How Broad-based Reforms Succeed in Changing the Business Environment: The Strategic Use of Drivers of Change©

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Broad Reform of the Business Environment: Drivers of Success in Three Transition Countries and Lessons for South Asia[1]

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[1] This paper relies substantially on two papers prepared by Jacobs and Associates in 2005 and 2006 for the Foreign Investment Advisory Service of the IFC/World Bank. The two papers, not yet published by FIAS, are Jacobs, Scott (2005) "Regulatory reform and business environments in South Asia: A Call for Action", and Jacobs, Scott and Jefferson Hill (2006) "Launching, implementing, and sustaining broad reforms to the enabling environment: Lessons for reformers from three countries" (2006).

Executive Summary

The South Asian region is slowly making an historic turn toward market-based development, but regulatory practices and policies in the region continue to lag far behind changes in economic strategies. Rather than grand reforms and or even a series of micro-strategies, economic reform efforts in the region have reflected strategies of gradualism, or muddling through.

This strategy is probably unavoidable in countries where democratic political processes are slow to build consensus, but the cost of slow reform in terms of lost growth is very high. Domestic business environments across South Asia remain hostile to the start-up and growth of private firms, particularly SMEs, and are among the worst in the world. Faster progress in building market-oriented regulatory regimes, skills, roles, institutions and capacities for change could bring large benefits in stabilizing and sustaining the rapid growth needed to meet poverty reduction targets.

This paper asks the question: *What strategy for broad-scale regulatory reform maximizes the chances of genuine and durable success in environments resistant to reform?* Through case studies in three transition countries, it finds that, regardless of the specific content of the reform, success is influenced by an evolving mix of "drivers of change". This paper then asks the question: *How can a reform strategy be designed to make best use of the opportunities provided by the drivers of change?* In answering that question, it links what others have called "exogenous factors" with the "choice factors" available to each government. The paper finds very little is truly exogenous. Like most of life, success relies on changing what can be changed and using what cannot be changed to best advantage. Finally, this report asks: *How can these findings explain slow progress in reforms in South Asia, and be used to design reforms that will speed up and broaden reforms in the region?*

Despite pessimism from many quarters, democratic countries can summon the energies and support to embark on major new directions. Hungary, Mexico, and Korea succeeded in managing broad reform programs over several years – even over several governments – and as a result enjoyed substantial multi-year gains in economic growth. Their three reforms faced substantially similar challenges: conceptualizing, organizing, marketing, sustaining and implementing major programs of regulatory reforms in the face of institutional weaknesses, incentive problems, and resistance from public and private sector interests.

- Hungary moved in ten years from a planned economy to a market-led economy that was more private sector-based than Western Europe. This transition required a massive program of deregulation and re-regulation, a complete rebuilding of the institutional framework and the creation from first principles of strong transparency and accountability measures.
- South Korea succeeded in eliminating 50% of its regulations in less than a year through a national program of reform.
- Mexico reversed 70 years of economic controls by revising over 90% of its national legislation in three years to open up and transform its economy.

Assessment of the reform process in these three countries illustrates similarities: broad-based and sustainable reforms occurred over several years, were messy in that they evolved unpredictably over time, and unfolded through a series of discrete steps that required the efforts of many actors. The success of reform depended on how these actors and steps were linked together to sustain a momentum of reform.

The three cases suggest that reformers can influence the direction and pace of change by mobilizing and exploiting drivers of change. "Drivers of change" are defined here as *forces that expand the opportunity for reform within the political economy of the country.* The main drivers of change are identified as:

1. The globalization or competitiveness driver
2. The crisis driver
3. Political leadership driver
4. The unfolding reform driver
5. Technocratic drivers
6. Changes in civil society driver
7. External pressure driver

Rather than a cause and effect scenario in which a single driver of change such as a crisis creates and defines the success of a body of reforms, what actually happens is an unfolding sequence of events in which various drivers rise and fall, that is, become more and less important in driving phases of the reform process. "Crisis" does not create reform, nor does political leadership. The three cases show little support for the "champion" model of reform. All three countries used a changing mix of drivers through an unfolding sequence of events, like a series of dancers in a waltz. Behind the country-specific situations, there seems to be a pattern to how drivers were sequenced:

- Crisis, a sense of impending crisis, or pressures arising from unavoidable external obligations were always important at the beginning of their market reforms. These drivers redefined the political economy of launching change, weakened defenders of the status quo, and emboldened reformers inside the government;

- Crisis and external obligations generated the first wave of market-oriented reforms only when politicians set reform agendas outside of traditional insider-interest processes. Agendas were imported from outside the country, or politicians permitted reform-minded technocrats to define the specific goals and content of reforms, sometimes in a "stealth" mode that caught opponents off-guard. These reform-minded groups were empowered by crisis, external pressures, and political direction to define much more radical and bold reform agendas;

- The first wave of bold reforms created a momentum of reform by creating new pressures and new allies whose advantage lay in further reform. The technocratic agendas, more or less rapidly, received support from a growing circle of public and private interests, and such support, in turn, promoted the further evolution of the agenda. And some reforms increased the costs of non-reform. Market opening led to deeper domestic reforms as domestic businesses faced external competition;

- Market-oriented reforms become sustainable reforms only when they were institutionalized into the machinery of government and constituencies for change were mobilized and included in policy processes. Reforms were more successful when governments built progressively wider networks of reform-minded institutions through the public administration. For example, Korea explicitly attacked the public choice foundations of regulation.

How these steps unfold is the reform strategy. The strategic exploitation of successive drivers of change appears to be key to the success of sustainable reform. In addition to understanding and exploiting these drivers of reform to launch and sustain change, the reform strategy must include specific steps such as setting the reform agenda, processes for designing solutions, mechanisms for implementing reforms, and mechanisms for sustaining and monitoring reforms.

None of the South Asian countries have carried out broad-based reforms similar in scale or longevity to the three cases. As a result of a range of anti-market policies and behaviors, the operating costs and risks facing businesses due to poor regulatory environments have scarcely been reduced at all in South Asia.

The experiences in the three cases are shown to be relevant to South Asia. The paper suggests that South Asia is unlikely to succeed with broad reform unless it develops drivers of reform that are stronger, better linked, and more numerous, followed by sustainable implementation strategies based on the factors of success identified here. For example:

- Sustainability is a particular problem in South Asia. Reforms stop before they are completed, or are reversed over time. This suggests that drivers of reform have been episodic and ad hoc. This might be explained by over-reliance on drivers of reform that are short-term – such as a political champion or a technocratic leader or temporary external pressures – and that are not supported or followed by other drivers of reform such as linkages to further reform, or by institutionalization in the public sector.
- Institutions dedicated to reform are almost nonexistent. Strategies of reform are short-term, non-institutionalized, and poorly financed. Effective mechanisms and processes have not been established to prioritize areas of reform, to design solutions to business environment problems, to build consensus among stakeholders, and to manage the reform process. This has allowed the blocking of implementation by administrations with outdated roles and rent-seeking incentives.

The drivers of reform likely to be most important in South Asia in fueling future growth are the competitiveness drivers, civil society drivers (specifically, the growing class of entrepreneurs that are export oriented), and external drivers (mostly donors). Reformers in these countries must develop ways to exploit and extend the pro-reform pressures from these drivers. They should be linked to launch and sustain a strategy of broad reform, particularly when there is strong political leadership, even if it is temporary.

The factors of success are even weaker in South Asia. None of the factors identified in the three case studies are well developed in the region. Since these factors are mostly issues of institutional reform and strategy development, these areas could prove to be fruitful areas of investment.

The paper concludes with 12 lessons for reforms in South Asia. It find that success factors seem to be inter-related; that is, the more successful governments seem to invest simultaneously in strategies such as managing the reform program, on-going public-private dialogue, and results monitoring. All of these factors do not have to be highly developed for reform to succeed. Weakness in one area may be compensated in another area.

I. THE GLOBAL SEARCH FOR MORE EFFECTIVE REFORM STRATEGIES

2. The South Asian region is slowly making an historic turn toward market-based development, but regional regulatory practices and policies continue to lag far behind changes in economic strategies. Rather than grand reforms and or even a series of micro-strategies, economic reform efforts in the region have reflected strategies of gradualism, or muddling through. This kind of strategy is probably unavoidable in countries where democratic political processes are slow to build consensus, but the cost of slow reform in terms of lost growth is very high. Faster progress in building new, market-oriented regulatory regimes, skills, roles, institutions and capacities for change could bring large benefits in stabilizing and sustaining rapid growth.

3. South Asia shares with many other developing countries the challenge of speeding up and broadening enabling environment reforms that stimulate pro-growth business behavior at the micro level. Around the world, governments are basing ambitious economic development and poverty reduction strategies on commitments that they will speed up and broaden policy and institutional reforms to improve the business environment. Yet these kinds of broad-based reforms are notoriously difficult to carry out and sustain over the whole of the public administration and across several years.

4. This report asks the question: *What strategy for broad-scale regulatory reform maximizes the chances of genuine and durable success in environments resistant to reform?* Through case studies in three transition countries, it finds that, regardless of the specific content of the reform, success is influenced by an evolving mix of "drivers of change". This report then asks the question: *How can a reform strategy be designed to make best use of the opportunities provided by the drivers of change?* In answering that question, it attempts to link what others have called "exogenous factors" with the "choice factors" available to each government. The report finds very little is truly exogenous. Like most of life, success relies on changing what can be changed and using what cannot be changed to best advantage. Finally, this report asks: *How can these findings be used to speed up and broaden reforms in South Asia?*

5. There is little question that success in the development process depends on making the right changes happen more quickly with better results. Economic transition to sustained higher levels of growth requires fundamental (not marginal) improvements in the performance of the private sector. In countries characterized by legacies of public sector intervention, instability, rent seeking, and weak public and market institutions, better performance of the private sector depends, in turn, on better performance by the public sector, particularly in how the public sector relates to the private sector through its legal and regulatory functions. These reforms are part of the body of reforms that are sometimes called the "enabling environment" for private sector performance.

6. This paper does not review the reasons why enabling environment reforms are important. The role of such reforms in stimulating the performance of the real economy through productivity growth is widely discussed elsewhere. Just as the regulatory reform agenda became the norm for microeconomic policy in the 1990s in OECD countries, "enabling environment" reforms have become the norm in the 2000s in developing countries seeking to transition to a higher sustainable growth rate. The enormous inefficiencies that are holding back growth must be addressed mostly at the micro level, rather than through macroeconomic policy.

7. The problems of successful reform are familiar. Vested interests in public and private sectors, fears of the consequences of change, low skill levels, lingering anti-

market sentiments, and the complexity and uncertainty of reform in dynamic economic and social environments must be dealt with effectively if reform is to succeed. Transforming how the public sector carries out its regulatory and administrative functions is extremely difficult for three reasons:

- First, it is a far-reaching agenda. In effect, governments must themselves move through the transition process from state-led growth to market-led growth. Transformation of the public sector goes beyond policies and formal legal instruments, since the role and style of regulation in society is deeply embedded in traditions, capacities, interests, and the organization of power. Far-reaching change to the regulatory function stretches from the collection of existing legal instruments into the institutions, processes, and capacities of government, and even further, into the institutions of the rule of law and the changing relationship between the state, market, and society. The culture of governance is relatively path-determined, and so reforms are often reversed or simply ignored.
- Second, existing incentives strongly favor the status quo. Interest groups inside and outside public sectors have organized the public sector for their own benefit. Reform meets massive passive and organized resistance that results in delayed, blocked, or reversed results at the implementation stage. Due to the highly decentralized and captured nature of regulatory systems in many developing countries, some governments have today simply lost control of their regulatory functions.
- Third, capacities and strategies for change are insufficient to tackle the magnitude of the problem. Lack of political leadership, poor coordination capacities, fragmented policy jurisdictions, low levels of human skill, and weak accountability mechanisms, within the larger context of a weak rule of law, conspire together to make successful reform extremely difficult even when the government decides to move forward. Weak reform capacities mean that reformers often tackle the easiest or isolated issues, with marginal and unsustainable results.

8. For these reasons, the story of enabling environment reforms is mostly one of disappointment. Results have rarely matched expectations, leaving reformers exhausted and disillusioned. Isolated and one-off reforms have not produced concrete, lasting benefits for the private sector. Reformers often underestimate or are intimidated by the sheer scale of the problem. And the problem is vast. Those who believe that public sectors in developing countries are slow to act have never looked at the regulatory function. For example, Kenya's government estimated in early 2005 that around 600 business licenses existed. By end 2005, a comprehensive count[2] showed that Kenyan businesses actually suffer from over 1,500 business licenses and fees imposed by 178 state bodies, and the government is still counting (while regulators continually produce new licenses). Moldova's reformers originally estimated that its 67 inspectorates had

[2] Kenya carried out its comprehensive inventory and deregulation of licenses using the Regulatory Guillotine™ strategy developed by Jacobs and Associates, and supported in Kenya by the Foreign Investment Advisory Service and the World Bank. For an explanation and assessment of the guillotine strategy, see Jacobs, Scott with Irina Astrakhan (2006) *Effective and Sustainable Regulatory Reform: The Regulatory Guillotine in Three Transition and Developing Countries* published by Jacobs and Associates at www.regulatoryreform.com.

created 300-500 regulations for businesses: the actual number turned out to be more than 1,100, many of them illegal and never published.

9. Reforms aimed at single processes and rules will never catch up with the productive capacities and incentives of governments to create regulations and controls. The issue is clearly a systemic one.

10. Yet some governments do meaningfully reform, and have reaped the fruits of success. Democratic countries can in fact summon the energies and support to embark on major new directions. Countries such as Hungary, Mexico, and Korea that succeeded in managing a broad reform program over several years – even over several governments -- showed the fastest transitions and substantial multi-year gains in economic growth. Hungary moved in ten years from a planned economy to a market-led economy that was more private sector-based than Western Europe. This transition required a massive program of deregulation and re-regulation, a complete rebuilding of the institutional framework and the creation from first principles of strong transparency and accountability measures. Success is not limited to the extraordinary transformations in Eastern Europe. South Korea succeeded in eliminating 50% of its regulations in less than a year through a national program of reform, while Mexico reversed 70 years of economic controls by revising over 90% of its national legislation in three years to open up and transform its economy.

11. The question is how? To assist in developing strategies for promotion of broad reforms in South Asia, this paper examines these three countries that have successfully reformed to understand the political economy of reform, the drivers of change, and the relation between reform processes and instruments and the constraints posed by the larger political economy in each country.

II. THE CONTEXT OF BUSINESS ENVIRONMENT REFORMS IN SOUTH ASIA

12. South Asian reforms have not, to date, matched regional development needs, which are pressing. South Asia, with GNI per capita at $510 in 2003, is home to nearly 40 percent of the world's poor living on less than $1 a day.[3] India alone must create 100 million new jobs in the next decade just to keep the unemployment rate stable.

> "People often perceive the bureaucracy as an agent of exploitation rather than a provider of services."
>
> Atal Bihari Vajpayee, Prime Minister of India, 1998-2004

13. In August 2005, Jacobs and Associates completed for the Foreign Investment Advisory Service (FIAS) a report assessing the quality of regulatory and administrative environments for business across eight countries of South Asia (Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka). The report reached three general conclusions:

- Progress on regulatory and administrative reforms varies substantially across the eight countries, from zero or negative process over the past decade (Afghanistan, Nepal) to genuine and occasionally substantial progress (India, Sri Lanka, Maldives). Combined with macroeconomic stabilization, these efforts helped to stimulate economic growth in the 1980s and 1990s. However, the reforms and their effects were not sustained, because the reforms were almost

[3] See World Bank (2005) Millennium Development Goals, South Asia, at http://ddp-ext.worldbank.org/ext/MDG/regions.do

entirely restricted to one-off reforms that are usually considered the easiest – reducing barriers to entry (border barriers such as tariffs), eliminating legal barriers to FDI, and targeting individual red tape problems within enormous and tangled administrative jungles. In consequence, the eight South Asian countries, while diverse in many respects, continue to suffer from similar structural regulatory and administrative problems that impede market entry and increase risks, production costs, and operating costs for businesses, and hence slow private sector development.

- All countries in the region continue to suffer from a common failing: none of the countries in the region are effectively addressing the systemic, governance, and institutional problems that increase regulatory costs and risks for businesses. Governance reforms have, in fact, faltered just as growth strategies across the region require that these more difficult issues be resolved. Reform strategies, political commitment, and capacities for implementation remain weak. Others have arrived at similar conclusions. The World Bank's regional brief for South Asia notes "…improved governance—including stronger regulatory reforms and increased transparency—is a critical challenge for the region if it is to achieve its long-term development goals and its potential for higher growth rates."[4]

- As a result, domestic business environments across South Asia remain hostile to the start-up and growth of private firms, particularly SMEs, and are among the worst in the world. Achieving poverty reduction targets in the region is improbable without deeper, broader, and faster enabling environment reforms. Sustained, rapid economic growth fueled by private sector investment is the only answer to many development goals in the region.

14. The urgency of such reform is masked by the recent upturn in growth rates. Growth rates are projected to be relatively good for the next few years (Figure 1 in the Annex). Only Nepal is projected to grow at less than the average of South-east Asia, although China will continue to grow faster than almost everyone.

15. Despite this spurt in growth, South Asian is in fact far underperforming economically, and sustained growth is not assured:

- South Asian countries still show higher levels of poverty than do their peers in South-east Asia, even Viet Nam, a latecomer to market-driven growth (Figure 2). Informal sectors seem to be growing rather than diminishing.

- Productivity levels are very low, and rising slowly.

- In FDI performance, a good indicator of the quality of the business environment, South Asia does far worse than South-east Asia and Eastern Europe (Figure 3). A product of low investment is that the share of industry in GDP in the region is far below Asian and global standards. India's share of industry in GDP, at 27%, lags by Asia standards; in China, for example, the figure is more than 50%.[5]

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[4] See World Bank at http://lnweb18.worldbank.org/sar/sa.nsf/0/9bcec7b2e99856fe852567f4006ec27d?OpenDocument

[5] David Burton (2004) *Emerging Asia: Outlook, Challenges, and India's Growing Role*, International Monetary Fund, Speech at The Reserve Bank of India, New Delhi, October 21, 2004

- The region lags behind regions such as South East Asia and Eastern/Central Europe in reforming the business environment.

16. Economic growth in the region will be increasingly constrained by out-dated and inflexible public sectors that regulate badly and inconsistently with market needs. The conclusion of the Asian Development Bank on India's progress is true of the entire region: "The accomplishments of the past decade are dwarfed only by what remains to be done."[6]

III. SUMMARY OF BROAD REFORM EXPERIENCES IN THREE COUNTRIES

17. The three case studies on Korea, Mexico, and Hungary summarized in this section are not based on the least developed countries, but on three transition countries (one Asian, one European, and one Latin American) that successfully carried out broad and sustained programs of business environment reform. (Three other case studies in G7 countries were also carried out for FIAS, and support the conclusions in the three transition countries, but the G7 cases are not cited here.) The relevance of these specific case studies to South Asian countries is, as always, subject to challenge, but the overall lessons – the importance of linking reform strategies with the drivers of reform and the design of factors of success -- seem to be transferable, with care.

18. This section does not provide a detailed summary of these cases, since the cases themselves (written by a series of country expert) will be available from FIAS in a forthcoming publication. Rather, a brief summary of reform in each country is given below, followed by analyses of the drivers of reform and the critical success factors across the three countries. The pattern is clear: broad-based and sustainable reforms occurred over several years, were messy in that they evolved unpredictably over time, and unfolded through a series of discrete steps that required the efforts of many actors. The success of reform depended on how these actors and steps were linked together to sustain a momentum of reform.

- ***South Korea***: The case study focuses on the period from 1993 to 2002, when Korea's growth slowed, the performance of the *chaebol* contributed to the massive financial crisis of 1997, and Korea joined the OECD, forcing it to open its markets. An ambitious program of regulatory, financial, and structural reform was aimed at boosting the competitiveness of the economy and recreating the foundations for sustainable growth. The aim of the reform was to move Korea from a highly interventionist and authoritarian model of economic development to a market oriented and open model based on values of consumer choice, democracy, and rule of law. These changes to the role of the public sector in development constitute one of the most far-reaching efforts at reform of regulation undertaken in OECD countries.
- ***Mexico***: Mexico expanded regulatory reform as a central element in a broad transformation from an inward-looking economy to an open and market-based economy. The rapid pace, broad scope, and depth of regulatory compared to those of the emerging market economies in Eastern Europe. By 1998, virtually all of Mexico's price controls had been eliminated. A government-wide deregulation program adopted in 1995 attacked the myriad forms by which the government

[6] Arvind Panagariya (2002) India's Economic Reforms. What Has Been Accomplished? What Remains to Be Done? Asian Development Bank ERD POLICY BRIEF NO. 2, Manila.

intervened into economic activity and promoted better regulatory techniques throughout the public administration (including at state and municipal levels). These efforts were supported by other efforts to modernize the Mexican state. Domestic reforms were boosted and underpinned by international commitments as Mexico joined the GATT, APEC and the OECD, and signed NAFTA and other free trade agreements with Latin American countries.

- ***Hungary***: By 2001, after ten years of determined reform, Hungary had largely completed an historic social, political, and economic transition. An indicator of the scale of the change is that, by the end of 1998, the private sector generated 85 per cent of GDP (one of the highest shares in the OECD), compared to 16 per cent in 1989. The transition was a regulatory as well as a deregulatory task, and a conceptual as well as a technical transformation. Since 1989, successive governments eliminated large swathes of laws and other regulations that under girded the centrally planned economy. At the same time, each year the Parliament passed more than a hundred laws, the government adopted twice as many decrees, and the ministries promulgated hundreds of orders. From government procurement laws to property rights, bankruptcy, and business start-up rules, many of the regulations and institutions needed for the smooth operation of markets were established and secured. Important lessons that can be learned from Hungary include the importance of accompanying market liberalization with governance reforms.

IV. DRIVERS OF CHANGE: THEORY AND EXPERIENCES IN THREE COUNTRIES

19. While the focus of the reforms differed from country to country, the three reform processes faced substantially similar challenges: conceptualizing, organizing, marketing, sustaining and implementing major programs of regulatory reforms in the face of institutional weaknesses, incentive problems, and resistance from public and private sector interests.

20. Sustaining change against vested interests was the key challenge in the three countries. In most countries where international donors are active, the dynamic of change is controlled by public choice and captured state interests, not by state commitments in poverty reduction plans. Opportunities for genuine reform seem to come rarely, often only when crises and external pressures make clear the costs of non-action and change the balance of power that previously protected the status quo.

21. How can drivers of change overcome defenders of the status quo? Changing the status quo is a long-term project that requires that governments unwind extensive state involvement in the economy, discourage entrenched habits of rent-seeking, build new regulatory and administrative capacities in the public administration, and create market-based regulatory regimes and institutions that will support investment, innovation, and vigorous competition.

22. The dynamics of such changes are being developed in academic fields such as political science and new institutional economics (NIE). These debates recognize that sustained changes in economic policy can be understood only in the context of wider changes, particularly in the stock of knowledge and in institutions, such as market institutions changed by globalization and political institutions changed by upheaval.

23. This macro perspective on the problem, which drives some NIE advocates to pessimism because of the difficulty of bringing about broad-based change, should not

obscure the fact that reform does happen and that reformers CAN influence the direction and pace of change by mobilizing and exploiting drivers of change. "Drivers of change" are defined here as *forces that expand the opportunity for reform within the political economy of the country.* This section reviews the main drivers of change identified in various threads of the academic debate and development literature:

1. The globalization or competitiveness driver
2. The crisis driver
3. Political leadership driver
4. The unfolding reform driver
5. Technocratic drivers
6. Changes in civil society driver
7. External pressure driver

24. These drivers are, in turn, assessed for their relevance in the three case studies. The three case studies illustrate that, rather than a cause and effect scenario in which a driver of change creates and defines the success of a body of reforms, what actually happens is an unfolding sequence of events in which various drivers rise and fall, that is, become more and less important in driving phases of the reform process. If this conclusion is correct, the strategic exploitation of drivers of change becomes key to the success of sustainable reform.

Table 1: Key Drivers of Regulatory Reform Across Three Countries

	Hungary	Mexico	Korea
The globalization or competitiveness driver	Reform was triggered by the need to create a market-based economy and join the European Union.	In the 1980s, competition for international capital and investment was growing stronger, and leaders saw the positive effects of trade liberalization for assembly plants exporting primarily to the U.S. market.	To increase FDI in the face of the other Tigers of Asia, reforms had to remove explicit investment barriers and excessive regulations.
The crisis driver	Very important. An unprecedented change of political regime and the collapse of the domestic economy created new elites and rising expectations for real change.	Very important. In the 1980s, a collapse in oil prices and default on a massive external debt, followed by five years of economic stagnation, triggered major reforms aimed at trade liberalization, privatization, and regulatory reform.	Very important. The 1997 crisis produced the most painful economic contraction in OECD history. 1998 was the first year since 1979 in which Korea recorded a negative growth rate.

Political leadership driver	Successive Prime Ministers actively backed reforms to secure democracy, a rule of law, open markets, and, later on, joining the European Union.	The President, with a tight group of reformers, initiated extensive reforms with a top-down approach based on traditional "command and control" mechanisms; the resulting backlash slowed reforms.	In the Presidential election of 1997, both the new President and his political party supported reform. The National Assembly agreed by enacting needed implementing legislation.
The unfolding reform driver	So many reforms were launched in such a short period that reform could be slowed, but not stopped, without disaster. A reform pause resulted in economic contraction, which fueled more reforms.	Mexico literally could not stop once it began. Market openness reforms increased competition in the domestic market, which increased stakeholder pressures for economic liberalization, which led to reforms in public sector capacities for good regulation.	Korea had problems maintaining momentum. While the initial top-down reform produced impressive results, a lack of incentives on regulatory reform within the government slowed reform.
Technocratic drivers	The strongly independent, professionally staffed Hungarian Competition Office played a vigorous role in privatization.	In 2000, an agency was created in the Ministry of Economy to impose quality and transparency disciplines on the public sector, and highly trained technocrats (economists) at the staff had the legal authority of political backing to drive the reform forward.	The ongoing Regulatory Reform Commission, staffed partly with academics and co-chaired by the Prime Minister, is responsible for examining new and existing regulations and for maintaining regulatory quality.
Changes in civil society driver	Reform was legally based, with the active involvement of Parliament and through extensive consultation with such stakeholders as businesses, trade unions, and disadvantaged social groups.	Elite teams of high-level public advisors triggered changes. Their actions were not transparent in the first stages, which limited their ability to gain support from private stakeholders. Later in the reform, as political support wavered, special private sector bodies were set up to oversee the reforms.	Political support for reform was built on a popular campaign to wipe out corruption, which coincided with an upsurge of NGOs focused on government corruption. Growth of NGOs in the 1990s was very rapid. By 2000, there were as many as 8,000, acting as a new political force for change.

External pressure driver	Close relationships between government officials and outside think tanks and international organizations helped the reforms through the inflow of new ideas, shared experiences, and some funding.	The close relationship with America cultivated through NAFTA helped Mexico to recover rapidly from the 1995 liquidity crisis.	Membership in the OECD brought new demands for openness and good regulatory practices. The government, in cooperation with the IMF, began in 1997 to reform regulations to deregulate the financial sector.

A. The Globalization or Competitiveness Driver

25. According to this view, as capital and corporations move more freely across national boundaries, governments are forced to engage in regulatory competition. To either retain current investments or attract new ones, they must lower the costs of doing business.[7] The globalization dynamic drives regulatory reforms intended to reduce the costs or risks of investment, and so increase the expected returns on investment.

26. This driver is often underpinned by the use of comparative indicators of performance that are intended to carry two messages:

- First, to the extent that such indicators can be correlated with the economic performance, relative ranking on the indicators is a proxy for relative performance. Improvement in the indicators is intended to improve economic performance;
- Second, the country targeted for reform is usually described as “falling behind” other peer countries. This message is intended to convey a sense of urgency to the government in pushing ahead with reforms in order to "catch up", that is, to capture its fair share of global wealth.

27. The competitiveness driver of reform is familiar to the donor community, which often relies on this argument to persuade political elites that the costs of non-reform will be greater than the costs of reform. In this case, the costs of the status quo are seen as rising, reducing the relative cost of change.

28. Competitiveness was important in each one of the three case studies. In each country, the reforms are explicitly part of the reaction to the fear of falling behind, of losing national markets, and of being hollowed out by rising imports. These fears were strong in those countries that were trying to integrate into new markets where competition was keener (Mexico into North America, Hungary into Europe). These fears were also strong where countries were dropping border barriers to trade and investment, exposing domestic businesses to new international competitors (Korea).

29. But competitiveness concerns can lead to damaging policy reforms, such as protection and government intervention, as well as market-oriented reforms. The decision to react with market oriented reforms in the three countries were due to other drivers, such as strong external pressures to open markets, and a liberal consensus that growth depended on private sector performance. Indeed, the regulatory reforms were

[7] Vogel, David and Robert A. Kagan (2004) *Dynamics of Regulatory Change: How Globalization Affects National Regulatory Policies*, University of California press, Berkeley and Los Angeles, p. 3.

widely accepted as an effective way to deal with competitiveness concerns, which is supported by the evaluations of these reforms. The first round of regulatory reforms in Korea reduced by more than half those industries subject to strong entry barriers, while the continued effort to drive down regulatory costs pulled Korea up on the Global Competitiveness Report of the World Economic Forum from 48 out of 53 countries in 1997 to 26 out of 75 in 2002.

30. The nature of regulatory competition in global markets has been the source of much debate in the developed world. Some feel that regulatory competition has led to a “race to the bottom" in which environmental and labor standards are undermined by companies seeking to become more competitive. Other groups, supported by most academic studies,[8] believe that regulatory competition tends to be for efficiency and quality rather than laxity, and that generally, higher levels of economic growth lead to higher levels of protection. The competitiveness driver, for that reason, must be deployed somewhat carefully in order to avoid the impression that competitiveness is all about deregulation and reducing burdens on businesses.

31. The globalization driver has the potential to drive a broad program of reform, but often, because its starting point is the interest of investors, this driver leads to a narrow focus that is focused on the needs of large investors. That is, the globalization driver has an inherent contradiction: competitiveness is a far-reaching concept, while the reforms related to competitiveness are often narrowly focused on the needs of large export oriented investors.

B. The Crisis Driver

32. “A crisis is a terrible thing to waste” writes Thomas Friedman.[9] Many theories of reform start with the idea of a galvanizing event, some kind of crisis that upsets the balance of power that has preserved the status quo. This theory of reform has much appeal because it seems to be one of the few realistic approaches to loosening the grasp of powerful interests that have captured the state apparatus.

33. The three countries present a mixed picture of the importance of crisis in reform. The three countries were in the midst of recovering from or avoiding painful economic and political crises (Hungary, Mexico, and Korea). All three of these countries used the crisis or threat of crisis to launch reforms whose consequences were probably not well understood outside of the reform elite.

34. Reformers may applaud crisis, but crisis is a high-risk approach to getting reform done. The Korean experiences show that reforms launched on the back of a crisis are not easy to sustain. And there is no assurance that leaders will make the right decision in the face of crisis, rather than making things even worse. Mexico went through a long series of peso crises in which policy reforms followed no coherent strategy, before finally arriving at the sustained pro-market reforms of the 1990s that finally reduced to their allowance of the peso crisis.

35. And crisis can simply be ignored. Even when crisis becomes apparent, lack of political leadership will result in little action. To use OECD examples, relative economic decline was a trigger for reform in New Zealand, which had fallen from fourth highest

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[8] A summary of the literature is given in Drezner, Daniel (2000) *Bottom Feeders*, Foreign Policy, November-December, pp. 64-70.

[9] Friedman, Thomas L. (2005) *The World Is Flat: A Brief History of the Twenty-First Century*, Farrar, Straus and Giroux.

GDP per capita among OECD countries in the 1960s to twentieth by the early 1980s. Reform, when it finally came, was driven top-down from a single party that had run on a reform platform, and was far-reaching and painful. Concrete evidence of rapid "hollowing-out" of Japan's financial sector due to competition from financial centres in other parts of Asia, Europe, and North America stimulated far-reaching reform only after 15 years of visible decline, and a shakeup in the monopoly of the LDP, which had held power for decades. These problems, although foreseen years before, could not be addressed until they became so acute that political change occurred. By then, the costs of reform were much higher.

C. Political Leadership Driver

36. There's little question that whatever the other drivers, political leadership is the yeast that makes them rise. Political leadership is at its most fearless just after elections, when promises of reform and the forbearance of the electorate are at their height. When crisis leads to political shakeup, the opportunities for reform are maximized.

37. Public choice theory assumes that courageous political leadership will not occur, because politicians will always maximize their own well-being by dividing up the economic pie so as to ensure reelection. But even under the public choice paradigm, predatory states sometimes create a situation where radical reform is a self-interested strategy. In these cases, political leadership simply means a political elite that is skilled enough to recognize that its advantage lies in reform. Such a skilled elite does not seem to emerge very frequently.

38. Political leadership in these three countries was, in retrospect, necessary. All three countries benefited from champions of reform either at the very center of government (the prime minister or president), or a strong minister in the Cabinet (finance, public administration). Indeed, it was the political leadership in these countries that guided reforms away from damaging reactions to crisis into more open and market-based reforms.

39. Political orientation does not seem to matter. In Korea and Mexico, the reform governments were on the left or nationalist. In Hungary, ideology had collapsed. This mixed pattern seems to support theories about “the end of history,” or the weakening of political ideology as a driver of reform.

40. As noted, the best political leadership is proactive, rather than reactive in the midst of crisis. Skilful political leadership is needed to improve the capacity for change in the run-up to crisis, and to design and implement strategies for reform earlier to reduce the cost of lost opportunities and the pain of transition. It is entirely possible that political leadership can simply watch a crisis unfold without taking action, as happened in Japan (neither right nor left) over the many years of the banking crisis.

D. The Unfolding Reform Driver

41. It has long been recognized in OECD countries that there are important complementarities across product, labor and capital markets. For example, New Zealand initiated labour market reforms in the early 1990s only after radical regulatory reform in product markets in the 1980s contributed to high unemployment because the labour market could not adapt to the new environment. The relevance of this for reform is that pro-market reforms in one area can increase the pressures for reform in other areas, and even change the political economy downstream or upstream so that pro-reform voices emerge. This can also be called the avalanche theory of reform in which moving a tiny stone can result in a huge landslide of reform years later.

42. Such sequencing can use several mechanisms to create a self-sustained and expanding reform movement. Where consumers see tangible benefits early, they are more likely to strongly support continued reform. New interests can increase pressure for reform in other areas. Reform in one area can make the costs of regulations in other areas more visible and painful. Tariff reform has stimulated reform of national product markets under pressure from import competition.

43. One of the three countries studied here, and others that have been studied such as New Zealand, was able to successfully exploit these linkages between reforms.

- In Mexico, the integration of the North American economy through NAFTA strengthened the technocrats and induced private industry associations to lobby government for less government intervention.

44. In the countries that did not exploit these linkages (Korea), reforms slowed after a few years or came to a halt at the change of government.

45. A recent survey of several country examples, including the three examined here, agreed that that linking reforms was a powerful driver of change.[10] It concluded that "in virtually all instances reforms were linked to or resulted from trade and other liberalizing reforms. Increased pressures from international competition often led firms to demand a better business environment." It noted that, in India, trade liberalization created a need for infrastructure investment and supply chain improvements, which led the national government in 1996 to initiate reform of the country's inefficient port sector by allowing private capital. Direct causality is not clear but it is interesting that those regions that have made the least progress on microeconomic reform (such as the Middle East/North Africa and South Asia) are also those with the highest barriers to trade and foreign direct investment.

46. Linkages across policies bring reformers to the debate on how reforms can be sequenced, and how important is sequencing. The optimal sequencing from an economic point of view, in the sense of reducing transition costs and achieving benefits quickly, may differ from the optimal sequence from a political perspective, in the sense of maximising the political momentum of reform. There seems to be little evidence that engineering the sequencing of reform works very well. Most countries have approached sequencing pragmatically, since waiting for the optimal sequence of reforms can delay reform for a long time. For this reason, the OECD has advised its members to "carefully consider sequencing, but don't give up opportunities while waiting."[11]

E. Technocratic Drivers

47. A popular notion in development literature is that reform can be driven by technocrats, who are politicians and senior civil servants with technical training in economics or other fields who develop rational policies to lead the country forward. Such technocrats develop reforms that operate on the basis of promotion of the general good, a goal that is formalized as maximization of the social welfare function based on a value criterion called the Pareto criterion. Neoclassical theory tells us that the general good will be promoted under certain conditions of competitive markets, a theory that has enjoyed

[10] World Bank (2005) MANAGING INVESTMENT CLIMATE REFORMS: A REVIEW OF EXPERIENCE, Investment Climate Department, Private Sector Development Vice Presidency (internal).

[11] OECD (1997) Report on Regulatory Reform, Paris.

considerable empirical support in the past 20 years. Such a theory of reform is in direct opposition to public choice theory.

48. It is clear that technocrats such as President Carlos Salinas of Mexico, President Lee Teng-hui in Taiwan, and Finance Minister Manmohan Singh in India played significant roles in defining and pushing forward dramatic economic reform programs. Skilled technocrats at various levels of government have been enormously important to the regulatory reform program in many OECD countries and in developing countries.

49. In the three case studies presented here, technocrats were extremely important to the success of the reforms. These technocrats were most effective when they were highly trained and located in independent or reform institutions with specific legal mandates to push forward change.

- Existing technocratic institutions were given special or expanded regulatory reform mandates. Competition offices, which had independent investigation and even veto authorities, were very important in Hungary in underpinning reforms. Finance ministries were important in only a couple of these countries, which is interesting given the frequent reliance on finance ministries as the counterpart for donors in developing countries.
- Special regulatory reform institutions in Mexico and Korea provided a central focus for technocrats to fight resistance on a day to day basis and to build up new, specialized regulatory expertise.
- The top-down reforms in Mexico and Korea were almost entirely driven by dedicated teams of technocrats who were either Ph.D. economists (Mexico) or supported by strong academic and research institutions (Korea).

50. These experiences suggest that technocratic drivers of reform work better with a strategic approach aimed at strengthening the muscle and capacities of pro reform technocrats relative to the parts of the state that are governed by public choice motivations. Institutions can be built that give such technocrats more power and influence in the governing system. This was the effect of NAFTA in Mexico, and the accession of the OECD in Korea, both of which reduced the grip of pure politicians on policymaking, and increased the power of technocrats. In effect, politicians gave up power to technocrats through legal devices in the form of international agreements.

51. Donors tend to select technocrats as counterparts, because they are more stable in the political process and more sympathetic to the theories and goals of microeconomic reform. Therefore, the role of technocrats in reform probably looms larger in donor strategies than is really warranted.

F. Changes in Civil Society Driver

52. Reform is not a task only for governments, even in countries where civil societies are weak. Other stakeholders such as firms and workers can help to build support for reform and to share information across borders. As civil society develops, for instance as NGOs emerge, the balance of power protecting the status quo can change, and opportunities for reform widen.

- This is a clear lesson from Korea, where rapid multiplication in the number of NGOs (from a few hundred to over 8,000 in a few years) focused on issues such as good governance, the capture of the state by the chaebol, and corruption. This new political movement helped break the decades-long grip of bureaucracy and special interests on regulation. Indeed, the Korean reformers put an unprecedented degree of transparency into the reforms, and an unending series of media stories kept political attention on reforms for longer than otherwise would have occurred. It might even be concluded that as the reforms were routinized, public and media attention dropped, which contributed to lower effectiveness in the later years.

- The Mexican reforms started with very little civil society support. They were top-down and technocratic, and were not well understood by the larger society. Importantly, as political support began to waver, revisions to the reform created more visible private sector advisory groups that played a much more participative, hands-on role in the reforms. This has helped sustain reform even as political regimes of change.

53. Fostering an active civil society that is reform-minded as a driver of reform that has been neglected in most developing countries, where donors have focused on changing the government itself. Assisting civil society to support necessary change is not just a notion, but an operational strategy. For example, the role of civil society in expanding opportunities for reform means that a crucial stage in reform comes before reform starts: communicating and selling reform to an often-skeptical citizenry. The public needs to be informed as to why reform is considered so important to their future well-being and that of their children. Open dialogue and communication involving major stakeholders on the benefits and costs of reform can improve understanding on all sides of short and long-term effects of action and non-action, and on the distribution of costs and benefits. In most countries, reform would benefit from wider and more informed debates less dominated by concentrated interests who stand to lose the most.

54. This strategy of easing the path for civil society to expand its influence The OECD has found that development of an articulated and transparent regulatory reform policy -- either government-wide or for individual sectors -- can underpin political commitment, result in more coherent and carefully planned reform, mobilise constituencies for reform, and focus a public debate on benefits and costs. The credibility of reform is heightened by clearly laying out the path forward, which is vital if the private sector is to invest and workers are to accept that they will reap some of the benefits rather than simply bearing the risks.

55. Communication can strengthen the voices of those that support and will benefit from reform. Important allies in the reform process include businesses who will gain from low cost, high quality goods and services inputs; consumers; and employees and their representatives in fields in which job creation and wage growth are constrained by unnecessary regulatory restrictions.

G. External Pressure Driver

56. One of the surprising patterns from the three case studies is how important external commitments and drivers are even for governments in highly developed countries. In some senses, external institutions seem to act as an escape valve, permitting a reform minded government to shift responsibility, and hence the political costs of reform, to external players. In other words, external drivers can weaken the public choice driver in which individual politicians are accountable to special interest groups. External players have included international bodies such as the OECD and the IMF, other levels of government such as the European Commission, trade agreements such as NAFTA, and bilateral relationships such as donors.

57. The most compelling example is in Mexico, where a trade agreement (NAFTA) made trade liberalization a binding national obligation that reformers used to justify further privatization and economic deregulation. The trade agreement shifted discretion away from the government that was unable to move forward quickly against a host of special interests, and toward technocratic and reform-minded institutions.

58. Donors have a very mixed record in using external drivers strategically. Most donors play the quiet game of claiming credit for reforms back home, while publicly giving credit to the government. Yet there is skepticism that donors are very effective at driving successful reforms. Recent evaluation work by the World Bank has found that compliance with policy conditions for World Bank structural adjustment operations is low, though these policy reforms are leveraged, negotiated, and monitored.[12]

59. In two of the countries studied here, conditionality for membership in OECD was important in strengthening other reform drivers. Conditionality seems strongest when reform is already supported by other drivers of reform such as political leadership and pre-existing commitment to change. An evaluation in 2004 of the FIAS administrative barriers program found that conditionality works when it is supported by reformers in the client country who need support during the implementation phase. In Latvia and Croatia, for example, implementation of the FIAS recommendations was included in World Bank Structural Adjustment Loans (SAL). This pressure was welcomed by Croatian reformers facing political fatigue. Latvia reformers actually volunteered the idea of putting the most difficult FIAS recommendations into the SAL conditions.

60. Conditionality seems to be in itself insufficient to break the balance of power that maintains the status quo. However, teamed up with other drivers of reform, particularly reform-minded technocrats, donor pressure seems to expand or at least maintain the opportunities for change.

V. CRITICAL SUCCESS FACTORS FOR BROAD REFORM

61. The drivers of reform are the fuel that enables governments to overcome the pressures for the status quo. But the drivers must be channeled into a reform strategy through which beneficial changes are identified, developed, communicated, adopted, and implemented. The design of these factors is the real technology of reform.

62. The purpose of this section is to identify critical success factors behind the strategies in these three countries. It is divided into five sections, corresponding with five major components of the reform process identified in earlier studies:

- Exploiting the drivers of reform,
- Setting the reform agenda,
- Designing reforms to match development needs,

[12] The nature of conditionality, particularly as applied by the World Bank, is changing in response to perceived failings in enforcement. See World Bank (2000) *World Development Report 2000/01: Attacking Poverty* (Washington). For a recent review of the literature on policy conditionality, see Paul Mosley, Farhad Noorbakhsh and Alberto Paloni (2003) *Compliance with World Bank Conditionality: Implications for the Selectivity Approach to Policy-Based Lending and the Design of Conditionality*, Research Paper 03/20, Centre for Research in Economic Development and International Trade, University of Nottingham, at www.nottingham.ac.uk/economics/credit/research/papers/CP.03.20.pdf

- Implementing reforms, and
- Sustaining reforms into the medium term.

Table 2: Critical Success Factors Across Three Countries

	Hungary	Mexico	Korea
Expanding reform opportunities with drivers of reform	Institutional drivers of reform were shifted at opportune times to have those driving reforms be the ones most adept at delivering the needed results.	Potential opportunities arising from NAFTA accession were amplified by creating new government institutions charged with preparing Mexico to compete.	The expanding NGO population was given more power to help reforms through government adoption of transparency and consultation procedures to assist regulatory reform.
Agenda setting and diagnostics	The high-level commitment to market-oriented reforms was vital to secure the positive support by foreign investors and creditors on whom the government was dependent for needed economic growth.	Current difficulties in furthering market-oriented reform indicate that the direction of earlier reforms was too top-down to overcome institutional resistance and build outside constituencies.	Political parties supported reform to counter the fiscal crisis. The public supported reform as a way to reduce corruption. Mutually reinforcing goals sustained long-term support.
Reform formulation and design	While seeking a dramatic change to free-markets, Hungary relied on existing legal and administrative frameworks to implement change.	Enacting federal competition and administrative practice laws provided greater certainty to businesses and, through greater transparency, improved public perception and acceptance.	The 1998 Basic Act on Administrative Reforms (BAAR) created the Regulatory Reform Body (RRB) and mandated such regulatory quality controls as RIA.
Sequencing	Periods of furious reform were followed by periods of building institutions and broadening ownership of changes.	Market openness increased pressures for economic liberalization, which led to reforms in the public sector capacities for good regulation.	Basing RIA on OECD recommendations and guidelines, reformers used the OECD peer review process as an outside pressure to maintain the quality of reform initiatives.

Implementing and monitoring	A courageous Guillotine Review system in less than a few months helped to eliminate obsolete regulations. Another led to harmonization with EU legal standards.	An accountable, transparent, and efficient regulatory framework was enhanced by placing draft regulations and RIAs on the internet for public review and comment.	In addition to legislating information disclosure, Korea included independent review of regulatory quality, supported by more consultation with stakeholders.
Sustaining reforms over the medium-term	Early market openness anchored the institutional restructuring of government ministries.	Three mutually supportive elements – market openness, privatization, and regulatory reforms – reinforced each other to build constituencies to move progress and needed initiatives along.	An independent regulatory review agency at the center of government countered the "pro-regulation" tendency of the ministries.

A. Expanding Reform Opportunities with Drivers of Reform

63. The strategic use of drivers of reform, even those that are exogenous to the policy process, is one key to successful reform. Drivers for the status quo can only be overcome by a mix of drivers for reform. How can the drivers identified in this report be amplified so that the opportunities for reform are maximized?

64. As noted, the three countries discussed here do not show a linear cause-and-effect scenario in which a single driver of change creates and defines the success of reform. "Crisis" did not create reform, nor did political leadership. All three countries used a changing mix of drivers through an unfolding sequence of events, like a series of dancers in a waltz. Behind the country-specific situations, there seems to be pattern to how drivers were sequenced:

- Crisis, a sense of impending crisis, or pressures arising from unavoidable external obligations were always important at the beginning of reforms. These drivers redefined the political economy of launching change, weakened defenders of the status quo, and emboldened reformers inside the government;
- Crisis and external obligations generated the first wave of market-oriented reforms only when politicians led the way, but delegated the actual reform process to reform-minded technocrats who defined the specific goals and content of reforms, sometimes in a "stealth" mode that caught opponents off-guard;
- The first wave of reforms created a momentum of reform by creating new pressures and new allies whose advantage lay in further reform. Market opening led to deeper domestic reforms as domestic businesses faced external competition;

- Market-oriented reforms become sustainable reforms only when they were institutionalized and constituencies for change were mobilized.

65. How these steps work together is the reform strategy. The effectiveness of drivers in seizing opportunities for reform will change with the strategy that is used. The power of using the right strategy to exploit the opportunities for change is illustrated in the case of Korea where an expanding NGO population was empowered through the unprecedented transparency and consultation procedures of the regulatory reform. The transparency of the Korean reforms was ideally matched to profit from, and encourage, the emergence of an NGO constituency that was militant, pro-active, and ready to challenge the government. Another illustration is the case of Mexico, where the opportunities provided by NAFTA accession were realized only though the creation of new institutions charged with preparing Mexico to compete. The In both cases, the governments were not satisfied with just reacting to the drivers of reform, but in creating situations where the drivers were amplified and sustained over a long period of time.

66. Hungary used the imperative of transformation and membership in Europe to launch its reforms, but made extensive efforts to build new institutions both top-down and bottom-up through the public administration. An initial and rapid economic deregulation and constitutional reforms, driven by the Prime Minister's Office, was followed by a period of consolidation and institution-building throughout the public sector in order to build the new market oversight mechanisms needed to oversee free markets. This pause was needed to maintain the support of an increasingly alarmed public, and to build new constituencies for reform in the public sector itself. It was followed by new rounds of reforms to push forward the change agenda.

67. While crisis and political leadership can launch reform, institutionalization of reform was key to steady progress against resistance.

B. Agenda setting and diagnostics

68. The pattern across these three countries is remarkable: crisis generates market-oriented reforms when agendas are set outside of the traditional insider-interest processes: either agendas are imported from outside the country, or politicians permit reform-minded technocrats to design the way ahead, that is, define the content and goals of reforms. The risks of getting reform wrong are highest exactly when pressures to reform are highest, because the incentive is strong for short term efforts to get fast results. If reform is captured by insider interests at this stage, it may simply paper over underlying causes, leading to a more virulent crisis later on. Many analyses of the 1997 Asian financial crisis concluded that this was exactly what had happened to earlier reform efforts to address the growing economic imbalances in the region. So the initial agenda setting is crucial.

69. Even in these relatively developed countries, agendas were heavily influenced by international practices and pressures. Whether in the interest of the European single market program, of the North American market, or of OECD members, outside agendas became domestic agendas. It seems that the benefits of integration and convergence were seen as more important political advantages than continued deference to the insider interests who had been the main influence previously. And international benchmarks of reform practices improved transparency for those reforms that had gone off-track.

70. The actual content of the reform agenda was variable and highly specific to the needs of the country, but international learning was clear in that all of these countries

moved from specific, short-term strategies to the longer-term, management strategies such as the OECD agenda. Hungary used a courageous regulatory guillotine that in less than a few months helped to eliminate obsolete regulations; a second review focused on deregulating and simplifying the stock of licenses and government authorizations; a third review used EU legal harmonization to modernize its regulatory oversight structure. In Korea, the target for a fast 50% reduction in each ministry's regulations was paralleled by a whole suite of new, long-term disciplines and controls such as regulatory impact analysis, and new administrative procedures that changed the machinery of government from the inside.

71. Measuring the problem has become a growing element of the strategy of reform. Governments are using a growing range of cross-country indicators as diagnostics to set the priorities and goals of regulatory reform. This is sensible if the indicators are sophisticated and flexible enough to push forward a broad-based program aimed at nett reductions of regulatory costs and risks, that is, changes that actually influence business behavior. None of the three countries studied here used indicators of business costs to drive reforms; rather, they were heavily influenced by indicators of macro economic performance. The narrower, bottom-up indicators increasingly used to set reform agendas may have a very different effect on results and sustainability.

72. The process of setting the agenda in the reform country also seems to be an important part of the strategy, communication, and political engagement necessary for success, although experiences are mixed here. The agendas in the three countries were initially set by fairly narrow groups in reaction to a consensus in the country that something had to be done. This is a risky moment since insider groups are strongest at this stage. The technocratic groups setting the agenda were groups already existing inside the governments who were newly empowered to carry out reforms that they had already been promoting. Regulatory reform had been promoted for at least eight years in Korea, with few results. Mexico had tried to open up its economy for years. Hungary had launched market-oriented reforms years previously. These reform-minded groups were empowered by crisis, external pressures, and political direction to define much more radical and bold reform agendas. Their previous experiences with reform were extremely useful in showing which reforms would not work, and in opening the way to new and innovative strategies.

73. But these technocratic agendas, more or less rapidly, received support from a growing circle of public and private interests, and such support, in turn, promoted the further evolution of the agenda. In all three countries, public-private arrangements were used to reach some kind of shared vision of the nature of the problem and of desired outcomes. Mutually reinforcing goals helped maintain support for reform.

- In Hungary, commitment to market-oriented reforms was vital to secure support by foreign investors and creditors, who, in turn, had powerful interests in maintaining rapid economic growth. Foreign investors were extremely influential in Hungary in maintaining focus on reform.
- In Korea, the major political parties agreed to support reform to fight the fiscal crisis; the public also supported this effort as a way to reduce corruption.

74. These three countries also show the converse lesson: a lack of public-private consensus on reforms reduces the likelihood of success. Mexican difficulties in moving forward with further urgent reforms, particularly in the energy sector, after 2002 are evidence that earlier reforms were too top-down and autocratic to overcome institutional resistance and build outside constituencies. Indeed, the three case studies show little

support for the "champion" model of reform. None of the three countries successfully used a single strong reformer to achieve sustainable results.

C. Reform implementation

75. Drivers, decisions, and designs are good starts, but the fatal flaw of many broad based reforms is failure in actually getting it done. At the nexus of public administrations and interest groups, public choice incentives are highly protective of the status quo. Technocratic reforms designed by a technocratic group or a political champion can easily run into problems at the implementation stage, where the incentives and capacities of existing institutions become a constraint on progress. Passive resistance is common. Reforms that are accomplished are easily reversed. Several key lessons can be learned about successful implementation from the three case studies:

76. First, reforms must be tailored to match the existing institutional apparatus of the country. These three countries mostly took pragmatic approaches in doing this, preferring to build reforms into existing, familiar institutional and legal structures and then, where needed, creating new institutions and regimes that did not exist before. All three countries built new structures on the back of pre-existing powers, structures, and incentives. Hungary knew that it needed to make dramatic shifts in its existing economic system to move rapidly to a free-market economy – for which there were many external models – but even Hungary in the midst of an historic revolution used pre-war legal and administrative frameworks to implement change, even 1930s administrative procedures. Korea used structures in the Prime Minister's Office, and an influential network of research institutes attached to the ministries.

77. Second, active management and resourcing of the reform process -- primarily through dedicated, day-to-day leadership within the public administration -- is essential. Governments that set up stronger capacities for promoting, monitoring, encouraging, and assisting in reform across the whole of the government seemed to do better in implementation throughout the public sector. The Presidential Commission on Regulatory Reform in Korea, and the UDE and COFEMER in Mexico institutionalized the reforms inside the machinery of government, and began, for the first time, to create incentives for good regulation. Where these units were weaker, in Hungary, reforms were more variable in speed and scope. This does not suggest that reforms should not be embedded throughout the public sector, as discussed in the next paragraph, but that centralized, accountable, and expert leadership of broad-based reform is closely correlated with success.

78. Third, reforms were more successful when governments built progressively wider networks of reform-minded institutions through the public administration.

- In Hungary, the independent competition office played a key role in the privatization process, and served to advocate regulatory reform based on sound competition principles and to block many highly distorting proposed measures.
- In Mexico, a network of regulatory reform units was created in the state governments, which began to compete with each for good regulation. Australia built a formal national network of regulatory reform bodies.

79. Countries that failed to build public sector allies – Hungary – tended to need more political energy to keep reform moving, and to falter faster when political attention weakened. This approach can backfire if the networks face conflicting incentives. In Italy, initially, partnership agreements were set up with the local authorities to seek a balance between strong central leadership to sustain common goals, and autonomy for the local

level to implement local solutions – but once top-level political support weakened, the premise of local autonomy facilitated a return to the *status quo ante.*

80. Fourth, administrative procedures backed up by judicial action were used to embed new behaviors in the public administration. This was particularly important in anti-corruption efforts. The power of administrative procedures to provide new protections and rights in the regulatory system is often underestimated. Mexico adopted a new Federal Competition Law, but amended its existing Federal Administrative Procedures Law to protect citizens against bad regulation. Providing greater legal security for businesses and individuals changed the conduct and perception of federal public administration in Mexico. In Korea, the adoption of the Basic Law of Administrative Regulation established quality controls on new regulations. Italy embedded "silence is consent" into law affecting hundreds of formalities. These procedures have become a permanent function of government, internalized in the public administration system, and protected by public administration and the courts.

81. Fifth, implementation seemed to be stronger when there was a continuous learning component. Efforts to benchmark based on good practices in similar countries, and to assess, pilot, innovate and learn from past experiences were important in Korea and Mexico particularly.

D. Monitoring

82. As has been shown in other studies, these three cases suggest that results monitoring that is integrated into the reform process from an early stage sustains political and bureaucratic attention to the reform process. Two reasons why results monitoring is so important is that (1) it helps maintain active management and political attention to the regulatory process during implementation; and (2) helps build some of the pro-reform drivers such as new constituencies for reform in civil society.

83. Two forms of monitoring were used in these three countries. The first was ongoing monitoring by stakeholders through consultation, transparency, and participation in the reform process. The second was more traditional monitoring in the sense of measuring results once implementation is completed. In both cases, monitoring seemed particularly effective when it is a public-private exercise, rather than controlled entirely by government.

84. Clear quality standards and goals in the reform program were powerful aides for reformers in pushing ahead. Even more important was the process of monitoring progress in reaching the standards and goals. Support for reform was maintained and strengthened by inviting stakeholders to participate, in constructive ways, in the reform effort and, through this participation, to become enrolled into ongoing oversight of the reform effort.

- In Mexico, the public was, for the first time, invited to participate in rulemaking. Draft regulations and RIAs were placed on the Internet for public review and comment. Reviews of the efforts of each ministry to produce high-quality regulations were made in public. A national benchmarking project permitted citizens to compare the relative quality of their state regulations.
- The Korean government set a public target of 50% reduction that held the entire government accountable for performance before the country. This public accountability is in a large part responsible for the success of this reform. In addition to legislating information disclosure, Korea opened up its regulatory system by including independent review of regulatory quality by the public-private

Regulatory Reform Commission, supported by more consultation with stakeholders in regulatory development.

85. These experiences suggests that monitoring, rather than being a technical exercise of checking results, should be conceived as a continuing process of active oversight that is built right into the implementation stage as well as the post implementation stage. Stakeholders should be continuously and heavily involved. Properly designed, monitoring the results of reforms actually improves those results.

E. Sustaining Reforms over the Medium-term

86. One of the main messages of this report is that market-oriented reforms become sustainable reforms only when they are institutionalized and constituencies for change are mobilized. Much of this report details how this was done in these three countries.

87. A point worth repeating is that well-designed reform programs do not work only in existing limits, but work actively to expand the opportunities for reform through exploitation of drivers, intelligent design, and building allies to weaken drivers for the status quo. Sustaining reform did not occur in fits and starts in any of these countries. The best case is the unfolding reform sequence that produces its own momentum, as in Mexico.

88. One of the most formidable barriers to sustaining reform is resistance to change in the public sector. In fact, in none of the three countries was there important opposition to reform by citizens or the private sector – only in the public sector. For that reason, the strategies in these countries were from the beginning aimed at institutionalizing new ways of regulating. Public sector reform was at the center for all of them. This lesson is easily generalized. If countries are to transit to the sustainable higher rates of growth that is necessary to reach poverty reduction goals, the public sectors must move toward a different culture of governance geared to an era of market-led growth. Indeed, this even be the definition of sustainable reform.

89. The imperative of public sector reform must shape the strategy. Short-term results are strategically, but not economically, important. The most important benefit lies in how well the short-term reform strategy prepares governments to move forward to a more sustainable strategy of reform. First phase reforms should lead to second phase reforms that are aimed at institutionalizing central units for regulatory reform, creating systematic consultation procedures, and building capacities for regulatory impact analysis.

90. Two of the three countries illustrate how a broad-based and evolving reform program can progressively change the role and culture of governments.

- Mexico did not start with public sector reforms, but adopted a comprehensive reform plan with mutually supportive elements – market openness, privatization, and regulatory reforms. As noted, these pillars of reform were mutually supportive – market openness increased pressures for economic liberalization, which created new pressures for reform in the public sector capacities for good regulation. Each reform revealed new weaknesses in the public sector that had to be corrected. For example, rapid privatization demonstrated that the existing competition and regulatory oversight frameworks were underdeveloped and insufficient to oversee private markets. Extensive reforms ensued. Throughout, reformers in Mexico used the OECD peer review process as an outside pressure to maintain momentum.

- Korea explicitly attacked the public choice foundations of regulation. The reform adopted an institutional approach that sought to balance traditional institutional incentives for capture and rent-seeking. Regulatory quality was controlled by an independent agency at the center of government intended to check the "pro-regulation" tendency of the ministries.

> "If an entrepreneur did finally get started and made a success of his enterprise, he was again in trouble. It was a criminal offense to manufacture beyond the capacity granted by the license. We became the only country in the non-Communist world where the production of goods sorely needed by the people was punishable by law."
>
> Gurcharan Das (2002) **India unbound**, Anchor Books, New York

91. Finally, sustaining reform requires a continuing and growing social consensus on market-based growth, the so-called "liberal consensus." In all three of these countries, such consensus was partly achieved by competitiveness fears, but this seems a fragile basis for long-term change. In the most successful of these three countries, regulatory reform sought to exploit and then develop social attitudes toward markets. In Korea, the most difficult of the three cases with respect to acceptance of markets, the ambitious program of regulatory reform was supported by messages from the government that the imposition of market discipline was a tool for achieving important national goals, rather than a threat to social stability. This struggle continues in Korea.

VI. APPLYING THE FACTORS OF SUCCESS IN SOUTH ASIA

A. Reform Experiences in South Asia

92. None of the South Asian countries have carried out broad-based reforms similar in scale or longevity to the three countries just described. But most governments in the region have carried out some substantial reforms to improve the enabling environment. Most of these reforms removed entry barriers such as the permits and price controls, subsidies, quotas, and regulation that had stalled private sector development for decades. The most important such reforms since 1990 have been

- Improving market openness by lowering trade and investment barriers, which increased competition for domestic industry, perhaps the most important driver of accelerated productivity growth. This kind of reform is among the easiest and fastest to carry out. Afghanistan, starting late, has become one of the most open economies in South Asia and already has the lowest tariff regime in the region.

- Abolishing industrial and import licenses. Economic freedom has expanded. All over the region, the trend has been to move from banning everything not expressly permitted to permitting everything not expressly banned. India is the best example: before 1991, a license was required for nearly every commercial activity. Almost all of these have been removed at the national level (although there are criticisms that the "licence raj" and a pervasive "inspector raj" still survive at the state level in India).

- Privatizing and de-monopolizing some sectors. In some sectors in some countries, state monopolies have been formally eliminated and privatization has gone forward. State dominance is diminishing, albeit painfully, slowly, and episodically. This went further in some countries, such as Sri Lanka, than others, such as Bangladesh, Maldives, and Nepal.

93. More recently, since 2000, the ADB states that widespread financial reforms, in particular reform of banking, have been carried out across South Asia, concluding that "The banking sectors in South Asia have not only improved their performance over the recent past, but have also reduced the performance gap between themselves and other economies in Asia."[13]

94. Yet these reforms are just the beginning and have made only marginal changes in the high-cost, high-risk legal and regulatory environments in the region. Where governments are unable to build consensus, are vulnerable to capture, are rent-seeking and self-protecting, and unskilled in market regulation, so too will regulation be narrowly based, anti-competitive, complex, and costly. These kinds of effects still constrain PSD in South Asia:

- Weak governance, corruption, anti-market regulation, poor law and order. Most countries in South Asia share a common economic history -- a half-century of state-led development strategies. Regulatory and administrative practices in these countries still reflect the legacy of that half-century, indeed, almost all institutions and practices in the public sectors in South Asia were developed for state-led development strategies, and are poorly suited to the new market-led strategies. The region is characterized by burdensome and ineffective regulatory systems, including regulation that is badly-designed and implemented, and regulation that is interventionist and frankly anti-market. Hence, the quality of public sectors across the region is the single largest obstacle to economic growth. To reach their poverty reduction targets, the eight South Asian countries need public sectors that are more market-oriented, transparent, and focused on enabling economic development. Improving transparency is an obvious target for reform.
- Corruption is an enormous problem that, except for the Maldives and Bhutan, seems worse in South Asia than almost anywhere else in the world, as Figure 5 suggests. Bangladesh has the dubious honor of ranking worst out of 133 countries on a World Heritage Foundation corruption ranking for the past two years.
- Lack of political commitment and capacities to build consensus about market reforms is another regional characteristic. Across the region, political capacities to build a liberal consensus on market-oriented reforms have proven to be weak. The incapacity of political parties to agree on a market development strategy is one of the biggest obstacles to further broad-based regulatory reforms.
- Low quality and costly infrastructure is evidenced by port bottlenecks and slow turnaround times, erratic energy supplies, and limited communications, particularly in rural areas. Incomplete privatization followed by poor regulatory governance has contributed significantly to this problem by reducing private investment.
- Rigid labor market regimes are cited as major problems by enterprises that are expected to comply, such as foreign investors, but not by domestic firms who do not expect to comply. This is evidence of a heavily distorted labor market. Labor

[13] Asian Development Bank (2006) *South Asia Economic Report*, Manila, October. p. 18.

laws are some of the most costly regulations on the books in South Asia, and are a major barrier to entry into the organized sector.

- Large gaps in the legal framework for market functioning. The absence of adequate legislation on corporate governance, foreign investment, intellectual property rights, utility regulation, and safeguards against anti-competitive behavior undermine private sector confidence and undermine access to long-term capital. For all intents and purposes, competition abuses in South Asia are completely unregulated. While the problem is mostly undocumented, anecdotal evidence suggests that cartels, price fixing, collusive bidding or tendering, and manipulation of sales prices abuses pose significant problems to market entry and reduce consumer welfare in liberalized markets.

- Incomplete market opening and privatization reforms that began in the 1990s. Some successful reforms of the 1990s have stalled. Market opening has gone the furthest, but even here reforms have not advanced. India is, for example, still among the most restrictive countries in the world. Bangladesh failed to continue tariff reform, and by 2004 Bangladesh's competitiveness was suffering from the highest tariffs in the region. Privatization has been incomplete in all countries, where significant public ownership reduces performance and increases fiscal drag. In Maldives, for example, the state is still involved directly or indirectly in many areas, and is still the largest employer. In Bangladesh, the program to divest state enterprises in manufacturing stagnated, and state enterprises remained a huge drag on the Bangladesh economy. T. N. Srinivasan noted in 2004 that privatization, usually called "disinvestment," meant "dilution of public ownership in an SOE through sale of equity in the enterprise. Most often the proportion of equity sold was too small to shift control and management of the SOE from the state…Outright sale of an SOE has been few."[14]

95. As a result of this complex of anti-market policies and behaviors, and the non-sustainability of reforms, operating costs and risks facing businesses due to poor regulatory environments have scarcely been reduced at all in South Asia. Entry and exit are still too difficult. The complexity and costs of the administrative and regulatory environments in South Asia are very high. The operating environment is undermined by difficult corporate governance and company law environments, including difficulties in enforcing contracts, gaps in regulation of contract and mortgage laws, The dismal result can be seen in Figures 4 and 6-9 in Annex 1, which suggest again that South Asia's competitiveness and business environment are still below those of Southeast Asia. Indeed, a 2005 study linking selected investment climate indicators with selected economic indicators found that relatively better investment climate indicators in Shanghai "give its garment factories a productivity advantage over South Asian cities (advantages of 18% vs. Bangalore, 43% vs. Dhaka, 78% vs. Calcutta, and 81% vs. Karachi)."[15]

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[14] T. N. Srinivasan (2004) *Economic Reforms in South Asia: An Update*, published on the site of the Global Development Network, at http://www.gdnet.org/pdf2/gdn_library/annual_conferences/fifth_annual_conference/srinivasan_paper.pdf

[15] Dollar, David, Mary Hallward-Driemeier, and Taye Mengistae (2005) *Investment Climate and Firm Performance in Developing Economies*. Economic Development & Cultural Change, vol 54 – 1, pp. 1-31, The University of Chicago.

B. Assessment of Reform Drivers and Success Factors in South Asia

96. Do the factors of success in the three case study countries have relevance in explaining the relatively poor South Asian reform experience just described? The answer seems to be "yes". As discussed further below, the reform experiences in South Asia show clear patterns that, interpreted in the context of the patterns of successful reform in the three countries studied, suggest some reasons for relatively slow reforms in the region, and even some possible ways forward.

- There is enormous and well-organized defense of the status quo in South Asia. Outdated institutions in the public sector and the failure of public sector reform, the capture of state machinery through corruption and rent-seeking, the highly organized interests in the market such as trade unions who are well protected by the current system – these and other pressures resist the kind of micro economic reforms in the enabling environment agenda. These "status quo" pressures are very hard to reverse without very strong drivers of reform. In Korea, Mexico, and Hungary, defense of the status quo was overcome initially by crisis exploited by strong technocrats and political leadership. South Asian countries did not suffer an economic contraction as severe, and are unlikely to do so in the next few years. It is likely that reform drivers will have to come from other factors.

- Sustainability is a particular problem in South Asia. Reforms stop before they are completed, or are reversed over time. This suggests that drivers of reform have been episodic and ad hoc. This might be explained by over-reliance on drivers of reform that are short-term – such as a political champion or a technocratic leader or temporary external pressure – and that are not supported or followed by other drivers of reform such as linkages to further reform, or by institutionalization in the public sector. This suggests that reform is more opportunistic than strategic.

- Follow-up factors of success are very weak in South Asia. Political consensus for market reform is fragile. Institutions dedicated to reform are almost nonexistent. Strategies of reform are short-term, non-institutionalized, and poorly financed. Effective mechanisms and processes have not been established to prioritize areas of reform, to design solutions to business environment problems, to build consensus among stakeholders, and to manage the reform process. This has allowed the blocking of implementation by administrations with outdated roles and rent-seeking incentives. This means that even initially strong reforms have been eroded and diluted over time as older incentives and interests capture the reforms.

97. These patterns suggest that South Asia is unlikely to succeed with broad reform unless it develops stronger, better linked, and more numerous drivers of reform for success, followed by strategies cleverly based on the factors of success identified here. These issues are reviewed more thoroughly in Table 3 below. Table 3 supports two general conclusions:

- The drivers of reform likely to be most important in South Asia are competitiveness drivers, civil society drivers (specifically, the growing class of entrepreneurs that are export oriented), and external drivers (mostly donors). Reformers in these countries must develop ways to exploit and extend the pro-reform pressures from these drivers. They should be linked to launch and sustain a strategy of broad reform, particularly when there is strong political leadership, even if it is temporary.

- The factors of success are even weaker in South Asia. None of the factors identified in the three case studies are well developed in the region. Since these factors are mostly issues of institutional reform and strategy development, these areas could prove to be fruitful areas of investment for donors.

Table 3: Assessment of Drivers of Reform and Success Factors in South Asia

SOUTH ASIA	
Drivers of reform	
The globalization or competitiveness driver	South Asia is facing strong competitiveness pressures through trade and investment, particularly from China. These pressures are probably the strongest drivers of reform in the region and will be part of any broad reform strategy. They are most explicit in driving recent reforms in India. But the failure of the competitiveness driver to lead to broad-based reforms in South Asia can be explained by the assessment of reforms in Mexico, Korea, and Hungary. First, the competitiveness driver results in narrow reforms to benefit big investors UNLESS there are technocratic or other supporting pressures to widen the reforms. Second, the decision to react to competitiveness fears with market oriented reforms in the three countries were due to other drivers, such as strong external pressures to open markets, and a liberal consensus that growth depended on private sector performance. South Asian countries face strong competitiveness drivers, but lack the other reform drivers necessary for reform, and hence predictably are reacting to competitiveness with narrower reforms to benefit vocal, larger investors (such as special export zones).
The crisis driver	Crisis is not a reliable driver of reform. South Asian countries have suffered from slow growth, but have avoided major contractions over the past several years, with the exception of Afghanistan (due to war) and the Maldives (due to a tsunami). Other wars are underway in the region as well, and have reduced growth. Economic crisis has not, however, translated into broad reform, partly because political leadership has not been able to create a social consensus for market reform. This is due partly to the lack of organization of groups most harmed by lack of reform, such as the enormous and probably growing informal sectors.

Political leadership driver	Across Asia, reforms are usually initiated top-down from strong Prime Ministers or Finance Ministers – supported by strong policy formulation and analysis capacities -- but social agreement on market reforms is weak, and has not supported political leadership on the issue. The difficulty of reaching political consensus on market reforms has meant that reforms in South Asia are usually half-hearted, incomplete, poorly implemented, and vulnerable to reversal.
The unfolding reform driver	The stalling and capture of reforms by vested interests – privatization, market opening – has constrained the pressures for wider reforms. The lack of strategic planning has meant that reform drivers are not linked or sequenced well in South Asian countries. The opening of the borders in several countries in the region was not followed by changes to regulatory structures and labor markets. The pressures caused by market opening are clear, particularly in India, but the reaction has been to contain such pressures through very limited reforms such as special economic zones. Three examples common in the region are establishment of specialized courts to bypass inefficient judiciaries (such as the tax courts in India and the Special Court for corruption cases in Nepal), special economic zones, as in India and Bangladesh, where rigid labor laws and complex licensing procedures are waived, and special procedures for foreign investors, such as the Board of Investment processes in Sri Lanka. Sometimes, these kinds of reforms are justified on the grounds that they will act as a "demonstration effect", showing the country what is possible and making it easier to move with bigger reforms later, but there is little evidence of this happening.[16]
Technocratic drivers	Independent technocratic institutions such as competition regimes that have supported reforms in other countries are notoriously weak in South Asia. Only Pakistan, Sri Lanka, and India have competition commissions, but they either have proven ineffective or are too new (as in Sri Lanka and India) to have track records. This is also true at the sectoral level. Utility regulatory bodies in most sectors suffer from a lack of coherence in mandates, a lack of regulatory tools to achieve their mandates, insufficient independence from ministerial authorities, and inadequate skills to regulate changing markets.

[16] Indeed, such reforms might have reduced the pace of reform. In Sri Lanka, UNCTAD expressed concern that the BoI processes might have undermined important reforms leading to economy-wide improvements by perpetuating a dual regime in which large investors obtained treatment far superior to that available to small and medium investors. See UNCTAD, 2004, Investment Policy Review Sri Lanka, Geneva January 2004.

Changes in civil society driver	Consumer and stakeholder participation is very weak in reform in the region. South Asian governments tend to carry out extensive consultation with businesses, but the approaches generally used add little value to policy decisions. The habit of systematic and routine consultation with stakeholders as a part of day-to-day policy making has not taken hold in the region. The strongest allies of reform tend to be a growing class of entrepreneurs who are competitive, ambitious, and well-versed in market needs outside of South Asia. These entrepreneurs are clearly distinct from other businesses that depend on protection for survival. A reform strategy should find ways to harness and organize these entrepreneurial energies into the machinery of reform.
External pressure driver	External drivers of reform certainly exist in South Asia, most notably from international donor organizations and from linkages at the intellectual level with information. Yet South Asia has no strong movement for a regional free trade zone comparable to NAFTA or the European Single Market, and its countries do not belong to international reform-minded institutions such as the OECD. Donors have done much to drive enabling environment reforms across the region, but the limitations of donors in driving broad, durable reforms are clear, since donors are usually time-limited, risk-adverse, and unable to challenge the accepted limitations of the political class. Yet donors could be more effective in using their resources and influence through coordinated and careful design of reforms based on exploitation of reform drivers and the factors of success.

Other success factors	
Agenda setting and diagnostics	No South Asian country has an explicit regulatory and administrative reform policy with a clear agenda. Such reforms are fragmented among a variety of plans. With some exceptions, reforms in South Asia have largely been ad hoc and driven by one-time measures on isolated reforms, rather than addressing deep-seated structural and institutional issues. In the three case studies, learning from experiences outside of the region was essential to success. Much reform strategy was simply accepted from international best practices. Such learning seems to have been slower in South Asia. Much reform has focused on the needs of big investors. The needs of SMEs and informal firms in business environment reforms have been systematically neglected. No South Asian government has developed an integrated plan to deal with the needs of informal businesses, and no government unit is responsible for the informal sector. Though there is much commitment in national development plans to SMEs, there are in fact few integrated policies or programs to improve the business environment for SMEs in South Asia. SME policy has focused on protecting rather than developing SMEs, and reforms have focused on providing more supports. SME policy is only now evolving from its traditional focus on small manufacturers to broader concerns with small service providers. Bangladesh began developing its first general SME policy through an SME Policy Task Force formed in 2004, and a Sri Lankan Task Force to formulate a 'National Strategy for Small and Medium Enterprise (SME) has recommended setting-up of an independent SME Authority (SMEA) as a 'one stop shop' for SMEs. The focus of concern in some countries is shifting from the national to the state level. National agendas and diagnostics are rarely applied at this level. Many problems of poor business environment, excessive red tape, poor delivery of services and inadequate infrastructure are the fault of local governments, not national governments. A business association in India, for example, identified 13 layers of state-level clearances to open a business, and found that obtaining those clearances requires 3,500 person days.

Reform implementation	There is little capacity at the center of governments in the region to organize, coordinate, and oversee a multi-year, cross-ministerial reform plan. No South Asian country has a central reform unit for enabling environment issues. Economic policy reforms have been mostly top-down, driven by strong prime ministers or Finance Ministers. These top-down approaches have worked best when making isolated policy reforms, but tend to fail when reforms are longer-term and when policies enter the implementation phase. Even if reforms are implemented, it is impossible to sustain reforms in South Asia without changes to public sector capacities and roles. The public sectors in South Asia still live mostly in the pre-1990s era. The institutions, skills, and incentives in the public sector, as well as its cost, largely reflect the needs of a state-led development strategy, not a market-led strategy. In reaction to the economic reforms of the 1990s, the main focus of the public sectors has become self-preservation against change. Government actions often reveal confusion about the role of competition, as evidenced by frequent interventions to “fix” the market. Among its 44 ministries, for example, India still has ministries for coal, steel, textiles, shipping, broadcasting and civil aviation – whose staffs are reluctant to give up outdated economic management functions.
Monitoring	Across the region, there is little analysis and monitoring of regulatory and policy impacts on businesses and market development to guide a reform program. There are few private sector bodies or think tanks to monitor externally.
Sustaining reforms over the medium-term	The strong defenders of the status quo inside the administrative machinery in these countries suggests that new, powerful, and durable institutions of reform, such as those used in Mexico and Korea, are needed. They must be supported by civil society allies, by strong mandates embedded in clear strategies, and by political ownership. None of these conditions are met in South Asia.

VII. LESSONS FOR REFORMERS IN SOUTH ASIA

98. The goal of this kind of work is to generalize operational lessons to countries not included in the three cases. The reforms were difficult enough in these countries, but are likely to be more difficult in countries with more hostile reform environments and weaker institutions in the public sector, the private sector, and civil society. But the key question is the same: How can reformers design reforms to maximize the chances for sustained success, that is, real and lasting benefits for businesses?

99. It must be noted that while there do seem to be clear patterns correlated with success, there is no single model for a reform program. The three case studies show that many institutional and design factors are important in developing and sustaining reform momentum, and that success factors seem to be inter-related; that is, the more successful governments seem to invest simultaneously in strategies such as managing the reform program, on-going public-private dialogue, and results monitoring. All of these factors do not have to be highly developed for reform to succeed. Weakness in one area

may be compensated in another area. For example, a stable political context based on cross-party consensus may be unattainable in many developing (as well as developed) countries. This implies more focused attention on building pro-reform coalitions among a broad range of stakeholders that can survive the ups and downs of political enthusiasm and discord. If there cannot be a stable cross-party consensus, working to develop institutions in the bureaucracy as long lasting reform “champions” is another means to develop and sustain reform momentum.

100. Reformers who wish to launch reforms capable of supporting the higher rates of economic growth needed to reach poverty reduction targets should consider the following:

1. ***Identify and exploit multiple drivers of reform***

101. The key insight from this paper is that these reforms occurred in an unfolding sequence in which various drivers of reform, partly exogenous and partly responsive to strategy, were amplified and sustained through clever reform strategies. That is, while substantial elements of reform were outside the control reformers, the reformers were able to exploit and extend the pro-reform pressures from those drivers. It shows how drivers of reform changed over time, and how strategies of reformers encouraged and supported the emergence of new drivers of change.

2. ***Use a crisis if available, but lock in political leadership and bipartisan political support through formal agreements, implementing legislation, international agreements, and new institutions.***

102. A crisis is a useful way to stimulate action, but a poor basis for sustained reform. Experiences in the three countries show that the opportunities provided by crisis should be used to “lock in” reform commitments and built expectations among enduring constituencies. International agreements, formal involvement of stakeholders, and new institutions in the public sector can help maintain reform as the crisis fades or new political imperatives take over. An approach used by several of these countries was to create new legal rights for citizens and businesses through administrative procedure laws. Reversing these new rights later was impossible.

3. ***Build durable consensus by spreading ownership of reform across a growing number of stakeholders.***

103. Spreading ownership of reform across as large a number of stakeholders as possible ensures that reform “champions” emerge who will outlast the departure of any particular individual. These case studies show that sustainability is at risk if reform relies on narrow political bases. The momentum for reform can be maintained through educating the public on the desirability of reform, and monitoring and informing them on the progress made.

4. ***Aim at systemic change, but use one-off reforms to build momentum***

104. The three case study countries examined here tackled reform through systemic change. This is in contrast to the tendency today for governments and donors in South Asia to find narrow and one-off reforms appealing. Such reforms seem to promise rapid results and provide quick fixes to highly visible regulatory problems. The pressure for the “quick fix” is unlikely to abate. Donors describe them as “realistic” and “demonstration projects” that can fuel further reforms. This might be accurate if they are contained within a larger medium-term strategy, but often they are not. Because the problem of poor business environments is systemic, genuine solutions must also be systemic.

105. One-off and visible projects certainly can contribute to systemic change, however. Early results help build credibility and momentum. Success breeds success.

5. ***Start reforms with a clear and well-designed medium-term reform strategy that has room to evolve over time.***

106. A medium-term reform strategy sustains the reform, provides a focus and rallying point for reform, and provides a basis for monitoring the reform progress. The content of the plan needs to be based on a careful appraisal of interlinked issues that need to be addressed. A piecemeal approach is possible, but the probability of success may be lower because of the higher risk of derailment and the effects of poor sequencing.

107. The strategy should synchronize regulatory reform with public sector reform that adjusts the role, functions, and capacities of the state. Changes in personnel and budget should follow naturally as commitments and responsibilities are allocated through the public administration.

6. ***Place the principle of transparency at the heart of the process and content reforms***

108. All three of these countries created a public reform process and public expectations for success. Processes of reform were based on public participation and stakeholder involvement, while the reforms themselves aimed to institutionalize greater transparency within the regulatory function of the government through tools such as regulatory impact analysis, public consultation, and registries of regulations.

109. Transparency is not only a tool for strengthening pro-reform drivers, it is also a key tool in reducing regulatory risks, one of the main objectives of the reform. Adherence to principles of transparency and accountability are vital to the confidence of the market in a modern regulatory state. This is an aspect of systemic reform. Reforms should include developing new transparency habits across the public administration (for instance through administrative procedures or access of information laws). New technologies such as e-registries can support openness at lower cost.

7. ***Maintain effective and ongoing communication at all levels.***

110. The communications strategy is a key cog in the reform technology. Continuous and clear communication of the reform's purpose and progress to participants in the reform process and to the general public was important to most of the countries studied here. Accurate information is important, since the general public is more likely to turn against reforms if it is ill-informed. Consultation mechanisms can also ensure that key stakeholders such as business stay on board. Communication of reform purposes and tools can prepare civil servants for their role in reforms, and reduce the anxiety that accompanies any change.

8. ***Ensure that the implementation strategy changes over time to reflect different phases of reform.***

111. There is a progressive "locking in" strategy as different stakeholders are involved. At the beginning of the reform, political support may mean pushing, commanding, and expending political capital to overcome resistance. Political leaders are assisted by building technocratic institutions early. But as reforms are adopted, legal texts are enacted, and the implementation phase starts, political leadership and top-down direction may need to change into guidance, management, and more open and participative approaches involving more stakeholders. Different phases of building

ownership and constituencies generally require different leadership styles, communication skills and mixes of incentives.

9. ***Develop a network of supportive institutions inside the public sector to implement reforms in daily policy processes, and to sustain reform as political attention wavers***

112. Because political support will shift to another crisis before long, an institution-building phase is needed to create sustained pro-reform incentives in the machinery of government. The countries leading here have adapted existing institutions or built new institutions to create supportive, pro-reform networks. All of them created “reform engines” at the center of government, supported by competition offices, networks in the ministries, audit offices, finance ministries, and other pro-reform institutions.

10. ***Encourage cultural change and the development of relevant skills in the public administration***

113. Steps are needed to equip the civil service for the task of implementing reform, which may mean that reform has, at some stage, to engage public sector reform. The bureaucracy must “buy in” to reform, perhaps through changes in incentives and skills. Centrally placed structures and the support of finance ministries can be very helpful in this process.

11. ***Monitor and evaluate to keep players on track, and publicize results to sustain reform momentum.***

114. Effective monitoring and evaluation of specific reform targets and of the aggregate picture is essential for sustaining reform against active and passive resistance. The core aim is to demonstrate credible benefits of reform to stakeholders and so disarm critics. A participative process of evaluation can sustain stakeholder support. Evaluation also helps keep players on track by creating feedback loops which allow reform programs to be monitored, modified and improved over time.

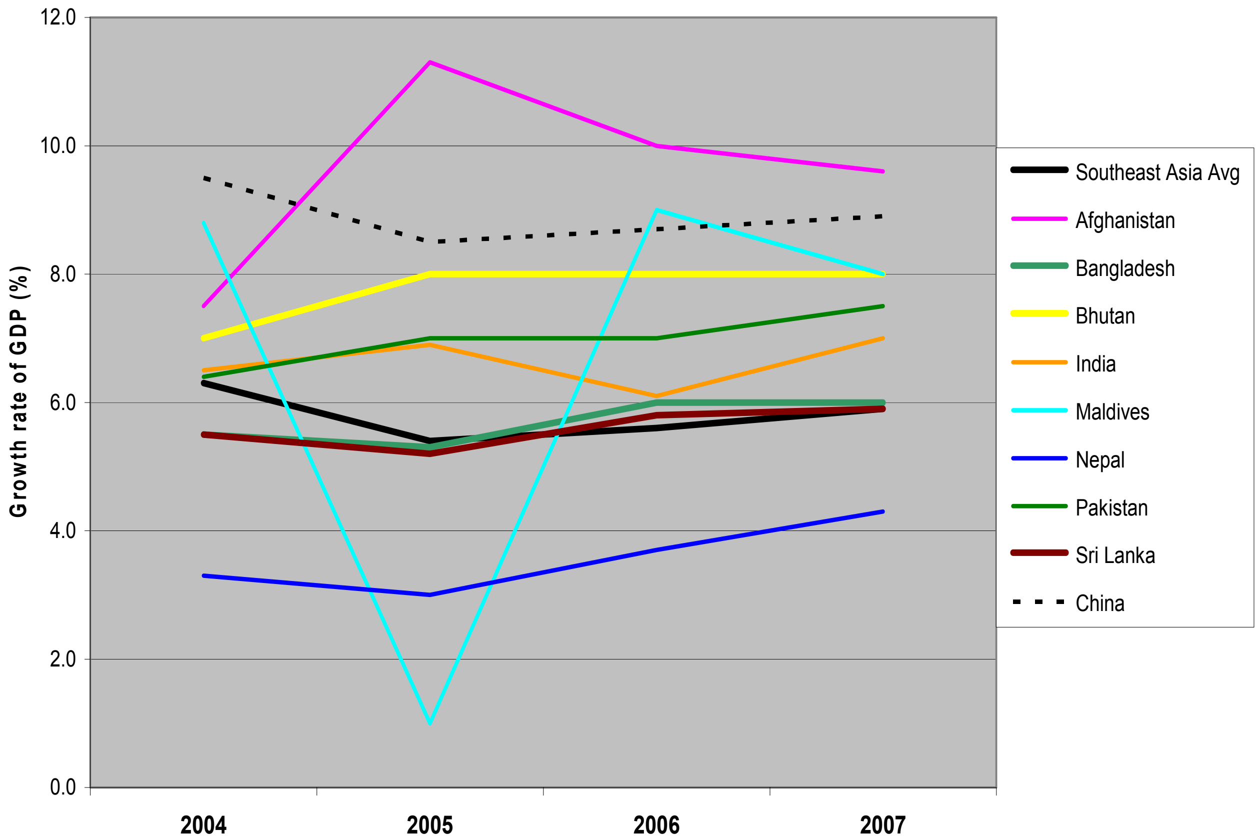
12. ***Prepare for the long haul.***

115. Effective and durable reform is a dynamic, long-term process, not a single, static program. Reform can be expected to span more than one political cycle, probably several. Gains from reform tend to dissipate over time with economic and social changes, and there can be constant pressure from losers to reverse or undermine achievements. New needs and expectations will require continual adjustments. Regulatory reform programs that began 25 years ago are just as dynamic as programs created last year. Reform mechanisms, institutions and processes must be sufficiently robust to withstand the long haul.

Annex 1: Figures

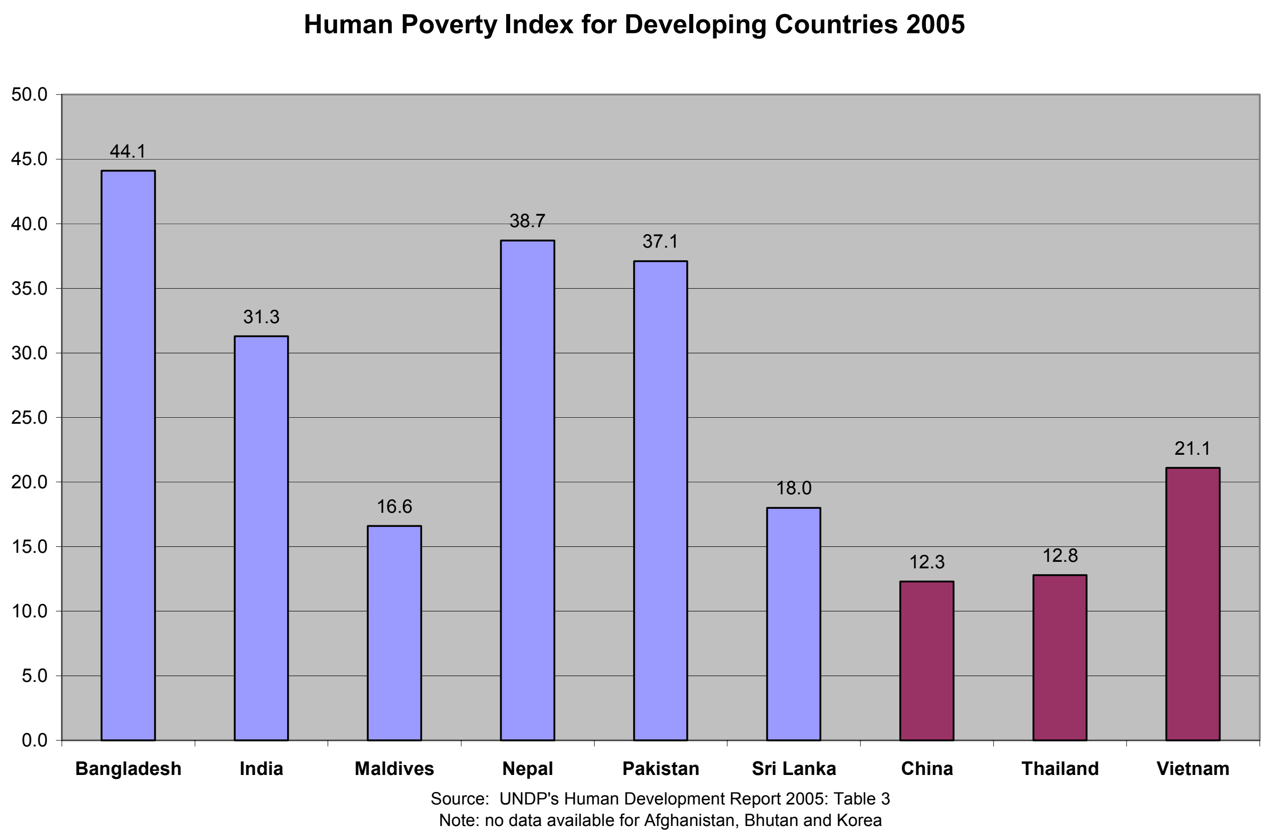
Figure 1

Forecasted Growth Rate for South Asian Countries



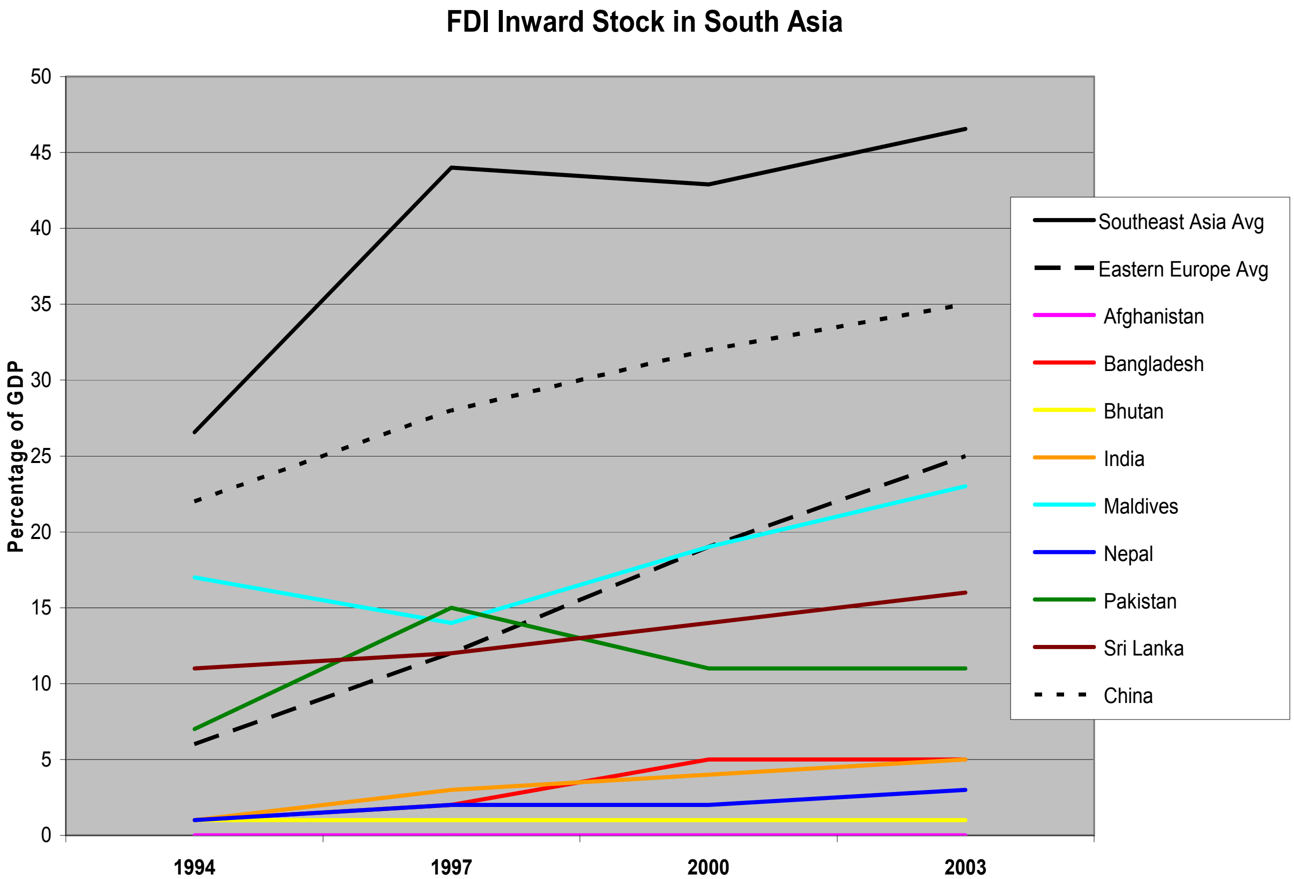
Note: Low growth rate for the Maldives in 2005 is due to the tsunami in late 2004
Source: ADB's Asian Development Outlook 2005 (www.adb.org)

Figure 2:



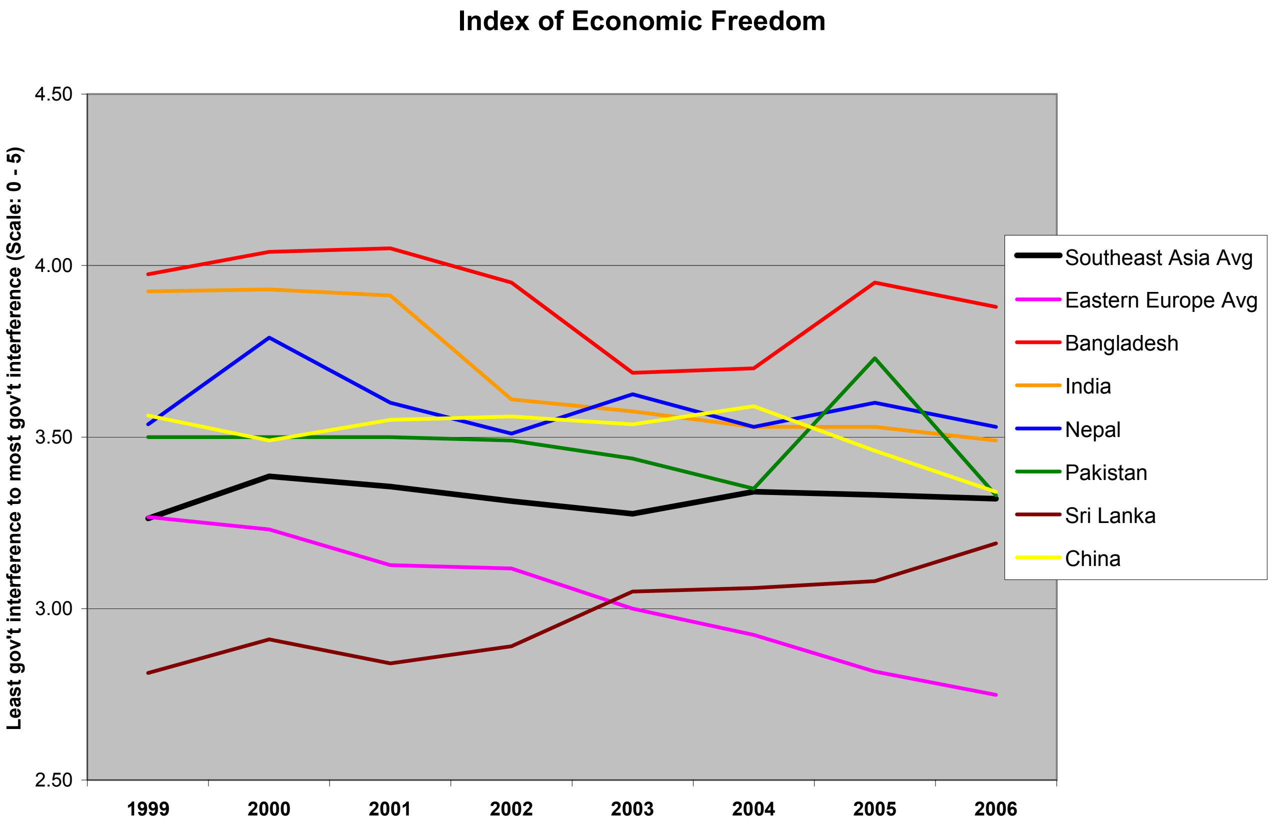
Note: This index is a measure of *deprivations* in the three basic dimensions of human development: 1) A long and healthy life—vulnerability to death at a relatively early age, as measured by the probability at birth of not surviving to age 40; 2) Knowledge—exclusion from the world of reading and communications, as measured by the adult illiteracy rate; and 3) A decent standard of living—lack of access to overall economic provisioning.

Figure 3:



Source: UNCTAD's Major FDI Indicators (www.unctad.org)
Note, Southeast Asia Avg includes Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand & Vietnam; Eastern Europe Avg includes 19 countries from Albania to Ukraine.

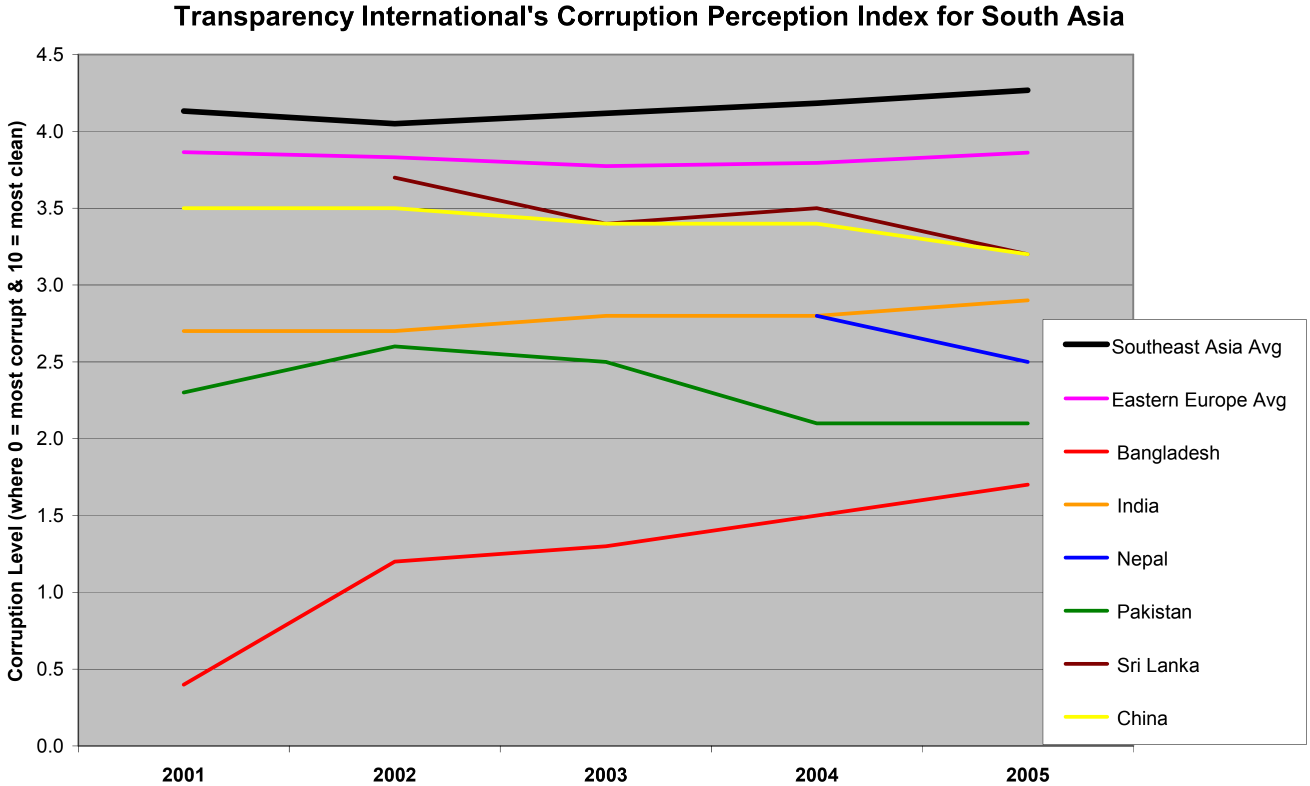
Figure 4



Source: The Heritage Foundation's Index of Economic Freedom 1999-2006 (www.heritage.org)

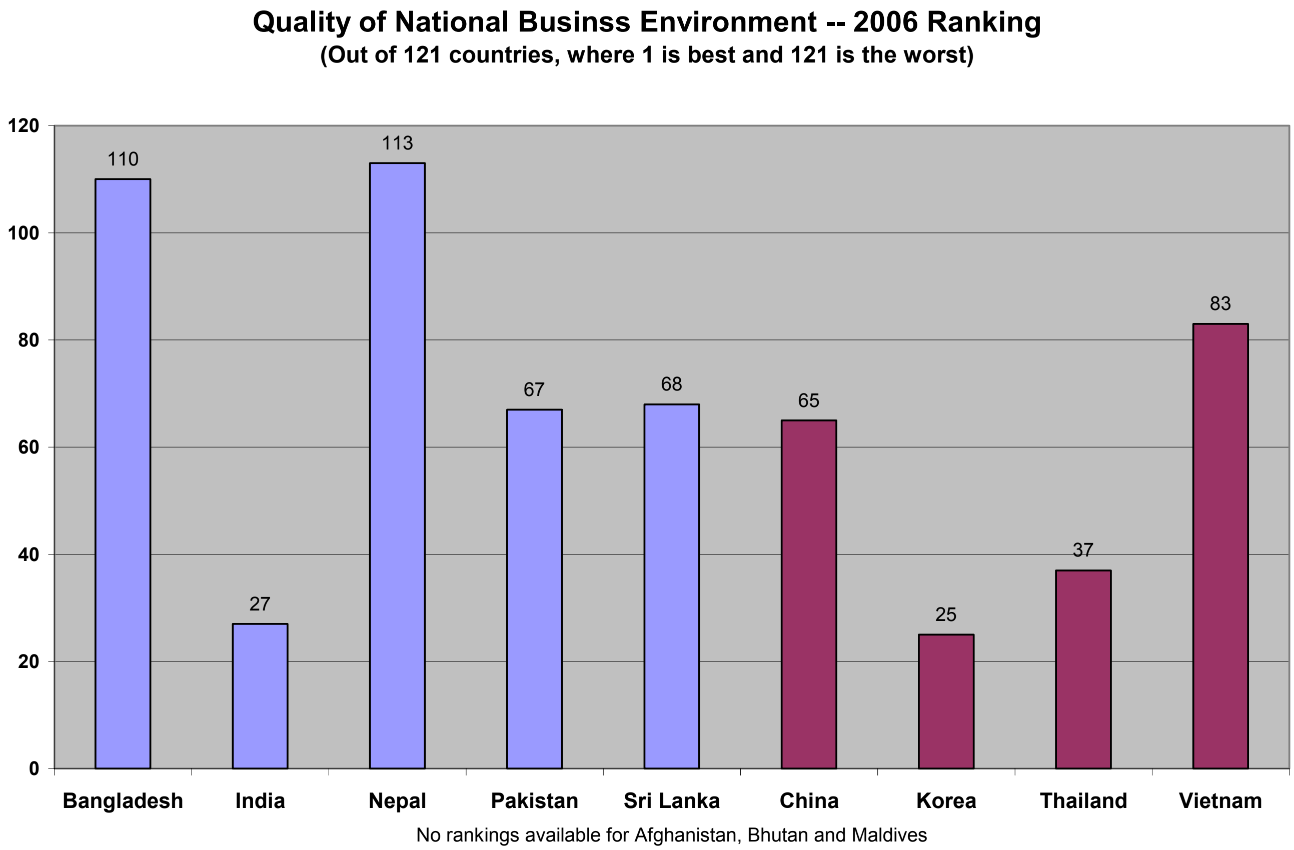
Southeast Asia average includes Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore & Thailand.

Figure 5



Source: Transparency International CPI Index 2001-2005 from www.transparency.org.
Note: No data for Afghanistan, Bhutan, & the Maldives;
Southeast Asia average includes Indonesia, Malaysia, Philippines, Singapore, Thailand & Vietnam.

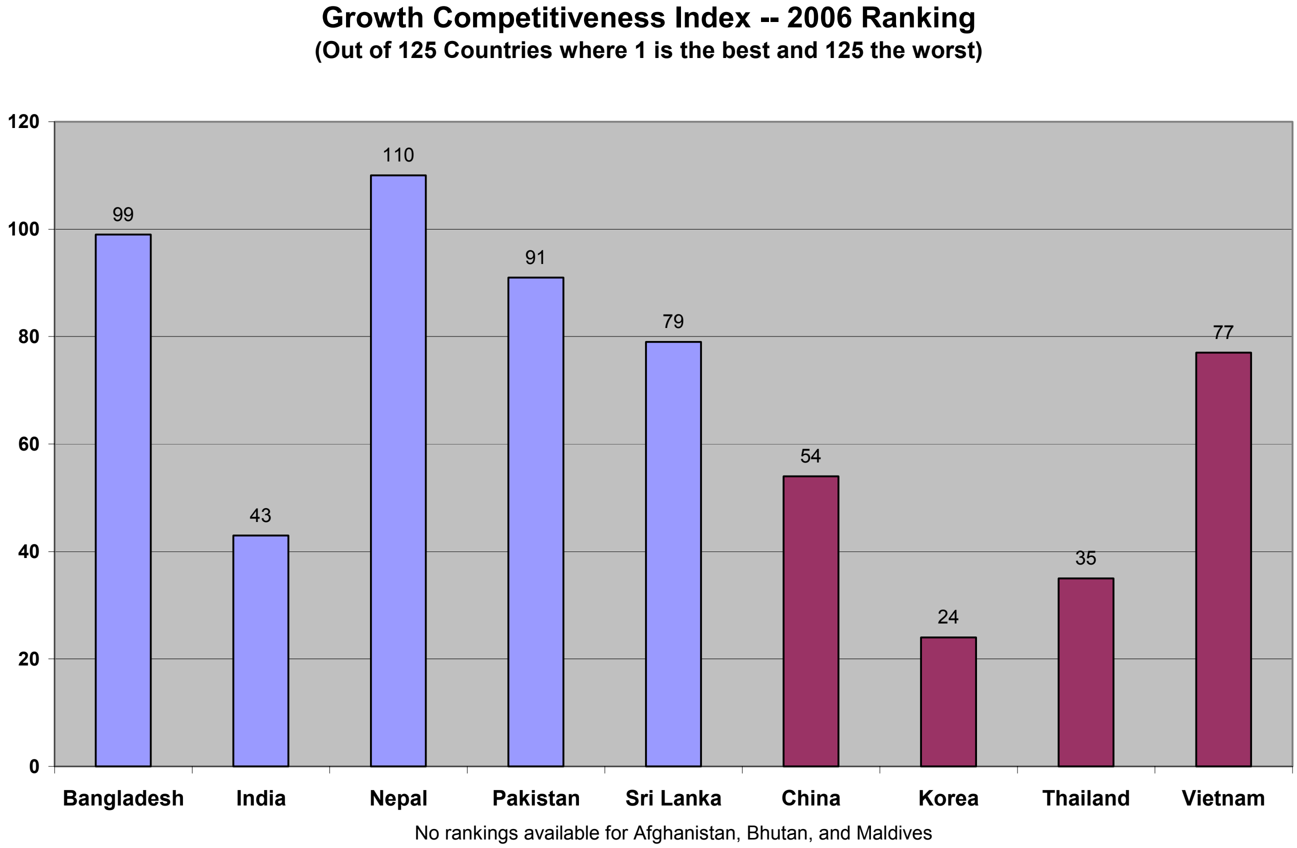
Figure 6



Source: World Economic Forum, *The Global Competitiveness Report 2006-2007*, see The Business Competitiveness Index[17]

[17] The "Business Competitiveness Index" was developed by Michael Porter, Director of the Institute for Strategy and Competitiveness of the Harvard Business School. The Index draws on economic data and surveys of more than 8,700 business leaders around the world to develop microeconomic indicators that measure the set of institutions, market structures, and economic policies supportive of high national prosperity. The Business Competitiveness Index consists of two sub-indexes, the quality of the business environments – financial markets, the impact of competitive pressure and support in the economy, and public administrative effectiveness -- and the sophistication of companies' operations and strategies.

Figure 7



Source: World Economic Forum, *The Global Competitiveness Report 2006-2007*[18]

[18] The GCI summarizes three important mechanisms: the macroeconomic environment, the quality of public institutions, and technology.

Figure 8. Private investment in infrastructure in developing countries, by region, 1990-2003

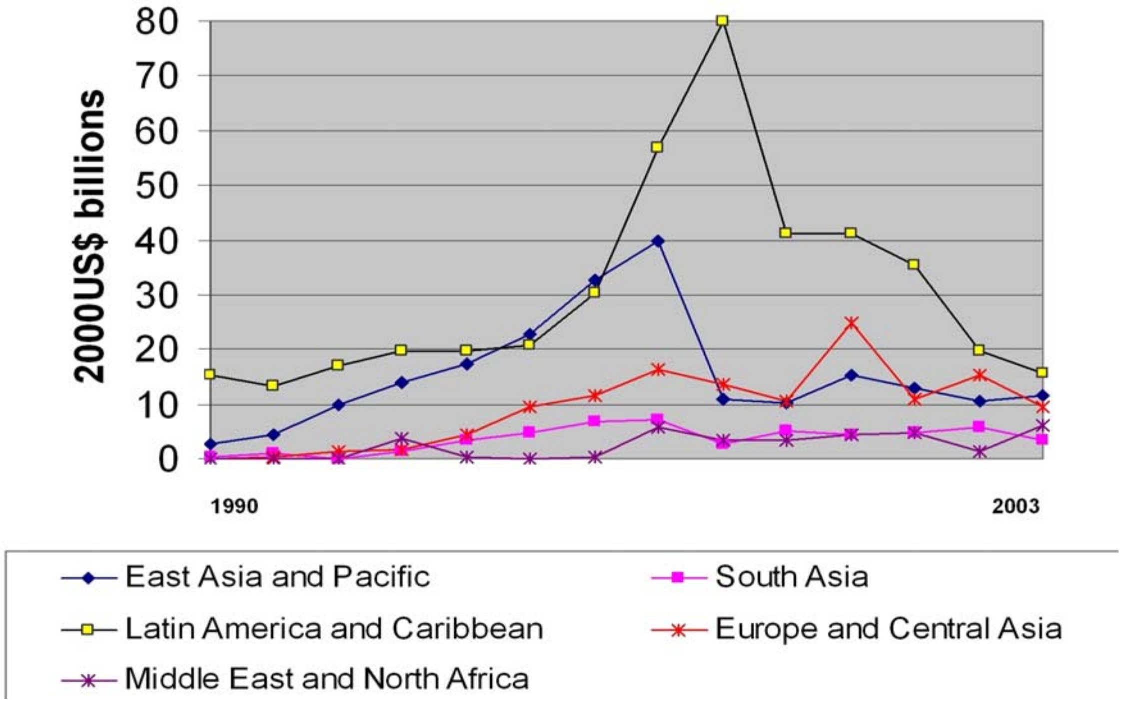


Figure 9. Private investment in infrastructure in developing countries, by region, 1990-2003, per capita