2. 'Don't waste the crisis': the agenda for public-policy reforms in a turbulent world

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A number of Organisation for Economic Cooperation and Development (OECD) member governments told us during the early 2000s that effective policy making was not only about 'where to go', but also about 'how to get there'. We heard ministers ask 'how to reform and to be re-elected' and 'how to reform and perform'. Almost all OECD countries face medium and long-term structural challenges in the context of global imbalances, economic recalibration, climate change, population ageing, and so on. On the other hand, these governments 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. In 2007, the OECD started a horizontal project to look systematically at the political economy of reform across our committees and our Centres of Government working group, which resulted in our 300-page report *Making Reform Happen*.

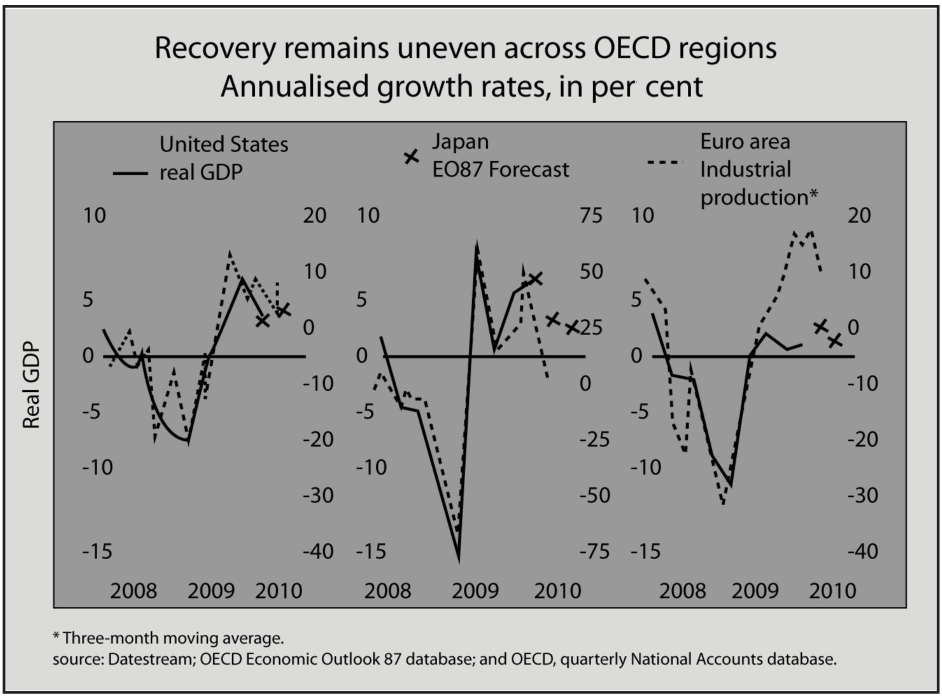
In this chapter I will draw on and update some of the findings in our study, which will be released in 2011. We need to have an understanding of past reform experiences that might be of use to policy makers seeking to design, adopt and implement reforms in the years to come. The value of such reform lessons is all the greater in the post-global financial and economic crisis environment. As OECD governments confront the challenge of trying to restore public finances without undermining a recovery that in many areas might 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 appropriate policy mixes will require the identification of effective reforms and strategies for implementing them. To put it bluntly, the present crisis is a terrible thing to waste.

This chapter will first provide an update about our current position in the global economic climate—a necessary prerequisite for understanding the case for structural reforms. It will next explore some areas of structural reform, and, in the process, discuss some of the challenges to successfully implementing public-policy reform. These will be based on my own personal experiences in the Netherlands, but also, principally, on the experience of the OECD in executing reforms in different areas. The chapter will conclude with some lessons for making policy reforms effective and durable.

The global economic climate

The OECD nations currently find themselves trying to reconcile economic recovery with the demands of fiscal consolidation and budgetary repair. The recovery of the global economy is fast gathering pace—a recovery led by the emerging Asian market economies. We observe that the Asian markets are the fastest-growing economies, and that they accelerate world trade. But we also observe that in many of the OECD countries fiscal consolidation is a serious issue, and consequently, these countries still grapple with huge unemployment.

Concerning the global recovery, as Figure 2.1 suggests, the United States has recovered from the recession in 2008–09 to an initial growth rate of 5 per cent, before dropping back to about 4 per cent. Clearly, the growth peak in the second half of 2009 was also due to the huge stimulus package in the United States. Japan saw an even deeper recession but is now relatively stable in its economic recovery. The euro area also experienced a recession and is now recording only a very modest recovery due to factors this chapter will discuss later. As for Australia—currently growing at about 3 per cent—it managed to avoid a recession thanks in part to being closely related to the economies of the emerging Asian markets.



* Three-month moving average.
source: Datestream; OECD Economic Outlook 87 database; and OECD, quarterly National Accounts database.

Figure 2.1

If we focus on the emerging economies in terms of their industrial production (their production rates as opposed to growth rates), it is interesting that countries such as China and India did not go below zero in terms of industrial production. Rather, their industrial production continued almost unabated—and this is one of the reasons Australia could continue to export to countries such as China, where demand did not fall too low. Even Brazil, which suffered significantly from the US economic downturn, has recovered to the point that, in industrial-production terms, it is one of the fastest-growing economies. Throughout the OECD, industrial production has recovered from its dip in 2008–09.

It is not surprising to learn (as shown in Figure 2.2) that while industrial production in the emerging economies at first increased in very buoyant terms, it is now starting to slow. This reflects the wearing off of the speed of recovery and whatever fiscal stimulus packages were injected into these economies. And yet, in spite of this small slowdown, the growth rate of these emerging economies remains strong. For example, in 2010 China was growing at 10 per cent, India at 8 per cent, Indonesia at 6 per cent, and Brazil at 5 per cent. Russia is an interesting case because its economy is heavily reliant on its energy sector, but as with the others it has recovered strongly—in its case, from a 2009 recession of –8 per cent to a current growth rate of +5 per cent.

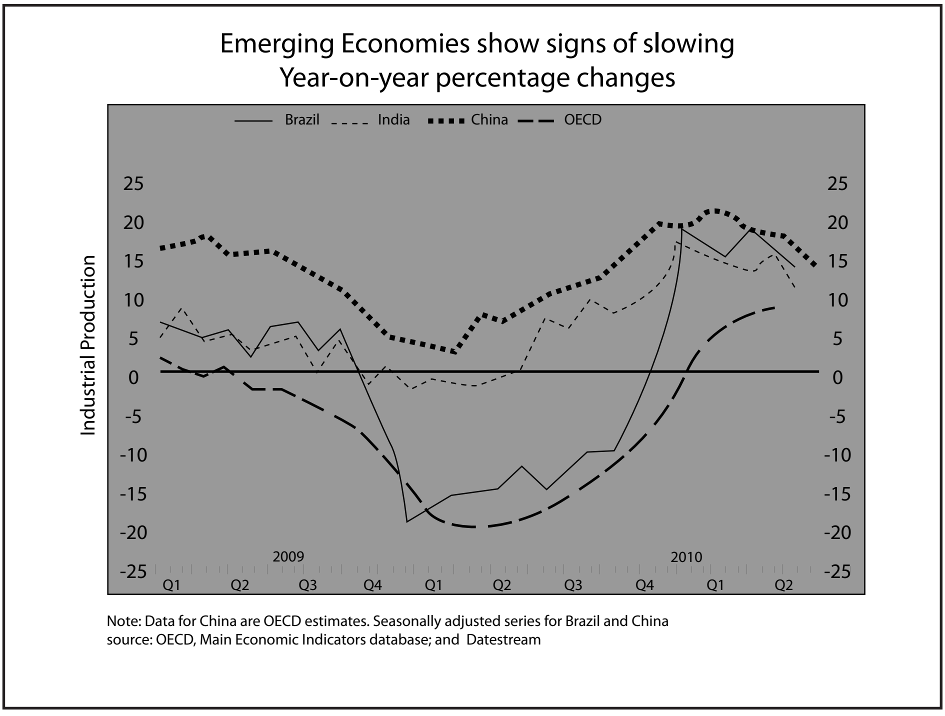


Figure 2.2

China and Brazil have already started to withdraw their policy stimuli, so naturally their growth will subsequently begin to slow. But they have been able to withdraw the stimulus only because their growth is sufficiently strong enough to support such a move. Other nations must follow their lead. Solid growth supports the expansion of global trade, and that is of course critical to the entire world. One need only consider that between the fourth quarter of 2009 and the first quarter of 2010, global trade grew at 5 per cent. According to the OECD's *Economic Outlook* of May 2010, future gross domestic product (GDP) growth in the United States, the European Union and Japan up to 2025 will be relatively modest, hovering between 1 and 3 per cent per annum. This stands in contrast with China, Indonesia and India, which are predicted to grow at a much faster pace—growth that Australia will benefit from over the next 10–15 years.

Now consider Europe. First, there is serious concern about Greece and its levels of indebtedness. The difference between Greek sovereign bonds and German ones—the latter essentially the standard in Europe—is currently growing at up to 8 per cent (as shown in Figure 2.3). In May, June and July, for example, we saw much higher figures for this than in 2007 and 2009. Portugal and Ireland are now also of some concern. Spain and Italy have been scrutinised in the media, but one cannot say a difference of 3 per cent to the German spreads is a reason to panic for these countries. There is, however, a need for fiscal consolidation, and this is related to the fact that all these countries have both a huge budget deficit and very high public (and private) debt. In Australia, the current deficit is about 5 per cent of GDP, but in the United States and the European Union the deficit is about 10 per cent of GDP—a very high figure indeed.

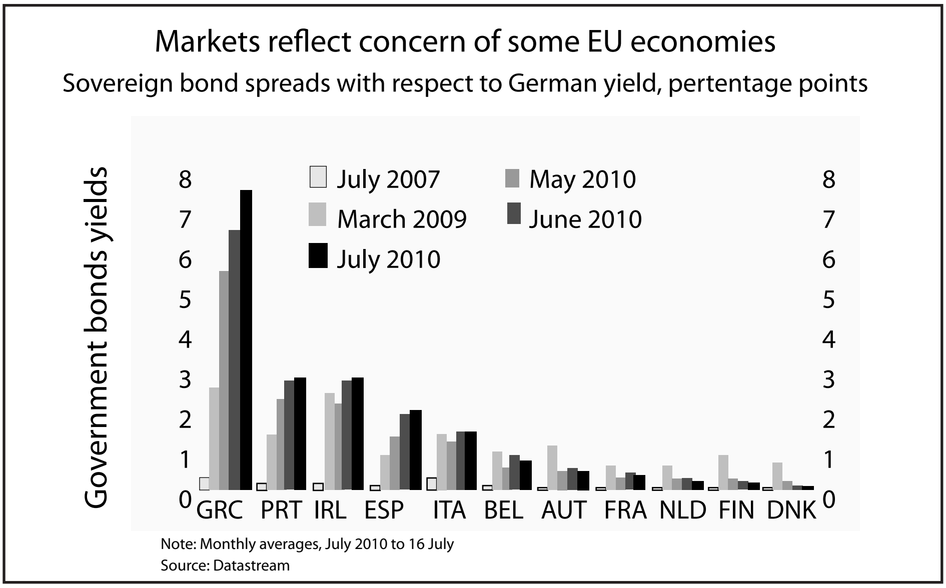


Figure 2.3

In terms of public debt, in Australia, the figure stands at about 6 per cent, whereas in the United States and the European Union it is pushing 100 per cent. Imagine what interest you have to pay if your public debt is 100 per cent of GDP? This is not about economies that do not work, but rather about governments that have spent too much in the past, and have failed to bring budgets back into balance. While on the one hand governments have to reconcile the fragile growth rates, on the other governments need to institute fiscal consolidation. This explains why the stimulus measures continue in some OECD countries, whereas in others their governments have announced severe fiscal-consolidation measures. These must be carefully designed in order not to break the balance. While it is probable that a country transferring its focus from policy stimulus to fiscal consolidation will experience smaller growth in the short term, it is fundamentally important to design a pathway to fiscal consolidation in order to gain the trust of the markets.

The opinion of the OECD is that such fiscal consolidation will not affect growth significantly in the long term, because most of the initiatives announced since the depth of the global financial crisis have been designed in terms of expenditure retrenchment and not in terms of increased taxation. The moment a government increases taxes it will damage growth or increase inflation. But when a government engages in fiscal consolidation through expenditure retrenchment, it can do so without significantly damaging economic growth. Additionally, with fiscal consolidation of this kind there will be an offset by lower private-sector savings and long-term interest rates.

The present global reform agenda

Let us now review which reforms are currently on the agenda. The first and most urgent area is the reform of financial markets. In the United States some reforms have already been announced and implemented. There is a new systemic risk council, for example, with the authority to break up American banks in the future if necessary. These US banks also face restrictions on trading with their own funds, and a limit of 3 per cent of their 'Tier 1' capital being invested in hedge and equity funds. In this regard, Europe has been slower to act, though it must be noted that the nature of the European Union—an aggregation of country sovereignties—means decision making is less coordinated than in the United States. On the other hand, the core European banks are doing relatively well. While some smaller banks in Spain, Greece and Ireland (and of course the German lenders) face current funding stresses, the core European banks remain solid. The *Basel III Agreement* on the financial markets for Europe will set new rules, and the region will also have some new institutions essentially in the same direction as the United States.

Nevertheless, the OECD has warned not to celebrate the fact that we are now able to control the financial markets with better regulatory reforms, because we can only ‘control’ present practices (what these institutions are currently doing). We cannot necessarily ‘control’ what they might get up to in the future (what does not yet exist). We need to recognise in financial markets there is always the drive to innovate and develop new ‘products’, and that is precisely how this global financial crisis began in the first place (the resort to high-risk instruments such as sub-prime mortgages and risky derivatives, for example). Part of the problem was poor supervision but it was also true that there were new products that had previously not existed. One cannot rule out in future that new innovation will bring new risks to financial markets.

In terms of the currently needed reforms, the policy agenda is not simply restricted to the financial markets. We also need reform regarding systemic integrity and the robustness of international tax administration—two fields closely related not just to financial markets but also to trade and foreign direct investment. Anti-bribery rules apply to all businesses, and this does not simply mean businesses in some of the more corrupt countries but also businesses with headquarters in the OECD nations. This explains the OECD Anti-Bribery Convention and subsequent UN efforts to clamp down on bribery. Businesses that have their headquarters in OECD and in UN member states are under scrutiny.

Concerning tax, we need consistency and better compliance regimes and a collective international effort to close tax havens. If not, we will still find that there are areas in the world where capital can hide without being taxed. There has been a tremendous effort in the past few years to tackle the problem of international tax evasion because, during the financial crisis, much was said about the fact that it was possible for some companies and people to store their money in locations where it was not taxed. This created a feeling of deep resentment among taxpayers towards tax-evading companies and individuals.

This spurred a chain of bilateral tax agreements. Indeed, we arguably saw more tax agreements in 2009–10 than in the entire previous decade. These tax agreements are not based on international rules but are founded mainly on the OECD Tax Convention. And here the difference between a convention and a rule becomes telling. A convention is something that is designed with government experts and is non-binding, serving rather to set an example that can be followed, implemented or applied voluntarily. Starting from this point, tax conventions can then set models for bilateral tax agreements and so on. It is clear that such examples of better international transparency—be they concerning bribery or taxes—can help to spur reforms in these areas. In this way, transparency can be a very powerful catalyst to make reforms happen.

A second area of concern in which reforms are necessary is the employment sector, particularly concerning participation. Across the OECD, we saw an enormous increase in unemployment in 2008–09. While in Australia unemployment now stands at 5 per cent, in other OECD countries it is up to 10 per cent. In the Netherlands it is about 4 per cent thanks to some reforms introduced before, rather than after, the crisis. But while both Australia and the Netherlands escaped relatively unscathed, in the OECD and in the euro area average unemployment is now about 10 per cent. Being an average, this reflects not just low figures such as that of the Netherlands, but also countries such as Spain, where 20 per cent of the population is unemployed. Spain's unemployment is of deep concern, but what is more concerning is that in all these countries youth unemployment is about double the overall level of unemployment. This causes real tensions. In Spain, France and other Mediterranean countries, almost half of all young people are without a job—a serious matter indeed.

This begs the question: should we adopt a policy of getting people first into work or into training programs to better equip them to work productively? This is a real dilemma. It is often asserted that unemployment is best combated according to the principle of 'find them work, whatever'. But we see now that the challenge is to prevent unemployment from becoming permanent, and therefore perhaps we have to shift to programs where we *train* first. If an unemployed person cannot find work despite their greatest efforts then perhaps we have to shift to a 'train first' form of intervention. Additionally, it is very important that we have directly targeted training programs for youth who find themselves unemployed because of the state of the economy. Some OECD countries, such as Denmark and France, already have such programs in place. We also have to consider that some of the employment-assistance measures adopted during the crisis to contain job losses should be phased out in order not to damage the growth of the economy. For instance, short-term work permits might have helped to cover up some unemployment, but if they continue to be subsidised by the government the situation will likely become unsustainable, resulting in companies relying on these permits defaulting. Such lessons from the past should now be implemented.

Another major problem today is not only the actual unemployed people, but also the so-called 'discouraged' and 'under-employed', who together represent as much as another 10 per cent of the population in some OECD nations. These are people who were once seeking work, but have ceased this endeavour because they consider their situation entirely hopeless. In other words, these people could enter the labour market but are not even trying, resulting in long-term damage to the supply of labour in the market. As with more orthodox cases of unemployment, in this area the focus should be on job-search and training programs, activation policies and well-designed employment subsidies. Arguably, this discouragement factor will not be solved or eradicated by a temporary response; it requires more fundamental reforms that go beyond the current crisis. This requires us to examine those aspects of society that needed fundamental reform well before the financial crisis existed, some of which I turn to below.

The long-overdue fundamental agendas for reform

The first fundamental issue we face is that babies and bosses are in competition for women, particularly in the thirty to forty age bracket. The recent OECD publication *Babies and Bosses* was produced to establish what can be done to reconcile these two sets of demands. The authors of *Babies and Bosses* consulted women on the subject, and realised that while governments are not entitled to proclaim fertility programs any more than they are to intervene in an employer's recruitment choices, what governments can do is facilitate the choices that mothers would like to make. This can be done by providing accessible, affordable and high-quality child care, by providing temporary-work rules, and by providing parental leave—a hot topic during the Australian Federal Election campaign of 2010. One conclusion of *Babies and Bosses* was for countries to look at the marginal revenues for those women who enter the labour market. If these are too low then the effect might be to further discourage workforce participation.

A second established need for reform concerns the ageing population across the OECD, and with it, an ageing workforce. Increased migration has been touted as one possible solution, but this is unwise, mainly because migrants themselves age over time. And if Australia were to address the problem of an ageing workforce simply by bringing in migrants to cover the labour shortages then it would need migration at more than double the current rate—an unrealistic solution. A more realistic solution would be to raise the minimum retirement age beyond sixty-five years. Luckily, for many professional and white-collar workers, this is not a problem—and is even logical, as experience and expertise in these positions often aid performance. There are, however, many manual or stressful jobs where it is not practical—or indeed possible—to continue working after age sixty-five. For these, generally more labour-intensive, positions, creative solutions must be sought. An agenda must be developed to build new competencies for certain workers once they hit the age of forty or forty-five. For example, a construction worker might gain teaching competencies to pass his experience to younger workers—to move, thus, to the vocational education sector. Similarly, the sixty-year-old professor who is losing enthusiasm in the classroom might benefit from a switch to more practical work such as assisting in the voluntary or non-governmental sector. Or a policeman who cannot do his work anymore might move into the administrative sector. This re-skilling agenda will be driven largely by the ageing of society.

As a footnote to these problems associated with employment, we must be wary not to make employment protection too rigid. When this is the case, people will not move, costs will go up, and employers will not hire all the workers they want. Thus, employment protection paradoxically does not always protect employees all the time.

Health is a third fundamental problem—made worse not just by the increasing cost of caring for an ageing population (as is the case in many OECD countries), but also by the increasing desire for ubiquitous health care. In the past there was a greater acceptance of the limitations of health care—helped by the greater prevalence of religion in Western societies. In contrast, there is now an ever-increasing demand for health care, anytime, anywhere. New technology will continue to bring new opportunities, but the reality is that the cost of health care will continue to grow. For this reason, bringing down the costs of health services is unrealistic and should not be on any reform agenda. Quite simply, it does not correspond with an ageing society.

And yet, we can institute some intelligent reforms in health care. The first is to determine and contain the so-called 'non-medical' costs of provision. For example, much of the cost in our health systems comes from transportation, administration and high costs of residence. If we rectify this—such as through collaboration and involving other parties—then as a society we can make gains. We can improve the administrative side (by streamlining bureaucracies and reducing gate-keeping) and thereby increase efficiency. We can, for example, use new technologies not only for better health care but also for more transparent administration (including some self-administration by users). In these ways, we can perhaps control the growth of the healthcare costs rather than simply avoiding it.

Another area for serious reform is migration. From the OECD's perspective, migration is overwhelmingly positive, contributing both to economic growth and to a balanced society. In addition to these benefits are the positive effects of regular remittances to the countries from where these migrants came. It is largely unknown that remittances are more important for these countries than official development aid. And yet, often governments try to reform what they see as problems with the system. This might mean deliberately not making provisions for what they consider 'temporary' migrants, or focusing only on highly skilled migrants. Both approaches are wrong. First, all new economic activities for the highly skilled are accompanied by activities for the low skilled. Further, 'temporary' workers tend to stay, socially investing in a country and enriching its culture. For this to happen smoothly, there must be a so-called 'integration agenda'—a policy in which migrants can retain their identity while successfully adjusting to the general characteristics of their new society.

Investment in human capital is another area where reform has long been needed. Governments must realise that social and educational spending is not a cost, but rather an investment with healthy returns. To do this (and to prompt governments to increase such spending), a mechanism must be in place to measure the outcomes—in educational and technical terms, but also in economic terms. Three such OECD-backed mechanisms include the Program for International Student Assessment (PISA), the Program for the International Assessment of Adult Competencies (PIAAC), and the Assessment of Higher Education Learning Outcomes (AHELO). The third program is the most contested because universities often argue that their results and their processes can never accurately be compared with others because of the unique nature of each institution and its students. But, of course, the market already makes such comparisons. Students and teachers choose a particular university for a particular reason, so it makes sense for their higher-education learning outcomes to be assessed so as to facilitate how they should be managed, and in which areas government spending should be made. Education is a wise investment for governments to make, but we still need more accountability and programs for comparison in this field.

Appropriate incentives are often critical to successful reform of the education sector. Take Mexico as an example of a developing nation engaged in much-needed educational reform. Until recently there were cases where a schoolteacher could hand on his job to his son. To change this culture, the Mexican Government and the OECD are working with teachers and school leaders to institute a program of performance management of education, and similar programs are being introduced in other countries. By creating an education system that rewards merit, governments can set appropriate incentives both in terms of career and in terms of payment.

An overview of contemporary reforms is not complete without discussing the issue of climate change. As the Guatemalan author Augusto Monterroso wrote in what is considered the shortest story in history: 'When he awoke, the dinosaur was still there.' The dinosaur for us is climate change, and no matter how much we talk about it, when we awake it will still be there and we will still have to address it. Climate change is the single most important challenge for future reform, and there is no way to postpone its urgency. To address climate change, we must put an economic price on emission costs and change our behaviour; there is simply no other way.

At the OECD, we regularly assess the efficacy and impact of various economic instruments (or policy responses), and we have clear evidence that taxes work better than subsidies. Subsidies tend to focus on the present and exclude new innovations, and they tend to cost too much to the government budget. As far as tax is concerned—in this case, a carbon tax—innovation to combat climate change would come from enterprises being heavily taxed for environmentally harmful practices. Trading schemes can also help to keep economies flexible, but cannot be the one and only answer.

Finding a way to reconcile ecology and economy, or achieve so-called 'green growth', is critical in the fight against climate change. In 2009, under the Korean presidency of our Ministerial Council Meeting, the OECD was mandated to achieve a green growth strategy by 2011. The OECD believes green growth is possible through a combination of taxes, innovation, education, markets, investment programs, and good governance. Perhaps most crucial is the need for international coordination for what is truly a global reform issue.

Last on our agenda for reform is the need to address socioeconomic imbalances across the globe. If global imbalances are not included on the international reform agenda then we will never succeed in having global solutions. Across the OECD, the average GDP per capita is roughly 14 times higher than that of India (7 per cent of the OECD average) and seven times higher than in China (14 per cent). Additionally, these two countries are both highly exposed to world-market volatilities in food prices, leaving them vulnerable to food crises. They also differ markedly from the OECD countries in that much of their economy is informal—with estimates claiming upwards of 85 per cent of economic activity in India is in the informal economy, not even counting agriculture. In China, the issue of informal employment is complicated by extremely complex rural land-use rights and low infrastructure, while in a country such as Indonesia we see very low levels of credit being extended to the private sector, which impedes growth. These examples demonstrate that aid is still needed to address global socioeconomic imbalances, but it should also come with coordinated efforts to achieve better regulations, freer markets, and economic climates attractive to foreign investors.

And yet, there are also many positive signs coming out of the developing world. In China, for example, the percentage of people living in poverty—defined by the United Nations as an income of $2 or less a day—has decreased in the past 10 years, from 85 per cent to 36 per cent. Correspondingly, during this period the average life expectancy in Indonesia increased from sixty-two years to seventy-one years. Further, while the percentage of people in these countries born between 1955 and 1964 to have completed secondary school is about 25 per cent, for the current generation of children it is more than 50 per cent. With the magnitude of such changes happening so fast, countries such as China, India and Indonesia will be extremely important to the future economic fortunes of Western countries. Consider that Japan and Korea together have a GDP of US$6 trillion. China, India and Indonesia have almost the same GDP but 15 times more people, so potentially this could translate to 15 times more GDP.

This is uncertain, but what is certain is that 20 years ago Korea was one of these developing countries; its transformation is a testament to the power of reform in addressing global imbalances.

Successful reform implementation: lessons from experience

As I have noted, the world shares many common interests in the international reform agenda. New global realities require new global approaches and institutions, while still taking into account the unique characteristics of individual nations. With so many reforms to make, here are a few general lessons to help make them 'stick'.

We must use the economic and political cycles to our advantage. Economic upswings are the best time to introduce labour-market reforms because the uncertainty that comes with the reforms is then balanced out by the fact that people will have more opportunities and rising incomes. As far as political cycles are concerned, the momentum that comes with a new government is often the best time to introduce substantial reforms; when governments cynically announce reforms in the year before an election they are either not serious or will not have the opportunity to properly implement them.

Reforms will be successful only if they are first supported by solid evidence for the need to reform and some degree of community acceptance of that need. If these are lacking then opponents will question the evidence on which the reform proposals are based. And even if such questioning is false or simply expedient, it will not usually be interpreted that way by the media, who will argue the government has overlooked something crucial or that it does not have a solid response to criticism of its policy.

Governments must communicate consistently about a proposed reform, because if there is an inconsistency in communication, the reform initiative will be hard to maintain. The wise policy maker proposes reforms in general terms so as to have the flexibility to adjust their instruments. If communication focuses on the goals of the reform and the instruments remain flexible then they will have greater chances of enduring success. It is also fundamental for the policy maker to monitor the process from day one because inevitably during the time it takes to introduce reform the context or some circumstances will change. Some opponents will become more powerful or less powerful. Some changes will emerge that were previously not there, perhaps relating to the international economy, changes in the labour market or whatever. In short, if we do not monitor the expected results of our reforms from the outset, the case for these reforms will weaken. In contrast, if we can prove through monitoring the results of such reforms that positive results have indeed been achieved, the case for reform can be strengthened.

Reforms are more likely to endure if strong institutions are in place to make the case or even prosecute the need for a consensus for the reform. In Australia, for example, institutions such as the Productivity Commission and the Council of Australian Governments (COAG) have successfully acted as a mechanism to create the casework for reform. Australian institutions do not, however, usually include other important stakeholders such as the business community, whereas some countries have institutions that include business and unions and can therefore make solid forums in certain areas and establish the support and involvement of business from the initial stage of the reform process.

The more you engage with your opponents beforehand, the more successful the implementation of the reform will be. This is difficult because engaging with opponents requires a clear distinction between building consensus and negotiating compensation for losses. The problem is that good negotiators—be they for business, unions, doctors or any other group—will start to make self-interested claims in the process of consultation. In other words, they want to negotiate first and build consensus later. Alternatively, they want to use the fact that they are needed for consensus as a ticket to negotiate. Take doctors or teachers as examples. These professionals enjoy a high degree of public trust. Consequently, if as a group they believe a reform proposal will inhibit their ability to provide adequate health care or educational outcomes, the public will agree, and will blame the government. This means that if reformers do not include players such as teachers and doctors in the reform process, they will become powerful opponents with the potential to generate blocking votes or veto points. And while compensating the losers is often necessary, it must be remembered that reforms are first and foremost made to correct an injustice, so subsequent losses are not always socially unjustified.

The final lesson for successfully 'making reforms stick' is the most obvious: set goals beyond election horizons, for governments to learn from each other to reduce the trial and error time. This is perhaps the wisest advice of all for authors of policy.

With these lessons in mind, I would suggest that the challenge awaits.