OECD recommends: A consensus for or against welfare states? Evidence from a new database

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Abstract

We describe the policy consensus in the OECD publication Economic Surveys, by constructing a database that contains both quotations and a quantification of the perceived reform need for 23 OECD countries around 1985, 1995 and 2005. Using the database, we examine whether or not the policy recommendations given by the OECD require welfare state cutbacks. We also examine how reform need correlates with social expenditure and income inequality. The recommendations in OECD Economic Surveys describe a policy consensus based on competition, work incentives, monetary reform, fiscal discipline and labor market reform. Reforms on these areas do not necessarily require welfare state cutbacks. Quantitatively, we find a significant positive correlation between reform need and social expenditure only for the mid 1990s, and no significant correlations between reform need and inequality. We conclude that OECD countries with large welfare states have managed to implement reforms without substantial welfare state retrenchment. The policy recommendations in Economic Surveys imply a restructuring of the welfare state but not necessarily welfare state cutbacks.

Keywords Welfare state, reform, OECD
JEL codes D63, P11, C82

1. Introduction

Several scholars have recently noted a policy convergence among OECD-countries, but there is disagreement on what implications this policy consensus has for the welfare state. This paper contributes by summarizing and quantifying the policy advice given in OECD Economic Surveys, and examining how the perceived reform need correlates with social welfare state expenditure and income inequality. The qualitative analysis suggest that reforms recommended by the OECD are compatible with welfare state generosity, and the quantitative correlations show no or only weak evidence suggesting otherwise.

As indicated by for example Mahon (2009) and Armingeon and Beyeler (2008), the policy advice given by the OECD is at the heart of the debate on reform in developed countries. The policy advice in OECD Economic Surveys is typically motivated by the need to foster growth and prosperity, but there are some worries that the scientific surface of this consensus masks an ideological agenda. Scholars such as Grinvalds (2010) and Bradley and Stephens (2007) find OECD's policy recommendations to be influenced by "neo-liberal" thinking. In the similar vein, Cammack (2009) talks of a "OECD/EU programme for restoring the hegemony of capital over labour in the developed world" (p. 24). Alluding to the warnings from Sinn (2003), that big welfare states will face a 'race to the bottom', Pitlik (2007) describes the policy convergence as a "race to liberalization". In contrast, Deacon and Kaasch (2008) argue the OECD is not a 'neoliberal stalking horse' but rather is concerned with balancing equity and market efficiency, and Mahon (2009) carefully notes that "[f]or some [OECD] has used its 'soft powers' to contribute to the construction of a neoliberal world order, however neoliberal solutions are not the only ones it has to offer, especially in the area of social policy".

To assess if the policy consensus of the OECD is compatible or not with welfare state universality and generosity, this paper presents a database of the OECD publication Economic Surveys. The database allows for both qualitative and quantitative analysis of the perceived reform need in 12 different policy areas for 23 OECD-countries at three points in time: The mid-80s, the mid-90s and the mid-00s. The database contains quotations from OECD's recommendations as well as quantifications of the perceived reform need.

The paper is structured as follows. In the next section, we present the database and its content. In section 3, we analyze whether the OECD policy recommendations are compatible or not with universal, generous welfare states, first qualitatively, and then by examining the correlation between reform need, social expenditure and inequality. Section 4 concludes the paper.

2. The OECD reform database

OECD publishes an Economic Survey every 1½-2 years for each OECD country. Each survey identifies "the main economic challenges faced by the country and analyses policy options to meet them".[1] The surveys contain descriptions of the economic situation in each country, as well as policy advice seemingly based on standard economic theory.

Based on the advice given in the surveys, we identify patterns such that similar reforms were recommended to different countries for similar reasons. We identify 12 types of policy reforms that together form five broader policy areas, all shown in table 1. We collected the perceived need of reform in these five areas, at the time around 1985, 1995 and 2005 for 23 member countries.[2] A qualitative part of the database contains the exact formulations used by the OECD, enabling anyone to group and quantify the recommendations differently than we have chosen to do.

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[1] Quoted from http://www.oecd.org/eco/surveys . Retrieved October 2010.

[2] Neither Turkey nor any new members, i.e. countries with membership from 1990 and onwards, are included. No country joined the OECD in 1980s. OECD Economic Surveys are available electronically from the late 90s, making Surveys covering the year of 2005 and/or years in vicinity of the year 2005 easily accessible. For Surveys published earlier, the database relies on printed publications. Although Surveys from one year before and one year after e.g. 1985 is preferable, there is some variation across the 23 member countries with regard to the number of years and which years covered in the database for 1980s and 1990s.

Table 1 Twelve policy reforms in five areas

A. Increased competition

A1. Increase trade and competition (e.g. the removal of trade barriers and capital regulation)

A2. Introduce freedom of choice in the public sector (e.g. vouchers)

A3. Use topping up and user fees to combine public and private financing

A4. Privatization of state-owned enterprise

B. Increased work incentives

B1. Lower taxation of labor (e.g. lowering marginal tax rates, broadening the tax base)

B2. Actuarial social insurance reforms: Strengthening the insurance aspects of pension systems, sickness benefits, unemployment insurance et cetera.

B3. Less generous social insurance (e.g. lowering replacement rates, establishing clear time limits for benefits durations)

B4. Increased conditionality of benefits (e.g. conditioning entitlements on active job search or participation in labor market programs)

C. Monetary reform

D. Fiscal discipline

E. Labor market reform

E1. Labor market flexibility (e.g. reforming employment protection laws)

E2. Reforming wage formation process towards greater wage flexibility and lower inflationary pressure.

The quantitative part of the database classifies the phrases in the surveys according to three degrees of reform need:

0. Little or no need of reform
1. Some need of reform
2. Big need of reform

A reform need coded as “2” describes a situation perceived to be quite serious according to the OECD. Such situations are generally described with formulations like “urgent” need for reform, “considerable” need for reform or “ample” scope for reform. The assessment can refer to a specific policy area or to the accumulated need over a number of policy areas. If the second case applies, the code “2” is assigned to all policy areas involved. For example, an ample scope for increased labour market flexibility may refer to the perceived need for less strict employment protection laws and increased wage flexibility through changes to the wage formation process.

A reform need coded as “1” describes a situation where some effort has been made to reform a policy area but where there is still room for improvement according to the OECD. To go from “2” to “1” we require that the government recognises the need for reform and takes some measures to alleviate the problems.

A policy area may consist of several elements, making the average progress over all related elements relevant. Thus, a reform state assigned a “1” may refer to a situation where little is done overall. It could also describe a situation where reform measures are taken with regard to some elements while other problematic aspects are left unresolved (e.g. reform need in the area of competition-enhancing policies is judged to be of degree “1” because the privatisation of state-owned companies is slow, while the deregulation of formerly strictly regulated sheltered sector is in progress).

The code “0” describes a situation where a “key reform” has taken place or where “considerable progress” has been made. Although additional improvements may remain, the reform process is going in the right direction. Alternatively, the number of identified reforms has decreased. A member country with OECD average performance or better is also given a 0.

With respect to fiscal policy, the performance of European member countries is often related to the Maastricht criteria from the 90s and onwards. When the OECD considers the criteria to be within reach and observes progressing consolidation efforts, the reform need is classified as small. For non-European members, there are no such criteria to which their performance can be directly compared. Nevertheless, there seems to be no significant discrepancy between

European and non-European members regarding the perceived reform need in this respect.

The ambition is to classify the initial reform need. When the OECD identifies a reform need in a certain policy area for the first time, the coding takes into account the build-up of problems prior to the year of study and reflects the success of the reform measures taken in the review of next year's performance. For example, if there has been a sharp increase in the budget deficit around 1980 and corrective steps have been taken around 1982/1983, the assessment of fiscal policy in 1982 is a "2", while the performance in 1983 is given a "1".

Each time period appears to have its own character in terms of main problems identified and described; sometimes the OECD "retroactively" identifies a reform need. There are instances where policy areas, previously not mentioned, are described with formulations like "the changes recently made to the function of public placement services will probably enhance efficiency". In those instances, we classify the situation prior to the undertaken measure as one with (some) reform need.

The database contains the reform need across time for the 23 OECD member countries, described by the above policy categorisation and quantification rules. It also contains comments from OECD Economic Surveys, comments that we consider to be relevant for the quantitative assessment of reform need (ie. "2", "1" or "0").

2.1 Potential caveats

Importantly, the database captures reform need as perceived by the OECD. This aspect means that the database is not intended as a description of objective reform need, or even an objective description of the situation in the countries examined. For example, a situation with serious need of reform in the mid 1980s may not be considered equally urgent when comparing it to the inflation levels, budget deficits et cetera of the mid 1990s. In many cases, a country given a "2" in both situations in reality experienced a deteriorating situation.

Furthermore, the subjective nature of the recommendations is an important reason for this study: Exactly what criteria are used when OECD deems a situation as problematic or improving? While the stated goal of the policy advice is to foster growth and prosperity, it may or may not be the case that the reforms suggested had the intended effects. This issue set aside, the goal here is to examine if countries that did badly according to the OECD tended to be countries with high taxes and low inequality.

3. Analysis

How compatible is the policy consensus upon which the OECD Economic Surveys rest with generous welfare states? At face value, reforms in the five policy areas (increased competition, increased work incentives, monetary reform, fiscal discipline and labor market reform) do not necessarily involve welfare state retrenchment or lowering of total taxation. It does, however, require a substantial restructuring of big welfare states.

Area A contains reforms aimed at increasing competition in several ways, none of which necessarily requires welfare state retrenchment. Trade-openness can increase the level of competition in the economy without demanding welfare state cutbacks. In fact, some scholars have noted a positive correlation between welfare state size and economic openness, suggesting that the two complement each other. For example, Iversen (2005) argues that labor-intensive, low-productivity jobs do not thrive in welfare states with high social protection and intensive labor-market regulation, but international trade allows these countries to specialize in high value-added services.

Tax-financing of welfare service can be combined with competition and freedom of choice by the use of voucher financing, as described for example by Bartlett, et al. (1998). The use of topping up and user fees to combine public and private financing is, at least in the short run, compatible with extensive welfare state arrangements. In the long run, it may pave the way for cutbacks following the “Leninist strategy” described by Butler and Germanis (1983), but it is also possible that these reforms increase welfare state support among high income earners as suggested by Bergh (2008). Finally, publicly owned corporations that are unimportant for the provision of welfare services can be privatized, thereby increasing competition without welfare state retrenchment.

Area B contains reforms to increase work incentives. While lower taxation of labor might lead to lower tax revenue and thus to decreased welfare state generosity, it is possible to lower tax rate without decreasing tax revenue if the tax system is made more efficient. Indeed, the trend in OECD countries is to decrease marginal taxes on labor, but this has not led to corresponding decreases of average tax revenue, as demonstrated by for example Curzon-Price (2008). Many high tax countries have implemented reform with the specific goal of increasing efficiency and work incentives without decreasing tax revenue – see Aarbu and Thoresen (1997) on the case of Norway and Agell, et al. (1996) on the case of Sweden. Furthermore, generous social insurance schemes and welfare benefits are often assumed to decrease work incentives, but designs such as negative income tax schemes, so-called Bismarckian benefits set as proportions of previous incomes and benefits with clear time limits may be generous without large negative effects on work incentives, as described for example by Lindert (2004).

Note further that between B3 (decreased generosity) and B4 (increased conditionality) there is some degree of substitutability. If replacement rates are lowered, there is less need for conditionality. Similarly increased conditionality might allow for relatively more generous benefit levels. Nevertheless, if countries choose to both lower benefits and increase conditionality, this is clearly a case of welfare state retrenchment.

Area D, monetary reform, has no obvious implications for welfare state size. The same goes for area E, fiscal discipline: While big welfare states often underbalance their budgets more in economic downturns, they also collect a bigger part of GDP when the economy is booming. Viewed over an entire business cycle, there is no reason to expect generous welfare states to be incompatible with fiscal discipline.[3]

Finally, when the OECD stresses the need for labor market reforms, the target is often the Nordic welfare states. But despite the historical correlation between welfare state generosity and labor market regulations, there is little if anything that prevents countries from changing their level of employment protection (such as e.g. the *last hired, first fired rule*). In fact, the case of Denmark is often used as an example of a Nordic welfare state that implemented most of what OECD suggested in terms of labor market reforms, resulting in what is sometimes called flexicurity, the combination of a highly flexible labor market and relatively generous insurance schemes for the unemployed.[4]

Summing up, an examination of the advice given in the Economic Surveys does not support the idea of a neo-liberal policy consensus hostile towards generous welfare states: In all areas, it is at least theoretically possible to implement the OECD recommendations without substantial cutbacks of the welfare state.

It is still possible, however, that countries with larger welfare states were de facto seen as more problematic by the OECD. It is also possible that countries that decreased their reform need as perceived by the OECD did so by cutting back on the welfare state. We examine these two questions below by calculating the correlation between perceived reform need and a commonly used measure of welfare state generosity: The OECD database for social expenditure.[5]

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[3] In fact, in the wake of the 2008 global financial crisis, problems with fiscal discipline did not systematically in countries with high taxes and extensive welfare states, but rather the opposite.
[4] See, for example, Andersen, T.M., and Svarer, M. (2007). Flexicurity—Labour Market Performance in Denmark. *CESifo Economic Studies 53*, 389-429.. Another example is the case of Greece, where the OECD actually recommended higher unemployment insurance to avoid the trend that people preferred early retirement to remaining as unemployed in the labor force (see the OECD reform database for Greece, mid-1990s).
[5] Data available at http://www.oecd.org/els/social/expenditure

Table 2. Correlations between reform need, social expenditure and inequality

Correlation	Mid 1980s	Mid 1990s	Mid 00s
Reform need and social expenditure (levels)[6]	0.12	0.51**	-0.07
Reform need and social expenditure (changes)	X	X	-0.19
Reform need and inequality (levels)[7]	0.06	-0.19	-0.22
Reform need and inequality (changes)	X	X	-0.28

Note: *** α<0.01, ** α<0.05, * α<0.1.

We first ask if countries with higher social public expenditure were perceived to have bigger reform need on average. In the mid 1980s there was a weak positive correlation between reform need and social expenditure share of GDP, while around 1995 the positive correlation was both bigger and also statistically significant at the five percent level. In the last period, however, the correlation is again weak. The correlations indicate that countries with big welfare states were perceived to have larger reform need immediately after the crisis during the early 1990s, but on average these countries handled the situation while keeping high levels of social expenditure. In general, it seems not to be the case that countries with more generous welfare state have systematically been seen as more problematic by the OECD.

Comparing levels of social expenditure over time and across countries may however be misleading for several reasons. The 1980s and the 1990s were decades when social expenditure were increasing in all countries, and this trend may mask a possible correlation with reform need: Possibly, countries implementing reforms are countries where social expenditure increase less than in other countries. To examine this possibility, we also examine changes rather than levels. Doing this exercise also controls for any country specific heterogeneity that remains constant over time and might possibly lead to false conclusions based

[6] Social expenditure are averages for the periods 1984-1986, 1994-1996 and 2004-2006.
[7] Inequality measured as average Gini coefficient for net income in the periods 1984-1986, 1994-1996 and 2004-2006. Iceland only has information for the 2000s and therefore is excluded.

on only level comparisons. As can be seen in the table, using changes rather than levels does not alter the conclusion. By far, the most common trend is to decrease reform need and to increase social spending. As shown in figure 1a, the negative correlation is driven by Switzerland and Japan, with relatively small increases in social spending and increasing reform need.

We also examine if countries with lower inequality levels were perceived to have bigger reform need. Examining inequality levels and reform need reveals no such pattern, although the correlation is more negative in recent years. Looking at changes reveals a tendency for countries that decrease their reform need more to exhibit larger increases in inequality, but the correlation is not significant and as can be seen in figure 1b, Switzerland is again an outlier. The negative correlation is consistent with recent findings of Carter (2007) and Bergh and Nilsson (2010) where reforms towards some types of economic freedom seem to come at the price of increased inequality.

Figure 1a

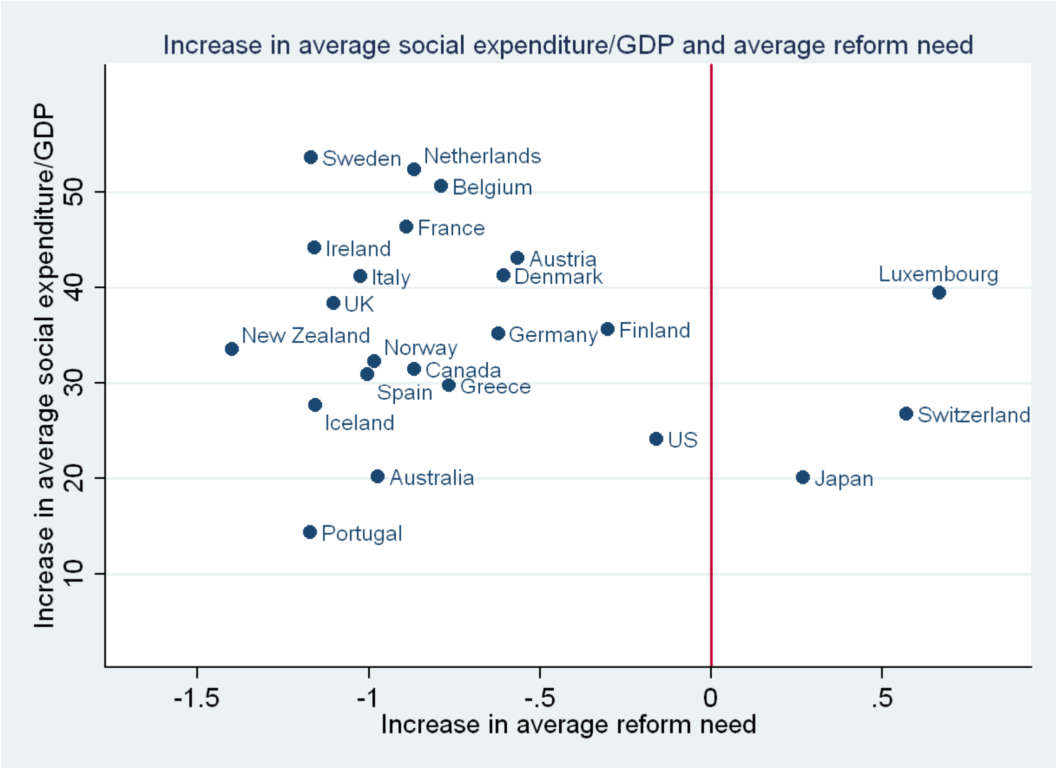
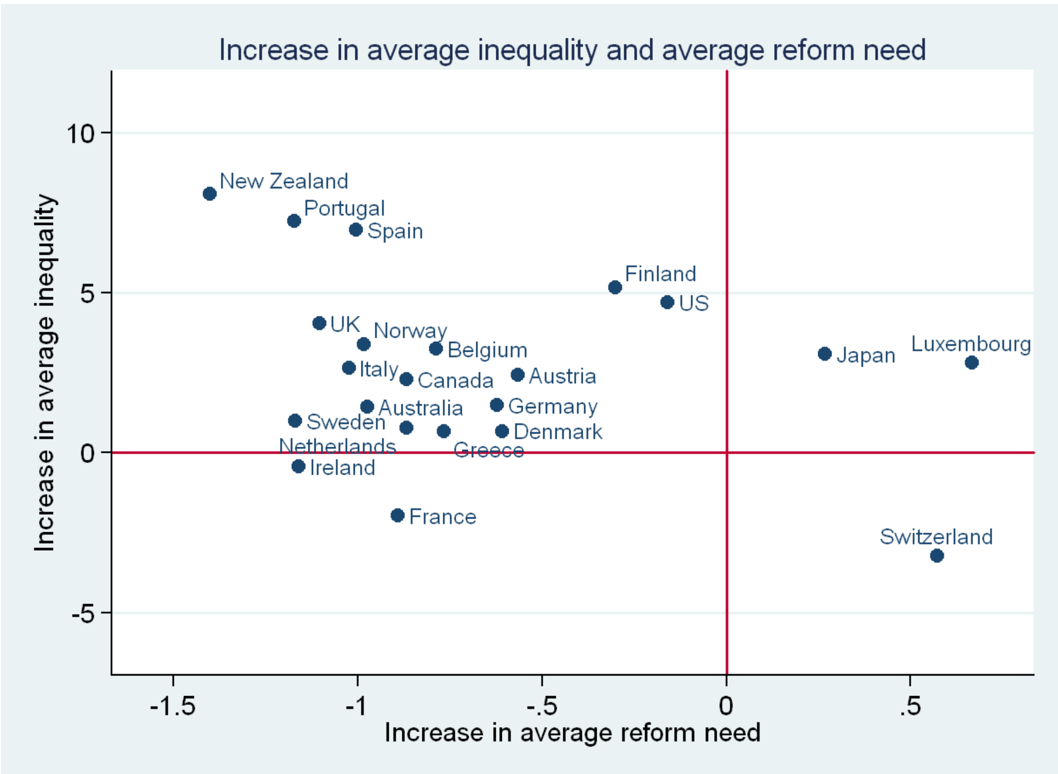


Figure 1b



4. Conclusion: A "Washington consensus" for welfare states?

Our analysis of the OECD Economic Surveys suggests that a "Washington consensus" for welfare states exists. The term Washington Consensus refers to a very rough description made in 1989 of the mainstream view in organizations such as the IMF on what policies should be implemented in Latin America at the time, as described by Williamson (2004). This observation fits well with the findings of Pitlik (2007), that policy diffusion is a driving factor for economic liberalization, in particular when it comes to the fields of regulatory, monetary and trade policies. A similar convergence trend is noted for product market regulations as measured by OECD (2009) index of product market regulations between 1998 and 2003.

While it seems to be true that there exists a consensus on certain types of reforms, it is hard to find evidence that this consensus is hostile towards welfare states, as suggested by several scholars cited in the introduction of this paper. As we have shown, only after the crisis of the early 1990s were extensive welfare states viewed as significantly more problematic. As it turned out, most of these countries handled their problems without substantial welfare state retrenchment. Our analysis thus supports the findings of Castles (2002) who explores the extent, structure and trajectory of welfare state change and reform in 21 OECD countries over the period 1984 to 1997, and find little or no evidence of systematic welfare retrenchment. For a case study of welfare state reform without welfare state retrenchment, see Bergh and Erlingsson (2009) on the case of Sweden.

As a final note, we emphasize that our study says nothing about the desirability and effects of the policies we have identified. The period we have studied ended in 2005, and the global economic development since then provide an interesting natural experiment for testing the OECD-consensus: Did countries with low reform need fare relatively better during the financial crisis that followed? We will return to this question in an upcoming paper.

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