POSITION PAPER

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Regulatory Reform for Recovery and Growth

In 2008-09, the global economy experienced the most severe downturn since the Great Depression. Governments intervened early to stabilise the financial system and implement stimulus packages. While these measures averted a more serious global crisis, they left countries with sizeable deficits. Indeed, the OECD-wide budget deficit is projected to reach more than 8% of GDP in 2010 – its highest level in 60 years. And in the OECD as a whole, gross government debt is projected to exceed 100% of GDP in 2011, about 30 percentage points higher than in 2007.

In this challenging fiscal environment, governments will need to consider *regulatory reform* as a strategy for recovery. Regulatory reform has been extensively used throughout the OECD to stimulate recovery from crises in the past, without further adding to debts and deficits. In the short term, reform can boost confidence in regulatory systems by showing that governments are committed to improving regulatory quality. Over a longer period of time it can liberate the productive forces necessary to increase competitiveness and growth.

Regulatory reform refers to changes that improve regulatory quality, enhancing the performance, cost-effectiveness, or legal quality of regulations and related policy instruments. This should not be confused with deregulation or privatisation for it is wider in scope. When governments withdraw from "command and control" measures, more regulations may be needed, not fewer. Regulations are one of the key levers of government to achieve policy objectives. How regulations are designed and evaluated, and what they demand of citizens and firms, help shape the regulatory environment. Reform can mean revision of a single regulation, the scrapping and rebuilding of an entire regulatory regime and its institutions, or improvement of processes for making regulations and managing reform. By improving regulatory quality, regulatory reform aims to increase competition, market openness and the health, safety and well-being of citizens.

This Position paper presents some key lessons learned and insights from recent OECD research on the use of regulatory reform during crises and its impacts. These lessons may be of use to policy makers seeking to design, adopt and implement regulatory reform programmes to boost recovery from the global financial and economic crisis. This Position paper is divided as follows: first, the role of regulatory reform in speeding up recovery from crises is highlighted, with some examples of how countries have used crises as opportunities for reform. Next, implementation challenges are discussed, along with the importance of articulating the benefits of reform. A section on the way forward for regulatory policy and reform concludes the paper.

Box 1. **OECD research on regulatory reform as a strategy for recovery**

This Position paper is based on work undertaken by the OECD's Regulatory Policy Committee (in collaboration with the Competition and Trade Committees) as part of an organisation-wide effort to support governments in tackling the crisis and moving towards stronger, cleaner and fairer economies. The approach taken was to derive lessons learned from a set of selected OECD countries (principally Japan, Korea, Mexico, Sweden and the United Kingdom), in terms of how regulatory reform played a role in helping countries recover from past crises of the 1990s and early 2000s. The final study is comprised of a synthesis report and four detailed country case studies of Japan, Korea, Mexico and the United Kingdom, available at *http://tinyurl.com/reformgrowth*, under the reference *Regulatory Reform for Recovery: Lessons from Implementation during Crises* (OECD, 2010).

How can regulatory reform speed up recovery from crises?

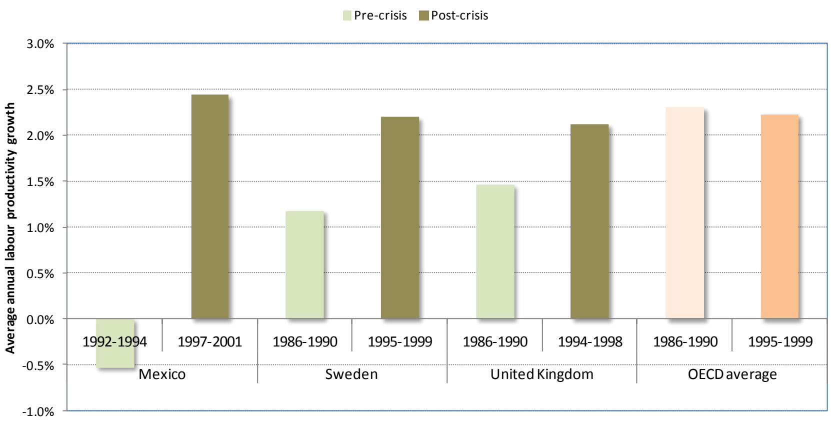
Regulatory reform aims to improve the quality of regulations and the regulation-making process, to create healthier competition, open markets and a regulatory framework that is innovation-friendly and makes it easier for firms to enter and exit markets. These factors contribute to increasing economic *resilience*, or the process by which resources can be effectively shifted from underperforming to robust sectors. Through this process of adjustment, resilient economies can recover more quickly from a crisis by being able to *i)* adapt to new economic conditions *ii)* take advantage of the opportunities offered by other recovering economies and *iii)* innovate more, adopting better, newer technologies that will drive productivity and growth.

Why does the speed of recovery, and hence economic resilience, matter? Because short crises that turn into long ones, with persistently high unemployment rates, can have dramatic consequences for an economy. If a crisis is long, even if the drop in GDP is shallow, behaviours and expectations tend to be permanently changed. The labour market will be subject to hysteresis or path dependency effects, as the newly unemployed will find it harder to reintegrate the workplace without retraining should they be out of work for an extended period of time. This can lead to a permanent loss of productivity and lower living standards, in a "lost generation" pattern. In the case of a resilient economy, shorter crises mean that the loss in productivity is only temporary and that there are no permanent changes in expectations and economic fundamentals. While resilience speeds up recoveries, it is important to note that it does not necessarily reduce the *frequency* of crises, because opening markets increases the synchronisation of the business cycles, making economies more vulnerable to external shocks. In the long run however, open economies with high quality regulation experience stronger growth than closed and heavily regulated economies.

Providing empirical evidence of reform impacts and benefits is a challenge, because of the combined effect of the wide range of measures implemented during economic downturns, including – but not limited to – measures involving regulatory policy or reform. The OECD has conducted research on a subset of regulation, product market regulation, and has found that easing anti-competitive regulatory constraints in product markets leads to greater employment and productivity growth, two channels that are the main determinants of economic growth. (See *e.g.* OECD, 2009b) Observing the pattern of productivity and GDP growth around crises can also be indicative of potential regulatory reform impacts. Figure 1 shows the evolution of productivity before and after crises of the early 1990s in Mexico, Sweden and the United Kingdom. All three countries engaged in significant regulatory reform in reaction to economic crises – these efforts appear to have produced a "productivity dividend" (although other measures, including fiscal measures would have also played a role), as the 5-year average labour productivity growth shows a net increase after the crises.

Figure 2 shows the evolution of GDP for Korea and Mexico during crises: in both countries, the recoveries from the crises of 1997-98 (Korea) and 1994-95 (Mexico) were strong and relatively quick, as GDP surpassed the previous peak in less than two years. The crises prompted the governments of both countries to implement comprehensive regulatory reform programmes. There are indications that these reforms have improved economic resilience. Korea was one of the first countries to recover from the 2008-09 global crisis, with GDP surpassing its previous peak (reached in the third quarter of 2008) within a year. In Mexico, the speed of recovery in 1994-95 compares favourably to the recovery from the 1982-85 crisis, as Figure 2 shows. In the 1982-85 crisis, the recovery took longer and was much weaker – this was a time when the Mexican economy was burdened with an extensive command and control regulatory environment and when, in contrast to the 1994-95 crisis, no comprehensive regulatory reform programmes were undertaken (at least until 1988).

Figure 1. **Comparison between five-year average annual labour productivity growth periods, before and after crises in selected OECD countries**

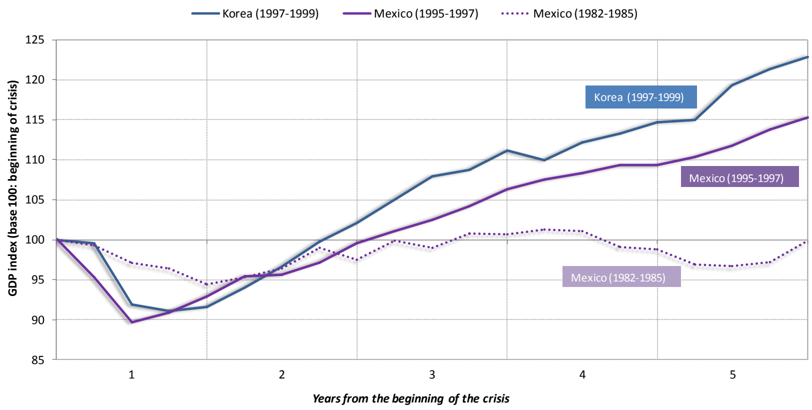


a. Crises are defined as 1995-96 for Mexico (peso crisis), 1991-94 for Sweden (banking and exchange crisis) and 1991-93 for the United Kingdom (exchange crisis). The OECD average annual labour productivity growth for the five-year periods of 1986-1990 and 1995-99 is presented for reference. Note: data was not available for 1990 and 1991 in Mexico.

b. Labour productivity is defined as GDP per hour worked. In theory if regulatory compliance costs decrease, then more resources are available for productive uses, thereby increasing labour (and total) productivity. For a more detailed discussion on the impacts of regulatory reform on productivity, see *e.g.* OECD (2010), OECD (2009b) and OECD (2008).

Source: OECD productivity database. Data extracted on 26 Feb 2010.

Figure 2. **GDP change compared with peak year, crises in Korea and Mexico**



Source: OECD.Stat.

A common misperception is that the impacts of reform take time to materialise. This is not necessarily true as some benefits, such as efficiency gains, can occur early on once reform programmes are launched, and can contribute immediately to a recovery. Knowing that competition will increase once the reforms take hold for example, businesses will be compelled to improve efficiency to be competitive ahead of time. This is illustrated by the adoption of NAFTA in Mexico in 1994, where businesses made operational adjustments and reduced costs even before NAFTA was signed. Businesses made these adjustments in anticipation of the expected increase in foreign competition once the agreement came into force. Anticipation alone was enough to stimulate the changes needed to improve efficiency and productivity within a short period of time.

Visible and short term results can also be obtained by reducing unnecessary red tape, transaction costs and market distortions by reforming outdated regulations that burden economies. Small businesses in particular will see their administrative and compliance costs decrease significantly. Reform can further strengthen recovery by levelling up productivity in highly regulated, low-productivity sectors, allowing these sectors to catch up with more competitive countries.

Is a crisis an opportunity for reform?

The heightened sense of urgency for action that typically prevails during a crisis can be favourable to reforms. This offers a window of opportunity to put through reforms that would otherwise not have enough broad-based support given the general inertia against changing the status quo. At the very least, a crisis is a time to initiate discussions on priorities, and to bring together key stakeholders to discuss revitalising the economy and rethinking the basis of its prosperity, through increased emphasis on better regulation.

Many OECD countries have considered crises and economic downturns as opportunities to introduce comprehensive reforms, often with considerable success. Below are some examples of successful reforms:

- **Korea**: a wide-ranging and impressive programme of regulatory reform was implemented in the midst of the 1997-98 crisis, the most severe crisis experienced by the country in decades. With strong support at the presidential level, 50% of all regulations were cut, a bold initiative aiming to bring an end to the tradition of political intervention in the economy and business. Increasingly there was a reliance on the market to correct business failures and to drive growth – this was made clear with the failure of Daewoo, which marked an end to the "too big to fail" policy for the biggest conglomerates. At the same time markets were opened and barriers to trade and foreign investment were lowered. These measures paid off in Korea: the economy fully recovered in less than two years, and witnessed strong growth in the following years.

- **Mexico:** also engaged in broad reforms following the peso crisis of 1994-95. At that time, regulatory reform was seen as the least fiscally demanding option in terms of public resources. Mexico's central regulatory oversight body was strengthened, bureaucratic discretion was reduced, transparency and predictability increased and multi-level governance improved. The competition authority resisted anti-competitive mergers, markets were opened to foreign competition and trade was radically liberalised through the adoption of NAFTA. These measures showed a strong commitment to reform, which evolved into systematic and permanent review processes after the crisis. Mexico enjoyed a significant productivity and growth dividend from those reforms: the value of exports more than doubled over the three years following the beginning of the crisis, and the economy fully recovered in less than two years.
- **Turkey**: a severe economic crisis in 2000-01 revealed extensive weaknesses in the regulatory system. Seeing regulatory reform as a crucial exit strategy, Turkey embarked on a very ambitious regulatory reform programme, including the creation of several independent sectoral regulators, increased transparency and the strengthening of the mandate and institutional capacity of the banking sectoral regulator. This programme proved successful: after 2002, growth picked up strongly, averaging an impressive 6.3% per annum in real terms over 2002-07.

Three observations arise from the examples above. The first is that comprehensive regulatory reform produces significant benefits, and especially in case of economies initially strapped with extensive command-and-control regulatory regimes. For countries that have already moved away from such regimes however, the marginal benefits of regulatory reform are likely to be lower. In such cases there may be merits to targeted approaches, focusing on sectors where the benefit to cost ratio of reforms is the highest.

The second observation is that keeping reforms focused on improving long-term sustainable growth rather than as an immediate reaction to a crisis is important. Reforms justified chiefly on the basis of dealing with a crisis may be difficult to sustain once the recovery has taken hold and that the crisis is no longer in people's minds. Even then governments tend to overestimate the impacts of reform on productivity growth in the long run; reform should not be considered as a one-off exercise, as the "vaccination effects" of reform introduced in past crises tend to fade away within a few years. This highlights the need to preserve reform as a continual process and to maintain the capacity to draw upon lessons learned from past crises.

A third observation is that far from threatening recovery, reform actually strengthens it, by increasing confidence in the regulatory system and showing that the government is committed to improving regulatory quality. For example in both Korea and Mexico, high-level political commitment to engage in regulatory reform in the midst of a crisis proved instrumental in reinstating confidence in regulatory systems and institutions, and contributed to create a regulatory environment conducive to investment and innovation, from both foreign and domestic sources.

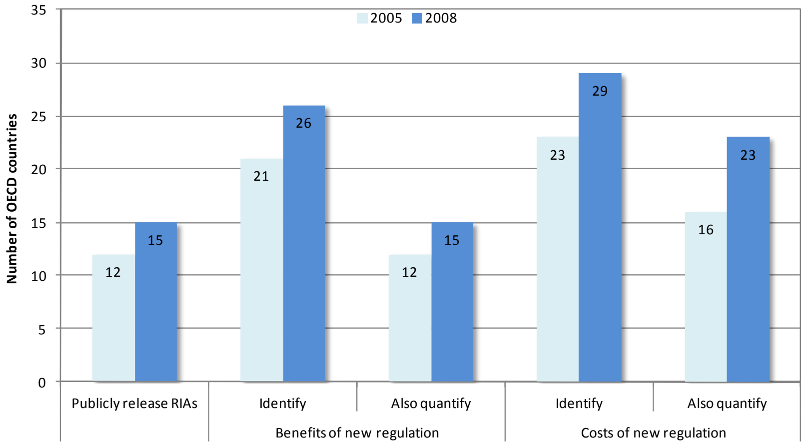
How can confidence in regulatory systems be strengthened?

One of the most difficult challenges in dealing with the far reaching consequences of the 2008-09 crisis will be to re-establish the confidence of citizens and businesses in regulatory systems and institutions, both financial and non-financial. Communicating and demonstrating the results of reform can help, by showing that governments are committed to continually improving regulatory systems with a view of making them more adapted to the current environment.

Articulating the benefits of regulatory reform, quality and governance can also help convince politicians of the importance of these levers of government and increase public acceptance and support. The lesson of administrative burden reduction programmes is that reform efforts that realise tangible benefits will be supported. A combination of analysis and advocacy is necessary to demonstrate where regulatory quality will be of benefit and what better outcomes can reform produce.

Some OECD countries have had success in communicating the tangible benefits that regulatory policy and reform can produce. This was done mainly through increased quantification of the benefits of regulatory quality, and the dissemination of these results (see Box 2). A greater use and publication of regulatory impact assessments, including fully quantified cost-benefit analyses, has followed. But this is not a widespread practice across the OECD (see Figure 3). While a majority of OECD countries require that the benefits and costs of new regulation be identified in regulatory impact assessments, a much lower proportion require that these costs and benefits be quantified and publicly released. There is scope for improvement in this area and the importance of effectively communicating the benefits of reform should not be overlooked. Effective communication requires broad efforts towards advocacy, clearly highlighting the rationale for reform strategies, and engaging in the public debate to win constituencies and stakeholders. New initiatives for open government and web-based consultation and communication are also likely to transform the relationship between the regulators and the regulated, making regulation user-centred.

Figure 3. **Requirements for Regulatory Impact Analysis (RIA): Analysis of Costs, Benefits and Public Accessibility of RIAs in OECD countries (2005 and 2008)**



1. This figure is based on country responses to the OECD *Survey of regulatory management systems* conducted in 2005 and 2008. Each column is the sum of country responses “always” and “for major regulations only”.

Source: OECD (2009), Indicators of Regulatory Management Systems, *http://tinyurl.com/indicatorsRMS.*

Box 2. **Better communication: Innovation in OECD countries**

Several OECD countries are currently leading by example in using innovative approaches to communicate results. As of August 2009, the UK has been using the *Forward Regulatory Programme*, a tool that provides an overview of all upcoming regulatory initiatives and associated monetised costs and benefits, as a way of improving transparency and predictability. Canada and the European Commission have taken a more open stance on publication of fully quantified costs and benefits of new regulations: this has helped the media and general public to better understand the benefits of sound regulation. The US has made of increasing transparency and public access to information a priority, in particular through the Open Government initiative. The OECD will provide a forum to highlight and disseminate these innovations in the context of its work on regulatory policy and public governance.

What strengthens implementation of regulatory reform?

Implementation is perhaps the most critical stage for the success of regulatory reform. Reform programmes can face significant pressures given that the costs of reform are often visible and localised, while the benefits, in their nature of reducing opportunity costs, are diffuse and much less visible. Regulatory reform can also lead to removal of rents enjoyed by special interest groups. Protected from competition under previous regulatory regimes, these groups will protest vehemently. This makes implementation a challenge, whether in good times or during a crisis, and governments may be tempted to postpone regulatory reform, relax competition rules and close markets in order to prop up ailing firms and preserve existing jobs. Through trial and error, countries have learnt a number of lessons in dealing with these implementation challenges. The following is a summary of key best practices based on these lessons learned:

Consider mechanisms to reduce transitional costs. Reform has important distributive consequences between stakeholders and across time. The presence of great income disparities and issues such as youth unemployment can create perceptions that reforms are “unfair”. Consideration has to be given to addressing the adjustment impacts of these policies and reforms.

The importance of considering mechanisms to reduce transitional costs is well reflected in the contrasting cases of Sweden and Japan. In Sweden regulatory reform of the early 1990s did not generate significant opposition by unions because there were sufficient safety nets to help those who became temporarily unemployed due to reforms. In Japan on the contrary, the absence of adequate safety nets for temporary workers vulnerable to the changes brought by regulatory reform in the early 2000s, created a public perception that reforms increased inequities. This perception to a certain extent makes implementation more challenging.

Clearly articulate the benefits of reform. As previously indicated, stimulating market access and eliminating regulatory protections through regulatory reform may result in the removal of the rents previously granted to particular groups through regulations. As such it is often obvious who will pay for the price of reforms, while the costs of the status quo are opportunity costs and as such, much less politically visible. Clearly articulating and providing quantitative evidence of the benefits of regulatory reform is important to overcome political pressure against reform, and to help maintain the consistent application of regulatory policy principles. To help better articulate the benefits of reform, governments may consider providing quantitative evidence.

Engage in broad consultations with stakeholders with the view of forming a consensus. Broad public support is essential for a successful reform. Public support was instrumental in Korea's success with regulatory reform in 1997-98. The experience of the benefits of reform can also strengthen public support for future reforms. In Korea for example, the opening of markets during the 1997-98 crisis contributed to the creation of new jobs and higher salaries through inflows of foreign direct investment. This played a central role in changing public attitudes towards reform. Public support for reform was in turn instrumental to the Korean President's unambiguous stance against protectionist measures at the G20 summit in April 2009.

Whole-of-government approaches are effective; but targeted approaches may also work. Broad, whole-of-government reform programmes show that the government is committed to reform and can increase the confidence of both citizens and investors in the capacity of government to ensure a high-quality regulatory environment. This approach has produced great results in Korea and Mexico, for example. But for economies where the regulatory system is more mature, more targeted, sectoral reforms may also produce results. As an example Japan has experimented with "special zones for regulatory reform" since 2002, a form of locally-driven reform initiatives.

Where do we go from here?

Experiences from implementing reform during past crises can guide to a certain extent responses to the global financial 2008-09 crisis and how to stimulate recovery without further adding to deficits and debt levels. But while the current crisis in some aspects resembles the crises of the 1990s, in other aspects it differs markedly. In light of these differences, do we need to rethink regulatory policy and reform?

To a certain extent, yes. The 2008-09 financial and economic crisis has shown the salience of global systemic risks in a networked and interdependent world, highlighting the need for greater international regulatory co-operation and a rethinking of how public and private sectors can co-regulate in a collaborative process. New concerns about climate change, environmental degradation and opportunities for growth have also prompted governments to turn towards green growth strategies, which will create both opportunities and risks for regulatory policy and reform.

But these issues are also a consequence of inadequate implementation. The financial sector suffered from a lack of proper assessment of risks and a lack of compliance with principles of regulatory quality. Sound regulatory frameworks for a better consideration of environmental impacts exist, but are not widely used outside of environmental departments.

This means that the way forward for the advancement of regulatory policy and reform will not only be to review if existing tools are appropriate, but above all, to review if their implementation is satisfactory. This is not an easy task. To meet these challenges, the institutions responsible for regulatory quality will need more resources, with a focus on:

- **Improving regulatory governance.** The crisis highlighted in some respects the gap between public and private regulation, and how optimal social outcomes depend on active collaboration and clearly delineated responsibilities between private institutions and government agencies. Progress calls for a shift in focus from *regulatory management* to *regulatory governance*, which involves a better understanding of the effective use and design of public and private regulation. A *governance* approach is vital to achieve the policy coherence and international regulatory co-operation that is necessary in today's interconnected world and global markets. Regulatory governance also calls for enhanced consideration of risk, as risk has been put in focus following the events that led up to the crisis.

- **Integrating the principles and tools of regulatory quality, including RIA and *ex post* evaluation in the decision-making process**. Regulatory policy has progressed considerably over the past 15 years. All OECD countries now require some form of regulatory impact assessment (RIA) for at least some forms of new regulation; however few countries have fully implemented RIA and integrated it in policy decision making. The systems elements of RIA recommended by the OECD are meant to accommodate and overcome some of the more welfare-reducing elements of real world policy making, but a better understanding of how RIA can be incorporated in policy development in different institutional settings would enhance its acceptance and influence. The evaluation of existing policies through *ex post* impact analysis is also necessary to ensure that regulations are effective. Successful integration of regulatory quality tools and principles in the decision-making process will also depend on the capacity to effect culture change within government. The top-down, overly prescriptive "regulate first, ask questions later" culture needs to move towards deciding whether a regulation is needed to achieve a policy objective, evaluating *ex post* the effects of regulations already in force, and promoting participative approaches to public policy decisions.

- **Highlighting regulation as a factor in horizontal issues such as *Green Growth* and Innovation**. A new growth model calls for a greater emphasis on strengthening regulatory policy principles and oversight. Growing concerns about climate change and the environmental quality have prompted many to consider regulation as a potential policy instrument that can reduce carbon emissions and drive energy efficiency. While regulation can help drive some environmental objectives, it can also impose unnecessarily high costs to businesses and citizens alike if not designed carefully. A sound framework for regulation making and review is necessary to ensure that new regulatory initiatives are coherent across departments and designed to minimise regulatory costs and burdens on businesses while creating the right incentives for innovation. While regulation may be necessary to stimulate the take up of green technologies, the careful selection of instruments is important to ensure that regulatory proposals are efficient, coherent with other policy initiatives and existing regulations, and do not constrain market dynamics. Regulatory quality also plays a key role in creating an innovation-friendly environment, which is fundamental to achieving green growth.

- **Creating conditions for successful international regulatory co-operation.** Formalised governance arrangements for international regulatory co-operation, and their practical consequences, are not well understood. Policy however is increasingly informed if not shaped by international organisations. Yet regulatory gaps occur, with potentially devastating results. Many sectors are involved: the financial sector, to be sure, but also health, transport, environment, energy, all with consequences on investment and for consumers. The domestic regulatory agenda must take account of the problems of cross-border risks, and contribute to preventing the development of international systemic problems.

- **Promoting open government and effective consultation.** Information and communication technologies (ICT) have the potential to enhance the understanding of the benefits of reform, empower regulatees and improve the collaborative development of regulatory solutions. Tools such as Web 2.0 applications and practices have the potential to rapidly reach large numbers of people at low cost, supporting "bottom-up" issues-based communities and user-centric regulation. One-stop shops can improve service delivery and greatly reduce compliance costs for businesses, as was recently the case in Mexico and other OECD countries.

Regulation is too important as a key lever of governments to be viewed only through a legal, an economic or a sectoral lens. All too often, ministries with sectoral responsibilities do not understand how their routine activities affect the overall impact of regulation on citizens and the economy, or put another way, how they can contribute to regulatory quality and performance. The regulatory policies, tools and institutions to deliver better results for citizens and businesses will require a horizontal approach to diffuse regulatory tools and practices as widely as possible and to test them at the interface between policy design and practices. New modes of working will need to be explored, including a greater collaboration between centre-of-governments and regulating agencies and departments to deliver on regulatory quality.

Further information

For more information about this *Position paper* and the OECD's work on regulatory reform as a strategy for recovery and growth, please contact:

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Related reading

OECD (2010), "Regulatory Reform for Recovery: Lessons from Implementation during Crises", available at *http://tinyurl.com/reformgrowth*.

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