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South Asia FDI Roundtable

Keynote Address 1:

The importance of institutions in determining the investment environment

Scott Jacobs

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1 The transition to market-led growth and the quality of state institutions

A better understanding of the role of institutions in growth and investment is necessary because most countries are engaged in an historic transition from state-led to market-led growth. This transition, which requires continual adjustment of state and market institutions, involves a decades-long shift away from the *dirigiste* and interventionist state models that arose in almost all countries in the 20th century, in Asia as elsewhere. Around the globe, market functioning is being revitalized through economic liberalization and market opening, including withdrawal of the state from ownership and from intervention in market entry, market exit, and pricing. Supply-side reforms to stimulate competition prefer consumers over producers, build appropriate regulatory frameworks, and reduce regulatory and administrative inefficiencies are now understood as central to effective economic policy.

Structural reform in South Asia

This global trend is much in evidence in South Asia. After years of inward-looking economic policies and tight regulation, structural reforms starting in the 1990s (and in Sri Lanka's case, in the late 1970s) led to a period of accelerated growth. South Asian nations reduced tariffs, removed trade barriers, dismantled restrictions on domestic and foreign private investment, and reformed their financial systems.[1] By the early 1990s, most countries had largely abandoned import substitution strategies in favor of more open international trade and market oriented policies. Average tariff rates declined from between 90 to 100 percent in the 1980s to between 17 and 32 percent today. The region grew rapidly during the 1990s, averaging 5.9 percent annually and 5.4 percent in 2001. Trade liberalization was an important component of structural reform efforts among the South Asian countries since the mid-1980s, with Sri Lanka leading the way.

FDI performances in South Asia

Yet structural liberalization and tariff reduction are not enough to make a country attractive to investors today. South Asia still attracts the lowest rate of foreign direct investment (FDI) in the world at just 0.5 percent of GDP.

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[1] World Bank South Asia Region Development Progress: http://lnweb18.worldbank.org/sar/sa.nsf/2991b676f98842f0852567d7005d2cba/9bcec7b2e99856fe852567f4006ec27d?OpenDocument

It is widely known that the South Asian region has fallen far behind in the global competition for FDI (Jacobs, 2002). Figure 1 shows that FDI per capita varies widely in South Asia, from just US$ 0.23 per person per year from 1999-2001 in Bhutan, to US$ 45.41 per year in the Maldives. The inflow of FDI into the region was an average of just US$ 2.57 per person each year. It is interesting that Sri Lanka, which began its structural reforms first and has gone the furthest in market liberalization, is among the front-runners in the region in FDI, despite years of internal strife.

Figure 2 compares the South Asia region to other regions. South Asia performs very poorly. The average FDI inflow for all developing countries in Asia is over ten times higher than in South Asia. Only the Maldives exceeded the Asian average. The Latin American region received almost 100 times more FDI per capita than did South Asia.

Figure 1: FDI per capita, annual average 1999-2001 (US$)

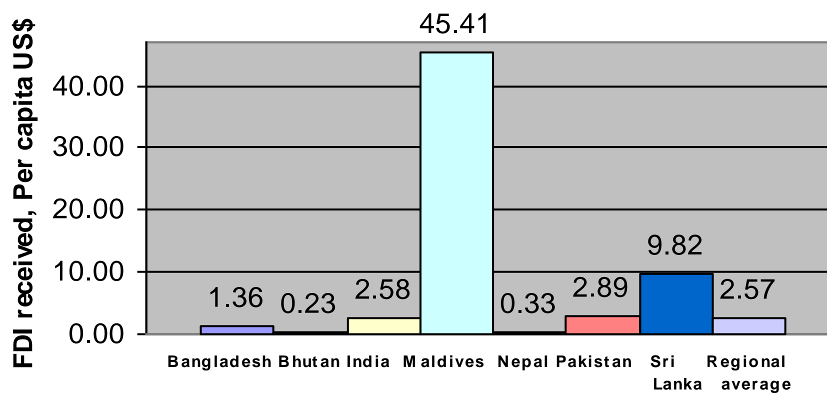
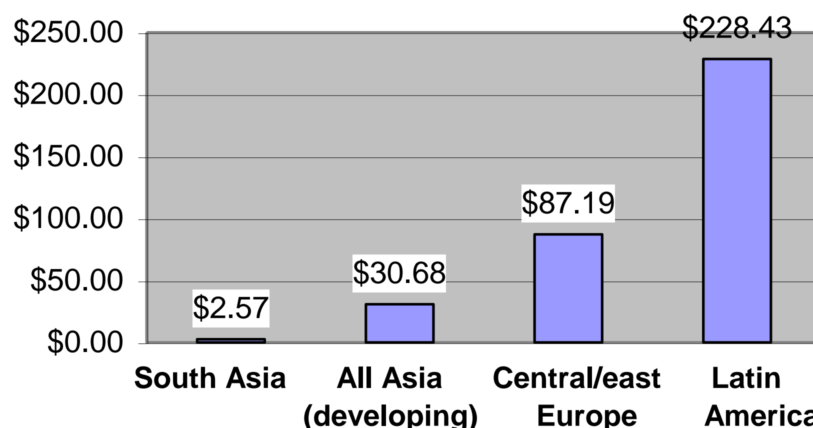


Figure 2: South Asia FDI inflows compared to other regions (US$ received annually per capita, 1999-2001)



Sources: UNCTAD data

Market-led growth

Current market-opening talks go beyond classical border barriers, such as tariffs, to attack far more difficult barriers – the thousands of behind-the-border barriers to trade and investment that arise from inefficient institutions, lack of transparency, poor regulations, uncontrolled market abuses, and corrupt administrative procedures.

In countries that began earliest and have gone furthest, the transition to market-led growth has created enormous wealth, innovation, and competitive advantages, along with the problems that come from structural adjustment. Most countries, though, are still in the early stages of the transition, and reforms to the roles of the state and the market, in combination with technological changes and global opportunities, are just beginning to change the structure of markets and methods of production. If the experiences of the pioneering countries can be replicated, we have not yet seen even a substantial fraction of the possible benefits of this transition. Market-led growth, within the right institutional framework, could be among the most significant of the policies aimed at alleviating global poverty and inequities. (Jacobs, 1999)

The right institutional framework

The key phrase in the preceding sentence is “the right institutional framework.” What is it? There is no single answer. It might be surprising that there is, as yet, no coherent concept of the role of the state in a period of global market-led growth. We agree only on a few basic issues. For example, it is widely understood today that, where a supportive legal and institutional framework exists, the market process is better than the state at gathering and

providing information to individual economic operators, as well as signaling the existence of unexploited opportunities (Saba, 1999). But there is less agreement today than at any time in the past 50 years about the roles and comparative strengths of market, state and civil society institutions in improving social welfare. Indian Foreign Minister Singh claimed a few years ago that the debate over the role of the state is over: the state is to support the creative, entrepreneurial capacities of the people (UNCTAD, 1999), that is, simply support the market. Yet support it how? Even from the limited perspective of economic growth, we just do not know what the "right state" looks like, what functions it should perform, or how it should perform them.

We are, however, slowly building up a body of evidence about good institutional characteristics that seem relevant to market performance. One lesson is that strong markets need strong states. Some governments (and many economists) have learned the hard way that deregulation and market liberalization are insufficient concepts to guide the reforms needed to establish sustainable market-led growth, much less to maximize social welfare. Benefits have often been less than expected, while costs have been higher than necessary. Deregulation understood as market *laissez faire* was always a myth, and a dangerous myth when it resulted in under-institutionalization and legal gaps that misled or crippled markets and harmed consumers.

The quality of institutions

Current discussions of governance reflect the need to move beyond the ideologies of the "small state" that often underlie deregulation policies toward a more positive and pro-active view of the state in cooperation with civil society. This is not the same debate that occurred in the early 1990s about "governing markets," (Wade, 1990; World Bank, 1993) which was triggered by active state interventions in the fast-growing East Asian tigers (though it may learn from those experiences), but a different debate about essential complementarities between the state, market, and civil society. In the current debate, the quantity of the state becomes less important than its quality.[2]

The correct debate about institutions, then, is not about the size of the state, but its role and its effectiveness, that is, its quality. Institutional reform – adapting institutions to perform new roles and functions in harmony with social needs – is a key ingredient of successful reform. Here is where we should concentrate our attention. Many state institutions are quickly losing quality as market-led growth makes them increasingly out-dated and irrelevant to the needs of our societies. Administrative entry barriers, for example, are not usually intentional efforts to block investment, but instead are artifacts or

[2] Standard notions that higher state intervention is associated with lower economic efficiency are being revised. The degree of intervention may not be as important as its quality. Higher taxes may, for example, be associated with better institutions. See NBER Working Paper 6727:7.

fossils of old public policies and state functions that now reduce rather than enhance the quality of life for citizens.

Changing bad institutions

A focus on institutional quality is appealing, because, like good governance, we all want high-quality institutions. So why is the problem of bad institutions so widespread and so difficult to correct? The answer is that segments of society have adapted themselves to these outdated institutions and are now dependent on them, so that change is painful and politically sensitive. Powerful political forces defend and vigorously protect harmful institutions, while only a few brave souls advocate modernization and improvement. Change usually comes only when there is complete failure and crisis. Seen from the view of political economy, institutions of the state, market, and civil society are not technocratic solutions, but are systems for mediating the complex interests of society. Institutional reform can be seen as a map of changing interests and relations in society, and the various incentives of those involved helps explain why institutions adapt at different speeds.[3]

I have written elsewhere (Jacobs, 1999) that the network of institutions between markets, the state, and civil society establishes the capacities of a society to use its resources optimally. The "fit" between institutional capacities and changing opportunities determines the gap between potential and actual welfare. There is always a shortfall in social welfare, because institutions and opportunities change at different speeds, particularly when there is a mix of exogenous and endogenous forces, as when global markets interact with domestic policies. For example, in OECD countries, outward-oriented policies are now relatively liberal and homogeneous, while domestic policies remain more anti-competitive and heterogeneous (Nicoletti et al.,1999).

An institutional crisis of the state

This means that the faster markets change, the wider the gap between institutional capacities and the needs and opportunities of society. FIAS writes correctly that there is "an 'implementation gap' between increasingly liberalized policies and legislation and the day to day reality faced by investors dealing with the many arms of bureaucracy charged with delivering regulatory services…. At the heart of the problems are the nature, activities and accountabilities of the various institutions of government." Our countries need institutional reforms to sustain and consolidate the move to market-led growth, which is evolving so rapidly that it is straining the capacities of lagging or obsolete institutions to perform important functions such as providing security, encouraging investment and consumer choice, intervening carefully to repair

[3] This explanation relies on public choice theory, but Djankov et al (2002) suggest that another factor responsible for institutional inefficiency is colonial transplantation.

market failures, and maintaining democratic legitimacy within the policy structure.

This is not just a market problem. Poor institutions damage governments and harm the citizens they serve. There is today a crisis of the state that is essentially institutional. The state is perceived to be losing effectiveness in the face of pressing economic, social, and environmental problems, and economic insecurity. Its most reliable instruments are progressively devalued. For example, regulatory tools are losing relevance to markets (as factors of production become more mobile and global, and as product cycles shorten) and to civil societies (as societies become more diverse, informed, and oriented toward choice).

Strong states and strong markets

The key conclusion is that institutional reform strategies must be aimed at strengthening markets and states simultaneously. This reform agenda is not about unleashing the market by abandoning the role of the state. Understanding the complementarities of strong states and strong markets will speed up institutional reforms, because their sustainability depends on acceptance by citizens. Citizens tend to mistrust market institutions, though today they may not trust public institutions more. Concrete and credible steps are needed to demonstrate to citizens that important public interests such as safety and equity will be safeguarded within dynamic and global markets. These steps can engender public confidence that, in turn, reduces political constraints and the risks of excessive regulation, and speeds up, deepens, and sustains market reforms. Lack of trust is a major cause of over-regulation. When effective, efficient government action improves trust in markets and states, it contributes to the performance of both. A strategic and inherently political approach is necessary, since building public confidence may require trade-offs in short-term and long-term benefits and costs.

2 Economic performance and the quality of institutions

Explaining cross-country growth performance

What new or strengthened institutions will increase the attractiveness of an economy to FDI inflows? This is difficult to answer operationally. A growing body of research links institutional success and failure, to economic growth and market development, over time and across countries. But, as the World Bank points out, most of these studies do not establish links between specific institutions and specific outcomes, but rather highlight the wide variety of institutions that support market growth. For example, income and the rule of law (including property rights, legal institutions, and the judiciary) are highly correlated. Development of financial institutions predicts growth (World Bank, 2002a: 9).

One reason why we know little about specific institutional designs and market outcomes is that these questions are recent. Some economists have stressed the role of institutions in economic growth since the 1980s, but this key issue gained popular currency only in the last few years, because it is based on a fundamental conceptual shift from a negative to a positive view of the role of the state. The empirical growth literature has developed substantially over the past two decades, drawing on larger and richer databases and exploiting better econometric tools to explain cross-country differences in growth performance. (Bassanini et al., 2001)

New Institutional Economics

The field of New Institutional Economics (NIE) suggests that governments themselves hold a key to faster growth by adjusting their domestic institutions to re-shape incentives among market agents. The main message of NIE is that economic activity is harmed by transactions costs and collective action problems. Aligning the incentives of agents with the interests of principals, and improving information flows about actions and outputs can improve outcomes. The essential principles are:[4]

- Institutions “consist of formal rules, informal constraints—norms of behavior, conventions, and self-imposed codes of conduct—and their enforcement characteristics.”(North, 1991). Institutions are the rules by which agents interact.

- Institutions do three main things important to markets:

[4] The following is partly based on World Bank (2002a).

- they reduce transactions costs from inadequate information (arising from informational asymmetries and the administrative costs of reducing informational asymmetries).

- they define and enforce property rights, and

- they determine the degree of competition by defining the terms of market entry.

Each of these goals involves tradeoffs. For example, the state must enforce property rights against thieves, but a government can itself violate property rights. To contain a government, institutions restricting its power are necessary, which are sometimes referred to as rule of law (Djankov et al. 2002).

- Effective institutions are those that are incentive-compatible. The most effective institutions are those with internal enforcement mechanisms because there is a self-correcting system of rewards and penalties. Public institutions should be designed to create incentives for the desired behavior. For markets, institutions should be designed to provide incentives for the desired outcome, such as efficiency, innovation, and consumer welfare. Producers should be rewarded, for example, for pleasing consumers, not cheating them.

- Governments work through formal institutions such as laws, while societies also use informal institutions such as norms of behavior, and the desire to be good citizens through voluntary compliance with rules. Good market regulation works through a combination of formal and informal institutions that differ according to the incentives and agents involved.

NE focuses on resolving several types of common institutional problems that interfere with efficient results. These include:

- the ***incomplete contracts problem***, which refers to how to design contracts when important variables cannot be observed;

- the ***principal-agent problem***, which refers to how a principal who cannot observe the agent's action, can induce the agent to take the right action;

- the ***adverse selection problem***, which refers to the problem of creating markets where the quality of the goods or the trustworthiness of the participants is in question; and

- the ***collective action problem***, which refers to how any rational agent alone would undersupply effort or resources to resolve group problems. (Azfar, 2002)

Right rules for the market

These principles are directly relevant to policy. The World Bank has usefully captured a great deal of complex literature into three questions that governments can ask to determine if they have designed the right rules for the market:

- Who needs information on what?
- Are property rights and contracts clearly defined and enforced?
- Is there too little competition – or too much?

Comparative Economics

However, the World Bank's three questions, while useful, miss entirely the capacity of the government to intervene efficiently, for example, whether it is vulnerable to capture by special interests or is able to monitor the market. The study of how institutions actually operate has been greatly expanded by a new comparative economics, which seeks to demonstrate how institutions differ systematically among countries, and how these differences have significant consequences for economic and political performance, with a focus on understanding which ones are appropriate in what circumstances (Djankov et al., 2002).

Much of this work is based on Barro's earlier work on the determinants of growth, which found the rule of law to be an important factor. This field of study is directly policy relevant to South Asian governments, although it arises mainly from study of varying transitional experiences in the formerly-socialist and Soviet economies. The quality of institutions has been identified as the difference between success and failure for these economies:

The important differences among countries had to do with the effectiveness of the newly created institutions rather than with the speed of reform. The countries of Central Europe succeeded in creating successful institutions of a market economy. Russia – having moved as fast or faster on many of its reforms – faced greater problems of corruption and capture, and failed to grow until recently. (Djankov et al, 2002)

Cross-country empirical evidence

A large and growing body of cross-country empirical work links various institutional and governance measures to growth rates. A good summary is given in Knack (2002). A few of the more cited studies suggest the following results:

Study	Results
Beck, Demirguc-Kunt, and Maksimovic (2001)	The study used data from the World Bank's World Business Environment Survey, which collects opinions from entrepreneurs in a large number of countries of the quality of institutions affecting their businesses. The authors find significant variation among countries in institutional quality, and evidence of lower business growth in countries whose institutions are lacking.
Olson, Sarna, and Swamy (2000)	The study tested whether various proxies for good governance can explain the residual that remains after regressing the growth of per capita income on the usual variables in the sources of growth equation, such as growth of labor, capital, and human capital. They include indexes for (1) the risk of expropriation, (2) risk of repudiation of contracts by government, (3) quality of bureaucracy, (4) corruption, and (5) the rule of law. Each of these variables turns out to significantly explain the variation in growth rates between countries. They conclude that the faster rates of growth by a few countries in the late twentieth century can be explained partly by the quality of governance.
Scarpetta et al. (2000)	A number of microeconomic policy and institutional factors are also likely to have an impact on growth by influencing the efficiency with which product and labor markets operate. This study showed that trends in labor utilization account for an important component of growth in a simple accounting exercise. While there has been a significant process of convergence in labor productivity levels over the past decades, countries still differ widely in terms of GDP per capita levels, precisely because of the very different degrees with which the population of working age is actually employed. And previous work has clearly identified a strong role for policy and institutions in determining the level of labor utilization in each country (see, among others, the OECD Jobs Strategy series).

Quality of governance

An emphasis on the quality of governance rather than its size is supported by recent work. Many studies have examined the relationship between the size of government and economic growth. Some cross-country analysis shows that taxes and government expenditures negatively affect growth both directly and indirectly through investment. An increase in taxes is usually held to reduce output, and increases in the size of government slow down growth. However, the size of government is a crude measure, because a small government (like the one in Japan) can promote policies that undermine economic growth, while a larger government (like the one in the United States) can promote policies

that encourage competition and innovation. Also, some governments consume while other governments invest.

More sophisticated analysis based on marginal rather than average tax rates seems to confirm that the *level* of taxation is not the real issue; high levels of taxation are compatible with both slow economic growth and rapid economic growth, depending on how well the tax revenue is spent. But the *marginal* rate of taxation is negatively correlated with economic growth because the marginal tax rate acts as a disincentive to produce and generate income (Padovano and Galli, 2001). Smart government, not small government, is the real key.

3 Economic performance and administrative barriers to investment

Administrative barriers

Administrative barriers to investment illustrate the broader case just made that institutions matter for economic performance. Administrative barriers are market rules with unforeseen or unfortunate consequences for certain categories of market agents (new entrants). They define comparative advantage among competitors by affecting the cost of entry, either through higher transactions costs, through property rights (such as IPR), or by straightforwardly setting limits on competition (such as by limits on foreign ownership).

An efficient and market-oriented institutional environment is needed not only to attract FDI, but also to create the incentives in which trade and investment liberalization will support longer-term economic growth.

- In a narrow sense, institutional reform can help governments meet the legal obligations of the international trading system by removing barriers to trade and investment; improving transparency, neutrality, and due process; and building new institutions and practices expected by international norms, such as autonomous regulators in utility sectors. Effective administrative reform can be a useful benchmark for credible commitment to the international trading system, and, as trade and investment develop, can help avoid costly conflicts between trading partners.

- In a wider sense, good institutions should be seen as a pro-active strategy that complements trade and investment liberalization in boosting potential growth. As part of a mix of macroeconomic and structural policies, market-oriented institutional reforms - properly designed and implemented - can increase private investment (domestic and foreign), business start-ups, and incentives for efficiency among private and state-owned enterprises. These effects should boost over-all productivity performance and potential long-term growth, and comprise a valuable tool in the national strategy for poverty reduction. Reducing regulatory risk (the risk that governments will change the rules of the market or will apply rules to benefit national incumbents) is critical in increasing investment inflows, particularly in vital infrastructure sectors characterized by long-term commitments, high sunk costs, and intricate property rights.

Reducing administrative barriers seems of small importance compared to dramatic structural reforms such as large privatizations. But this view is inaccurate. While some institutional constraints are probably more critical, such as the need to deepen and broaden local capital markets, study after study finds that administrative barriers are among the most important disincentives to investors in both developed and developing countries. Such barriers raise the cost of production, reduce entrepreneurship, market entry and business expansion, hurt consumers and weaken competitive forces throughout the economy. Improving the administrative and regulatory environment for private sector development is an essential element of national economic policy.

In fact, most studies show that the quality of the business environment (governance) is more important in influencing FDI flows than traditional investment incentives such as low wages, tariff cutting, and special investment inducements. Another important determinant of FDI flows is the relative size of the export sector. Countries that export more, attract more FDI. This is another channel by which efforts to reduce business costs and increase competition can support FDI inflows.

It is also important to note that, over the medium to long-term, administrative practices are seen by investors as a proxy for the commitment and capacity of the government as a whole. Poor administration shapes the reputation of the country, and raises the cost of capital. It is therefore surprising, the World Bank concludes, "When someone has finally made the decision to invest, he then is subjected to some of the worst treatment imaginable..." (FIAS, 1999). But this is a familiar story in South Asia, where a recent FIAS roundtable found that the day-to-day realities of doing business encounter unnecessary high transaction costs, bureaucratic barriers, and generally unfriendly investment environments. This amounts to nothing less than self-inflicted sabotage of potential investment.

The famous Djankov study (2002a) of entry barriers in 85 countries found that countries with heavier regulation of entry have higher corruption and larger unofficial economies, but not better quality of public or private goods. Countries with more democratic and limited governments have lighter regulation of entry. The study found that the worldwide average number of screening procedures facing a new entrant is 6.04, and that meeting the official entry requirements in the average sample country requires roughly 47 days and fees of 47 percent of GDP per capita. His sample included 3 South Asian countries, of which India is substantially worse than the global average. Pakistan is at about the global average in burdens, suggesting that it also could improve competitiveness by improving the efficiency of start-up procedures. Sri Lanka performs better than the global average on most measures. It is interesting that per capita FDI from 1999-2001 followed the same order: India worst, Pakistan next, and Sri Lanka far ahead.

Table 1: Results from the Djankov study of entry barriers (2002)

	# of Screening Procedures	Days	Fees as % pf GDP per capita
Global average	6.04	47	47
Sri Lanka	8	23	19.72
Pakistan	8	50	34.96
India	10	77	57.76

FDI and economic growth

The importance of FDI to economic growth is widely accepted. Growth over time depends on the extent to which productive capacity (including physical capital, human capital, and economic institutions) is able to grow. Sustained increases in productive capacity require increases in national savings and investment. Lower levels of investment result in a smaller domestic capital stock, which in turn reduces output and income. One way to increase national savings is to increase the inflow of foreign savings, in the form of aid inflows, borrowing, and private investment. Among these external savings, foreign direct investment (FDI) has swamped all other financial inflows since the 1990s.

Drawing on 25 years of data in the developed world, the OECD identifies what it calls "compelling" links between market opening, FDI, and growth:

- Open markets
- Higher rates of private investment
- Higher economic growth
- Firms and sectors with high FDI have higher average labor productivity and pay higher wages (OECD, 1998).

In fact, FDI seems to have more positive effects than other financial inflows. A study in five South Asian countries[5] found that, from 1980 to 2000, "FDI inflows contributed more to GDP growth in South Asia than did an equal amount of foreign borrowing. This suggests that FDI is preferable to foreign borrowing." (Agrawal, 2000) The growing importance of FDI in increasing national productive capacity in both developed and developing economies is one reason why the FIAS work is so valuable. Other work has shown that FDI is relatively resilient to financial crises. In East Asian countries, such investment was remarkably stable during the global financial crises of 1997-

[5] The five countries are India, Sri Lanka, Pakistan, Bangladesh, and Nepal.

98, in contrast to other forms of private capital flows such as portfolio equity and debt flows, and particularly short-term flows, which were subject to large reversals during the same period. (Loungani and Razin, 2001).

Past worries that foreign investment squeezes out domestic investment seem unfounded. Indeed, the contrary seems to be true. Foreign investment stimulates domestic investment. A comprehensive study by Bosworth and Collins provides evidence on the effect of capital inflows on domestic investment for 58 developing countries during 1978-95. They find that an increase of a dollar in FDI appears to bring about an increase of a dollar in domestic investment. (Bosworth and Collins, 1999).

Impacts of reducing administrative barriers

Because of the powerful impacts of FDI on domestic economies, reducing administrative barriers to investment can have significant macroeconomic impacts on productivity, price levels, capital accumulation, and national growth, and microeconomic impacts on entrepreneurship, poverty reduction, and consumer income.

- ***Improving the administrative environment promotes economy-wide growth, not just in FDI-relevant sectors and not just for foreign investors.*** Work by the OECD suggests that easing product market regulations and administrative burdens is associated with accelerating multifactor productivity growth across the economy. An analysis of a very large database in the OECD using cross-country time-series regressions recently provided supporting evidence that stringent regulations and administrative burdens have negative impacts on the efficiency of product markets and reduce overall economic growth. (Bassanini et al., 2001). Reducing barriers to entry helps domestic investors as much or more than foreign investors. Because the capital assets of domestic investors are usually lower, the opportunity costs of spending capital to satisfy government red tape are higher for domestic businesses. The rising tide of new entrepreneurs in the region will, ultimately, make a more important contribution to growth than will FDI.

- ***One mechanism by which reducing administrative barriers to entry helps the economy is by reducing the cost of capital.*** High regulatory risks reduce investment and competition by increasing the cost of capital. High regulatory risks slow economic adjustment and act as a protective barrier to incumbent firms and insiders vis-à-vis new domestic and foreign market entrants. Regulatory risks are inherently higher in a transition period, but, in South Asia, much regulatory risk is systemic, arising from poor governance and economic management practices that can be improved by better policy design and implementation. In general, the more uncertain and risky is the

legal/administrative environment in which economic activity occurs, the more likely it is that aggressive rent-seeking and short-term profit-taking will replace longer-term investment in a competitive climate. That is, risk reduces the value of investment.

- ***Reducing administrative barriers to investment has the same effect as increasing the national savings rate***. Investors do not invest just because administrative barriers are low. They invest because the returns on the investment seem higher than other opportunities. But estimated returns are affected by start-up costs, operating costs, and legal uncertainties due to complex or corrupt administrative environments. Therefore, there will always be a higher level of investment as the administrative environment becomes more transparent and efficient.

- ***Simplification can be a useful tool in the national poverty reduction strategy***. Reducing barriers to entry will benefit the poor mainly by increasing the value of entrepreneurship and investment, which should create new jobs. The most important anti-poverty mechanism in many countries today is a flourishing informal sector. Administrative simplification can aid the informal sector in contributing to job creation and investment, not only through indirect effects, but also through strategies such as accelerating the transition of the best-performing informal enterprises into the formal sector and improving linkages in export sectors to small producers. This will benefit those small producers who are disproportionately outside formal markets by reducing the costs of becoming insiders.

- ***Reducing administrative barriers to investment is complement to effective competition policy.*** Improving market openness is a powerful instrument to discipline domestic firms that have market power. Some argue that an open trade regime can be a perfect substitute for an active competition policy in small economies. (Blackhurst, 1991). Hong Kong and Singapore have been used as examples for this.

- ***Reducing administrative barriers is an anti-inflation strategy***. A high-quality growth strategy that permits faster growth at lower inflation. Another positive indirect effect of reducing entry barriers is that it increases competitive pressures throughout the economy, such as in key sectors in household consumption (food, clothing) important to the poor or that impact indirectly on the costs of consumption items, such as wholesaling and transport. The World Bank recently reported that lowering trade barriers can compete away monopoly profits: increasing imports in concentrated industries from zero to 25 percent of domestic sales reduces oligopoly profit mark-ups by 8 percent through lower prices to consumers. (World Bank, 2002b). More generally, measures to increase entry will increase the size of the

relevant market, which will increase the over-all intensity of competition and increase the purchasing power of households.

Quality and allocation of FDI

Countries should concern themselves with more than the quantity of FDI. Two other dimensions of FDI -- quality and allocation -- are even more important for economic growth, and each has implications for the design of state and market institutions.

It is not just the quantity of investment that is important for growth. Many people claiming today that FDI is essential to economic growth promote the concept that foreign investment is actually higher *quality* than domestic investment in developing countries. This is because foreign investment incorporates the flow of ideas and new technologies across borders. Michael Klein at the World Bank argues that "the very essence of economic development is the rapid and efficient transfer and adoption of "best practice" across borders. FDI is particularly well suited to effect this and translate it into broad-based growth, not least by upgrading human capital." (Klein et al.). UNCTAD, the OECD, and the WTO all agree with this concept.

The added value of FDI in spreading best practices applies also to state institutions, because investors have expectations about the quality of the state interaction with market actors. The institutional environment has rapidly become a key variable in international competitiveness. The Global Competitiveness Report published by the World Economic Forum has expanded the importance of the variables it calls "the quality of public institutions," in other words, governance.[6] In countries with net inflows of FDI, these expectations promote more attention by governments to the quality of institutions such as regulations, accounting rules and legal traditions. There are also important sovereignty issues here, because the global mobility of capital increasingly limits the ability of governments to adopt poor institutions and poor policies.

Quality standards for regulatory decision-making

Investment and trade pressures have prompted international institutions to give attention to *ex ante* spreading good institutional practices as a way to promote investment. The OECD was the first intergovernmental institution (in 1995) to formally adopt quality standards for regulatory decision-making for its

[6] The WEF explains, "Institutions are crucial for their role in ensuring the protection of property rights, the objective resolution of contract and other legal disputes, efficiency of government spending, and transparency in all levels of government. In the absence of good governance, the division of labor is likely to be impeded and the allocation of resources inefficient."

Members, in effect regulating domestic regulators. The OECD Recommendation recognized that the quality of market rules is important not only to the country where they exist, but to the wider trade and investment community. In the delicate task of explaining why the OECD countries should collectively pay attention to the quality of public institutions, which was previously thought to be purely a sovereign and domestic issue, the Recommendation noted:

- the importance of public sector management in ensuring policy effectiveness and economic efficiency under conditions of democratic accountability;
- that the regulatory instrument is among the most important tools of government in OECD countries and that high-quality regulation is crucial for government effectiveness;
- that the environment in which private enterprises are born and compete is substantially determined by the framework of responsibilities and constraints established by government regulation, and that economic growth and the efficient use of economic resources are promoted by high-quality regulations;
- that structural adjustment to changing social and economic conditions requires the removal of rigidities and barriers to competition within national economies that are often the result of inflexible, costly, or outdated government regulations;
- that the quality and transparency of government regulation is ever more important in an interdependent world where the effects of regulations cross national borders, and where regulatory co-operation is necessary to address urgent issues in areas such as environment, crime, migration, consumer protection, investment, and trade; and
- the substantial work being carried out by Member countries to improve and make more transparent administrative processes through which regulations are developed, implemented, evaluated, and revised.

The OECD regulatory quality checklist is included in Appendix 1.

International agreements and the quality of public institutions

The OECD work has been followed by more attention to the quality of public institutions by WTO agreements, the European Single Market, the World Bank, the IMF, and other intergovernmental institutions. Convergence in good institutional practice is driven more and more by international market-opening obligations contained in regional arrangements or trade and investment

agreements. For example, better empirical justification of regulatory decisions is strongly supported by international trade rules. The General Agreement on Trade in Services (GATS) requires that standards on the supply of services be "based on objective and transparent criteria…[and be] not more burdensome than necessary to ensure the quality of the service."

As Box 1 shows, the GATS increasingly emphasizes transparency in domestic processes as a means of reducing barriers to trade and investment. Foreign firms, individuals, and investors seeking access to a market must have adequate information on new or revised regulations so they can base decisions on accurate assessments of potential costs, risks, and market opportunities. However they have greater difficulties than domestic market players in obtaining information. Regulatory transparency has also been improved by the growing use of international standards, which reduce search costs and increase certainty for consumers and market players.

Box 1: Summary of selected GATS requirements pertaining to transparency in domestic trade-related regulation

Procedures to be employed by members in their domestic jurisdictions
Procedures to be employed between WTO members
Article III
-- Prompt publication or other means of making publicly available all relevant measures of general application which pertain to or affect the operation of GATS.
-- Establish one or more contact points for handling requests from other members for information on relevant measures of general application which pertain to or affect the operation of GATS.
Article VI
-- In sectors where members have specific commitments, they shall ensure that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner.
-- Each member shall maintain or establish judicial, arbitral or administrative tribunals or procedures for prompt review and remedy of administrative decisions affecting trade in services. Where such review is conducted by the decision-making agency, members shall ensure the procedures provide for objective and impartial review.
-- Where authorization is required for supply of a service, the competent authorities shall without undue delay provide the applicant with information about the status of the application and inform the applicant of the decision concerning the application within a reasonable period of time.
Article III
-- Respond promptly to requests from other members for information on relevant measures of general application which pertain to or affect the operation of GATS.
-- Notification to WTO of enquiry point details.
-- Annual notification to WTO of new, or changes to existing, laws, regulations and administrative guidelines affecting sectors where the member has specific commitments.
-- Opportunity to notify other members' measures to the Council for Trade in Services.
Article VII
-- Notification of existing recognition agreements, opening of negotiations on recognition, and the adoption or modification of a new recognition agreement.
Article VIII
-- A member may request the Council for Trade in Services to request another member to supply specific information concerning a monopoly supplier of that member.
-- Notification of new monopoly rights regarding supply of a service covered by a member's specific commitments.

Procedures to be employed by members in their domestic jurisdictions
Procedures to be employed between WTO members
-- In sectors where a member has made specific commitments, it shall apply any licensing and qualification requirements and technical standards based on objective and transparent criteria, ensuring they are not more burdensome than necessary, or a restriction on the supply of the service.
-- In sectors where a member has undertaken commitments on professional services, it shall provide adequate procedures to verify the competence of professionals of other members.
Article IX
-- A member is obliged to enter into consultations when requested by another member in order to eliminate practices that may constrain competition and restrict trade in services. The member subject of the request shall supply publicly available information and other information of a non-confidential nature.

Reference Paper on Basic Telecommunications
-- Provision on a timely basis to other service suppliers of technical information about essential facilities and commercially relevant information necessary for their provision of services.
-- Procedures for interconnection must be publicly available and major suppliers shall make publicly available either its interconnection agreements or a reference interconnection agreement.
-- Universal service obligations shall be administered in a transparent, non-discriminatory and competitively neutral manner and shall not be more burdensome than necessary.
-- Licensing requirements shall be publicly available and the reasons for denial of a licence will be made available to an applicant on request.
-- Any procedures for the allocation and use of scarce resources will be carried out in an objective, timely, transparent and non-discriminatory manner.

Source: Adapted from OECD (2001), *Strengthening regulatory transparency: insights for the GATS from the regulatory reform country reviews*, Paris.

Using FDI well

We must expand the analysis of FDI to another dimension. It is not just a question of attracting FDI, but in using it well, that is, in using FDI to raise productivity levels through the economy. The quantity and quality of investment can be exploited only by the capacity of the economy to allocate capital to highest-value uses. An economy can attract investment (foreign or national, private or public), but if that investment is not directed to productive assets, it can reduce economic performance by encouraging inefficient and unsustainable economic activities.

This was illustrated in the 1997 Asian financial crisis. Analysts have generally found that the Asian crisis was precipitated by savings-investments imbalances in the private sector operating in a weak domestic institutional and regulatory environment (such as in financial sector regulation and corporate disclosure standards and practices) and permissive international capital markets. Agreeing with most studies, Shirazi found that:

...government policies -- or the lack thereof -- fostered the incentives that led to the excessive short-term, foreign currency borrowing and to the

misallocation of those funds to unproductive investments. Exchange rate policy, combined with undeveloped domestic financial systems, provided strong incentives to borrow abroad. Weak supervision of the financial sector, inadequate corporate governance and the general lack of transparency allowed the problems to grow and fester for much longer than was prudent….the engines of Asian progress -- savings and investment -- need to be overhauled, with an emphasis on quality objectives. (Shirazi, 1998)

Domestic institutions are critical

As this suggests, several domestic institutions are critical in encouraging the efficient allocation of FDI through the economy:

- Amongst institutions that generate and channel information on market opportunities, **the financial sector** is the most important. Bagehot and Schumpeter argued decades ago that an efficient financial system greatly helped a nation's economy to grow, as well-functioning banks spurred technological innovation by offering funding to entrepreneurs that have the best chances of successfully implementing innovative products and production processes (Brandl). The channels through which the development of financial markets affect economic growth include facilitation of trading hedging, diversifying, and pooling of risk; the efficient allocation of resources; the monitoring of managers and exerting corporate control; the mobilization of savings; and the facilitation of the exchange of goods and services. Empirically, a growing body of studies at the firm-level, industry-level, country-level and cross-country comparisons have demonstrated the strong link between the financial sector and economic growth.

- Regulatory regimes that **protect competition in the post-privatization** phase. Failure to provide an institutional and regulatory environment where restructuring and investment can occur has reversed the gains of privatization and liberalization in some transitional countries. There is broad consensus on the importance of new regulatory institutional arrangements as part of the move to a competitive market in network sectors, of which the independent regulator is the best-known strategy. The International Energy Agency believes that "institutional reform – adapting regulatory institutions to their new roles and functions – is a key ingredient of effective reform. Institutional arrangements have a big impact on the quality and effectiveness of regulation and, in particular, on shaping the incentives and expectations of firms, investors, and consumers." (IEA, 2001: 1). The Asian Development Bank, too, stresses that FDI in infrastructure "does not mean a total retreat by governments; on the contrary, moving to best or better practice involves a shift to good governance, and requires an upgrade of governments' regulatory, restructuring and monitoring roles…without improved governance, private sector

promotion (PSP) would eventually flounder and the demands for infrastructure would not be met, as risks would become unacceptable." (O'Sullivan, 2000). Jacobs has agreed on the need for new public oversight institutions, but expressed doubt about the effectiveness of the independent regulator model in transitional countries. He puts more stress on transparency and checks-and-balances as means to gain credibility among infrastructure investors. (Jacobs, 2002).

- **Competition policy.** At the core of the new institutional regime within which FDI creates wealth are competition, consumer, and corporate governance institutions. Market liberalization has created in some sectors new competition problems, and in others expanded the scope for market abuses. Privatization of state monopolies often create dominant private firms. In many sectors, deregulation attracted substantial entry, followed by consolidation and concentration. This did not necessarily reduce contestability,[7] but effective competition institutions and strong legal tools have proven essential in the aftermath of reform to guard against undue concentration over many years of restructuring. Competition policy is the principal component of the economic "constitution" that should regulate new market relationships. Abandoning concepts of "fair competition" that open the door to many forms of state intervention, OECD countries are moving today toward a basically economic conception of competition policy. This conception encourages rivalry while preventing private firms from engaging in collusion or monopoly at the expense of the public.

- **Corporate governance.** Likewise, the role of corporate governance in improving the efficient allocation of capital in global markets is increasingly important for long-term development and stable economic growth. Good corporate governance, on which the World Bank and the OECD have joined forces, requires a set of complementary institutions: self-regulation by the private sector, driven by powerful market incentives to comply with good international practices in transparency, must be coupled with establishment by the state of an overall institutional and legal framework. Empowered by disclosure standards, civic institutions such as shareholders, citizen watchdogs and worker groups can participate in upholding standards of corporate conduct. These institutions are in various states of development. The OECD principles (OECD, 1999) recognise that no one model can work well in

[7]. The significance of trends in airlines in the United States, for example, has been hotly debated. Overall, competition has increased under reform, especially on major routes, and prices have dropped dramatically. Morrison and Winston (1996) note that 90 per cent of the realignment of relative prices of different routes reflects differences in underlying costs of serving those routes. But there has been significant retrenchment on smaller routes and around hubs where there is a dominant carrier. In these cases, monopolistic pricing has raised prices by an estimated 2 to 27 per cent, sometimes substantially reversing the initial price declines (Grimm and Windle, 1998).

differing national situations, but they stress the importance of fairness, transparency, and accountability in whatever model is used.

- **Mechanisms to avoid moral hazards.** Efficient resource allocation requires that risks be borne by investors who operate on the basis of risk-adjusted return on capital. Government intervention, even when necessary for other reasons, often creates moral hazard problems by suggesting that governments could be made to share those risks. This is an important problem, because many opportunities for such moral hazards exist from past and current practices of government intervention. In most countries, a moral hazard fog obscures assessment of true investment risks. At its worst, moral hazards can so distort resource allocation that they contribute to macroeconomic crisis. Consider the example of the Korean *chaebol*, which drained away capital from the rest of the economy because they were, accurately for many years, considered “too big to fail” and hence shielded from market discipline. Even today, reforms driven by macroeconomic turbulence and restructuring risk creating new moral hazards. In Korea, *chaebol* “self-directed restructuring” was moving too slowly. By the end of 1998 the government took a more directive role, including agreeing consolidation in key sectors, and restructuring programs. Though the Korean government may need to intervene where the banks are incapable of overseeing successful restructuring, the role of the government must be carefully disciplined to avoid creating the perception of official approval of the new and perhaps not sustainable enterprises. Such a perception will distort investment and entry in the restructured sectors. In infrastructure sectors, Asian governments have often accepted commercial risks that should have been assigned to the private sector, including foreign exchange risk and demand/traffic (volume) risk such as in take–or–pay provisions in power purchase agreements. These guarantees isolated the private investors from the market, and created substantial contingent liabilities for governments which are now contributing to their fiscal problems (O’Sullivan, 2000). Moral hazard problems are extremely difficult to resolve because they are embedded in the reputation of governments. The solution to credibly establishing a regime change lies in implementation of a mixed package of policies: an aggressive competition policy, combined with transparent corporate governance, well constructed exit policies such as orderly mechanisms for settling and restructuring debts, and extraordinary care in ensuring that investors bear the risks for investments, that is, complete transparency in financial markets.

4 Change strategies for improving the investment environment

More aggressive and broader reform programs

It seems inescapable that South Asian governments must implement more aggressive and broader reform programs if they are to materially improve their competitiveness. As shown in Box 2, partial liberalisation is only an invitation to disaster. Success will not be easy.

Box 2: Partial liberalization: an invitation to disaster

A market cannot be wished into existence. Yet many governments try precisely this. Through a process of political negotiation that is intended to reduce opposition to reform, governments have often adopted unworkable and risky policies of partial liberalization. For example, they privatize telecommunications, but do not separate competitive activities from natural monopolies, leading to higher prices. They liberalize business entry but do not remedy competitive abuses, leading to cartels. They privatize but do not control dominant firms, reducing entry. They establish independent regulators without giving them the powers and political support to challenge the huge incumbent utilities, in effect using inadequate institutions to remedy weak reforms. They maintain exclusive concessions even while encouraging entry. They reduce existing permits without controlling the introduction of new permits. They permit foreign entry behind high tariffs, which can create foreign-dominated oligopolies that reduce national income. They deregulate retail prices, but not wholesale prices (a cause of the electricity crisis in California, USA in 2001). They maintain golden shares of former public companies even while hoping for new investors.

Selective liberalization is dangerous. It produces unforeseen incentives and increases the risk of costly market failures. Many market problems that have arisen after liberalization are due, not to too much or too fast reform, as critics have charged, but to too little, too hesitant, uncoordinated, and fragmented reforms. Often, the neglected aspect of reform has been the construction of new institutions to provide the right market incentives. For example, in countries that have introduced market forces in network sectors, lack of an adequate institutional basis for regulatory oversight has blunted competition and delayed structural reform, distorted incentives for market actors, reduced the social value of investments, and provided opportunities for corruption.

Indeed, the benchmarks for competitiveness are rising as FDI becomes scarcer. Due to the sluggishness in the world economy, FDI flows to developing countries fell from a peak of $180 billion in 1999 to the $160 billion range in 2002. "We're looking at the most sustained fall in foreign direct investment in developing countries since the global recession of 1981-83," the World Bank’s Global Economic Prospects 2002 report noted.

Institutional quality is one of the core elements of this program. The key issues are: What change strategies should countries pursue in improving the institutional environment for FDI? What institutions are most critical for increasing the value of investment? How can governments build a reputation for good governance that reduces regulatory risk for investors? More generally, how can governments improve their flexibility and adaptation so that institutions and policies adjust in the right direction? How can adjustment be initiated and sustained against powerful special interests that benefit from existing practices?

To bring investors to South Asia, governments must expand market reforms, and work harder and more visibly to establish a liberal policy environment that sustains market incentives and investor trust. Better institutions are at the core of this competitiveness agenda. The World Bank, too, has noted that "investors are becoming more selective in choosing their investment destinations. As a result, investment is flowing to countries with better domestic investment climates: good governance, sound institutions and a system of property rights." (World Bank, 2002b).

For South Asia, the major institutional challenges over the next few years are to systematically unwind extensive state involvement in the economy, discourage entrenched habits of rent-seeking, build new capacities in the public administration, and create the market-based regulatory regimes and institutions that will support investment, innovation, and vigorous competition. This kind of program, if implemented, will accelerate structural adjustment and create economies that are more flexible and competitive in regional and global markets, and that grows faster with lower inflation.

Some approaches to attracting FDI

Some approaches to attracting FDI cannot be easily replicated. China is a good example of a country that appears to threaten what investors most fear – unaccountable government, high levels of corruption, baffling red tape, lack of due process, courts dependent on political support. Risks to investors are still very high. But, in 2002, China was first in the world in FDI, pulling in an estimated $54bn of foreign direct investment. Why is China so attractive? Investors are not making high returns from China – profits appear to be low or negative for most foreign investors. One explanation is that investors are making strategic decisions for medium or long-term returns in a very large market.[8] This unique situation is not easily transferred to other countries, although current efforts to establish free trade regions – through efforts similar to ASEAN – might stimulate investment by increasing the size of the market and potential returns. Free trade zones are essentially institutional reforms.

[8] The size of the market, typically proxied by the level of GNP, appears to be an important determinant of FDI flows, as suggested by studies going back 20 years.

There are other lessons to learn from China. Chinese reforms are genuinely on a grand scale and are opening numerous real opportunities for investors in sector after sector. This can be contrasted with the marginal and hesitant reforms in many countries that restrict investment opportunities. Even more important, the Chinese economy and its reform are highly decentralized, reflecting the Maoist policies of regional self-reliance. Except for customs and banking regulations, which are wisely centralized due to the need to have national standards, regions and cities in China have substantial authority to reform on their own schedule. The decentralized economic and political structures have produced a flexible and fast-moving dynamic – almost a competition in market reform -- in which many areas of China are opening markets faster then Beijing ever could. (Roland, 2000). Inaction at the center only encourages reforms at lower levels. Contrast this dynamic with the centralized, top-down reforms in many Asian countries that have delayed or even reversed progress.

Some recommendations for increasing FDI are suspect. The strategies of nurturing "clusters" advocated by Michael Porter and his many followers in governments seem to some to be almost unfeasible for developing countries, and the examples of success are very few.[9] Nor do countries wish to attract FDI by reducing the cost of labor, or offering lax regulations. Institutional reform, by contrast, is practical, realistic, and, if done well, can produce fast results. The challenge is to design administrative and regulatory arrangements in a particular country that i) are adapted to that country's administrative and political environment, and ii) meet rigorous international standards for transparency, independence, and market credibility. If the principles of good market regulation are kept at the forefront of reform, many possible institutional arrangements can be found that can deliver good results.

In building credibility for foreign investors, reformers should rely on a few key governance principles.

Key governance principles

- ***Commit to ethics.*** A reputation for honesty is the bedrock of credibility. Governments should build strong ethics infrastructures to reduce problems such as corruption and conflicts of interest. Institutions with direct contacts with the private sector should take strong and visible action by adopting a tough ethics code on conflicts of interest and revolving doors for upper level officials. Revolving doors are particularly damaging, since regulatory leniency is linked to the potential for future employment contracts.

[9] Thanks to Thomas Waelde, CEPMLP/Dundee University, for making some of these arguments in his ENATRES Internet forum.

- ***Build credibility through consistent adherence to market solutions***. Institutional reform will not achieve much if the government is not committed to market-led growth. The litmus test in attracting private investment is whether the institutional regime, through sustained commitment to a clear set of rules, is credible to investors, producers and consumers. Foreign investors are willing to forgive much as long as the government behaves consistently in its relations with markets. New institutional arrangements must win the confidence of market actors that regulatory decisions will be transparent, secure, and neutral. Credibility can be built in many ways. Weaker independence of independent regulators can, for example, be offset by transparent procedures and stronger judicial review and consumer oversight.

- ***Maximize transparency throughout the entire policy process***. Information is the critical bottleneck in the entire regulatory regime. The single institutional reform that would be most welcomed by potential market entrants is improved transparency throughout the policy process. Transparency is key to regulatory quality. In addition to democratic values of openness, transparency in regulatory decisions and applications helps to cure many of the reasons for regulatory failures - capture and bias toward concentrated benefits, inadequate information in the public sector, rigidity, market uncertainty and inability to understand policy risk, and lack of accountability. Transparency at any stage has powerful upstream and downstream effects in the policy process – it encourages the development of better policy options, and helps reduce the incidence and impact of arbitrary decisions in regulatory implementation. Moreover, transparency helps create a virtuous circle - consumers trust competition more because special interests have less power to manipulate government and markets. Transparency is also rightfully considered to be the sharpest sword in the war against corruption.

- ***Adopt clear and simple rules, and enforce them***. Policies and standards must be unmistakably clear and fairly implemented.[10] Simplicity is more important than a regulatory regime that addresses every situation. In countries with weak legal traditions, simple rules place fewer demands on courts, are cheaper and more likely to be accurate, and reduce the risk of corruption. It can be more costly and time-consuming to create new institutions than to agree on clear rules for existing institutions to administer, as Richard Posner has noted. China followed the rules-first strategy by introducing modern commercial rules of law when it liberalized its economy. China also moved regulatory powers from line ministries into the State Council, which did not create "independent regulators," but did separate SOE management from regulatory decisions, and was welcomed by investors.

- ***Strengthen external checks on administrative action by consumers, competition authorities, courts and parliaments***. A range of oversight mechanisms – such as the Hong Kong Consumer Council -- is another good protection against capture and administrative abuse. The Sri Lankan telecommunications regulator concluded that "one of our biggest achievements was that instead of…appeals going through back channels, we created a situation where an appeal was submitted to the court of appeals." Checks-and-balances cannot become paralysis, however, and many countries are working out dispute resolution procedures that can work more efficiently and rapidly.

- ***Improve skills in the public sector***. The World Bank emphasizes that investing in people is a key to growth, and this is particularly the case when civil servants unfamiliar with market principles are responsible for regulating market behavior. New skills and concepts will be needed in re-orienting the role of the public sector to meet the needs of enterprises in competitive markets. Training of administrators is needed to deal positively with the needs of business, to maintain and develop regulatory quality, and to reflect the growing complexity of economic activity. A civil service training institute is essential if these reforms are to take hold.

Contestability and incentives in public policies

Successful reform usually requires that the powers of special interests be diminished. As noted, vested interests have often been able to install and defend policies that benefit them, blocking needed reform even when its benefits to the wider society are vastly larger than the concentrated (and highly

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[10] "Focus on rule based versus outcome based regulation. There is no worse feeling for an investor than thinking the game is rigged or having a rightful victory taken away," a prominent investor in the region recently remarked. (Kaye, 2003).

visible) costs to the interest group. In some countries, a "regulatory culture" has emerged, in which businesses have come to look to government protection for survival rather than to their own performance.

If they are to be credible, new institutional structures must show clearly that the institutions have broken the linkages between insider pressures and decisions on market regulation. The solution is to create new incentives, participants, and controls in regulatory reform processes to re-orient old relationships with producer groups. Transparency is key. Vested interests are strengthened by opaque decision processes and unaccountable administrative discretion (OECD, 2002). Open administrative procedures are needed to break down information monopolies inside bureaucracies, and to permit emerging interests to challenge established interests. The idea here is that the capacity for change is largely determined by the contestability of public policies. Contestability is driven by open and transparent processes, multiple actors, and administrative, political and judicial channels for challenge. In that sense, the emergence of more vibrant multi-party political systems and dynamic civil societies are extremely valuable for structural reforms.

In some cases, governments must establish new relations with market players through new instruments and structured communications that reduce rather than increase the risk of capture. For example, in Mexico, concessions have been a costly, opaque and overly discretionary way to regulate the network and natural resources industries. The OECD recommended that other market entrants be permitted to comment on concession changes for dominant firms, and that many concessions be transformed into permits and licenses or replaced with other regulatory alternatives. (OECD 1999a).

There is a substantial management challenge to organizing an effective program of market reforms. A common cause of reform failure in countries moving to market-based economies is a lack of a coordinated strategy based on an understanding of market needs, and effective incentives for implementation. "The complexity of reform and uncertainty about its broad consequences have blocked progress. This is in part due to policy fragmentation in the structure of government. Governments have often lacked the co-ordination and planning capacities necessary to move forward with coherent packages of policies and reforms." (OECD, 1997). Most countries have found that clear accountability, a strong central reform body, and a comprehensive strategy are necessary in overcoming sectional interests and bureaucratic inertia. Managing a broad reform program over several years – even over several governments -- is one of the most difficult tasks of governments, yet those countries that have succeeded, such as Hungary and Mexico, have shown the fastest transitions and the greatest gains in economic development.

A 1997 OECD report found that every country with an organized, multi-year program of regulatory reform has found it necessary to establish an explicit policy statement on reform at the highest levels of government, and to restructure institutions so that they are capable of carrying out the policy. Countries with explicit regulatory policies make more rapid and sustained progress than countries without clear policies. The more complete the principles, and the more concrete and accountable the action program, the wider and more effective is reform. Development of an articulated and transparent program can also mobilize constituencies for reform and focus a public debate on the reasons for reform. Countries that have lacked a systematic approach have often focused on superficial reforms and marginal changes that do not significantly improve the total administrative environment.

Successful experiences of two countries

It is useful to examine the experiences of two countries that have successfully organized and sustained multiyear, cross-cutting reforms – Mexico and Korea. Both countries began the 1990s with outdated and corrupt legal and administrative environments. Both succeeded in making major improvements through the efforts of new institutions with the capacity to plan, coordinate, and implement a sustainable, government-wide reform program. Appendices 2 and 3 detail how their reform programs were designed and managed. In essence:

- Both countries had (and still have) substantial administrative and regulatory problems for businesses. A 1999 OECD report found Mexico's accumulation of regulatory formalities increased the arbitrary nature of administration; such detail made it impossible for a business to be aware of or comply with all the procedural requirements, leaving regulators to decide which rules to enforce, and how (OECD, 1999a). A 1999 Korean government report found that "development of a market economy was seriously hindered, as the government became increasingly bloated and unresponsive to demands for reform. The economy was hampered by collusive ties between government and businesses, arbitrary regulations, and corruption. The government looked upon regulations as ends, not the means to achieve efficient public service." (Government of Korea, 1999: 67).

- Both Mexico and Korea (which have presidential systems) adopted centralized approaches to reform, in which line ministries were accountable to powerful bodies located at the center of government with broad-ranging responsibilities for setting goals and priorities, monitoring compliance and reporting on outcomes. This approach helped maintain momentum, ensure consistent application of the requirements and aid accountability and transparency.

- In six years, Mexico revised over 90% of its national legislation to support a more open and competitive economy.[11] These legislative reforms established market mechanisms and links to a global economy (i.e. market openness) by reducing the state's role in market structure (i.e. privatization), in its functions (i.e. deregulation), in its relationship with the other constitutional branches of government (i.e. political, electoral and judiciary reforms), with the states and municipalities (i.e. decentralization) and with citizens in general (i.e. transparency and administrative procedures). Korea eliminated 50% of its 11,000 regulations in less than a year and simultaneously reformed 40% of the regulations that remain. Another 1 840 "informal regulations", not resting on proper legal authority, were identified and either abolished or, in a minority of cases, formalized. Korean reformers observed that most of the regulations eliminated were so outdated that they could not be justified as meeting any current public need.

Institutional reform in all its aspects – deregulation, re-regulation, administrative simplification, and building new institutional capacities for developing and applying high quality market rules – should be integrated with efforts to generate the investment growth and market development needed to combat poverty, improve standards of living, and lay the foundation for long-term sustainable development. Governments will need to increase intervention in some areas, and reduce it in others (contrary to the advice of recent studies that conclude, "Nearly all the available evidence points in a particular direction of desirable reform: reducing government intervention in markets" Djankov, 2002).

Specific reform actions

Building on the experiences of Korea, Mexico, and other countries such as China, governments of South Asian countries might consider the following specific actions that have proven useful in reducing administrative barriers and moving economies toward international norms of rule-based governance. These reforms will not only improve the institutional basis of the new market economy, but also support more effective social policies, in areas such as environmental protection and human safety and health, which are highly dependent on administrative and regulatory instruments. They are designed both to produce short-term, visible benefits meeting the immediate needs of businesses and citizens – what the World Bank calls "near-term growth" -- and to build new capacities that will have medium-to-longer-term benefits for development.

[11] It is interesting that Mexico's economic reforms – the most far-reaching in 70 years – came at just the time that the multi-party system was emerging, and federalism was strengthening the voices of the state governments, who had long been subservient to central authorities.

Commit to consistent, coordinated reform by adopting a multiyear action plan at the highest political level. Strategic planning, budgeting, and coordination is crucial to a government's ability to bring resources to bear on the right priorities over time, and to secure the confidence and support of others. Reforms can be expanded and accelerated through development of multiyear reform plans revealing the priorities of the government and containing plans for the future in reducing barriers to entry. Such planning must be followed by reliable implementation and public evaluation of results. Forward planning is particularly important in capital-intensive sectors with high levels of FDI, such as the utility sectors, where long lead times are needed for capital investments. Governments should, for example, adopt 3 to 5 year strategic reform plans, after publishing a draft for consultation, and also publishing the comments received from the public.

Borrowing from FIAS and other work such as good regulatory practices recommended by the OECD for transition countries, the strategic plan should address several major reform challenges:

- Reviewing and eliminating or revising the large body of existing laws, rules, and formalities that have built up over decades. This body of rules is often inefficient, outdated, and inconsistent with market principles and the role of the state in a market economy. Without systematic and well-organized reform, this legal legacy will pose a major barrier to the performance of the market economy;

- Creating new disciplines and capacities – such as better assessment of market-based principles of regulation, and more organized consultation with the private sector -- to ensure that the continuing and large stream (the flow) of laws and other regulations is drafted with an adequate understanding of market needs and impacts, and through more transparent and consultative processes. Without diligent attention to the quality of new laws and rules, and under pressure for rapid reform, the administrative environment in transition countries could easily worsen;

- Improving regulatory application through clearer, simpler rules, more accountability, and more transparency regulatory systems, and more efficient judicial review of administrative action.

Establish effective coordinating superstructures at the center. The Korean and Mexican examples demonstrate the importance of a powerful pilot agency at the center guiding, coordinating, and overseeing the reform process in the ministries. Both countries elected to create new commissions, responsible to the highest political authorities, with mandates cutting across jurisdictions and layers of government. That is, they were able to focus on overall results.

To be effective, the reform unit should: 1) be independent from the ministries and at ministerial level, since the most important ingredient for successful regulatory reform is the strength and consistency of support at political levels. Ministers must be accountable for progress; 2) have a dedicated, expert secretariat of lawyers and economists to assess issues and draft reform proposals; 3) have a legal mandate to examine all government policies and instruments that affect competition and businesses, identify problems, develop solutions, initiate action, and monitor results. In industrialized countries, permanent reform bodies are more numerous today than ad hoc bodies, indicating a growing understanding of the administrative reform agenda as a permanent responsibility of government, rather than as an episodic reform effort (OECD, 2002).

Adopt a prioritized program of administrative simplification to speed up investment and reduce corruption. Few reforms are more popular than promises to simplify government "red tape" and many countries have launched programs targeting administrative burdens. An important benefit of these programs is a reduction in corruption due to fewer opportunities and more accountability for public decisions. The program should directly attack the underlying problem – too many of the wrong kind of formalities. Rather than addressing problems one by one in separate proposals, a better approach to speed up simplification and overcome resistance by special interests is to package reforms into periodic omnibus laws that can win broad support. For example, the government can develop a simplification "hit list" of priority measures and prepare, each six months, a consolidated simplification law integrating measures from across all ministries.

Simplification strategies fall into three categories:

- **Informational approaches.** Many countries have adopted central registries of business formalities that gather in one place all administrative requirements. Many of these registries have "positive security," that is, no formality not in the central registry can be enforced. Another common informational approach is the "one-stop shop" for obtaining license and permit information. These are widespread, and are based on the notion of reducing business search costs by providing all information on licences and permits at a single point. The information usually includes the permits required by a given business, application forms and requirements and contact details, and information on related issues, such as codes of practice, lists of applicable laws and regulations, as well as information on licenses and permits required by other levels of government. Delivery mechanisms have expanded from telephones and guichets through CD-ROM systems, information kiosks and now the Internet. Mexico has developed private "one-stop shops", typically established by business and industrial associations. Also in the category of information-based approaches are attempts to count formalities and measure the burdens

involved. Clearly, governments must have a sound understanding of the size and nature of the problem before they are able to undertake a strategic effort to address it.

- **Process re-engineering approaches** are based on review of information transactions required by government formalities with a view to optimizing them, including reducing their number, and as appropriate, reducing the burden through redesign, elimination of steps and application of technology. Reducing licensing, permitting and other "burden rich" forms of regulatory intervention are particularly important. The ex ante license or permit is one of the more damaging forms of regulation, as it increases investment delays and risks, while being very costly for public administrations to apply. Countries differ widely in their use of *ex ante* controls, from a general presumption of a freedom to commence a business, with licensing reserved only for those areas in which identifiable risks are identified, to a presumption in favor of licensing for most activities. The most common goal is to reduce licenses and permits through tools such as amalgamations of related licenses and "referral authority" arrangements, "silence is consent" clauses, "negative licensing" options and rigorous review, as well as co-ordination between levels of government. Out-sourcing of certification functions has occurred in technical areas in some countries. In countries that have historically used ex ante licensing very widely, policy is now moving toward ex post checking such as market audits.

- **Electronically-based mechanisms.** An important mechanism for reducing administrative burdens in recent years has been the explosive development of systems for the electronic interchange of data as an alternative to traditional paperwork transactions. For example, customs authorities in many countries now allow exporters, importers and customs brokers to submit their declarations electronically, improving accuracy and speeding up procedures. Similar approaches are being used for tax returns and filing other information with the government, such as business registration, annual balance sheets, and so forth. A notable reform in Korea is the OPEN program, which established an on-line application system for business and other applications that improves the transparency and timeliness of decisions, and has reduced "irregularities" such as bribes by up to three-fourths in some applications. Mexico is among the leading countries in the implementation of an integrated electronic-based customs system. Mexico has established an Integral Automated Customs System (SAAI) which allows for the electronic exchange of information between the General Customs Administration, Customs offices, Customs brokers, warehouses and authorized banking institutions to collect duties. These changes have resulted in efficiency gains for all concerned parties in terms of the improvement in the transparency of

procedures. Maximum clearance time for goods fell from up to 24 hours to a few minutes. Moreover, the number of Customs officials in entry ports was reduced by more than 20%, while import and export operations increased by more than 25% and 62%. The more transparent system also improved efficiency in duty collection and reduced discretionary power by Customs officials, with improved integrity levels. And in 1996, Mexico launched an innovative process of government procurement through the Internet, known as COMPRANET, to improve the transparency of overall procedures.

Adopt procedures to improve transparency. Governments should invest in making more information available to the public, listening to a wider range of interests, and being responsive to what is heard. Transparency should be built into every market institution and policy process through systematic consultation, explanation, and information disclosure procedures. All communications should be public. All policies and rules affecting the industry and individual companies should be subject to disclosure and public consultation under notice and comment procedures. All decisions should be explained on the record. The key principle to retain market confidence is that everything is on the record except confidential data collected from individual companies.

Transparency practices take many different forms, but OECD countries, where most FDI originates, have identified several concrete practices that they deem essential to reach an acceptable level of regulatory transparency:

- Notification in advance of intent to regulate to increase confidence
- Public consultation with all major interested parties on draft laws and regulations before decisions are made. Appendix 4 lists common consultation methods that would meet the expectations of international investors.
- Publication of decisions in easily accessible form (increasingly, this means electronic dissemination of regulatory material).
- Establishment of broad-based business and consumer advisory groups to allow ministries to consult routinely with the private sector on new and existing policies and rules.
- Registers of regulations and formalities with positive security. In many countries, it is difficult to access regulations, even for civil servants. Often, no one is quite sure how many regulations exist because there is no published legal code, nor any secure central accounting of laws, decrees, rules, formalities, or other forms of government regulation. As a result, businesses and citizens must bear high costs to discover their legal obligations, and exist in a state of perpetual legal uncertainty.

- Legislative codification to ensure a coherent legal structure.
- Plain language drafting to improve readability, certainty, and clarity.
- Clarification and simplification of regulatory responsibilities within the public administration, including across levels of government, so that responsibilities are clear.
- Public explanations of the rationale for regulatory decisions Such disclosure improves accountability and political responsibility for decisions, and improves dialogue between regulators and the industry. It is another step in building trust in the market in the good faith of the regulator.
- Controls on undue regulatory discretion by standardizing procedures for making, implementing, and changing all regulations and decisions, with regulatory effects such as licenses and permissions.
- Elimination of informal regulatory instruments, such as unpublished guidance and instructions, that have coercive effect.

Improve due process and administrative certainty. A key to controlling excessive administrative discretion is the administrative procedure law. Many countries are now adopting or amending administrative procedure laws to improve the orderliness of administrative decision-making and to define the rights of citizens more clearly. In some countries, such as Italy and Spain, the silence-is-consent or tacit authorization rule switches the burden of action entirely: if administrators fail to act within time limits, the citizen is automatically granted approval. Japan used its new 1994 administrative procedure law to attack the problem of administrative guidance by forbidding the use of coercive guidance and establishing transparency standards for voluntary guidance. Reforms to the Mexican Federal Law of Administrative Procedures in 1996 established a broad framework of principles for regulatory quality. A series of amendments to the 1958 Administrative Procedure Law was the platform in Spain to increase accountability and transparency across the public administration, to move away from the authoritarian traditions of the Franco regime to new relations between government and citizens. The importance of these kinds of reforms for improving certainty and reducing regulatory risk in the market, while enhancing democratic accountability, can hardly be over-estimated.

Use international agreements, benchmarks and disciplines to guide institutional reform. There is no universal model for the right regulatory system, since solutions must be designed to fit within the specific circumstances of a country's values and institutions, and its development needs. However, since South Asia is competing in American, European and global economies for capital and markets, international expectations and

experiences for high-quality regulatory regimes can provide valuable benchmarks for action. A system of international comparative benchmarking with the best practices – through the FIAS program, for example -- can help drive and target reforms.

Reformers should also use international disciplines such as WTO requirements to drive administrative and regulatory reforms. Reform programs should recognize the linkages between institutions and competition and trade policies. WTO accession was extremely useful to Chinese reformers in driving government-wide reforms on a tight schedule. The role of international regulatory frameworks was critical in accelerating reform in Mexico. Mexico's accession to the GATT in 1986, APEC in 1993, the OECD in 1994, and the negotiation of NAFTA and other free trade agreements acted as catalysts for domestic regulatory reforms and provided strong policy anchors which minimized the adverse effects of the peso crisis in 1995.

Link administrative reform to broader civil service reforms. Improving incentives for good administrative actions inside the civil service will assist reform efforts. Incentive structures within regulatory bureaucracies have not encouraged effective and accountable use of discretion. Incentives have too often favored vocal rather than general interests, short-term over long-term views, pursuit of narrow mission goals at any cost, and use of detailed and traditional controls rather than flexible and innovative approaches. Most regulators are not equipped to assess the hidden costs of regulation or to ensure that regulatory powers are used cost-effectively and coherently. Many regulators and offices are captured by special interests, who actively undermine reforms.

Two public management strategies are directly relevant to improving incentives for a high-quality administrative and regulatory environment for FDI: client service and results orientation. Many countries have moved toward a customer-oriented approach to delivering administrative services. The current global move to results-oriented public management will assist in linking institutions more closely to transparent policy objectives. Many outdated administrative actions survive because there is no accountability for their performance. Linking client satisfaction and measurable results to career advancement and pay incentives will help change the behavior of civil servants over time.

Appendix 1: The OECD reference checklist for regulatory decision-making

Government performance is under pressure. Systems of governance are adapting to global transformation involving more cooperation between countries, intensified economic competition, and new technologies. Budget deficits and economic constraints must be managed even as citizens demand more action to deal with emerging social and environmental issues. As a result, public sectors must learn to do more with less, differently and better, as the OECD Public Management Committee has noted. Governments must find effective ways to make responsive policy decisions and to identify the right mix of instruments and incentives to implement them.

The *OECD Reference Checklist for Regulatory Decision-making* responds to the need to develop and implement better regulations. It contains ten questions about regulatory decisions that can be applied at all levels of decision- and policy-making. These questions reflect principles of good decision-making that are used in OECD countries to improve the effectiveness and efficiency of government regulation by upgrading the legal and factual basis for regulations, clarifying options, assisting officials in reaching better decisions, establishing more orderly and predictable decision processes, identifying existing regulations that are outdated or unnecessary, and making government actions more transparent.

The *Checklis*t, however, cannot stand alone -- it must be applied within a broader regulatory management system that includes elements such as information collection and analysis, consultation processes, and systematic evaluation of existing regulations.

Question No. 1

Is the problem correctly defined?

The problem to be solved should be precisely stated, giving clear evidence of its nature and magnitude, and explaining why it has arisen (identifying the incentives of affected entities).

Question No. 2

Is government action justified?

Government intervention should be based on clear evidence that government action is justified, given the nature of the problem, the likely benefits and costs of action (based on a realistic assessment of government effectiveness), and alternative mechanisms for addressing the problem.

Question No. 3

Is regulation the best form of government action?

Regulators should carry out, early in the regulatory process, an informed comparison of a variety of regulatory and non-regulatory policy instruments, considering relevant issues such as costs, benefits, distributional effects, and administrative requirements.

Question No. 4

Is there a legal basis for regulation?

Regulatory processes should be structured so that all regulatory decisions rigorously respect the "rule of law"; that is, responsibility should be explicit for ensuring that all regulations are authorized by higher-level regulations and consistent with treaty obligations, and comply with relevant legal principles such as certainty, proportionality, and applicable procedural requirements.

Question No. 5

What is the appropriate level (or levels) of government for this action?

Regulators should choose the most appropriate level of government to take action, or, if multiple levels are involved, should design effective systems of coordination between levels of government.

Question No. 6

Do the benefits of regulation justify the costs?

Regulators should estimate the total expected costs and benefits of each regulatory proposal and of feasible alternatives, and should make the estimates available in accessible format to decision-makers. The costs of government action should be justified by its benefits before action is taken.

Question No. 7

Is the distribution of effects across society transparent?

To the extent that distributive and equity values are affected by government intervention, regulators should make transparent the distribution of regulatory costs and benefits across social groups.

Question No. 8

Is the regulation clear, consistent, comprehensible, and accessible to users?

Regulators should assess whether rules will be understood by likely users, and to that end should take steps to ensure that the text and structure of rules are as clear as possible.

Question No. 9

Have all interested parties had the opportunity to present their views?

Regulations should be developed in an open and transparent fashion, with appropriate procedures for effective and timely input from interested parties such as affected businesses and trade unions, other interest groups, or other levels of government.

Question No. 10

How will compliance be achieved?

Regulators should assess the incentives and institutions through which the regulation will take effect, and should design responsive implementation strategies that make the best use of them.

Appendix 2: Organization of regulatory reform in Korea

While regulatory reform programs in Korea date from the 1980s, the government of President Kim Young-Sam (1993 - 1998) engineered a major shift toward a more active and wide-ranging approach to regulatory reform. This period saw the establishment of important reform bodies and several pieces of key legislation. Much of the current program of reform builds upon foundations laid during this period. The major reform bodies created were the Presidential Commission on Administrative Reform, the Economic Deregulation Committee and the Industrial Deregulation Committee.

The Presidential Commission, established in April 1993, was the prototype of the current Regulatory Reform Committee. Its 15 members, drawn from outside government, included public administration scholars, representatives of business and private organisations, presidents of government research institutes and representatives of labor and the press. The Commission's role involved reviewing and deciding on reform proposals submitted by Ministries, local governments and the public. Though members of the Commission also had the right to initiate reform proposals, the process of reform by the Commission was essentially "bottom up" and reactive, an approach continued by its successor Regulatory Reform Committee. The Commission's decisions were reported to the President, who retained a right of veto over their implementation, though this was never used.

The Commission's guiding principles for reform were "..putting citizens' convenience first, abolishing authoritarian legacies, opening new opportunities for development for everyone and eliminating discrimination and privileges…" In pursuit of these goals, the Commission promoted mandatory Regulatory Impact Analysis (RIA) for new regulations, development of "one stop service systems" for citizen interactions with the public administration, removal of many government-imposed entry barriers, and simplification and removal of licensing and permitting requirements in areas such as export inspections. In addition, administrative reforms including government restructuring, paperwork reduction and decentralization were emphasized.

A Committee on Deregulation of Economic Administration was also established in 1993. It was seen as complementary to the President's Commission on Administrative Reform, since it dealt with economic deregulation issues, while the other dealt with administrative reform. Initially, the Committee was to operate only for 100 days (as part of the "100 Day Plan for a New Economy"), but this was greatly extended and the Committee, renamed the Economic Regulatory Reform Committee was transferred to the Fair Trade Commission in 1997. This committee was also predominantly composed of non-government members (19 of 25 members).

The third major committee established in 1993 was the Industrial Deregulation Committee. It was established by the Ministry of Commerce, Industry and Energy, under the authority of the Act on Special Measures for Industrial Deregulation (No. 4560) and continues to operate today. The Committee's purpose was to provide a mechanism for dealing with industry complaints and requests in relation to a number of regulatory areas including industrial zoning, factory construction requirements, and economic regulation of production and sales. However, as the Committee reports to a Minister, its operations remain subordinate to the other reform committees described above.

The invitation by the government to experts from academic, business, private organisations and the professions to participate in these Committees was an important strength in terms of their ability to generate reform initiatives and provide critical, independent analyses of those proposed by Ministries. However, these bodies were ad hoc in nature, with limited mandates and resources, and thus vulnerable to declining political support in the face of opposition to reform. They approached reform largely on a case-by-case, rather than strategic, basis, and hence their reforms, while sometimes important in isolation, were marginal in nature, with little prospect of fundamentally changing public administration or the market environment for competition. The notion of a 100-day timeline for achieving a major program of reform was unrealistic, as indicated by the fact that the Economic Regulatory Reform Committee ultimately enjoyed a much longer existence.

In 1994, the Basic Law on Administrative Regulations and Application implemented basic elements of a regulatory quality assurance system, including clarifying principles for regulation and administration (clarity of regulatory provisions, minimal administrative discretion, "one-stop shop" administrative procedures), and requiring Regulatory Impact Assessment, advance notice of proposed new regulation, and public consultation. In 1996, Korea's first freedom of information legislation, the Act on Disclosure of Information by Public Agencies, was passed. The 1996 Administrative Procedures Act set out general requirements for developing and implementing new legislation and established the Administrative Appeals Commission to hear a wide range of administrative disputes.

The APA's requirements have been further supplemented by provisions of the 1997 Basic Act on Administrative Regulations (BAAR). The BAAR, much broader in its application, forms the legislative core of current regulatory reform policy in Korea and is a key driver of the reform process. According to explanatory material published with the Act:

The aim of the BAAR is to break away from the hitherto fragmentary and dispersed attempts at regulatory reform and to move toward building a foundation for a more fundamental, enduring and systematic regulatory reform… The purpose of this Act is to promote private initiative and creativity

in the social and economic sphere in order to improve the quality of life for the people and to enhance national competitiveness.12

The Act consists of five chapters:

1. General principles requiring adequate legal authority for regulation, respect for "autonomy and order", minimum necessary regulation, improved regulatory efficiency and improved transparency.

2. Rules dealing with making new regulation, including the use of RIA, sunsetting, review by Regulatory Reform Committee and the Office of Legislation.

3. A Comprehensive Regulatory Improvement Plan, requiring that all existing regulation be reviewed by agencies in conjunction with the Regulatory Reform Committee.

4. The establishment, membership and functions of the Regulatory Reform Committee.

5. Supplementary rules, including regular reviews of progress and publication of an annual reform White Paper.

The Korean government has, particularly since 1997, established important central regulatory co-ordination and management capacities. Establishing central drivers of reform has been easier in Korea than in most countries due to the strong presidential system in Korea. Most important is the Regulatory Reform Committee, established legislatively in the 1997 BAAR, under the authority of the President. Article 23 of the Act provides the Committee with a general mandate to develop and co-ordinate regulatory policy and to review and approve regulations. Article 24 sets out seven functions for the Committee, requiring it to "deliberate and co-ordinate" on each of the following:

- The basic direction of regulatory policy and research and development on the regulatory system.

- Review of new and amended (strengthened) regulations.

- Review of existing regulations and "drawing up and enforcing the comprehensive plan of regulatory clearance" - i.e. the program to reduce regulatory numbers by 50% carried out in 1998/1999.

- Registration and publication of regulations.

- Obtaining and responding to public opinions on regulatory improvement.

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[12] *Basic Act on Administrative Regulations*, Act No. 5368, August 22, 1997. References to this Act are to the English edition, dated June 1999, which includes explanatory and supplementary material.

- Monitoring and evaluation of regulatory improvement efforts of each agency; and
- Other matters approved by the Chair.

The Committee is composed of 15 to 20 members (it currently has 20 members), and a majority of members must be drawn from outside the civil service. Current membership includes 13 non-government members (from academia, the economics profession and business), the Prime Minister and six Ministers, representing the, Ministry of Finance and Economy, Ministry of Commerce, Industry and Energy, Ministry of Government Affairs and Home Administration, the Office of Government Policy Co-ordination, the Fair Trade Commission and the Ministry of Legislation. Members are appointed by the President and serve two-year terms with provision for a second term. Dismissal can only occur if a member has been sentenced to imprisonment or is ill. The Committee is empowered to form sub-committees to consider specific areas (Article 28) and to employ experts to conduct research work on its behalf. The Committee is actively involved in the reform process, meeting fortnightly in normal circumstances and weekly when implementing the 50% reduction in regulation. The Committee has effectively exercised an approval function over Ministries' plans for implementing the 50% regulatory reduction and is expected to operate in a similar way in relation to the targeted reform processes currently being established. It has adopted a robust approach in doing so and been successful in requiring Ministries to significantly upgrade initial reform proposals. In this respect it has been a crucial element in the achievement of rapid reform during 1998 and 1999.

The Committee is supported by a unit within the Office of the Prime Minister. This unit performs a secretariat function, including preparing meetings and agendas, liaising with the Cabinet and general management and co-ordination within the public administration. The unit is well resourced, with 30 civil servants and 10 experts seconded from research institutions and is headed by an Assistant Minister or Deputy Minister. A third body with an active role in reform is the Ministry of Government Administration and Home Affairs, which has taken the lead in the Government's efforts to work with local governments to facilitate the implementation of reform and improve compliance and enforcement.

Under the guidance of the Committee, the Korean government has enunciated five principles for its reform programme:

- Elimination, in principle, of all anti-competitive economic regulations.
- Improvement in the efficiency of social regulation in areas such as environment, health and safety.
- Shifting from ex ante control to ex post management.

- Regulation to be based on adequate legal authority.
- Global standards to be benchmarked.

These principles usefully address both economic regulations and social regulations, and distinguish how they are to be addressed. The policy direction is explicitly market-based.

Following from these principles, four areas of regulation were identified for priority reform: reform of foreign exchange and transaction regulations to encourage foreign investment, reform of industrial and land use regulations to liberalize business activities, reform of monetary and business regulations to improve industrial competition, and reform of procedures and regulations related to everyday life for the citizen.

Korean policies embrace a mix of regulatory quality and deregulation principles that, once fully implemented, will create a well-balanced framework to improve regulatory activities into the future. On the one hand, there is a clear commitment to eliminate damaging government restrictions on market entry, exit, and prices, and to reducing the overall quantity of regulation. On the other hand, a wide range of initiatives related to regulatory quality, including adoption of the reform principles, adoption of RIA, implementation of enhanced consultation procedures, and scrutiny by the Regulatory Reform Committee have also been implemented and are continuing to be developed.

The current program was launched with the President's commitment, now implemented, to reduce the number of regulations by 50%. This initial focus on deregulation and reducing regulatory burdens accurately reflects Korea's starting point, that is, one in which there was a large volume of low quality regulation, particularly in the economic sphere. The ambitious 50% reduction target was set in order to force a rapid reduction in burdens and create confidence in the government's commitment to reform.

The size of this quantitative reduction is important. Experiences in other countries show that it is not difficult to produce impressive results if non-monetary units such as page numbers or numbers of regulations are used instead of more relevant measures. Regulation that is no longer relevant or not enforced can be credited with removal from the statute books and consolidation of regulatory requirements can reduce the apparent numbers of rules. Also, regulators can compensate for the loss of regulations by writing new ones. However, in Korea, ministries facing a dramatic reduction of 50% over an extremely short timeline of one year could not escape real and significant changes, particularly when combined with the strong scrutiny of the Committee over every regulation reviewed.

The ability to achieve a 50% reduction in regulations was heavily dependent on strong support for reform from the highest political levels. The President strongly supported the reform targets, while the Office of the Prime Minister also had a central role. Organizational support is another key factor: the role of the Regulatory Reform Committee was crucial in ensuring that the target was met. Some Ministries' proposed reform programs were returned to them several times by the Committee for improvement before being accepted.

The quality aspects of regulations were not developed very deeply in this program -- members of the Committee indicate that most of the regulations eliminated could not be justified under any current public policy, and hence they failed the most basic tests of need. The process, however, had severe weaknesses that suggest that it should not be repeated. In particular, there was a lack of time and capacity to assess regulatory benefits and costs, which are the best tests of regulatory desirability. The process was almost entirely reactive, and could not address the regulatory gaps and institution building that are needed in a quality regulatory system. The process of review and elimination was not very transparent to those not directly involved. The government has now indicated that it will move away from the quantitative approach and will further develop attention to regulatory quality in future reform activity.

A key direction of the current reforms has been, for the first time, to emphasize the feasibility of compliance with regulation. Historically, there has been a strong tendency for Korean regulation to embody "ideal" standards, with little attention paid to compliance. Rules tended to define ambitious goals, not practical requirements. This has important implications for the nature of enforcement activity and the rule of law. Implementation of RIA requirements, as well as enhancements to consultation, should provide a more effective check on the feasibility and appropriateness of regulatory standards.

A related issue is the tendency for Korean regulation to be formulated in vague and imprecise terms that deliberately provide much discretion in interpretation to regulatory bodies. This provided opportunities for extensive use of "administrative guidance" in interpreting and applying regulation. Reform efforts since 1997 have attempted to eliminate administrative guidance and other "quasi-regulatory" instruments. The government has directed that such material must either be legitimized by adoption as formal regulation or removed.

Appendix 3: Organization of regulatory reform in Mexico

Mexico is ranked among the OECD's best performers in terms of the speed with which its legal and regulatory system is advancing toward international standards of good practice. The Mexican economy, heavily regulated and protected two decades ago, is now largely open and market-based. The rapid pace, broad scope, and depth of regulatory reforms in Mexico exceed those of most other OECD countries.

The role of international regulatory frameworks was critical in Mexico. Mexico's accession to the GATT in 1986, APEC in 1993, the OECD in 1994, and the negotiation of NAFTA and other free trade agreements acted as catalysts for domestic regulatory reforms and provided strong policy anchors which minimized the adverse effects of the peso crisis in 1995 and helped Mexico stage an impressive recovery. After some setbacks in the aftermath of initial privatization efforts due to the lack of appropriate regulatory frameworks, the Mexican government shifted its attention to regulatory improvement and efficient re-regulation of certain sectors.

Since the early 1980s, the pace, scope, and depth of Mexico's structural reforms have exceeded those of most other OECD countries. Policies of privatization, market openness, public sector modernization, competition enhancement, and regulatory reform have substantially reduced the direct role of the state in the economy, strengthened competitive market forces, and in some sectors, boosted the efficiency of regulation needed to protect public policies and promote competition. This process of deep structural change, still underway, has been accelerated by a transformation of the political landscape toward a multi-party system, the rapid development of federalism in governance structures, and integration of the North American economy through NAFTA. As part of these changes, regulatory decision-making moved from opaque and highly centralized processes, in which policy decisions at the center were undermined by weak policy implementation at lower levels, toward more decentralized, flexible, transparent and accountable approaches. These changes have moved Mexico closer to good international regulatory practices. By end-1998, Mexico had established a solid policy, legislative and managerial basis at the national level for addressing the serious regulatory problems that remain.

In 1989, Mexico launched its first explicit regulatory reform policy to improve economic performance and to stimulate entrepreneurial energies. The reform program expanded in three stages: (1) sectoral deregulation was followed by (2) improvements to sectoral regulatory frameworks, which were complemented by (3) efforts to establish a government-wide regulatory quality control system based on critical review, transparency, and consultation. Government capacities for carrying out regulatory reform have been built over

the past six years, including enactment of laws (such as an administrative procedure law and a law on standard-setting) to improve regulatory transparency and other aspects of regulatory quality.

The current administration has reinforced these capacities through implementation of a broad review program for new regulations and existing formalities, launching of a co-operative program to help states and municipalities improve their regulatory frameworks, and establishment of new government-wide regulatory reform tools, such as regulatory impact analysis, a Federal Registry of Formalities, and an equivalence test to speed the adoption of performance oriented regulatory alternatives. Ministerial accountability for the quality of regulatory impact analysis was established by requiring that RIAs for proposed laws, presidential regulations (reglamentos) and decrees be signed by high-level officials such as the deputy minister, and for other subordinate regulations by general directors.

These regulatory initiatives were supported and implemented through new institutions, such as a ministerial-level Economic Deregulation Council, a team in the Ministry of Trade and Industry, and specialized regulatory agencies for telecommunication, energy and competition policy. The judicial branch was strengthened and modernized, though there is room for further progress in fortifying the role of judicial review of the use of administrative discretion.

The reform process was made permanent by the establishment of a new presidential commission in 2000, the Federal Regulatory Improvement Council (COFEMER), with broad-ranging responsibilities for setting goals and priorities, monitoring compliance and reporting on outcomes. The head of the Council is appointed by the President, and it has a large permanent staff of analysis, including economists and lawyers, who review ministerial draft laws and regulations, comment on regulatory impact analysis, and draft reform proposals.

New consultation mechanisms were set up. Businesses and other interested parties now participate in an advisory committee to COFEMER, through a dozen or more ad hoc consultation groups organized to review existing formalities and new regulations.

A particular focus was reducing start-up costs. According to a World Bank estimate, opening a business in Mexico in the late 1990s, could take up to a year and a half, while the costs of complying with all the formalities governing business operations in some cases accounts for 3% of a large firm's operating expenses, without considering transaction and opportunity costs.

A systematic review of all business licenses was undertaken in Mexico between 1995-2001. The review process first established a complete inventory of all formalities, second to review all of them by a certification body on the basis of a simple RIA, finally to include the justified ones into a register. As a

result of this process, almost 80% of the pre-existing formalities were either eliminated or simplified. The Federal Registry of Formalities is now the unique source of enforceable formalities. A further important benefit of this review mechanism was that it permitted a substantial reduction in the excessive levels of discretion being exercised by the lower levels of the bureaucracy, eliminating opportunities for corruption.

Appendix 4: Methods of public consultation for new laws and regulations in OECD countries

The design of public consultation methods must recognize the specific cultural, institutional and historical context of the country, as these factors are crucial in determining the effectiveness and appropriateness of particular approaches. OECD countries use several major approaches to public consultation:

Informal consultation includes all forms of discretionary, ad hoc, and un-standardized contacts between regulators and interest groups. It takes many forms, from phone-calls to letters to informal meetings. Access by interest groups to informal consultations is entirely at the regulator's discretion. Informal consultation is carried out in virtually all OECD countries, but it is not acceptable as a standard means of consultation, since it is vulnerable to capture and corruption, and risks “locking out” important interests that are not a part of the ministry’s usual network.

Circulation of regulatory proposals for public comment. A straightforward way to consult is to send regulatory proposals directly to affected parties and invite comments. This procedure differs from informal consultation in that the circulation process is more systematic, structured, and routine, and may be based in law, policy statements or instructions. Groups on the circulation list expect to receive drafts of important regulations. This flexible procedure can be used at all stages of the regulatory process. Responses are usually in written form, but regulators may also accept oral statements, and may supplement those by inviting interested groups to hearings. The circulation-for-comment procedure is among the most widely used forms of consultation. The Internet is increasingly being used for this purpose. Circulation-for-comment is a relatively inexpensive way to solicit views from the public and, being targeted, it is likely to induce affected parties to provide information. It is flexible in terms of timing, scope and form of responses. The weakness of this procedure is deciding who will be included. Circulation for comment is likely to be unsatisfactory in dealing with new and shifting interest groups, since it increases the risk of neglecting key interests.

Public notice-and-comment. Public notice-and-comment – publication of draft legal texts for public scrutiny and comment -- is more open and inclusive. Publication permits all interested parties to be aware of the regulatory proposal and to comment. Notice-and-comment was first adopted in the United States in 1946. By 1998, 19 OECD countries were using notice and comment in some situations. Procedures vary widely. The U.S. model is the most procedurally rigid: comments are registered in a formal record and regulators are not permitted to rely on factual information not contained in this public

record. Notice and comment is, theoretically, more open and inclusive than other approaches. The openness of notice-and-comment procedures means that policymakers are more confident that significant views have been heard and that the risks of policy failure are known. However, many countries have found that levels of participation are low. Participation depends on the ease of response, the effectiveness of the publication, the time allowed for comment, the quality of the information provided, and the attitudes and responsiveness of regulators in their interactions with commentators.

Public hearings. A hearing is a public meeting on a regulatory proposal for interested groups. Regulators may also ask interest groups to submit written information and data at the meeting. A hearing usually supplements other consultation procedures. By 1998, 16 OECD countries used public meetings. Hearings are, in principle, open to the general public, but effective access depends on how widely invitations are circulated, its location and timing, and the size of the meeting room. Public meetings provide face-to-face contact in which dialogue can take place between regulators and wide range of affected parties. A disadvantage is that they are likely to be a single event, which might be inaccessible to some interest groups, and require more planning to ensure sufficient access.

Advisory bodies. The use of advisory bodies to improve the flow of expert advice and information to regulators is the most widespread approach to public consultation in OECD countries. Advisory bodies are involved at all stages of the regulatory process, but typically early to define positions and options. There are many different types of advisory bodies -- councils, committees, commissions, and working parties. Their common features are that they have a defined mandate or task within the regulatory process (either providing expertise or seeking consensus) and that they include members from outside the government. Their relationships to regulatory bodies can vary from reacting to a regulator's proposals to acting as a rulemaking body. Advisory bodies may carry out extensive consultation processes involving hearings or other methods.

Most countries combine different consultation tools throughout the regulatory process. Informal consultation and circulation for comment approaches are likely to be used to test the views of limited numbers of key players at an early stage, while an ad hoc advisory group of experts may be created to gather reliable data before moving to notice and comment or public hearing processes which allow input from the general public.

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