Structural Reform in APEC Economies

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PAPER PREPARED FOR THE

APEC PERU 2008 THEMATIC SEMINAR

LIMA, PERU.

27-28 NOVEMBER 2007

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Abstract

The promotion of sustainable economic growth and improved living standards in the Asia-Pacific region through enhanced trade and economic integration lies at the heart of APEC's mission, and is reflected in the theme for Peru's host year in 2008 - "A New Commitment to Asia Pacific Development." While APEC's economic focus has traditionally been on trade and investment liberalisation and facilitation, it is increasingly also turning its attention to the role played by "behind-the-border" policies (also referred to as "structural policies" or "structural barriers") in enabling or impeding regional economic integration.

This paper discusses the contribution of structural policy reform to APEC's economic agenda. It presents and discusses evidence of the costs of doing business in the region and reviews some international research pointing to the potential benefits of reducing regulatory and other compliance costs of doing business. The paper concludes with a discussion of the reasons why APEC is a good place to promote structural reform, some challenges to undertaking structural reforms, and the ongoing programme of APEC initiatives that will be progressed during 2008 in order to promote improved regulatory systems, competition frameworks and governance structures in the Asia-Pacific region.

1. The contribution of structural reform to APEC's economic agenda

While APEC's economic focus has traditionally been on trade and investment liberalisation and facilitation, APEC is increasingly also turning its attention to the role played by "behind-the-border" policies (also referred to as "structural policies" or "structural barriers") in enabling or impeding regional economic integration. This increasing focus on behind-the-border policies is reflected in the Leaders' mandate provided by the Leaders' Agenda to Implement Structural Reform (LAISR) (APEC, 2004); and more recently in the endorsement by Ministers in Sydney of a detailed and ambitious Forward Work Programme for LAISR, and the agreement by Leaders for Australia to convene the first APEC meeting of Ministers responsible for structural reform in 2008 (APEC, 2007a,b).

Behind-the-border barriers refer to domestic policies and institutions that impede the efficient operation of markets and the capacity of businesses to access markets and to operate efficiently. These impediments can take the shape of poorly designed domestic regulatory systems, competition frameworks and governance structures. The economic fallout from the Asian financial crisis of 1997 and 1998 was a harsh illustration for many APEC economies of how weak institutions and poor governance structures can eventually impinge on economic growth with long-lasting effects. Moreover, the dramatic growth benefits arising from the greater outward orientation of some economies, such as China since the 1970s and Vietnam since the implementation of "doi moi", and the reversal of sustained periods of relatively low growth in economies that have undertaken comprehensive economic reforms, such as Australia (for example, Parham, 2004) and New Zealand (for example, Evans, Grimes, Wilkinson and Teece, 1996), have illustrated the benefits that can accrue from structural policy reforms.

The Leaders' Agenda to Implement Structural Reform (LAISR) identifies five priority areas of regulatory reform, competition policy, public sector governance, corporate governance, and strengthening economic and legal infrastructure. The LAISR priority areas are illustrated in Figure 1.

Figure 1: Leaders' Agenda to Implement Structural Reform

Regulation refers to any law or other government-endorsed "rule" that influences or controls the way that people and businesses behave. Competition policy refers to laws, cases, policies, rules and regulations of government that are aimed at protecting and preserving the competitive process in markets with the goal of promoting economic efficiency and consumer welfare. Competition policy also entails advocacy of pro-competitive principles when the government formulates other laws, policies, rules or regulations. Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Public sector governance refers to the structure, laws, regulations and decision-making processes that govern, enable and constrain the provision and financial sustainability of the provision of goods and services by government. Good economic and legal infrastructure ensures that property rights are protected, and contracts and regulations are enforced, and is therefore fundamental to the efficient operation of markets.

An insight from the experiences of economies that have undertaken comprehensive or even partial structural reforms is the importance of policy coherence. Policy coherence is achieved when economic policies (for example, trade, investment, structural and macroeconomic policies) support, or at least do not undermine, the effectiveness of other policies in attaining overall policy objectives, such as improved economic performance and higher standards of living.

For example, regulatory policy settings applying in one sector of an economy can spillover and influence the efficiency and effectiveness of policy settings in other parts of the economy. Deregulation of the transport sectors in USA, Australia and New Zealand, for example, is considered to have been an important influence on the implementation of “just-in-time” inventory methods and the consequential rise in productivity in the wholesale and retail trade sectors of those economies.

Work by the OECD evaluating the interaction between trade, investment and competition policies suggests that, while relatively small economies like ‘Hong Kong, China’ and Singapore have achieved economic efficiency through the disciplining effect of openness and imports on competition without general cross-sector competition policies, in general it is only when markets are contestable that trade and investment liberalisation have significant disciplining effects on competition. Barriers to entry or exit, sunk costs or network effects might prevent foreign products and services reaching domestic consumers and will therefore reduce the impact of the removal of trade and foreign direct investment (FDI) barriers on domestic competition.

Chile’s pro-competitive reform is an example of how policy can be designed to enhance the beneficial effects of trade policy reform. During the period after the late 1970s, Chile gradually removed high import tariffs and moved toward a low-level uniform import tariff (Corbo, 1997). In order to avoid the negative impact of a uniform tariff on domestic competition, from the 1990s Chile introduced a more liberal investment regime and started to negotiate preferential trade agreements (PTAs) with many trade partners in a strategy of “additive regionalism”, thus allowing a significant number of foreign firms to fully compete with domestic producers.

The linkages between the three mutually-reinforcing elements of trade and investment policies, structural policies, and macroeconomic and financial policies are depicted in Figure 2. These linkages explain why structural policy reform is becoming increasingly recognised as a crucial third element of APEC’s economic agenda. Each of these linkages is described below.

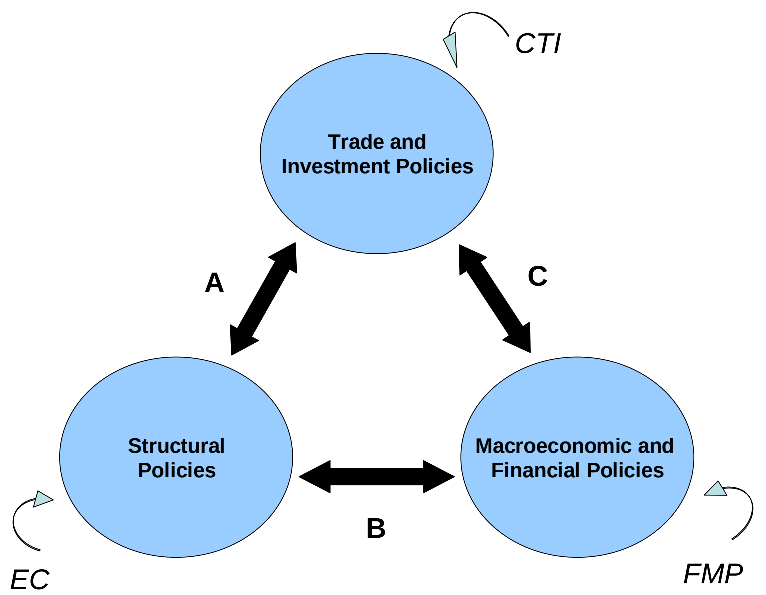
Linkage A represents the interaction of structural (behind-the-border) policies and trade and investment policies. These policies intersect to reinforce their respective goals of promoting efficiently operating markets, economic integration and improved productivity. For example, liberalisation and facilitation of trade and foreign investment can enhance competition, and will generate higher productivity when domestic markets are competitive and regulation costs are lower. When trade is liberalised and domestic competition promoted, foreign investments will be made on the basis of efficiency considerations and will promote beneficial interactions with domestic firms, including technology spill-overs and organisational efficiencies.

Linkage B represents the interaction of structural policies and macroeconomic and financial policies. Good structural policies promote the efficient and effective operation of markets, such as product, labour and financial markets. Efficient and effective product, labour and financial markets intersect and reinforce sound macroeconomic policies. For example, flexible and efficient markets increase product diversity and lower risks of macroeconomic instability. In turn, sound macroeconomic policies enhance the stability of good competition policy and regulations; for example low inflation reduces risk of price regulation. Well functioning markets are able to absorb adverse shocks more effectively and therefore also enhance macroeconomic stability.

Linkage C represents the interaction of trade and investment policies and macroeconomic and financial policies. Sound macroeconomic and financial policies enhance investment by contributing to policy sustainability, price stability and increased certainty. Similarly, sustainable investment flows, especially foreign investment, can enhance the stability of domestic financial markets and the sustainability of macroeconomic policies.

These three elements broadly represent the responsibilities of APEC's Committee on Trade and Investment (CTI), the Economic Committee (EC) and the Finance Ministers' Process (FMP) respectively.

Figure 2: Three elements of APEC's economic agenda



2. Structural impediments to growth in the APEC region

Economic growth of the Asia-Pacific region has been stronger on average than that of OECD economies over the last two decades. The growth "take-off" of China has, of course, been a critical factor influencing the region. Nevertheless, a number of indicators and international empirical studies suggest that many economies could achieve improved economic performance and higher living standards by pursuing enhanced economic policy settings, including enhanced trade, investment, structural and macroeconomic policies.

Recent thinking also suggests that what is necessary to achieve growth at lower income levels may be different from what is necessary to sustain growth at higher levels of income, and over the long term (Porter, 1990; World Bank, 2007a; Rodrik, 2003; Gill and Kharas, 2007). The World Bank (2007a) identifies a number of transitions that economies may need to make to move from middle-income toward higher-income status. These include the transition from being able to absorb knowledge to becoming a source of innovation, developing deeper financial systems, and managing greater urbanisation. This implies that structural reform is an ongoing challenge and that structural policies within economies will therefore need to evolve to meet such challenges.

An important mechanism for achieving regional economic integration and improved economic growth and living standards in the Asia-Pacific region is the flow of international investment funds and fixed capital investment growth. According to the World Bank (2007a), one of the reasons why growth in financial crisis affected Asian economies has been running at around 2% less than during the two decades before the crisis are the effects of higher risk premiums and greater uncertainty impacting on investment in the region.

There is also a growing body of evidence to suggest that performances in the region are likely to be adversely affected by high costs of doing business and weak institutional settings. These factors are affecting the domestic performances of economies and impede the processes by which economies can fully realise the benefits of trade and financial market integration; mechanisms such as foreign investment flows, production networks, the relocation of skills, and the transfer of ideas and technology. The following sections review some of this type of evidence.

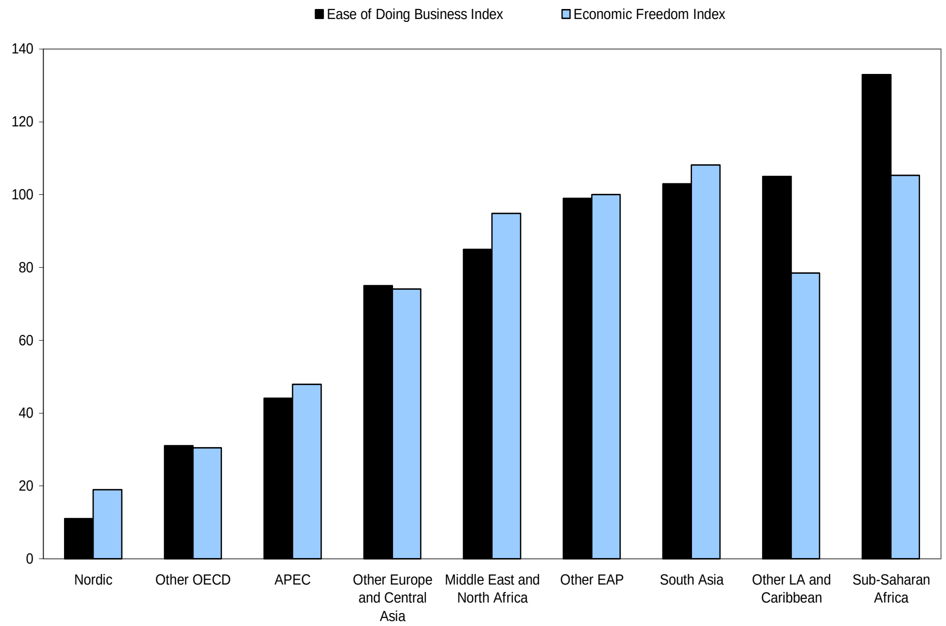
2.1 International benchmarking of the costs of doing business

Several organisations have developed indicators measuring the costs of doing business in economies around the world. These indicators are a tool that can be used to identify specific micro-level impediments to the efficient operation of markets, such as regulation, taxation and property rights, which may be suitable for unilateral reform.

The World Bank's "Ease of Doing Business" indicators data set provides internationally comparable measures of the costs of business regulation and enforcement across 175 economies (World Bank, 2007b). For example, it provides international comparisons of the number of days to register a business, the number of days to close a business and the ease of enforcing contracts. The World Bank's index currently ranks economies across 10 indicators of the ease of doing business and also produces an overall ranking (based on the average ranking of the component indicators). There is a high degree of correlation between these 10 indicators suggesting that they may also be indicative of broader structural policy settings, such as competition policy and regulatory frameworks.

Another commonly referred to indicator of domestic structural policy settings is the "Index of Economic Freedom" which provides internationally comparable measures of 10 "economic freedoms" across 161 economies (Heritage Foundation and Wall Street Journal, 2007). For example, it provides comparisons of the freedom of movement of labour, capital and goods as well as the enforcement of property rights across economies. As is the case with the components of the World Bank's index, there is a high correlation between the individual country rankings of the components of the economic freedoms index. This index also provides a single weighted index which can be compared across economies.

Figure 3: Ease of doing business and economic freedom indices, regional groupings



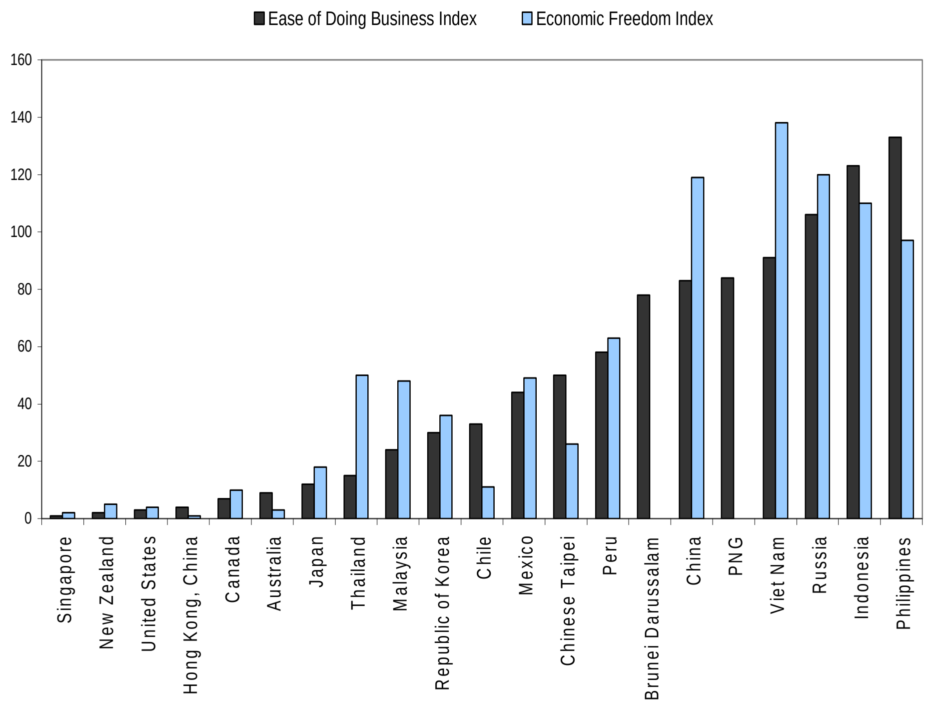
Source: Ease of Doing Business Database, World Bank 2007; and Index of Economic Freedom Database 2007.
Note: Includes only economies surveyed in both the Index of Economic Freedom and the Ease of Doing Business reports.

A comparison of these indices across economic regions indicates that APEC performs quite well on average as a group, but in general the costs of doing business are higher, and economic freedoms are lower, than the average for Nordic and other OECD economies. Figure 3 shows the most recent average ranking in the "Ease of Doing Business" index and the "Index of Economic Freedom" across different regional groupings.

There is, however, significant variation in rankings across APEC economies, ranging from 1st to 133rd out of 175 economies in the Ease of Doing Business indicators, and from 1st to 138th out of 161 economies in terms of the Economic Freedom indicators. Figure 4 shows the ranking of individual APEC economies according to the two indices. Furthermore, there appears to be considerable variation in the pace of reform across the region. In their most recent Ease of Doing Business report the World Bank (2007b) commented on the pace and direction of reform in the region. Although some APEC economies had made significant improvements in terms of their ranking (notably China, Indonesia and Viet Nam), the East Asia, Pacific and Latin American regions were identified as the "least reforming" regions globally.

There is a high (inverse) correlation between these indicators and the levels of labour productivity across the APEC economies (Buckle and Cruickshank, 2007). This would indicate that, given the wide range in the ranking of APEC economies across these indicators, there is considerable potential for structural policy improvements to raise productivity and income levels across the region. The next section looks at international and Asia-Pacific studies that have attempted to estimate the payoffs from structural policy reforms.

Figure 4: Ease of doing business and economic freedom indices, APEC economies



Source: Ease of Doing Business Database, World Bank 2007; Index of Economic Freedom Database 2007.

2.2 International studies of the payoffs from structural reforms

Empirical work on the payoffs from structural reforms has relied on both subjective estimates of the policy impediments to business activity based on expert opinion and on objective estimates that capture some aspects of regulation and other compliance costs. One of the costs of regulation is that productive resources are used to achieve compliance with regulation. This has a direct effect on measured productivity and on the returns on investment. By reducing the present value of investment, costly regulation and compliance costs can reduce productive capital investment, and may impact on the incentives to invest in technological progress and innovation. Other ways in which structural polices can impact on investment, productivity and growth is through the effect on uncertainty about the policy environment, and the effect on resource allocation. Similarly, regulations that impede the entry and exit of firms into product markets (for example, through licensing and start-up costs) will reduce the intensity of competition. Hence, poorly designed structural policies and high compliance costs can have direct effects on returns to investment and on the degree of competition which in turn can have dynamic effects on investment and productivity growth.

Results from growth regressions suggest that deregulation in countries that start from a position of heavy regulation will result in improved economic performance. Djankov, McLeish and Ramalho (2005) found, after controlling for other factors, that economies with better regulations, as measured by the World Bank's Ease of Doing Business indicator, grow faster. In particular, they concluded that improving from the worst quartile of business regulations to the best implies a 2.3% increase in annual GDP growth. Improving from the worst quartile to the 3rd quartile implies a 1.1% increase in annual GDP growth. Erickson (2006) updated this work using the 2006 Ease of Doing Business data and an expanded sample of economies. Erickson was not able to reject the basic message of Djankov, *et al.* that economies with better regulations grow faster, although his estimates of the gains were smaller (concluding that economies would achieve a 1.4% growth increase from moving from the worst quartile to the best, and 0.6% increase from moving from the worst quartile to the 3rd quartile).

This type of evidence and a similar type of evidence from the work of Gorgens, Paldam and Wurtz (2003) for example, reveals a consistent pattern. This is namely that deregulation since the 1980s in previously heavily regulated, less developed economies has been a significant factor contributing to the resurgence in growth in those economies.

Regulatory compliance costs in developed economies may be lower and the differences amongst developed economies may not necessarily be as dramatic, but neither are they trivial. There has been a fairly steady tendency towards deregulation in OECD economies since the early 1970s (see, for example, Crafts, 2006, Table 3, page 193). This process of deregulation has provided solid evidence that product-market deregulation increases multi-factor productivity growth and investment.

Alesina, Ardagna, Nicoletti and Schiantarelli (2005) show that the effect of product-market deregulation in OECD countries since the 1970s had significant effects on investment in utilities, transport and communications. By using indices of product market regulation and by estimating the effects of these regulations on the rate of growth catch-up at the industry level in OECD economies, Nicoletti and Scarpetta (2003) show that product market regulation tended to slow down catch-up growth in manufacturing and services. Their evidence also suggests that entry-limiting regulation may hinder the adoption of new technologies, possibly by reducing competitive pressures, technology spill-overs, or the entry of new high-technology firms.

Using a different approach, which captures general equilibrium adjustments and links various economies in the region, Dee (2005) evaluates the economic payoffs from structural policy reform in the East Asian region. This study includes nine APEC economies: China, Japan, Korea, Indonesia, Malaysia, Philippines, Singapore, Thailand and Australia. Dee examines the impact of three scenarios: a regional preferential trade agreement (including trade liberalisation and the elimination of regulations that discriminate against foreigners), the successful completion of the Doha round of World Trade Organisation (WTO) negotiations, and unilateral regulatory reform. Dee's estimates show that preferential trade liberalisation and preferential reform of regulations would add US$16.6 billion per annum and US$2 billion per annum respectively to regional income. The successful completion of the Doha round would result in much larger gains of over US$30 billion per annum. However, by far the largest gains result from unilateral regulatory reform, which is estimated to result in gains of over US$100 billion per annum for the region.

On a cautionary note, the studies referred to in this section do need to be treated with some care given the difficulties in quantifying the extent of domestic regulatory restrictiveness, and hence measuring the gains for reforming. However, reviews of the evidence, such as the paper by Crafts (2006), do find solid evidence that regulation can reduce productivity growth. Crafts also reviews other evidence of the effects of regulations on productivity and growth, including the transmission channels, and concludes there is solid evidence that product-market regulation reduces productivity growth, particularly through creating barriers to entry, and this is more damaging in the context of new technological opportunities.

3. APEC provides a good platform to promote structural reform

APEC's cooperative, voluntary and informal manner of operations means that it is a useful forum for discussions on economic policy challenges facing the Asia-Pacific region in an informal and non-adversarial environment. Because structural policies are behind-the-border, they cannot easily be negotiated between economies. Therefore, APEC can contribute to improvements in members' domestic policies by fostering meaningful dialogue on structural policy issues.

One of the interesting features of APEC is that it is a grouping of economies at quite different stages of development. While this raises some challenges, it also means that there is considerable scope for the sharing and learning from each others' experiences. APEC also has a unique linkage to perspectives from the business community through the APEC Business Advisory Council (ABAC).

In addition to the Economic Committee (EC), there are a number of APEC fora that have a focus on structural policy issues, including the Competition Policy and Deregulation Group (CPDG), the Strengthening Economic Legal Infrastructure (SELI) Coordinating Group, the Finance Ministers' Process (FMP), the Small and Medium Enterprises Working Group (SMEWG), the Anti-Corruption and Transparency Taskforce (ACTTF), and the Investment Experts Group (IEG), as well as a number of sectoral working groups. The EC has the mandate to lead and coordinate APEC's structural reform work to ensure consistency and prevent unnecessary overlap across APEC fora.

There are a number of challenges and strategies for managing the ongoing process of structural policy change for APEC economies. While the benefits of structural policy change are becoming increasingly clear, reforms often involve quite fundamental changes to how markets operate, and so can face resistance from groups that have a vested interest in the status quo. Reform can also involve transitional dislocations. Hence there are potentially significant social and political tensions and challenges involved in undertaking structural reform. Figure 5 illustrates a framework for thinking about how the set of desirable and feasible structural policies (zone "SR") can be expanded by making improvements across the three dimensions of: policy dialogue, capacity building and awareness raising. These are each explained in turn below.

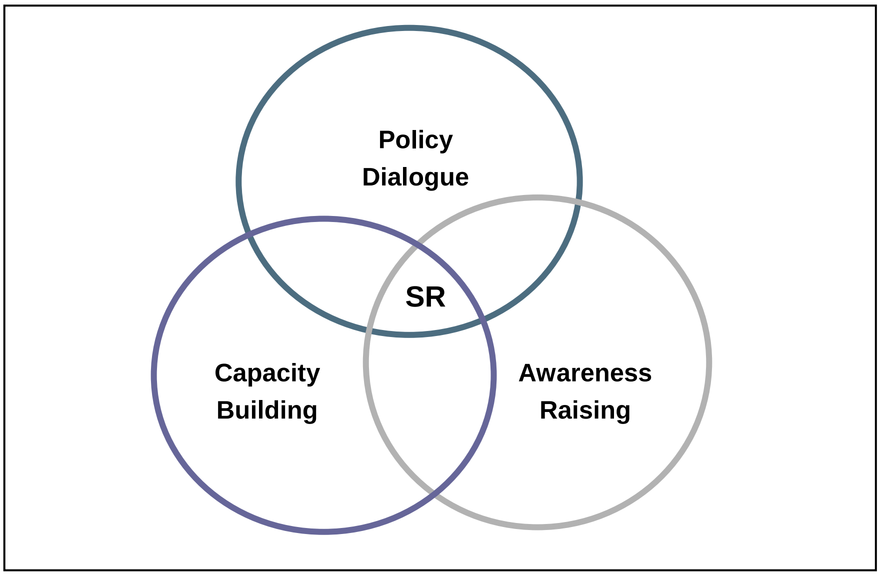
Policy dialogue: Structural policy reforms can be supported by discussing and drawing on examples of good practices from other economies. APEC facilitates the discussion and sharing of experiences on structural policy reforms in the Asia-Pacific region through holding policy discussions, workshops, seminars, and developing good practice guidance in areas such as regulation, competition policy and corporate governance.

Capacity building: Economies need the financial resources and technical expertise to drive structural change. There are several ways this can be achieved. For example, the World Development Report (World Bank, 2005) suggests that economies may wish to start strengthening capacity by improving the expertise of the civil service and the quality of information available to guide and administer reforms. It also highlights the importance of economies improving processes for ongoing learning from within economies and from the experiences of other economies.

Awareness raising: For reforms to be successful, it is important that the costs and benefits of policy approaches are well communicated and understood by key stakeholders. Practical steps suggested by the World Development Report (World Bank, 2005) include raising public awareness about structural reform and mobilising a broader range of support, and maintaining momentum by, for example, establishing institutions to sustain reform progress. The role institutions have played in supporting structural reforms in some APEC economies is discussed in the 2007 APEC Economic Policy Report (APEC Economic Committee, 2007).

The Economic Committee has prepared a multi-year forward work programme that includes initiatives across the three dimensions of this framework. The Committee is also working with other APEC fora and associated institutions (such as APEC Study Centres, ABAC, the World Bank, OECD and others), to advance initiatives across these three dimensions leading up to the stocktake of this work programme in 2010.

Figure 5: Framework: Increasing the set of feasible structural policy improvements



4. Conclusion

The promotion of sustainable economic growth and improved living standards in the Asia-Pacific region through enhanced trade and economic integration lies at the heart of APEC's mission and is reflected in the theme of Peru's 2008 host year: "A New Commitment to Asia Pacific Development."

The linkages between the three mutually-reinforcing elements of trade and investment policies, structural policies, and macroeconomic and financial policies are being increasingly recognised, and structural policy reform is increasingly being seen as the third element of APEC's economic policy agenda. While the benefits of structural policy reform are becoming better understood, there are, of course, significant challenges to undertaking structural reform. These include identifying reform priorities, building support for reform and sequencing policy reforms. It is clear that continued progress on structural policy reform will require a sustained focus and concerted effort from all APEC members.

APEC 2008 provides us with an important opportunity to make concrete steps toward promoting improved structural polices in APEC economies. The first Senior Officials' Meeting policy dialogue on structural reform will be held on the margins of the first Senior Officials Meeting (SOM1) in February 2008, in the lead up to the first APEC ministerial-level meeting on structural reform in August. A comprehensive ongoing programme of initiatives is also being progressed through the EC and other APEC fora aimed at information sharing and promoting improved regulatory systems, competition frameworks and governance structures in the Asia-Pacific region.

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