

## *Chapter II*

# **Fiscal Consolidation: The Need for Evidence-Based Decision Making**

## Introduction

Over the past three years, governments acted decisively on national and international fronts to avoid a global financial and economic meltdown. Although governments have heeded the call to action, their job is far from over. While governments pursue policies to create jobs, grow their economies, improve fairness, reduce inequalities and rebuild trust, many also need to introduce reforms to address rising debt levels that resulted from the crisis.

Fiscal consolidation has become the cornerstone of the current policy debate across the OECD area. Rising debt levels have called into question the sustainability of the *status quo*, and the prevailing wisdom is that governments must consolidate finances in order to ensure future growth. However, fiscal consolidation is not in itself a policy. Rather, it links to underlying issues and imbalances in individual sectors, such as welfare, pensions, health care and education: fiscal consolidation is a key tool for addressing these other concerns.

Politicians across the OECD area are currently discussing and debating fiscal consolidation, and many governments have begun announcing plans. Building on the recent OECD *Restoring Public Finances* (OECD, 2011b) and using the data presented in *Government at a Glance 2011*, this chapter begins to assess the quality of the planned reforms. It takes a critical look at whether the announcements will fulfil the objectives of consolidation, and identifies risks and missed opportunities. The data presented in *Government at a Glance 2011* can help governments identify best practices by providing evidence of what works and what doesn't, and how policies can be strengthened and better implemented. International benchmarking and data collection on public management practices and arrangements are relatively new and are still evolving; the OECD is working with member countries to expand our evidence base.

## Most OECD countries are planning reforms to consolidate finances

### ***Fiscal consolidation is needed to reduce debt to sustainable levels***

Government measures to rescue the financial sector, stimulate the economy, and provide safety nets for workers and the unemployed averted a serious global breakdown. However, compounded with sharply reduced revenues, they also left governments with sizeable deficits. The crisis aggravated existing imbalances in public finance, as many OECD countries ran structural deficits when their economies were growing. The average deficit across the OECD was 5.6% in 2010 compared to 1.3% in 2007 (Indicator 12). These deficits, combined with low economic growth, have sharply increased debt levels in many countries. On average, debt stands at 74.2% of GDP across the OECD area in 2010, up from 55.6% in 2007 (Indicator 13).

For some countries, high levels of debt have led to fiscal solvency concerns, manifested in large interest rate hikes on sovereign bonds and downgrading by rating agencies. High levels of debt can have negative long-term consequences, as revenues are diverted from policies and programmes that can create economic and social value to cover interest payments. Likewise, higher interest rates resulting from larger levels of debt can impede future economic growth, increase the vulnerability of public finances to shifting

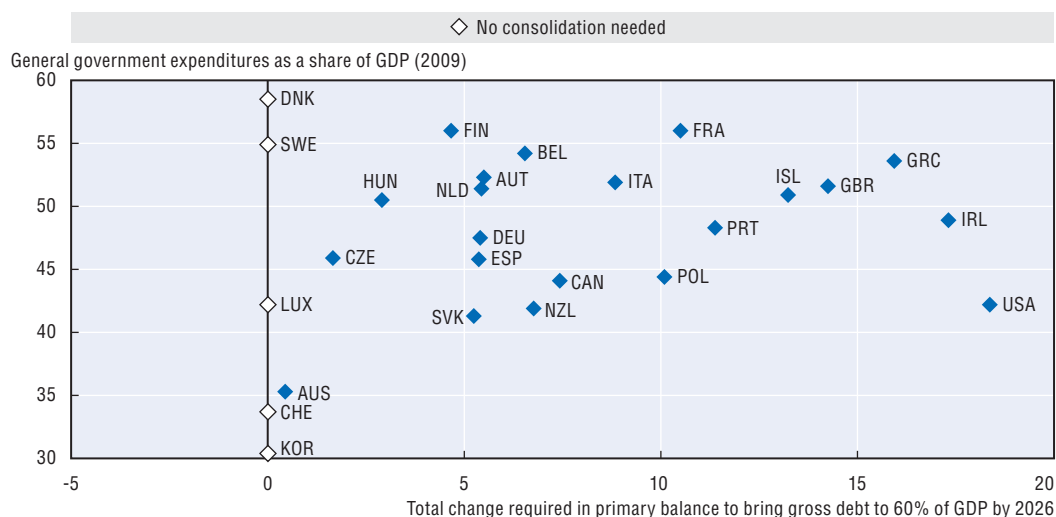
market sentiments and crowd out private investments. Furthermore, the ability of the government to address future economic downturns via fiscal policy is hampered. It also means that the programmes and benefits that are enjoyed by citizens today are paid for by future generations.

OECD projections indicate that as economic growth resumes, automatic stabilisers (such as increased revenues and reduced expenditures on unemployment insurance) will not be enough to reduce deficits or stanch the growth of debt as a share of GDP in many member countries. Fiscal sustainability indicators developed by the OECD show that on average, governments need to improve their fiscal balance by 3.6% of potential GDP over the next 16 years in order to just stabilise debt ratios by 2026 (Indicator 15). Governments will need to run even higher surpluses if they want to bring debt as a share of GDP back to pre-crisis levels. Accomplishing this will require governments to take politically difficult steps to both restore fiscal discipline and work towards fiscal consolidation.

### **Fiscal consolidation requires agreement about the function of government**


The size of fiscal consolidation needs across countries is related to government's ability to match revenues to expenditures – not the overall size of government relative to the economy. For example, Belgium (where government expenditures totalled 54.2% of GDP in 2009) and New Zealand (where government expenditures totalled 41.9% of GDP in 2008) demonstrate similar fiscal consolidation needs.

**Figure II.1. Fiscal consolidation requirements are unrelated to the size of government**



Note: Data are not available for Chile, Estonia, Israel, Mexico, Slovenia and Turkey. Data on general government expenditures for Australia and New Zealand refer to 2008. Data for Japan and Norway are not presented.

Source: OECD Economic Outlook, No. 89 (Preliminary Version), May 2011 and OECD National Accounts Statistics.

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Achieving fiscal consolidation has triggered a public discussion on what should be the appropriate role of government in society and the economy. While government efforts to cushion the effects of the financial and economic crisis were applauded, the rhetoric has sharply switched in many countries as government debt as a share of GDP has risen as a result of these efforts. Across the OECD area members of the public are calling on governments to consolidate their finances and, in particular, target aspects of operations that may be wasteful or inefficient. As unemployment has soared in many countries, the

level and relative stability of public sector jobs and wages has come under fire. Yet, in many countries, citizens are simultaneously demonstrating an increased demand for public services and their expectations regarding quality are reaching ever higher. Consequently, sound, sustainable public finances will result from an agreement between governments, citizens and businesses about what level of services the government should provide (and to whom) and how the public will pay for them.

## Ability of the government to reform under pressure

### **Evidence-based reforms are more long-lasting**

Achieving fiscal consolidation involves a realignment of the role of government in society. It entails questioning what is the need for public goods and services and whether the government is best placed to provide these directly, indirectly or not at all. Answering these questions requires evidence and data. Evidence-based decision making examines and measures the likely benefits, costs and effects of government decisions. Evidence can be gathered using a 360-degree approach: looking to the future to identify risks and opportunities, looking to the past to evaluate what has worked and what has not, and looking horizontally to identify synergies across Ministries and levels of government. A whole-of-government approach that is open and inclusive can identify linkages between different sectors and groups (particularly because a risk in one area may be an opportunity somewhere else, or a benefit to some may come at a cost to others) and prioritise goals and objectives.

Countries that have undergone consolidation programmes in the 1990s, including Canada and Sweden, have found that programme reviews, value-for-money assessments and cost/benefit analyses have helped decision makers identify the best ways to generate savings (Box II.1). This requires detailed information on how much is spent, what (and how much) is produced, what is achieved and what impact the changes will have on different parts of society.

#### Box II.1. **Canada's Programme Review Initiative**

In the mid-1990s, Canada introduced the *Programme Review* initiative, a 10% reduction in federal government programme spending and a reduction in the size of the public service by over 55 000 full-time equivalents which led to the debt to GDP ratio being cut by more than half over the next ten years. The expenditure reductions were identified by the centre of government (the special Cabinet Committee on Programme Review) based on data and information gathered by the Department of Finance and the Treasury Board Secretariat over the years, and the results of self-reviews undertaken by departments and agencies. Canada's *Programme Review* looked at all programmes in a Ministry at once; this large scale helped to balance single interests with the collective interest. It allowed the public to judge the relative fairness of the proposals among regions, groups and income levels.

Source: Blöndal, J. (2001), "Budgeting in Canada", *OECD Journal on Budgeting*, Paris.

### **Do governments have the capabilities to conduct evidence-based decision making?**

The public administration's role in evidence-based decision making is to seek out, consult and engage with actors in key knowledge areas, and analyse and package that knowledge to inform policy options. In particular, deficit reduction of the scale required in many OECD countries is a social project that calls for a more open and inclusive approach, not a normal budget exercise.

Unfortunately, comparative data on governments' ability to implement evidence-based decision making are weak and represent an area for future development by the OECD. However, the data that do exist suggest that room for improvement remains and that countries can learn from best practices in the leading countries.

OECD countries have varied experience with embedding evidence-based decision making in their everyday operations. Although not directly linked to cost containment efforts, one area where countries have made strides in using evidence-based decision making is in the process for making rules and laws. Regulatory impact analysis (RIA), which is used to examine and measure the likely benefits, costs and effects of new or existing regulations, has been adopted by all OECD member countries. However, the depth of RIA systems varies and the analysis may not provide a full view of the trade-offs needed to take decisions. For example, while 24 countries reported systematically quantifying the costs of regulation in 2008, only 16 reported quantifying the benefits. In addition, OECD countries can do more to close the policy loop: *ex post* assessment can help monitor quality and compliance, and evaluate the assessment methodologies themselves. As of 2008, only six countries mandate *ex post* evaluations for all policy areas: Australia, Greece, Hungary, Japan, Korea and Norway (Indicator 47).

Consultations with stakeholders, a key aspect of evidence-based decision making, are uneven across policy areas in OECD countries. Information and communication technologies (ICTs) are allowing governments to obtain information directly from individuals, households and communities compared to intermediation through non-governmental organisations (NGOs), expanding the set of views available to inform policy options. For example, OECD country reviews indicate that consultation processes on proposed regulations have improved, helped by e-government. Consultation in other areas, such as procurement, is not as widespread. Around a third of OECD members involve citizens at some point in the procurement process, most often to monitor the integrity of the award process (via inviting the public to attend bid opening ceremonies) or to monitor the implementation of the contract (Indicator 41).

Japan has found that ICTs can help build public support for fiscal consolidation plans. Japan has embarked on a series of public budget hearings that are streamed and televised; they are among the most watched and discussed events in Japan. Spending Ministries and the Minister of Finance must defend every aspect of the budget to a committee of "cross-examiners" consisting of members of Parliament and academics.

### ***Do governments have the discipline to stick to reforms?***

#### ***Strong budget institutions can reinforce fiscal discipline***

The existence of a strong institutional framework for decision making can help to ensure that governments stick to reforms. In particular, a multi-year fiscal programme, such as a medium-term expenditure framework, combined with clear fiscal rules that limit spending, can help policy makers adhere to an appropriate fiscal path and give investors and businesses confidence in the government's capacity to manage public finance (Schick, 2010). For example, Sweden successfully consolidated its finances following a fiscal crisis in the early 1990s, in part by adopting a medium-term target (a surplus of 2% of GDP over the cycle) and implementing fiscal rules based on expenditure targets.

Prior to the crisis, OECD members had taken steps to adopt budget practices that introduce fiscal discipline, and debt as a share of GDP in many countries was stable or decreasing (Indicator 13). While the institutional framework is to a large extent in place, it may need to be strengthened. In many countries, medium-term expenditure frameworks

put rules in context of a 3-5 year horizon, and reduce incentives to shift revenues or expenditures to future years to get around the constraints imposed by rules. As of 2007, all but 6 of the (then) 30 OECD member countries used fiscal rules to constrain debt, total revenues or expenditures, or other aggregates. However, experience with fiscal rules indicates that the design of rules is important; expenditure rules (used in 15 OECD countries in 2007) couple deficit and debt reduction with spending constraints, are simpler to explain to elected officials and the public, and are more difficult to evade.

In addition, the creation of independent fiscal councils or parliamentary budget offices can reinforce discipline by serving as an institutional check against the assumptions and forecasts underlying the budget. In less than a decade, the number of specialised budgetary research units has more than doubled, and in some cases their size has increased. In 2000, only seven OECD country legislatures had specialised budget research offices. This number increased to 10 in 2003 and 14 in 2007 (Indicator 35).

Finally, an inclusive budget formulation process can build ownership and buy-in which are critical for making and sustaining hard choices. As part of its process of fiscal consolidation in the mid-1990s, Sweden introduced top-down budgeting which involved setting priorities at a political level, allocating financial envelopes to line Ministries, and then giving Ministers and managers authority to make final allocations of the funds within a given envelope. Among OECD member countries, there is a large range in the level and type of flexibility granted to the executive to use budgeted funds for different purposes (see *Government at a Glance 2009*, Indicator 21).

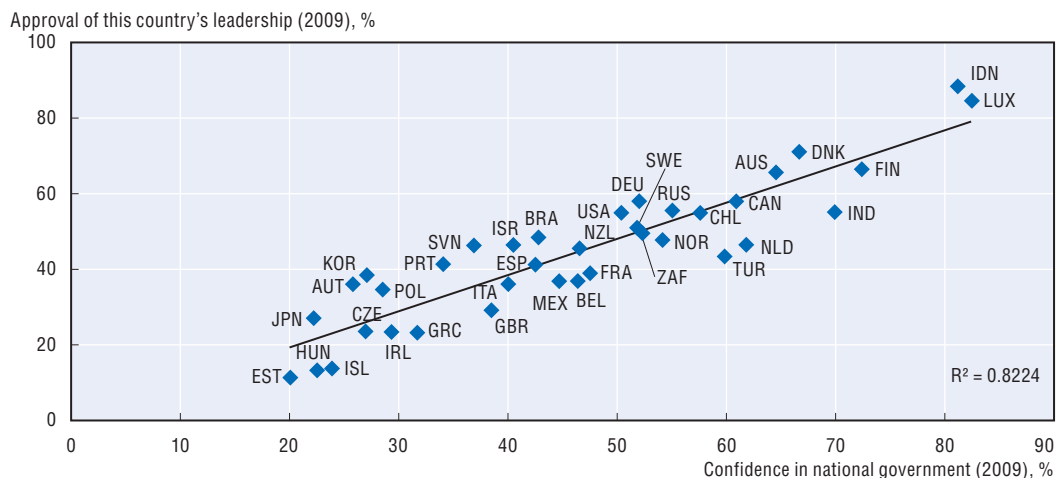
### **Trust promotes legitimacy**

Trust is a key ingredient in effective governance. In particular, the public is more likely to support reforms through their implementation if it has confidence in political institutions and political leaders. While overall levels of trust vary across the OECD area, there is a strong association between trust in the national government and trust in leadership ( $R^2 = 0.82$ ), implying that citizens are apt to think of political leaders when judging the trustworthiness of government. Thus, to a certain extent, strong leadership is the *sine qua non* of successful reform (OECD, 2010c). 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.

### **Cross-partisanship can lead to more sustainable reforms**

Given that most reforms span multiple years that go beyond the average term of government, those reforms developed and supported by a coalition of political parties may be more likely to last. Reform reversals have two causes: either a decrease in political attention to reform, or a political decision by a newly elected government to reverse the reform of the previous one. Case studies of OECD country experience with fiscal and pension reform suggest that governments that engage multiple parties and factions in developing the reforms are more likely to enact consolidations that are sustained over time. Some governments in OECD countries have more of a tradition than others in forming coalitions.

Figure II.2. **Confidence in national government and approval of leadership are strongly correlated**



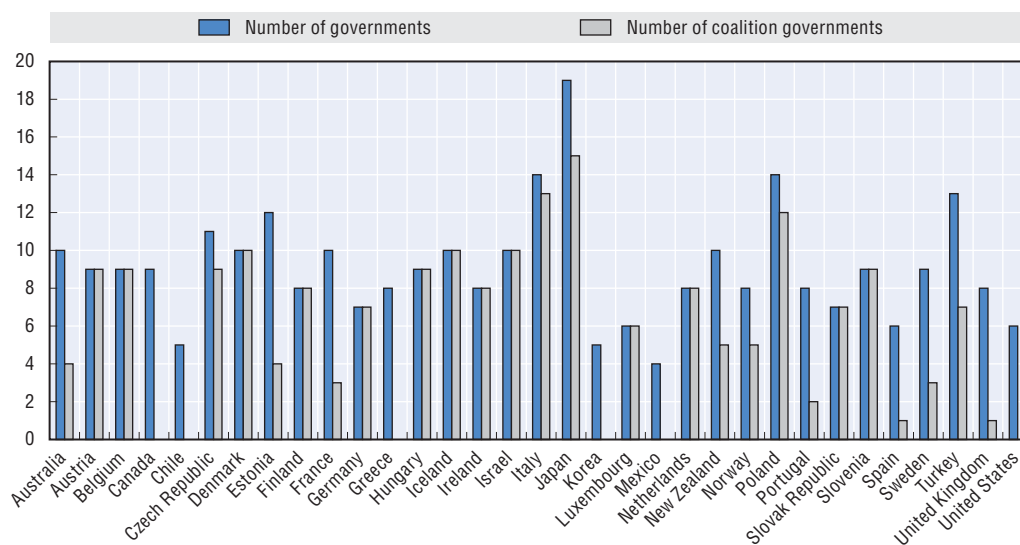
Notes: Data refer to the share of respondents who answered affirmatively to the following questions: In this country, do you have confidence in the National government? Do you approve of the job performance of the leadership of this country? Data are not available for the Slovak Republic and Switzerland. Data for the Czech Republic refer to 2007. Data for Australia, Austria, Belgium, Denmark, Finland, Iceland, Japan, the Netherlands, New Zealand, Norway, Portugal, Sweden and Turkey refer to 2008.

The Gallup World Poll is conducted in approximately 140 countries around the world based on a common questionnaire, translated into the predominant languages of each country. With few exceptions, all samples are probability based and nationally representative of the resident population aged 15 and over in the entire country (including rural areas). While this assures a high degree of comparability across countries, results may be affected by sampling and non-sampling errors. Sample sizes are limited to around 1 000 persons in each country.

Source: Gallup World Poll.

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Figure II.3. **Frequency of coalition governments (1990-2010)**



Note: Data for Switzerland are not presented.

Source: OECD member country government websites.

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### ***Accountability for achieving results is supported by openness and transparency***

Communication helps to build credibility for the reforming government, increase the sense of ownership of reforms by keeping civil servants and citizens informed, and reduce information asymmetries by making the information available to each stakeholder. In addition, transparency of decision making and the results of reforms can help the public hold governments accountable for sticking to reforms and achieving results.

Governments in member countries are taking steps to become more transparent and open. Countries are proactively making more and more information publicly available about their activities, performance and decisions. While almost all OECD countries have laws on access to information, many also require the publication of or routinely make available budget documents, audit reports, government assessments of the potential impact of regulations and tender documents (Indicators 38, 41, 45). Increasingly, governments are opening up administrative data sets to the public in the hopes that the information can be reused by entrepreneurs and civil society in innovative ways to improve current government services or create new ones.

While the trend across the OECD area is to release more information proactively, are governments doing so in a way that promotes trust and accountability? Many governments are grappling with how to make information available in ways that maximise benefits and minimise costs. Some information may not be useful to the public. Should governments provide interfaces to interact and interpret the data or provide the raw data? Under certain circumstances, transparency can be the reverse of accountability: the release of large volumes of information in inaccessible formats can overwhelm the public and discourage active reuse and scrutiny. Participation rates may decline, followed by a loss of trust in government. In addition, information can be used by special interest groups to protect certain expenditures from cuts.

To maximise the benefits of transparency, many member country governments are actively focusing on accessibility and the quality of information. For example, many government-run websites include search features to help find key documents and data. Over half of OECD countries have established provisions in laws or policies requiring electronic information to be published in formats that allow for reuse and manipulation (Indicator 38).

### **Evaluating the quality of planned reforms: Key questions and risks**

In addition to the extent to which it is based on evidence, key aspects of quality of the reform process include its size, pace and interface with other public policy goals. For example, reforms work better when they are applied in a predictable, gradual way that allows administrators and stakeholders to adapt. Likewise, in high-quality reform programmes, effectiveness in attaining fiscal goals is not made at the expense of other priority public policy goals – or at a minimum expense of these goals. As governments in OECD countries design and implement reforms as part of their fiscal consolidation plans, a key challenge is to do more (or the same) with less. The main risk is that governments end up doing less with less.



In addition, the ability of governments to carry out well-conceived reforms may be distorted by the interplay between fiscal accounting and politics. For example, it is oftentimes more politically palatable to apply spending cuts to line items (usually operational expenses such as salaries, travel costs, investment, etc.) than at the programme level because the impact on service delivery is less evident. Whereas many members of the public can get behind cutting travel or even compensation, opposition is higher when cuts more clearly target aspects of programmes, such as ending after hours care in schools. However, it is possible to find an intersection between politics and evidence. For example, at the programme level, reforms that cut the least effective or lower priority programmes may be more likely to garner support. In addition, plans that are large in scale are often more politically feasible, as the pain of cuts is spread across the population and thus perceived as more fair. In fact, OECD research suggests that the most successful consolidation plans involve large, multi-year adjustments.

### ***Key characteristics of fiscal consolidation plans***

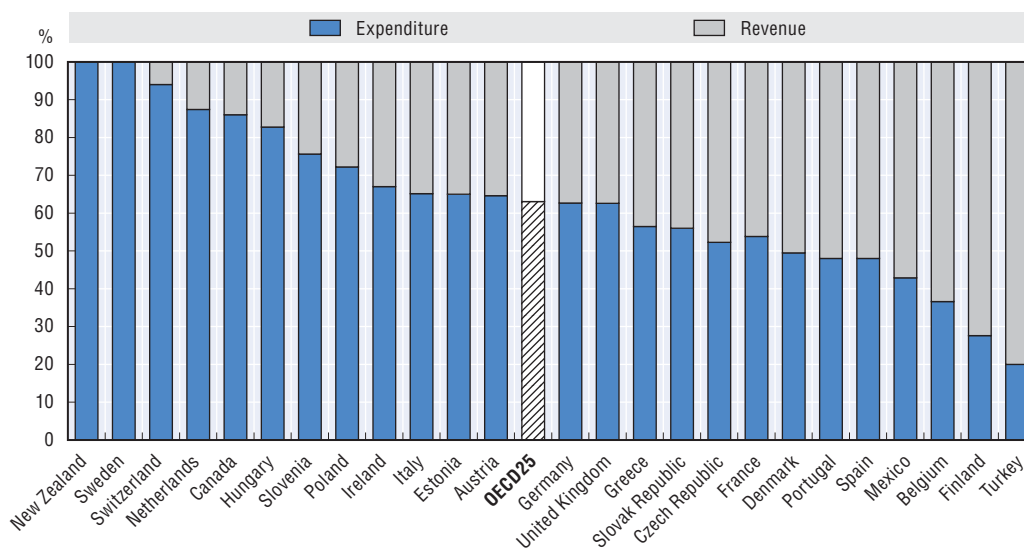
By the end of December 2010, around half of OECD member countries had announced medium-term plans to consolidate government finances (OECD, 2011b), and the analysis below is based on these announcements.\* The announcement of plans to consolidate finances is an important signal to markets and the public about the steps governments will take to address sustainability concerns. The transparency of planned actions can help build trust and enables the public to judge the relative effects and fairness of the plans on regions, groups and income levels.

In this publication, fiscal consolidation is defined as concrete policies aimed at reducing government deficits and debt accumulation. These consolidation plans and detailed measures are given as a per cent of nominal and potential GDP. Merely announcing an ambitious deficit target over the medium term with no accompanying consolidation plan on how to achieve the deficit target is not regarded as a consolidation plan in this analysis. See *Restoring Public Finances* (OECD, 2011b) for further information on the quantification of fiscal consolidation plans.

### ***Fiscal consolidation plans emphasise cutting expenditures over raising revenues***


Empirical research suggests that expenditure cuts, including cuts to government wages and social transfers, are more effective than revenue measures in achieving long-term consolidation (although the empirical association could reflect that those governments more determined to consolidate are more willing to cut spending) (Guichard et al., 2007). Most of the fiscal consolidation plans rely more heavily on cutting spending compared to increasing revenues. Fiscal consolidation is weighted two-thirds towards spending cuts on average, and one-third towards revenue enhancements. While potentially more effective in the long term, expenditure-based measures often take time to fully implement, while increases to taxes can provide immediate gains.

\* It does not include measures decided after this cut off date. Additional fiscal consolidation measures could result in a reclassification of countries.

Figure II.4. **Expenditure versus revenue-based measures in fiscal consolidation plans (2010)**

Notes: Figures are the contribution to consolidation from expenditure and revenue measures, weighted by the incremental volume of consolidation across each year reported.

Source: OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.

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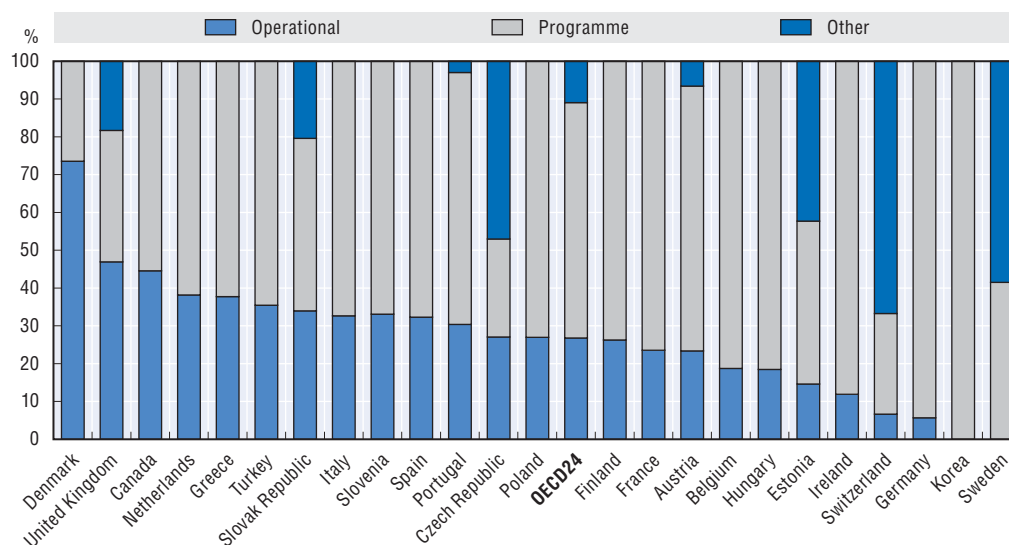
### **Most expenditure cuts focus on programme areas**

In most countries, plans focus predominately on reducing programme expenditures. Expenditure cuts concentrate on two main areas: 1) reducing spending on programmes (such as health, changes to social benefit systems, old-age pensions, capital infrastructure and official development assistance) which includes all spending except for compensation costs; and 2) reducing operational spending by cutting compensation costs (through staff reductions or wage and benefit cuts), reorganising government, or implementing across-the-board efficiency cuts. Some countries have announced other types of cuts, such as overall spending freezes. While the *System of National Accounts* includes compensation costs in its expenditures by function (which broadly correlate to programme areas, see Annex B), these are considered operational cuts in Figure II.5.

### **Cuts target big and small programmes**

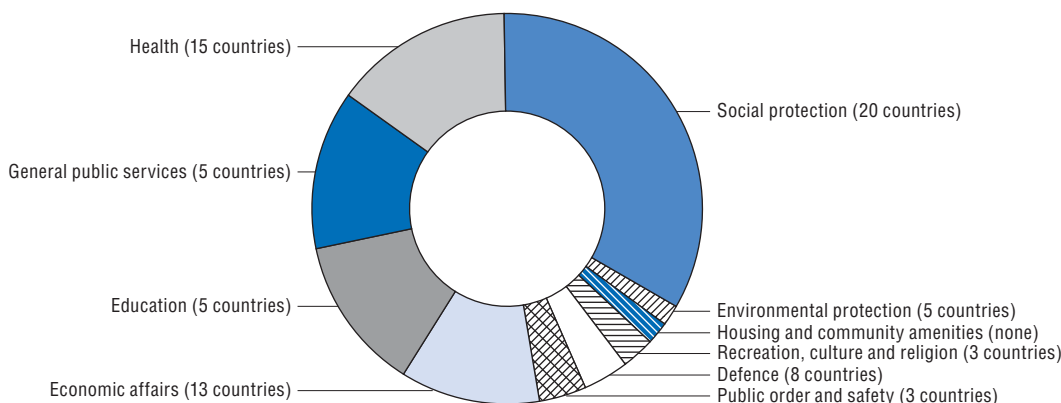
Many OECD country governments are cutting funding for the programmes that absorb the most resources, although their cuts do not go deep enough to restore fiscal sustainability. On average, governments in OECD member countries spend the most money on social protection programmes (such as unemployment benefits, welfare and pensions), followed by health programmes, general public services (which includes interest payments on debt), education programmes and economic affairs (which includes spending on agriculture, transport and communication). Most fiscal consolidation plans focus on structural reforms in these “big ticket” areas which can reduce expenditures over time, leading to improvements in fiscal sustainability. A few countries, particularly those under market pressure to reform, also plan one-off or short-term adjustments that will reduce deficits immediately but do little to address the long-term drivers of expenditure increases (OECD, 2011b).

Figure II.5. **Composition of quantified expenditure measures in fiscal consolidation plans**



Source: OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.  
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Figure II.6. **Structure of government expenditures by function and number of countries targeting these areas for cuts, average for OECD29 (2008)**



Note: Average does not include Australia, Chile, Mexico, Switzerland and Turkey. Thirteen countries have planned cuts to infrastructure, which is included in economic affairs in the figure above, although may span to spending in other functional areas such as housing and community amenities, health and education. The 20 countries focussing cuts on social protection programmes include 6 countries cutting welfare, 2 cutting pensions and 12 cutting both areas. The five countries included in the general public services category have all focussed cuts on development aid programmes.  
 Source: OECD National Accounts Statistics and OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.

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In addition, some governments are focusing on areas that form a relatively small portion of total public spending. For example, environmental protection, targeted by five countries, comprises 1.7% of spending or 0.7% of GDP on average. Likewise, three countries are targeting recreation, culture and religion which comprises only 2.7% of spending or 1.2% of GDP. Defence, targeted by eight countries, forms on average 3.7% of spending or 1.6% of GDP. While general public services comprises 13% of spending, the five countries targeting this area are focusing on foreign aid, which accounts for only 5% of spending in this area (or 0.3% of GDP).

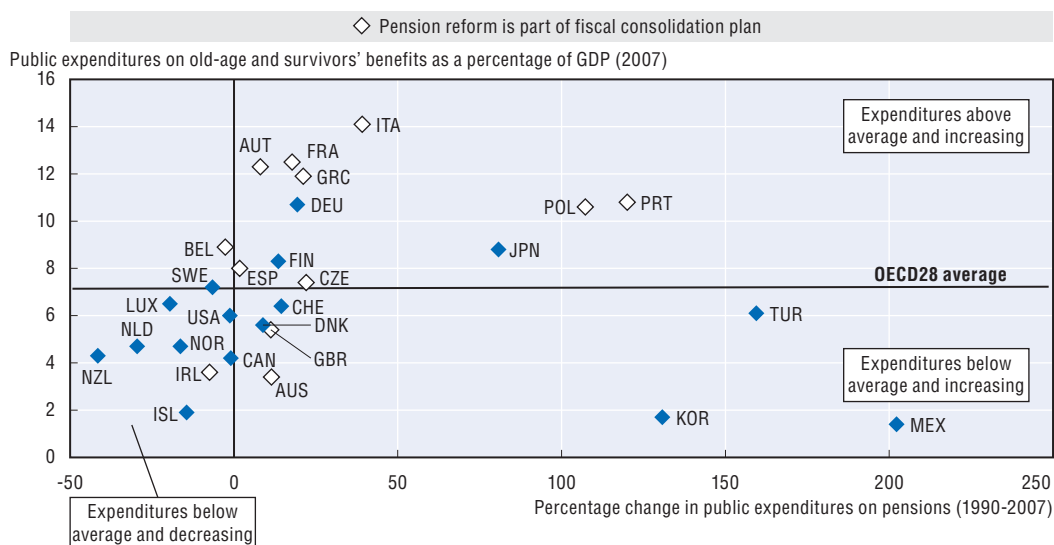
### Pension reforms aim to address rising costs

As OECD projections based on demographic change indicate that pension costs will continue to rise in most countries, reforms in this area are important for longer-term sustainability. Fourteen countries are looking to reform their pension systems as part of their fiscal consolidation plans. In several of these countries, such as Italy, Poland and Portugal, pension expenditures represent a large and increasing share of GDP. However, other countries with above-average and increasing expenditures have yet to address reforms in this area.

Most reforms focus on reducing the costs of pensions for future retirees and will not affect those currently receiving benefits. In part to reflect that citizens are living longer, eight countries have announced increases in the retirement age ranging from two to five years, which can positively affect economic growth due to higher labour force participation of older people and the potential increased demand (and consumption) as older people need to save less since they will be retired for fewer years. New Zealand curbed growth in general government pension expenditures between 1990 and 2007 in part by increasing the pension age from 60 to 65 and by freezing the basic value of the pension in 1992-94. However, these effects could be mitigated to the extent that age discrimination in the labour force prevents older workers from finding jobs. Recent OECD research suggests that ageism remains, despite legislative efforts to combat this form of discrimination (OECD, 2011a). In addition, older workers need help to preserve and augment their skills and knowledge to make them more employable. Evidence exists that younger workers are favoured over older staff, in part due to seniority-based wage structures, which make it expensive to employ older workers, and strict employment-protection regulations which may encourage employers to use early-retirement pathways to adjust their workforce.

Figure II.7. **Some fast-ageing countries are not reforming pensions**

Public expenditures on old-age and survivors' benefits as a percentage of GDP (2007 and change 1990-2007)



Note: Data are not available for Chile, Estonia, Hungary, Israel, the Slovak Republic and Slovenia. Hungary has included pension reform as part of its fiscal consolidation plan.

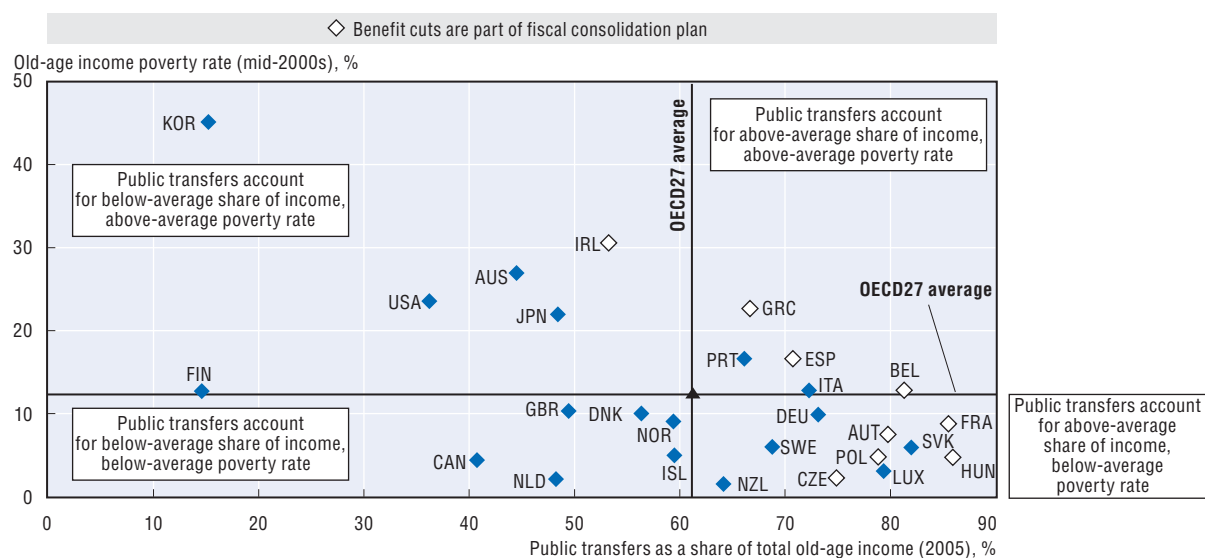
Source: OECD Social Expenditures Database (SOCX); OECD Main Economic Indicators Database; OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.

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Eight countries have announced pension benefit reductions. In seven of these countries, pensions account for an above-average share of older citizens' incomes. While cutting benefits could achieve substantial savings to the government, it also presents risks that will need to be addressed. For example, in these countries, cuts in support could affect the poverty rates among this segment of the population if citizens do not compensate by increasing their private savings. There is some relationship between the incomes of older people and public expenditure on old-age benefits, especially when account is taken of differences between countries' demographic situations. A 10% increase in public pension expenditure is associated with a 1.5 percentage point increase in older people's relative incomes (OECD, 2009c). The precise design of retirement-income systems also has an effect. Austria, France, Luxembourg and Poland have large public, earnings-related pensions and they have among the highest relative incomes in old age.


Figure II.8. **Public pensions help fight old-age poverty in many OECD countries**

Public transfers as a share of old-age income and old-age income poverty rate (mid-2000s)



Note: The poverty rate is defined as the percentage of over 65s with incomes of less than half median equivalised population incomes. Public transfers include retirement, family, unemployment, housing and disability benefits. In Finland, mandatory occupational plans are included as capital income, whereas the national accounts and *Pensions at a Glance* treat these schemes as part of the public sector. The share of old-age income derived from public transfers is very low in Korea because the public pension scheme was only established in 1988.

Source: OECD (2009), *Pensions at a Glance 2009* and OECD (2008), *Growing Unequal? Income Distribution and Poverty in OECD Countries*, OECD Publishing, Paris and OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.

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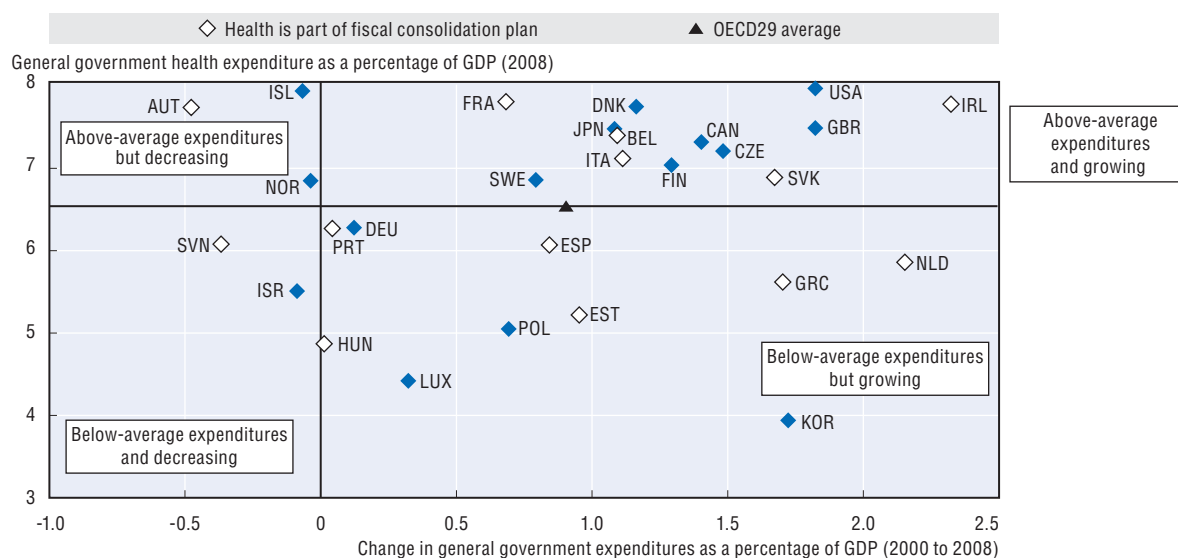
### Countries with biggest potential for health savings are not exploiting this area in consolidation plans

Health programmes account for a large and increasing share of government expenditures in OECD countries. On average, OECD countries devote 15% of total general government expenditure to health and this share has increased by 1.7 percentage points since 2000 (Indicator 5). However, in those 15 countries targeting health programmes as part of fiscal consolidation plans, health spending is not necessarily above the OECD average nor has it been increasing at an above-average pace since 2000. Furthermore, apart from Greece and Turkey, where health reforms focus on reducing pharmaceutical expenses, health expenditure savings do not constitute a major share of consolidation, contributing less than 0.4% of GDP on average (OECD, 2011b).

The Slovak Republic and Ireland, two countries planning health reform, stand out as having relatively large portions of total general government expenditures devoted to health, with this share increasing since 2000. While the United States and Japan have not yet announced large fiscal consolidation measures, health forms a substantial and increasing portion of government expenditures in these countries. As data refer to 2008, they do not reflect the health reform adopted in the United States in 2010. Decreases in government expenditures in health could shift costs to households, which currently account for about a third of expenditures on health on average across the OECD area (Indicator 10).

Figure II.9. **General government health spending is large and increasing across most of the OECD area**

General government health expenditures as a share of GDP (2008 and change 2000-08)



Note: Data are not available for Australia, Chile, Mexico, New Zealand, Switzerland and Turkey. New Zealand and Turkey have included health as part of their fiscal consolidation plans. Data for Canada refer to 2006.

Source: OECD National Accounts and OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.

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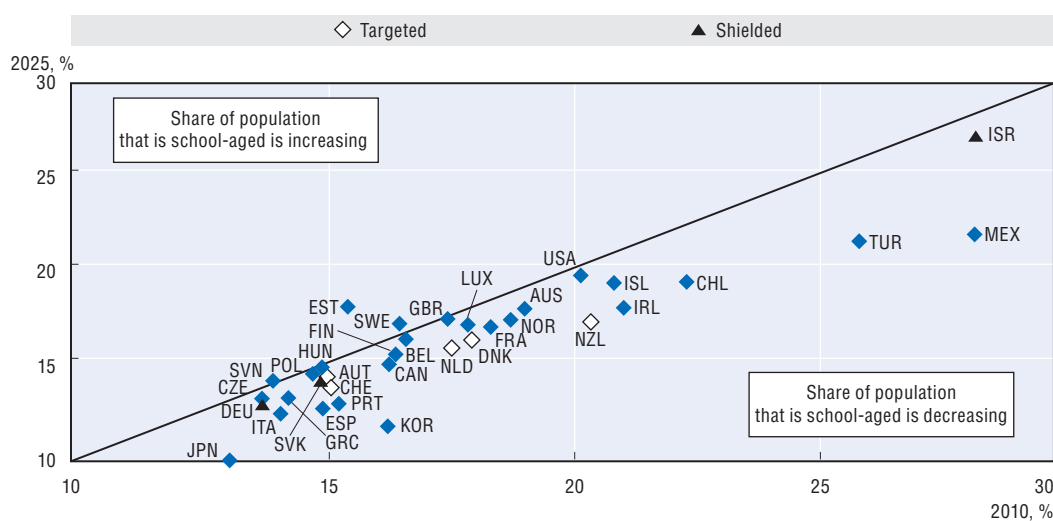
OECD estimates of efficiency in the health sector indicate that room for improvement exists. International studies of efficiency in health care delivery are relatively new and still under development. Efficiency is calculated by comparing the ratio of inputs to outputs (or outcomes). Improvements in efficiency can occur by achieving the same level of outputs using fewer inputs, or by achieving more outputs using the same level of inputs.

The OECD conducted exploratory work to assess the potential savings from greater efficiencies in public health care spending using data on health expenditures and life expectancy. The OECD estimates that public spending savings could approach 2% of potential GDP in 2017 on average by improving the efficiency of the health care system (OECD, 2010b). Efficiency gains in Greece and Ireland, two countries targeting health care as part of their fiscal consolidation plans, could top 3% of potential GDP in 2017. Currently, Australia, Iceland, Japan, Korea and Switzerland perform best in transforming spending into health outcomes. In order to achieve efficiency gains in this programme area without sacrificing quality, detailed data on the costs and the benefits of each programme are needed.

### Education spending is generally not targeted in fiscal consolidation plans

While prior OECD work suggests that room for efficiency improvements in educational programmes exist, well-performing schools are critical to ensure the competitiveness of the labour force and securing future economic growth and societal well-being. Few countries are targeting education programmes for cuts: five countries have identified education as a target for programme spending cuts, while an additional three countries have shielded this area from cuts (OECD, 2011b). In both countries shielding and targeting educational programmes, the population is getting older: the share of the total population that is school-aged (younger than 15) will decrease between 2010 and 2025 in all OECD countries except Estonia, Sweden and Slovenia. The share of the population that is school-aged will drop most dramatically in Mexico, Turkey and Korea over the next 15 years (by over 4 percentage points), followed by Chile, Japan and New Zealand (between 2 and 4 percentage points). New Zealand is the only country in this group that has targeted education programmes for cuts. Of the four other countries targeting education for cuts, the school-age population will decline at a faster pace than the OECD average in the Netherlands and Denmark while the declines in the school-age population are slower than average in Austria and Switzerland.

Figure II.10. **School-aged population is decreasing across the OECD area**  
Population younger than 15 as a share of total population (2010 and 2025)

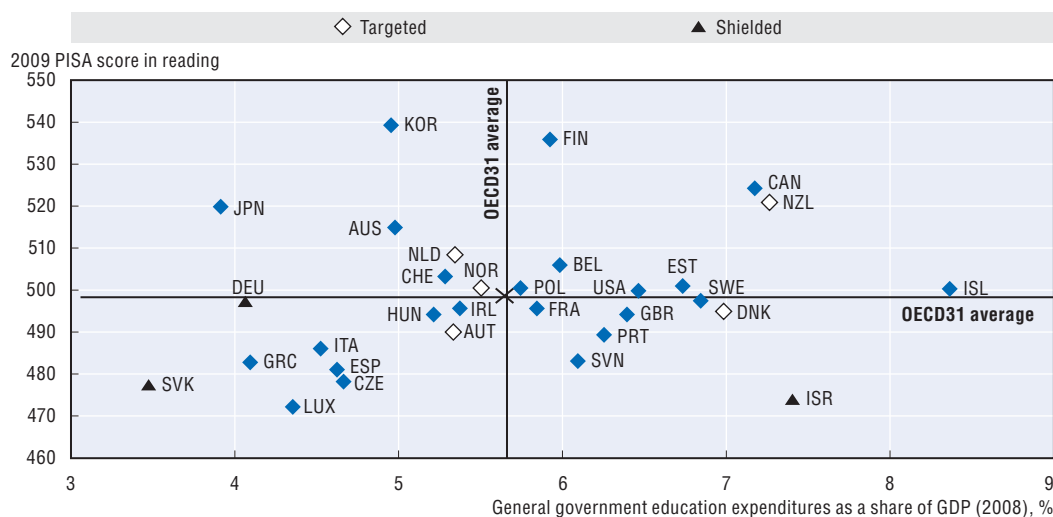


Source: OECD Population Statistics.

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The Netherlands and Switzerland, two countries targeting education for cuts, showed above-average PISA scores in reading in 2009 with below-average government spending on education. The challenge in these countries will be to ensure that the cuts do not hurt student achievement. In comparison, the challenge in Denmark, another country targeting education programmes for cuts which has above-average expenditures but average scores, will be to improve efficiency by increasing achievement using fewer resources.



Figure II.11. **Countries shielding education from cuts score below average on PISA scales**

Note: Data are not available for Chile, Mexico and Turkey. Expenditure data for Canada refer to 2006. Expenditure data for New Zealand refer to 2005. PISA reading scores for Austria refer to 2006.

Source: OECD National Accounts, PISA 2009 and OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.

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### **Some countries targeting infrastructure for cuts already show declining investment in this area**

Although comprising less of government spending than social protection, education and health, infrastructure spending is a large ticket item in many OECD countries, representing 4.5% of GDP in 2009 on average. Maintaining transportation and communication networks, as well as building schools, hospital and community housing, is an important foundation for a productive economy. While postponing infrastructure spending is often an easy way to save money, failing to make key investments to repair or update the nation's public infrastructure can ultimately hurt economic growth and international competitiveness. Of the 13 countries planning to decrease infrastructure spending as part of their fiscal consolidation plans, Ireland, the Czech Republic, Estonia and Slovenia exhibit above average spending currently and have invested more heavily in infrastructure over the past decade, suggesting that they have been building up their infrastructure stock. On the other hand, countries such as Switzerland, Austria and Portugal spent below average on infrastructure in 2009 and spending as a share of GDP has decreased since 2000. These data suggest that these countries have not been investing as heavily in building up or maintaining stocks over the past decade, potentially because they already had high levels of stock established. However, further reducing investments could lead to deteriorations of the infrastructure stock by postponing needed repairs or modernisations.

### **Are operational reforms targeting the areas that are likely to bring about efficiency and productivity gains?**

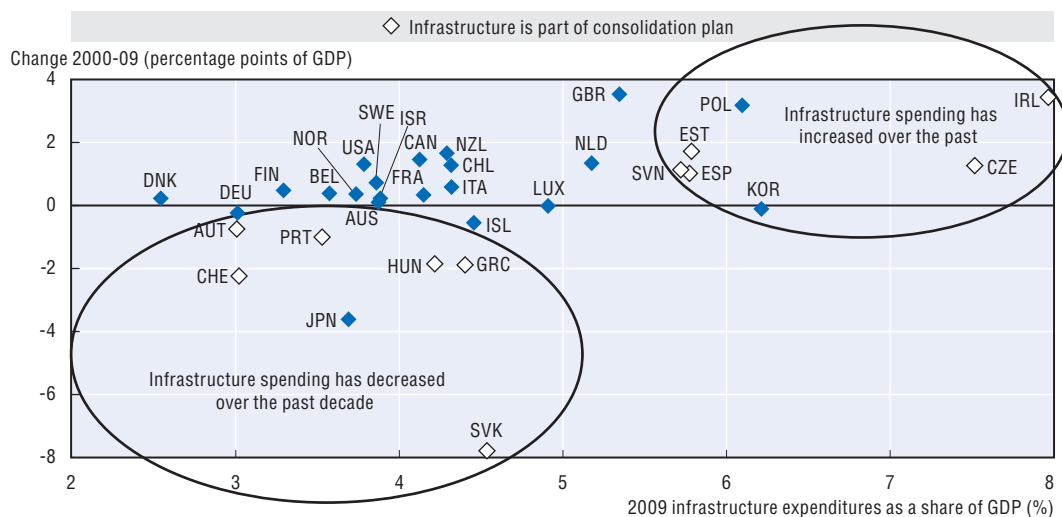
#### **Little empirical evidence exists regarding which public administration reforms result in efficiency gains**

Despite a plethora of reforms implemented by countries over the past decade, little empirical evidence currently exists about which public administration reforms bring about efficiency and productivity gains. This scarcity of evidence is due to a lack of resources within governments to conduct evaluations; a lack of pre-reform measures of performance



Figure II.12. **Infrastructure spending has mostly increased in recent years**

General government infrastructure spending as a share of GDP (2000 and change 2000-09)



Note: Infrastructure spending is calculated from government expenditures on gross fixed capital formation and capital transfers in all programme areas. Data for Australia, Chile, Japan, Korea, and New Zealand refer to 2008. Data for 2000 are not available for Mexico and Turkey and these countries are not depicted in the figure above. Turkey focuses on infrastructure in its fiscal consolidation plans.

Source: OECD National Accounts and OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.

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that can serve as a baseline against which to measure progress; complexities in measuring efficiency in the public sector; and problems with isolating the effects of specific institutional reforms on efficiency from other external influences (Currstine *et al.*, 2007). In addition, there could be substantial differences in the short- and long-term effects of these reforms, such as efficiency gains dissipating over time.

Of the common public administration or management reforms implemented by OECD countries over the past decades, empirical evidence points to three institutional factors that may improve public sector performance:

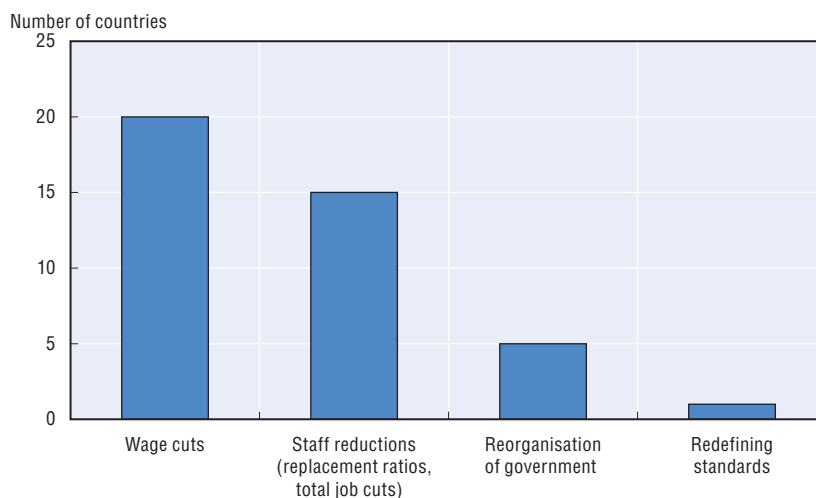
- Decentralisation of political power and spending responsibility to sub-national governments.
- Human resource management practices that improve employee satisfaction and morale.
- Adjusting operations to maximise economies of scale (particularly in the education and health sectors) (van Dooren *et al.*, 2007).

Findings are inconclusive on the impact of ownership (such as privatisation), competition (including outsourcing) and agencification. Private ownership is not a guarantee for efficiency and public ownership does not necessarily lead to inefficiencies. Likewise, not all services can benefit from competition which can impact prices but also costs and quality. Given the heterogeneity of public services, from refuse collection to municipal buses, the nature of service delivery (such as low asset specificity and low information costs) is crucial for successful competition in public services. Regarding agencification, there is some evidence that a reduction of input controls combined with steering for results, financial incentives and competition could lead to increased efficiency. However, the impact on the quality of service delivery and policy effectiveness is unclear. Agencification is also not without risks, which can affect financial and human resources and increase opportunities for political patronage and corruption.

### Operational cuts focus on reducing compensation costs


Most operational cuts focus on reducing compensation costs (Figure II.13). Compensation costs account for about 24% of government expenditures (11% of GDP). On average, governments in OECD countries employ 15% of the labour force. In most countries, government employees include teachers, doctors and police officers, many of whom are employed by local governments (Indicator 22).

Figure II.13. **Measures in fiscal consolidation plans to reduce operating expenditures (2010)**



Note: Some countries have announced cuts in more than one category. Data refer to consolidation plans in 29 countries as of December 2010.

Source: OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.

StatLink  <http://dx.doi.org/10.1787/888932389531>

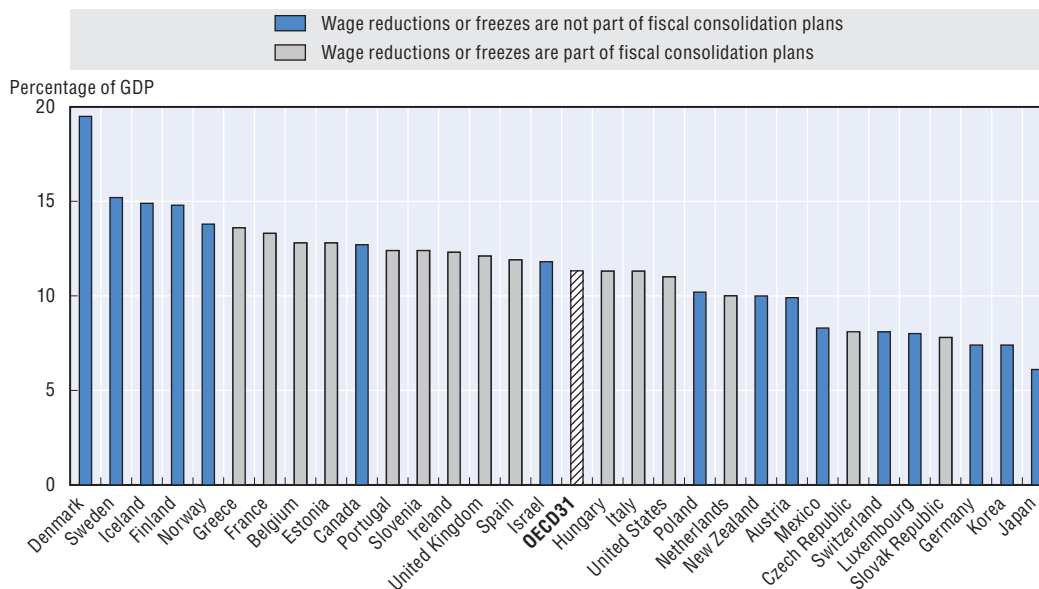
Compensation costs can be lowered by reducing the size of the workforce and/or cutting wages. While government employment tends to be sticky and has been stable over the past decade, over half of governments across the OECD have announced workforce reduction measures and/or cuts to salaries and benefits in order to cut costs (Indicators 21 and 24). Nordic countries where compensation costs are highest as a share of GDP have not announced reductions in this area.

Eleven OECD countries have set replacement ratios to fill the gaps left by central government staff leaving through retirement. These policies will likely have a large effect on the size of the central government workforce in Italy, given the large share of workers approaching retirement age (over 53% of central government workers are 50 years or older) and the low replacement ratio (only 1 in 5 staff will be replaced). Similar large effects may also occur in Spain and Greece, given the low replacement ratios and ageing profile (for example, Spain aims to replace 1 worker for every 10 who leave). Replacement ratios could be used in other countries that have yet to announce plans and where older workers make up over 40% of central government staff, such as Belgium, Germany, Sweden and the United States.

Twenty OECD member countries have announced plans to freeze or cut public sector wages. Cuts to salaries and wages could affect the government's ability to attract and retain staff, with high performers leaving (or forgoing) the public sector to pursue higher-paid opportunities with private companies.

**Figure II.14. Compensation costs account for a significant portion of government expenditures**

Compensation of general government employees as a percentage of GDP (2009)

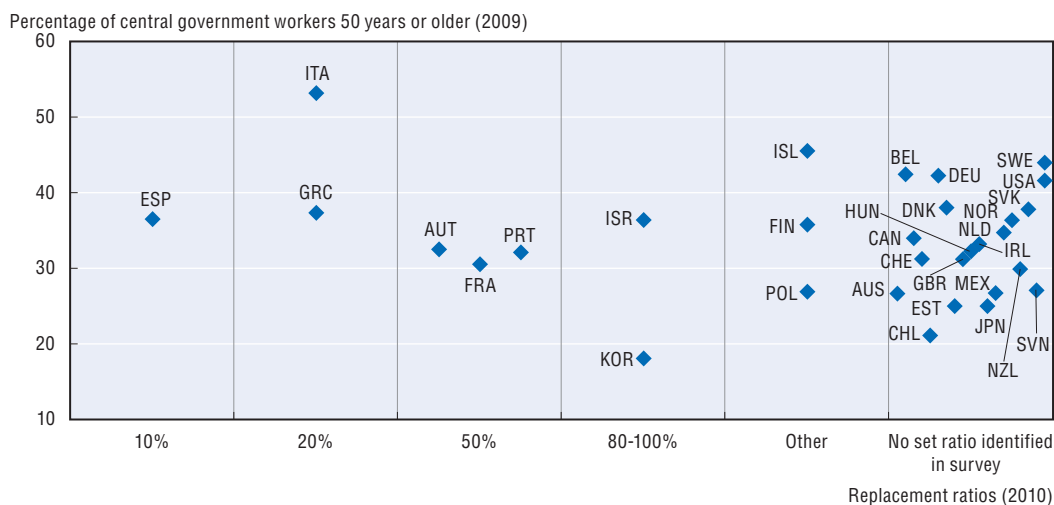


Note: Data are not available for Australia, Chile and Turkey. Turkey has planned wage reductions as part of its fiscal consolidation plan.

Source: OECD National Account Statistics; OECD Fiscal Consolidation Survey 2010 as presented in OECD (2011), *Restoring Public Finances*, Paris.

StatLink <http://dx.doi.org/10.1787/888932389550>

**Figure II.15. Government workforces are ageing**



Note: The Czech Republic and Turkey have also set replacement ratios (less than 50% of departing workers will be replaced in both of these countries) but are not included in the figure due to missing data on the age profile of their workforces.

Source: 2010 OECD Survey on Strategic Human Resource Management in Government.

StatLink <http://dx.doi.org/10.1787/888932389569>

Unfortunately, evidence is scarce to guide decision makers in this area. Many countries do not have the data they need to determine whether public sector staff are overpaid or underpaid compared to private sector counterparts. Salaries and wages are not a monolithic item across the government; they vary by position, by the share of remuneration that is based on performance, working hours and benefits. For example, in

Australia, performance-related pay can represent either over 20% of the basic salary or less than 10% depending on the position. While there is a large variation across countries in the average annual compensation paid for certain positions (see Chapter VI) teachers and nurses tend to make less than the average wage for university-educated adults in most countries (Indicators 25 and 26). OECD data on remuneration for key public sector positions show that wages and salaries represent on average 80% of total compensation. In addition, government (as an employer) contributes to retirement plans or pensions, and private health insurance costs or other social contributions. Thus, reforms to the pension and health systems (discussed above) could also have important effects on government compensation costs. However, changes in these areas may be more difficult to implement for current staff as they involve altering long-term contracts.

In addition, experience with prior reform indicates that ministerial rearrangements, wage cuts and voluntary retirement schemes (three common reforms included in the announced fiscal consolidation plans to date) tend to perform below expectations in terms of fiscal savings or may have adverse consequences on performance. Wage freezes may be reversed and may reduce public sector efficiency by lowering salaries and compressing salary scale differentials. Across-the-board expenditure cuts may be inefficient and less likely to lead to permanent cuts in expenditure. In addition, they can affect segments of the population unevenly, particularly women and children who benefit most from government programmes.

Prior experience with reforms suggests that operating expenses can be adjusted in a sustainable fashion by using sophisticated workforce planning, accompanied by good use of the departures due to ageing; automatic productivity cuts; long-term policy reviews; skills strategies and redesign of work. However, recent data collected by the OECD suggest that many governments can do more to manage staff strategically (Indicator 16). For example, fewer than half of OECD member countries require senior and middle managers to plan and report on workforce strategies to close competency gaps in a cost-efficient manner.

Spending cuts to operational expenses may be more effective when managers are given flexibility to decide how to apply them across the portfolio, because they may have a better idea than decision makers removed from daily operations where inefficiencies exist. In addition, involving workers or their representatives in developing restructuring plans can build buy-in and reduce the reform's negative effects on morale. While unions are often involved in negotiating remuneration, OECD data indicate that they are less involved in workforce restructuring plans (Indicator 33).

### ***Uncovering the drivers of rising production costs is needed***

Governments produce goods and services using a mix of their own staff (48%), private contractors (43%) and capital (9%) (Indicator 8). Between 2000 and 2009, governments' use of outsourcing (contracting with private and non-profit actors) has increased from 8.7% to 10.3% of GDP (Indicator 48). As it represents a large proportion of government expenditures, it is important to understand the reasons behind this growth, whether outsourcing is yielding value for money and quality services for tax-payers, and whether further productivity savings can also come from these private contractors, either directly or by improving the way that governments interact with them. A forthcoming OECD review of the federal procurement system in the United States has identified that potential productivity gains could be achieved through better leveraging of the knowledge held in the market. For example, engaging with potential suppliers of goods and services enables governments to understand the trends and innovations within the market and how these can be used to improve the delivery of public services. By focusing on outcomes rather than inputs and processes, performance-based

procurement enables the government to give scope to the market and suppliers to propose innovative solutions to the government's desired objectives. Ongoing work on measuring quality of public service delivery in different OECD countries could add further insights into the advantages and/or disadvantages of outsourcing.

In addition, some countries are looking beyond traditional contracting to focus on involving citizens and users in the design, production and delivery of services (Indicator 50). For example, the "Big Society" plans announced in the United Kingdom are based on the idea that communities can be given more power and to encourage individual citizens, co-operatives, charities and volunteers to take more responsibility for service delivery. This rebalancing of the relationship between government and citizens puts service delivery in an obscure space somewhere between market and government provision. While some governments are hoping that these new forms of collaboration will generate cost savings for governments, they also pose questions about accountability, transparency, efficiency and effectiveness in the delivery of those services. Business cases would need to be developed, including a focus on managing the risks posed by these new relationships.

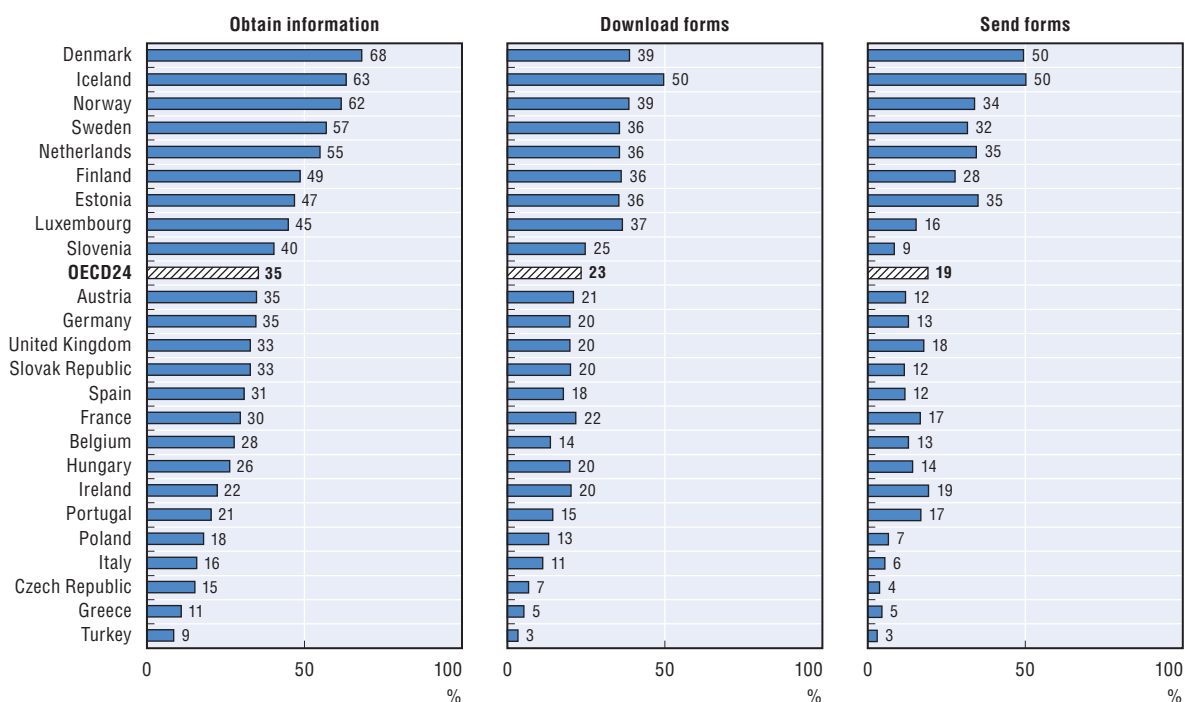
### *Efficiency gains from ICT use*

Although not a specific part of fiscal consolidation plans, ICT development and support is critical to helping all the branches of government work in a collaborative fashion and to achieve back-office efficiencies, which can lower operating costs. ICTs enable efficiency improvements in mass processing tasks and public administration operations. Internet-based applications can generate savings on data collection and transmission, provision of information and communication with customers. Significant future efficiencies are likely through greater sharing of data within and between governments. E-government is most effective when agencies work together in customer-focused groupings that allow them to share infrastructure, ensure interoperability, maximise implementation efficiency and avoid duplication.

While the use of ICT to interface with citizens and businesses in service delivery is fairly established in OECD countries, fewer countries have developed policies or strategies to realise internal efficiency gains. For example, only 6 of the 23 countries surveyed by the OECD have laws or policies regarding knowledge management (Indicator 20). The wide sharing of information electronically across sectors and boundaries within government is critical to foster innovation and reducing administrative burdens. Standardising knowledge management practices within Ministries or Agencies and across government can improve communication and decrease duplication – saving time and money. Unfortunately, internationally comparable data providing evidence on cost savings resulting from the use of ICT are scarce, although the OECD plans to develop these data in the future. As cloud computing and other new technologies become more widely used by governments in OECD countries, monitoring their costs and benefits will be key to learning more about the potential efficiency gains enabled by ICT and better contribute to the development of good practice.

In addition, governments are increasingly using ICT to improve service delivery, leading to reductions in red tape and saving time and money for citizens and businesses. Most countries have established a legal framework to enable widespread use of e-government by citizens and businesses (Indicator 20). For example, all countries have legislation or policies regarding the recognition and use of digital signatures and protecting the privacy and security of personal data. More and more citizens and businesses are looking on line: on average, 75% of businesses and 35% of citizens report using the Internet

Figure II.16. Citizens' use of the Internet to interact with public authorities (2010)

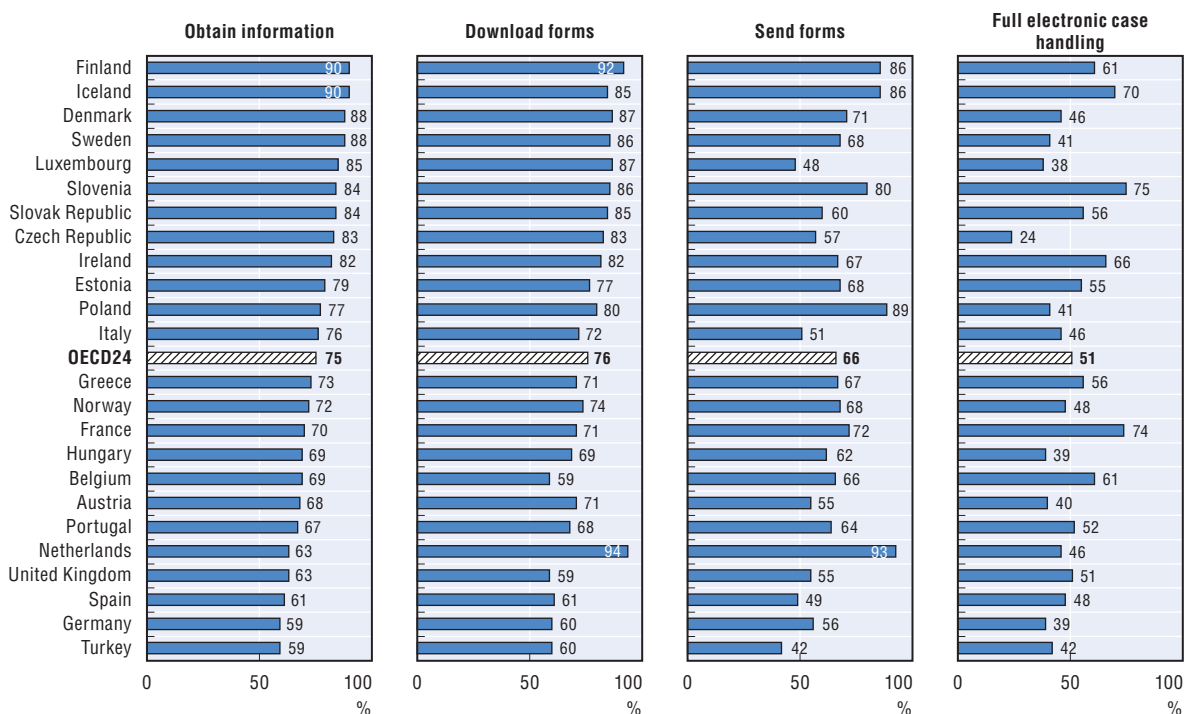


Note: Data are not available for Australia, Canada, Chile, Israel, Japan, Korea, Mexico, New Zealand, Switzerland and the United States. Data for Iceland refer to 2009.

Source: Eurostat.

StatLink <http://dx.doi.org/10.1787/888932389607>

Figure II.17. Business' use of Internet to interact with public authorities (2010)



Note: Data are not available for Australia, Canada, Chile, Israel, Japan, Korea, Mexico, New Zealand, Switzerland and the United States.

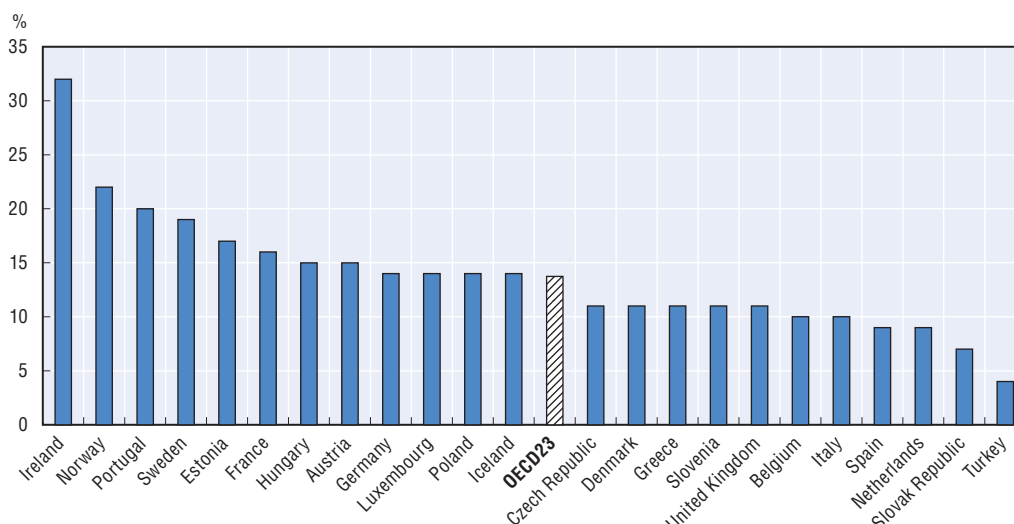
Source: Eurostat.

StatLink <http://dx.doi.org/10.1787/888932389626>

to interact with public authorities in 2010. However, room for improvement exists. Data indicate that most citizens and businesses go to government websites to find information, but fewer use the websites to complete transactions. For example, on average 51% of businesses report using full case handling on line whereas only 23% of citizens report downloading forms, with even fewer (19%) sending forms.

E-procurement is one area in which governments are using ICT to improve service delivery, lowering transaction costs and improving the timeliness and transparency of communications. Sixty per cent of procurement websites in OECD countries allow for two-way communication between government officials, bidders and the general public and over 50% permit bids to be submitted electronically. Over half of OECD countries provide contract management tools via their portals, such as tracking contract outcomes or statistics related to past procurements. Electronic payment schemes (*e.g.* e-invoicing) are less common (Indicator 42).

Figure II.18. **Share of enterprises using e-procurement (2010)**



Note: Data are not available for Australia, Canada, Chile, Finland, Israel, Japan, Korea, Mexico, New Zealand, Switzerland and the United States.

Source: Eurostat.

StatLink  <http://dx.doi.org/10.1787/888932389645>

In addition, new technologies have the potential to introduce a paradigm shift, where service delivery is entirely rethought from a user-centred perspective (*e.g.* around life events for citizens and businesses). However, while many OECD countries (20 of 23 respondents) identify e-government as a key tool to enhance innovation in the design and delivery of public services, fewer countries see this innovation as stemming from enabling users to participate more directly in service design and delivery (11 of 23 countries) (Indicator 20).

### **Revenue measures could have negative effects on equity**

The most frequently announced tax measure in fiscal consolidation plans is raising consumption taxes, followed by reducing tax expenditures and increasing income taxes (OECD, 2011b). In contrast, increases in property taxes are used by only three countries. The effectiveness of tax measures depends on how they influence production and income distribution. In general, OECD research suggests that those taxes which are least

distortionary should be targeted for increases: property taxes (particularly taxes on immovable property) seem to be the most growth-friendly (least distortionary) followed by consumption taxes and then by personal income taxes. Corporate taxes seem to be the most harmful for growth.

There is considerable variance between OECD member countries in terms of relative reliance on tax sources, and the revenue mix has important implications for the responsibility placed on different segments of society for funding government operations (Indicator 2). While consumption taxes may be relatively growth-friendly, they are regressive and disproportionately affect the services sector, which can compound the negative effect on lower income households whose members hold jobs in this part of the economy. First, as consumption taxes (such as the value-added tax, or VAT) are a flat tax placed on certain goods and services, they constitute a larger proportion of salaries for low income households than for high income households. Second, the public may reduce consumption in reaction to the tax, which can have knock-on effects on employment. For example, if demand for certain services decreases as a result of the tax, then companies operating in these areas may decrease their payrolls.

## Conclusion

While the announced fiscal consolidation plans represent a first step in identifying areas for savings in government spending and signalling to citizens and markets that changes will come, they do not go far enough to achieve fiscal sustainability for a number of countries. Policy makers face a dilemma when devising and implementing plans: while there is general public support for consolidation, resistance occurs when cuts get specific or tax increases are proposed. While health consumes a large portion of government resources, reforms in this area may not generate enough savings to balance budgets. Infrastructure is a comparatively smaller portion of government expenditures and yet it is targeted by many countries. While shielding education from cuts may be important to ensure future economic growth, the magnitude of fiscal consolidation needs in some countries may not make this feasible. In addition, putting off needed reforms until market pressures force changes means that cuts have to be more drastic and are less likely to be based on evidence.

Practicing strategic insight can help governments identify when and where more changes are needed. Strategic insight here is the ability to understand and balance government values, societal preferences, current and future costs and benefits, and expert knowledge and analysis, and to use this understanding coherently for planning, objective setting, decision making and prioritisation. Strategic insight is based on assessing and managing risk, and embedding evidence-based decision making in policy development and implementation. It requires strong leadership from the centre of government to assume a whole-of-government approach that incorporates views from multiple actors to help prioritise goals and minimise unintended consequences. Almost all OECD member countries produce long-term fiscal projections that assess the likely consequences of continued current spending with the impact of demographic change and other factors. However, while international data exist on government performance in key policy areas – such as health and education – decision makers are not using this information to make strategic decisions regarding programme cuts. Governments also need to understand how efficient their spending is and make cuts or changes to areas identified as inefficient. To accomplish this, governments need data on costs (inputs), outputs and outcomes.



A role for the OECD continues to be to monitor the quality, implementation and success of reforms using data on government expenditures, revenues, processes and performance. Future editions of *Government at a Glance* aim to further broaden the evidence base by developing performance indicators, including those on service quality, and moving from measuring the existence of laws to evaluating their implementation. In addition, implementing reforms provides governments with the opportunity to put in place new performance measures that can help track and monitor the effectiveness of their actions, and report to citizens on their progress. As governments forge a new role, a key challenge for governments will be measuring and monitoring public perceptions to ensure that reforms are on the right track and capture the sentiment of the electorate.

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**From:**  
**Government at a Glance 2011**

**Access the complete publication at:**  
[https://doi.org/10.1787/gov\\_glance-2011-en](https://doi.org/10.1787/gov_glance-2011-en)

**Please cite this chapter as:**

OECD (2011), "Fiscal Consolidation: The Need for Evidence-Based Decision Making", in *Government at a Glance 2011*, OECD Publishing, Paris.

DOI: [https://doi.org/10.1787/gov\\_glance-2011-6-en](https://doi.org/10.1787/gov_glance-2011-6-en)

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