater information, accountability and consultation. However, administrative reforms are usually not seen as relevant to the wider society: as long as citizens perceive that their contributions are being carefully managed and that they receive public services of good quality, there is no social demand for public administration reform. When the state is efficient enough to avoid major crises, support for change is much lower, even if reforms could make it more effective and efficient. This explains to a large extent why, for example, the French have been so slow, as compared to many other countries, in launching civil service reforms. International organisations such as the OECD can also play an important role, by providing cross-country comparisons and benchmarks, and creating opportunities for experts and high-level officials to meet to exchange information and experience.

Still, even if there is no explicit citizen demand for reform, citizens do not usually oppose it, as reforms may promise them more efficient provision and a higher quality of service, and they rarely bear the direct costs of change. Citizens should be the winners in all cases, even if, from time to time, some categories may lose (*e.g.* inhabitants of areas benefitting from over-provision of public goods) or reforms impose short-term costs.

Yet, if citizens do not usually feel threatened by public administration reforms, the same cannot be said of civil servants. Indeed, the modernisation of government clearly and broadly seeks to change their behaviour and culture, through changing rules, incentives, norms, values, and structures. Civil servants may be threatened by changes that challenge their psychological profile (*e.g.* risk aversion) or their personal values or that may render their specific skills obsolete. For example, most civil servants are not used to evaluating and managing risks. In many countries, they are trained to follow procedures rather than to make decisions. Finally, they have developed strategies that fit the pre-existing "social contract" with the society or with their employer, which could become inadequate. Career-based systems, in particular, value compliance with the formal and informal rules structuring bureaucratic communities. Individuals are not asked to exhibit or develop qualities of entrepreneurship, which are often valued in the new logic. It is vital to understand that internal resistance to the reform of the civil service is not based solely on the rent-seeking behaviours of bureaucrats. Officials may indeed prefer the status quo because they benefit from secure positions that result in rents of all kinds. However, they have also entered into an implicit bargain with their employer (guaranteeing security and long-term employment in exchange for lower wages and loyalty), whose essential terms may be voided by reform.

Independent expertise and open debate can help when building the case for reform

There are a number of tools that can be used to overcome the challenges identified here. The tools chosen and their mix depend on local specificities, but international experience can be a useful guide. Two types of tools seem to be particularly relevant to the challenges of the planning phase. First, independent systems of expertise can be relied upon to establish the general framework of the reform and to document the main issues. For instance, in the case of the Danish reform of local governments, specific studies were carried out to analyse whether smaller jurisdictions provided better guarantees of democratic accountability and responsiveness to citizen needs. The negative answer was an essential argument to persuade citizens to accept municipal mergers. It also undermined the position of some politicians in favour of the status quo. International organisations can both generate new information (best practices, international benchmarks, etc.) and communicate and create citizen awareness and demand for reform. When reliable data are not available *ex ante*, it may be necessary to create them. The UK Better Regulation reform illustrates well how this can be done during the planning phase (Box 8.1).

Box 8.1. The planning of the "Better Regulation Reform" in the United Kingdom, 2004-08

The groundwork for the "Better Regulation reform" in the United Kingdom began in October 2004, with the establishment of the Better Regulation Task Force, with a mandate to develop a better regulation agenda. International benchmarks were analysed, including the better regulation work being done in the Netherlands and Denmark, which had introduced targets to reduce the paperwork faced by businesses.[1] The Task Force report made eight key recommendations, including the adoption of a "one in, one out" rule to bring discipline and better balance to the regulatory process. A related review, launched in 2005, focussed specifically on identifying ways to reduce unnecessary administrative burdens for businesses while maintaining the quality of the regulatory regime. It proposed reducing the number of forms required, deleting duplicate requests associated with regulations and better targeting inspections. To this end, it suggested introducing risk assessment.

Both reports were published about the same time and urged the government to measure the administrative burden of regulation on businesses. In 2005-06, the Regulatory Impact Unit and it successor, the Better Regulation Executive (BRE) began measuring the administrative burden on business created by international, EU or national regulations. All told, the burden associated with some 20 000 obligations to provide information was measured with the assistance of external consultants using the Standard Cost Model that is widely employed in the EU. Compliance costs for businesses and third-sector organisations were estimated at GBP 19 billion per year.

1. In line with the Conclusions of the March 2007 European Council, almost all EU countries have committed to reducing administrative burdens by 25% by 2012. Most are using a variant of the Dutch Standard Cost Model (SCM) or of the EU-SCM to measure these burdens.

Secondly, a large-scale public debate can, if properly organised – and focused on the actual problems rather than general principles – provide an excellent way to allow all stakeholders to discuss how they will be affected, in terms of costs and benefits. Such events can help create interest in, and support for, reform, and they may help reveal new evidence and data, since citizens, lobbies and communities have an interest in documenting their cases and sustaining their claims. This process of information revelation may lead to some alteration of the reform. This can be done on a decentralised basis, as in Denmark (Box 8.2), or by the central government, as in the Swiss equalisation reform (Box 8.6, later in this chapter). This can be an excellent way to assess the potential benefits and costs of reform and to give credibility to commitments to compensate the losers.

The Spanish consultation process on the revision of the Basic Statute for the Public Employee in 2006 provides an interesting example of how the participation of a number of political actors and members of civil society in the discussions of a draft reform during the planning phase can be crucial for ensuring legitimacy, support, and political commitment from authorities at every level of government (Box 8.3). In the end, consensus was achieved on three levels: institutional (between the autonomous communities and the Spanish federation of provinces and municipalities); social (with the unions) and political (with all political parties).

Box 8.2. **Local government reform in Denmark, 2007**

In 2007, Denmark passed a substantial reform of the organisation of its infra-national jurisdictions. The reform resulted in the replacement of 14 counties by 5 regions and the amalgamation of 271 municipalities into just 98, thereby substantially reducing the number of directly elected officials at sub-national levels. The objective of the reform was to improve the public services delivered to citizens, while preventing their recentralisation. Many Danish counties and municipalities were clearly below the size needed for efficient operation, especially in health care, where new medical technologies required increased specialisation and thus larger regions. The reform aimed at defining more relevant levels of government and included a new allocation of tasks between the municipalities, the regions, and the central government. It was implemented in conjunction with a related funding and equalisation reform.

The reform was designed, adopted and implemented rapidly. In October 2002, the government appointed a Commission on Administrative Structure, which released its report in January 2004. In April 2004, the government presented a proposal for a reform of the structure of the public sector based on the commission's conclusions and on the results of a public hearing which followed. In June 2004, the main political parties signed an agreement that set out the principles and timeframe of the reform. Municipalities were then given six months (until 1 January 2005) to find merging partners. This was called a "controlled voluntary process", as municipalities were free to choose merging partners as long as they reached a minimum target of 20 000 inhabitants. The schedule for implementation was very strongly influenced by an exogenous constraint, the local elections scheduled for November 2005. The new municipal borders and division of tasks had to be settled before the elections. The reform came into force at the beginning of 2007. From the adoption of the bills to the commencement of the reform, the central government, counties and municipalities had to make the necessary preparations to implement the new geographic division and distribution of tasks. These had to be reorganised within the new authorities, buildings and materials had to be transferred, and staff numbering about 170 000 full-time equivalents had to be allocated to new employers.

The major opponents of reform were the mayors and local politicians in small municipalities as well as some special interest groups, such as the handicapped, who feared that the service level would be reduced as the responsibility was decentralised. However, research finding that smaller municipalities were neither more responsive nor more efficient undermined their defence of the status quo. The main driving forces for the reform were as follows:

- The strong personal commitment and political leadership of the minister of interior and the minister of health.
- The support and sense of ownership of the reform created by a public hearing held in April 2004. Almost 500 organisations, counties, municipalities, associations and individuals were invited to express their views on the commission's conclusions.
- The bundling of three different reforms (territorial organisation, redefinition of tasks and responsibilities, and equalisation of finance). Indeed, in many cases, stakeholders who stood to lose from one of these reforms would gain from other elements. Thus, local politicians, for example, disliked the reduction in the number of elected positions, but they also recognised that those positions that remained would control larger budgets and responsibilities.
- The provision of safeguards and guarantees. It was guaranteed that no public official would lose his job in the first year of implementation, and the "funds follow the tasks" rule ensured that local budgets would not be harmed by the reform. There was also a "tax freeze", which guaranteed that local taxes would not be increased as a result of the reform.

Box 8.3. **The Spanish consultation process for the Basic Statute for the Public Employee, 2007**

In 2006, Spain carried out a consultation process for reforming the Basic Statute for the Public Employee (EBEP). Prior to the reform, the civil service was still regulated by a pre-constitutional Civil Service Law of 1964, partially amended in 1984. Therefore, the EBEP came to fill a gap in the legislation for the public service by creating a single normative framework for its management. Political parties, autonomous communities, local entities, social agents, trade unions and citizens took part in the discussions through national forums, co-ordinated by the Ministry for Public Administration. The parliamentary debate resulted in more than 300 amendments to the draft, which was finally approved in April 2007. One of the most difficult issues was the scope of the EBEP. It was decided, after much debate, to include all members of staff working for the public administration, including temporary staff.

International organisations can also help generate knowledge, citizen awareness and support

International organisations like the European Commission, the OECD and the World Bank often play an important role in the development and implementation of public administration reforms. The way in which they influence reform processes depends largely on the status of the organisation. Some intergovernmental organisations work like "clubs", with strict accession rules, or have clear delegation of powers from governments in given fields (*e.g.* some United Nations agencies or the European Commission). Such organisations usually do not have strong and independent means of implementation. However, they have some legitimacy in promoting practices, norms and even reforms, particularly when countries apply for accession and are required to bring their institutions and legislation into compliance with the required standards. For example, the EU accession process requires strong administrative capacity in order to harmonise and enforce European Community legislation and policies, to represent the country's national interests before the European Community, and to apply for financial assistance to raise the country's performance to attain EU standards. Thus, in the early 2000s, accession required a number of candidate countries to strengthen institutional capabilities and to accelerate public administration reforms as an implicit condition of accession (World Bank, 2000).

Even without restricted membership or delegation of power, some international organisations can strongly influence national reforms. This is clearest where they grant money, as they can make these funds conditional to the adoption of certain policies and reforms. However, such explicit conditionality is not necessary to influence national reforms. When international organisations do not exercise delegated authority or provide direct financial incentives, their role and *modus operandi* are likely to be more oriented toward the sharing of knowledge and information, policy evaluation and the promotion of co-operation among participating countries. Their evaluations and recommendations can be perceived as both credible and neutral, since they do not lend nor grant funds, and therefore have no direct stakes in the reforms. Thus, OECD analyses of countries' policies have influenced many national reforms. For example, the Irish authorities adopted an OECD recommendation following the Public Management Review of Ireland in 2008 (OECD, 2008), which requires that annual output statements in budget submissions be consistent with the overarching strategy statements. The present accession processes of five new OECD members (Chile, Estonia, Israel, the Russian Federation and Slovenia) are also helping to focus attention on a number of necessary reforms in these countries by allowing national situations to be compared to OECD members.

There are three main roles for international organisations in public administration reforms:

- *Bridging information gaps and promoting knowledge sharing*: thanks to their links with governments, international organisations can access relevant information and thus proceed to informed cross-country comparative analysis that governments can use to plan their reforms. International organisations can provide updated information to regulators and governments about rapidly evolving innovations and practices in other countries, sharing best practices and international benchmarks against which to evaluate policies and institutions. Domestic stakeholders are usually happy to provide information in relevant forums, as it is a way for them to access information and to influence public regulators.

- *Creating citizen awareness and support*: international organisations are not involved in the day-to-day management of public affairs and are not subject to the pressure of regular electoral cycles. They can therefore provide non-partisan, forward-looking analysis that governments can use to communicate the need for reform and thus create citizen awareness and support. However, this distance from the day-to-day concerns can also cause their views to be dismissed, as they may come as insufficiently aware of local conditions or even as promoters of some unwelcome norms or ideologies.

- *Providing tools and incentives for reforms*: by providing international benchmarks and channelling peer pressure, international organisations can increase incentives for reform. Such bodies can provide a politically neutral, multidimensional assessment of performance that can be used to promote reforms, monitor their implementation, assess their results, and communicate their successes. In some cases, less neutral international organisations can strongly influence national reforms. For example, the European Commission had great influence on decentralisation processes in a number of European countries. Its structural funds are distributed on a regional basis, and some countries therefore had to create regional tiers of administration in order to benefit from these funds. This led to the redefinition of the administrative map in these countries.

Crises and other shocks can sometimes create opportunities to pursue needed reforms

Reorganisation of the structure of government and of the civil service has been necessary in most countries, because the logic of the functioning of states that developed in the post-World War-II period proved increasingly unsustainable in the face of globalisation, the development of an innovation- and knowledge-based society, and the evolution of the implicit social pacts underlying public governance arrangements – specifically, citizens were calling for more collective support and greater individual autonomy at the same time. There was also a need for rationalisation, following the largely *ad hoc* growth of the state in many countries after 1945, as governments progressively extended their actions in various domains to address specific needs, resulting in a sometimes inconsistent patchwork of financial circuits, state bodies, and corporations of civil servants. Even when structurally necessary, uncertainty and vested interests often prevented reforms from taking place. Gradual processes of marginal enhancement were often preferred. However, gradualism was often overwhelmed by inertia. Vested interests fought even marginal changes, for fear that they might lead to further, more threatening reforms.

The danger that incremental change will lead either to incoherence or to stasis constitutes a major reason why it is usually preferable to launch identifiable reform processes with clear goals. However, it is also critical to choose the right moment. Launching a reform process is much easier when the public is convinced of the need for change. Radical reforms were accepted in the United Kingdom in the late 1970s and early

1980s, because most citizens felt that the performance of the state and the economy were no longer sustainable. In Italy a decade later, revelations of the widespread corruption of the political elite gave the impetus to reform the state. In the absence of a strong catalyst, a reform can only be launched after long processes of assessment and information sharing, aimed at convincing the public and stakeholders of the need for change. This is one of the reasons why fiscal problems have triggered reforms in so many countries. This was the case for the reform of the civil service in Canada, for instance. However, citizens do not always regard rising debt or persistent deficits as major issues. Fiscal stress may help prompt the initiation of major reforms, but it is not a sufficient condition for them. The Canadian experience after 1993 illustrates the importance of both financial stress and clear electoral mandate as drivers of reform. After 23 consecutive years of budget deficits, raising the public debt to 69% of gross domestic product (GDP), a new Liberal government was elected on a platform that included a pledge to reduce the federal deficit from 5% to 3% of GDP within three years. Learning from the largely unsuccessful efforts of the previous decade, the new government crystallised its vision in the phrase “Getting Government Right”, which linked restraint to renewal, and made deficit reduction a “public good”. It then acted swiftly and dramatically early in its mandate, in order to give itself maximum room for manoeuvre. Hence, the government announced a review of programmes with the objective of redefining the role of the federal government, reducing expenditures and adopting alternative ways of delivering services (Box 8.4).

Box 8.4. **Programme review reforms in Canada, 1994-99**

To oversee its new “Getting Government Right” initiative, the federal government constituted a special committee of ministers. The ministerial committee was supported by a shadow committee of deputy ministers, the most senior officials in their departments, and was chaired by the Clerk of the Privy Council Office, the country’s most senior public official. A secretariat of about 15 senior officials, located within the Privy Council Office (*i.e.* the prime minister’s department) managed the bureaucratic implementation of the reform. Final decisions were taken in the cabinet, with the prime minister in the chair. There was no direct involvement of parliament. Reform became the defining political priority for the government, wholly embraced by the leading ministers, with full involvement and leadership by the most senior civil servants. This consensus and leadership held throughout the most difficult part of the reforms. Decision making was extremely disciplined and budgetary expenditures were used to drive the reforms, one goal of which was to transform the relationship between the federal government and the provinces: federal transfers to the provinces were cut, but the provinces were given greater autonomy as to how to use them. The government chose to focus on short-term fiscal targets and the minister of finance gave each of his ministerial colleagues specific spending-reduction targets. The prime minister refused to consider requests for changes from the spending ministries.

Although comprehensive, the reforms were nonetheless strategically targeted: almost no components of the state escaped the cuts. However, priorities were defined and short-term compensation packages were offered to both public servants (CAD 4 billion for early departures and early retirements) and select groups, such as farmers, who received a CAD 1.6 billion payout and a CAD 300 million adjustment fund to offset the impact of a 25% cut in the Department of Agriculture’s budget and a reduction in government support for farm income safety nets of 30%. A wide range of specific activities were developed and implemented by a team that had been assembled to deal with the human-resource components of the programme review. In addition to job fairs, counselling sessions and ongoing discussions with the unions, one of the most successful measures was the creation of union-management transition committees in all regions to assist with the reallocation of affected employees. To guarantee the sustainability of the process the government reinvested part of the money saved in key priority policies like education, infrastructure and poverty alleviation, so as to demonstrate the benefits of fiscal responsibility. Moreover, the government publicly released information about the plan and its results to keep informed the multiple stakeholders and maintain public support.

While costly in terms of employee compensation, the programme was very successful overall. The federal government recorded an annual surplus in 1997, a year ahead of forecasts, the debt-to-GDP ratio began to fall, and programme spending was reduced to its lowest levels in almost 50 years. The federal public sector workforce was reduced in size by about 16%. Remarkably, there were no strikes or interruptions in service during the reforms, and citizens passed their judgment on the transformation by re-electing the government with a substantial majority. The unilateral cuts in transfer payments to the provinces, however, led to tension in federal-provincial relationships.

As the Canadian case suggests, the economic climate can affect the nature of the reform, as well as the timing. The desirability of certain structures can depend on the climate and on the overall level of risk. In stable periods, the public sector tends to evolve towards organisational diversity and delegation, but in times of crisis, when uncertainty and risks tend to be high, the need for rapid action and the desire for greater security and stability, as well as the size of the stakes, tend to favour increased centralisation. Thus, some of the reforms discussed in this chapter would have been virtually impossible in the midst of the global financial and economic crisis.

Trade unions and other intermediation bodies can play a crucial role in negotiating reforms

Intermediation bodies, such as civil servants' unions or associations of regions or municipalities, are essential to public administration reform processes. Indeed, these reforms typically involve a large number of actors and thus face substantial information asymmetries and high transaction costs due to the need for co-ordination. Intermediation bodies can help solving these problems, by grouping individual stakeholders and thus increasing the availability of information. They also reduce transaction costs by providing stable negotiating partners for the government. Their role in facilitating or impeding reforms tends to depend not only on their constituent members' interests but also on political culture and institutional configuration of the country. The number and representativeness of such bodies also determines their weight in negotiations with the government, as unions and associations representing a greater percentage of workers will have more weight than fragmented bodies with low levels of affiliation. In Ireland for instance, there appears to be a consensus among unions and government that "the public service needs to modernise" (OECD, 2008). The country has a strong culture of social consultation, as illustrated by the "social partnership agreements", which result from negotiations on social policy issues between the government and the social partners (trade unions, employers, farming organisations, and the community and voluntary sector).

Reform: the implementation phase

One of the tasks facing those trying to implement almost any reform is to overcome resistance to change on the part of those whom will lose out as a result. However, because public administration reforms must often be implemented by those they most directly affect, there is a further challenge: for a reform to be truly successful and long lasting, a sense of ownership must be created among the affected stakeholders, so that the reform actually changes the culture and behaviours of public servants, and not just the text of the law. Since such reforms are lengthy processes (changing the culture and behaviours takes time), they need a strong and long-lasting political commitment. Indeed, if stakeholders sense that political commitment is weak, their best strategy is passively to resist reform, waiting for political commitment to vanish and the reform to be abandoned.

There are a number of possible ways to address these challenges. This chapter will focus on four specific tools:

- mitigating the impact of reform on the losers, either via compensation mechanisms (financial and non-financial) and or by packaging several reforms together, so that those who lose from some measures may gain from others;
- creating new actors in the form of independent organisations charged with driving the reform, to ensure that it does not lose momentum during the long implementation phase;
- increasing civil servants' capacity and leadership skills by creating schools of public administration; and

- using contracts in order to allow experimentation, pilot schemes and partial implementation of reforms in given areas, thus eventually creating benchmarks and good practices that can then be generalised to the rest of the public administration.

Successful reforms need strong, high-level leadership…

Strong leadership is a *sine qua non* of successful reform. Yet building strong leadership is in itself a challenge. Leadership might emerge from an election, and this opportunity should be seized to implement reforms. Leadership is linked to yet another key challenge in implementing reform, which is locating or creating the necessary capacities, first, to implement the reform, and then, to function in the new environment and to address the new tasks assigned to civil servants and/or levels of government. The key issue in public sector leadership is the capacity to promote adaptations in order to advance the public interest in situations in which there is a large gap between how things are and how they should be. Leaders must help diffuse and maintain the new values that are necessary for successful public sector reforms, and have the capacity to persuade people to focus their efforts in a common cause. The support of the national political leadership is therefore essential, not least because, to the extent that agents come to believe that reform is likely or inevitable, they will focus on adapting to change, rather than resisting it. Leadership is required to unite the government behind the reform, to convince the civil servants to back it – often by appointing pro-reform figures to head the public administration – and to convince the population of the need for change. Covering these three fronts is essential to avoid the formation of a strong coalition against change. As public administration reforms are long-term projects, political commitment may need to be institutionalised, to ensure that reform does not become dependent on the tenure in office of a particular politician or party.

…but a top-down leadership style may fail to engage those who will implement the reform

Clarity about the goals of reform – and not only the instruments – is crucial, largely because administrative reform is not only about changing structures within government, but also about changing the administrative culture, in other words, changing public servants' behaviours and attitudes. Public servants will not have any incentive to let go of the status quo unless they know the values underlying the reform, the goals they are working towards, and the role they play in the process. They must therefore have a sense of ownership of the reform if the benefits of change are to be realised in full. In many OECD countries, public administration reform is intimately connected with the aspirations, pressures and contingencies of the political world. Decision making is often located at the top of the organisational hierarchy, and top-down approaches dominate the policy process. Many times, reform packages are designed in cabinet meetings, among political appointees and policy advisors, limiting the involvement of civil servants. But excluding civil servants from the design of public administration reforms is a mistake, as it is the civil servants who will sooner or later be charged with implementing them. Therefore, they potentially have both the motive and the means to block any public administration reform.

Although it is hard to oppose policies that aim to increase openness, efficiency, effectiveness, accountability and transparency, the experiences of OECD countries suggests that public servants may resist change as it comes to transform the administrative culture. Yet civil servants are not the only potential losers from a reform of public administration. Reforms affecting the size and number of sub-national governments, and the allocation of responsibilities and resources among them, can be even harder to advance, as they directly impinge on the interests of elected politicians and citizens, as well as civil servants. The need for change and the expected benefits for citizens must therefore be clearly stated and widely communicated in order to create support for reform, and proper compensation mechanisms must be put in place to reduce resistance from potential losers.

Reforming public administration requires appropriate capacity, knowledge and time. Capacity refers both to the capacity of leaders to manage and steer the reform process, and to the capacity of civil servants to adapt to the new rules and ways of working. Knowledge derives from availability of information, which allows stakeholders to understand the need for change, its rationale, and the ways to achieve it. Availability of information facilitates the establishment of learning processes within the organisation, generating the necessary structures for capacity building and the production of local knowledge. As public administration reforms typically imply changes in work practices and the expected competencies of civil servants, they require new capacities and skills, which are not necessarily found *ex ante* in the civil service. Identifying existing capacities and knowledge within the service, and helping civil servants adapt and acquire the necessary skills, are challenging issues. Reform processes can also be hampered by the lack of practical experience of policy makers in the specific area reformed, thus obliging reformers to rely on external (and sometimes foreign) advisors, who have the specific skills for the reform, but lack knowledge of the local administrative culture.

Reformers can benefit from having a clear electoral mandate for reform…

A decisive national election can provide the occasion to launch a national debate about the general drift of the public administration. Both the French *Révision générale des politiques publiques* (RGPP) reform of 2007, and the Canadian reforms of the 1990s were launched after a national debate and elections that gave to the winning party the legitimacy to undertake these major reforms. The former well illustrates the importance of leadership, an electoral mandate and effective mechanisms for accountability (Box 8.5).

In the absence of a fresh electoral mandate, citizen and social demand may give legitimacy to a leader seeking to implement reforms. In the United Kingdom, for example, approximately 60% of businesses in the early 2000s felt that the overall level of regulation was an obstacle to their success and nearly half rated a reduction in administrative/regulatory costs as “very important” (National Audit Office, 2007). There was thus a demand for reforms to reduce the administrative burden, and in 2006, the government committed to a 25% reduction or the administrative burden on the private and third sectors by 2010 (equivalent to GBP 3.5 billion). Citizen consultation mechanisms such as referenda can also be used, but they might result in a reform being rejected, as the proposed introduction of an elected regional assembly in northeast England was in 2004 (OECD, 2006). The proposal was intended to address the anomalies that arise as a result of asymmetric decentralisation in the United Kingdom – Scotland, Wales and Northern Ireland have elected assemblies (albeit with varying powers), but England does not. However, 78% of voters in the region affected voted against the English devolution reform.

…but they may still need creative strategies for compensating those adversely affected by it

Compensation of those who stand to lose from reform can be critical in winning support for reform – or at least curtailing opposition. It may be financial or non-financial, and its adoption and character depend on the context. Much depends on the character of the reform itself: compensation mechanisms are very different in public employment reforms, where civil servants generally have to be compensated, and in decentralisation reforms, where whole regions or communities must be compensated.

Box 8.5. **The French RGPP and the strong commitment of the national leader, 2007**

French public debt is five times greater now than it was 25 years ago, and France has had a budget deficit every year since 1975. Debt service is the second largest item of state expenditure after education. The *Révision générale des politiques publiques* (the "General Review of Public Policies", RGPP) launched in June 2007, only a month after the election of a new president of the republic. One of the main justifications of the reform was to restore the budget situation in the medium term by reducing the debt-to-GDP ratio to below 60% by 2012 and achieving a balanced budget by the same date. This implied reducing the real growth of public expenditure from 2.25% to 1.1% per year over the next five years.

To a large extent, the RGPP is the continuation of more than 20 years of reform effort by successive French governments. There have been ministers or secretaries of state responsible for administrative reform in every government since 1988. In 1995, a Committee for State Reform was instituted, followed by an inter-ministerial delegation for state reform in 1998 and a delegation for the modernisation of the public management and government structure in 2003. The RGPP also built on the budgetary reform that came into effect in 2006, known as the *Loi Organique Relative aux Lois de Finance* (LOLF), which dramatically increased budgetary transparency and accountability, and strengthened the role of the parliament in approving expenditure by introducing a project-oriented budget and multi-year budgeting.

However, the RGPP clearly marked an increase in the intensity of reform. This was achieved thanks to a strong political commitment at the highest levels. The president of the republic chairs the *Conseil de modernisation des politiques publiques* (CMPP), composed of all ministers, who make the final decisions. The detailed work of evaluating programmes and determining the direction of the reforms is left to a steering committee, chaired by the general secretary to the presidency and the director of the prime minister's office. It is responsible for reviewing and monitoring the reforms proposed by each ministry. A secretariat of key officials drawn from the Ministry of the Budget supports the process. The process relies on an in-depth survey of public expenditures covering all sectoral, horizontal and intergovernmental dimensions. The audits underlying this survey focused on the organisation of the state, and the CMPP proceeded to a redefinition of the missions of the central state, a re-engineering of its organisation, a rationalisation of the multi-level organisation of the civil service, and a redesign of many procedures, in general by simplifying them. Ministries and senior civil servants were then asked to implement the reform and to manage its social aspects, in particular, many aspects of the reform having strong impacts in terms of human-resource management.

Day-to-day decision making is under the control of the President's Office, the Prime Minister's Office, and the Ministry of Budget. The latter provides the expertise and the workforce to steer the reform. For instance, the elite Inspectors General of Finance (approximately 40 in number) from the Ministry of the Budget led the 16 ministerial audits at the root of the reform. The minister of budget has overall responsibility for the reform, though each ministry is responsible for reform within its own domain. In June 2008, the CMPP approved 374 measures that were immediately implemented, since there is not parliamentary action required to implement the reform. On the fiscal side, the government has so far announced EUR 7.7 billion in savings over three years, of which it has committed to reinvest EUR 13 billion in public service compensation and other human-resource reforms. Hence, the potential savings amount to about 4.5% of the state budget, setting aside social expenditures. The actual effect of the RGPP on the French budgetary situation will be however difficult to assess due to the aftermath of the global financial crisis.

Compensation for increased effort and risk is often a way to better motivate civil servants. However other tools may take the place of (direct or indirect) monetary compensation, especially by altering the content of the job, to make it more interesting. Increased job satisfaction can be one of the benefits of reform for civil servants. An adequate redesign of jobs can significantly increase their interest. The techniques of "participative management" can be particularly valuable, including involvement in teams, reduction of routinisation, better visibility of the final output and of their contribution to it, and greater freedom to propose and implement improvements. This mix of individual empowerment and inclusion in communities can enhance the quality of life in the workplace, and, more generally speaking, increase job satisfaction. Steps to enhance the human capital of civil servants may also be useful, as these can both advance the reform and enhance their future employability. Thus, some forms of compensation can be tools of reform in themselves, as well as means of enhancing its acceptability.

This can be illustrated by the federal public administration modernisation process that the Mexican government undertook after the economic crisis of the mid-1990s, whose main achievement was a change in the administrative culture. As a consequence of the crisis, civil servants suffered a reduction in their salaries and promotions, and new recruitment was frozen. To compensate civil servants for their losses and to obtain their commitment to reform, the modernisation programme envisaged giving civil servants a greater role in decision making. This was in line with the objectives of fighting corruption and impunity, and the creation of a new culture of service. Civil servants were given more responsibility and participation in decision making and policy implementation, but the modernisation programme also contemplated assessing their performance.

Decentralisation reforms pose very different challenges, as the stakeholders are mainly citizens and the political leaders of sub-national governments. Citizens might indeed see their financial situation affected (if the reform leads to increases in local taxes, for instance), and political leaders will experience a change in their mandate (increased or reduced autonomy), or the outright suppression of their posts (in the case of municipal mergers, for instance). Here, an additional challenge has to be addressed, as the credibility of the commitment of the central/federal government to compensate the losers might be questioned. Indeed, once a reform is endorsed and implemented, the incentives to pay the promised compensation in full are lower. Governments can change, emergencies can lead to reconsideration of political priorities, and those actually contributing to pay compensation can question its legitimacy. Thus, compensations promised for a distant future are never very credible, and their ability to guarantee adhesion is therefore limited.

Nevertheless, recent Swiss (Box 8.6) and Danish (Box 8.2) reforms of fiscal equalisation and municipal government, respectively, show how these obstacles can be overcome, at least in certain conditions. In both cases, the strategy was roughly the same, involving *ex ante* negotiations with stakeholders to discuss the details of the reform and to amend it, before a quick implementation. The Swiss example shows how compensation mechanisms can be used to create very broad support for a reform that has large redistributional effects. Both financial and non-financial compensation mechanisms were used.

"Bundling" complementary reforms can sometimes make the process smoother…

E-government reforms, which promote the use of information and communication technology (ICT) in public governance, provide an excellent example of the way in which opposition to a given reform may be reduced by packaging, or "bundling", it with another, more popular reform. E-government reforms tend to be popular, because they facilitate the voicing of citizens, both by increasing the flow of information between them and the political elite, and by favouring more direct democracy. Moreover, the use of ICT by the public administration to deliver services can make both co-ordination within the public bureaucracy and interactions between the bureaucracy and its citizen-clients easier. E-government reforms can do more than simply empower individuals and groups to use new technology or substitute capital for labour in the framework of the current organisation of operations.

Box 8.6. **The Swiss equalisation reform, 2004**

Switzerland approved a complete overhaul of its fiscal equalisation system in 2004. The enormity of this project is evident from the fact that 27 of the 196 articles of the Swiss constitution have since been amended. The reform came into effect at the beginning of 2008.

Accounting for almost 75% of state spending and 69% of revenues, sub-national authorities (*i.e.* the cantons and municipalities) play a very important role in the Swiss federal system. The imbalance between the expenditure and revenue side is corrected by a system of vertical fiscal equalisation. The former fiscal equalisation system was introduced in 1959 and further developed in the decades that followed. Over time, it became a disordered and confusing system of vertical fiscal transfers from the confederation to the cantons. Two main issues arose. First, the vertical transfers had an important element of horizontal equalisation, as most of funds were raised by the "financially strong" cantons. These horizontal transfers were, however, unclear and out of control. Secondly, over time, areas of overlap developed between the confederation and the cantons in terms of tasks and expenditures. The confederation – as a financial contributor – gained an important say over issues that were in principle, the cantons' responsibilities.

In an effort to address these problems, the federal government and the cantons embarked upon an extensive overhaul of the fiscal federal relationships in 1992, involving six elements: the disentanglement of tasks, an overhaul of co-operation between the confederation and the cantons, the fostering of inter-cantonal co-operation with equalisation of burdens, the equalisation of financial strength (resource levelling), the equalisation of financial needs (compensation for special burdens), and hardship relief as a temporary interim instrument. While many political and civic forces were in favour of the reform, it provoked much debate because of its potentially large distributional consequences and also because of conflicting visions of federalism. The reform touched on tensions between the confederation and the cantons, between the departments of finance and other ministries, between wealthy and poor cantons, between urban and rural cantons, between French- and German- speaking cantons, etc. The solution was found through the establishment of a steering committee composed of politicians from different regions and levels of government, supported by specialist technical working groups. The potential winners and losers were clearly identified, and distinctions were made along two axes: winners versus losers, and rich versus poor. A temporary cohesion fund was created to guarantee that no poor canton would be a net loser in the first years of the new system. The majority of richer cantons were losers in terms of transfers across jurisdictions, but they benefitted in exchange from a substantial reduction of the percentage of earmarked grants from the confederation (*i.e.* increased expenditure autonomy). A principle of budgetary neutrality was adopted, but this principle was violated owing to the need to establish a hardship fund to provide financial compensation for losers. Decentralisation – desired by the conservatives – was combined with greater fiscal equalisation, desired by the social democrats. These compromises resulted in a complex reform that was approved by almost 65% of voters in the ensuing referendum and that won majority support in 23 of 26 cantons.

At their best, e-government methods can reshape organisations, changing both their "back office" operations and their modes of interaction with outsiders. Apparently simple and desirable changes, like digital "one-stop shops" for entrepreneurs dealing with the formalities of registration, can imply the in-depth reshaping of administrative procedures. The development of a fully integrated e-administration is therefore an in-depth, long-term, and costly reform in itself. At the same time, the logic of e-administration is very close to the logic of the "modernisation of the state": both call into question the logic of the current organisation of the public bureaucracy and of the policy process, and both seek to increase responsiveness to citizens needs. The main advantage of the "e-administration" is that it tends to be more popular and it has a tangible aspect that is easier to explain to the public: the progress of e-administration can be measured. Coupling the "reform of the state" with the development of "e-government" capabilities can therefore be a promising strategy. The Copernicus Reform in Belgium, the French reform of the public administration, the Canadian "public service renewal" initiative, among many others, have all significant e-government components.

Bundling two different reforms together can also help build political support, as stakeholders may accept to make concessions on one of the reforms in order to get other elements adopted. This was, for instance, what happened in respect of Belgium's 2001 Lambermont agreement (Box 8.7).

Box 8.7. **An example of bundling reforms: Belgium's Lambermont agreement, 2001**

The Belgian federation is characterised by strong centrifugal and bipolar forces, and an institutional set up that reflects ethnic and cultural cleavages. The country is divided into three regions, responsible for services linked to the "territory", such as transport or housing, and three communities that are responsible for services linked to the "person", such as education or cultural affairs.[1] Any institutional reform requires a qualified majority in the national parliament and a simple majority in each of the regional parliaments to prevent any of the linguistic groups from imposing a reform on the others. The Lambermont agreement is the most recent agreement on the Belgian state reform, which has unfolded in five phases (1970, 1980, 1988/89, 1993 and 2001), with powers increasingly devolved from the federal level to the federated entities. A sixth state reform was thwarted in 2007.

Adoption of the 2001 reform was made possible largely by the existence of demands for reform in the two main linguistic groups: the Dutch-speaking Flemish region demanded more tax autonomy, while the French-speaking Walloon region needed to increase the funding for the communities, which are responsible for education. The Walloon region had little interest in more tax autonomy but was not strongly opposed to it, and the Flemish region had no particular interest in increasing community funding, but was not strongly opposed either. The reform stances hence became symmetrical. Bundling the two reforms together therefore led to agreement. In 2007, more tax autonomy was still on the Flemish agenda, but there was no countervailing demand from the Walloon side. The scope for bundling and compromise between the two regions was therefore limited, and the reform attempt failed.

1. Flanders, Wallonia and the capital region of Brussels constitute the three regions while the French, the Dutch and the (small) German speakers represent the three communities. The bilingual Brussels capital region does not have its own community and its community responsibilities are shared between the French- and the Dutch- speaking community, while the German community does not have its own region, whose responsibilities are assumed by the Walloon region. The Flemish region and the Dutch-speaking community have merged.

…as can flexible approaches involving voluntary participation, "contracts" and experimentation

Obstacles to change may arise as a result of mistrust: potential losers from reform, be they citizens or parts of the public administration, may not be prepared to rely on promises of compensation from the architects of reform. The reformers may then need to circumvent, rather than appease, the opponents of reform. Decentralisation reforms illustrate how this can be done via experimentation and voluntary arrangements. The reformers can allow the districts/municipalities that want to implement a reform to do so, either by contracting with the central government or by entering into agreements between peers. The central government must therefore provide the legal infrastructure to allow this type of contracting.[2] Those jurisdictions that want to merge or implement new types of relationships may do so. Such a policy can be backed up by measures designed to encourage participation. In particular, grants can go to those local governments that implement reforms. France has done this in the case of voluntary co-operation among municipalities, as has Finland. Since the 1970s, the Finnish government has been trying to increase the pace of voluntary municipal amalgamations by providing special assistance to merging municipalities. The aim of this policy is to reduce the number of municipalities and make the municipal structure more economically and functionally viable. The case of France (Box 8.8) is particularly enlightening since the central government's determination to reduce the number of municipalities has been constant for the last 30 years. The strategy is clearly a long-term one, with strong fiscal and financial incentives to develop co-operation among municipalities, resulting in a progressive withdrawal of *de facto* prerogatives from them. Periodically, the government tests the idea of major mergers. There is currently a debate about the idea to create a "Grand Paris" by merging most of the departments and part of the municipalities involved in the more dense part of the French capital and its suburbs. The actual future of the government of the Paris region is not totally clear yet.

Box 8.8. **Using "contracts" to promote municipal co-operation: the case of France**

France has more than 36 000 communes (the basic unit of local governance), whereas countries of the same size usually have around 8 000 municipalities. Nevertheless, France has long resisted municipal mergers. Though many are too small to be efficient, municipalities are considered as an essential component of the French democracy. For more than three decades, the central government has been encouraging co-operation among municipalities, both to allow small rural communes to surpass minimal thresholds necessary to provide public services, and to allow urban areas, which are often fragmented into several municipalities, to be managed coherently. There are approximately 19 000 inter-communal structures aimed specifically at facilitating horizontal co-operation, and some 88% of communes are involved in them. There are three main types of supra-communal structures: communities of communes (groupings of small rural communes), "agglomeration" communities (groups of 50 000 inhabitants subject to a single business tax), and the urban communities (groupings of 500 000 inhabitants or more).

Each grouping of communes constitutes a "public establishment for inter-communal co-operation" (EPCI). The EPCIs assume limited, specialised, and exclusive powers transferred to them by member communes. Unlike the communes themselves, the EPCI is not governed by elected officials, but by delegates of municipal councils. Although the EPCI are created by the communes directly, there are two notable roles for the central government. First, EPCIs must be approved by the state in order to exist legally. Second, to encourage municipalities to form an EPCI, the central government provides a basic grant plus an "inter-communality grant" to those communes that accept a single business tax. This is to preclude competition on tax rates among participating municipalities. EPCIs draw on budgetary contributions from member communes (for the syndicates) and/or their own tax revenues (for the EPCIs).

In Italy (Box 8.9), a different strategy was employed to address a similar concern. It is well known that, especially in the south, corruption and lack of competence hampered both the development and the credibility of the public sector. Decentralisation reforms in the early 1990s went hand in hand with a desire to develop good governance practices at local level by both empowering local civil services and making local politicians more accountable. Modernisers in Italy thus developed a contractual approach to regional development policy. Beyond the determination to rationalise co-operation among the various public and private stakeholders involved, the goal was explicitly to rely on contractual arrangements, which are voluntary commitments by the local authorities, to change their practices, and develop their skills. In both France and Italy, the key point was the combination of incentives and contractual agreements. While the instruments (grants and the contracting framework) were designed by the central government, which was thus able to initiate a policy, the concrete implementation of the policy lay in the hands of local governments. Funding implementation on the voluntary adhesion of stakeholders may thus be the best way to overcome mistrust and lack of confidence.

Experiments can also be launched. They provide both an opportunity to refine and enhance the quality of the reform and the chance to demonstrate its potential benefits. Of course, such a strategy might have a drawback in terms of delays and costs. Many resources are spent in these decentralised processes of negotiation and experimentation. The creation of co-operative entities may result in duplication of efforts and a lack of accountability. In France, many public establishments for inter-communal co-operation are misunderstood by citizens and misused by politicians. Gradual implementation of the reform thus has a cost, especially if the *ex post* rationalisation of administrative and governmental structures is not carried out. However, this may be the only way forward if an *ex ante* consensus in support of reform cannot be built *ex ante*.

Box 8.9. **The Italian contract for regional development**

Italian regional development policy has a rather marked contractual nature. The emphasis on participatory forms of territorial development planning and on the recourse to contractual forms of multi-level governance can be considered the outcome of at least three factors: (i) the influence of foreign experiences; (ii) a country-specific need for procedural and decision-making simplification; and (iii) the influence of EU territorial development policies. Indeed, the shift towards instruments of a predominantly contractual nature is part of a process that dates back to the mid-1980s and is partially modelled on foreign experiences. This influence entwined the country-specific needs for simplification that were at the basis of the first experiences of "contractualisation" of public policies, notably the institution of the *accordi di programma* (programme agreement, likely modelled on the example of the French *contrats de plan*) and the *conferenza dei servizi* (service conference), that were primarily aimed at overcoming bureaucratic inertia and veto powers and thus speeding up the decision process. The choice to rely on contractual instruments as a strategy of co-ordination of development policies involving multiple actors, public and private, complex decision making and the unified management of financial resources dates back to the mid-1990s and goes under the label of "negotiated programming" (Law No. 662/1996).

The choice of the tools of development policy was also influenced by EU policies, not least because the latter have helped make deep policy changes more politically acceptable. National funds devoted to economic and social cohesion are currently allocated according to objectives and rules analogous to those employed for EU structural funds. In particular, the system includes bonuses to promote co-operation among the various actors and levels of government. The central government is responsible for elaborating the general strategy of development, regional governments decide on the territorial allocation of resources and local governments elaborate the concrete design of projects and organise co-operation with the relevant local actors. The primary instruments through which the above criteria find concrete application are the *Intese Istituzionali di Programma* and the *Accordi di Programma Quadro*. Both have a rather marked contractual nature, as instruments of "negotiated programming", the former representing a preliminary and strategically oriented act, while the latter serves as its implementation tool. A number of other instruments of negotiated programming exist, some of which may (and do) involve private parties. The primary purpose of these instruments is to co-ordinate the actions of the many (vertically or functionally specialised) public and private agents involved in the definition of territorial development policies. Co-ordination is achieved through an *ex ante* process of negotiation of the objectives and the instruments of multi-year territorial policies, as well as of the definition of reciprocal commitments and of a clear schedule.

Investment in human capital can form a core element of the implementation strategy

Education and training are important means to implement reforms, since they often call for changes in the skills of public employees. Moreover, training can be a tool in a win-win strategy that combines reforms with an enrichment of civil servants' jobs and a broadening of their career horizons, by facilitating their mobility across the public administration and even to the private sector. Training plans may therefore have to be developed to increase both the feasibility and the acceptability of reform. Some international organisations, such as the Council of Europe have training programmes for local political officials.

Two different populations have to be targeted:

- Front-line civil servants have to be trained so as to increase their skills and to enhance the value of their human capital. In Canada, the Public Service Renewal Action Plan focusses on employee development at all levels. For instance, in 2008, it obliged all deputy ministers for all public departments and agencies to put learning plans in place, so as to guarantee that at least 90% of their public service employees would be covered. In 2009, it made assessment and discussion between each employee and his/her supervisor about career development and related learning needs a mandatory requirement, with strict deadlines.

- Senior executives have to be trained, because they should become essential agents of change. Three main targets should be reached. First, they have to understand and to appropriate the new principles according to which they should act. In Canada, for instance, one of the key priorities has been to develop the ability of senior executives to manage risk, rather than simply to avoid it by strictly complying with procedures. Second, they have to understand the logic of the reform so as to be able to support it, and to manage change in their respective department/agencies. Third, they have to be integrated into interpersonal networks and to adhere to common values so as to guarantee the consistency of their initiatives and their compliance with the general interest. Specialised high-level schools or programmes aimed at "preparing the next generation of public service leaders" have been set up in most actively reforming countries. Moreover, specialised task forces responsible for managing the careers of top public executives have been set up. For instance, the Canada Public Service Agency, in co-operation with the Public Service Commission, is responsible for actively hiring university students and developing executive development programmes.

One reason that reform leadership poses such a challenge is that many countries do not count on a pre-existing pool of leaders, and leadership is a delicate quality to develop. The experiences of OECD countries like Germany, Norway, Sweden, the United Kingdom and the United States show that the first and crucial stage in the development of leadership is the selection of leaders and the clear definition of the skills and competences that future leaders should have. Box 8.10 describes leadership development strategies in a sample of OECD countries.

Box 8.10. **Leadership development strategies in OECD countries**

Germany: Almost all ministries and departments in the federal administration have formulated their own strategies to develop and improve leadership. Newcomers to the civil service take part in compulsory introduction and induction programmes organised by the Federal Academy for Public Administration. The academy also offers ongoing training during the first three years of appointment. The German public administration favours generalists and increasingly needs leaders with international skills and competence in European matters. Assessment of leadership involves performance dialogue at least once a year, established criteria for appointment and advancement, and the evaluation of performance by one's own staff.

Norway: The Directorate for Public Management, which is a subordinate agency of the Ministry of Labour and Government Administration, has primary responsibility for leadership development through the preparation of a detailed strategy for managers and management. Ongoing training of managers is regarded as being as important as initial training, and managers are supported by seminars and workshops to aid in relating to staff and to acquire skills in encouraging teamwork, vision and incentive.

Sweden: Most recruitment decisions and management training are handled by agency managers. This provides greater flexibility to individual departments, but central government maintains control by appointing those who manage the agencies. It also maintains a formal recruitment policy that has six key aspects: professional recruitment, the promotion of more women in managerial positions, good induction programmes, continuous development of managers' skills, performance dialogues, and mobility between appointments.

United States: Leadership development has been supervised by the Office of Personnel Management (OPM). One of its strategies is to draw up a list of executive core qualifications (ECQs) which are continually monitored and adjusted to suit current requirements. Training schemes are based on these ECQs, which are designed to foster creative thinking, the ability to negotiate, relate with staff, handle increasingly complex information technology, improve business acumen, and aid in recognising particular talents among staff. The OPM established the Office of Executive and Management Development (OEMD) to organise assessment programmes, training seminars and continuous learning opportunities. The OEMD also engages in partnership with agencies and departments within the federal administration to examine and improve leadership skills according to their specific requirements.

Finland provides another interesting example of leadership building: its rapidly ageing population has created a number of challenges for the country, particularly for the public service. By 2015, a large part of the senior civil servants will have retired, with the subsequent loss of experience and skills required for the operation of the public service. The Finnish authorities have implemented regionalisation and productivity programmes aimed at addressing the challenges of an ageing population, but these initially faced difficulties, because of inadequate communication and discussion with affected actors. For instance, there was disagreement regarding the number of staff that needed to be cut, and top managers sometimes lacked commitment to the initiatives. The authorities recognised the need for increased dissemination of information on concrete means and tools for change management to safeguard the implementation of the programmes. Hence, in December 2006, the Ministerial Committee for Economic Policy established a change management programme called Finwin – Towards a New Leadership. Its aim was to bring about a shared understanding and vision of future challenges and the way to manage them (Box 8.11).

Box 8.11. **The Finnish Finwin programme, 2007-08**

Finwin was directed at top-level civil servants and employee representatives. It started in June 2007 and it finished by May 2008, having involved roughly 1 200 participants. The programme was organised around seminars on topics like well-being at work, social innovations, the functions of the state sector and regional administration reform. There were also other working methods such as learning cafes and workshops that complement the discussions held at the seminars. This leadership initiative focused on creating a common understanding and vision in different 150 ministries and agencies. The message was that all efforts should point to a common aim. Finwin concentrated particularly on training top managers on managing change. It intended to provide them with the necessary communication and leadership skills to face a changing environment under a common vision. One of the advantages of the programme was that it facilitated horizontal dialogue among senior managers from different ministries and agencies. The seminars gave them the opportunity to share experiences and concerns regarding the future.

Communication is important throughout the implementation phase

An essential tool in all phases of reform, and to address many key challenges is communication and the building of information loops. Communication helps to build credibility for the reforming government, to increase the sense of ownership of reforms by keeping civil servants and citizens informed, and to reduce information asymmetries by making the information available to each stakeholder. Where the economic or political situation is particularly difficult, communication can also be used to create a sense of crisis and thus citizen demand for reform. In Mexico, for example, the federal government organised a national meeting on administrative development once or twice a year, giving local and municipal governments, federal ministries, and state-owned enterprises the opportunity to exchange experiences in the administrative modernisation process. These meetings showed the importance of internal and external criticism and helped to create ownership of the reform process, as officials from different levels of government were allowed to provide feedback. Although the administrative modernisation programme was focused on the central government, local and municipal governments were inspired by these events, and by the fourth year of the reform, governors and mayors were taking an active part in the national meetings.

Sustaining public administration reform

Institutional and other changes may be needed to ensure that reforms are not reversed

Making reform happen implies not only having the capacity to launch a process of change, but also to follow up its implementation and provide regular assessments. The key challenge here is to avoid the reversal of the reform. Reform reversals can have two causes: either a decrease in political attention to reform, leading to the resurgence of the previous culture, or a political decision by a newly elected government to reverse the reform of the previous one. A second challenge of this phase is actually evaluating the reform's results. These challenges can be addressed by creating independent, permanent authorities responsible for sustaining the reform after the political priorities have shifted and by implementing periodic evaluations, to assess the progress of reform.

The importance of leadership in the success of reform implementation is clearly recognised. However, public administration reforms cannot rely solely on strong leadership, particularly given their long-term character. They are implemented over periods that greatly exceed the average tenure in office of most governments. Moreover, the period during which public administration reform represents a top political priority is usually even shorter. Responsibility for the reform may change hands several times, and newcomers often prefer to manage agendas that are associated to their names. This can result in a loss of policy continuity, slower implementation and time inconsistency. Political support for reform may weaken, while opponents organise coalitions of the dissatisfied.

Evaluating reform is not an easy task, not least because of the difficulty of defining the relevant criteria. Simple assessments of progress in terms of the number of civil servants whose status has changed or the percentage of rules that have been redrafted as a function of an *ex ante* goal do not reveal much, about either the actual impact of the reform in terms of quality of service or its results in terms of decreasing costs. Moreover, the quality of the process of change, hence its actual costs and its sustainability in the long run, must also be considered. Moreover, rough indicators of the quality or cost of public services are often biased: public employees may focus on performance measures to the detriment of unmeasured dimensions of their work (typically, they may focus on direct costs to the detriment of quality or externalities). Finally, it can be difficult to gauge long-term impact due to changes in attitudes and behaviours. Multi-criteria analyses and expertise should be preferred to the use of (inherently biased) synthetic indicators, which can often be misleading tools in the management of institutional and governance issues.

Effective mechanisms for ex post *evaluation can help entrench reforms and also to adapt them…*

The main tool used by OECD countries to avoid incomplete reforms is the institution of evaluation mechanisms and periodic progress reports on the advancement of reforms, for instance giving "red, yellow and green" scorecards for departmental implementation. This was the case for instance in the French RGPP (2007-09), where public reporting of progress was an essential part of the sustaining strategy. The guidelines established for the measures were intended to enable long-term tracking of the results of the reform against implementation performance indicators. In February 2010, Budget Minister Eric Woerth issued the third progress report on the 374 measures, with "traffic light" marks indicating the state of each: red for measures that had stalled (3% of measures); yellow for those that were being implemented but had encountered delays or technical difficulties (21%); and green for measures meeting all conditions for achieving the goals set in the time allowed (76%). Prior to the release of the report, there was intensive discussion of the implementation of the measures within each department at the *Comité de suivi*. The next report card is due in June 2010.

Publicising assessments can be a good way to guarantee the quality of the evaluation – since they are more likely to attract external scrutiny if publicised. Moreover, the incentive effects of reputation mean that publicity can increase the impact of the evaluation on the course of reform: individuals and groups wish to be held up as models of good performance rather than being shamed for bad performance. Thus, the practice of an annual public report by an indisputable "high authority", as in Canada can be of great value. This detailed report, published annually by the Prime Minister's Advisory Committee on the Public Service, is structured around assessments of progress in four broad areas: planning, recruitment, employee development and enabling infrastructure. It includes both observations and recommendations to public service executives. The independence and experience of the experts involved in the committee ensure its authority, so the suggestions made often result in tangible action by the government and the civil service. In addition, the committee's annual assessment of action (or the lack thereof) on its past comments is a very effective way to influence government behaviour. By contrast, the annual reports of the French *Cour des Comptes* seem to be less likely to result in significant change, for two reasons. First, the *Cour des Comptes* report is very extensive and covers a wide range of issues in great detail. This limits the visibility of each individual issue raised, so the reports are not particularly effective in publicising problems. Secondly, the investigations of the *Cour des Comptes* usually focus on different issues from one year to the next, meaning that poor performers have less to fear from any follow-up review.

…as can the creation of dedicated institutions charged with overseeing public administration reforms

Long-term support for reform cannot rely only on the personal involvement of a leader, since the time horizons involved are far longer than the tenure in office of most officials in democratic countries. To be sustained, political leadership needs to be backed up by institutional solutions. Placing the reform in the hands of a leading and permanent organisation is often the only way to avoid capture of the reform process by pre-existing organisations and lobbies, which are often keen to embrace the reform rhetorically, while not implementing it in fact. The primary role of this leading organisation is therefore to permanently remind the various components of the civil service that they should comply with the spirit of the reform and implement it. It can also provide technical assistance to the various line ministries. Its knowledge of the reform and of the way it is implemented in various circumstances allows sharing experience across the various parts of the public administration.

In Korea, for example, three waves of civil service reform have been launched since the early 1990s under three successive presidencies. They were designed to restructure the traditionally closed Korean civil service system by promoting principles of openness, competition, performance, autonomy and efficiency. Each reform enjoyed the strong support of the president, of central agencies – in particular, the newly established Senior Civil Service agency – and the backing of most politicians and citizens. However, sustaining reform over time can be difficult, as bureaucrats come to resist to actual compliance with the reform. This has been a particular challenge in Korea, where the constitutional one-term limit on the presidency makes it difficult to sustain reform. This is illustrated by the transition between the Kim Dae-jung and Roh Moo-hyun administrations: while the latter pursued the essential objectives of the reform inaugurated by its predecessors, it introduced two amendments that had an adverse impact on the process. First, the new administration put more emphasis on better performance of government than on streamlining its operations as the general objective of the reforms. This led to a reduction in attention to cost-containment and resulted in an increase in the size of the government. Second, many detailed reform plans formulated by the previous administration were amended right after the new team took office. This encouraged strategic behaviours by various components of the public sector, resulting in a slowing down of the process of reform.

Comparative case studies highlight some of the characteristics that seem necessary to ensure that a "reform institution" is able to sustain support for reform (OECD/Korea Policy Centre, 2008):

- The organisation driving reform has to be closely connected to the political leader. In Korea, the reforms driven by organisations connected to the Presidential Office are progressing better than those under the control of line ministries or even the prime minister. In France, the RGPP is monitored by the *Secretariat Général du Gouvernement*, which is considered as the head of the whole public administration and reports directly to the prime minister.

- The organisation has to be a permanent one. In Korea, the only reform-supporting organisation that was not permanent failed to implement the measures for which it was responsible. In Belgium, the transversal Human Resource and Organisation department is the guarantor of the Copernicus Reform.

- The mandate of the organisation leading the reform should be a single reform. There is a trade-off there. On the one hand, the organisation has to have most of the levers that are necessary to implement the reform under its control. For instance, the French *Sécretariat general de la défense nationale* (SGDN) is in charge of the design of the entire set of central administrative bodies and of the all their major procedures; it is therefore the entity best able to implement the RGPP. The Korean experience, by contrast, suggests that those organisations that are charged with multiple tasks may fail to focus their attention on the management of reform. As highlighted by Osborne and Plastrik (1997, 2000), an organisation tends to focus on "rowing" functions rather than on steering functions, because the latter are generally less imminent.

- The institution driving the reform should be organised around flexible teams with vague responsibilities in order to maximise organisational flexibility. Bureaucratic organisations are obviously poorly adapted to the management of change. This is why, in some cases, new task-specific organisations can be quite successful in implementing reforms. While they may initially be weak due to their youth, they can be successful in designing and implementing the reform if they succeed in organising quickly, since they are designed for the reform and are not diverted by alternative goals, duties, and organisational constraints.

- The body leading the reform should be staffed with civil servants originating from both the public and private sectors.

Australia and Canada provide good examples of such independent institutions, created to implement a policy across complex federal systems. Australia, in particular, has developed an institutional framework consisting of various bodies which have different mandates and constituencies, but which all work together to design, implement and sustain reform across a number of domains (Box 8.12).

The need for a central body with the authority and responsibility to oversee the reform does not mean that the thrust of the reform need to be centralising in character. OECD analyses of the modernisation of government in OECD countries suggest that centralisation of the management of strategic issues can go hand in hand with devolution of responsibilities to line ministries.

Box 8.12. **The Australian federation and COAG co-ordination**

The Council of Australian Governments (COAG) is the main forum for the development and implementation of inter-jurisdictional policy. Chaired by the prime minister, it brings together state premiers, territory chief ministers and the President of the Australian Local Government Association. Prior to the creation of COAG in 1992, financial premiers' conferences served as the peak intergovernmental forum through which the Commonwealth, states and territories discussed issues of national concern, but these were mainly driven by the Commonwealth with limited opportunity for input from the states. In contrast, COAG meetings have been characterised by a high degree of collaborative effort by state, territory and federal political leadership, as well as agency officials, who participate in COAG decision making through heads of government meetings, ministerial councils and working groups. Ministerial councils working under the auspices of COAG facilitate consultation and co-operation between the Commonwealth and state/territory governments in specific policy areas, and take joint action to resolve issues that arise between governments. In particular, ministerial councils develop policy reforms for consideration by the COAG, and oversee the implementation of policy reforms agreed by COAG. In 2006, the states established a Council for the Australian Federation (CAF), comprising state premiers and territory chief ministers. The CAF aims to facilitate COAG-based agreements with the Commonwealth by facilitating the development of common positions among the states and territories, as well as common learning and sharing of experiences with one another. Since 2007, the implementation of the COAG reform agenda has been boosted by new Commonwealth leadership and new working arrangements at COAG, including the use of working groups of senior state officials chaired by a federal minister, to identify areas for reform and develop implementation plans.

In 2008, the COAG agreed to a new Intergovernmental Agreement on Federal Financial Relations (IGA). The agreement increased the financial autonomy of the states, moving from input control to the monitoring of outputs, and rationalising the payments made to the states into five broad areas (health, affordable housing, early childhood education and schools, vocational educational and training and disability services). Each payment area is funded by a special purpose payment (SPP), distributed to the states on an equal per capita basis (there is no need to adapt the amounts to the needs and costs of each state, as this is done by the Commonwealth Grants Commission). For each area, a mutually agreed national agreement clarifies the roles and responsibilities that will guide the Commonwealth and the states in the delivery of services across the relevant sectors and covers the objectives, outcomes, outputs and performance indicators for each SPP. The performance of all governments in achieving the mutually agreed outcomes and benchmarks specified in each SPP is then monitored by the independent COAG Reform Council (CRC) and publicly reported on an annual basis. The CRC is an independent body established by COAG in 2006. It is meant to help COAG to drive its national reform agenda by strengthening accountability for the achievement of results through independent and evidence-based monitoring, assessment and reporting of the performance of governments. The CRC is independent of individual governments and reports directly to COAG.

In addition, in order to maintain the momentum of reform, the IGA provides for a system of incentive payments (a system that was already successfully used to implement the competition reform agenda of the 1990s). National partnership agreements outline mutually agreed policy objectives in areas of nationally significant reform or service delivery, and define the outputs and performance benchmarks. National partnership payments (NPPs) support the implementation of the agreed agenda by providing three types of payments: *project payments*, to support specific projects *ex ante*; *facilitation payments*, to initiate reform in a specific area and lift standards of service delivery; and *reward payments*, based on the achievement of agreed performance benchmarks. The evaluations which trigger the reward payments are carried out by the CRC.

Source: OECD (2010), *OECD Reviews of Regulatory Reform: Australia 2010: Towards a Seamless National Economy*, OECD Publishing, DOI: *http://dx.doi.org/10.1787/9789264067189-en.*

New institutions may be needed to help achieve a balance between flexibility and determination

Reform paths are often narrow, since success requires both determination and flexibility. Reformers must show sufficient determination to discourage opponents from seeking to delay or renegotiate implementation. Such strategies can not only postpone the benefits of reforms, they can also reduce the credibility of the reform. Yet the process of reform itself usually throws up unexpected issues, so insufficient flexibility can lead to avoidable policy errors. Moreover, since reforms are typically implemented over long periods, the conditions in which they are to be implemented evolve and may require some adaptation of the reform. Finally, the political climate can evolve, leading either to increased resistance to some elements of the reform or, on the contrary, to pressure for faster, more radical change. Mechanisms for feedback and adaptation are therefore essential. One way to avoid too much direct pressure – that might hinder leadership – is to rely on third-party assessment and mediation. High-level committees and ombudsmen are of particular relevance.

High-level committees can allow a voice to major stakeholder groups, while controlling for the legitimacy of their claims and avoiding the simple expressions of requests. Members of such bodies should be independent and possessed of a high level of expertise if they are to have the legitimacy to aggregate, screen and prioritise claims, and to then evaluate their relevance and legitimacy, as well as the possible discrepancies among them. Moreover, they can balance claims and proposals for change against the objectives and expected benefits of the reform. Finally, their expertise and independence can allow them to embody the general interest and potentially to propose solutions. In particular, they can take up issues they consider essential. This prevents them from being simple chambers of appeal or even informational buffers between stakeholders and reformers.

The reform of public service in Canada is performed under the supervision of several committees. For instance, the Deputy Ministers' Committee is a senior forum for overseeing the process of renewal. The Prime Minister's Advisory Committees on the Public Service brings together senior leaders with a wide range of experience outside and inside the government. As compared to the previous committee, its task is to bring new insights and perspectives in the process of reforms. The Committee of Senior Officials is responsible for the management of the deputy minister community. It aims at addressing issues such as performance management, succession planning, profiling of needed competences, etc.

The purpose of ombudsmen differs from that of committees. While committees may structurally amend the reform if need be, ombudsmen are there to allow customised adaptation of the reform if necessary. The institution of an ombudsman allows individuals to highlight potential inequalities, possible ways to deal with local specificities, etc. Ombudsmen are particularly useful when some stakeholders – like governmental employees – are likely to be individually impacted by measures that have been designed to address general issues. The ombudsman should thus serve as more than a simple "informational buffer" between stakeholders and those in charge of the implementation of the reform on the ground, is pointless. Such an institution can allow necessary flexibility (and therefore acceptability) on the ground. It is important to point out that ombudsmen are key components of wider policies aimed at increasing the transparency and accountability of government by making available a low-cost and low-tech option for citizens seeking redress, rather than requiring them to go through complex and possibly expensive judicial or bureaucratic processes. In turn, ombudsmen's offices should be seen as powerful mechanisms of information revelation that can be relied upon by the public sector to detect problems. Ombudsmen are a relatively recent institutional innovation in OECD countries – only 3 member countries had such institutions in 1960, as against 27 in 2010. Usually appointed by legislatures, ombudsmen are rarely empowered to make recommendations that are binding on the bureaucracy, but they have proved to be a strong source of pressure on governments for remedial action, both in specific cases and, in many countries, via the regular publication of reports on the performance of various agencies and other public bodies (OECD, 2005).

Notes

1. While this chapter recognises the interaction between public administration reforms and political/institutional reforms, the latter are not within its scope; it analyses administrative reforms, taking the institutional environment and political constraints as given.
2. In this context, a "contract" is any arrangement that reorganises the rights and duties of government bodies, other than via legislation or constitutional change. See OECD (2007).

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Chapter 9

Enabling regulatory reform

by Gabriella Meloni*

This chapter examines the role of institutions in the promotion of regulatory reform, exploring the link between the existence of specific institutional arrangements and the endorsement of timely and appropriate practices of regulatory management. It highlights how the widespread use of regulatory impact assessment has facilitated the introduction of mechanisms of systematic consultation with those affected by reforms. The chapter then discusses the role played by regulatory management in improving the overall functioning of the government and in ensuring the coherence of its action, thus providing a wider perspective for the definition of reform opportunities. The chapter's last section provides an overview of the literature developed to explain the importance of international organisations in supporting reforms, underlining in this framework the specific methods used by the OECD. In particular, it draws attention to the role of the OECD in improving the regulatory environment in member countries. It emphasises that the OECD does not rely on conditionality in order to promote reform but on "soft methods of co-ordination", which represent a slower, but not necessarily less effective method of disseminating best practice and supporting the timely adoption of reform initiatives.

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If regulation is, as Brown *et al.* (2006) conclude, the least explored of the three main government functions (taxation, expenditure and regulation), the factors which promote regulatory reform have generally received still less attention. Yet the capacity to promote timely and appropriate regulatory management in a situation of ever-increasing economic and technical complexity is of utmost importance, and recent experience has shown how disruptive regulatory inadequacies may be. In the past 20 years, governments have come to understand that regulatory reform is both an end in itself and a means to the end of enabling markets and supporting competition and trade liberalisation, while promoting economic, social and environmental welfare. In the meantime, the nature of the regulatory process has dramatically changed. The transition from a "command and control" model to a model of regulatory governance has been a key focus of public sector reform in many OECD countries. Throughout this period, the understanding of regulatory reform has evolved, from an early concentration on eliminating regulation (deregulation) to a more systemic approach that comprises a mixture of deregulation and reregulation, and focuses on improving the effectiveness of regulation. At the same time, the process of reform itself has changed: once seen as something essentially episodic in nature – a one-off set of interventions – it is now understood as a dynamic process that is increasingly integrated into public policy making.

Today, almost all OECD countries have established explicit institutions and tools to implement regulatory policy. As with other core government policies, such as monetary or fiscal policy, regulatory policy is now an integral part of government activity and is pursued on a permanent basis. However, there is still resistance to a better regulation agenda, in both private and public sectors, and the pace of regulatory reform often lags behind the pace of innovation: telecommunications and financial services are the most instructive examples. This chapter therefore focuses not on the reform of regulatory regimes in specific product or labour markets, which are addressed in other chapters in this volume, but on the development of the institutions and processes that enable governments to generate and adapt high-quality regulation on a continuing basis. It is thus less concerned with the *substance* of regulatory reforms than with the creation of the *capacity* to reform.

The importance of a high-quality regulatory environment has been highlighted by the OECD with the adoption of the "Recommendation for Improving the Quality of Government Regulation" (OECD, 1995), *The OECD Report on Regulatory Reform* (OECD, 1997) and of the "OECD Guiding Principles of Regulatory Quality and Performance" (OECD, 2005). In recent years, the OECD has carried out a large number of regulatory reviews of individual countries, which represent an important source of information on the basis of which it is now possible to draw some important lessons. This chapter takes stock of the accumulated experience of these country reviews in order to explore the link between regulatory management and reform and to identify factors conducive to good regulatory outcomes. In particular, the chapter systematically scrutinises four sets of factors, which have been defined in the context of the overarching "Making Reform Happen" project and points out their relevance in promoting reform:

- the existence of appropriate regulatory institutions;
- the capacity to take into consideration the impact on, and the reactions of, those affected by reforms;
- the timing of reform and the interactions across different policy areas; and
- the role of evidence and international organisations in sustaining reforms.

The existence of appropriate institutions to support reform, from decision to implementation

While regulatory policy needs to focus to a large extent on the design and application of high-quality regulatory instruments, even well designed instruments may be ineffective without the right set of institutions to ensure effective implementation,. The institutional framework within which the "Better Regulation" agenda is to be implemented extends well beyond the executive centre of government, although this is the starting point. A wide range of institutions with regulatory functions or influence play a role in the promotion of regulatory reform. OECD regulatory reviews have highlighted the existence of four different sets of considerations pertaining to the institutional framework that are relevant in this respect. These considerations concern:

- the central government architecture;
- the existence of central oversight bodies for the promotion of regulatory quality;
- the presence of independent regulators; and
- the state of the relations between central and sub-central governments.

The structure of central government institutions can greatly affect the quality of regulatory policy

The scrutiny of central government architecture is essential in order to devise the best options available for the co-ordinated promotion of regulatory reform. Institutional settings and legal systems are country-specific, and every recommendation concerning the most appropriate solution for regulatory management across central government has to be carefully tailored to the specific national context. Some considerations are, nevertheless, valid for every country. They concern the importance of:

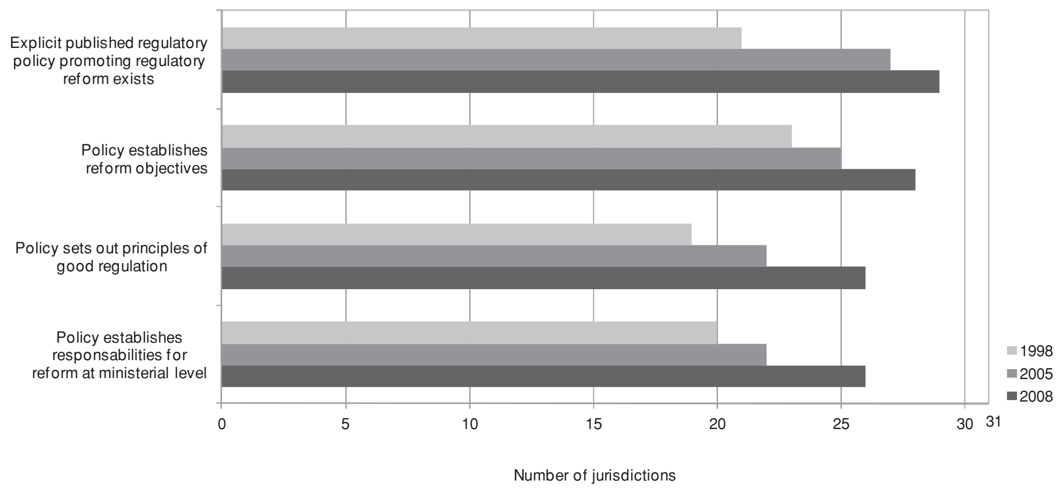
- a general policy framework which defines the roles and the competencies of the actors involved in the regulatory process;
- a "whole-of-government" perspective, able to take into account in a dynamic perspective the interplay between the institutions involved in the regulatory process;
- a regulatory culture which favours regular exchange of information and the establishment of a climate of trust and co-operation; and
- a political commitment to regulatory reform, showing the determination of the government to realise the Better Regulation agenda.

All components of central government have roles to play in the regulatory process. If parliaments have formal responsibility to approve or reject primary legislation, the executive is a key source of regulation, both in terms of proposing new laws to the parliament and defining secondary rules to implement primary legislation. At the same time, the judiciary has an essential role in rule enforcement through the judicial review process, while national audit offices (NAOs) and ombudsmen help to strengthen administrative accountability and to ensure the effectiveness of regulatory regimes. Competition bodies are also important, as they enforce rules which are vital for the effective functioning of markets. As a result, their role has to be carefully defined in order to avoid different interpretations of sectoral laws and to guarantee the coherence of the regulatory framework.

OECD country reviews have consistently found that the institutional context for implanting effective regulatory management is complex and often highly fragmented, and that the involvement of a large number of institutional players can reduce the transparency of the regulatory process, slow co-ordination and increase transaction costs if competences are not duly defined and mechanisms of co-operation carefully devised. If co-ordination is easier to achieve in small countries with closely knit governments that can rely more on trust and informality, larger countries must find ways of dealing with a higher level of complexity, a task that is sometimes complicated by the existence of multi-layered federal arrangements.

Thus, a first important step for the improvement of regulatory quality across central government is the clarification and, eventually, the simplification of the institutional set-up of the regulatory system, through the development of a general policy framework that defines the roles and competencies of the different actors in the regulatory process and fully articulates their respective jurisdictional authorities, powers, duties and responsibilities. A sound general policy framework for regulatory management should also contain an integrated strategic vision of a Better Regulation policy that clearly articulates its long-term direction and its intended contribution to public policy goals. Countries with explicit regulatory policies and comprehensive general policy frameworks consistently make more rapid and sustained progress than those that lack such policies (OECD, 2002, 2008). By 2008, nearly all OECD member countries had some form of a published regulatory policy promoting regulatory reform (Figure 9.1). Among the first countries to adopt an explicit regulatory policy were the United States, where regulatory reform was pioneered in the 1970s, and Canada, which developed its regulatory reform strategy in 1986. Several more OECD countries introduced elements of a regulatory quality policy during the 1990s. In most countries where an explicit regulatory policy has been put in place, it has been substantially revised and developed in recent years (OECD, 2009a).

Figure 9.1. **Explicit regulatory policy promoting government-wide regulatory reform in OECD countries, 1995, 2005 and 2008**



Note: The sample includes 31 jurisdictions for 2008 and 2005. For 1998, 27 jurisdictions are included as no data were available for Luxembourg, Poland, the Slovak Republic and the European Union.

Source: OECD (2009a), "Indicators of Regulatory Management Systems", *www.oecd.org/regreform/indicators* and *www.oecd.org/dataoecd/44/37/44294427.pdf* (full report).

Effective regulatory policy requires a whole-of-government approach

Regulatory reviews have consistently highlighted the importance of adopting a "whole-of-government" perspective, able to take into account in a dynamic perspective the interplay between the different institutions involved in the regulatory process and to overcome the obstacles created by a traditional compartmentalisation of functions. The adoption of a "whole-of-government" perspective implies the capacity to devise the mechanisms of co-operation needed to achieve a defined policy objective. OECD country reviews have found that ministries such as finance, justice, trade and industry generally retain important responsibilities linked to the regulatory quality agenda, but accountability for reform results should be increased within all individual ministries.[1] Parliaments are also taking an active interest in regulatory quality and supporting tools. However, the OECD reviews find that there is still considerable room for their integration into regulatory quality systems and processes in most countries.

The importance of judicial review in supporting regulatory reform has also been emphasised. Judicial review can promote regulatory quality and correct legal inconsistencies. At the same time, it may help to resolve conflicts of competence on different regulatory issues. Timescales for judicial decisions and the relative ease or difficulty with which rules can be challenged have been identified as important factors which need to be taken into account in the regulatory process in a whole-of-government perspective. For example, when liberalising infrastructure sectors, it is advisable to consider ahead of time whether and how market opening might be challenged in the courts, as even an ultimately unsuccessful legal challenge can cause uncertainty and delay, adding to the cost of reform. Alternatively, the reform of the court system dealing with such issues may be desirable in order to complete the liberalisation process without major disruptions.

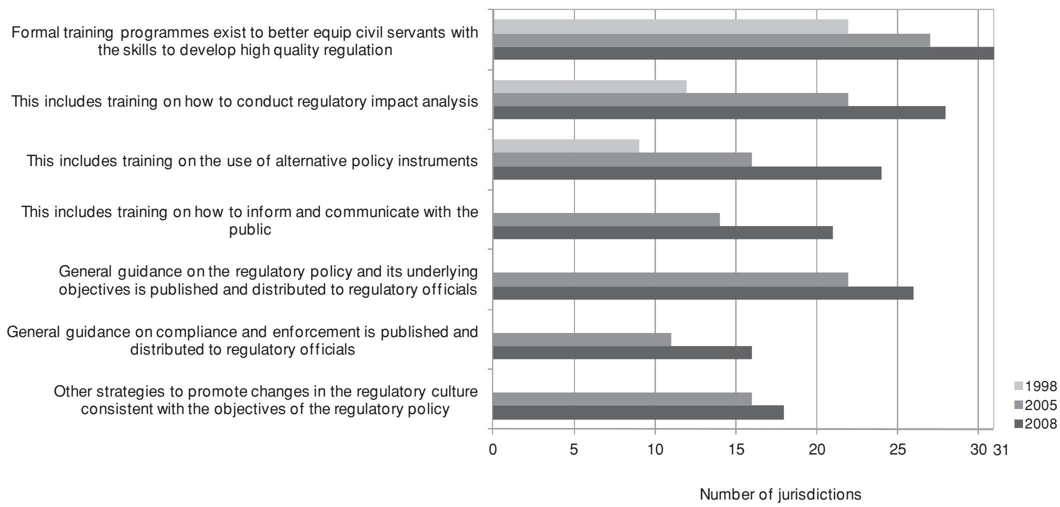
OECD country reviews have also shown that NAOs and ombudsmen are emerging in many countries as important structures for the promotion of regulatory quality. NAOs often play a role which goes beyond accounting for the efficient use of resources and which includes the assessment of the public administration's performance and of the effectiveness of the implementation of regulatory regimes. Moreover, they are independent of government and have the advantage of taking into consideration whole areas of policy, thus overcoming the shortcomings of many more fragmented approaches to regulatory quality. Ombudsmen oversee the investigation of complaints of improper government activity against the citizen and play an important role in the promotion of administrative accountability and, hence, regulatory quality.

The creation of a culture of regulatory quality across public administration is critical

If a "whole-of-government" perspective is essential in order to capture the interrelations which allow a proper functioning of central government and determine the quality of regulation, the promotion of regulatory quality culture can help spread a sense of increased responsibility for reform results. In many countries, administrations have not yet fully integrated the need for regulatory quality into their policy processes. Improving state-citizen and state-business relationships is the starting point. The administration needs to be approachable, avoiding secrecy, complexity and opacity in administrative acts. Modernising public administration involves promoting a service and client-oriented attitude from the staff of public institutions, and a less bureaucratic and administratively burdensome approach (see Chapter 8). Most countries have already recognised and acted on these aspects of administrative culture. However, much deeper reforms are needed to embed an awareness of regulatory quality and its importance across public administration.

A climate of trust and co-operation and the promotion of a regular exchange of information continue to be critical for the development of an effective regulatory management. The enhancement of a programme of continuous training and capacity building within the government provides an important contribution to the improvement of regulatory culture. This kind of initiative not only improves the technical skills needed in certain processes, such as regulatory impact analysis (RIA) or plain drafting, it also communicates the importance attached to the regulatory quality agenda by the administrative and political hierarchy. Training and capacity-building programmes create opportunities to meet and to discuss the Better Regulation agenda, thus fostering a sense of ownership of reform initiatives and facilitating communication within and beyond individual institutional settings. Moreover, the use of adequate financial resources to support the organisation of these initiatives is an important sign of political commitment, drawing further attention to the Better Regulation agenda. All OECD member countries report having formal training programmes in place to promote high-quality regulation. Training programmes are also converging in terms of the set of skills they provide to regulators. Approximately 90% of OECD countries report that they provide training in the conduct of regulatory impact analysis, up from 40% in 1998 and 70% in 2005 (OECD, 2009a). Training in the use of alternative policy instruments and communications has also expanded, although less strongly. About four-fifths of OECD countries provide training in alternative policy instruments, while approximately three-fifths train regulators to inform and communicate with the public. The quality and intensity of this training differs considerably across countries (OECD, 2009a) (Figure 9.2).

Figure 9.2. **Training in regulatory quality skills in OECD countries, 1998, 2005 and 2008**



Note: The sample includes 31 jurisdictions for 2008 and 2005. For 1998, 27 jurisdictions are included as no data were available for Luxembourg, Poland, the Slovak Republic and the European Union.

Source: OECD (2009a), "Indicators of Regulatory Management Systems", *www.oecd.org/regreform/indicators* and *www.oecd.org/dataoecd/44/37/44294427.pdf* (full report).

A high level of political commitment is needed to sustain the regulatory reform processes

Political commitment to regulatory reform has been unanimously highlighted by country reviews as one of the main factors supporting regulatory quality. Effective regulatory policy should be adopted at the highest political level, and the importance of the Better Regulation agenda should be adequately communicated to lower levels of the administration. Political commitment can be demonstrated in different ways. As noted earlier, the adoption of a general policy framework for regulatory policy and the organisation of adequately financed training and capacity-building programmes highlight the government's determination to realise the Better Regulation agenda. However, the creation of a central oversight body in charge of promoting regulatory quality is by itself perhaps the most important element to show the political commitment of the central government and to spread awareness about the Better Regulation agenda among the different actors involved in the regulatory process.

Central bodies for promoting regulatory quality can both signal and render a policy effective

OECD reviews find a strong relationship between an effective, comprehensive regulatory policy and the existence of a central oversight body. These structures are best placed at the centre of government, a position which demonstrates the government's commitment to the Better Regulation agenda and which creates the best conditions for these bodies to perform their co-ordinating role from a whole-of-government perspective with sufficient independence and authority.

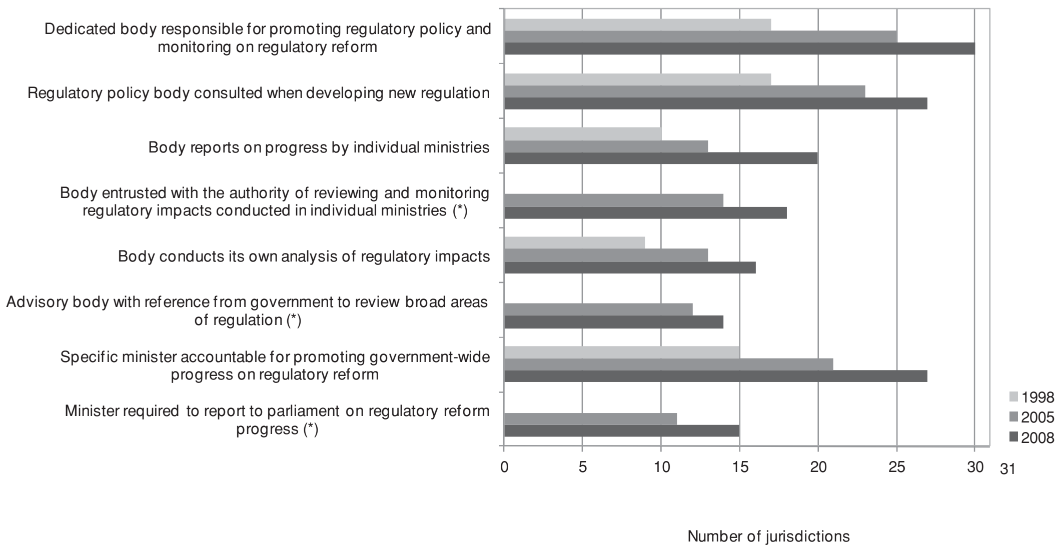
Promoting reform may require the allocation of specific responsibilities and powers to monitor, oversee and promote progress across the whole of the public administration and to maintain consistency between the approaches of the different actors involved in the regulatory process. In particular, if some countries rely on trust and informality for co-ordination, other countries, with more complex and sometimes fragmented institutional settings, have allocated this function to a structure created for this purpose. More and more OECD countries have established central oversight bodies whose key role is to make certain that regulatory reform: (i) meets quality standards; (ii) is in line with the general policy framework and the general economic strategy of the country; and (iii) makes appropriate use of regulatory tools (such as RIA).

The existence of a specific structure charged with promoting regulatory quality indicates per se a strong commitment to the Better Regulation agenda and, in OECD countries, it is closely correlated with the development of an effective and comprehensive regulatory policy. The functions of central oversight bodies usually go beyond improved co-ordination between existing bodies involved in the regulatory process. In particular, they monitor the progress achieved by the different actors involved in the policy process and scrutinise new policy/regulatory proposals. Moreover, oversight bodies can have a "challenging function", which gives them the power to question regulation and to assess the quality of regulatory policy through RIA. They can also act as gatekeepers, with the power to veto a regulation which does not fulfil the necessary requirements. Central oversight bodies also have an important responsibility in terms of advocacy and communication, encouraging the long-term development of Better Regulation principles across the government and managing external communication of the government's policy on Better Regulation. Central oversight bodies may thus have a variety of roles and structures which reflect the legal, economic, social and cultural characteristics of each country. There is no "one-size-fits-all solution". However, OECD reviews indicate that these structures are best placed when they are located at, or report to, the centre of government, rather than in a line ministry, which is likely to be too closely linked to specific policy and regulatory functions (OECD, 2008). This position is in fact an important indication of the political commitment to regulatory quality and provides the best conditions for these bodies to perform their co-ordinating role from a whole-of-government perspective and with sufficient independence and authority.

A growing number of OECD countries are creating such bodies

Figure 9.3 illustrates the progress observed since 1998, when only 17 of the 27 OECD countries surveyed had a dedicated body responsible for promoting regulatory policy; in 2008 almost all did. The European Commission also reported having one (OECD, 2009a). In the majority of OECD countries, regulatory oversight bodies are placed at the centre of government – in a prime minister's office or a presidential office with some form of interdepartmental co-ordination. Ministries of finance and ministries of justice also play a significant role in hosting these functions (OECD, 2009a). The last decade has also witnessed significant reforms to empower regulatory oversight bodies. In 2008, it was reported that most bodies in charge of promoting regulatory reform were consulted when new regulations were developed. At the same time, the number of bodies that report on progress by individual ministries had almost doubled since 1998. However, the authority to conduct analysis of regulatory impacts remains limited to about half of the regulatory oversight bodies. In 1998, about half of OECD member countries had a specific minister accountable for promoting regulatory reform. By 2008, eight further countries had assigned this task to a specific minister (out of those countries for which data were available for both years). These included Belgium, the Czech Republic, Denmark, Finland, Germany, Greece, Ireland, Norway and Spain. In about half of OECD member countries, this minister is required to report to parliament on the progress of the regulatory reform agenda.

Figure 9.3. **Institutional arrangements to promote regulatory policy in OECD countries, 1998, 2005 and 2008**



Note: The sample includes 31 jurisdictions for 2008 and 2005. For 1998, 27 jurisdictions are included as no data were available for Luxembourg, Poland, the Slovak Republic and the European Union. (*) indicates data only available for 2005 and 2008.

Source: OECD (2009a), "Indicators of Regulatory Management Systems", *www.oecd.org/regreform/indicators* and *www.oecd.org/dataoecd/44/37/44294427.pdf* (full report).

Interesting examples of central oversight bodies include the Regulatory Reform Committee (RRC) in Korea, which has been set up by law with "a general mandate to develop and co-ordinate regulatory policy and to review and approve regulations." Its main functions are to give some strategic perspective to regulatory reforms, to undertake research, to monitor the improvement efforts of each agency and to make sure there is coherence between their actions. In the Netherlands, a regulatory committee co-ordinates fairly independent ministries, and extensive inter-ministerial co-ordination and supervision have been put in place. In this context, it is also worth mentioning the example of the United Kingdom, where – in contrast to what was suggested earlier – the central oversight body was moved away from the centre of government. The transfer of the Better Regulation Executive (BRE) from the Cabinet Office to the Department for Business, Enterprise and Regulatory Reform (BERR) was motivated by the fact that the Cabinet Office had neither direct practical links with business and other stakeholders nor direct responsibility for policy areas which need to be better regulated. In this case, the need to insulate the main central oversight body in charge of regulatory quality was counterbalanced by the need to bring it closer to the issues and to the interests to be regulated. At the same time, the BRE retains a high degree of autonomy from the BERR via its management structure (Box 9.1).

Box 9.1. **The Better Regulation Executive in the United Kingdom**

The Better Regulation Executive was established in 2006 and given primary responsibility for the government's Better Regulation agenda. The BRE is made up of a strategic support team and three directorates:

- the Regulatory Reform Directorate, which is responsible for the "on the ground" management and promotion of key Better Regulation tools and processes, such as impact assessment and departmental simplification plans, as well as for the management of the EU-related dimension of regulation;
- the Regulatory Innovation Directorate, which functions as a think tank; and
- the Regulatory Services Directorate, which is in charge of service delivery.

The BRE is staffed by civil servants, most of whom are on secondment from departments, as well as business people and professionals seconded from the private sector. The staff comprises around 80 people. It is the central authority for advocacy and co-ordination of Better Regulation policy across the government. In particular, it has the following functions:

- Monitoring and challenge: the BRE monitors the Better Regulation policies and progress of departments and key national agencies through a network of account managers on a day-to-day basis and through the executive chair briefing the prime minister on progress across the government. It scrutinises new regulatory proposals and advises whether they should be examined by the Panel for Regulatory Accountability. It is not, however, a formal gatekeeper, as it lacks the power to block proposals for regulation.
- Advocacy and communication: the BRE encourages the development of Better Regulation principles across government and manages external communication of the government's policy on Better Regulation.
- Institutional co-ordination and cultural change: the executive has developed – and continues to develop – a broad range of relationships within central government as well as outside, including with the National Audit Office, consumers' representatives, parliamentary committees, local authorities and its EU counterparts.
- Support and guidance: the BRE is a facilitator. Its staff offers departments guidance in the development of impact assessment and simplification plans, among other issues. It has produced a wide range of guidance material and training tools.
- Policy and project development and management: the BRE is the main driver for all main Better Regulation initiatives, taking forward projects in this field.
- Handling EU Better Regulation policy (shared with the Cabinet Office): the BRE liaises with colleagues at home, across EU countries and with the European Commission to help drive forward the Better Regulation agenda in the EU.

Source: OECD (2009b), "Better Regulation in Europe: An Assessment of Regulatory Capacity in 15 Member States of the European Union", European Commission and OECD, *www.oecd.org/document/24/0,3343,en_2649_34141_41909720_1_1_1_1,00.html*.

However, some countries find the concept of new central bodies for regulatory quality promotion hard to accept, on the grounds that the guiding function is already embedded in existing policies and structures. In particular, such units may be perceived in large countries as undermining or competing with other more established centres, as well as raising a possible threat to ministerial discretion. By contrast, in small countries, with small homogeneous societies, characterised by close and informal networks of contacts within government and society based on mutual trust, central bodies are sometimes seen as unnecessary (OECD, 2008). The lack of a central regulatory oversight body, however, need not imply the absence of co-ordination of regulatory policy. Instead, it can be the result of a relatively decentralised model of government administration. The most striking example in this area is Denmark, where the development of a generally favourable regulatory environment has not been promoted by a central oversight body as traditionally understood. Strong traditions of autonomous ministries have supported, on the one hand, the establishment of a number of inter-ministerial committees (which have responsibility for monitoring and developing Better Regulation policies and are involved in vetting draft regulations), and, on the other, the strengthening of informal co-ordination mechanisms between officials in ministries. In this framework, co-ordination is provided by the Co-ordination Committee, a ministerial committee which represents the hub of Better Regulation management (Box 9.2).

Box 9.2. **The Co-ordination Committee in Denmark**

The Co-ordination Committee (Koordinationsudvalget) is a ministerial committee which vets and approves major new policy initiatives and changes. It is also the focal point for the government's Better Regulation policy. It reviews the final version of the annual law programme before approval by the cabinet, and approves individual draft laws before they are sent to the parliament. It endorses ministries' action plans to reduce administrative burdens on business and reviews progress reports from ministries on the De-bureaucratisation Programme. The Co-ordination Committee is headed by the prime minister and includes the most important ministries. Participation can extend to other ministries on occasion. Its Regulation Committee prepares the Co-ordination Committee work on Better Regulation policy. This officials' committee, established in 1998, is formed from the Group of Permanent Secretaries that prepares meetings for the Co-ordination Committee and is the highest level for co-ordination between civil servants. It includes the permanent secretaries of the Prime Minister's Office (chair), the Ministry of Finance, the Ministry of Economic and Business Affairs and the Ministry of Justice. The group vets minsters' proposals for inclusion in the annual law programme, including the impact assessments that must be carried out before a proposal can be tabled, and develops policy on regulatory quality.

Source: OECD (2009b), "Better Regulation in Europe: An Assessment of Regulatory Capacity in 15 Member States of the European Union", European Commission and OECD, *www.oecd.org/document/24/0,3343,en_2649_34141_41909720_1_1_1_1,00.html*.

Independent regulators can help shield regulatory policies from political intervention…

Independent regulators are another key institution, frequently used by OECD countries, which establish separate "agencies" at arms' length from the political system, with delegated powers to implement specific policies in a number of sectors. The term covers regulators found in utility sectors with network characteristics, such as energy and telecoms, but also in other sectors where sector-specific oversight is needed, such as financial services. Their main functions vary significantly across countries and sectors. However, "they tend to be concerned with rule enforcement and the application of sanctions for non-compliance with rules relating to their areas of competence, and authorisations for the issue of licences and permits" (OECD, 2008). OECD experience shows that independent regulators have been most effective and credible where their independence and roles are based on a distinct statute with well-defined functions and objectives. Their independence requires an adequate resource base and staffing policy and should be carefully counter-balanced by the introduction of accountability mechanisms.

Independent regulators may be found in a wide range of institutional settings:

- Ministerial departments are part of the central government and do not have the status of a separate body. They are headed by, or report directly to, a minister, and they are typically funded from tax revenues. They can have statutory independence in carrying out some regulatory functions and considerable administrative autonomy from other ministries.

- Ministerial agencies are executive agencies established at arm's length from central government. They may have a separate budget and autonomous management powers, but they are ultimately subordinate to a ministry and subject to ministerial intervention.

- Independent advisory bodies provide official and expert advice to government, lawmakers and firms on specific regulations and aspects of the industry. They may also have the power to publish recommendations, which may be more or less binding.

- Independent regulatory authorities are responsible for the regulation of specific aspects of an industry. This is the most widespread type of structure. Even if their budgets may be under ministerial control, political or ministerial intervention tends to be prohibited or at least limited to providing advice on general policy matters rather than specific cases.

Independent regulators provide an important contribution to regulatory reform, inasmuch as they can, to some extent, shield market interventions from the direct interference of political and private interests. They therefore have the authority to deal with complex issues, assuring market participants that their decisions are not vulnerable to uncertain, politically driven government action. In particular, independent regulators are often important for providing non-discriminatory access to essential facilities and guaranteeing "fair" regulations. Moreover, in those countries in which the state holds shares in network industries, independent regulators help to mark out the separation of the roles of the state as an owner, as a policy maker and as a regulator. However, independent regulators must be credible in order to promote reform effectively. As a matter of fact, their authority and, hence, their capacity to impose their decisions, depend greatly on the legitimacy of their actions as independent bodies and on the professionalism, openness and fairness with which they are seen to discharge their duties and exercise their powers.

...provided that their own independence and impartiality are adequately safeguarded

OECD reviews show that independent regulators have proved to be more credible where their independence and roles are based on distinct statutes with well-defined functions and objectives. Key aspects concern governance structure, the transparency of, and respect for, procedures, the selection and the appointment of staff, and financing. As far as governance structures are concerned, a board is considered more reliable for decision making, inasmuch as collegiality is expected to ensure a greater level of independence and integrity. As a result, the great majority of independent regulators in OECD countries have a board. Strict rules for the transmission of instructions to regulators and for ministerial appeals against them are needed in order to ensure transparency and to maintain the market's confidence in the regulator's own procedures. The terms of appointment of staff also have considerable influence on the autonomy of regulators. In general, longer appointments, which span political cycles, ensure a greater degree of independence. Moreover, a flexible staffing policy is needed in order to allow these bodies to attract and keep competent and authoritative staff. Finally, country reviews find that independent regulators need adequate resources to enjoy an appropriate level of independence from ministers. Several arrangements have been used in OECD countries, ranging from directly levying fees from the regulated entities to central funding from the state budget. Funding is often constrained by the nature of the agency and the possibility of levying sufficient fees from the sector being regulated. It may also be influenced by the need to reduce the risk of capture.

However, independent regulators also present a number of risks. The main risk is "regulatory capture". This may involve political capture (*i.e.* the subordination of the regulator to the government or some elements of it) and/or capture by the regulated entities. Moreover, insofar as independent regulators are often established along sectoral lines, they may tend to obstruct convergence between sectors and favour the fragmentation of government policies. In particular, OECD competition reviews show that when network sectors have restructured rapidly, driven by technological innovation, sector-specific issues have tended to become less important *vis-à-vis* general competition issues. However, regulators tend not to transfer their powers to competition authorities, thus hindering the establishment of a single level playing field for economic activities across different sectors.[2] In this sense, they may slow structural changes and cause potential losses to consumers. However, many of these risks can be minimised by careful regulatory design. The independence of regulators raises the issue of accountability, perhaps the biggest challenge for their future development. Evaluation mechanisms for their performance and governance structures need attention. At the same time, as mentioned earlier, appeal systems against independent regulators need to be carefully evaluated in order to avoid undermining their independence.

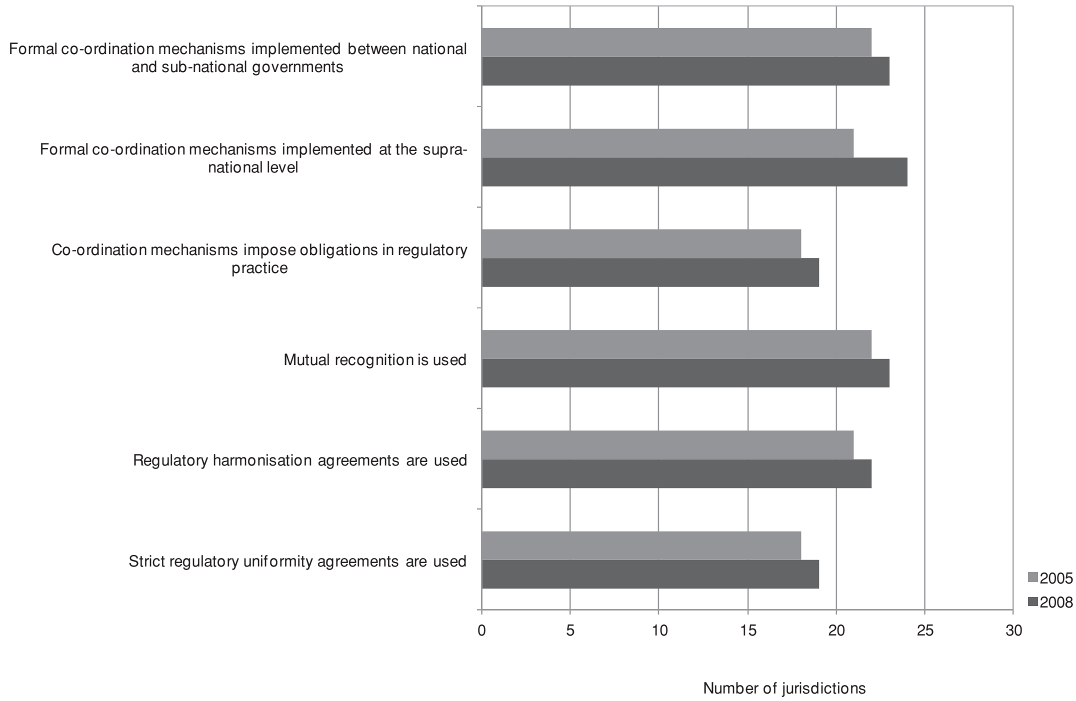
Multi-level governance presents additional challenges and opportunities for reform

The promotion of regulatory reform has to take into account the competences, capacities and co-ordination mechanisms existing at different levels of government. If a strong and strategic direction for regulatory quality must be retained at the centre, local governments need increasing flexibility in order to meet their goals and to retain the capacity to promote regulatory reform provided the specificities of local context. The importance of regulatory multi-level governance has emerged clearly in country regulatory reviews as relevant to all countries. As a matter of fact, local governments are of increasing importance not only in federations but also in unitary states, including historically strong ones, and a failure to carry out effective regulation at one level of government can undermine efforts elsewhere. As a result, regulatory reform needs to be "cascaded" systematically in order to be effective (OECD, 2008).

In many countries, local governments are entrusted with several tasks which cover issues having a direct impact on the welfare of businesses and citizens. This may include social services, health care and education, as well as licensing, housing, environmental protection, planning and construction issues. OECD experience shows that regulatory responsibilities have to be allocated across the different levels of government, taking into consideration the nature of the policy area concerned and the regulatory capacity existing at each level. This should be done bearing in mind that if a strong and strategic direction for regulatory quality must be retained at the centre, it is important to find the right balance between central authority and local autonomy on regulatory issues. As a matter of fact, local governments need increasing flexibility in order to meet their economic, social and environmental goals, provided the specificities of their geographical and cultural settings.

In this framework, co-ordination across levels of government, through the conclusion of appropriate agreements between central and local authorities, is needed in order to manage the complexity generated by the large number of players engaged in the regulatory process. Co-ordination mechanisms at the national and supra-national levels are reported to be in place by approximately four-fifths of OECD member countries (Figure 9.4).Co-ordination of regulatory policies across levels of government can involve a forum for regular dialogue among jurisdictions and, in a supra-national context, among countries, thus facilitating sharing of experience and the emergence of champions of reform. It can also facilitate agreement on a set of Better Regulation principles, thus helping strengthen regulatory quality within each jurisdiction. The data presented in Figure 9.4 confirm that the institutionalisation of the dialogue across levels of government is facilitating the use of mechanisms for better regulation. As a matter of fact, three-fifths of OECD member countries report that co-ordination mechanisms commit jurisdictions to adopt better regulation practices. At the same time, countries increasingly rely on mutual recognition and harmonisation to lower regulatory and technical barriers across jurisdictions (OECD, 2009a).

Figure 9.4. **Intergovernmental co-ordination on regulatory policy in OECD countries, 2005 and 2008**



Note: Data is presented only for the 30 member countries as this question is not relevant for the European Union.

Source: OECD (2009a), "Indicators of Regulatory Management Systems", *www.oecd.org/regreform/indicators* and *www.oecd.org/dataoecd/44/37/44294427.pdf* (full report).

Multi-level regulation creates both opportunities and challenges to the promotion of regulatory quality. As a matter of fact, multi-level regulation can help bring decision making closer to the citizens and be better tailored to local needs and circumstances. Moreover, it can create competition across levels of government, thus helping improve efficiency and effectiveness of government services. "Special Zones for Structural Reform" – geographically limited areas where certain regulations can be eased or lifted – were launched in Japan in June 2002 in order to stimulate local economies and to act as a testing ground and first step for reforms to be implemented at the national level. The Special Zones initiative was intended to trigger innovative endeavours of "regulatory competition" among municipalities in order to attract domestic and foreign companies. An implicit yet clear motivation behind this idea was to use the creativity and knowledge of local authorities and private actors to remove obstacles to growth and overcome vested interests which were hindering or blocking reforms (OECD, 2004a).

However, multi-level regulation can also raise barriers to national and international trade in goods and services, increase administrative costs and create regulatory duplication and overlap that constrain and fragment the development of markets (OECD, 2009a). Concerns about regulatory quality at local level have been highlighted in many country reviews. As a matter of fact, there is often a lack of resources and training to promote more effective rule making at this level. Local governments have been active in promoting regulatory quality in only a few countries, where they have sometimes been important drivers of reform. However, other countries still have room to improve their regulatory frameworks at the local level. In particular, local governments need adequate resources in order to accomplish their missions and it is important to match regulatory responsibilities with budget allocations, especially where new or broader mandates are given. It is equally important to establish the right incentives to promote cost control and encourage the use of cost-benefit analysis at local level.

Recent OECD evidence suggests a move towards deepening and strengthening inter-governmental co-ordination on regulatory policy across OECD countries (OECD, 2010a). Belgium reports that federal, local and regional governments signed a co-operation agreement that aims to ensure co-ordination, stimulate synergies and create scale effects due to common efforts. Denmark has also strengthened co-ordination across levels of government through mechanisms that facilitate buy-in from local jurisdictions (OECD, 2010b). Australia has renewed its commitment to stronger inter-governmental co-operation through the Council of Australian Governments (COAG), a forum for systematic dialogue on regulatory reform across jurisdictions which was active since 1992 (Box 9.3). In 2008, COAG introduced an ambitious regulatory reform agenda, supported by incentive payments to facilitate implementation of agreed policies, and reinforced its commitment to better regulation practices across jurisdictions (OECD, 2009a). Multi-level regulatory governance is particularly important in those countries where micro, small and medium-sized enterprises are particularly important and where local authorities are in charge of licensing activities. In Mexico, for example, the Federal Regulatory Improvement Commission (COFEMER) established a specific Rapid Business Start-up System (SARE) in order to co-ordinate all levels of government and to make start-up easier and faster.

Box 9.3. **The Council of Australian Governments**

The Council of Australian Governments (COAG) is the peak inter-governmental forum in Australia. It comprises the prime minister, state premiers, territory chief ministers and the president of the Australian Local Government Association (ALGA). The role of COAG is to initiate, develop and monitor the implementation of policy reforms that are of national significance and which require co-operative action by Australian governments. Under the auspices of COAG, the Commonwealth, states and territories have engaged in a significant programme of co-ordinated national reform over the period 2008-13 to improve the productivity of the national economy. They have agreed on a reform agenda focussing on competition, regulatory reform and human capital. This involves significant changes to the management of inter-governmental financial relationships to give the states and territories more autonomy and accountability for the delivery of services to citizens in key areas under a new agreement for funding arrangements, including financial incentives to facilitate or reward reforms. Regulatory reform is at the core of the reform agenda. It involves actions to improve the quality of the stock and flow of regulation within the governments of the states and the Commonwealth, and to promote regulatory harmonisation and the removal of regulatory overlap and duplication. The reforms also aim to preserve regulatory competitiveness and innovation where this is beneficial to the national economy.

Source: Council of Australian Governments, *www.coag.gov.au*.

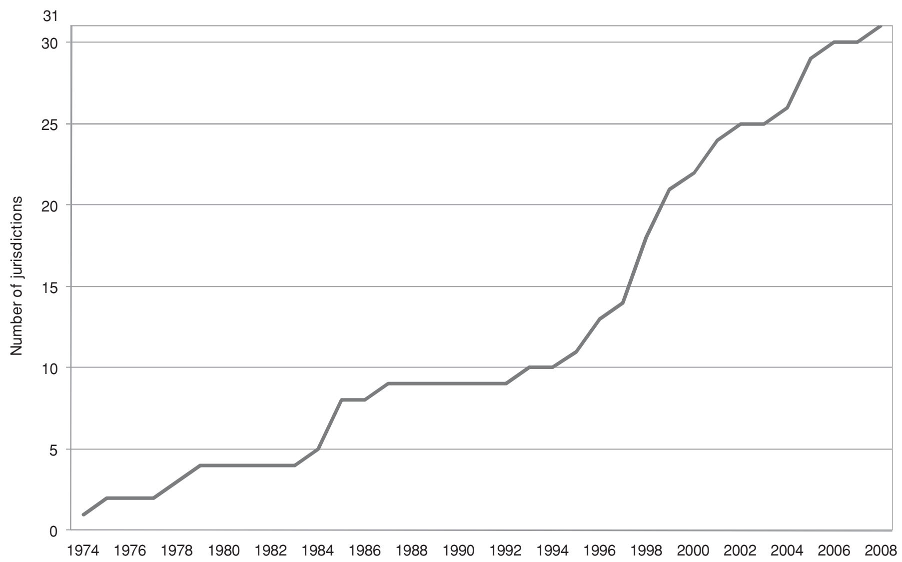
The impact and reactions of those affected by reforms

Inclusive policy processes can improve the quality of reforms and make adoption easier

Reforms require building constituencies with strong policy drivers and political support. Indeed, reforms require bringing domestic constituencies on board, creating participation in procedure, educating the general public and taking stakeholders fully into account in the design of regulatory reform policies. The capacity to take into account the impact of regulation and the reactions of those affected by reform can therefore improve the effectiveness of proposed regulations and provide a precious source of information that can contribute to well-timed reform. The growing use of regulatory impact analysis has given policy makers an important tool to enlarge the basis for empirically based decision making and for systematic consultation with those affected by reform. The use of RIA has become widespread among OECD countries. If in 1980, only two or three countries were adopting it, by 2000 this number increased to 14 (of

28 members) and by 2005 all member countries were systematically carrying out some form of RIA on new regulations before finalising and implementing them (Figure 9.5) (OECD, 2009a). At the same time, the establishment of advocacy bodies in many OECD countries has favoured the strengthening of constituencies to support reform. The challenge here is in ensuring that these practices become part of the culture of policy making, instead of contributing to the fragmentation of the regulatory process.

Figure 9.5. **Adoption of regulatory impact analysis by central governments in OECD countries, 1974-2008**



Note: Data for 1998 are not available for Luxembourg, Poland, the Slovak Republic and the European Union. This means that this figure is based on data for 27 countries in 1998 and for 30 countries and the EU in 2005-08.

Source: OECD (2009a), "Indicators of Regulatory Management Systems", *www.oecd.org/regreform/indicators* and *www.oecd.org/dataoecd/44/37/44294427.pdf* (full report).

The move towards evidence-based policy making is intended to strengthen support for regulatory reform, clarifying the cost-benefit balance of policy initiatives. RIA examines and measures the likely benefits, costs and effects of new or changed regulations and aims to provide guidance on how better to achieve policy makers' aims in a cost-effective way. In doing so, it provides a comprehensive framework for assessing the consequences of alternative policy decisions and to ensure that government action is justified and appropriate (Box 9.4). The need for consultation as part of the RIA process is also crucial, as only by holding consultation processes with key stakeholder groups can policy makers really know what the potential impacts of the proposed regulation will be. The systematic inclusion of consultation practices into RIA processes has helped to draw new or previously unheard stakeholders into the policy debate. Information gathered during the RIA process to ensure that government action is justified and appropriate is a valuable resource which opens channels of communication and dialogue with relevant social parties and which thus provides a stimulus for appropriate and timely reform.

Box 9.4. **The use of regulatory impact analysis in OECD countries**

There is no single model that OECD countries have followed in developing RIA. However, there are certain elements that remain consistent to the methodology and that should be understood when considering the implementation of a RIA programme. In its practical application, RIA commences with an analysis and an articulation of the problem, which creates the context for regulation, and proceeds through an evaluation of costs and benefits, including a consideration of the processes for the implementation of the regulatory action. As a support to decision making, RIA includes an evaluation of a number of possible alternative regulatory and non-regulatory approaches – including a "do-nothing" approach – with the overall aim of ensuring that the final selected policy and regulatory approach provides the greatest net public benefit. In order to do that, RIA requires detailed information about the potential effects impact of regulatory measures in terms of costs and benefits. This systematic process of questioning at the beginning of the policy cycle facilitates reflection on an important range of details to be taken into account when designing and implementing a regulation. In particular, from a business perspective, one very important element is the determination of the responsibilities to be allocated to different government agencies for enforcement and compliance. It is vital to know how the proposed regulation will be enforced and to understand the capacity of the affected parties to comply with it. Recent assessments have underlined three different categories of factors which determine the success of RIA. These relate to: the design of RIA processes and methodologies; the level of formal authority and political support for the process; and the incorporation of specific quality assurance mechanisms (OECD, 2009c).

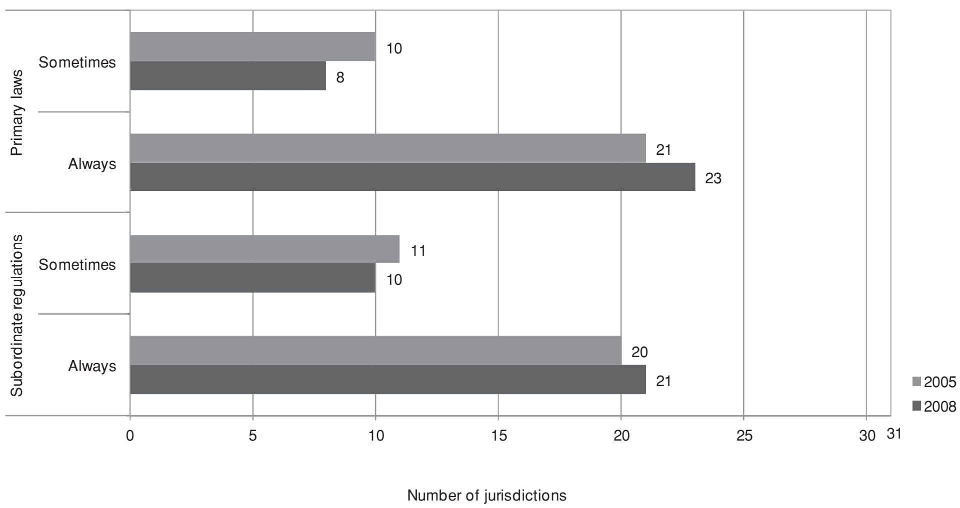
In terms of the design of RIA processes, OECD work has highlighted the importance of commencing RIA at an early stage of policy development, ideally at the inception of a policy proposal. As a matter of fact, only in this case RIA may be appropriately integrated into the policy-making process. By contrast, when it is included at the end of the policy cycle, it risks being used to justify regulatory choices that have already been made. The breadth of application of RIA has also been highlighted as an important element of the regulatory policy process which contributes to the effectiveness of impact assessment. Analytical capability is a scarce resource that needs to be allocated efficiently, and RIA should not be required in respect of relatively minor regulations. Many countries have adopted "filtering" mechanisms that imply the definition of quantitative and sometimes qualitative thresholds for the selection of regulations to submit to RIA. The impact of a regulation may be calculated not only in its entirety, but also partially depending on the relevance of the expected effects across the different interests affected. As regards the design of methodologies, OECD experience has shown that cost-benefit analysis is the "gold standard" for RIA. However, a wide range of other methods are also regularly employed, partly because of the difficulties of performing quantitative benefit-cost analysis in respect of certain types of regulatory proposals and partly because of the costs of fully fledged cost-benefit analyses.

The level of formal authority and political support for RIA procedures is also important. According to the 2004 RIA inventory, there are four different bases from which RIA policies may derive their authority: (i) law; (ii) a presidential order or decree; (iii) a prime ministerial decree or guidelines of the prime minister; (iv) a directive or a resolution of the cabinet or the government. It may appear that the establishment of RIA via legislation would convey the greatest authority. However, there appears to be little, if any, evidence to support this supposition. It appears that the formal basis on which RIA policies are established may be less important to RIA quality than other factors, like the level of political support at the centre of government (OECD, 2009c).

Finally, there remains the question of quality assurance mechanisms. The requirement for RIA to be assessed by an independent body within the government administration constitutes the most common form of quality assurance. However, many countries have implemented additional mechanisms for assessment and/or review of RIA. In particular, if RIA – when conducted in respect of a new regulation – is necessarily *ex ante* analysis, requirements for *ex post* review of regulatory impacts can also have a positive impact on the quality of the assessment. The knowledge that the RIA will be revisited within a relatively short period may act to undermine any incentives that regulators would otherwise have to manipulate the analysis in a manner which favours the case for the proposed regulation (OECD, 2009c).

Public consultation, however, is one of the key regulatory tools in and of itself. It is employed to increase the information available to governments for decision making and to improve the transparency, efficiency and effectiveness of regulation. Consultation enhances the quality of rules, strengthens compliance and reduces enforcement costs for both governments and citizens subject to rules. Public consultation procedures when developing new primary laws and regulations exist in all OECD countries as well as in the European Union (Figure 9.6).

Figure 9.6. **Public consultation in developing draft primary laws and subordinate regulations in OECD countries, 2005 and 2008**



Note: Data for 2005 and 2008 are presented for the 30 OECD member countries and the European Union.

Source: OECD Regulatory Management Systems' Indicators Survey, 2005 and 2008, *www.oecd.org/regreform/indicators*.

OECD countries use a wide range of mechanisms for policy consultations

Consultation processes differ widely across countries with respect to timing, the availability of guidelines and the degree of openness of the process (Box 9.5). In 2008, 25 OECD countries reported mandatory consultation processes at the inception of regulatory proposals, but consultation guidelines were only mandatory in only 12 jurisdictions for both primary laws and subordinate regulations (Figure 9.7) (OECD, 2009a). Countries claim to have increased the openness of their consultation processes. Most countries report publishing the views of participants in the consultation process and granting access to any member of the public to participate in the consultation. The number of countries included the views expressed in the consultation process in RIA rose from 17 in 2005 to 24 in 2008, for primary laws, and from 15 to 21 for subordinate regulations. Processes for monitoring the quality of consultations exist to varying degrees in at least seven jurisdictions.[3] In Poland, for instance, the quality of the consultation process is monitored by the Chancellery of the Prime Minister, which provides opinions on the scope of consultations before proposals can be transmitted to inter-ministerial clearings (OECD, 2009a). Extensive consultations appear, however, to have resulted in consultation fatigue by interest groups, which may feel overwhelmed by the volume of materials on which views are requested. Consultation fatigue may be a positive signal and stems from success in developing highly consultative and transparent regulatory regimes. Alternatively, it may arise from weaknesses in the mechanisms for responding to consultation inputs and eventually erode trust in the process (Malyshev, 2006).

Box 9.5. **Public consultation in OECD countries**

OECD countries have five different ways of performing public consultation:

1. *Informal consultation* includes all forms of discretionary, *ad hoc*, and non-standardised contacts between regulators and interest groups. Informal consultation is carried out in virtually all OECD countries. However, if it is widely accepted in some countries and is seen as a norm of the regulatory process, other countries view informal consultation with suspicion. In the United States, for example, it is perceived as a violation of norms of openness and equal access, since interest group participation in informal consultations is entirely at the regulator's discretion.

2. *The circulation of regulatory proposals for public comment* is a relatively inexpensive way to solicit views from the public. Furthermore, it is fairly flexible in terms of the timing, scope and form of responses. It is among the most widely used forms of consultation. This procedure differs from informal consultation in that the circulation process is generally more systematic and structured and may have some basis in law, policy statements or instructions. It can be used at all stages of the regulatory process. Responses are usually in written form, but regulators may also accept oral statements and may invite interested groups to hearings. The negative side of this procedure is again the discretion of the regulator deciding who will be included in the consultation.

3. *Public notice-and-comment* is more open and inclusive than the circulation of regulatory proposals for comment, and it is usually more structured and formal. Notice-and-comment has a long history in some OECD countries, and its use has become much more widespread in recent years. Procedures vary. In some countries, the process is prescribed by law and judicially reviewed, while in others it has no legal force. The public notice element implies that all interested parties have the opportunity to become aware of the regulatory proposal and are thus able to comment. There is usually a standard body of background information, including a draft of the regulatory proposal, discussion of policy objectives and the problem being addressed and, often an impact assessment of the proposal and, perhaps, of alternative solutions. This information – and particularly the RIA elements – can greatly increase the ability of the general public to participate effectively in the process. Many countries, however, have found that levels of participation have in practice been low. Participation is also dependent on the ease of response and the expected results of participation, including the effectiveness of the notice process, the amount of time allowed for comment, the quality and nature of the information provided to interested parties and the attitudes and responsiveness of regulators in their interactions with participants in the comment process.

4. *A public hearing* is a meeting on a particular regulatory proposal at which interested parties and groups can comment in person. A hearing usually supplements other consultation procedures. Hearings tend to be formal in character, with limited opportunity for dialogue or debate among participants. Experimentation with online hearings has begun. Hearings are usually discretionary and *ad hoc* unless connected to other consultation processes (for example, notice-and-comment). A key disadvantage is that they are likely to be a single event, which might be inaccessible to some interest groups, and thus require more co-ordination and planning to ensure sufficient access. In addition, the simultaneous presence of many groups and individuals with widely differing views can render a discussion of particularly complex or emotional issues impossible, limiting the ability of this strategy to generate empirical information.

5. *The use of advisory bodies* is the most widespread approach to public consultation among the OECD countries. The role of such bodies can vary from reacting to a regulator's proposals to acting as a rule-making body, in which advice is only one of several regulatory functions. Advisory bodies may themselves carry out extensive consultation processes involving hearings or other methods. Many countries have greatly expanded its use of consultative committees in recent years. This has coincided with a massive rise in the number of non-governmental organisations (NGOs). Advisory bodies are involved at all stages of the regulatory process, but are most commonly used early in the process in order to assist in defining positions and options. Regulatory development – drafting and reviewing proposals, or evaluating existing regulations – is rarely the only, or even the primary, task of advisory bodies. Some permanent bodies, for instance, may have broad mandates related to policy planning.

Source: Malyshev, N. (2006), "Regulatory Policy: OECD Experience and Evidence", *Oxford Review of Economic Policy* 22:2.

A growing number of countries rely on reform-advocacy bodies to make the case for change

In order to communicate the need for reform, governments have often established advocacy bodies with a clear mandate to campaign for reform. Advocacy bodies should not be confused with the increasing number of institutions set up by governments to improve consultation with stakeholders, which can be assimilated to traditional advisory bodies.[4] The nature of advocacy bodies is a function of countries' local political, administrative and cultural traditions. However, five main characteristics have been highlighted (OECD, 2007):

- The key mandate of an advocacy body is to conduct research and persuade the government, legislators and society in general of the need for reforms. It works with and through the regulatory bureaucracy, consults stakeholders, engages in legal proceedings, as well as other means to fulfil its mandate.
- Non-governmental personalities participate on the executive board of the advocacy body. They serve as the voice of business, labour or some other civil society constituency, as well as bringing the citizens' perspective in challenging vested interests, overcoming resistance or even bureaucratic inertia to reform in the public sector.
- The advocacy body and its supporting secretariat are mostly financed from the state budget, though the participation of non-governmental members – in particular through their time – might complement its resources.
- The advocacy body has the capacity to provide independent advice to the government, though framed under accountability rules.
- The advocacy body does not administer government programmes or exercise executive power.

In some countries, the advocacy bodies have become central and influential operators in the institutional framework for better regulation. Their value has been acknowledged and supported. A clear performance indicator is the fact that they have continued to be politically supported by successive governments. Some of these institutions, like ACTAL in the Netherlands and the Office of Best Practice Regulation (OBPR) in Australia, have even seen their mandates expanded by the government (OECD, 2007). Advocacy bodies are "part of a governance toolkit, and represent government's response for pressure to reform when blockages exist, and when new ideas are needed to steel political will for reform. Equally they provide "a voice and support for regulatory reform as well as a forum for dialogue, co-operation and co-optation" (OECD, 2007).

Successful, credible and sustainable reforms rely on the capacity to build wide coalitions, identify external drivers and pressures and bring them into the policy-making process. In this framework, regulatory policy can provide an important contribution. More open, evidence-based and accessible procedures are more legitimate, less vulnerable to capture and more likely to bring high-quality information that improves analysis of reform opportunities and policy options. However, the integration of RIA, of consultation policies and of advocacy activities into policy making is a challenging process that needs to be built up over time, if they are to become a routine part of policy development. Both RIA and consultation practices are sometimes seen as an unnecessary burden which slows down the policy process. In this view, RIA – and possibly also consultations – can degenerate into "incremental form filling", promoting a "box-ticking" that does not seriously influence policy development (OECD, 2009c). The big challenge here is in ensuring that these practices become part of the culture of policy making and, instead of contributing to the fragmentation of the regulatory process, develop into an important element of a "whole-of-government" approach which enhances the coherence of the government action.

Timing and the interactions across different policy areas

Timing and sequencing issues represent a key concern when dealing with regulatory reform

The definition of a long-term regulatory reform programme requires careful identification of targets and the prioritisation of reform activities. Moreover, the interactions and spillovers between reforms in different policy areas are a critical factor not only in ensuring the effectiveness of the reform programme, but also in winning public support. Reform in one market may fail to deliver results, if not accompanied by reform in others. Moreover, a "critical mass" of reforms may be needed for benefits to be visible (OECD, 2007). Experience has also highlighted the benefits of proceeding with multiple reforms in parallel in order to realise potential complementarities among reforms[5] and reduce the risks of winners and losers (OECD, 2007).

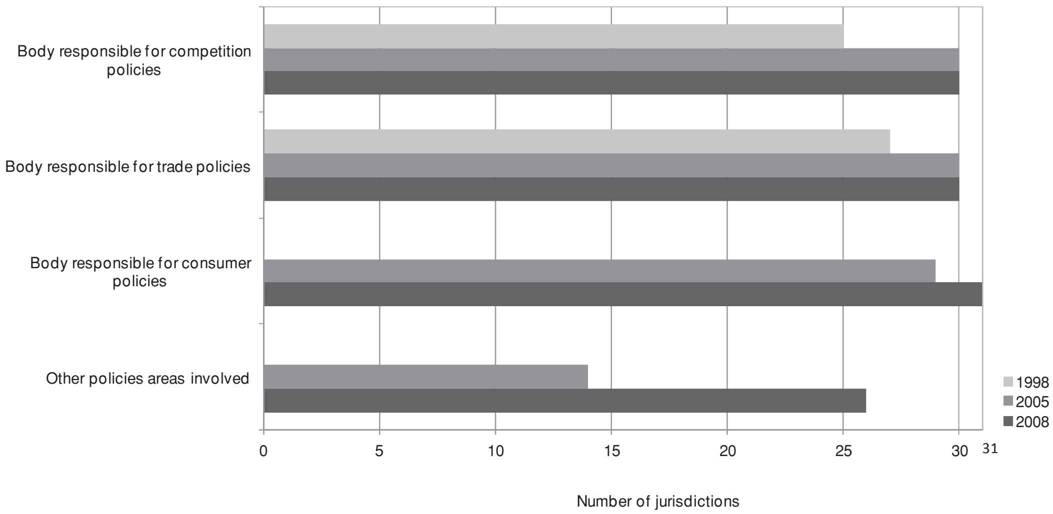
In this framework, regulatory policy provides a framework for collaboration that favours the identification of potential synergies within and across government. Increasingly, governments are seeing the linkages and interrelationships between regulatory reforms and other policies. OECD regulatory reviews show that different disciplines are mutually supportive and contribute to quality regulation. The Better Regulation principles give competition policy a prominent place. Regulation which unnecessarily restricts competition imposes costs on society and the calculation of these costs may be desirable in order to establish proper limits to regulation. Substantial synergies also exist between e-government and regulatory policies. In particular, the ability of government to best exploit and utilise these synergies can greatly improve the overall environment for service delivery and speed up regulatory reform which highly benefits from the use of information and communication technologies (ICTs).

The interconnectedness of different policy domains requires the capacity to establish links across policy areas in order to foster policy coherence. Most countries have some form of consultation within government on competition, trade and consumer policies (Figure 9.7). In only around half of OECD countries is such consultation always mandatory (OECD, 2009a). In Switzerland, for example, consultation within government is mandatory for every regulation adopted by the government and includes all seven ministries and the main agencies, as well as any other affected agency. In Belgium this intergovernmental consultation is also mandatory for all regulations concerning finance, trade, economy, social affairs, social security, justice and environment (OECD, 2009a).

Comprehensive reform packages have attractions, but can "overload" the public administration

The problem of timing and sequencing is also connected with the choice of an incremental or of a "big-bang" approach to regulatory reform. Better regulation policies have largely evolved and been implemented by OECD countries on an incremental, rather than a "big-bang" basis. In part, this has been due to the way in which the regulatory policy agenda has itself been forged over the years. Initially, the focus was on improving understanding of the nature of regulation as a tool for government and increasing the effectiveness of such a tool. Efforts have broadened and deepened over time, progressing from ideas of deregulation towards concepts of regulatory management and regulatory governance. However, some OECD members, which have come more recently to implementing a regulatory policy, have attempted to introduce a myriad of reforms in one go: a *de facto* big-bang approach (*e.g.* Greece). The choice of a big-bang strategy is understandable, given the link between a well functioning regulatory framework and economic growth. However, given the interdependence of regulatory policy and other enabling factors – such as leadership, political support, staffing capacities and resources, availability of appropriate training and support at central level, etc. – big-bang approaches to regulatory reform should be undertaken with caution. As a matter of fact, the pace of regulatory reform has to take into consideration the capacity of the system to ensure, for example, that staff have access to training, guidelines, advice and support, which are necessary in order to enable them to cope with the new challenges they confront. Proceeding too rapidly on too many fronts raises the risk that officials and other stakeholders will experience "reform fatigue", seeing policy innovations as unnecessary burdens rather than opportunities, and thus making effective implementation more difficult.

Figure 9.7. **Consultation within government on competition, trade and consumer policies in OECD countries, 1998, 2005 and 2008**



Note: The sample includes 31 jurisdictions for 2008 and 2005. For 1998, 27 jurisdictions are included as no data were available for Luxembourg, Poland, the Slovak Republic and the European Union.

Source: OECD (2009a), "Indicators of Regulatory Management Systems", *www.oecd.org/regreform/indicators* and *www.oecd.org/dataoecd/44/37/44294427.pdf* (full report).

In many cases, crises might serve as a driver for reform and allow politicians to justify the necessity and cost of change. This may induce governments to wait for a crisis in order to find momentum for reform. However, crises may induce worse regulatory outcomes, as governments may be tempted to adopt a big-bang approach and regulatory responses may be too heavy-handed. Moreover, reform options have to be considered in light of the budgetary cycle. As a matter of fact, governments may have a greater capacity to implement reforms in times of relative prosperity, when they are more likely to have the resources to compensate those who are expected to lose from reform. At the same time, those who are expected to benefit from reform are more likely to facilitate the introduction of change in times of relative prosperity (OECD, 2007).

The role of evidence and international organisations in supporting reforms

Recent research has shown that international organisations can foster reform not only by using incentives and coercion, but also through education, teaching and learning at the national level. Such a "policy-dialogue approach" is supposed to favour reform by persuasion, rather than bargaining over conditions and rewards. Such "soft methods of co-ordination" represent a slower, but not necessarily less effective, means of supporting the timely adoption of reforms.

There are growing doubts about the utility of strong forms of conditionality

There is a wide body of literature on the role of international organisations in supporting reforms. In particular, much has been written on the methods used to promote domestic compliance and induce countries to follow a path of reform. In this framework, conditionality has certainly attracted more attention than other methods. Conditionality is technically a means to ensure the execution of a contract, "a promise by one party to do something now in exchange for a promise by the other party to do something else in the future" (Mosley, Harrigan and Toye, 1991). It implies the use of "sticks" and "carrots", with the offer of positive incentives – such as promises of more aid, trade concessions, seats at international negotiating tables or protection by foreign troops – and the threat of negative disincentives – such as aid cuts, sanctions of various kinds, military intervention and commercial or diplomatic retaliation (Edwards, 1999).

Reliance on conditionality has grown enormously in scale and scope since the 1980s debt crises in the developing world. In particular, its use has been associated with the operation of the World Bank and, especially, the International Monetary Fund, whose assistance has at times been conditional on wide-ranging changes in economic, environmental or social policies, such as macroeconomic stabilisation, privatisation or increased investment in health or education. However, in recent years, there has been a large expansion of the application of conditionality to the promotion not only of economic policy changes, but also of a wide range of political and institutional reforms. During the 1990s, organisations such as the North Atlantic Treaty Organisation, the European Union and the Council of Europe offered membership to various countries in eastern Europe and the former Soviet Union on the condition that they execute reforms that went far beyond the standard conditionality packages of the main international financial institutions (IFIs). In these cases, conditionality touched the core political and institutional attributes of the countries to which it was applied. Among these institutions, the European Union has undoubtedly developed the most impressive set of instruments, using incentives ranging from full membership to trade concessions, technical aid, co-operation agreements and institutional ties, and applying them not only to aspirant members, but also to third countries (Smith, 1997).[6]

Nevertheless, there is wide agreement that policy-based conditionality has been broadly ineffective in most arenas.[7] Checkel (2000) summarises the criticisms of conditionality along three key dimensions. The first has to do with the politicisation of conditionality: international institutions have been pressured to release funds despite failures in national compliance and, more and more often, states know they can get "something for nothing", thus "undermining the entire incentive logic behind conditionality" (Checkel, 2000).[8] The second has to do with a problem of domestic ownership. Particularly in cases where conditions for rewards are strictly posited and strongly backed, reforms are seen to be the result of external imposition and support for policy change lacks a strong domestic political base. Thus, compliance and implementation become problematic. The third criticism has to do with the poverty and fragmentation of the policy environments. When political institutions have collapsed or are in the process of collapsing, countries are often unable to effectively enhance reforms. In these situations, "it is almost as if proponents of conditionality assume that it is imposed in a vacuum, where history and institutions do not matter" (Checkel, 2000). These kinds of considerations have led different critics to highlight the "shallow intellectual environment" that has characterised the thinking on conditionality and to stress that conditionality is "profoundly a-historical" (Killick, Gunatilakia and Marr, 1998).

"Softer" methods take longer but can often achieve greater legitimacy and ownership of reforms

Recent research has shown that international organisations can induce reform not only by using incentives and coercion, but also through education, teaching and learning at the national level (Checkel, 2001). The effectiveness of the so-called "soft methods of co-ordination" in order to promote reform has been at the centre of the attention, in particular in the field of EU studies. As a matter of fact, when the traditional "Community method"[9] is not at hand, the European Union has tested other methods in order to promote policy integration.[10] Such a "policy-dialogue approach" is supposed to favour reform by persuasion, rather than bargaining for conditions and rewards. The OECD has made an important contribution by promoting "good practices" for regulatory policy as embodied in the 1995, 1997 and 2005 Council Recommendations, a form of soft law. These have been disseminated to a wider group of countries through the development of an OECD/Asia-Pacific Economic Cooperation (APEC) checklist on regulatory reform. The exchange of experiences and good practices which has taken place in this framework has facilitated cases of "policy transfer" from one country to the other (Dolowitz and Marsh, 2000). At the same time, the institutionalisation of regular meetings between public officials working across different OECD countries on similar issues has provided a precious opportunity for discussion, contributing to the promotion of policy convergence and to the convergence of regulatory practices (Radaelli, 2000).

Several authors have argued that, since the mid-1990s, the development of the Better Regulation agenda has been shaped by a high degree of internationalisation, both in terms of the crucial role of international organisations such as the OECD in setting the agenda (Lodge, 2005) and the transnational exchange between high-level bureaucrats working on regulatory issues (Wegrich, 2009). In particular, the diffusion of the standard cost model (SCM) for measuring administrative burden has been used as a case to explore the mechanisms facilitating policy diffusion in this domain. The analysis developed by Wegrich (2009) reveals patterns of rapid diffusion of the SCM between 2003 and 2007, when the example of the Netherlands was followed by 15 other countries (including almost all the EU15 member states). A similar tendency has been highlighted with the diffusion of RIA. As a matter of fact, while the United States was at the forefront in adopting regulatory impact analysis early in the 1980s and different sector-specific impact assessments have been carried out since the mid-1980s in various countries, the diffusion of RIA accelerated only from the early 2000s, when the majority of the EU15 member states and several of the 2004 accession countries started adopting this tool (Radaelli, 2005).

The OECD has long promoted mechanisms of "soft co-ordination" between member countries, using ingredients, such as peer reviews, recommendations and benchmarking, which are at the core of the organisation's daily activity in promoting policy reform (OECD, 2003). The use of soft methods of co-ordination between member countries has allowed the OECD to promote policy convergence without the use of conditionality. Member countries are not asked to adopt the same policies, with the exception of a series of basic undertakings, which represent the core of the "like-mindedness" of the members of the Organisation (OECD, 2004b). OECD countries are asked to exchange experiences and to be open to learn from each other. This allows members to retain ownership of reforms and to avoid the contradictions that underlie conditionality strategies (OECD, 2009d).

Conclusions

Over the past 20 years, the OECD's work on regulatory policy has been instrumental in building policy support and identifying the necessary skills, tools and processes needed by member countries to promote the development and the implementation of high-quality regulations. The "OECD Indicators of Regulatory Management Systems" (Jacobzone, Choi and Miguet, 2007) indicate that almost all OECD countries have now adopted broad programmes of regulatory reform, which also establish clear objectives and frameworks for implementation. The precursor to the "OECD Guiding Principles for Regulatory Quality and Performance" (2005), the "Recommendation of the OECD Council on Improving the Quality of Government Regulation" (1995) was the first-ever international statement of regulatory principles common to member countries. These principles have been endorsed by all OECD members and have often been the basis for reviews of regulatory reform efforts in member countries. To date, country peer reviews of the regulatory processes in force in 24 member countries have been completed, as well as three reviews of non-members: the Russian Federation (2002-05), Brazil (2007), China (2005-08).

The OECD has served as an international forum to exchange experiences, ideas, techniques and benchmark progress across member countries and has suggested, but not imposed, preferred options for reform. In this sense, the OECD represents an exception in comparison with other international organisations. As Cremona and Hillion (2006) observe, "it is hard to reconcile true joint ownership with the unequal relationship implied by conditionality" and the often unilateral definition of a series of conditions to fulfil in order to receive certain rewards limits the possibility of supporting a serious process of learning between countries. The absence of a range of incentives to distribute in order to promote a preferred option for reform is not – in this view – a weakness but is rather a point of strength of the OECD, which can provide a framework to facilitate the exchange of experience between member countries and support mutual learning without coercion. Member countries are free to follow a specific example, to adapt it to the peculiarities of their national contexts or to reject it outright. The assistance of the OECD secretariat and the involvement of OECD committees notwithstanding, every reform adopted is fully "owned" by national authorities who decide autonomously on the strategy to pursue.

This chapter has highlighted information on four sets of factors which are likely to promote regulatory reform. Moreover, it has underlined that successful, credible and sustainable reforms rely on the capacity to build wide coalitions, identify external drivers and pressures and bring them into the policy-making process. In this framework, regulatory policy can provide an important contribution. As a matter of fact, good regulatory practices put the basis for more open, evidence-based and accessible procedures which are more legitimate, less vulnerable to capture and more likely to generate high-quality information. This improves analysis of reform opportunities and policy options. At the same time, the integration into the policy-making process of appropriate practices of regulatory management allows governments to develop a more coherent approach to policy formulation. In particular, regulatory policy provides a framework for collaboration that favours the identification of potential synergies within and across government, and allows them to overcome the obstacles created by a traditional compartmentalisation of functions.

Implementing an effective regulatory policy requires governments to tackle a number of challenges:

- Leadership: experience from across OECD countries has illustrated that a more coherent approach to policy and regulatory formulation requires not only high-level and cross-governmental support, but also the capacity to lead and develop a pro-active approach.

- Embedding cultural change: an awareness of the importance of regulatory quality is needed throughout the public administration and among key private sector actors in order to promote deeper reforms, together with the establishment of a climate of trust and co-operation and the promotion of a regular exchange of information between the actors involved in the regulatory process.

- Skills, competencies and training: the enhancement of a programme of continuous training and capacity building within the government continues to be the key for the development of an effective regulatory management. This kind of initiative not only improves the technical skills needed in certain processes, it also communicates the importance attached to the regulatory quality agenda by the administrative and political hierarchy and helps to embed cultural change. Training and capacity-building programmes allow officials to meet and discuss the Better Regulation agenda, thus fostering a sense of ownership of reform initiatives and favouring communication within and beyond individual institutional settings.

- Transparency and volume of regulation: ease of access to regulation, through printed or electronic means, is essential. From a business perspective, being able to readily access information on new regulations, as soon as they are approved, is key to ensuring compliance. Easier access to codified legislation also simplifies the process for those seeking to enter the market.

- Availability of data: a challenge for many OECD countries is the availability of suitable, independent, *ex ante* data that can best inform the policy-making process. The availability of these data allow policy makers to develop appropriate indicators to measure the effectiveness and outcomes of regulation, without creating unnecessary burdens for citizens, business and the public service.

The creation of the new Regulatory Policy Committee by the OECD Council in October 2009 represents a recognition of the importance of assisting member and non-member countries in building and strengthening their regulatory reform efforts. The committee is to foster a multi-disciplinary approach to regulatory quality in the OECD and assist institutions in managing risks and reducing regulatory gaps, while adhering to good governance principles.

Notes

1. To this end, different proposals have been advanced, such as the introduction of mechanisms to better monitor the regulation performance of all executive bodies.

2. Regulatory and competition reviews show that the relationship between competition authorities and sectoral regulators is central in determining how competition principles are applied. Their approach to the same issue may diverge, with the added complication that there may be more than one relevant law which is applicable to the same case (OECD, 2008).

3. Australia, Canada, Poland, Sweden, Switzerland, the United Kingdom and the European Union.

4. Traditionally, governments have explicitly endowed oversight bodies in charge of regulatory quality policy with some advocacy functions (*e.g.* the Mexican COFEMER). Other governments have clearly dissociated advocacy and oversight bodies. Some other oversight bodies, such as the Netherlands' ACTAL, clearly separate their activities when acting in their advisory and advocacy roles (OECD, 2010c).

5. Reform complementarities arise when the co-ordinated pursuit of multiple mutually reinforcing reforms may increase the benefits generated by each; this is distinct from, but related to, the notion of policy coherence. Whereas policy coherence is largely seen as a constraint, the notion of policy complementarities highlights the potential to realise positive benefits from co-ordinated reforms. See Braga de Macedo and Oliveira Martins (2008).

6. The conditions set for the accession of Central and Eastern European (CEE) countries in 1993 at the Copenhagen European Council were undoubtedly the most detailed and comprehensive ever formulated, and conditionality is, without any controversy, the basic strategy through which the European Union has promoted compliance by the candidate countries (Checkel, 2000). The use of incentives to alter a state's behaviour or policies was designed to minimise the danger of new entrants becoming politically unstable and economically burdensome, with the dual purpose of, on the one hand, reassuring reluctant "old" member states that disruption risks would be minimal and, on the other, guiding CEE applicants down the road to membership (Grabbe, 2002).

7. See, *inter alia*, Mosley, Harrigan and Toye (1991); Killick (1998); Dollar and Svensson (2000); Burnside and Dollar (2000); OECD (2009d).

8. Creditors often worry about getting their loans serviced, but ever since the Napoleonic Wars (and arguably even going back to Roman times), wealthier states have also used international loans to promote military, economic and ideological objectives (OECD, 2009d). Such objectives have been especially prominent since the latter part of the 20th century, when the "international financial institutions, which have embodied the values of the more

advanced capitalist states, have been more concerned with promoting particular domestic changes in borrowing countries than with being repaid" (Krasner, 1999).

9. See *http://european-convention.eu.int/glossary.asp?lang=EN&content=C*. The "Community method" is the expression used for the institutional operating mode for the first pillar of the European Union. It proceeds from an integration logic and has the following salient features: (i) EU Commission monopoly of the right of initiative; (ii) general use of qualified majority voting in the Council; (iii) an active role for the European Parliament in co-legislating frequently with the Council; (iv) uniformity in the interpretation of Community law ensured by the Court of Justice. The method used for the second and third pillars is similar to the so-called "intergovernmental method", with the difference being that the Commission shares its right of initiative with the Member States, the European Parliament is informed and consulted and the Council may adopt binding acts. As a general rule, the Council acts unanimously.

10. In particular, a lot has been written on the use of the "open method of co-ordination" (OMC) in order to expand policy activities beyond legally limited spheres and speed up European decision making. The main institutional ingredients of the OMC are common guidelines, national action plans, peer reviews, benchmarking, joint evaluation reports and recommendations (Ferrara, Matsaganis and Sacchi, 2002). These ingredients are organised in relatively structured processes, which are repeated over time, promoting, on the one hand, trust and co-operative orientation among participants and, on the other hand, learning dynamics. Thus, even in the absence of hard regulation and sanctions, the OMC creates several incentives for compliance and proves a strong potential of conditioning partner states. The OMC was codified for the first time during the Portuguese presidency in 2000; it was originally applied in the area of employment and then extended to a wider array of other policy areas. In contrast to the traditional Community method, this approach has been defined as "soft" and "national state friendly" (Ferrara, Matsaganis and Sacchi, 2002). It has been indicated as a panacea to enhance policy integration, expand policy activities beyond legally limited spheres (de la Porte and Nanz, 2003) and speed up European decision making (Héritier, 2003). The use of benchmarking adds objective points of reference to the process described here and gives countries yardsticks with which to assess the direction and the pace of reform.

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Chapter 10

Achieving and sustaining fiscal consolidation

by Robert Price*

This chapter begins with an examination of the factors that condition the propensity for governments to take on debt: political and governance factors, public attitudes to debt, the role of financial markets and the general imprecision about which debt targets should be pursued. It then examines the evidence, based largely on pooled regressions over large country samples, regarding the exogenous and policy-related factors which have affected the success of fiscal consolidation efforts. The chapter goes on to examine the role of fiscal institutions: rules and autonomous agencies in fiscal retrenchment. The chapter's final section sums up and assesses how the political economy context has changed with the financial crisis, giving some pointers as to what may be needed to re-establish a consolidation path and make it less prone to setbacks.

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This chapter explores the political economy factors that have contributed to problems of fiscal sustainability in OECD economies and those that may have impeded or facilitated fiscal consolidation. At its broadest, and most normative, fiscal consolidation may be defined as a political process aimed at achieving a sustainable fiscal balance, where sustainability means issuing debt to finance government expenditure only to the extent that it creates a future debt burden that does not interfere with the attainment of macroeconomic objectives. Excessive government borrowing can be inflationary, economically destabilising, allocationally distorting and generationally arbitrary in its impact. After decades of application, the results of consolidation policies have been irregular, uneven across countries and ultimately subject to a severe setback, due to the financial crisis. The 1990s were characterised by significant fiscal adjustments, following a period in which many OECD economies saw a run up in debt, sometimes to very high levels. However, there remained substantial divergences among OECD economies in terms of the degree of consolidation achieved, and the gains that have been made have not proved permanent. Following the recession of 2008–09, the average OECD budget deficit is expected to reach 9% of gross domestic product (GDP) in 2010, when the average debt-to-GDP ratio will reach 100% – a post-war record. This means that the consolidation process will need to begin anew and success will depend largely on the lessons learned from past consolidation episodes.

Fiscal governance, public attitudes and financial discipline: the roots of deficit bias

Making reform happen in the area of fiscal consolidation involves dealing with the interests and incentive structures of policy makers in addition to those of economic agents that are directly affected by consolidation measures, where sectional vested interests, the protection of economic rents and acquired rights dominate the defence of the status quo. For instance, with respect to government debt issuance, governments may expect to reap a potential electoral advantage over their opponents by raising and spending money against future tax income. On the control side, the principal actors and interests include central banks and financial markets, which have an interest in preventing inflation and protecting the property rights of money and bond holders in general, but which have not always exercised effective oversight over government borrowing. As underwriters of government indebtedness, the general public play an ambivalent role: they have to service government debt via taxation, but the benefits of borrowing may accrue to different groups of voters (both within and across generations) from those that pay.

Counter-cyclical policies may be easier in downturns than expansions

Against the background of changing attitudes to the macroeconomic usefulness of deficits, the public choice literature[1] identifies an endemic bias towards deficit finance, because governments can provide the electorate with benefits that do not have to be paid for immediately. Provided voters value public expenditure and consistently underestimate its costs in terms of higher future taxes, politicians can indulge in opportunistic deficit-financed public spending increases and tax cuts prior to elections, inducing a "political business cycle" (PBC) (Nordhaus, 1975). PBC models have come up with mixed empirical results and the hypothesis is often contradicted empirically. Of greater interest from the viewpoint of debt accumulation is the possibility that fiscal expansions and contractions are asymmetric, both because the deficit expansion is not offset by an equivalent consolidation and/or because expenditure instruments are favoured for expanding demand and tax instruments for reducing it. This would be consistent with a tendency for deficits to be used to enable the public sector to expand (Buchanan and Wagner, 1977).

It would be too simplistic to view the cyclical behaviour of OECD economies as being conditioned by the kind of political opportunism posited by some PBC models, but there is evidence of responses to cyclical shocks being affected by electoral factors. In a study of 16 OECD countries, Balassone and Francese (2004) find evidence that fiscal policy does tend to react asymmetrically to cyclical conditions: a downturn is usually accompanied by a deterioration of the budget balance, while an upturn does not entail an equivalent improvement of that balance. Although governments sometimes need to take action to cut budget deficits in downturns, this is electorally difficult, and there is cross-section evidence that consolidation tends to be more prevalent just after election years (OECD, 2003). This may reflect the fact that the benefits of fiscal retrenchment, as of a reformist agenda in general, take some time to come through.

In some OECD countries, there is evidence that fiscal policy tends to turn pro-cyclical during upturns; this seems to be particularly true of in euro area countries (Ahrend, Catte and Price, 2006a).[2] Expenditure increases and tax cuts in the expansionary phase of the cycle are politically difficult to resist if windfall revenues are mistaken for structural increases in budgetary income. Towards the end of the dotcom boom, for example, the OECD-area fiscal stance became distinctly pro-cyclical, particularly in the larger euro-area economies, pushing up structural deficits (Girouard and Price, 2004). In the more recent financial market boom and bust, the same phenomenon of abnormal revenue buoyancy recurred, prompting pro-cyclical discretionary action in several countries.

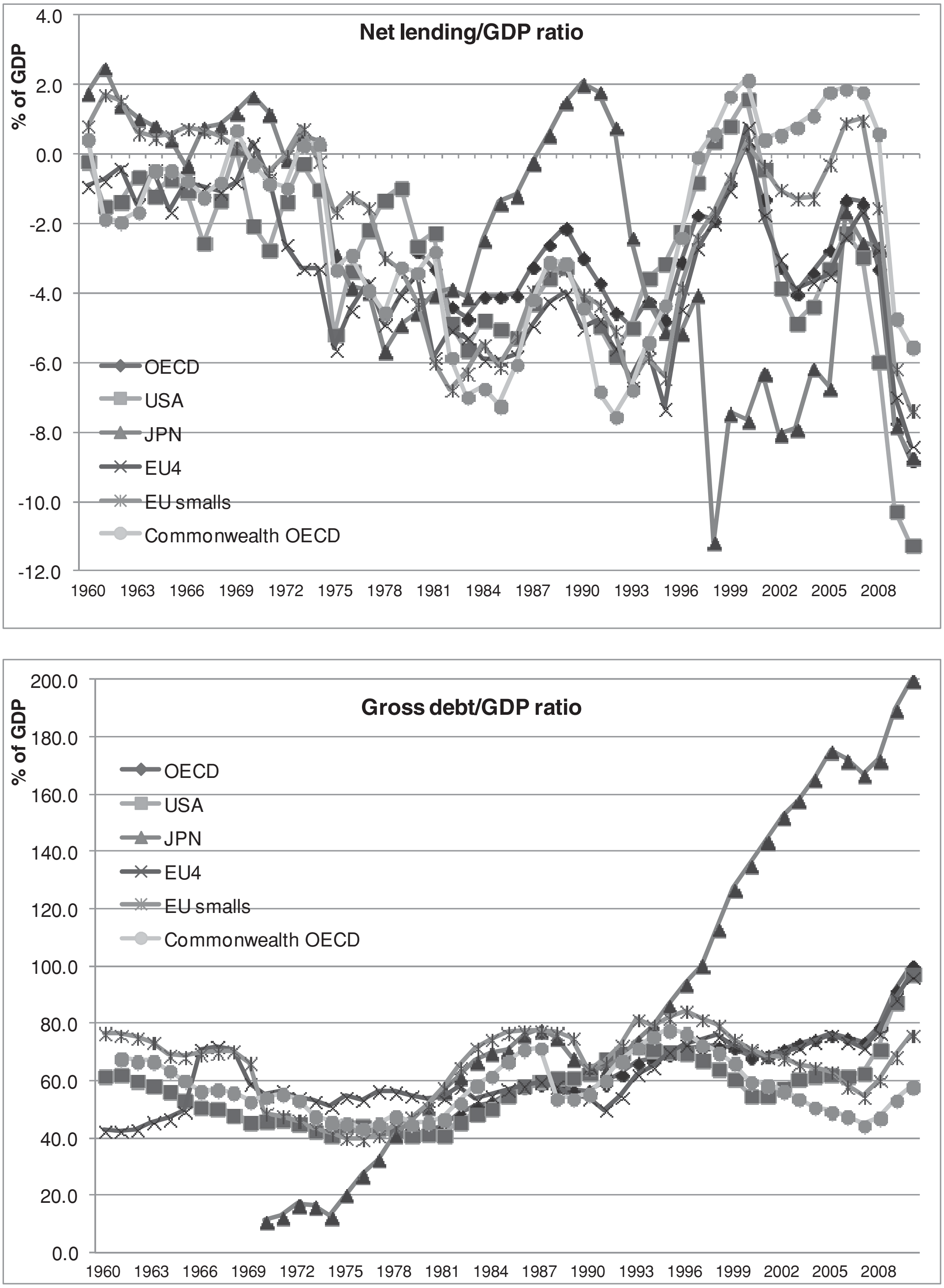
Stabilisation policies help condition the time profile of OECD deficits…

There has been a high degree of consensus across OECD economies as to what governments can achieve via the active use of fiscal deficits, which has made for a significant degree of fiscal synchronisation over time. The operational consensus up to the second oil shock – which included the response to the first – had been that deficit finance could stabilise output, subject to some trade-off with inflation. That consensus disappeared as inflation accelerated, output stagnated and public borrowing surged (Figure 10.1), and was replaced by a supply-side approach to macroeconomic policy. This was associated with a wariness of discretionary action and an emphasis on built-in fiscal stabilisers, which should, in principle, exert a symmetrical impact on deficits, at least in the absence of supply shocks. There have been differences among OECD economies as to the application of that approach, dependent on the strength of the automatic stabilisers. However, the process of globalisation – by which trade leakages and interest rate effects reduce fiscal multipliers, especially for small, open economies – tended to create a relative conformity of views with respect to what fiscal policy could achieve compared with a growth-oriented policy of structural reform. The financial crisis has called this consensus on public sector "neutrality" into question; large discretionary fiscal interventions have taken place, which some have labelled a "new fiscal policy activism" (Auerbach, 2009).

…but ideological factors explain some differences

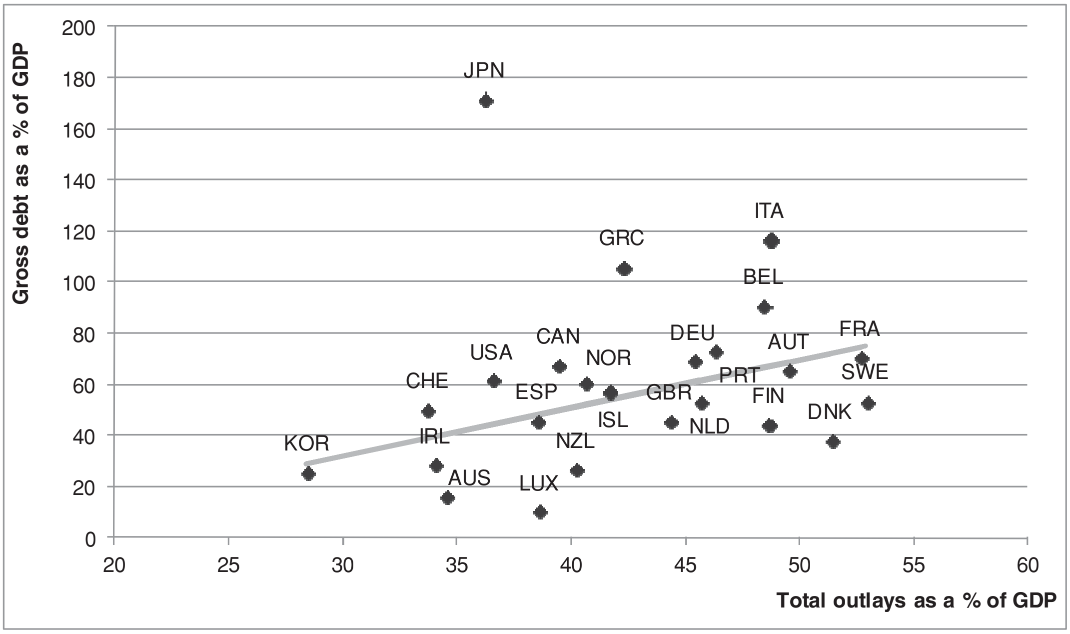
There is at least *prima facie* evidence that deficits have been used to expand the public sector in that a positive correlation can be observed between gross debt-to-GDP ratios and outlay-to-GDP ratios among OECD economies prior to the crisis (Figure 10.2). Ideological factors obviously play a part here. While there has been a high degree of consensus on the limited macroeconomic benefits of fiscal activism, there have still been differences in fiscal behaviour among OECD economies driven, in part, by partisan attitudes to deficit accumulation (Hibbs, 1977). Governments that expect to be voted out of office may be tempted strategically to over-issue debt so as to tie the hands of their opponents, thus using debt to limit their successors' spending. In some countries, cutting taxes before spending was seen as means of increasing budgetary pressure to reduce spending – "starving the beast" in the parlance of some advocates of this approach. This view was particularly influential in the United States in the early 1980s and the early 2000s.[3] Whether such a strategy has been fully effective is doubtful (Romer and Romer, 2007), but it may help to explain why the US debt ratio is high relative to the expenditure ratio (Figure 10.2). Conversely, the fiscal bipartisanship of Scandinavian countries, based on the acknowledgment of the positive links between taxation and the universality of benefits may help to explain the relatively low debt ratio, relative to the size of the public sector, in those economies.

Figure 10.1. **Trends in government deficits and debt**



Source: OECD Economic Outlook 85 database.

Figure 10.2. **Gross debt and expenditure ratios compared, 2006**



Source: OECD Economic Outlook 85 database.

Government fragmentation and lower electoral accountability may contribute to deficit bias

Institutional factors governing fiscal policy formulation, approval, implementation and accountability may also create deficit bias. Much attention has focused on conflict between different groups over the distribution of funds, within fragmented political systems, as a driver of public debt accumulation. Changes in fiscal stance are less frequent and less radical – the greater the number of players with veto rights over enactment (Tsebelis, 1999). On the other hand, a lack of political cohesion appears to make it difficult to muster political support for fiscal consolidation when the necessity coincides with periods of cyclical weakness (OECD, 2003).[4] Deficit bias appears to be most marked in parliamentary regimes with proportional representation, where spending (particularly welfare spending[5]) tends to react more strongly to negative than positive shocks and to be more persistent over time. Conversely, post-election fiscal adjustments are more prominent in majoritarian democracies (Persson and Tabellini, 2003).[6] Deficit-generating behaviour will be facilitated where a lack of transparency reduces budgetary accountability. Countries with more transparent budget procedures exhibited greater fiscal discipline in the 1980s and early 1990s (von Hagen and Harden, 1994). Recognition of the importance of transparent budget practices has led to greater openness, often embedded in legislation.[7] Using a transparency index for 19 OECD countries during the 1990s, Alt and Lassen (2006) conclude that weaker transparency is associated with higher deficit and debt levels.

Private sector responses may contribute to deficit bias

Whether and to what extent governments resort to deficit finance obviously depends, in part, on private sector responses. Persistent opportunistic fiscal behaviour only makes sense if electorates underestimate the future costs of current public consumption and a political business cycle can only emerge if the public treat the extra debt as real wealth and spend more as a result. Even if the electorate is initially convinced that deficit-financed spending is sustainable, it cannot be subjected to “fiscal illusion” consistently, unless it is denied information by incumbents (Rogoff, 1990). Governments thus have to take account of private responses before engaging in deficit budgeting. The evidence suggests that perceptions of policy makers' expectations concerning those responses have an important bearing on the effectiveness of both opportunistic fiscal expansions and the costs of consolidation; this, in turn, may affect the incentives for governments to run deficits or adopt policies to reduce debt.

The evidence on private sector responses to budget deficits is mixed, but private and public saving tend to vary inversely. However, one cannot simply attribute this correlation to anticipatory household responses, because it is difficult to separate private saving responses to budgetary shifts from budgetary reactions to changes in private saving. Moreover, the savings rate could be affected indirectly by budgetary shifts, where, for example, deficits are accompanied by positive effects on real and financial asset prices. It is unlikely that full anticipation of future financing costs obtains for any OECD country (Box 10.1). However, there is evidence that electorates in some OECD countries respond partially to deficits by saving more (de Mello, Kongsrud and Price, 2004). In others, notably the United States and Scandinavian countries, there is no apparent saving offset (Cotis *et al.*, 2004). Where there are saving effects, there is less incentive for governments to use deficit finance to compensate for the business cycle, since the effectiveness of reflationary public spending is partly offset by higher private saving; Ahrend, Catte and Price (2006a) show that the most prominent exponents of discretionary fiscal policy action have been Anglo-Saxon and Nordic countries, where private savings responses to deficit spending are weakest.[8] Elsewhere in continental Europe, economies have been more likely to rely on automatic stabilisers alone, which should, in principle be less vulnerable to the political business cycle. This pattern of fiscal activism might seem to be loosely related to the different political perceptions about tax discounting displayed by OECD countries.

Box 10.1. **Budget deficits and private saving behaviour**

To the extent that the public are aware of government borrowing – and various other conditions – there is a presumption that forward-looking private agents will fully internalise the fact that borrowing implies higher future debt service and, hence, deferred taxation (Barro, 1974, 1989). They will, therefore, save more in anticipation. The existence of such "tax discounting" has been the focus of much theoretical debate and empirical work. Empirical validation of this hypothesis is constrained by the difficulty of disentangling all the channels through which offsetting movements in private and public saving may take place. However, there are strong theoretical objections to the existence of completely offsetting movements in private saving in response to changes in the timing of taxes, a theoretical result that requires, *inter alia*, a perfect credit market, non-distortionary taxes, and certainty about future taxes, income and other variables. It also assumes that current consumption decisions are based on infinite planning horizons, with positive transfers to future generations based on altruism. In general, these assumptions cannot be expected to hold. That said, the behaviour of the private sector in some OECD countries is often consistent with a measure of tax discounting. The existence of even partial offsetting effects of private savings may help account for differences in attitudes to discretionary fiscal policy and debt sustainability. Where there is tax discounting, the effectiveness of fiscal policy is reduced and the potential for a politically induced business cycle reduced. At the same time, where governments build up debt because of exogenous shocks, the need to reduce debt is less urgent, since it is financed from higher private saving and does not crowd out investment.

Typically, consolidation entails output costs which can deter policy makers. Initiating a consolidation effort at moments when cyclical slack is increasing poses the risk of amplifying a recession through negative short-term multiplier effects. These costs are smaller where private saving falls in response. In certain cases, especially where confidence effects on saving and investment are engendered, private saving will fall and the multiplier may even be negative (Giudice, Turini and Veld, 2004).[9] Some fiscal corrections have thus had a positive, stabilising effect. Since the existence of such "non-Keynesian" effects make it less costly to reduce deficits once they occur, they might *a priori* be associated with low deficits and debt. This does not seem to be the case, however, probably because even when the net effect of fiscal retrenchment on the economy is positive, there will still be distributional effects which have political costs.

In any case, the information available to the public is usually incomplete, and anticipatory saving responses will be partial. The empirically robust conclusion in the literature is that the link between government deficits and private savings tends to be clearest when debt ratios are high, suggesting that there is a signalling process involved (Nicoletti, 1992; Berben and Brosens, 2007; Kinari and Shibamoto, 2007).[10] Below this threshold of awareness, a lack of transparency may contribute to an apparently myopic public indifference to deficits – though the threshold will vary from country to country. This suggests that only beyond a certain point, where debt become intrusive, does both the activity-increasing benefit of debt-financed public spending and the cost of reducing it become so small as to make fiscal consolidation an economically costless option.

Unfunded future liabilities can build up without the public being aware

Much of what governments decide in the present has implications for future spending and deficits and problems will arise when these are not adequately foreseen. The expansion of OECD welfare states in the 1960s and 1970s created largely unanticipated liabilities in terms of future pension and health-care obligations. These have meant that governments have had to consolidate even to stand still in terms of current deficit and debt ratios. In particular, the unscheduled build-up of future liabilities, via changes to entitlement programmes, where costing of future obligations has been imperfect, meant that the cost of "off-budget" implicit liabilities would in several countries dwarf that of outstanding public debt. The problem has been that because of the demographic build-up in spending pressures, delays in implementing consolidation increase the ultimate costs (Cournède, 2007).

To some extent, the argument about the costs of delay seems to have been understood by policy makers, since there are numerous examples of successful pension reform. Nevertheless, selling fiscal consolidation to the population can be difficult when it involves redistribution among current taxpayers and between current and future taxpayers, particularly where the protection of acquired rights will involve higher taxes if benefits are to be maintained. Unfunded acquired rights to state pensions have proved very difficult to alter because of popular resistance, and this has generated a need to educate the public in order to achieve reform. One of the strongest findings to emerge from a series of case studies of the political economy of structural reform, which would seem transferable to fiscal consolidation at large, is that convincing electorates and gaining an electoral mandate are crucial (Tompson, 2009). Indeed, insofar as pension reforms tend to focus on questions of long-term sustainability, they tend to be adopted only after extensive consultation. One of the most important factors in the consolidation process may thus be persuading the public of the need for it, with greater budget transparency and fiscal rules possibly having a part to play here.

Resistance to tax increases varies among countries

While during the 1970s and early 1980s deficit bias was associated with secular tax and expenditure increases, popular opposition to tax increases was also growing over this period in some OECD countries. The resistance was encapsulated by the rhetorical device of the "Laffer curve", according to which attempts to raise the tax rate above a certain level lead to a reduction in revenue. The existence – or more precisely the shape of tax rate/revenue curve – has been much discussed, and the influence of the concept on policy makers has varied substantially among OECD economies.[11] It may have played a prominent part in the "tax revolt" of the 1970s in the United States, but estimates of the supply-side limits to taxation differ substantially, within and between countries. However, the idea that high taxes could be economically distorting began to have an important influence on policy making. After the severe ratcheting up in general government claims on resources that occurred in the 1960s and 1970s, there was a perceived need to cut taxes rather than to raise them (OECD, 1989).[12] As productivity growth declined, concerns grew about the efficiency effects of over-taxation. In this context, tax increases began to be seen as possibly more detrimental to economic performance than the effects of high deficits.[13] Correcting budget imbalances through tax increases was thus seen as potentially worsening the budget problem in the longer run. This view has contributed to a growing emphasis on expenditure cuts as the principal means of consolidation, which meant that the rigidities described earlier needed to be confronted.

Markets can discipline profligate governments, but they may be too accommodating for too long

The political economy literature is concerned with deficit biases that arise because providers and recipients of public services do not fully discount the costs of borrowing. However, borrowing does have to be paid for, by issuing debt. Financial markets can therefore exert an important disciplining effect, but governments also have privileged access to debt finance because of the implicit collateral they have in terms of future taxing power. This lowers (and for some countries virtually eliminates) risk for lenders and encourages government borrowing. Governments may also have access to money finance, via the central bank. Rates of interest on government debt have varied substantially over time – particularly in inflation-adjusted terms, and it would appear that government-spending behaviour reacts to these variations.

Up to the second oil crisis, the real interest paid on government debt was substantially negative in most countries, implying a substantial "inflation tax" – a form of expropriation of bond holders' wealth.[14] While the dominant economic rationale at the time was that higher inflation was acceptable if it came with higher output, the extent of the inflation-tax generated was a surprise rather than deliberate. Nevertheless, primary government balances decreased markedly up to the end of the 1970s, as governments took advantage of the negative real costs of borrowing. Sustaining inflation-tax revenue is particularly problematic, however, given that money and bond holders will react to the tax by cutting back on money and bond holdings, unless inflation persistently accelerates. The adoption from the early 1980s of a new orthodoxy to prevent this, based on monetary and inflation control and central bank independence, cut off finance and forced governments to compete for funds in the capital market, while bond holders began to demand a risk premium for holding government debt (OECD, 1982).

Real bond yields do seem to be pushed up as governments compete for loanable funds with the private sector, although the extent of this effect is subject to some controversy (Laubach, 2004). Most research finds it to be incremental and very small, though by no means negligible in its impact on the cost of interest payments.[15] Ratings changes also seem to react slowly and to give poor anticipatory information about budgetary problems (Balassone, Franco and Giordano, 2004). Markets thus do not always tend to respond proactively to debt accumulation. Rather, there appear to be thresholds that trigger large movements in risk premia, at which point the penalty for over-borrowing can suddenly become steep. Financial-market discipline is thus episodic rather than smooth. For most OECD economies, the importance of this trigger mechanism has been accentuated by the process of global financial and trade integration, which, in an environment of floating exchange rates, means that external pressures could turn public debt imbalances into financial crises.[16]

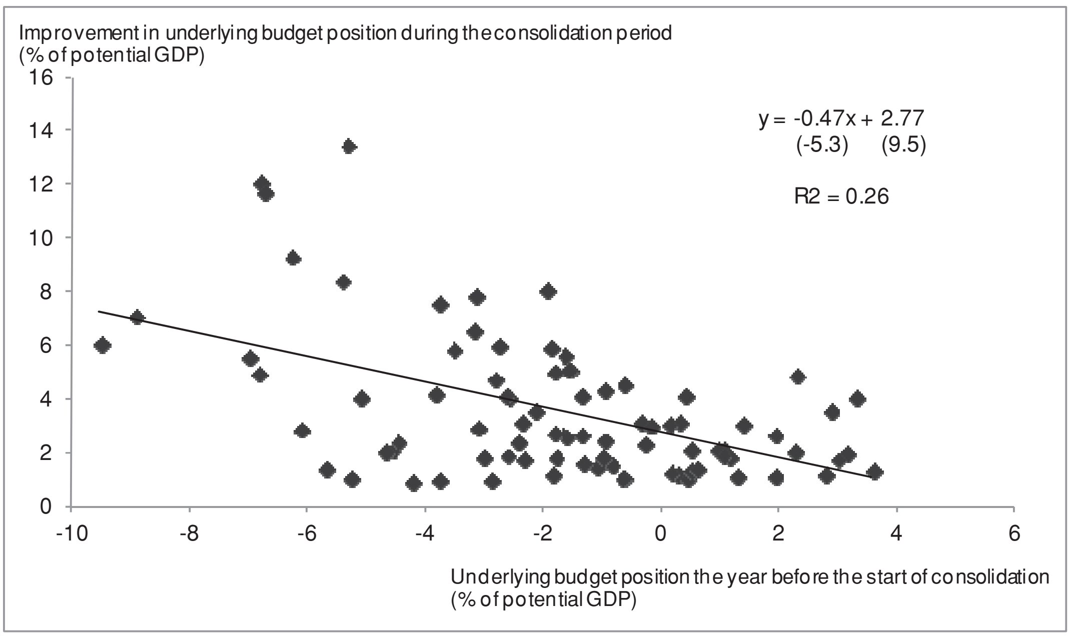
For long periods, financial market influences can be benign. Governments' budget constraints eased early in the 21st century, as evidenced by historically low bond yields (Ahrend, Catte and Price, 2006b). The real rate of interest on government debt was well below economic growth rates from 2003 to 2007, creating the "conundrum" that the build-up in US government and external debt did not trigger a market reaction in the United States. The explanation may lie in the existence of ample global private sector savings – a global savings glut – which may have made budget financing easier (Bernanke, 2005). A further reason may be the fact that a large proportion of overall financing of the US "twin deficits" came in the form of official dollar purchases by central banks in Asia, for whom a stable dollar exchange rate has been more important than the rate of return on dollar assets. Prior to the financial crisis, liquidity in general was plentiful and risk premia low, so governments were shielded from pressures to reduce their borrowing as global leverage increased. Subsequent to the crisis, governments (with some exceptions, where sovereign risk premia have increased) have been able to finance large increases in debt at favourable rates, partly because risk premia on other financial instruments have risen. The markets have thus been party to the process of fiscal "deconsolidation". This behaviour would seem to be consistent with historical experience of a strong market appetite for government debt when inflation is low, but it does not preclude a sudden reversal.

Drivers of consolidation: fiscal crises and the pursuit of sustainability

Consolidation occurs mainly where deficits become excessive

Against the background of an underlying deficit bias, there have been frequent interventions by OECD countries to correct excessive borrowing. Recent OECD research has identified 85 consolidation episodes in 24 OECD countries between 1978 and 2004 (Ahrend, Catte and Price, 2006a; Guichard *et al.*, 2007), defined as actions which, once started, resulted in a noticeable improvement in the cyclically adjusted primary balance (CAPB).[17] Most of the consolidation episodes have been of short duration and have involved only modest gains. The median improvement of the underlying budget position has been 2.8% of GDP and the median duration two years. There have, however, been a number of large efforts, amounting to more than 8% of GDP, as well as a few episodes lasting from six to eight years. The consistent conclusion of empirical studies is that fiscal consolidation is more likely in times of "crisis" than in good times. The initial levels of the fiscal deficit and interest rates are highly significant in explaining when adjustment episodes begin or continue (Figure 10.3). Moreover, fiscal crises are often associated with economic crises. Consolidation is also more likely to be started after large exchange rate depreciation and when inflation is high, and it is more likely to be continued when the real effective exchange rate is weak relative to its long-run average.

Figure 10.3. **Initial fiscal positions and subsequent adjustment**



Note: The budget concept referred to is the cyclically adjusted primary budget balance. The total change during the episode is defined as the value in the last year of the episode minus the value in the year before the start of the episode.

Source: Guichard, Stéphanie, *et al.* (2007), "What Promotes Fiscal Consolidation: OECD Country Experiences", *OECD Economics Department Working Papers*, No. 553, DOI: *http://dx.doi.org/10.1787/180833424370*.

The precise mechanism by which crises generate consolidation is uncertain. It may be a *force majeur*, driven by an unsustainable fiscal stance. Crises also increase public awareness of fiscal problems and thus help in overcoming resistance. The importance of crises for fiscal consolidation is consistent with the reform framework outlined by Alesina, Ardagna and Trebbi (2006) who employ a "war-of-attrition" model to explain why some countries introduce fiscal reform more rapidly and effectively than others. According to this model, political conflict over what type of stabilisation to implement and, in particular, about who will bear the costs, leads to delays in adjustment. Stabilisations occur when exogenous factors intervene to make opposition unsustainable (crises), when one contending faction or another concludes that it will incur even higher costs in the event of further delay than it will if it gives way and accepts a greater share of the costs of stabilisation, or when trade-offs can be designed to resolve distributional conflicts.

The extent of the initial fiscal imbalance is an important determinant of the intensity of the adjustment effort, but this finding is somewhat tautological – fiscal problems are required for there to be fiscal solutions – and of limited policy relevance (engineering calamity is not a politically viable way of inducing reform). However, while a difficult initial situation generally evokes a larger immediate consolidation, it is not always associated with sustained consolidation once the economy begins to improve. There is empirical evidence that a poorer initial fiscal situation actually delays institutional budgetary reforms (Fabrizio and Mody, 2007), and it may be this that makes it harder for countries starting from an initially very weak position to sustain consolidation efforts. Certainly, this finding is consistent with the "war-of-attrition" hypothesis. A country experiencing large fiscal deficits will find it difficult to embark on reforms of the fiscal framework before the budget itself is brought under control, especially where the government is fragmented. It is important in this context to distinguish between the fiscal consolidation process itself and fiscal reforms, which may be desirable to help embed fiscal discipline in the policy process and thus ensure that consolidation gains are not subsequently reversed. The distributional conflicts associated with the immediate consolidation challenge will be hard enough to manage, making it less likely that the authorities will find it easy to move beyond consolidation to real reform of fiscal institutions.

Longer run consolidation processes depend on definitions of fiscal sustainability

While there has been a certain amount of cross-country consistency in the motivation for reducing deficits, the picture with respect to net government debt positions indicates that there have been significant differences in strategic approaches to debt reduction. There was considerable variation in the extent to which OECD economies consolidated their fiscal stances during the period between the mid-1990s, when the OECD area public debt ratio reached its peak, and the onset of the financial crisis (Table 10.1). In 2007, net debt positions (gross financial liabilities minus financial assets) varied substantially among OECD countries, there being a positive correlation between government net debt ratios and underlying fiscal balances, which are constructed so as to eliminate one-off and cyclical factors (Figure 10.4). In 2007, eight countries had both a fiscal surplus and a positive net financial asset position: three Asia-Pacific countries (Australia, Korea and New Zealand), four Nordic countries (Denmark, Finland, Norway and Sweden) and Luxembourg. Once an economy achieves a surplus and/or a net asset position, special political economy problems arise, as surpluses seem to be highly visible and politically vulnerable (Price *et al.*, 2008).

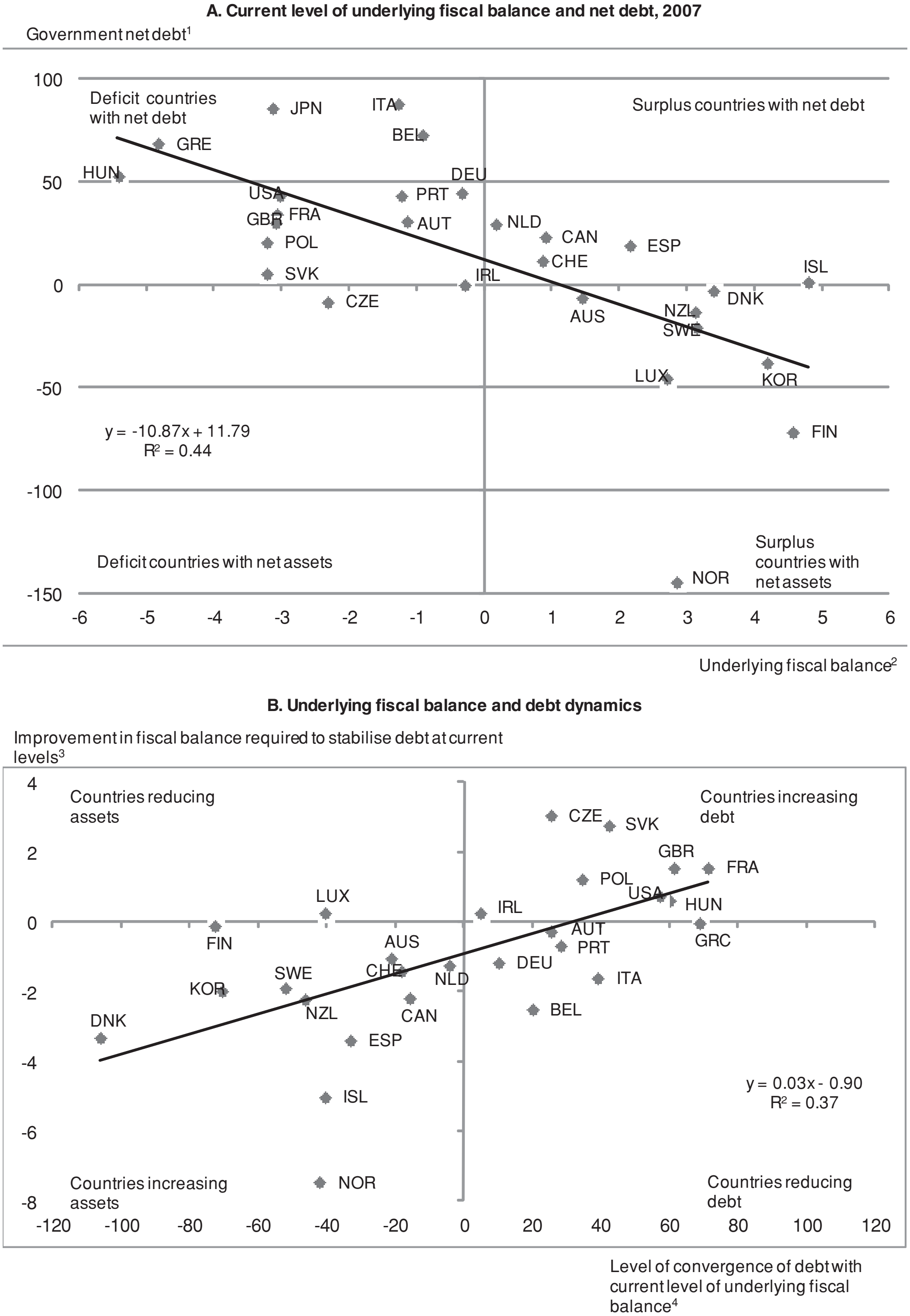
Table 10.1. **Consolidation measured by debt-ratio change and primary balance in OECD countries since 1994**

	Debt ratio		1994-2007		Debt ratio	2007-10	
	1994	2007	Change in debt ratio	Average primary balance	2010	Change in debt ratio	Average primary balance
Australia	40.6	15.3	-25.3	2.2	21.5	6.2	-0.6
Austria	65.4	61.9	-3.5	0.2	79.2	17.3	-0.6
Belgium	137.7	87.7	-50	4.6	106.4	18.7	0.6
Canada	98	64.2	-33.8	2.9	82.0	17.8	-1.9
Denmark	78.9	31.6	-47.3	2.9	51.4	19.8	0.7
Finland	60.8	41.5	-19.3	1.8	52.4	10.9	0.6
France	60.2	69.9	9.7	-0.4	94.2	24.3	-2.7
Germany	46.5	65.5	19	-0.2	84.1	18.6	-0.3
Greece	101.2	103.2	2	1.5	111.8	8.6	-1.2
Hungary	94.3	71.9	-22.4	-1.6	87.1	15.2	-0.4
Iceland	77.3	53.8	-23.5	0.9	108.8	55.0	-5.0
Ireland	62.2	28.3	-33.9	3.1	80.3	52.0	-7.3
Italy	120.9	112.5	-8.4	3.0	127.3	14.8	1.2
Japan	79.4	167.1	87.7	-4.8	199.8	32.7	-4.5
Korea	5	25.7	20.7	2.4	39.3	13.6	-0.2
Netherlands	86.7	51.1	-35.6	1.4	76.6	25.5	-0.6
New Zealand	57.4	26.2	-31.2	3.1	33.4	7.2	-1.0
Norway	37.3	58.4	21.1	7.6	72.3	13.9	9.9
Portugal	68.8	71.1	2.3	-0.4	90.2	19.1	-1.5
Spain	64.3	42.2	-22.1	1.2	68.2	26.0	-4.0
Sweden	82.5	48.4	-34.1	1.4	57.3	8.9	0.3
Switzerland	45.5	48.1	2.6	-0.2	47.8	-0.3	0.3
United Kingdom	46.8	46.9	0.1	0.0	89.3	42.4	-6.6
United States	71.1	62.9	-8.2	0.5	97.5	34.6	-5.7
Euro area	69.1	71.2	2.1	0.9	89.2	18.0	-1.1
OECD	67.8	73.5	5.7	0.1	100.2	26.7	-3.5

Source: Economic Outlook No. 85 database.

Differences as to what constitutes good (or bad) fiscal policy may be responsible for variations in the extent to which OECD economies are consolidated. There is no consensus on, and no accepted theoretical basis for, judging the extent to which a budget position is fiscally sustainable. At its simplest, sustainability can mean debt stability – present or future. Yet even if fiscal parameters are adjusted to the point where the debt ratio will eventually stabilise, there is no guarantee that it can financed without pushing up interest rates and "crowding out" the private sector, generating inflation, or raising tax rates to unsustainable levels.[18] The most operationally influential consolidation objectives have been the 3% deficit rule, as imposed by the Maastricht Treaty, a balanced budget rule, or a balanced budget excluding public investment (the "golden rule"). However, where there are off-budget (present or future) government liabilities, or where government income is dependent on resources which will eventually be depleted, governments may need to follow a surplus rule. The level of the budget balance will eventually determine the debt ratio – under a balanced budget rule, net debt would tend to zero, while a surplus rule would lead to the build-up of net assets. In any given period, governments can maintain completely different – and sustainable – combinations of the two, since views about "optimal government debt" can differ even more than those about debt sustainability (Price *et al.*, 2008).

Figure 10.4. **Correlations between fiscal balances and net debt**



1. In % of GDP.
2. Cyclically adjusted balance excluding one-off and other temporary measures expressed in % of potential GDP.
3. Difference between the 2007 underlying fiscal balance and the level of the fiscal balance which would stabilise debt at the 2007 level, assuming a steady state nominal GDP growth equal to the 2007 potential GDP growth rate.
4. Level to which net government debt would converge in the long run if the level of the underlying deficit were to remain constant in the future.

Source: OECD Economic Outlook 84 database.

During drawn-out retrenchment processes, the pace of consolidation tends to be determined by debt dynamics, which evoke different political economy considerations from discretionary budget cuts, because the process is passive and less politically visible (until surpluses begin to appear). Negative "debt dynamics" arise when governments do not set aside sufficient resources to service their debt and if they do not, debt will expand indefinitely (which is unsustainable). Formally (focusing on the debt-to-GDP ratio rather than debt itself), an unsustainable situation arises when the primary budget balance-to-GDP ratio is insufficient to offset the increase in the debt ratio arising from increasing debt interest, which depends on whether the economic growth rate is above or below the interest rate on government debt. Conversely, with favourable debt dynamics, the debt ratio will reduce automatically. Given the advantageous fast growth/low interest rate environment before the crisis, all but a few OECD countries had achieved an underlying fiscal balance sufficient to stabilise or reduce the net debt ratio (Figure 10.1). In some, including the Nordic countries, Korea and New Zealand, maintaining the underlying surplus at the level than prevailing would have ensured a continued increase in their net asset position to above 40% of GDP, while in Australia, Canada, Spain and Switzerland, the net asset ratio would eventually have reached around 20% of GDP. Such ratios are not an intentional outcome of fiscal policies, of course, and could even cause problems if they were to occur, so countries which have successfully faced important issues as to where to draw the line under the consolidation process (Price *et al.*, 2008).

Factors conditioning the success of consolidation

This section looks at the empirical evidence concerning the factors that impede or facilitate fiscal consolidation and, perhaps more importantly, that make for permanent improvements in fiscal positions. Factors which make for short-run improvements in the primary balance do not necessarily lead to the attainment of longer run deficit/debt equilibrium.

Monetary policy can assist consolidation, but should not encourage excessive optimism

Translating favourable debt dynamics into consolidation is not always easy. Cross-sectional studies confirm the tendency for higher interest costs to promote consolidation of the primary balance and for a lower average interest cost to be offset by a lower intensity of adjustment, as measured by the change in the cyclically adjusted primary balance. The offset may be only partial, in which case there would still be an improvement in the overall budget balance and hence in the debt ratio following a fall in interest payments. However, the cross-section/time series analysis reported in Hercowitz and Strawczynski (2005), which considers a sample of 18 countries over 1980-2003, indicates that a sustained decline in interest payments generates a long-run increase in other expenditure not statistically different from the decline in interest payments: hence, declining debt service do not on average seem to feed through to a reduction in total government spending. Country experiences differ, however. Some of the large consolidation episodes of the 1990s – such as Belgium in 1993-98 and Canada in 1995-97 – were followed by periods where lower primary surpluses gradually offset the decline in interest payments, but the improvement in the overall balance was maintained. In Italy, by contrast, the decline in the primary surplus after the 1995-97 consolidation far exceeded the decline in interest payments reversing a large part of the earlier gains. A similar reversal of earlier consolidations has occurred in France, the United Kingdom and the United States.

The role of monetary policy in supporting consolidation is much debated. It is difficult to get debt dynamics under control in circumstances of tight monetary policy and longer run consolidation would seem to require that monetary policy gradually ease, so as to facilitate growth. Indeed, allowing for the fact that consolidation episodes are more likely to start when monetary policy is tight, Ahrend, Catte and Price (2006a) find that consolidation efforts are more likely to be pursued, *ceteris paribus*, if they are assisted by an easier monetary stance in the early stages of the episode. Lambertini and Taveres (2005) also find some support for the hypothesis that fiscal consolidation is assisted by a simultaneous easing of monetary policy. However, the link is far from mechanical and there are also instances where monetary easing was followed by aborted consolidation efforts: some researchers have found no evidence of a favourable effect (von Hagen and Strauch, 2001). If monetary ease helps consolidation, it must depend on the confidence that consolidation efforts will not be dissipated by using lower interest payments or higher growth-related receipts to raise spending. However, a government's difficulty in delivering such a commitment leaves the potential for a suboptimal outcome, where the monetary authorities, viewing fiscal consolidation plans as insufficiently credible, refrain from offsetting their potential deflationary impact – or at least not until the effects can be seen, which may be too late. Moving from such a "prisoner's dilemma" to a superior outcome may only be possible through some form of commitment mechanism, since explicit collaboration may be ruled out because of central bank autonomy. The extent to which such a commitment can be made credible would seem to depend on the institutional transparency and accountability with which fiscal policy is implemented (see below).

The combination of low interest rates and high growth can be one of the most powerful mechanisms supporting longer run consolidation, leading to substantial and sustained reductions in debt ratios (for example, in the case of Ireland). A degree of caution is warranted, however, insofar as monetary ease can be associated with artificial revenue buoyancy set in train by asset price effects. Ahrend, Catte and Price (2006b) demonstrate that relatively easy monetary policy may be associated with asset price inflation in housing markets in particular. A common characteristic of expansionary consolidation episodes is the presence of strong exogenous wealth effects (de Mello, Kongsrud and Price, 2004). In some circumstances, this can be a sign of economic resilience which can assist consolidation (Catte *et al.*, 2004). However, easy monetary policy can also help to introduce spurious elements into the consolidation process. It can give fiscal policy over-optimistic signals about the strength of potential growth and structural revenues, which can severely undermine consolidation. In those circumstances progress towards fiscal consolidation can be more apparent than real. This appears to have been a factor – though by no means the only one, nor the most important one – in several countries in the run up to the present crisis (OECD, 2009a).

Structural reform can help longer-run consolidation

In the adoption phase, pressure on public finances can stimulate the pursuit of structural reforms, adding a sense of urgency to the reform agenda (Tompson, 2009). However, reforms driven by immediate fiscal needs may also prove harder to sustain once the fiscal pressure has eased, not least because they are often presented as necessary responses to a financial squeeze rather than desirable changes in structural policy settings (Williamson and Haggard, 1994; Tompson, 2009). Indeed, the process of fiscal consolidation may in itself exhaust the political capital available for introducing other reforms (Duval and Elmeskov, 2005). This suggests that relaxing the pace of fiscal consolidation could be beneficial for structural reform and, conversely, the pursuit of reforms in other areas may make fiscal consolidation more difficult.

This is clearly the case in non-crisis situations. If structural reforms are costly in the short run, it often proves necessary to compensate the "losers" of reforms in order to win political support (Høj *et al.*, 2006). Case-study evidence shows that pension reform, in particular, may involve making upfront concessions for longer term gains, which could show up as a deceleration in the current pace of consolidation (Tompson, 2009). In addition, perseverance with structural reform requires that it show results at a relatively early stage, to which fiscal relaxation might contribute. Høj *et al.* (2006) find that fiscal consolidation (an increase in the primary surplus) is associated with a slowdown of labour-market reform, though it does not seem to affect the political economy of product-market reforms (Duval and Elmeskov, 2005). The possibility that reducing the pace of fiscal consolidation may assist reform elsewhere has been explicitly recognised in the revised Stability and Growth Pact (SGP) rules, which allow as an "exceptional circumstance" the budgetary upfront cost of countries' structural reform.

Even if it imposes immediate budgetary costs, structural reform tends to benefit fiscal consolidation in the longer run. In an analysis of 21 OECD countries, van den Noord and Cournède (2006) find that structural reform is associated with significantly lower public expenditure in the longer run.[19] Inflexible structural policy settings, by contrast, are associated with higher levels of spending on social programmes.

Consolidation is more likely to succeed when based on spending restraint

A number of arguments and empirical studies suggest that spending restraint (notably with respect to government consumption and transfers) is more likely to generate lasting fiscal consolidation than a strategy that relies mainly on tax increases (Alesina and Perotti, 1996; Alesina and Ardagna, 1998; Ahrend, Catte and Price, 2006a; Guichard *et al.*, 2007). Von Hagen, Hugues Hallett and Strauch (2002) also find that the likelihood of sustaining consolidation efforts seems to rise when governments tackle politically sensitive items on the budget such as transfers, subsidies and government wages. Both policy and long-term interest rates are more likely to fall when consolidation relies on current expenditure cuts rather than on tax increases, possibly reflecting the effects of the latter on costs and prices (Ahrend, Catte and Price, 2006a). This may be why Giudice, Turini and Veld (2004) find that consolidation episodes based on expenditure cuts rather than revenue increases generally involve far lower costs in terms of output. In non-euro area countries, where consolidation gains have been most persistent, on average half of the consolidation was due to expenditure cuts, half of which related to cuts in capital expenditures. On the other hand, in euro area countries, on average across all consolidation episodes, three-quarters of the adjustment was achieved on the revenue side. The Italian fiscal consolidation during 1994-97 provides an example of an immediately successful consolidation that was not sustained because expenditure restraint played little part (Balassone *et al.*, 2002). The adjustment relied on significant temporary increases in tax revenues and the ratio of primary current outlays to GDP did not change significantly. Its bias towards taxation made the carrying forward of consolidation gains difficult once the goal of EMU entry was achieved. The primary surplus started to shrink after entry.

The fact that expenditure cuts tend to have a more lasting consolidation impact than taxes may be related to the positive effects that they can have on overall activity by facilitating the take-up of freed resources by the private sector. Cuts in current expenditures may also show greater commitment and government cohesion, which makes substantial consolidation more feasible – especially in terms of being able to resist relaxation in primary spending as interest costs fall (Alesina and Perotti, 1996). It may also reflect the fact that consolidation measures are more closely targeted on correcting the biases that caused the debt build-up in the first place, especially where adjustment is characterised by cuts in transfers and the wage bill (von Hagen and Strauch, 2001). Consolidation via spending cuts tends to involve changes to contractual elements that pay longer run dividends once new manpower and remuneration practices are locked in. Alternatively, tax measures are often marketed as temporary or one-off expedients (as in the Italian case mentioned earlier).

There is an important link between public sector downsizing and the pursuit of efficiency gains, which may also make expenditure cuts more sustainable than tax increases. Faced with rigid expenditures and too high taxes, consolidation has come to rely quite heavily on improvements in public sector efficiency to make savings. This is an area which is rather easy to sell to the public, though less easy to implement in practice. Progress towards identifying the factors that make for higher public sector efficiency is so far very partial. However, there are rather large differences in the ratio of outcomes to inputs among OECD economies in those sectors where benchmarking is possible (mainly education and health), offering the possibility of substantial reduction in inputs for given outputs in many cases (Sutherland and Price, 2007; Joumard *et al.*, 2008). The involvement of sub-central tiers of government in the rationalisation process also seems to make consolidations successful, helping in implementing cuts in expenditure and, in particular, the wage bill (Derby, Muscatelli and Roy, 2005). It may also be useful because sub-central governments are often better placed to identify cost-effective measures that suit the local electorate.

Embedding fiscal discipline: the role of rules and institutions

Fiscal rules can help to impose discipline

Fiscal rules have been central to the search for fiscal discipline. The number of fiscal rules in force has increased continuously over the last 15 years, especially within the European Union (Ayuso-i-Casala *et al.*, 2007). In the early 1990s, most numerical fiscal rules were applied at the local or regional level and were designed to prevent spillover effects which might affect aggregate fiscal objectives (Sutherland, Price and Joumard, 2005). Latterly, however, fiscal rules applying to the central government sector have increased considerably; the Maastricht Treaty and the SGP having been particular catalysts for their introduction, because of the incentives monetary union gives for national governments to defect from financial discipline.[20] Budget balance and debt rules are the most widespread, but expenditure rules are the most commonly applied at the central level (Box 10.2).

Box 10.2. **The uses of fiscal rules**

There is a great deal of variety in the design of fiscal rules, with respect both to the coverage of the rule and process by which it is implemented. The following characteristics apply to EU countries, as reported in questionnaire responses in Ayuso-i-Casala *et al.* (2007).

Coverage of rules

Budget-balance and debt rules are most frequent. Fiscal rules can be applied, individually or in combination, to budget deficits, debt, public spending and taxation. About one-third of the numerical rules currently in force in EU countries are budget-balance rules and about one-quarter are rules imposing restrictions on borrowing and debt; most of these rules are applied at regional and local levels. A few budget-balance rules at the national level are defined in cyclically adjusted terms.

Expenditure rules are most used at the national level. Expenditure rules are applied in a further quarter of EU countries and these mainly apply to the central government and social security sub-sectors. About two-thirds of expenditure rules define ceilings for levels or growth rates in nominal terms, the remainder being defined in real terms.

Revenue rules are infrequent. No countries apply a rule limiting the tax burden as a percent of GDP; the most commonly used revenue rule, which applies to only a small number of EU economies, concerns pre-defined principles for the allocation of higher-than-expected revenues.

Process of implementation

Central government rules have a longer time horizon. Rules applied at the regional and local level tend to be annual, while those applying to general and central governments are usually integrated into a multi-annual framework.

The legal status of rules differs. Rules applying to sub-national levels are enshrined in law or the constitution, while rules concerning higher levels of government are based more on political commitments.

Correction and enforcement mechanisms differ. The majority of local and regional government rules foresee either automatic correction mechanisms or the obligation to adopt measures in cases of non-compliance. Most central government rules do not include *ex ante* defined actions in the case of divergence.

Because of the heterogeneity of the rules applied, their contribution to consolidation is difficult to quantify. However, Guichard *et al.* (2007) find that a combination of cyclically adjusted budget-balance and expenditure rules seems to have been most successful in assisting consolidation. Certain episodes stand out and may have a particular weight in this finding. Under the US Budget Enforcement Act (1990-2002), stringent caps on discretionary spending and "pay-as-you-go" financing restrictions on entitlement outlays helped lock in the revenue surprise of the late 1990s until passage of the tax cut in 2001.[21] Those EU countries which enjoyed some of the largest government debt/GDP declines, such as Finland, the Netherlands and Sweden, have supplemented the SGP deficit rules with national rules, including expenditure ceilings. Using more extensive survey data, among EU countries Ayuso-i-Casala *et al.* (2007) find that higher values of a synthetic fiscal rule index and the coverage (in terms of share) of government sectors by an expenditure rule are robustly associated with a better primary cyclically adjusted balance and with lower primary government expenditure.

Certain features of expenditure rules may contribute to their success. One advantage is that they allow spending ministers/ministries to be held accountable (Atkinson and van den Noord, 2001), and they make the availability of financial resources predictable for policy makers and programme managers, factors that are less clear under deficit rules alone. The presence of a strong enforcement mechanism is important, both with respect to the independence of the body monitoring the rule and the authority responsible for enforcement (Ayuso-i-Casala *et al.,* 2007). Some countries have been more involved in this process than others: countries that delegate budget authority to the finance minister to ensure compliance with budget norms use rules less often than those who need rules to create cohesion among more independent-minded participating members of a budget process.[22] Indeed, government fragmentation appears to be a significant stimulus to tighter and more encompassing fiscal rules, which are a convenient way of circumventing the need for continuous negotiations among coalition partners (Debrun and Kumar, 2007a).

Commitment and transparency are needed for rules to succeed

Since the effectiveness of fiscal rules cannot be meaningfully evaluated in isolation from the institutional context in which they are applied, some controversy exists over the impact of rules *per se*. Their effectiveness may reflect the preferences of dominant constituencies for a certain course of action (Posen, 1995). It may also depend on the efficiency of other institutional factors as much as the discipline imposed by the rule itself (Wyplosz, 2005; von Hagen, 2006). There are several cases in which successful rules followed the set-up of new budgeting frameworks and changes to public sector management that fostered increased accountability and efficiency (Australia, New Zealand, Sweden). More generally, it has been argued that rules *per se* reflect, rather than create, the motivation towards fiscal discipline. Indeed, rules may lack credibility unless they are accompanied by a commitment to complete budget transparency (Debrun and Kumar, 2007b). Given budget transparency, accountable governments may even use rules and institutions as signalling devices of their fiscal competence: rules may be as much linked to good performance as good performance to rules. With incomplete transparency, governments may also set up rules as signalling devices, but their impact will not be as great.

A problem with rules that do not reflect real commitment is that they may encourage attempts to circumvent them, which resurrects the original problem of political opportunism. The literature on the subject suggests that the imposition of numerical fiscal rules may encourage recourse to fiscal gimmicks, by which governments shift from overt to hidden forms of borrowing, such as accelerating the collection of future tax liabilities, forcing public pension schemes to lend to the government at favourable rates, etc. The European experience over the past decade shows that such gimmicks come in many different guises, but that when deficit rules or, to a lesser extent, debt thresholds tend to become more binding, recourse to gimmicks is more likely (Koen and van den Noord, 2005). In practice, national administrations will seek, and are likely to find, ways to obfuscate and circumvent fiscal restraints if doing so serves their own interest. Fiscal rules may not prove resilient to political interference.

Some governments have responded by excluding some capital items from the overall spending subject to debt limits, as is the case with the "golden rule". However, many of the problems with opportunistic political behaviour have related, historically, to the budgetary obfuscation entailed in distinguishing between above- and below-the line spending. Accounting conventions usually leave significant room for judgment as to what is investment, which governments may be tempted to exploit, especially when fiscal rules bite. Operational and definitional problems are hard to overcome. The UK golden rule was not proof against the recent debt explosion, and if the targets are too loose and make an exception for public investment, policy makers may try to push all kinds of so-called "investment projects" with dubious financial returns under this heading. In practice, this may make the rule more difficult to monitor as well as easier to circumvent (Fatás, 2005). Germany, which was long one of the main exponents of such a rule, has recently abandoned it (see Baumann and Kastrop, 2007 for a discussion of the reasons), while Belgium, Netherlands and Sweden have all given up the golden rule.

Rules need to prevent budget errors in cyclical upturns

Of all the problems rules have had to deal with, perhaps the most difficult has been ensuring that revenues generated during cyclical upturns are not used to finance spending or tax give-aways. It was noted earlier that that has been one of the most important contributors to deficit bias. Balanced budget rules, or rules targeting a particular level of budget balance (such as the early SGP) automatically incorporate the property that cyclically high revenues may be spent. Part of the answer is to set budget rules in cyclically adjusted terms, as is now the case with the SGP, but even that may not be sufficient protection against the misuse of windfall gains where potential GDP and the structural balance are overestimated, as has occurred recently, for example, in Ireland (OECD, 2009a). Where the budget fails to distinguish between temporary and permanent revenues, the structural budget can be biased towards surplus, though in actual structural deficit.

One of the benefits of expenditure rules is that a nominal cap on expenditure growth may act to prevent a pro-cyclical upward drift in spending during expansions, allowing revenue buoyancy to be used to pay down debt (Anderson and Minarik, 2006). However, such an approach is not proof against optimistic planning assumptions. Avoiding pro-cyclical expenditure drift requires a cautious approach that excludes volatile revenue sources and ensures that surpluses are saved. In the case of the Netherlands, for example, the cyclically adjusted budget balance and expenditure rules were combined with deliberately cautious macroeconomic assumptions, while incentives and cost-benefit analysis were used for controlling, managing and reorganising public expenditures, underscoring the importance of robustness with respect to shocks and of efficiency considerations in the consolidation process.

Independent fiscal institutions can reduce deficit bias

The spread of fiscal rules has been associated with the expansion of independent fiscal institutions, the underlying rationale for which is that specific tasks of fiscal policy should be delegated to bodies that are less likely to be affected by distorted incentives (see, for example, Hemming and Kell, 2001). The argument is analogous to that used to establish central bank independence. However, the arguments do not carry over automatically, as fiscal policy objectives are more diverse and affect welfare more widely and discriminatingly than monetary policy objectives. For this reason, proponents propose handing over only certain budget functions.

In the European Union, independent fiscal institutions have a long history and perform a variety of functions (European Commission, 2009).[23] Debrun and Kumar (2007a) find that there is a strong relationship between the *de jure* influence exerted by non-partisan agencies ("fiscal councils") and their impact on fiscal performance, especially where there are formal guarantees of independence. The presence of fiscal councils appears to contribute both to the emergence of fiscal rules and to their effective enforcement. Again, it is difficult to distinguish between the hypotheses that such institutions are devices to demonstrate government commitment or that they are put in place to ensure discretionary budget discipline. Whatever the case, such institutions tend to exist where there are lower levels of transparency, so they may play an important signalling role, resulting in lower deficit bias.

One area in which independent institutions may be of particular value is with respect to pro-cyclical budgeting. Some countries, as noted earlier, have established revenue rules to deal with the problem, which govern what should be done with revenue surprises. However, while this may help with tax smoothing, public expenditure, once it is set on a medium-term course may be difficult to alter when medium-term growth assumptions change. This suggests that some technocratic functions, such as estimating the long-run elasticities of revenue and growth rates of potential could be delegated to an independent body or at least subjected to independent scrutiny, since a medium-term, input-oriented focus may not by itself be enough to prevent political interference from diverting fiscal stance from a sustainable path. One of the most notable recent examples in this regard is the creation of a Fiscal Policy Council in Sweden (Box 10.3).

Box 10.3. **The Swedish framework: rules and institutions**

Beginning in the mid-1990s, Sweden engineered an improvement in the cyclically adjusted budget balance of around 11.7% of GDP over seven years; the gross public debt-to-GDP ratio (Maastricht definition) fell by almost 35 percentage points over a decade. In order to ensure that the benefits of this dramatic and difficult consolidation process were not subsequently lost, the authorities have since adhered to a rules-based framework supported by all the major parties. Its core elements include: (i) a cylically adjusted surplus target for general government finances, designed to reflect the need to prepare for long-term population ageing; (ii) multi-year nominal expenditure ceilings for the central government covering all spending except interest; and (iii) a balance requirement for local governments. This framework is not anchored in legislation. It is founded on a political commitment, reinforced by strong expectations from outside observers (Ljungman, 2008).

The Fiscal Policy Council (Finanspolitiska rådet) is an independent agency created to strengthen the rules-based fiscal framework. It has been operational since August 2007. Its eight members are appointed by the government for three years. They are mostly academic economists, but former policy makers are also included. The council typically reports to government once a year during pre-budget discussions. It focuses on: (i) the degree to which the government's budget proposals are consistent with long-term fiscal sustainability, the budget surplus target and the multi-annual expenditure ceiling; (ii) alignment of policy objectives; (iii) how well budget documents explain and justify the fiscal policy stance; and (iv) the quality of forecasts and the models used to generate them.

As noted, budget deficit goals have been more ambitious in some OECD economies and some have even aimed to run surpluses. However, this takes the political economy debate into particularly difficult territory. On the one hand, governments have found it especially difficult to convince populations of the need to pre-fund at least some future social service liabilities – especially pensions – which need to be part of the tax-smoothing process when demographics are expected to push up future government spending. Balancing the need to reform pension parameters, such as the retirement age, against that of building up assets to meet future liabilities involves especially difficult choices. Running surpluses in anticipation of future deficit increases, however, creates political economy problems of its own. Surpluses typically imply that the authorities come under pressure to spend more and tax less. Running surpluses to repay debt is unpopular, as the electorate usually does not appreciate being taxed to cover the cost of past spending programmes. Running primary surpluses to pre-fund future expenditure commitments can be equally unpopular because the people who may benefit are not necessarily the ones who pay. Surpluses may thus be a political problem, encouraging unsustainable current spending or tax cuts (the inverse of the "starve the beast" principle discussed earlier).

A minority of OECD countries have built Sovereign and Public Pension Reserve Funds (SPFs) to finance at least part of the implicit liabilities stemming from pay-as-you-go public pension schemes. Differences about the desirable degree of prefunding obviously account for much of the actual variation in net indebtedness among OECD economies (Combley and McKissack, 2005).[24] Countries whose revenues are sensitive to terms-of-trade changes (such as Mexico and Norway) have also found it useful to establish stabilisation funds to deal with the windfall gains. Deliberate pre-funding strategies may be firewalled to some extent where assets are bought with the contributions to a pension plan and with members having a legal right or contractual claim against these assets. However, funds are always fungible to some extent, and political interference may lead to the use of dedicated funds to "invest" in government bonds during downturns (OECD, 2009a). Particular problems arise where surpluses are unanticipated, and not the result of deliberate decisions to prefund, since these often prove to be the source of pro-cyclical budgeting.

Even where there are formal safeguards against spending surpluses, political economy problems can arise, because the way they are invested can lead to political interventionism. Investing surplus assets in privately issued securities could impose large deadweight losses on the economy because it creates incentives for private firms to lobby for public investments and the temptation for political intervention in the allocation of funds could increase. Alternatively, if the assets accumulate with the central bank it may jeopardise its independence, as noted above. An approach is thus needed that avoids the deadweight losses from private lobbying and inefficient investment of surpluses and ensures the diversification of funds across marketable assets.

Conclusion: fiscal consolidation prior to, and in the wake of, the financial crisis

Deficit bias is real and will not be corrected by the markets alone…

The discussion in this chapter leads to a number of conclusions about the political economy challenges involved in fiscal consolidation, at least prior to the financial crisis:

- Politically-induced deficit bias is marked and related to particular characteristics of governance institutions. This may be a partial explanation of differences in budgetary situations in OECD economies. In particular, deficit bias is related to government fragmentation and government stability (electoral uncertainty) which contribute, if left uncorrected, to a political business cycle.

- The private sector is partially aware of the deficit bias and responds by saving more in anticipation of future budget corrections; however, it appears that deficits only impinge on saving behaviour when they pass a certain threshold. There is evidence of self-interested indifference to debt accumulation on the part of many agents.

- Financial markets do sometimes exercise discipline on governments – particularly when deficits become unsustainable – but their influence on government borrowing has often been too benign.

- Fiscal crises have often been needed to prompt consolidation episodes; however, fiscal crises are not the best times to embark on longer run budgetary reforms, because they exacerbate distributional conflicts.

...and requires a policy response involving informational transparency and effective institutions

The analysis of more, and less, successful consolidations points to some lessons about the kind of policy mix best suited to supporting sustained fiscal adjustment:

- Ensuring that consolidations are lasting requires some assistance from monetary policy, via the beneficial impact on potential growth; however, monetary policy independence needs to be preserved to ensure the longer run credibility of the consolidation process.
- Consolidation based on expenditure cuts is more likely to endure than adjustment based on tax increases, and is also likely to impose lower costs in terms of output. Relying primarily on tax increases to consolidate appears to be detrimental to longer run consolidation gains.
- The empirical studies show that failed consolidations usually result from a breakdown of spending discipline. This points to the need for structural cuts in expenditure that address the underlying causes of over-spending, rather than simply relying on *ad hoc* measures such as postponement of public investment or temporary freezes on certain expenditure items.
- Fiscal relaxation can help structural reform in the short run, which may impede short-run fiscal consolidation; however, the longer run effects of structural reform on growth and employment assists fiscal adjustment in the longer term.

It is likely to be far easier to sustain such an approach where fiscal rules and institutions are supportive of consolidation. Fiscal rules may help overcome some of the problems of fiscal bias, but they can also be used as "smokescreen" devices and can be circumvented, via creative accounting. The quality of fiscal rules and their institutional settings thus matters enormously:

- Fiscal transparency is crucial: greater transparency facilitates effective monitoring and enforcement of fiscal rules. It also makes it easier for policy makers to explain the need for consolidation to the electorate.
- The most effective combination of rules appears to include both multi-year nominal expenditure ceilings and an explicit, cyclically adjusted budget-balance target.
- Rules may need to be supported by new fiscal institutions. There has been an expansion of independent fiscal institutions in recent years, designed to compensate for built-in deficit bias. These may be particularly helpful in controlling the tendency for spending to rise in response to unexpected revenue buoyancy.

International institutions have a role to play in fostering fiscal consolidation and reform

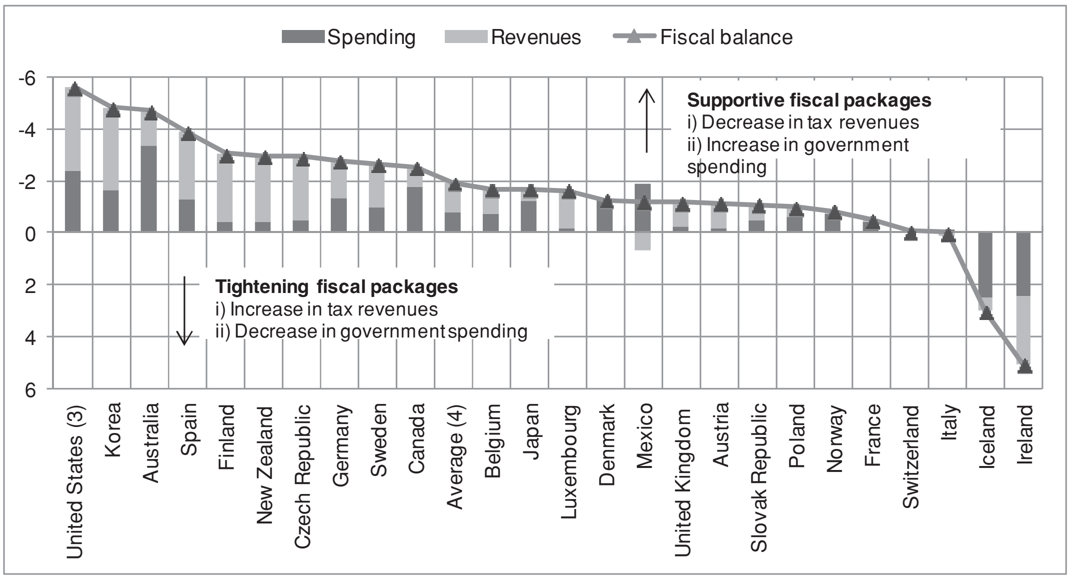
As noted earlier, it is useful at times to distinguish between consolidation and the reform of fiscal institutions such as budgetary processes, fiscal rules and the activities of fiscal oversight bodies. The role of international and supra-national institutions in consolidation is often linked to some form of "strong" conditionality – International Monetary Fund (IMF) programmes or the European Union's application of the Maastricht Treaty's criteria for participation in Economic and Monetary Union (EMU). The experiences of many OECD members confirm the impact that such conditionality can have on policy, but fiscal slippage has often followed once the conditions have ceased to constrain policy makers. If the hard-won gains of a consolidation effort are to be sustained over the long term, a reform of fiscal institutions may be needed. Yet such institutional change cannot be imposed with the same kind of hard conditionality as an IMF programme or the EMU entry criteria. For institutional reforms to work, governments must take ownership of them. Consequently, the role of international institutions in respect of such reforms relies much more on "soft" methods of co-ordination – on education, the exchange of experiences among policy makers and, to some extent, peer pressure to adopt "best practice" in various fields. Many of the activities of the European Commission fall within this domain, as does the work of the OECD, with its "best practices for budgetary transparency" and other work on budgeting processes, as well as the growing focus on fiscal institutions in the context of country reviews in the OECD Economic and Development Review Committee.

What has changed with the financial crisis?

With the financial crisis and the subsequent recession, OECD countries find themselves in a position where the consolidation lessons of the past need to be reappraised and/or adapted to new circumstances. Perhaps the most notable departure from the previous orthodoxy has been the espousal of sizeable discretionary fiscal stimuli as a response to the crisis (Figure 10.5). This is to be interpreted as a response to the severity of the crisis, but it creates challenges in terms of its eventual withdrawal which has proved problematic in the past. The emphasis has been on "timely and temporary" interventions, but where spending has continued on its pre-crisis path but potential output has declined, the structural spending ratio will have risen and structural deficits increased. In several countries, debt trends are such that even the mildest sustainability criterion will not be achieved without discretionary action, and future sustainability crises cannot be ruled out. Experience shows that expenditure cuts are the most viable means of medium-term consolidation, allied to measures to improve public sector efficiency. However, implementation will involve severe problems of political economy. The size of the necessary future fiscal adjustment will exceed that of past consolidation episodes for some economies.

Figure 10.5. **Fiscal responses to the economic downturn**

Impact of fiscal packages over 2008-10 on fiscal balances as % of 2008 GDP[1,2]



1. As measured by the cumulated deviations of fiscal balances, tax revenues and/or government spending, compared with a "no-action" scenario. Estimations provided here do not include the potential impact on financial balances of recapitalisation, guarantees or other financial operations.

2. Only 2009 data are available for Iceland, Luxembourg, Mexico and Norway. They are expressed in % of 2009 GDP.

3. Figures for the United States refer to the federal government. Available information indicates that a few states, including California, have passed restrictive fiscal measures which are not included here. Figures are based on the 2008 Economic Stimulus Act, the 2008 Emergency Extended Unemployed Compensation Act, the 2008 FHA Housing Stabilization and Homeownership Retention Act and the 2009 American and Reinvestment Act. Note that some of these measures, especially the USD 787 billion package signed into law on 17 February 2009 by President Obama, will be only partly spent by the end of 2010.

Source: OECD Economic Outlook 85 database.

A number of factors will aggravate the difficulty of consolidating. Interest rates on government debt are currently low, and if they were to stay low while growth picked up, debt dynamics would be favourable. However, monetary policy may well have to turn towards restraint rather than to assist consolidation, both globally and, especially, in those countries that have experienced substantial quantitative easing. At the same time, the synchronisation of post-crisis consolidation will complicate its implementation. Usually, smaller open economies face fewer costs in consolidating because of the relatively high import-content of supplies, but this benign situation will not hold when the OECD area at large is consolidating. That may not augur well for the peer pressure on which the momentum to consolidate will depend, since countries could see delayed adjustment in trading partners as being to their own advantage.

Fiscal rules and institutions will need to be reappraised. Against this background of discretionary fiscal policy once more being used as a stabilising device, the possibilities for opportunistic fiscal behaviour would seem to have risen, while the difficulties of maintaining transparency have increased. The role for fiscal rules and autonomous fiscal bodies would thus seem set to expand. However, the crisis itself has called the operation of rules into question. In some cases, the political urgency for discretionary action has led to their effective abandonment. To some, this would appear to be a vindication of the view that there will always be circumstances where scrapping rules will be preferable to enforcing them, creating a serious credibility problem that will affect future attitudes to rules. Before the crisis, fiscal rules also failed, in some cases, both to prevent the over-estimation of structural budget balances and to prevent cyclical revenue windfalls from being spent. In terms of political economy, an institutional means will need to be found whereby revenue overshoots are saved rather than spent.

Notes

1. This political economy literature has a long lineage, going back to Ricardo. Alesina and Perotti (1995) review the contributions to the debate in the 1980s and early 1990s; a survey of subsequent research and discussion is provided by Eslava (2006).
2. See also Ballabriga and Martinez-Mongay (2003)who show that for the European Monetary Union (EMU) countries during 1979-98, indebtedness is associated with greater pro-cyclicality.
3. The most conspicuous examples of such a strategy are provided by the Reagan and G.W. Bush tax cuts, which were based on the argument that the most effective way to contain government spending is to "starve the beast" by reducing taxes and increasing deficits.
4. The indicators of political cohesion are based on the World Bank's Political Institutions database.
5. Proportional elections induce politicians to seek support from a wider range of the electorate via broad spending programmes, favouring spending on social transfers under such a regime.
6. The data set covers 60 countries over 40 years. Primary spending, and in particular spending on transfers to individual and households, tends to rise more in response to macroeconomic shocks in countries with more proportional electoral systems (Milesi-Ferretti *et al.* 2002).
7. New Zealand pioneered a more formal approach to fiscal transparency with its Fiscal Responsibility Act. Australia followed with its Charter of Budget Honesty in 1998, which also saw the publication of the IMF Code of Good Practices on Fiscal Transparency.
8. It is also relevant in this context that the United States has the weakest automatic stabilisers and thus a greater need, *ceteris paribus*, for discretionary fiscal policy.
9. Among the episodes of fiscal consolidation identified in the European Union in the three decades studied, around half have been expansionary. Those which have proved expansionary have generally been based on expenditure cuts.

10. Kinari and Shibamoto (2007) find that an increase in government expenditure causes a decrease in private consumption when the government debt-to-GDP ratio is high, whereas when the ratio is low, it has a positive effect. In Japan, an increase in government expenditure had a Keynesian effect before around 1998, but after that, it had a non-Keynesian effect.

11. For a retrospective discussion, see Middleton (1997). The idea that that the tax rate can reach a point where revenue begins to fall and becomes zero again can be traced to the 19th century French economist Dupuit.

12. It had become clear "that the real social progress we can achieve is limited by economic means, that methods of achieving social objectives should not be allowed to undermine the economic system which produces the means; and that we live in societies based on the principle that individual consumers are, in the main, the ultimate arbiters for allocating means to ends." (OECD, 1981)

13. The critical assumption here is that the marginal excess burden of taxation increases with the square of the tax rate (a proposition noted in OECD, 1989). This means that the net efficiency gain from substituting tax for debt finance is likely to become negative at some point as the tax burden rises, depending on whether the debt ratio is stable.

14. The concept of the inflation tax is closely related to that of seignorage, where governments can finance part of their borrowing needs by issuing base money; the amounts raised via seignorage have sometimes been quite large in the past (Fisher, 1982). Seignorage and the inflation tax are often viewed as equivalent, at least in the long run, where inflation grows proportionally to base money.

15. Increasing the debt level would add four basis points to the bond rate according to Laubach, which would translate (depending on the pace at which debt is rolled over) into an increase in the debt burden of 0.25% of GDP where the debt ratio is 60%.

16. Research with respect to industrial economies in the 1980-2004 period finds that rising government debt and high current account deficits tend to be important ingredients in currency "crashes" (Gagnon, 2005).

17. According to the study, a fiscal consolidation episode: (i) starts if the cyclically adjusted primary balance (CAPB) improves by at least one percentage point of potential GDP in one year or in two consecutive years with at least ½ percentage point improvement occurring in the first of the two years; (ii) continues as long as the CAPB improves (an interruption is allowed without terminating the episode as long as the deterioration of the CAPB does not exceed 0.3% of GDP and is more than offset in the following year [by an improvement of at least 0.5 % of GDP]); (iii) terminates if the CAPB stops increasing or if the CAPB improves by less than 0.2% of GDP in one year and then deteriorates.

18. Under the Bretton Woods system (of fixed exchange rates), sustainability usually showed up in imbalances on the external side, before people could become concerned about public debt. With the adoption of floating exchange rates, from the early 1970s, fiscal sustainability problems emerged in the form of accelerating inflation control. Since expanding budget deficits were financed by money creation, the tax gap was filled by an "inflation tax", which was effective in reducing debt even though recorded deficits were high.

19. The positive association between structural policies and fiscal consolidation may also reflect consistency in social choices, as well as causality.

20. While targets under the Stability and Convergence Programmes are formulated according to standardised rules, how states achieve those targets depends on national rules relating to budget planning, implementation, evaluation and parliamentary involvement, which makes for a great deal of heterogeneity in the application of rules (Hallerberg, Strauch and von Hagen, 2001).

21. Again, external conditions may help or hinder: in this case, lower defence spending may have been a safety valve, since non-defence spending continued to grow.

22. See Hallerberg and von Hagen (1999) for a discussion of the coverage of the two types of systems within the European Union.

23. In 2005, 13 among the EU15 had such institutions, some issuing normative recommendations, others fiscal and economic forecasts, though only 4 member states relied on independent fiscal institutions for budget preparations and medium-term planning.

24. Countries with "strong" prefunding have slightly higher expected increases in pensions (around one percentage point of GDP between 2000 and 2050) than the OECD average and higher initial tax-to-GDP ratios, consistent with policy motivated by the desire to improve efficiency by tax smoothing.

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