VI. ENHANCING THE COST EFFECTIVENESS OF PUBLIC SPENDING

Introduction

Curbing the growth in public spending and raising its effectiveness…

Public spending rose steadily as a share of GDP in the three decades to the mid-1990s, but this trend has since abated. The spending pressures stemming from the continued expansion of social programmes have been partly compensated by transient or one-off factors. Pressures on public spending, however, appear likely to intensify, in particular as a consequence of ageing populations. Since most OECD economies have very little scope for raising taxation or debt to finance higher spending, reforms to curb the growth in public spending while raising its cost effectiveness are now required. This process will involve difficult choices as to the allocation of resources, the more so that public spending programmes also have important roles to play in pursuing economic growth and equity objectives. This paper presents a reform strategy for progress in this direction, based on detailed country reviews for over two-thirds OECD countries.[1] Three main areas for action are identified: the budget process; management practices and the use of market mechanisms in the delivery of public services.

… require reforms to the budget process…

To enhance the efficiency of the *budget process*, and as a means of ensuring fiscal sustainability, many countries have introduced or strengthened fiscal rules, either through limits on expenditure or through tax, budget balance or debt ceilings. Effective use of such rules requires that they be accompanied by budget principles conducive to an efficient allocation of funds across spending programmes. In particular, there is a need to extend planning horizons, while reducing budget fragmentation (for example, by incorporating tax expenditure in the budget framework, controlling extra-budgetary funds and monitoring contingent liabilities such as those stemming from loan guarantees and from public pension schemes) and increasing the focus on public spending outcomes.

… public management practices…

The reform of *management practices* has embraced a trend towards a results-oriented management approach in several OECD countries, whereby policy-makers define output or outcome objectives while managers decide on how best to reach them. Implementation difficulties have, however, been important in this area. In particular, identifying good performance indicators and designing appropriate incentive

1. This chapter draws extensively on OECD individual country Economic Surveys, in particular on in-depth public expenditure chapters prepared for 21 OECD countries. For many of these chapters, a revised version is freely available on the OECD website. Although other sources of information have been used, country references in this chapter largely reflect this non-exhaustive coverage. A more detailed synthesis of these individual country chapters and information available elsewhere is provided in Joumard *et al*. (2003).

mechanisms to encourage public entities to reach the desired outcomes are critical to the success of these new public management approaches.

… and greater use of market signals

Market signals have a strong role to play in enhancing the effectiveness of public spending. On the supply side, competitive pressures can be strengthened to create incentives for providers of public-funded goods to improve cost-efficiency while better responding to the citizens' needs. Several instruments can be used in this respect: benchmarking; subcontracting combined with open and transparent tendering; and giving users the choice among alternative providers, through the use of voucher schemes for instance. The demand for publicly-funded services can, however, be spurred by the provision of higher quality and more diversified services and the absence of appropriate price signals to users. Avoiding an adverse effect on the public purse may require introducing or raising user charges to contain excessive demands for several publicly-funded services. In exploiting the role of market signals, a trade-off between efficiency and equity objectives may emerge, either because user fees deny some population groups access to public services or because compensation mechanisms for providers create an incentive to concentrate on the most lucrative segments of the market (to "cream-skim").

Rising demands on public spending programmes

In cyclically-adjusted terms, the public spending ratio has been steady…

Having risen steadily over several decades, the public spending to GDP ratio in the OECD area has declined mildly since its peak in 1993, to stand at slightly over 40 per cent in 2002 (Figure VI.1). This profile has largely been shared across OECD countries, Korea and Japan being the main exceptions. There is, however, little scope for complacency, since the decline in the public spending to GDP ratio largely reflects the prolonged economic and employment boom over the second half of the 1990s, which triggered a decline in transfers to households. In cyclically-adjusted terms, general government primary outlays have remained broadly constant since the mid-1990s in the OECD area at large. Moreover, the steadiness of the cyclically-adjusted ratio largely reflects the influence of several one-off or transient factors which have temporarily offset more persistent underlying pressures on public spending.

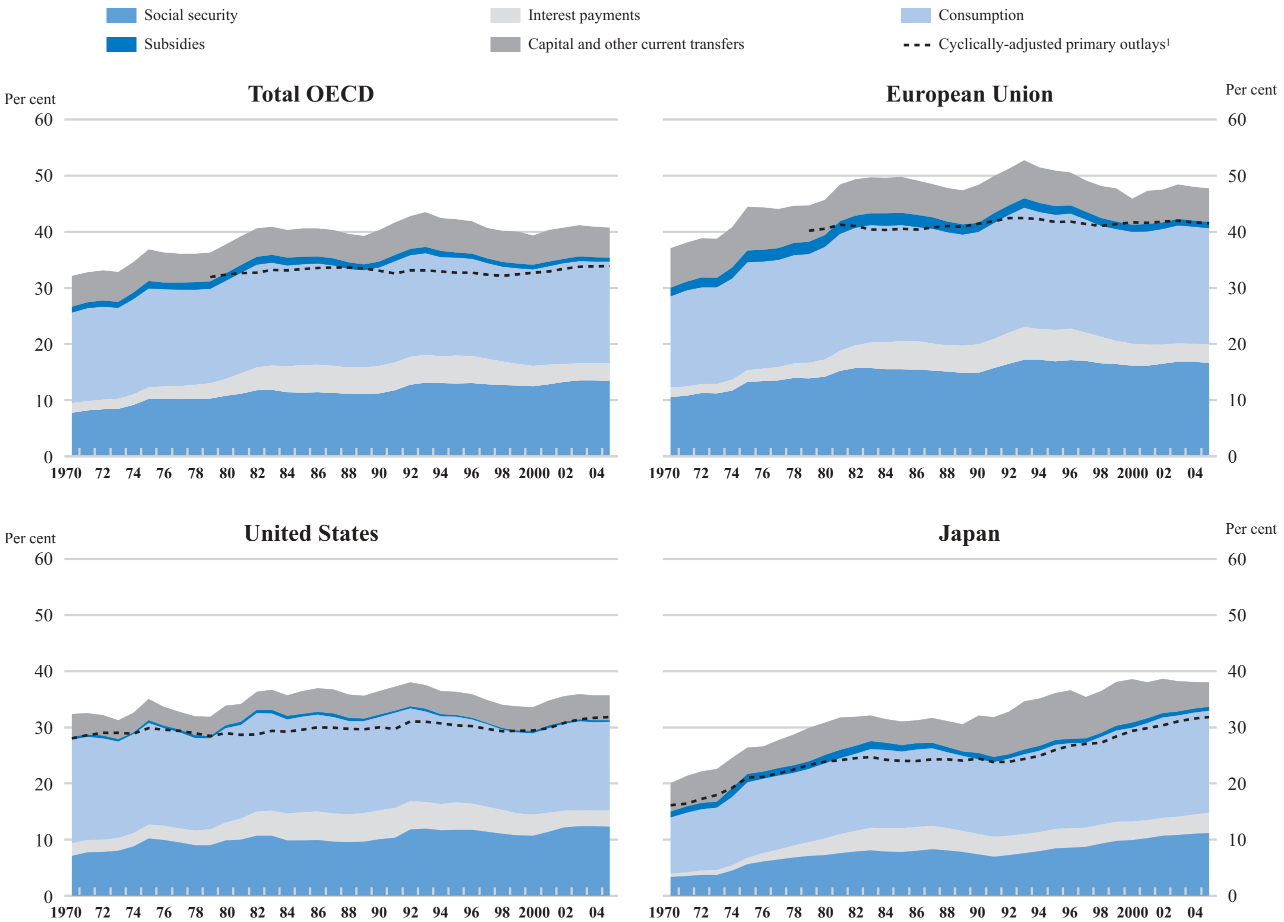
… largely due to transient factors

The principal downward forces, which have now abated or been reversed, include:

- The disinflation process of the early 1990s, which was gradually reflected in lower nominal and real interest rates and contributed to a reduction in debt servicing costs.
- Privatisation operations, whose proceeds were partly used to reduce public debt and thus also contributed to falling debt servicing costs.
- The "peace dividend", which was reflected in a steady fall in defence spending up to the late 1990s but has been partly reversed since then.
- *Ad hoc* spending freezes (*e.g.* cuts to capital outlays, public sector wage freeze), which by their nature are usually only temporary in their effect, in particular when they are followed by a subsequent "catch-up" round.

Figure VI.1. Trends in general government outlays

As a percentage of GDP



Note: From 2003 onwards data are based on OECD estimates and projections.
1. Expressed as a percentage of potential GDP.
Source: OECD.

Demands on social programmes have not abated

Meanwhile, public spending on pensions, poverty alleviation programmes, education and health care have continued on a clear upward trend over the past two decades in virtually all OECD countries. Population ageing has already been reflected in an increase in spending on old-age cash benefits and services for the elderly and disabled, as well as on health care services. In the health care sector, technological changes and increased demands for access to new forms of health care have created additional pressures on expenditure. In the education sector, spending has also continued on an upward trend in most OECD countries despite a significant decline in the size of the school-age population in several of them (Greece, Japan, Poland and Spain). In parallel, early retirement, disability and unemployment programmes have often been used as a means of premature, and usually permanent, exit from the labour force (including Finland, France, Germany, Italy, Norway and Poland). Schemes to fight poverty have also been introduced or made more generous in several countries (France, Japan, Korea, Mexico and Portugal) although others have cut in benefit rates and tightened eligibility criteria (New Zealand and Sweden).

Cross-country differences in spending levels should not be overestimated

Marked differences are apparent in the public spending-to-GDP ratio among OECD countries, with Nordic and most continental European countries being above the OECD average, while Australia, Korea, Japan, New Zealand and the United States are below. However, several factors should be taken into account in drawing cross-country comparisons (Box VI.1). The organisation of the welfare system is of particular importance. Adjusting for tax breaks for social purposes ("tax expenditures"), for the taxation of social benefits and for the reliance on private insurance schemes (some of which are mandatory) leads to a convergence in the amount of resources allocated to social protection across countries (Figure VI.2).

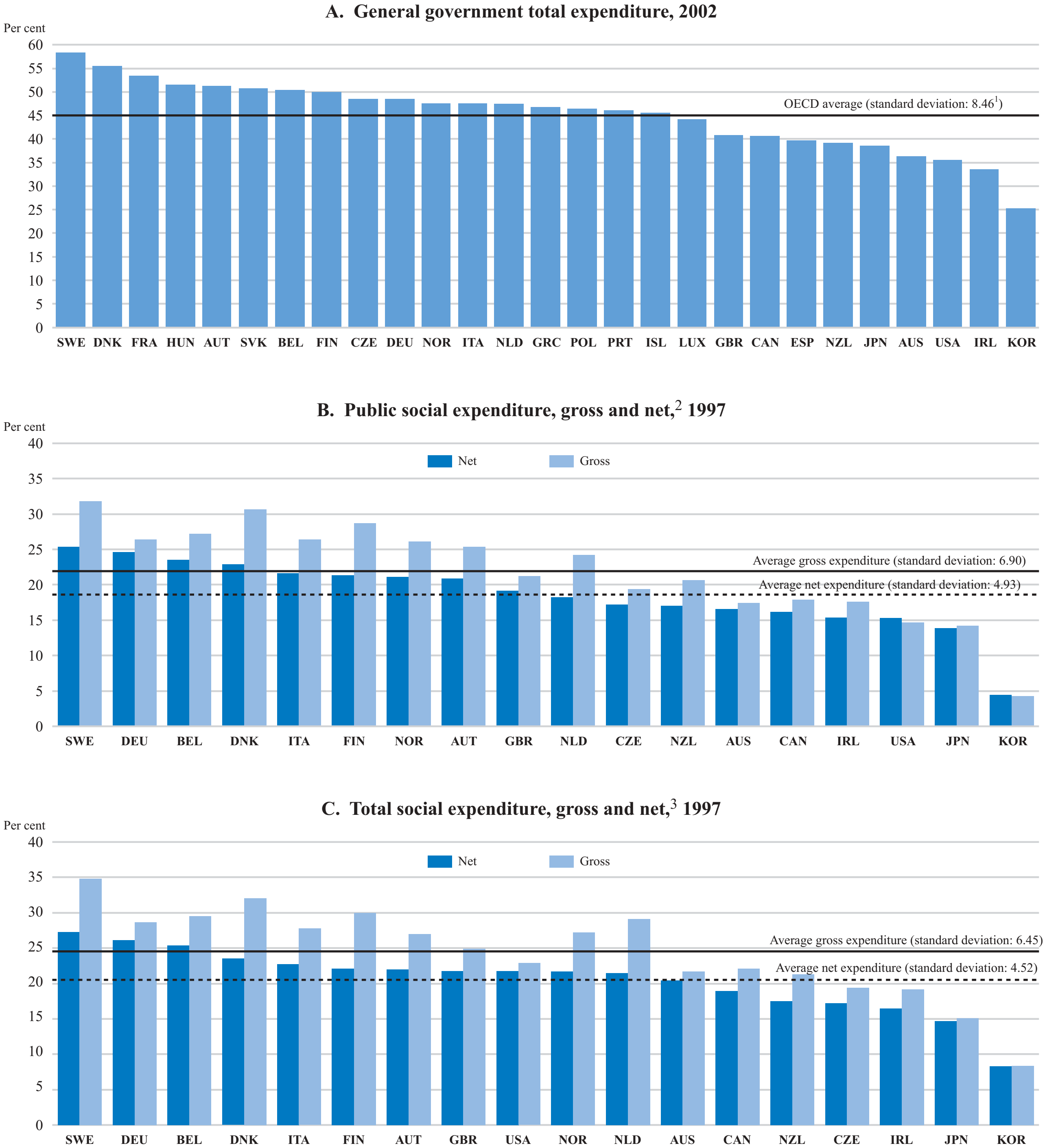
Box VI.1. **Public spending measurement issues in drawing cross-country comparisons**

It is difficult to draw solid cross-country comparisons, either with respect to the level or the composition of public spending. Particular issues to be taken into account include:

- The extent to which countries rely on *tax expenditures* as opposed to direct expenditure. Tax expenditures are substantial in some countries. As an illustration, in the United States, income tax expenditures amounted to about 8 per cent of GDP at the federal level in 2002. In Denmark and Norway, total tax expenditures amounted to about 5 per cent of GDP. Fully adjusting data for this factor is, however, difficult since there is no consistent information on the amount of tax expenditure across countries, largely reflecting the absence of an agreed operational framework for measuring tax expenditures.
- The *taxation of social benefits*. In some OECD countries, transfers are subject to broadly the same tax treatment as wage income (Italy and the Nordic countries), while in others they are predominantly untaxed (Mexico; Austria, Germany and Portugal for unemployment cash benefits; Germany and Portugal for sickness benefits). For a given amount of net social transfers paid by the public sector and received by households, the level of public outlays will be higher in the first group of countries. Differences in levels of indirect taxes often add to those resulting from income taxes, with the proportion of benefit income which comes back to the government indirectly through taxes on consumption being much larger in European countries than in Australia, Canada, Japan, Korea and the United States.[1]
- The reliance on (mandatory and/or voluntary) *private insurance schemes* for pensions, unemployment, and/or health care system. In particular, the earnings-related elements of the pension system, which are a feature of public pension systems in a large number of countries are almost entirely organised as private pension funds in Denmark, although they are largely mandatory by nature (being embodied in collective agreements). Benefits associated with mandatory contributions to privately-owned and managed insurance funds are also important in Korea (mainly sickness benefits) and Switzerland (health care insurance). On the other hand, benefits associated with voluntary contributions to social security funds (amounting to 1.2 per cent of GDP in Germany in 2000) are counted as public expenditure.
- Financing projects through *public-private partnerships* as opposed to conventional public investment. Several countries are increasingly relying on public-private partnerships (PPPs) to finance investment projects. As far as public finance data are concerned, conventional public investment is reflected in public accounts statistics as and when projects are undertaken, whereas in the case of PPPs the cost is spread over a much longer period, in particular when the service of infrastructure utilities are purchased by the government (a feature of the Private Finance Initiative in the United Kingdom). Thus, there will be a transitory decline in public expenditure in periods when reliance on PPPs is increasing.
- *The use of guarantees on loans* as a substitute for direct capital transfers or subsidies. Guarantees issued by state-owned enterprises (as in the Czech Republic and Poland) are not reflected in general government expenditure in the year they are extended although they may enter as a "below-the-line" item as the government assumes full responsibility for the debt in the future. In Poland, however, these guarantees and expected calls upon them are recognised in the national definition of public debt, which is subject to a ceiling specified in the Constitution.

1. Adema (2001) provides estimates for net public social expenditures, adjusting for the impact of the taxation of social benefits and tax allowances for social purposes as well as for indirect taxes.

Figure VI.2. **Comparing public spending-to-GDP ratios across OECD countries**



1. The standard deviation is calculated using only the data for countries shown in Panel B and C.
2. Net public social expenditure is equal to gross public social expenditure, less direct taxes and social contributions paid out of public cash benefits and indirect taxes on private consumption financed by net cash transfers, plus tax breaks for social purposes (not including pensions).
3. Total social expenditure is made of public social expenditure and private programmes which serve a social purpose and contain an element of inter-personal redistribution.

Source: OECD; Adema (2001).

Pressures on public spending are likely to intensify

Ageing will have severe fiscal consequences in virtually all OECD countries while public investment is scheduled to rise in several of them. Recent OECD projections, though highly uncertain, suggest that the progressive ageing of the population will, *ceteris paribus*, result in an average expenditure increase of 7 per cent of GDP over the period 2000-50 (OECD, 2001a). In addition, efforts to develop public infrastructure are a national priority in those countries where there is currently a perceived deficiency (Germany in the New Länder, Hungary, Ireland, Italy in the Mezzogiorno, Mexico, Poland and the United Kingdom) and this could be another source of public spending growth. Meanwhile, pressures on the revenue side limit what can be financed through taxes and put further emphasis on the value-for-money of public spending programmes. Such pressures are intensified by internationalisation, with the corresponding enhanced mobility of tax bases, and by the detrimental impact of taxes on economic behaviour of consumers, workers and producers, and thus on economic growth (OECD, 2001b).

Making the budget process more responsive to priorities

Fiscal rules have been adopted to control public spending growth…

OECD countries have taken several initiatives in reforming the budget process so as to contain the growth in spending. Many OECD countries have either adopted some form of fiscal rules, or tightened existing ones, since the early 1990s putting direct constraints on public spending via expenditure caps or indirect ones via deficit and/or tax ceilings (OECD, 2002). A complementary approach has been to implement a top-down strategy, whereby Parliament makes a binding political decision as to the level of total expenditure and ceilings for broad expenditure areas at an early stage in the budgetary process.

… but their effectiveness depends on the quality of economic assumptions

Biased economic assumptions can result in fiscal slippages and sub-optimal resource allocation. Overly optimistic economic assumptions have hindered progress in fiscal consolidation and have often required subsequent *ad hoc* adjustments. Conservative assumptions as to the rate of economic growth or of revenues may also have adverse effects, with positive revenue "surprises" being used to boost spending demands, sometimes permanently. Recognising that economic forecasting deserves greater scrutiny and a higher degree of independence, measures to improve forecast reliability have been taken in several OECD countries (*e.g.* Austria, Canada, Germany, Hungary, the Netherlands and United States). But further progress in this direction is needed in others (including France, Hungary, Korea, Portugal and the United Kingdom).

The budget process should encompass a longer-term perspective

Anchoring the budget process in a medium-term perspective can contribute significantly to a more efficient allocation of spending and hence to fiscal sustainability. Efforts to control the growth of public spending over too-short a budget horizon may have adverse allocative effects. Failure to look far enough ahead entails the risk that adjustments will be made without accounting properly for the economy's position in the cycle, that spending whose benefits take time to materialise will be squeezed (in particular investment) and that structural reforms to control spending will not be promoted. To avoid these potential pitfalls, some countries have shifted the emphasis to cyclically-adjusted fiscal rules (Switzerland and European Union (EU) countries within the context of the Stability and Growth Pact). By permitting deficits during recessions, while requiring that surpluses be achieved during upswings, such rules may help to avoid *ad hoc* and sub-optimal spending adjustment. Estimating the economy's cyclical position and cyclically-adjusted budget balances is based on an element of judgement, however, and this introduces a possible source of bias.[2] Moreover, allowance for the business cycle in itself may come at the expense of transparency, which is essential for the credibility of the fiscal framework.

Medium-term budgeting takes various forms

Strategies to raise awareness of longer-term trade-offs implicit in the annual budget process, and thus promote fiscal discipline and reallocation, have also been implemented. Several countries have opted to present regularly medium-term budget projections (Canada, New Zealand, Poland and EU countries in the context of the Stability or Convergence Programmes) or information on medium-term budget impacts for any new spending initiative to the Parliament (Czech Republic and Switzerland). Furthermore, a number of OECD countries now present longer-term budget projections and/or generational accounts (Australia, Norway, New Zealand, the United States and EU countries). Some have also introduced mechanisms to provide greater certainty about future entitlements and avoid arbitrary short-term spending adjustments. These include multi-year budgeting (Canada, Netherlands, Sweden and United Kingdom) and multi-year plans for specific expenditure programmes in particular public investment (including Czech Republic, Denmark, Ireland, Japan, Korea and Norway).

Enforcing fiscal targets is also a political economy issue

Although fiscal rules approaches and/or multi-year budgeting procedures have been strengthened, they have not been proof against deteriorations in financial positions or lack of political willingness to enforce them. In the euro area, the Stability Programmes did not prevented some countries from easing fiscal policy during the upswing in the late 1990s while some countries have breached the deficit ceiling of 3 per cent of GDP. They are now subject to an enhanced surveillance procedure, but are still allowed a long time span before complying with the deficit ceiling. In the United States, the *Budget Enforcement Act* in place up to 2002 was an effective means of spending control, but could sometimes be circumvented by designating funds as emergency spending or by using advance appropriations to spread budget authority over more than one year. Moreover, the impact of fiscal rules can be blunted by creative accounting approaches and/or by channelling expenditure through the tax system or relying on off-budgetary funds, public-private partnerships and loan guarantees to implement policies which would otherwise appear more directly in the budget and fiscal accounts.

The budget process should be less fragmented…

Improving the transparency of spending decisions, underscoring both current and future costs, is a necessity for supporting an effective allocation of public funds towards national priorities. Although they may have some merits, tax expenditures, off-budgetary funds, public-private partnerships and loan guarantees are often subject to less scrutiny and can be more difficult to terminate. They may thus hamper an efficient control on public spending and an optimal allocation of resources across competing demands. To mitigate these potential drawbacks, budget papers should provide information on tax expenditures on a regular basis (Denmark, Poland and Switzerland), on extra-budgetary funds (Czech Republic, Hungary, Korea and Poland), as well as on contingent liabilities associated with loan guarantees (Czech Republic, Hungary, Japan and Poland). A wider use of accrual accounting, as a complement to current cash accounting used in most OECD countries, would also help to make the true cost of government activities more transparent.

2. For a fuller discussion, see Chapter IV.

… with a clearer focus on overall priorities and programme outcomes

Efforts to restrain the growth of public spending have often been accompanied by initiatives to strengthen the focus on overall priorities in the budget process and make them more visible. Pre-budget reports, or reports presenting the policy platform for the government's term in office, have been introduced (including Canada, Finland, France, Hungary, Ireland, Italy, New Zealand, Norway, Sweden and the United Kingdom). To further facilitate strategic prioritisation, many countries have given greater emphasis to programme results (Kristensen *et al.*, 2002). While Australia, Canada, the Netherlands, New Zealand and the United Kingdom have been front-runners in this area, budget papers have been restructured according to programmes defined by objectives in a majority of OECD countries, and the number of budget lines has been, or is being, reduced. Over three-quarters of OECD countries now include information on performance and targets in their core budget documents, or in separate documents accompanying the budget. In this context, sunset clauses, which provide an opportunity to ensure regular reviews of the costs and benefits of spending programmes, could play a more important role in some countries (including Czech Republic, France, Korea, New Zealand and Poland).

Implementing public management approaches geared towards outcomes

New public management approaches have attractive features

With a view to improving public spending outcomes, many countries have reassessed public sector management practices. The main focus has shifted from the amount of resources used by a programme or ministry to the services delivered or outcomes achieved. This has entailed clarifying desired or targeted results for governmental and public bodies, with heightened emphasis on user-orientation, while entrusting the managers of spending agencies with more flexibility in their day-to-day operations. In particular, constraints on the timing of spending appropriations have been somewhat relaxed through carry-over provisions in a large number of countries and the line-item budgeting and management approach has been gradually abandoned, with managers now receiving a single appropriation for all their operating costs in many OECD countries (Australia, Canada, Denmark, Finland, Iceland, Netherlands, New Zealand, Norway and Sweden). Partial evidence suggests that this has allowed public bodies to respond better to user needs, while improving cost-efficiency (*e.g.* by helping to avoid end-year spending splurges).

Successful implementation requires identifying "good" targets…

The success of performance-oriented management approaches for both public bodies depends critically on the existence of well-defined performance targets and effective performance evaluations. Country experiences, however, suggest that identifying good performance indicators is not an easy task, with countries frequently undergoing a learning-by-error process. If they are too numerous, performance targets carry the risk of blurring priorities. Easily quantifiable targets also often come at the expense of those that are important but cannot be easily measured. In this context, the need to strengthen performance evaluations by independent auditors and to compare actual performance with targets has been identified for several countries (France, Hungary, Iceland, Japan, Korea, Poland, Switzerland and the United Kingdom).

… and designing appropriate incentives…

Designing appropriate incentives to encourage public entities to reach their performance targets has become an issue in several countries. The lack of a reward and sanction system has been considered as a problem in certain countries (including Finland and the United Kingdom). For specific services, there is an increasing recourse to activity-based funding which directly acts as a reward and sanction system. This entails that providers of publicly-funded services are compensated according to their performances, often measured by the volume of activities, with prospective payment systems and fee-for-services in the health care sector as examples. In the education sector also, several countries have made institutions' resources conditional on the number of students or degrees passed (*e.g.* universities in Denmark, Norway, New Zealand and Switzerland). One major difficulty, however, lies in defining what should happen if the approved performance or activity level is not achieved. In the case of essential goods and services, it is doubtful whether poor performers could be sanctioned, especially if there is no alternative supplier, as this could lead to further cut backs in service provisions.

… while avoiding a hike in public spending

Relaxing input controls in favour of results-based financing may spur efficiency gains but may also put spending control at risk. In the presence of pent-up demand (*e.g.* waiting lists for health care services) and productivity reserves, the surge in public spending may only be temporary. But, in the longer-run, there are several necessary conditions for results-based financing to deliver efficiency gains while controlling total spending. This includes, in particular, setting appropriate prices for publicly-funded goods in order to contain excessive demand pressures, while ensuring adequate and fair competition across providers. Even under such circumstances, designing payment systems that limit incentives to oversupply has been difficult, in particular in the health care sector where providers are typically better informed than patients and insurers about the true need and scope for medical treatment. Setting an overall envelope for a given publicly funded service and allowing providers to compete for market shares within this envelope – as implemented in the hospital sector in Austria and for research activities in Norwegian universities – could mitigate the risk of a supply-induced rise in demand.

Reforming human resource policies is becoming more urgent…

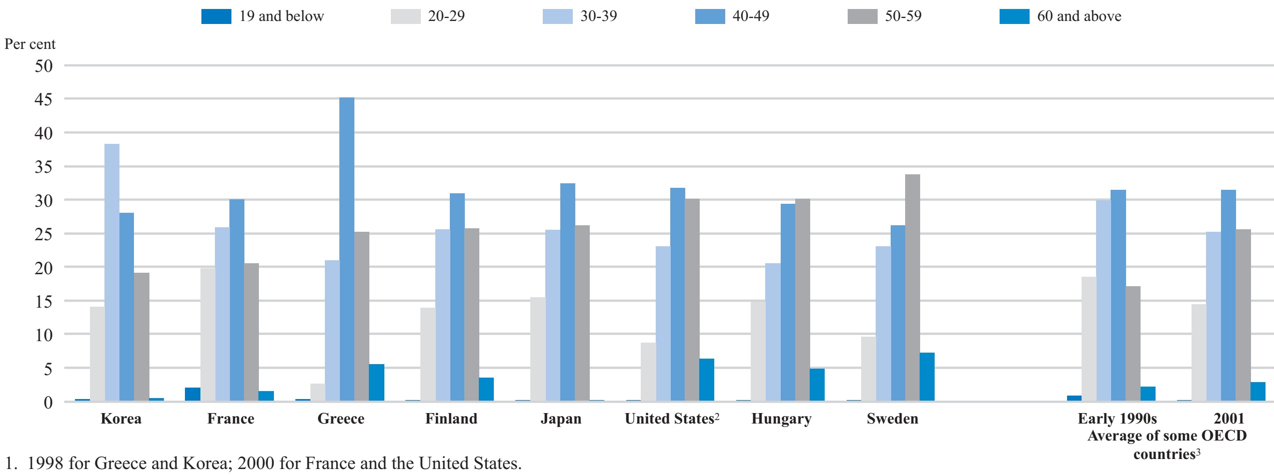
With labour being the main input to public services, implementing a results-oriented management approach has made personnel management reform in the public sector more pressing. In several countries, a significant proportion of public employees will soon reach the retirement age (Figure VI.3) – a more acute problem in Canada, Denmark, Finland, Ireland, New Zealand, Portugal and Sweden – and serious skill or personnel shortages have already been a cause of concern. Until recently, job security, reduced working hours and more generous pension provisions have often been part of the attraction of the public sector as an employer. But, by locking workers into life-long public sector employment, these practices have contributed to make public spending behaviour asymmetric, with public employment adjusting upwards when a new demand emerges but failing to adjust downwards when demand wanes. The retirement of a significant share of employees should be taken as an opportunity to reconsider the overall need for labour, and the nature of both job contracts and compensation in the public sector, so as to better adjust the workforce to changing needs in the future.

… through more flexible job status…

To address these issues and complement changed approaches to public management for public bodies, many countries have introduced a new flexibility and performance orientation into human resource management systems. Life-long contracts are used less frequently, and have even been abolished, in a number of countries (Canada, Denmark, Finland, Iceland, Italy, New Zealand, Portugal and Switzerland).

Figure VI.3. **Age structure of public employees in selected OECD countries**

2001[1]



1. 1998 for Greece and Korea; 2000 for France and the United States.
2. Age groups are slightly different from those shown for the other countries: less than 31, 31-40, 41-49, 50-59 and 60 and above.
3. Australia, Finland, Hungary, Japan, Netherlands and Switzerland.

Source: OECD, *Public Management Service,* 2002.

Reducing barriers to mobility within the public sector so as to avoid duplication and understaffing should, however, be considered in several countries (Greece, Italy, Mexico and Portugal). Measures to encourage the mobility of staff between public and private sectors also need to be considered (*e.g.* by facilitating the portability of pension rights between public and private employers).

… and compensation schemes

To enhance the attractiveness of the public sector as an employer in sectors and regions characterised by serious labour shortages, several measures have been introduced. These include enhanced training opportunities (Czech Republic and Italy) and more flexible working time (Germany, Italy, Portugal and Switzerland). Pay arrangements are often being reviewed, with automatic seniority bonuses and fringe benefits being reconsidered (Canada, Finland, Ireland, Mexico and Switzerland) and public sector wages adjusted to reflect market conditions better (including Finland and Ireland). To improve motivation, elements of incentive-based promotion and pay have been strengthened in many countries (Canada, Denmark, Iceland, Ireland, Italy, Mexico, New Zealand, Switzerland and United Kingdom).

Performance-related pay raises challenges

Performance-related pay schemes for public sector employees have raised intricate challenges. The efficiency gains from performance-related pay schemes remain problematic, in particular when individual performance is difficult to measure. When wage gains are spread over a large proportion of staff, these may be seen as “quasi-normal” pay supplement, reducing incentives to outperform. On the other hand, restricted to a small group of high-performers, rewards may result in a majority of dissatisfied “losers” who could be demotivated. In practice, managers often appear unwilling to differentiate among their subordinates and most employees tend to receive similar, lenient, rating. Country experiences further suggest that implementing performance-related pay systems can contribute to wage pressures in the public sector and fail to deliver efficiency gains if it is not accompanied by adjustment in employment levels (Czech Republic and Iceland). Mitigating these potential adverse effects would argue for applying performance-related pay rather selectively in the public sector, targeting those activities where performance can be more easily measured (as, for example, with hospital employees, where outputs can be identified through the use of a case-mix system).

Extending market signals to enhance the effectiveness of public spending programmes

On the supply side, more competitive pressures can be imposed…

Raising competitive pressures on providers of publicly-funded goods can promote cost-efficiency and responsiveness to evolving customer preferences. In this respect, various instruments have been used in OECD member countries, including benchmarking, competitive tendering for public procurement and promoting user choice among alternative suppliers. The choice of instruments, and their effectiveness, depends on several factors. If permanent contracts for public employees predominate, outsourcing and user choice may not be financially attractive options, at least in the short run. Likewise in a decentralised setting, the presence of very small government units and large geographical distances between them may not permit efficient market solutions because transaction costs may be high (with respect to competitive tendering, for example), so that competition may fail to develop or scale economies may be difficult to achieve. In both cases, allowing comparisons on quality and costs to be made across providers of similar services could provide a promising avenue.

… through benchmarking,…

Benchmarking can help identify both best practices and inefficiencies, and thus be an effective means of exerting competitive pressures. Several countries have recently developed benchmark indicators for selected services, particularly for hospital care and/or education (including Czech Republic, Finland, France, Hungary, Iceland, Japan and Portugal). In some decentralised countries, there has also been a conscious effort to provide local citizens with information on the coverage and costs of public services across jurisdictions (Norway and Sweden), leading to pressures on local administrations to raise the cost-effectiveness of their spending programmes. Reaping the full benefits of benchmarking requires improving the quality of the information system and/or disseminating more widely the results of spending evaluations (a requirement acknowledged in the case of Canada, Finland, Iceland, Sweden and Switzerland). Difficulties in setting up a reward and sanction system may, however, limit the degree to which competitive pressures actually deliver cost-efficiency gains.

… outsourcing and competitive tendering

OECD countries have tended to rely increasingly on sub-contracting and competitive tendering to obtain a more cost-effective provision of services (Lundsgaard, 2003). Legislation and procedures on public procurement have been simplified and standardised in a number of countries while information technology has been used more intensively, thus reducing some of the costs associated with outsourcing and tendering. There are, however, still significant regulatory impediments to a wider use of competitive outsourcing which need to be reconsidered. Public procurement policies have sometimes been used to protect local and/or small enterprises (Czech Republic and Japan). Tendering rules do not apply to large segments of the public sector in a number of countries (Hungary and Poland). Tax rules, and in particular VAT regulations, may also create a competitive bias in favour of in-house production (*e.g.* Finland and Norway). Furthermore, in highly decentralised countries, a lack of professional experience among subnational government staff, including the absence of proper cost-accounting, may hamper the diffusion of outsourcing, calling for greater co-operation across subnational government and possibly technical help from the central government (Denmark, Finland and Norway).

Greater user choice can also strengthen competition…

Promoting user choice among alternative providers of publicly-funded services can strengthen competitive pressures, trigger innovation and result in services which respond better to citizens' needs. A number of OECD countries have recently taken measures in this direction, in particular in the health care sector (Czech Republic, Hungary, Poland and Sweden), in job placement or training services (Australia, Denmark and Netherlands) and in the education sector (Sweden and the United Kingdom). In most cases, implicit voucher models, whereby money follows the user, have been implemented, allowing providers to adjust to the level of demand. Restraints on the choice of service providers persist, however, in many countries and need to be overcome. They include: zoning restrictions; restrictions on market entry for private providers; discriminatory financial arrangements (funding arrangements for public providers may not properly reflect the number of users and/or be more favourable than for private providers), and restricted disclosure of performance information.

… but it carries risks

Despite commendable features, promoting user choice may aggravate two risks. *First*, it could lead to sub-groups of population carrying more risks or higher costs not being properly provided for ("cream-skimming"). This issue has arisen in particular in the health care sector where public hospitals may assume the role of agent of last resort, taking care of the more costly patients (France and the United States), or where public health insurance schemes have been left with the most unhealthy segments of the population (Czech Republic and Germany). Risk-adjustment systems can mitigate this danger, with implicit voucher schemes accounting for the characteristics of the user (Netherlands in the education sector; Australia for labour market assistance for the long-term unemployed). Risk-adjustment systems have also been implemented for health insurance schemes, though their success in avoiding cream-skimming has been rather limited (Docteur and Oxley, 2003). *Second*, allowing for more user choice, if accompanied by services which better respond to the users' needs, may spur demand for publicly-funded services, and thus raise overall budget costs.

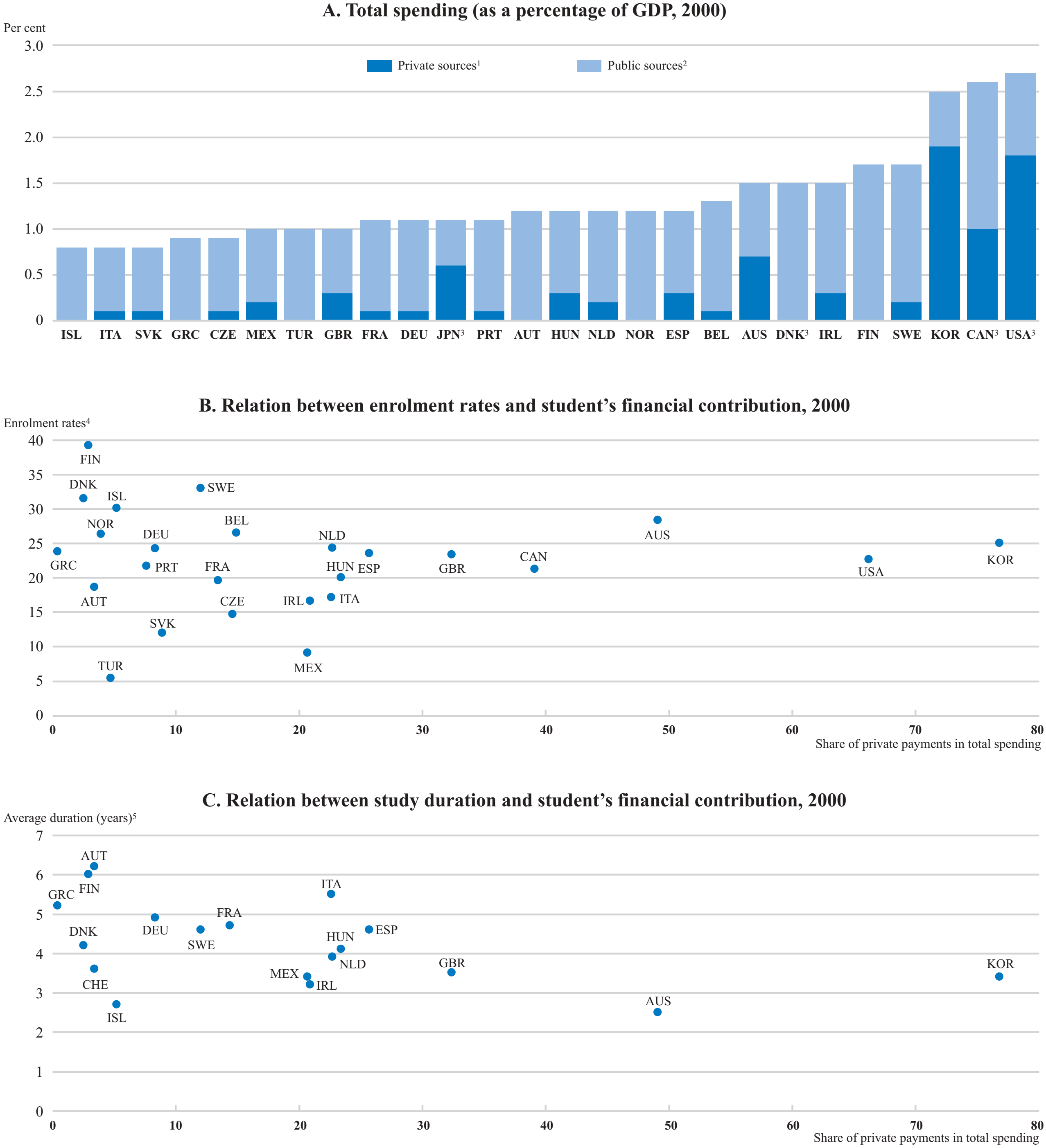
User charges may help to contain excessive demand…

Country evidence suggests that demand for some publicly-funded goods reflects and adjusts to cost-sharing. As an illustration, tuition fees in the tertiary education are low and sometimes accompanied by generous student support through grants and subsidised loans in several countries (in particular the Nordic countries, Austria and Switzerland). This is often accompanied by not just high enrolment rates but also long study duration (Figure VI.4), and sometimes involves queuing or access restrictions (Greece and Sweden). A similar picture arises for elderly care, with relatively low user charges in the Nordic countries leading to both higher public spending on elderly care and a high share of population in specialised institutions or receiving formal help at home.

… but adverse effects on welfare and equity objectives need to be avoided

Enhanced reliance on user fees can have adverse effects on welfare and equity objectives. In the health care sector, the impact of a given change in co-payments on demand is estimated to be larger when co-payments are near zero, while it weakens when cost-sharing is already high. With out-of-pocket payments already accounting for over 15 per cent of total health expenditure in a majority of countries, containing demand would imply raising charges significantly, with potentially adverse health outcome and serious equity effects. To mitigate these effects in the health and other

Figure VI.4. Tertiary education: public and private spending, enrolment rates and study duration



1. Excluding public subsidies attributable for educational institutions except in the case of Austria, Denmark, Greece, Iceland, Poland, Portugal and the Slovak Republic.
2. Including public subsidies to households attributable for educational institutions (except for countries listed in note 1) and direct expenditure on educational institutions from international sources.
3. Post-secondary non-tertiary included in tertiary education.
4. Enrolment rates are defined as the percentage of students aged 20-29 in the population of 20-29 year-olds.
5. In the case of Denmark, France, Korea, Mexico, Netherlands, Spain and Switzerland, data concern the academic year 1995. In the case of Hungary, Iceland, Italy and Switzerland, data apply to public institutions only.

Source: Education at a Glance, OECD 2003.

sectors, countries have adopted various strategies, including: “stop-loss” provisions (which provide full or higher reimbursement rates above a given ceilings); means-testing approaches; and a two-tier system which guarantees access to core services at low cost in the case of “reserved” providers (usually public). None of these strategies have proved to be a panacea, particularly where they create unemployment and poverty traps.

User fees may not always conflict with equity objectives

Raising user fees need not always create a conflict between efficiency and equity objectives, the tertiary education sector being a core example. With the rate of admission to tertiary education being highly correlated with family socio-economic background in most countries, low tuition fees (often combined with generous student support programmes) tend to benefit well-off families most. Thus, increased user fees should have only muted distributional effects. Where private returns to tertiary education are high, increased user fees would improve incentives to complete studies in a more expeditious manner but should not result in a significant decline in the overall participation in higher education (Blöndal *et al*., 2002). Capital market imperfections, and in particular the difficulty for students from low-income families to obtain a loan from commercial banks, may, however, warrant some public intervention, such as loan and fee regimes with elements of means-testing.

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