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Political Challenges of Implementing Successful Regulatory Reform: Issues Paper

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This paper was prepared to introduce the discussions on the political economy of reform at the meeting of the Group on Regulatory Policy on 3rd December.

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INTRODUCTION

1. This note discusses the benefits of liberalisation through regulatory reform, and the challenges of implementing reforms from a political economy perspective. The story of rapid but uneven progress across the OECD underscores that regulatory reform is not a one-off effort, but calls for continual measures towards liberalisation. Regulation is a core government function to promote the economic and social well-being of its people. There is a real risk, however, particularly in a time of profound and rapid change, that regulations can become an obstacle to achieving the policy objectives for which they are intended. All governments have a continuing responsibility to review their own regulations and regulatory structures and process to ensure that these enhance the efficiency of national economies and their ability to adapt to change and to remain competitive.

2. The first part of this paper draws on the experiences of OECD countries to show that regulatory reform, done properly, contributes to improvements in economic performance. Reform is particularly important for small and medium-size enterprises which provide a large share of new jobs and are a key factor for economic growth in some countries. Reforms that reduce unnecessary requirements and remove conflicting or duplicative procedures enhance entrepreneurship and cross-border trade.

3. Knowing the benefits of liberalisation is not enough. Those who would benefit are often scattered and un-organised. Those who would lose are more likely to be well organised and articulate. In addition, the benefits may take time to appear while the costs are incurred in the short term. Reform does not necessarily enjoy a favourable image either in the public at large or among politicians, who may well question how reform will affect their chances for re-election. Advocacy and communication need more attention in a broader approach to implementation linked to the political economy of reform.

4. Strategies for successful reform call for political leadership, well-functioning institutions, and co-operation across and between different levels of government. Democratic processes which are transparent and promote consultation can also expose governments to pressures from interest groups and stakeholders for whom reforms raise costs and risks. The second part of this paper draws on the record of more than ten years of reform efforts among OECD countries, to identify some of the challenges for implementation, as well key ingredients for success promoting a change in administrative culture within government, and building better relations between states, citizens and business.

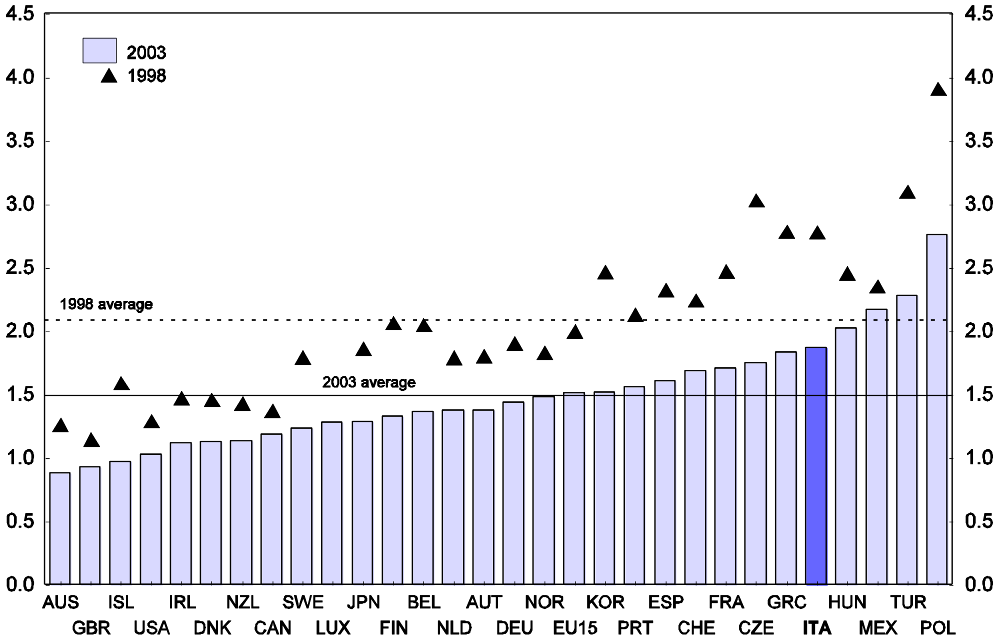
WHAT ARE THE ECONOMIC BENEFITS OF LIBERALISATION?

1. Progress with liberalisation

5. Over the past 10 years, OECD countries have made significant progress in terms of product market reform. OECD work shows that countries that had relatively restrictive product market policies in 1998 have generally made more progress than countries with fewer impediments to product market competition.

6. The indicators available over the period 1998-2003,[1] which measure the degree to which policies promote or inhibit competition, clearly highlight this positive trend. For example, Italy, Poland, Korea and Greece were among the countries with the most restrictive policies in 1998, made significant progress over the time period (Figure 1).

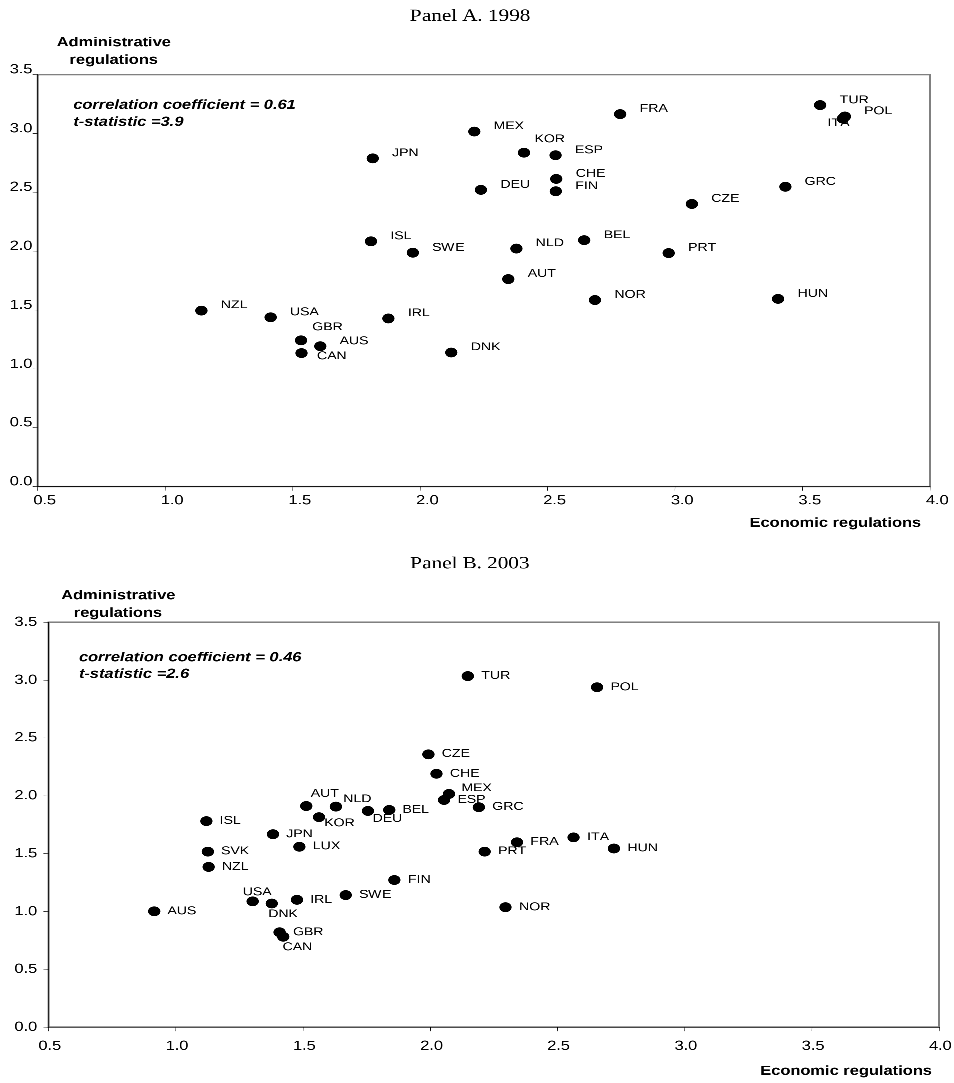
Figure 1. Product market regulation in OECD countries



Source: Conway, P., V. Janod, and G. Nicoletti (2005), "Product Market Regulation in OECD Countries, 1998 to 2003", OECD Economics Department Working Paper, No. 419.

7. Over the period 1998-2003, many countries made substantial improvements affecting state control, barriers to entrepreneurship and barriers to international trade and investment (Figure 10, Annex 1). However, in 2003, list of the "relatively restrictive" countries included Poland, Italy, Turkey, Mexico, Hungary, Greece, the Czech Republic and France. These countries remain far from countries such as the United Kingdom, the United States, Australia, New Zealand, Canada, Ireland, and Denmark (Figure 2).

Figure 2. Administrative and economic regulations, 1998 and 2003



1.Administrative regulation includes reporting, information and application procedures, and the burdens on business start-ups, implied by both economy-wide and sector-level requirements. Economic regulation includes all other domestic regulatory provisions affecting private governance and product market competition (such as state control and legal barriers to entry in competitive markets). The scale of the indicators is 0-6 from least to most restrictive of competition.

Source: Conway, P., V. Janod, and G. Nicoletti (2005), "Product Market Regulation in OECD Countries, 1998 to 2003", OECD Economics Department Working Paper, No. 419.

8. More detailed data shows that a 'hard core' of regulations that impede competition still persisted in some areas, such as barriers to entry in non-manufacturing industries. This is particularly important since regulation in non-manufacturing industries have spillover effects throughout the economy because these industries provide intermediate inputs to other sectors.

2. How are the benefits of regulatory reform realised?

9. Over the past decade, the benefits for economic growth from competition in product markets have been highly visible in a number of sectors across OECD countries. Countries as diverse as Australia or Sweden have enjoyed significant productivity dividends from product market reforms. Consistent cross-country empirical evidence shows that competition has a direct impact on growth by enhancing investment and innovation, and by boosting productivity. Moreover there are also indirect benefits and spill-over effects in terms of increased employment.

- Effects on GDP per capita

10. Liberalisation policies have been estimated to have significant effects on GDP per capita. Significant reductions of the barriers that still inhibit economic performance could substantially increase the GDP per capita. As shown by a recent OECD study, reforms that would reduce competition-restraining regulations, cut tariff barriers and ease restrictions on foreign direct investment to "best practice" levels in the OECD area could lead to gains to GDP per capita of up to 2 to 3 per cent in the European Union[2]. These gains would be even higher in Europe than in the United States, given the fact that initial levels of regulation are higher. In addition, given the fact that the analysis was confined to a relatively narrow set of policies, and abstracted from potential dynamic effects from reform-induced increase in innovation, research and technological progress, the overall gains from broad reforms could even be significantly higher. Product market deregulation would provide more gains than just a lowering of tariffs, since tariffs and non-tariffs barriers are already rather limited while domestic product market regulations often remain important, especially in the services sector.

- Effects on Employment

11. Increased competition may also stimulate employment through various channels. A growing number of empirical studies show that there are spillover effects from product market reforms in terms of employment as well as labour productivity, following a survey by Bassanini and Duval (2006).[3] (The labour productivity effects are discussed in the following section).

12. Lower barriers to entry tend to curb market power and rents of incumbents and create opportunities for new firms. These effects tend to expand activity levels and labour demand. Lower product market rents tend to induce lower wage claims, tending to close the gap between productivity and real wages that generates unemployment. Increased product market competition may also increase real living standards, through lower prices, even if this effect may be attenuated somewhat if wages prior to reform contain a large element of rent that is reduced with intensified competition. OECD estimates also suggest that restrictive regulations have curbed employment rates significantly in countries where no product market reforms were implemented.[4]

13. The effects of product market regulations are magnified by the interaction of such regulations with labour market settings that provide a strong bargaining power to insiders, suggesting that rent sharing tends to depress employment. Therefore employment gains from liberalisation policies are likely to be higher in countries that have rigid labour markets (Nicoletti Scarpetta, 2005). Interestingly, a recent study by Fiori *et al* (2007),[5] confirms these results estimating the impacts of changes, both in domestic regulation and in border barriers to investment: the systematic accounting of policy interactions shows that employment gains have been larger when workers' bargaining power was initially high, due to labour market policies. The conclusion is that product market deregulation and labour market deregulations can be both considered as substitutes and complements.

14. Although activity is expanded and employment rates tend to rise when restrictions are eased and competition increases, employment in some large firms, particularly in the network sectors, where previous regulations were conducive to over manning, may be adversely affected by deregulation. If product market deregulation tends to reduce unemployment and boost employment in the long term, it may, in the short-term, generate important adjustment problems. Increased competition may produce a labour shake-out. Whether this adjustment is absorbed quickly or leads to an increase in joblessness and a drop in employment is not clear cut however. Some institutions may lengthen the transition process, for example, when unemployment and related benefits are linked to past wages.

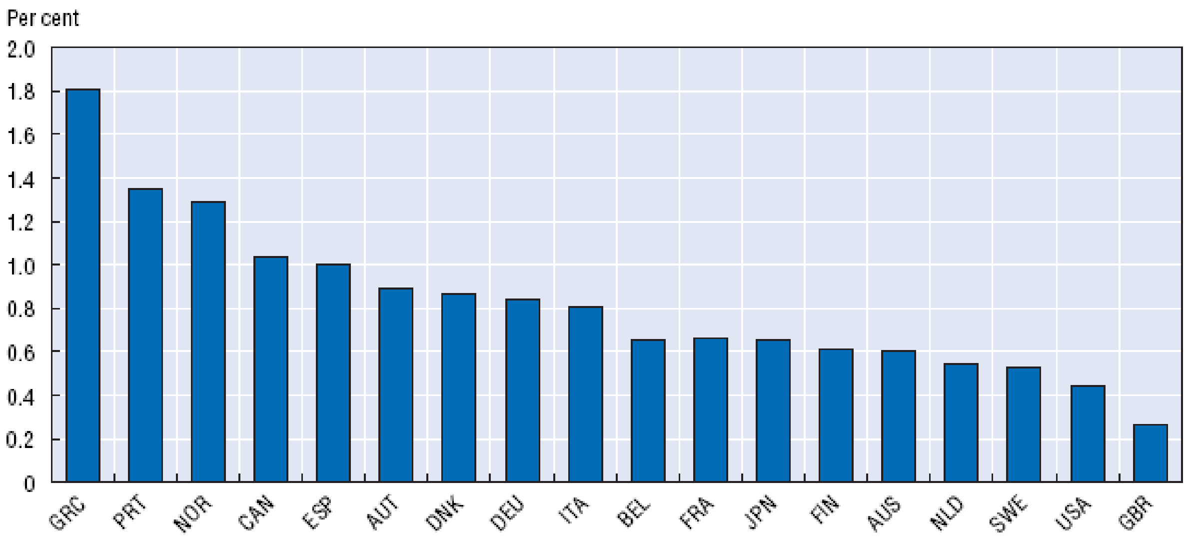
- Effects on Labour Productivity

15. Labour productivity is determined by investment and multi-factor productivity, among other things, but can also be influenced by product market competition. Recent empirical research indicates that regulatory environments that favour competition have a positive impact on economy-wide productivity even when other potentially important factors - such as human capital and country- and industry-specific effects - are accounted for (Conway et al, 2006). Regulation has an impact on catch-up to best practice, as shown in estimates of labour productivity at both the aggregate business sector and sectoral levels. The results suggest that remaining cross-country differences in product market regulation can partially explain the recent observed divergence of productivity in OECD countries, given the emergence of new technologies over the 1990s.

16. An increase in the intensity of competition can enhance productivity by improving the allocation of resources and encouraging a stronger effort on the part of managers to improve efficiency. Increased innovation and technological diffusion have also been shown to be important factors in explaining this link between competition and productive performance (Aghion *et al.*, 2001; Gust and Marquez, 2003).

17. Using the estimated relationships between anti-competitive regulations and productivity growth, simulations suggest that increases in labour productivity from adopting the least restrictive regulations applied in each sector would be substantial (see Figure 3). For Italy for example, these increases would amount to 0.8% of annual business sector productivity.

Figure 3. Potential increase of annual business sector productivity in the presence of pro-competition regulation



1. Data are the average increase in annual business-sector productivity over the period 1995 to 2003 given an easing in the stance of regulation to the least restrictive of competition in the non-manufacturing sectors in OECD countries in 1995. The business-sector results are calculated as weighted averages of the sectoral productivity increases using value-added weights.

Source: Conway *et al.* (2006).

- Effects on Innovation and Multi-Factor Productivity (MFP)

18. The stringency of product market regulation exerts a direct influence on business sector expenditure in R&D, and clearly affects the level of patenting as well as the proportion of firms which are successful innovators. Empirical estimates suggest that light product market regulation in Australia, the United Kingdom and United States helps to raise their R&D intensity by 10% or more above the OECD average. In contrast, heavy product market regulation reduces R&D intensity in Ireland, Italy and Portugal, by over 8% relative to the OECD average (Jaumotte and Pain, 2005). The quality of the regulatory framework is thus crucial for stimulating innovation and supporting economic growth.

19. Improvements in multi-factor productivity (MFP) - whose "broad" definition measures the residual growth in output that cannot be attributed to changes in the quantity of labour and capital used in production - play a crucial role for long term economic growth. In OECD countries they accounted for between one third and one half of the average business sector GDP growth observed over the past two decades (OECD, 2003).

20. Cross-country evidence suggests that countries that have extensively reformed their product markets have also experienced an acceleration of MFP over the 1990s, while other countries have experienced a productivity slowdown or stagnation. Regulations that promote product market competition can have important effects on MFP performance by affecting the incentives to innovate and improve efficiency. Nicoletti and Scarpetta (2003) find that restrictive industry-specific product market regulation in manufacturing tends to reduce MFP growth mainly via the process of technological catch-up. They also find evidence of a direct link between a proxy for economy-wide product market regulation and sectoral MFP growth.

- Effects on domestic and foreign direct investments

21. The regulatory environment may have a direct influence on both domestic and foreign direct investments (FDI). As quantitative estimates show, product market reforms have important potential effects on investment.[6]

22. The impact of regulation on FDI should be of particular interest given the strong presumption that FDI can significantly contribute to productivity growth. In this respect, it appears that countries where regulations restrict access for foreign businesses tend to receive less inward FDI. As a result, relatively restrictive host countries - such as Italy or Greece – that receive FDI from relatively liberal countries could increase their FDI inward positions.

23. The impact of administrative burdens on FDI deserves particular attention. Economic and administrative regulations tend to be positively correlated. Pro-competition reforms that enhance the role of market-based mechanisms may lead to a reduction of administrative burdens and procedures. Moreover, a less burdensome administrative environment may make it easier to reform economic regulations that must be endorsed and implemented by national and/or local administrations (OECD, 2003; Koromzay, 2004; Nicoletti, 2004).

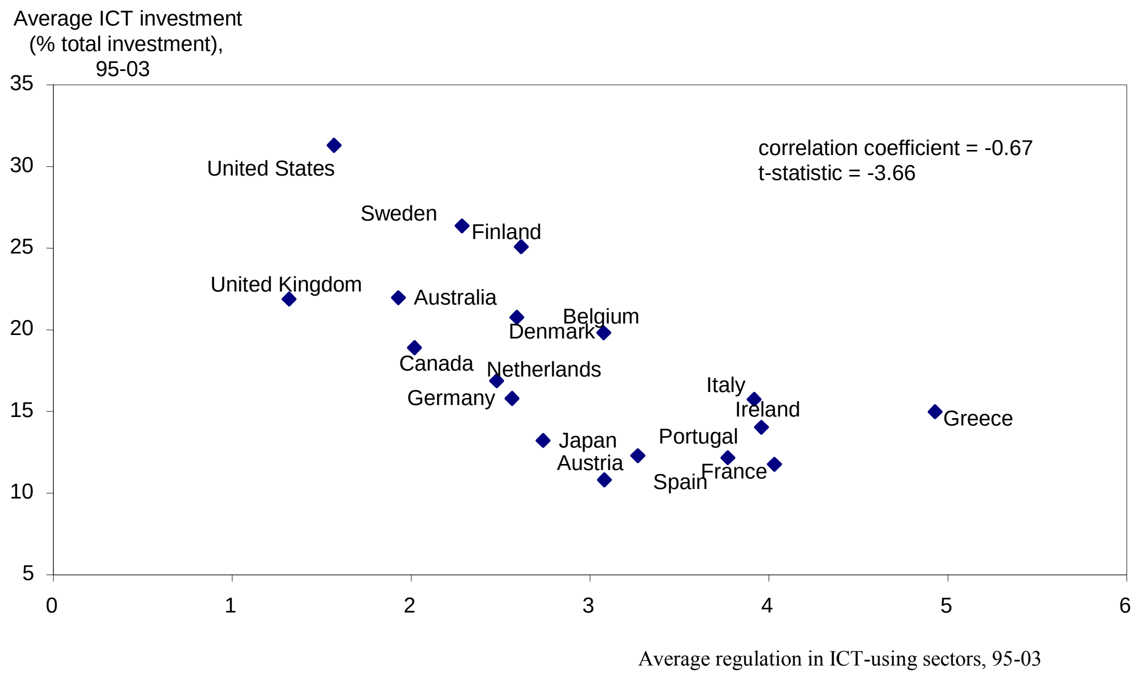
24. In the context of liberalisation policies, proper institutional design matters to provide adequate incentives for investment, particularly when existing incumbents may have the possibility to raise barriers to new entrants and curb competition[7]. Therefore, it is crucial to ensure the right balance between regulations and market forces as well as the right incentives for investment.

- Effects on investments in and the adoption of Information and Communication Technology (ICT) services

25. Regulations that tend to restrict competition appear to have detrimental effects on innovation and on the adoption of ICT (see Figure 4). They tend to reduce and slowdown the investment in ICT. As suggested by Aghion and Howitt (2005), well-functioning product markets increase the incentive and lower the cost of incorporating new technologies into the production process. As a result, weak competition is even more harmful for technology-driven productivity improvements in ICT-intensive sectors (ICT-using and ICT-producing sectors) which are generally more exposed to regulatory barriers than the non-ICT intensive sectors.

Figure 4. Product market regulation and the diffusion of ICT

The scale of the indicators is 0-6 from least to most restrictive



1. The indicator of regulation in ICT-using sectors is the simple average of the 'regulation impact' indicators for the individual industries included in these sectors.

Source: Conway, P., D. de Rosa, G. Nicoletti, and F. Steiner (2006), "Regulation, Competition and Productivity Convergence", OECD Economics Department Working Paper No. 509.

26. Given ICT's potential for increasing productivity and diminishing prices, the share of ICT investment in the OECD rose from 10% in 1985 to 20% in 2002. However this significant increase conceals important variations existing between OECD countries, which are very much linked to the extent to which regulation favors competition.

27. OECD analysis shows that product market regulation is estimated to explain 12% of the cross-country differences in ICT investment (Conway *et al.* 2006). Thus, in the United States, the share of ICT investment in total investment is found to be more than four percentage points higher than the OECD average of 15% as a result of relatively pro-competitive regulations. By contrast, in Italy, Greece, Portugal and France, relatively restrictive regulations are estimated to have significantly dragged down ICT investment relative to other OECD countries (by 2.5 to 3.5 percentage points for the period 1985-2003). However, there is some evidence that the diffusion of ICT and internet related technology and services is now picking up in countries such as France or Italy and, that part of the more recent economic growth in recent years in such countries could be attributed to a catch up effect.

28. One common feature is that in all OECD countries, the detrimental effects of anti-competitive regulation have proven to be larger in ICT-intensive sectors because the regulatory barriers to diffusion are estimated to be higher in these sectors in comparison to non-ICT intensive sectors. These effects can also be significant for a sector such as retail, which has significant spillovers and implications for the diffusion of ICT related technologies as a whole at national level.

29. The negative impact of competition-restraining regulation on ICT investment may affect productivity by slowing down the productivity enhancements related to the production and the adoption of new technologies. Thus, empirical results indicate that countries with a relatively liberal approach to competition have tended to experience a greater acceleration in productivity growth after 1995.

THE POLITICAL CHALLENGES OF IMPLEMENTATION

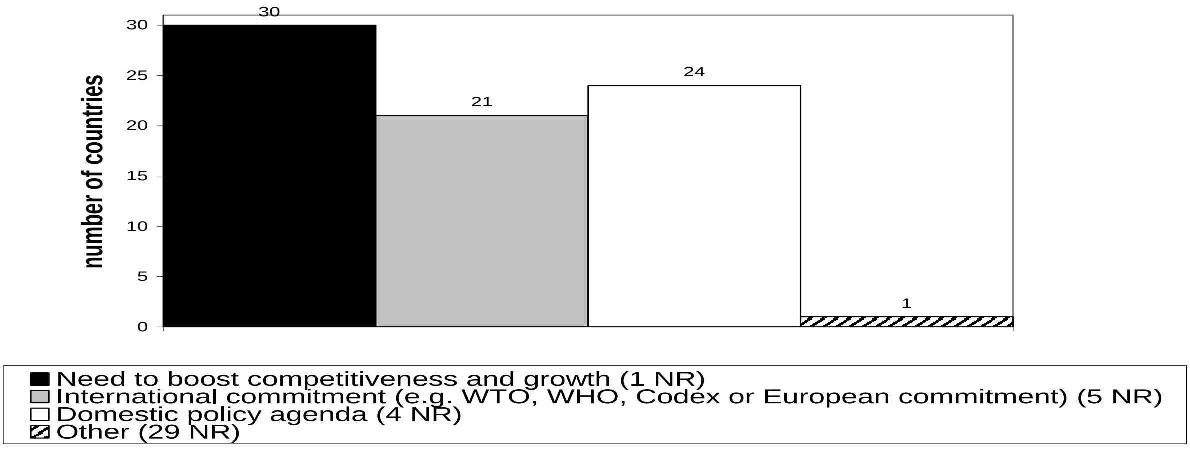
30. Economic evidence may point to the long run benefits of reforms, but reforms will only be implemented and sustained if they are carefully designed and accepted by stakeholders. This is all the more important as in most countries, an initial push for reform is usually followed by a conservative, cautious phase. The timing, scope, modalities of reforms as well as the interactions with macroeconomic policies are important elements for success. The relationships among structural policies themselves also play an important role. OECD work has had a significant impact beginning with the adoption of the first set of Principles on Regulatory Reform in 1997, and the subsequent set of country reviews.

31. Since the mid 1990s, a wealth of information and experience has been collected which can help governments implement regulatory reform and liberalisation policies. Between 1997 and 2007, the OECD carried out 23 country reviews of regulatory reform, as well as three monitoring exercises which bring a country review up to date. In 2004, on the basis of 18 reviews supported by approximately 1 000 recommendations, the OECD carried out a stocktaking of the progress made on the regulatory quality agenda: what has worked, where progress needs to be made, what are the obstacles and how can they be overcome. This also supported the update of the 1997 principles with the 2005 Guiding Principles for Regulatory Quality and Performance.

1. Policy drivers, institutional capacity and the importance of political support

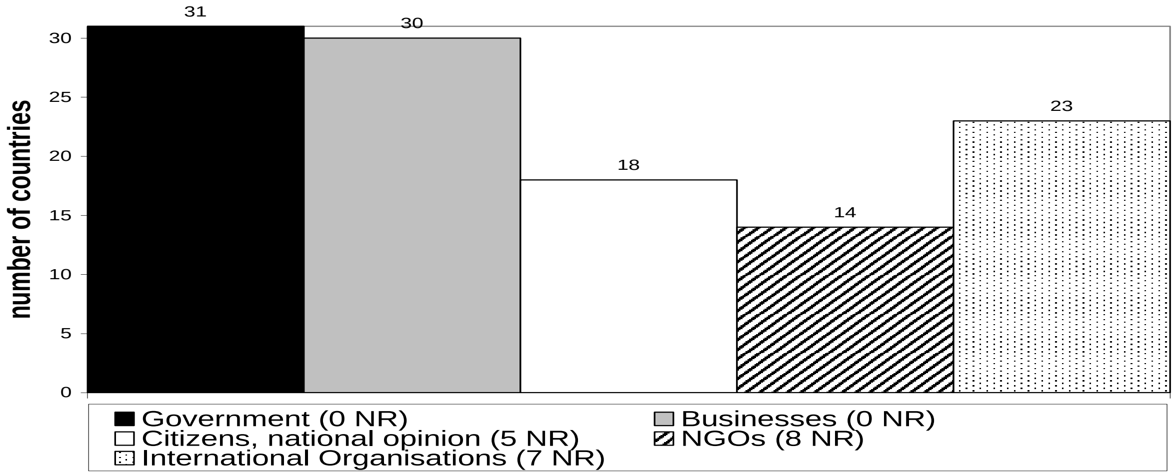
32. The lessons of implementation underscore the importance of building a constituency for reform with strong policy drivers and political support at a high level. Recent OECD work[8] shows that in most OECD countries, the need to boost the competitiveness of the economy was acknowledged as the most important motive for reform (Figure 5). Government and businesses were the main drivers for reforms, with international organisations also playing a significant role in over two thirds of the countries (Figure 6).

Figure 5. Main motives for reform



Source: OECD Regulatory Indicators Questionnaire.
Number of respondents 31; number of countries who do not provide any response see number of NR.

Figure 6. Drivers for reform



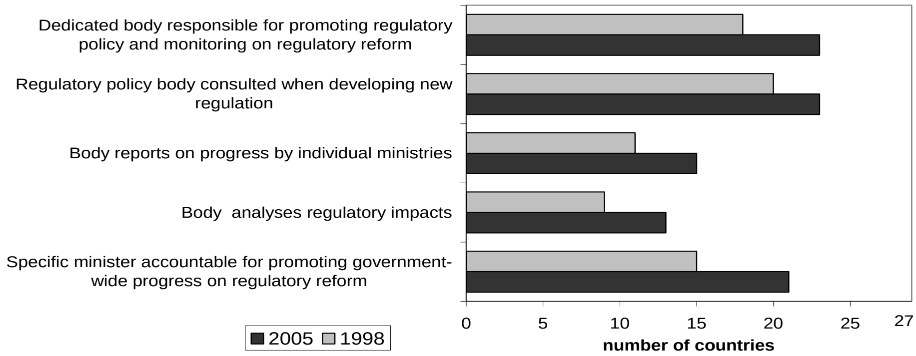
Number of respondents 31; number of countries who do not provide any response see number of NR.

Source: OECD Regulatory Indicators Questionnaire.

33. The OECD reviews also point to the crucial role of high-level political support as well *capacity-building and institutional development, all of which take time and resources.* For example, over two thirds of the countries in 2005 had a specific minister accountable for promoting government-wide progress on regulatory reform (see Figure 7).

34. *S*upport from an effective central oversight body is also important for the successful implementation of *effective, comprehensive regulatory policy.* Such a body can help ensure that the most efficient and effective approaches are used. Recent trends show that most countries made progress between 1998 and 2005 in terms of consolidating their dedicated bodies responsible for regulatory reform, as well in expanding their role.

Figure 7. Institutional setting to promote regulatory policy
Recent trends 1998-2005



Source: OECD Regulatory Indicators Questionnaire.
The sample includes 27 countries. The responses of the EU, Luxembourg, Poland and the Slovak Republic could not be taken into account since no data was available for 1998.

35. Parliament can play an important and useful role in supporting and promoting a high quality regulation agenda. Parliaments, which have a formal responsibility to vet and agree primary legislation, need to be more closely integrated into regulatory quality systems and processes. This is often the case if parliaments have strongly structured permanent committees in charge of the regulation process. Some countries have specialised committees for specific issues, such as EU legislation. The approach taken by parliamentarians to scrutinising legislation should be aligned with the regulatory quality approaches adopted in the executive, as they should be mutually reinforcing.

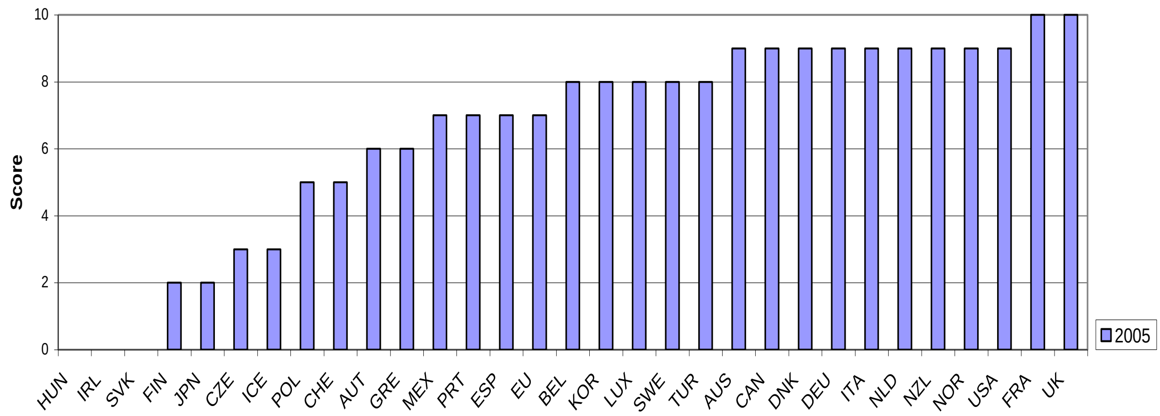
2. Reaching out to businesses and citizens

36. Improving the state-citizen and business relationship is the starting point to develop a constituency for reform that can be sustained across electoral and economic cycles. The state has to set an example by overcoming complexity, opacity and even secrecy in administrative acts. Only by involving many stakeholders, by changing procedures for consultation, by enhancing transparency, can governments adjust the roles and responsibilities within the public sector and between the state and economic actors. This holds in countries where consensus is the norm, just as much as in countries where public opinion is divided and polarised.

37. In many countries, administrations have yet to integrate the need for regulatory quality, and remain too inward-looking and focused on specific sectors. Administrative simplification policies are required to counter the natural effects of administrative frameworks which generate increasing complexity and an accumulation of subordinate regulations. Access to administrative documents and laws on-line, user charters, etc., are only the beginning: deeper reforms are needed to embed a cultural awareness of regulatory quality and its importance.

38. *Programmes to reduce administrative burdens are proving effective as a driver of reform*, transmitting a sense of urgency. Baseline measurements, time-bound quantitative targets aimed at simplification where it will have the greatest impact, strong co-ordination at the centre of government, links to the budget process and cross-party consensus have been identified as factors for a successful drive to cut red tape. As a result, the reduction of administrative burdens has received significant attention across OECD countries recently. The front runners are developing explicit government programmes to modify and streamline regulations, to use information and communication technologies in the context of e-government, as well as reallocating of powers and responsibilities between government departments and/or levels of government.

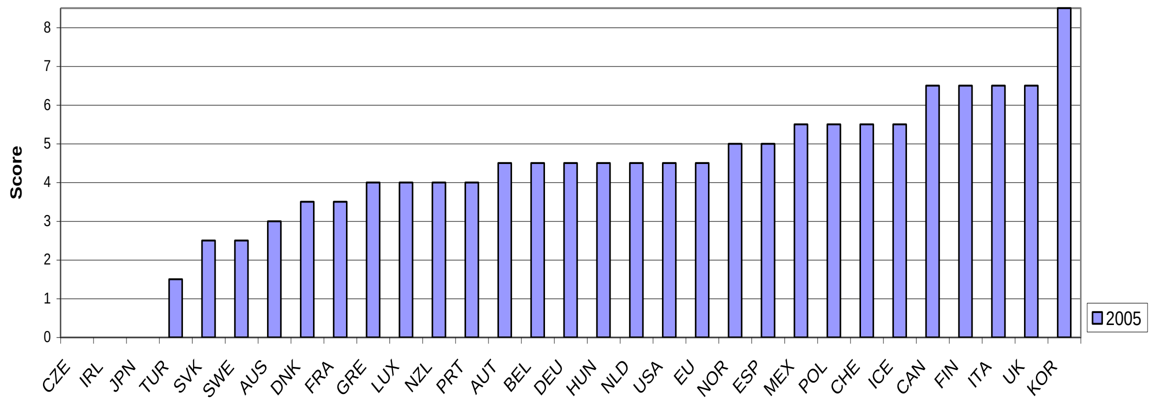
Figure 8. Reduction and control of administrative burdens in 2005



	Weights:
Is there an explicit government program to reduce the administrative burdens imposed by government on enterprises and/or citizens?	if yes, weight=2
If the answer is "yes": does this program include quantitative targets?	if yes, weight=1
If the answer is "yes": does this programme include qualitative targets?	if yes, weight=1
If the answer is "yes": which of the following strategies are used?	
- Modification and streamlining of existing laws and regulations	if yes, weight=1
- Information and communication technologies for regulatory administration (e.g. electronic databases, online formats)	if yes, weight=1
- Other streamlining of government administrative procedures	if yes, weight=1
- Establishment of a system for measuring administrative burdens of regulation	if yes, weight=2
- Reallocating powers and responsibilities between government departments and/or between levels of government	if yes, weight=1

See Q13 / 2005 OECD regulatory indicators questionnaire

Figure 9. Dynamic process of evaluation and update of regulations in 2005



Weights:

Is periodic evaluation of existing regulation mandatory?	if not required=0, specific areas=1, all policy areas=2
Are there standardised evaluation techniques or criteria to be used when regulation is reviewed?	if yes, weight=1
Are reviews required to consider explicitly the consistency of regulations in different areas and take steps to address areas of overlap/duplication/inconsistency?	if yes, weight=1
Are there mechanisms by which the public can make recommendations to modify specific regulations?	if yes, weight=1
If the answer is "yes", please specify:	
- Electronic mailboxes	if yes, weight=0.5
- Ombudsman	if yes, weight=0.5
- Other	if yes, weight=0.5
Is sunsetting used for primary laws or other regulations?	if yes, weight=1
Do specific primary laws include automatic review requirements?	if yes, weight=1

See Q19 / 2005 OECD regulatory indicators questionnaire

39. Countries need a process to deal with the stock of regulation. This calls for periodic *ex post* evaluation, with reviews assessing the consistency of regulations in various areas and the use of various mechanisms (see Figure 10, Annex 1).

40. *Regulatory Impact Analysis (RIA)*, for *ex ante* analysis, with the assessment of small enterprise impacts of new regulations, may also facilitate the transition towards a more business friendly regulatory environment as well as better relations between national administrations and businesses. RIA is especially helpful to develop a stronger economic and policy perspective, to overcome the tendency to focus only on the legal quality of a rule. The legal framework is essential, but overly strong legal cultures complicate the task of developing an economic perspective or a full appreciation of the importance of evaluation.

41. Besides RIA, governments must give greater consideration to alternatives to regulation to overcome built-in inertia and risk aversion, and to accept policy risks. They must also ensure that self-regulation schemes are transparent and monitored, to minimise the risk of abuse and capture. Outsiders to government and ministers are powerful levers for increasing effectiveness, especially as regards advocacy. Advisory bodies have been created in some countries which are external to the administration and hence to vested interests, including the External Advisory Council for Smart Regulation in Canada or the Better Regulation Task Force in the United Kingdom.

42. In addition to alternatives to regulation, compliance and enforcement are the poor relations in the regulatory toolkit. Compliance is closely linked to good regulatory design in the first place. This connects to the role of the judiciary as an essential part of the regulatory process. Judicial review can help promote regulatory quality, where there are inconsistencies for example, and may also help to resolve conflicts. Timescales for the judiciary's decisions, and the relative ease or difficulty with which rules can be challenged, are important factors which need to be taken into account in regulatory processes. Enforcement is another matter needing attention, as lack of enforcement or unrealistic expectations may increase the role of the informal economy.

3. Sequencing of reforms and building synergies towards consensus

43. Sequencing of reforms can affect the performance and effectiveness of the reform process. Examples may include the need to ensure adequate institutional oversight for newly liberalised markets: the strong market power of former incumbents requires adequately staffed regulatory authorities to "put markets to work". Countries which failed to establish or consolidate strong regulatory authorities early on in the process have faced the risk of coping with strong private sector incumbents, with significant market power. Another issue concerns the timing of reform across sectors and policy areas. On the one hand, there is a theoretical logic to follow to get results; on the other, governments may feel that success may depend on identifying the optimal areas for priority action, given a mix of considerations, including the identification of the strongest needs for reforms as well as the practical possibility and political capital needed to implement them.

44. The *possible synergies between structural policies* deserve particular attention as they may significantly facilitate reform and generate momentum for further reforms. The timing, scope and modalities of reform efforts, and the interactions with other macroeconomic and structural policies, represent policy levers which policy makers can use to foster consensus around a structural reform agenda (OECD Going for Growth, 2007). Estimates suggest that the likelihood of reform in one area is increased by 5% when reforms in other areas have already been implemented (Duval and Elmeskov, 2005). For instance, further opening of borders and more extensive liberalisation of product markets within countries may have spill over effects, in terms of indirectly improving underlying labour markets and facilitating future labour market reforms.

45. One pro-reform factor is progress in other, similar countries. This goes beyond simple demonstration effects, which may be very strong in the EU, to include co-ordinated efforts at liberalisation and reform among trading partners. Reform in one area may also spill over into other areas, ("band-wagon effects"). The threat of competition or a fall in comparative rankings in league tables are another example of pressure from outside. *International influences may rally consensus for reforms* that make domestic product markets more competitive (and efficient). On the other hand, this may compromise reforms: the feared effects of globalisation, for example, may generate resistance to labour market reforms. This calls for increased communication efforts as well as adequate safety nets and compensation packages.

4. Weighing adjustment costs as well as the cost of inaction

46. Adjustment costs may need to be borne. Changes in the content of regulations and in overall regulatory settings produce short-term and long-term losers as well as long-term winners. It is often said that those who benefit from reform are more widely dispersed and less vocal than those who are likely to be adversely affected. Information asymmetries make it difficult for the public to understand how reforms work their way through the economy; vested interests can exploit this condition to "capture" the attention and interest of regulators. There is scope in some countries for a "divide and conquer" strategy, but targeted reform efforts which may not provoke as much resistance as an all-encompassing strategy may take more time and consistency than a government disposes. There may also be a need to compensate some

of the losses, particularly the long term ones, for equity and efficiency reasons to ensure the sustainability of the long term process. Special strategies may have to be developed to outmaneuver the short-term losers. Adjustment may be facilitated by adequate timing in the economic cycle as well as by prior fiscal consolidation. It may be easier for governments to compensate for the losses when public finances are sound, than to undertake reform at a time where tighter constraints would make any reallocations impossible.

47. In the final analysis, governments have to weigh the political costs of making progress against the long term social and economic costs of doing nothing. The latter include slower growth, which may have electoral as well as fiscal consequences, and an environment for business marked by lower levels of entrepreneurship and of investment. Relatively liberal countries benefit from improvements in the world productivity frontier more quickly than countries with more restrictive policy regimes. Restrictive product market regulation slows the process of adjustment through which gains in productivity and the incorporation of technological innovations in production are realised. In some of the more restrictive OECD countries, the loss of adaptability that occurs as a result of anti-competitive regulation can be sizeable. Regulatory reform also helps make economies more resilient and recover more quickly from short term economic crises, which is essential in an era of rapid technological innovation and of economic development.

5. The importance of multi-level regulatory coherence

48. The economic and institutional landscape is becoming ever more complex, and economic players and citizens alike are increasingly insistent in their demands for better services. Globalisation and economic interdependence, together with greater market openness, have increased the need for regulation as a framework for the market. This has given rise to new, more sophisticated and more participatory mechanisms of regulatory governance.

49. Multi-level regulatory governance is a cross-cutting issue common to countries with different institutional and constitutional structures and political and social values. Top-down and bottom-up, regional competitiveness, regulatory coherence and cross-border co-operation are terms which connect multi-level issues to the challenges of providing better public services based on the principles of accountability, transparency and leadership.

50. In this context, the multilevel dimension deserves special attention. In a context of competition among legal systems, optimising regulatory quality requires that the multilevel dimension be taken fully into account, given its significant impact in terms of economic and social consequences. Regulation at local and regional levels offers competitive markets for retail and public utilities. The housing sector is also affected by national regulatory practices. The goal should be to promote high-quality regulation at each level of government, and to enhance overall efficiency by instituting appropriate coordination mechanisms. Recent OECD work has begun to analyse this issue with a pilot study of some Italian regions.

51. The transfer of powers to local entities should not be seen as simply a convenient way of shifting responsibilities. Thus, a clearer allocation of responsibilities and better coordination among different levels of government are becoming strategic issues for the attractiveness of regions, in unitary and federal countries alike. With the multiplication of decision-making centres and competition over the sharing of powers, coordination among the different levels of authority is becoming a key question. The subject is a very broad one, and it may be considered useful to focus on two points:

- The relationship between the private and public sectors, in particular through public procurement and concessions of public services at local level.

- Enforcement of the law: mechanisms for prevention, control and sanctions must be appropriate to the multiplicity of stakeholders and must allow for their necessary interaction in a timely manner.

52. The regional perspective must also be taken into account. Over the last 20 years - in fact a comparatively brief period for so far-reaching a change - , aspirations for greater democracy and more efficiency have sparked a dynamic regionalism in OECD countries and particularly in Europe. The institutional model and the degree of decentralisation will of course depend on the political, historical and economic factors of each country. In most countries, whether unitary or federal, there has been increasing emphasis on sub-national levels of government as the appropriate level for the deployment of public policies; in Europe this trend has been accompanied by the simultaneous shift of certain responsibilities to the supra-national level. The impact of national (and supra-national) regulation on regions, however, is relatively under-developed from an analytical perspective, either ex-ante or ex-post.

53. The multilevel exercise of government responsibilities should empower all players in the regulatory process, optimise the allocation of resources and the transparency of procedures and promote their capacity for promote regional networking. Put another way, the emergence of regulatory pluralism, in the absence of proper rules, can constitute a factor for legal uncertainty and complexity, and can increase costs for economic agents. By bringing decision-making closer to beneficiaries while promoting horizontal coherence, however, multi-level governance offers some solutions for managing the decision-making process and for optimising the decisive asset represented by regulatory quality. Constitutional changes, which are cumbersome and can be costly in political terms, are not necessarily essential. The search is on for other ways of identifying and deploying regulatory roles at the appropriate administrative levels. The way is open for innovative thinking to promote new regulatory strategies and to influence behaviour through agreements or transactions to guarantee regulatory quality in regional and institutional settings.

6. Promoting cultural change within administrations is a dynamic process

54. The different disciplines contributing to quality regulation are mutually supportive, lending weight to the argument that a "whole of government" approach is needed. The application of competition principles and effective regulatory policy are reinforced by a shared agenda. This is one of the reasons why political commitment and leadership, often at the highest level, are so important to overcome administrative inertia and the division of responsibility across many sectoral ministries which may divert attention and resources away from the main objective.

55. Communication inside government promotes cultural change within administrations and at the working level. It needs to be applied early in the policy-making process and supported by adequate incentives. A step forward would be a broader and more systematic monitoring and evaluation of regulatory performance, one covering all regulations and taking a consistent approach. An even more ambitious effort would be an assessment of regulatory performance to see what difference it makes to policy performance and outcomes.

56. Countries must be engaged in a continuous process of adjusting and developing their regulatory regimes. The regulatory reform agenda is not just about "one-off" reforms. It is a dynamic undertaking which must be responsive to new challenges. Recent years have highlighted the role of regulatory burdens, and the need to measure, identify and reduce them which has been part of the Lisbon Growth Agenda in Europe. Other issues such as risk management may gain significant importance in the future.

Notes

1. These are the OECD indicators of Product Market Regulation (PMR) initially collected in 1998 and updated in 2003 (Nicoletti *et al*., 1999). The PMR indicator system rests on a pyramid of 16 low-level indicators at the base and one overall indicator of product market regulation at the top. Each of the low-level indicators captures a specific aspect of the regulatory regime, such as barriers to trade, the different restrictions to FDI, or the regulations and market conditions in network and services industries. For example, measurements cover the pervasiveness of state ownership across business sectors, the overall size of state-owned enterprises relative to the size of the economy, the use of command and control regulation, licenses and permits systems, sectors-specific administrative burdens and legal barriers. By covering a wide range of product market policies, the PMR indicators allows exploring the complex and intertwined links existing between regulation, competition, and the determinants of growth.

2. OECD (2005), "The benefits of liberalising product markets and reducing barriers to international trade and investment: the case of the United States and the European Union", Economics Department Working Paper No. 432, OECD, Paris.

3. See also Krueger and Pishke (1997), Amable and Gatti (2001), Pissarides (2001), Spector (2002), Blanchard and Giavazzi (2003), Messina (2005), and Haefke and Ebell, 2003.

4. Nicoletti, G. Scarpetta S. (2005), "Product Market Reforms and Employment in OECD Countries", Economics Department Working Paper No. 472.

5. "Employment Outcomes and the Interaction Between Product and Labor Market Deregulation: Are They Substitutes or Complements?", IZA Discussion Papers, No. 2 770, May 2007 (G. Fiori, G. Nicoletti, S. Scarpetta and F. Schiantarelli).

6. Nicoletti, Scarpetta (2005). Taking the 1994-1998 period average as a benchmark, the estimated model would predict that, if Italy were to align regulation in non-manufacturing industries with US standards, its investment rate would increase by rate by 3.3 percentage points, from 6.8% to 10.1% (the US average level of 9.0%).

7. See Sappington and Siddak (2003).

8. See OECD Indicators on regulatory management systems quality, which were collected in 2005. Jacobzone, Choi, Miguet (2007).

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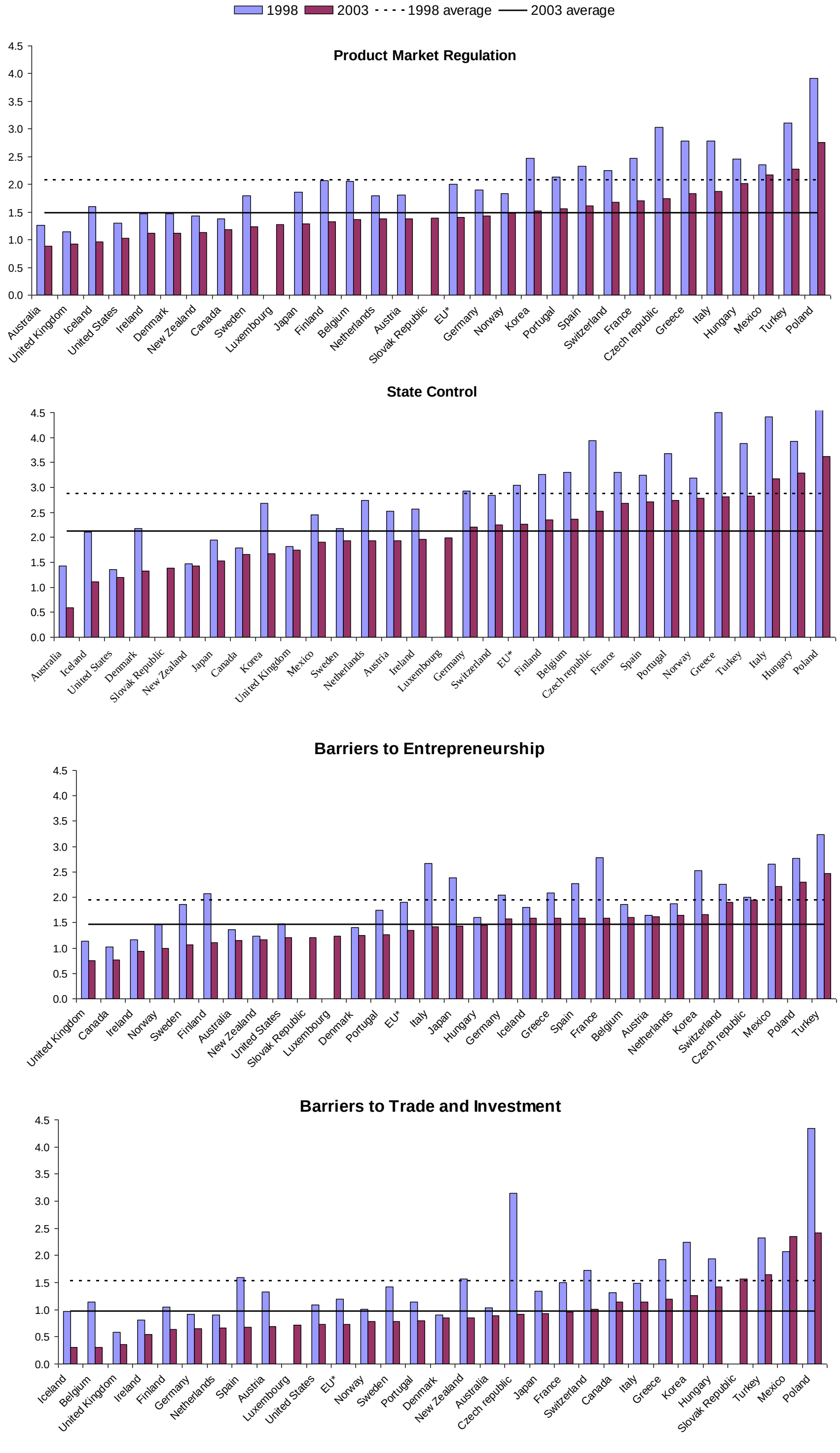
ANNEX 1. PRODUCT MARKET REGULATION 1998-2003

Figure 10. Regulation in 1998 and 2003



1. Sorted by 2003 values. The scale of indicators is 0-6 from least to most restrictive of competition.
* EU 15 (simple average)

Source: Conway, P., V. Janod, and G. Nicoletti (2005), "Product Market Regulation in OECD Countries, 1998 to 2003", OECD Economics Department Working Paper, No. 419.

ANNEX 2. OECD WORK ON REGULATION, COMPETITION AND ECONOMIC PERFORMANCE[1]

Product Market Regulation in OECD Countries: 1998-2003 (Conway *et al.*, 2005)

The original 1998 set of regulatory indicators, designed to measure how policies promote or inhibit competition, is updated and refined and then applied to analyse trends in product market regulation in OECD countries between 1998 and 2003. A randomising method tests whether the summary indicators are sensitive to the weights assigned to the subcomponents, producing confidence intervals that define groupings of broadly similar regimes. The paper confirms that competition improves economic performance. It finds that, between 1998 and 2003:

- Regulatory impediments to competition have declined;
- Regulation has become more homogeneous; and
- The most competition-friendly regimes are the most consistent.

Regulation and Economic Performance: Product Market Reforms and Productivity in the OECD (Nicoletti and Scarpetta, 2005)

To assess how reforms in product markets could reduce the labour productivity gap, which is a key component of cross-country differences in GDP per capita, the theoretical literature and previous empirical work are collected and reviewed. Those earlier results are used to gauge the likely effect of further reforms on investment (domestic and foreign) and on multi-factor productivity. The focus is on the effects of policies aimed at strengthening private governance and opening up access to markets where competition is economically viable. The paper calculates that these improvements in regulation would:

- Increase investment by 2-3 percentage points;
- Increase foreign direct investment by 20% overall, and up to 80% in some countries; and
- Reduce the (multi-factor) productivity gap with high-productivity countries by 4-10%.

Product Market Reforms and Employment (Nicoletti and Scarpetta, 2005b)

Employment effects of reforms aimed at increasing competitive pressures and easing government controls are estimated in a sample of OECD countries over the past two decades. Cluster analysis of aspects of labour and product market regulations reveals four patterns: liberal in both product and labour markets (most of the common law countries); relatively restrictive in both product markets and employment protection (most of continental Europe and Japan); restrictive product market regulations but more liberal labour rules (Ireland, Switzerland and for some purposes Japan), and restrictive rules about all (southern Europe including France). The paper finds that:

1. From OECD, DAF/COMP(2007)2, "Relationship between Competition Policy and Economic Performance".

- Regulations that restrict competition reduce employment rates;
- Insider bargaining power increases this effect – that is, rent sharing depresses employment;
- Employment could increase 2.5-5 points after a shift to pro-competitive regulatory policies; and
- Sequencing of reform could be a challenge, since employment gains would be greater, but harder to achieve, where regulations are most restrictive.

The benefits of liberalising product markets and reducing barriers to international trade and investment in the OECD (OECD, 2005)

Improvements in GDP and productivity from adopting a package of reforms related to trade liberalisation – tariffs, constraints on foreign investment and regulation affecting inward trade – are computed by applying coefficients derived in previous regression studies. A general equilibrium model of foreign trade is used as a check. The paper finds that reforms affecting trade could lead to gains in GDP per capita of up to 4-5 percent. Different methods yield different estimates of the gains from reforms that encourage competition through trade liberalisation:

- Direct test: 4.7% gain in GDP per capita;
- Linked through effect on productivity: 2.7% gain in GDP per capita;
- General equilibrium model: 1.9% gain in GDP per capita.

Regulation, Competition and Productivity Convergence (Conway *et al*., 2006)

Regression analysis examines channels through which more competitive regulation could affect productivity, particularly the diffusion and adoption of information and communications technology and location decisions by multinational firms. To test the effect of regulation on catch-up to best practice, a model of labour productivity is estimated for the business sector as a whole and at sectoral levels. Labour productivity growth in this model depends on the ability to keep pace with growth in the productivity leader, by innovating or by technology transfer.

- Anti-competitive regulation slows productivity growth in sectors where information and communications technologies are particularly important;
- Anti-competitive regulation slows down the process of catching up to the productivity leader;
- Rates of investment in information and communications technologies are several percentage points above average in the US, UK, Canada and Australia because of their competition-friendly regulations; by contrast, constraints on competition lead to ICT investment rates well below average for Greece, Italy, Portugal and France.