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# Reforming the Investment Climate

Lessons for Practitioners

**Sunita Kikeri**  
**Thomas Kenyon**  
**Vincent Palmade**



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## Foreword

**E**conomic policymaking remains more an art than a science, in common with many other areas of public policy. We know a few things about the technicalities of reform—for instance, how to streamline customs procedures or simplify the process of business registration. But it is less clear how one gets these and other more complex policies agreed upon and implemented. Some believe that we can study the matter and develop typologies and recipes, almost a manual. I very much doubt this makes sense. The management of societies may not lend itself to engineering-type approaches, where we can hope to discover principles of how things work and then design manuals. Fundamentally, the process of reform and implementation is about humans agreeing, compromising and acting together. In the process, innovation is possible. At the same time credibility and some level of predictability matter. The equivalent of immutable physical laws remains elusive. For reform we cannot write a blueprint. As with change management in firms, the best we may be able to do is to generate interesting case studies that help sharpen judgment and inform policymakers about the process and impact of reforms.

What interest do policymakers have to sharpen their judgment and learn from other experiences? Here, competition matters. Not

competition between firms, but between jurisdictions. When some countries pull ahead, when they see incomes rise—that makes policymakers in other places wake up. Statistics that allow us to compare the performance of different jurisdictions make success and failure visible. GDP statistics show us who earns more, who grows. The benchmarking of “competitiveness” gets policymakers’ juices flowing, often under pressure from the media, who highlight deficiencies revealed by statistics. Just consider the impact of the OECD PISA study on comparative performance of education systems or the World Bank/IFC reports on “Doing Business.”

It is in that perspective that we have embarked on a review of reform episodes. Our hope is that the experiences and lessons of the cases analyzed in this paper will indeed help sharpen judgment. Additional work is being done on reform episodes monitored by our “Doing Business” project. Between our work and that of others, there will be close to one hundred cases written up. The challenge is to find useful ways of sharing experiences among relevant policymakers and to develop the best possible ways of learning—maybe in the spirit of business school case study teaching and, just maybe, in the more distant future by using emerging multiplayer games to explore governance and policy problems.

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## I. Introduction

**T**he importance of investment climate reforms for boosting growth and reducing poverty is increasingly well understood. Much less understood is how to manage such reforms. Investment climate reforms are challenging for three main reasons. First, the list of possible reforms is long, and figuring out the right priorities and sequencing can be a daunting task. Second, such reforms are often politically contentious because of their distributional consequences: groups that lose in the short term are often well organized and in a position to resist, while those that benefit usually do so only in the long run and are too dispersed to matter politically. And third, investment climate reforms can be institutionally challenging: their implementation typically requires coordination among diverse departments and levels of government as well as fundamental institutional changes in organization, incentives, and behavior that can be difficult to achieve.

So, in tackling the investment climate, would-be reformers face many technical, political, and institutional challenges. Key among these challenges: How to identify the most important constraints, and how to sequence reforms? How to overcome opposition from interest groups and get reform onto the agenda? How to package

reforms so that they are both credible and feasible? How to mobilize support for reform? How to create the incentives and capacity to implement reform? And how to create institutional mechanisms to drive, monitor, and sustain reform?

We address these questions through an analysis of the literature and the findings of more than 25 case studies of reform. The case studies, drawn mostly from developing countries, cover a range of reforms (including product market, land market, labor market, infrastructure, and customs reform). They suggest that reform is highly dynamic and idiosyncratic: there is and can be no standard process. Different investment climate reforms involve different mixes of technical, political, and institutional issues and thus call for different approaches. The country context also matters, particularly the type of political system and the capacity to plan and carry out reform. Elements of luck and unpredictability too play a part.

Yet, as the rest of this book shows, our analysis highlights ten common lessons which emerge across different types of reform and country conditions:

1. *A growing set of diagnostic tools and proven good practices is making it easier to identify priorities for reform.* Benchmarking indicators, country rankings, business surveys, and industry-specific analyses are now available to help reformers more easily identify and target the key constraints in their country's investment climate and therefore the priorities for reform. And as the case of China shows, reformers can also determine priorities through policy experimentation and learning from their own experiences and the successes of other countries.
2. *Exposing the economy to international competition through trade and product market reforms is a good place to start.* Exports and competition not only are among the most important drivers of growth; they also help create domestic pressures for tackling the other important investment climate reforms—in land, labor, and capital markets. By increasing competition, trade liberalization in Mexico compelled business associations to lobby the government for reforms aimed at reducing regulatory red tape. In Colombia

the greater competitiveness resulting from global integration led employers to become vocal supporters of labor market reforms. In Central and Eastern Europe reformers deliberately used the process of accession to the European Union (EU) to push through regulatory reform, building support for the reform by linking it to the broader goal of joining the EU. That an economy's openness is significantly associated with institutional change is among the main findings of the International Monetary Fund's *World Economic Outlook, September 2005* (IMF 2005). Conversely, the regions that have done the least on the investment climate front (such as South Asia and the Middle East and North Africa) also tend to be those with the highest barriers to trade and foreign direct investment.

3. *New information plays a powerful role in exposing a policy problem, fostering competition between jurisdictions, and creating demand for change.* Generating new and specific information about a policy problem can be an especially important catalyst for contentious reforms involving multiple stakeholders. In land market reforms in China (Shenzhen), Mozambique, Peru, the Russian Federation (Veliky Novgorod), and South Africa (Cape Town), reformers used detailed diagnostic studies to identify problems of access to land and, for the first time, to measure the costs and benefits of tackling it through reform. These studies helped foster debate and overcome interest group opposition. In Vietnam detailed studies exposing the costs of corruption helped develop support to confront the many vested interests opposing reform of the old Company Law. Benchmarking and rankings provide another powerful impetus. The World Bank Group's recent publication of the *Doing Business* country rankings (World Bank 2006), for instance, prompted calls for reform in more than 20 countries. In such countries as India and Mexico, subnational benchmarking is playing a vital role in fostering reform due to increased competition between states.
4. *Crisis and political change provide opportunities to push through bold reforms.* A deep fiscal crisis together with a newly elected gov-

ernment generated the support reformers in the Slovak Republic needed to adopt and carry out tax, labor, and other regulatory reforms far more ambitious than the piecemeal efforts of the past. Financial crisis helped thrust more ambitious regulatory reforms onto the agenda in Hungary in the mid-1990s. Other types of crises also helped propel reform: In Mozambique the resettlement crisis made radical overhaul of the land code possible; in Italy and the Republic of Korea major corruption scandals helped launch regulatory reforms; and in the Netherlands two major safety accidents pushed inspection reform onto the agenda. Strong political support for dealing with these crises made it easier to overcome resistance and gain wide acceptance for reform.

5. *Pilots and other pragmatic steps provide important learning and demonstration effects, and can help get the reform process going.* Reform often comes about from a process of policy learning and experimentation. Pilots, in particular, can help create momentum and provide a testing ground for deeper change, especially when there is uncertainty or strong opposition. Peru and South Africa used pilots to test the technology involved in property registration and valuation, assess the difficulties larger-scale programs would face, and convince politicians that such programs were administratively and politically feasible. China has put pilots at the center of its reform strategy, using special economic zones to test market-oriented policies such as land use rights before extending them nationwide.
6. *Leveraging and empowering supporters through education and dialogue can help mitigate interest group opposition.* Supporters and potential supporters are often taken for granted, but educating and mobilizing them early on helps create coalitions for change and minimize the incentives and ability of narrow interest groups or politicians to obstruct the reform process. Greater discussion may be needed for reforms that will have wide distributional consequences and are likely to involve multiple stakeholder groups. These strategies appeared to be important in both democratic and nondemocratic settings: the shift to market-oriented policies

in China and Vietnam involved greater discussion than is commonly perceived. Yet consultation may have its limits even in democratic settings, especially when reform is resisted by narrow interest groups. Under pressure to change, policymakers pursuing port reform in Colombia and customs reform in Mexico opted for rapid, top-down change, made possible by rampant corruption and inefficiency, broad public support, and a brief political window of opportunity for reform.

7. *Incentives and capacity for implementation can be created by leveraging change management techniques from the private sector.* Technical and administrative constraints—particularly at state and local levels, which carry the burden of implementation—highlight the interdependence of investment climate and public management reforms. Yet these constraints can be overcome without undertaking long-term public sector reform, by leveraging change management techniques from the private sector. To support business registration and capital market reforms, Pakistan transformed an existing government body into a new, high-powered commission, driven largely by leadership and skills brought in from the outside. The new team helped introduce flexible financial and administrative procedures, foster a service culture, and train staff in all the regional offices. Others contracted out implementation directly to the private sector—Jordan the management of ports and airports and Mexico its environmental auditing. Information technology solutions also were instrumental. In customs, business, inspections, and land registration reform, such solutions helped in simplifying procedures and alleviating capacity constraints, but also in removing undue discretionary powers, minimizing corruption, and forcing transparency.
8. *Investment climate reforms, more cross-cutting and continuous than one-off events, call for special efforts to make the reforms permanent, insulate the process from political and bureaucratic interference, and ensure transparency and accountability.* That can mean a need for new functions—providing oversight and advocacy, fostering policy coordination and compliance, and supplying technical

support to local levels. This need led to the creation of new oversight mechanisms—often in the form of dedicated and empowered teams or institutions—in more than 60 percent of our cases. Regulatory reforms in Hungary, Korea, and Mexico, for instance, adapted the oversight mechanisms established in most Organization for Economic Cooperation and Development (OECD) countries, supported by new umbrella laws specifying the standards and processes for reviewing the stock and flow of regulations.

9. *Monitoring should be an integral part of the reform process, not an afterthought.* Monitoring was effective in only a few cases, even among more developed countries. Among the few positive examples were Australia and Latvia, which built in clear performance targets and monitoring agreements at the start. Elsewhere, monitoring was poorly enforced or bore little relation to the underlying objectives of the reform. Monitoring fell short even in higher-capacity countries such as Korea and Hungary, where lack of analytical capabilities and opposition from ministries made the process difficult. In low-capacity countries monitoring proved to be even more difficult, and harder than initiating reform. Yet monitoring is critical—not just to evaluate impacts and outcomes, but also to ensure transparency, provide a feedback loop to adjust course as needed, allow citizens to hold reformers accountable for results, and build support for sustaining reform.
10. *Above all, getting the reform process right is just as important as ensuring sound policy content.* Paying attention to the way in which reforms are initiated and carried out builds the legitimacy, support, and ownership needed to achieve policies and outcomes that are both desirable and sustainable. As the economist Joseph Stiglitz has noted, reform process and in particular “implementation and political sustainability are not sideshows, but the main event in a reform agenda” (Stiglitz 2000, p. 556).

## II. Understanding the Challenges to Reform

Recent analytical work has led to a broad understanding among policymakers and development practitioners that microeconomic reforms aimed at strengthening property rights, unleashing competition, and reducing the cost of doing business are critical in creating a sound investment climate and promoting economic growth (World Bank 2004; World Bank 2005a; Lewis 2004). Also recognized is that these changes need to be credible and sustained for private firms to respond by increasing investment and production.

But there is much less understanding of how to manage these investment climate reforms. Our goal is to contribute to that understanding through an analysis of the literature and the findings of more than 25 recent case studies commissioned by the *World Development Report 2005* team and by the Foreign Investment Advisory Service (FIAS) of the World Bank Group (table 1).<sup>1</sup> The case studies, drawn mostly from developing countries, cover the main broad areas

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1. The *World Development Report* cases can be found on the Web at <http://econ.worldbank.org/wdr/>.

**TABLE 1. Reform case studies**

<b>Product markets</b>	<b>Inspections</b>	<b>Land</b>	<b>Labor</b>	<b>Infrastructure</b>	<b>Customs</b>
Australia	Latvia	China (Shenzhen)	Colombia	Colombia (ports)	Philippines
China (Hangzhou)	Mexico	Mozambique	Poland	India (Mumbai ports)	South Africa
Hungary	Netherlands	Peru	Slovak Republic	Uganda (telecommunications)	
Italy		Russia (Veliky Novgorod)			
Republic of Korea		South Africa (Cape Town)			
Pakistan					
Slovak Republic					
United Kingdom					
Vietnam					

of the investment climate: product markets,<sup>2</sup> land markets, labor markets, and infrastructure. They focus on countries that adopted and implemented a particular investment climate reform with positive results, though many also include negative episodes from which lessons can be learned.<sup>3</sup>

Though reform is a nonlinear dynamic process, for analytical purposes we distinguish between two main stages of reform, each with its own set of challenges and processes:

2. Product market reforms include reform of the policies and institutions governing the way in which products and services are produced and sold. They tend to be industry specific. The main such regulations are those governing: entry (general business registration, industry-specific licensing, and restrictions on foreign direct investment); the import and export of goods (quotas, tariffs, and customs); and production (price regulations, product standards and government certification processes, intellectual property rights, investment incentives, subsidies, and competition policy or agency).
3. Detailed discussion of the reforms and their impacts can be found in the case study reports, cited throughout the paper. Summaries of selected cases are presented in Chapter VI.

- *Initiating and designing reform*—This involves identifying priorities for reform, getting reform onto the agenda, developing reform proposals, and building acceptance for reform.
- *Implementing and sustaining reform*—This involves strengthening the incentives and capacity to implement reform and creating institutional mechanisms to monitor and sustain reform.

We also distinguish between two sets of factors that influence reform processes: contextual factors and those that are within the control of policymakers. A country's political system and culture affect what reformers can achieve.<sup>4</sup> Together they explain a large part of the variation in the outcomes of reform and in its impact on economic performance. But while reformers must take political institutions and the structure of domestic interest groups as given, within this framework—and short of fundamental political reform—they have much scope to design and manage the reform process in ways that get the process going and achieve favorable outcomes. We focus on those factors within the direct control of policymakers, with the goal of highlighting a menu of strategic choices at each stage of the reform process.

## Why Investment Climate Reforms Are Challenging

Macroeconomic reforms are often carried out in times of crisis by a stroke of the pen—achieved by administrative decree and a few key actors. The benefits are usually immediate, visible, and spread across the population, with losers or potential losers often too dispersed or too small in number to be of political importance.<sup>5</sup>

Investment climate reforms are a different matter—and face very different challenges:

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4. The role of political systems in development is an important and much broader topic that is not covered in any great detail in the paper. Fukuyama (2006) discusses in greater detail how different types of political institutions and political culture shape the ability to generate reform decisions and enforce outcomes.
  5. See Krueger (2000) and Navia and Velasco (2002) for more detailed analysis and comparisons of policy reform in macro vs. microeconomic areas. This section draws from their work.

- *Getting the priorities and sequencing right can be technically challenging.* Identifying the right package and sequence of reforms can be a difficult task when reformers face a long list of constraints and possible reforms. The list of possible reforms is indeed long: it is now known that developing countries have to improve the way they regulate capital, labor, land, and product markets; reform their tax and judiciary systems; protect investor and property rights; invest in infrastructure and education; and tackle administrative barriers and deeply rooted governance issues. The challenge is to identify the reforms that will stimulate a quick, strong supply response while laying the groundwork for the next round of essential reforms.
- *The reforms are often politically contentious.* They involve significant transfers of income and opportunity. Moreover, those who lose in the short term tend to be powerful interest groups or politicians capable of blocking reform, while those who gain tend to do so only in the long term and are often too dispersed to matter. Thus while removing barriers to entry, for example, favors new entrants, it may be resisted by incumbents, feeling threatened by the prospect of competition and changes in traditional ways of doing business. The involvement of many players and political institutions also mean much slower and less predictable decision-making processes.
- *The reforms can be institutionally challenging.* Their implementation can be demanding, requiring detailed technical and administrative work and the development of institutional mechanisms for sustaining reforms that tend to be ongoing rather than one-shot events.

So in tackling the investment climate, would-be reformers face many technical, political, and institutional challenges. Key among these challenges:

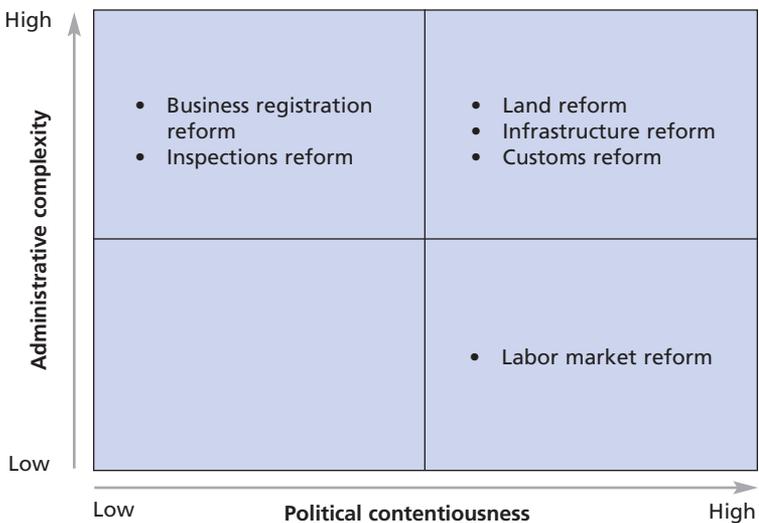
- How to identify and sequence the most important reforms.
- How to overcome opposition from interest groups and get reform onto the policy agenda.

- How to achieve reforms that are both credible and feasible.
- How to mobilize support for reform and mitigate opposition.
- How to create the incentives and capacity for implementation.
- How to create institutional mechanisms to monitor and sustain reform.

### Different Reforms and Country Conditions, Different Challenges

Identifying priorities for reform is a first challenge and a process that is highly country specific (as we discuss in greater detail in the following section). But once priorities are determined, the reform process tends to confront common political and institutional challenges. Not all reforms of the investment climate face these challenges to an equal extent, however. Indeed, there is much variation across different reforms (figure 1) as well as across different country conditions.

**FIGURE 1.** Different reforms, different levels of political and institutional challenge



## Political challenges

The political science literature uses a number of analytical approaches in studying political impediments to reform. Chief among them are: collective action by organized interest groups; the institutional setting in which policy decisions are made; and political competition and incentives for politicians to reform.

### *Interest groups*

Interest groups include political parties and representatives and institutions of the state bureaucracy at the central, state, and local levels. Depending on the area of reform, they also include a range of external actors—private firms, business associations, labor unions, consumer groups, judges, notaries.

Policy preferences and the importance attached to reform vary significantly among these groups, depending on the distribution of the costs and benefits of the reform. Their relative power—the extent to which they are organized and have access to the political process—also varies. Groups likely to lose in the short term, even if small in number, tend to resist reform. They also tend to have greater influence in the process, through “insider” connections or formal ties to decision-makers and political parties, than do the beneficiaries—new entrants and other larger and more diffused groups for whom the benefits tend to materialize only in the medium to long run. Even if there are no clear losers, uncertainty about the consequences of reform can generate suspicion and hostility or weaken the incentives for potential beneficiaries to organize.

Some investment climate reforms face greater challenges from interest groups than others. Reforms that are more technical or administrative, such as business registration or inspections reform, tend to affect few clearly identifiable groups capable of mobilizing against reform and so may be politically less contentious. The main resistance comes from departments and bureaucrats at different levels of government seeking to preserve their roles. Reforms with wider distributional consequences are more likely to provoke a response from interest groups. These groups can have a positive impact when they mobilize support and help get reform onto the agenda. But more

often they act to block reform, seeking to preserve existing benefits. That makes it difficult to obtain support for reform from politicians who benefit from ties to these groups and who are often preoccupied with short-term costs and electoral horizons rather than long-term benefits. Two examples illustrate:

- Labor market reforms often meet resistance from “insiders” such as unions and formal sector workers, who benefit from existing laws and tend to be well organized, compared to new entrants or informal workers who benefit from reform and lack voice. Moreover, labor market reforms may be opaque to ordinary people: voters may not understand or care about their impact and are difficult to mobilize in support of reform. These factors help explain why in Latin America during the 1990s, unions and their parliamentary allies repeatedly stalled legislation to extend the use of fixed-term contracts or to reduce severance payments. While 24 countries in the region liberalized trade and the financial sector, only 6 substantially amended labor laws (Gill, Montenegro, and Domeland 2002, p. 5).
- Land reform is similarly contentious. Most large-scale redistributions of land have taken place only under exceptional circumstances: either under pressure of revolt and revolution or in the aftermath of war and foreign occupation. Even where de facto property rights are recognized, formalizing land titles and creating land registries can run into resistance from interest groups. Notaries and other registry personnel may oppose modernization for fear of losing their jobs or opportunities for bribery. In Peru local public officials resisted land titling reform because they saw it as encroaching on their jurisdiction over urban planning (Endo 2004, p. 19).

### *Institutional setting for decision-making*

A second political challenge is the institutional setting in which policy decisions are made. Reforms which entail fundamental institutional change often require legislation to signal government commitment and limit the scope for deviations or reversals in implementation. And

securing legislative approval often requires the involvement of a wide range of political institutions and “veto players”—typically the executive (president or prime minister), political parties, the legislature, and the judiciary. (Interest groups may have special ties to veto players enabling them to influence these players, but they do not normally exercise veto power directly.) The political science literature suggests that the more veto players there are in a political system, the more credible and stable are its policies—but also the more difficult and time-consuming it is to initiate and pass reform.

One common finding: initiating reform appears to be easier in presidential than in parliamentary systems, but securing approval can be time-consuming. The reason is that presidential systems typically grant the president formal agenda-setting powers, including the right to initiate reform by executive decree. Presidential authority seems to have been important in initiating regulatory reforms in such countries as the Republic of Korea and Mexico.<sup>6</sup> But presidential systems may also be less effective at generating decisions because they have another veto point: unlike in parliamentary systems, the executive and the legislature are independently elected and may be of different political parties. Tensions between the executive and the legislature help explain why, for example, many Latin American countries with presidential systems found it difficult to agree on labor market reforms during the 1990s. In Colombia, labor reform that first appeared on the agenda in 1999 took nearly four years, several working drafts, and two failed attempts to achieve legislative approval in 2002 (we discuss this example in greater detail in Chapter VI below).

### *Political competition and incentives*

A third strand of analysis focuses on the dynamics of political competition and the extent to which it provides incentives for politicians to reform.<sup>7</sup> In democratic countries, elections allow voters to express

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6. As the Organization for Economic Cooperation and Development (OECD 2002, p. 87) puts it, “More so than most parliamentary systems, presidential systems have the capacity for cross-cutting, top-down policy reforms.”

7. This discussion is drawn from Keefer and Khemani (2005), who examine the role of political competition in understanding political incentives for providing public services.

their political opinions and hold politicians accountable for results. But their role may be undermined by political market imperfections. One such imperfection is lack of information, which makes it difficult for voters to judge the performance of individual politicians. Even in developed countries politicians can evade electoral punishment through obfuscation, particularly when they control media outlets, or by spending public money on highly visible but socially worthless projects, or by targeting narrow voter groups at the expense of the majority. These problems are compounded in developing countries, where literacy and press freedoms are generally lower. They are also more pronounced in countries with greater social polarization—where voters may value politicians’ ethnic identity or other attributes over their performance and where politicians make promises to these groups at the expense of wider benefits—and in countries where patronage and clientelistic politics predominate. The lack of competition between political parties and the short time horizon of politicians can be further disincentives to deal with reforms with long-term benefits and payoffs.

These shortcomings help explain why many investment climate reforms are not passed even when they might benefit a majority of citizens and voters. They also help explain the persistence of corruption and other forms of narrow self-interest among elected officials. If politicians know that there is little chance of being held accountable, they have little incentive not to be corrupt. But politicians may be less likely to take the risk if voters are kept informed about the process through which political decisions are made—through decentralization, independent validation and communication of the results of reform, or other means to encourage participation (Keefer and Khemani 2005, p. 22).

### **Institutional challenges**

Investment climate reforms, often ongoing rather than one-shot events, demand technical and institutional capacity to plan, implement, and sustain change. Moreover, their implementation often involves many different departments and levels of government. Inef-

ficient and often corrupt bureaucracies are normally responsible for implementation. And monitoring mechanisms that ensure accountability are often lacking. Overcoming these challenges requires making fundamental and difficult organizational change or creating new institutions with appropriate incentives and capabilities to implement and sustain reform.

These challenges are especially prominent in reforms that are ongoing or cross-cutting—such as regulatory reform aimed at assessing the stock and flow of business regulations or inspections reform cutting across a wide range of inspectorates. Other reforms, such as labor market reform, face a different type of problem: while less institutionally demanding, they often suffer from delays in implementation or lack of policy enforcement.



Technical, political, and institutional challenges can pose important obstacles to investment climate reforms. Yet reformers have great scope to design and manage the reform process in ways that overcome these challenges and make reform possible. As we show in the subsequent chapters, deliberate choices and strategies arise at each stage of the process. A better understanding of these choices can help would-be reformers and development practitioners deal with the challenges and improve the prospects for change.

### III. Initiating and Designing Reform

Identifying priorities for reform and countering resistance from interest groups, politicians, and political parties are often the biggest challenges in the early stages of the reform process. Our case studies suggest that reformers can deal with these challenges by: relying more on new diagnostic tools and practices to identify priorities for reform; seizing windows of opportunity to get reform onto the policy agenda; sequencing and packaging reforms so that they are both credible and feasible; and using a combination of techniques to build coalitions for reform.

#### Identifying Priorities for Reform

Investment climate reforms cover a wide agenda, and no country can tackle everything at once. Establishing priorities is especially important for less developed countries, which tend to face all the possible problems but have the least capacity to tackle them. In the past, choices were based on a standard list of reforms known as the “Washington Consensus” (macroeconomic stabilization, privatization, trade liberalization, protection of property rights). But this approach has not always triggered an adequate supply response. Reformers often tried to do too much at once, and often failed, or started with reforms

that were not of high priority; and, sometimes, reform in one area created unexpected distortions in another, often leading to weak or even adverse effects (Hausmann, Rodrik, and Velasco 2006, p. 12).

Over the past few years, however, the process of identifying priorities for reform has become much more context-specific, and increasingly more targeted. Reformers can make use of a growing body of new analytical tools and information to identify priorities with greater precision, and in a way that helps deliver results and build momentum for more reform. These tools include:

- Surveys of investors that help identify some of the most important issues.
- Detailed benchmarking data, such as those provided by the World Bank Group's Doing Business indicators, which benchmark and rank the cost and quality of business regulations for key cross-cutting investment climate issues.
- Market information on prices and return on investments, which provide important information. For example, high real interest rates indicate that access to finance is a key constraint, while low returns to education suggest that aggregate skills are not, at least for now (Hausmann, Rodrik, and Velasco 2005).
- In-depth industry analyses that can be used to identify industry-specific policy issues, such as entry barriers, undue protection and subsidies, inadequate price and product regulations, and issues relating to government certification and protection of intellectual property rights (Palmeade 2005).

Complementarity between reforms and the role of policy learning also need to be considered. Reforms in one area, such as trade and product markets, may amplify the benefits of reforms in other areas, such as the labor market. Moreover, labor market reforms may allow for the compensation of losers from trade and product market reforms.<sup>8</sup> Synergies in economic impact (for example, reforming land

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8. An analysis and more detailed discussion of reform complementarities, drawing from reform experiences in OECD countries over a five-year period, can be found in the IMF's *World Economic Outlook, April 2004* (IMF 2004).

markets and contract enforcement also improves access to financing) and in political economy (combining trade reforms with social protection can diffuse opposition) also come into play. And reform priorities often emerge through a process of policy learning and experimentation. China is a striking example of a country that designed and sequenced reforms by learning from its own policy experiments and, to some extent, from the experiences of other economies as well (discussed in greater detail on p. 33).

### **Seizing Opportunities to Get Reform onto the Policy Agenda**

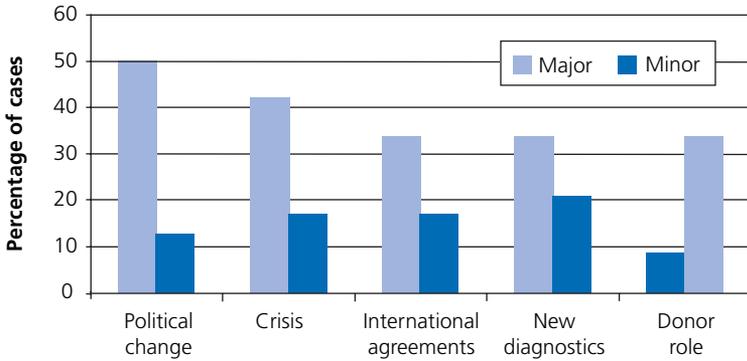
Once the priorities for reform are determined, what makes reform happen? One popular view is that reform is possible only in times of crisis or under a new government, when reformers benefit from strong political and popular support that makes it easier to counter opposition from interest groups. Indeed, our cases suggest that policymakers more often than not use these events to sharpen the focus on a problem and bring it onto the policy agenda. But crisis and political change are not the only factors that make reform possible.

Reformers often take advantage of periods of growth to make hard choices, because public support is high and resources are available to compensate losers. Two other factors also appear to play an important role (figure 2):

- Increasing competition, created by global integration and technological changes more broadly, and by spillovers from other policy initiatives such as trade liberalization or international agreements.
- New information and diagnostics that expose a policy problem and create awareness of the need for reform, as well as new policy ideas generated from past experiences and an ongoing process of learning and diffusion.

Our analysis also suggests that identifying a single cause of reform can be difficult: only a few of our cases highlight just one factor as being important (table 2). More often it is a combination of factors—and players—that helped create a window of opportunity to get

**FIGURE 2.**  
**The main triggers of investment climate reform**



reform onto the agenda. Indeed, in all our cases, *political leaders* played a critical role in recognizing a problem and seizing the brief window of opportunity to get reforms onto the agenda. Moving quickly was seen to be important, given that policy windows remain open only for brief periods, before policymakers feel they have addressed the problem, before events or personnel change, or before interest groups coalesce against reform (see Kingdon 1995 for a detailed discussion of policy windows in the agenda-setting phase of reform).

### Using political change and crisis as catalysts

Political change and crisis are often considered important catalysts for reform. New governments or new political leaders benefit from a “honeymoon” period in which opposition parties and interest groups are less likely to oppose reform and reformers have enough time before new elections to win back the support of groups that might be alienated by reforms. And crisis is seen to help focus attention on policies that are not working, induce legislators and citizens to grant executives greater discretionary authority, and weaken the influence of interest groups opposed to reform (Haggard 2000; Tommasi 2002).

**TABLE 2. Reform triggers**

	New govt./ leadership	Crisis	International agreements	New diagnostics	Donor role
<b>Product market</b>					
Australia	○	○	○	○	○
China (Hangzhou)	○	●	●	○	○
Hungary	●	●	●	○	●
Italy	●	●	●	○	○
Korea, Rep. of	●	●	○	●	●
Mexico	●	●	●	○	○
Pakistan	○	○	○	●	●
Slovak Republic	●	●	●	○	●
United Kingdom	○	○	●	○	○
Vietnam	●	●	●	●	●
<b>Inspections</b>					○
Latvia	●	○	●	●	●
Mexico	○	○	●	●	○
Netherlands	○	●	●	○	○
<b>Land</b>					○
China (Shenzen)	●	○	○	●	○
Mozambique	●	●	○	●	○
Peru	●	○	○	●	○
Russian Federation (Veliky Novgorod)	○	●	○	●	●
South Africa (Cape Town)	○	○	○	●	○
<b>Labor</b>					
Colombia	●	●	○	●	●
Poland	●	●	●	○	●
Slovak Republic	●	●	●	○	●
<b>Infrastructure</b>					
Colombia (ports)	●	○	○	○	○
India (Mumbai ports)	●	○	○	●	○
Uganda (telecoms)	○	○	○	●	○

Note: ● = important role; ● = minor role; ○ = no role.

Indeed, political change played a big part in catalyzing reform in half of our cases. Newly elected governments, especially those that gained political control, used their first year in office to launch or pass difficult and unpopular reforms. In Colombia labor market reforms came onto the agenda in 1999, but it took a new government to get the reforms passed in 2002 amidst a severe unemployment crisis. In office for less than a year, the new government had strong popular support and faced little threat of political defeat. The appointment of a new minister of labor who championed the reforms proved critical. Rapid approval of the new labor code was also aided by the fact that many of the policy proposals had been prepared and widely discussed during two previous attempts in 1999 and 2001 (Echeverry and Santa Maria 2004, p. 30). New governments in Poland and the Slovak Republic also passed difficult labor market reforms well within the first year of taking office, building on preparatory work that had already been done.

In nondemocratic settings, reform came about as a result of new political leadership rather than electoral change. In Vietnam pressure from the domestic private sector for market institutions and clear regulatory rules had been growing since private activity was legalized in 1990. But the turning point came with changes in the country's one-party leadership in 1997. The appointment of a new prime minister, president, and party secretary general led to early public announcement of an action plan to improve the business environment and the subsequent passage of a new Enterprise Law in 1999 (Mallon 2004, p. 15). A similar change in political leadership in China in 1978 initiated the country's vast and sustained program of pro-market microeconomic reforms, including the decision to pilot major land market reforms in Shenzhen in the mid-1980s.

Often coinciding with political change, crisis played a big part in 40 percent of our cases. Fiscal and financial crises were most often the catalyst, leading policymakers to bundle investment climate reforms with a larger package of macroeconomic and structural reforms aimed at addressing the crisis. In the Slovak Republic the 1998 fiscal crisis created the political support the new government needed to pass a comprehensive reform package that included a range of con-

troversial labor, social welfare, and tax reforms (Jurajda and Mather-nova 2004, p. 8). The government also benefited from a relatively homogeneous coalition of four center-right parties and from the relative underdevelopment of trade unions and other groups opposed to reforms. In Korea the 1997 Asian financial crisis enabled the government to move away from a piecemeal approach and adopt a radical deregulation initiative as part of a broader economic recovery program; the reforms called for eliminating 50 percent of business regulations and deepening regulatory reforms that had so far yielded little result (FIAS 2005f, p. 6).

But it was not always a fiscal or financial crisis that provided the impetus. Other types of crisis also helped propel reform onto the agenda: unprecedented levels of unemployment in the case of labor market reforms in Colombia and Poland; big corruption scandals in the case of regulatory reforms in Korea and Italy; and two major safety accidents in the case of inspections reform in the Netherlands.

### **Taking advantage of spillovers from trade and product market reforms**

Growing competition from global integration and rapid technological change is a broad force driving change. But investment climate reforms are also pushed onto the agenda as a result of spillovers from more specific policy initiatives. Trade and product market reforms proved to be a major driver of other reforms in virtually all our case studies. By increasing competition, such reforms helped shift the incentives of incumbents once opposed to reform while creating new constituencies for change. In Mexico, trade liberalization through the North American Free Trade Agreement (NAFTA) induced business associations to lobby the government for reductions in the regulatory burden to help them compete (Salas 2004, p. 6). And in Colombia, greater openness and competition led employers to become vocal supporters of reforms aimed at increasing labor market flexibility (Echeverry and Santa Maria 2004, p. 13). That an economy's openness is significantly associated with institutional change is among the main findings of the IMF's *World Economic Outlook, September 2005*

(box 1). Conversely, the regions that have done the least on the investment climate front (such as South Asia and the Middle East and North Africa) also tend to be those with the highest barriers to trade and foreign direct investment.

Reformers also took advantage of international agreements to build popular support for a broader goal and create the climate for change. Such agreements were a major catalyst for reform in more than a third of our cases. Integration with the European Union, which provides tangible political and economic benefits for member countries, was the main impetus in all the cases in Central and Eastern Europe.<sup>9</sup> In Latvia political consensus in favor of joining the EU, combined with a push from a strong, well-organized private sector, made it easier for the government to adopt regulatory and inspections reform as part of the broader EU harmonization program (Coolidge, Grava, and Putnina 2004, p. 9). To a lesser extent such countries as China and Vietnam leveraged the prospect of joining the World Trade Organization to deepen market reforms aimed at leveling the playing field between the public and private sectors (Mallon 2004, p. 20).

## **Generating new information to create demand for change**

New information about a specific policy problem provides another impetus in creating demand for policy change. In Colombia the 2002 labor market reforms originated in a 1999 study led by a small group of technocrats in the Ministry of Labor supported by private think tanks and academia. By benchmarking regulatory performance against that of neighbors and OECD countries for the first time, the study

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9. The IMF, in its *World Economic Outlook, September 2005* (IMF 2005), notes that external agreements or anchors are more effective in supporting reform when they provide tangible benefits and a credible commitment device, such as the EU, which provides clear political benefits as well as market access, increased foreign direct investment, and a well-defined set of legislation and reforms. Regional trade groups such as NAFTA or the Association of Southeast Asian Nations (ASEAN) are also important but have had more limited success because their requirements are less stringent. While such anchors are not present in other regions, some initiatives offer promising potential for creating anchors in the future, such as the New Partnership for Africa's Development (NEPAD) through its peer review mechanism in Sub-Saharan Africa (see IMF 2005, p. 146).

**BOX 1.****What drives institutional change?**

**T**he International Monetary Fund's *World Economic Outlook, September 2005* (IMF 2005) investigates the main factors driving such institutional transitions as strengthening property rights, lowering corruption, and improving accountability. An econometric analysis based on transitions in some 65 countries uses a probit model linking the probability of transition to several possible explanatory factors. The findings suggest that while a country's institutions are shaped by a combination of history, economic structure, political system, and culture, they are not immutable. A range of factors can help bring about institutional change:

- Trade openness is significantly associated with a greater likelihood of institutional transitions and with greater institutional quality. A move from complete autarky to full liberalization increases the probability of transition by about 15 percentage points. Greater openness allows a greater role for export sectors that are rent-proof and require innovation, creating momentum for positive institutional changes. It also reduces the ability of domestic producers to sustain monopolistic rents, which impede improvements.
- Transitions are also more likely in countries with high levels of press freedom, a broad indicator of political accountability. With the political leadership answerable to a broad cross-section of the population, policies are more likely to be beneficial to the broader economy. Greater accountability is also associated with higher institutional quality.
- Improvements are more likely in countries whose neighbors have higher institutional quality. This is consistent with the view that a strong regional effect exists: transitions are more likely to happen in clusters of countries within a region around the same time, reflecting competition and the demonstration effects of regional success stories.
- By contrast, aid appears to have a negative impact on the probability of transition. This may reflect the fact that countries that receive more aid are also those that suffer from disadvantageous initial conditions that impede change. The empirical evidence on the net effect of aid on institutions is mixed.

Source: IMF 2005, chapter 3.

helped spark a national debate and laid the groundwork for the passage of the new labor law in 2002 (Echeverry and Santa Maria 2004, p. 12). In Vietnam detailed diagnostic studies by the Central Institute for Economic Management, a government think tank, exposed the costs of doing business (including corruption) under the old Company Law. These analyses, providing the first measures of the potential growth and employment gains from reform, were used to counter opposition to the new Enterprise Law from vested interest groups (Mallon 2004, p. 30). In all the cases of land market reform, new information about the costs and benefits of improving access to land among other issues helped focus attention on the problem and build broad consensus for change among a wide group of stakeholders.

International benchmarking indicators and cross-country comparisons are important in identifying priority areas for reform, but they are also valuable tools for fostering competition and promoting reform. The country rankings recently published by the World Bank Group's Doing Business project (World Bank 2006) triggered calls for change in more than 20 countries. Subnational benchmarking can help foster reform by creating competition between jurisdictions, as it is doing in India and Mexico. In these and other cases diffusion of ideas between national and subnational levels has also helped jump-start the reform process. In Mexico federal regulatory reforms helped promote fast-track business start-up programs in several states and more than 20 cities (Salas and Kikeri 2005), while in China policy experimentation with land reforms in Shenzhen municipality led to changes at the national level (see p. 33).

Reform often comes about through the accumulation of "intellectual innovations"—or new policy ideas—and through a dynamic process of policy learning and diffusion of best practices among specialists or by international and other organizations (Orenstein 2000, Stern et al. 2005). Regulatory reforms at the federal level in Mexico were prompted in part by the example of the United States and by advice on best practices from the Organization for Economic Cooperation and Development. In other cases the direct exchange of experience helped convince policymakers of the need for reform. Pakistani reformers learned about capital market reforms through visits to Aus-

tralia and Malaysia, and mainland Chinese officials garnered ideas about land reform on frequent visits to Hong Kong (China).

The spread of new information has been aided by the information revolution of the past decade. The rapid proliferation of the Internet, mobile communications, and other technologies allows reformers and citizens in developing countries to learn what has been tried elsewhere, what has worked, and what has not. Especially in countries with a free press, these new sources of information have helped put pressure on governments to reform; indeed, some analysts have argued that the explosion of information was largely responsible for the spread of market-oriented reforms in Eastern Europe (Kedzie 1997).

### **Securing political leadership**

Getting reforms onto the agenda appears to be a largely top-down process: the policy reform literature suggests that political leaders (heads of government and their political appointees) play a key role in seizing opportunities and promoting reform, drawing on their institutional and organizational powers and their ability to command public attention (Kingdon 1995). But technocrats and policy entrepreneurs, both in the government and outside (think tanks, NGOs, academia), also perform a crucial role in this process, helping to shape and continuously promote reform proposals.

The case studies indeed underscore the importance of political leadership in seizing reform opportunities and getting the process started. In Mexico a powerful president who controlled the party in power was instrumental in launching regulatory reforms in the late 1980s that had been designed and promoted by a small group of technocrats in the Ministry of Economy and Trade. And in Peru presidential support was crucial to getting the second round of land market reforms onto the agenda in the early 1990s, aided by the persistent diagnostic and advocacy efforts of the Institute of Democracy and Liberty. Just as persuasive are the many converse examples from those countries where, despite no shortage of high-quality analysis and proposals, reforms failed to get onto the agenda because of a lack of political leadership.

## Role of donors

Donors did not play an important role in initiating reforms in our cases, though they are often perceived to do so in developing countries. Instead, reform was largely a domestic process driven by local champions. Part of the reason may be that many of the reforms we reviewed took place in the 1990s, when donors focused more on macroeconomic and structural reforms than on microeconomic ones. Investment climate reforms are still relatively new to the agenda, and donors, like policymakers, are on the learning curve.

Where donors were involved, in such countries as Hungary, Latvia, Pakistan, and the Slovak Republic, they focused largely on providing diagnostic support rather than (as in earlier reforms relating to macroeconomic or privatization policy) on imposing conditionality, given the different political and institutional challenges and timeframes of such reforms. Even so, the presence of donors in these cases was seen as strengthening the hand of reformers against their opponents.

## Starting with Reforms That Are Both Credible and Feasible

The accumulation and diffusion of knowledge and perspectives among policy specialists will generate a range of policy options in any area of reform. Which of these options should be considered? Should reformers start with radical options that may have bigger payoffs, or incremental steps that may provide smaller payoffs but are easier to implement? Can pilot and sector-specific programs help iron out technical difficulties and build support through demonstration effects?

Different circumstances may call for different strategies and tactics. Reformers with strong political support (as a result of crisis, a new government, new leadership) may find it easier to “strike while the iron is hot,” embracing faster and bolder reform. But reformers contending with divided politics, strong interest group resistance, and weak capacity may face constraints on the extent of change. In these cases, policy learning through pilots and other pragmatic measures that target specific constraints, build on previous experiences,

encourage the development of constituencies, and are easy to implement can help jump-start the reform process.

Our cases suggest there are simply no hard and fast rules. What matters more is to achieve policy credibility by recognizing and targeting the main policy constraint, adopting a clear strategic direction, and undertaking a steady and sustained process of change.<sup>10</sup>

### **Setting the pace of reform—radical or incremental?**

Agenda change can often be sudden and radical, aimed at signaling a shift in direction and securing political support (Kingdon 1995). But the process of reform tends to be more incremental—though crisis or new governments can create opportunities for more radical shifts.<sup>11</sup> Financial crises in Hungary and Korea for instance provided reformers strong political support to adopt far-reaching regulatory reforms, while the 1998 fiscal crisis did the same in the Slovak Republic. Similarly, in Mozambique the resettlement crisis made possible the complete revision of the Land Law in 1995, designed to eliminate the most important distortions and demonstrate credible government commitment to land reform (Tanner 2002, p. 15).

But radical change, while it may be desirable, may not always be feasible, especially in systems with many checks and balances, fragile coalition governments, strong interest group opposition, or weak implementation capacity. In circumstances such as these, the process of reform tends to be more incremental. Reform may start by adopting the easier measures first—to demonstrate feasibility, achieve initial successes, and develop the constituencies and capacity for deeper changes over time. Vietnam's enterprise reforms in 2000, for instance, began by simplifying business start-up procedures. That helped

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10. Klein and Hadjimichael (2003) discuss in greater length the issue of policy credibility and what it takes to achieve it; see in particular their chapter 7 on policy and the country context for reform.

11. On a slightly different but related note, an analysis of growth accelerations by Rodrik (2004b) suggests that the vast majority of growth takeoffs is not produced by significant or comprehensive radical reforms, and that the vast majority of significant reforms do not produce growth takeoffs. The paper highlights the problems with the “do as much as you can, as quickly as you can” approach (pp. 6–7).

expand the private sector and create a constituency for the more difficult licensing reforms, which then enabled reformers to offset resistance from line ministries and provincial authorities (Mallon 2004, p. 26). Peru's land market reforms began with the politically easier titling measures. These led to quick, tangible gains, helping create support and capacity for the more difficult and longer-term program to formalize property (Endo 2004, p. 10). And Mexico's deregulation unit started its ambitious program to reduce red tape by reviewing the regulations of simpler, more cooperative line ministries. In this way it slowly built experience and credibility to tackle the more complex ministries (Salas 2004, p. 16).

Incremental or partial reforms can be risky, however: if they produce no effects or even adverse effects, they can undermine the credibility of the entire reform effort. Before adopting a bold land reform program, Mozambique first took an incremental approach; Korea and the Slovak Republic did the same in regulatory reform. In these cases the incremental reforms were unsuccessful—and costly to taxpayers. Similarly, piecemeal inspections reforms in the Philippines and the Russian Federation were no more than short-term palliatives, and they quickly became subject to backtracking and reversals (Coolidge 2006).

Moreover, short-term winners from partial reform may act to preserve their gains by blocking further reform. A study of partial reform in the early stages of post-communist transitions shows that financial-industrial conglomerates that gained from privatization used their power to block new market entry, while new “entrepreneurs cum mafiosi” undermined efforts to establish a viable legal system to support the market economy (Hellman 1998). The study suggests that the success of partial reform depends on both creating winners and “constraining” them. Winners can be constrained by increasing political competition and expanding political participation to include short-term losers and a wider range of constituencies in policymaking. In this case post-communist states with greater political participation and competition were able to adopt and sustain more comprehensive reforms than those largely insulated from mass politics and electoral pressures.

Identifying the most important constraints at the beginning of the process is one way to minimize these risks and achieve credibility. Another is through the use of targeted, pragmatic interventions that seize opportunities for reform but are also politically and technically feasible.<sup>12</sup> Pilots and sector-specific approaches are among such interventions.

### **Using pilots and sector-specific reforms as learning and demonstration tools**

When reform faces technical and political challenges, pilot programs can help by providing learning and demonstration effects. In China, where pilots have been at the center of the reform strategy, states and provinces have often functioned as “laboratories of reform,” with policy experiments in one location feeding into the agenda-setting process for others (box 2). In Jordan, customs reform was first developed and tested in the Aqaba special economic zone before being rolled out to the rest of the country. In Peru, land reforms began with a series of pilot projects in the early 1990s that provided useful learning about constraints and effectiveness for the nationwide program (Endo 2004, p. 14). And in South Africa, the property valuation approach using market assessments was applied to the entire country in 2004 (with Parliament’s adoption of the National Property Tax Act) only after being piloted by Cape Town in 2000 (FIAS 2005h, p. 6).

Identifying and supporting sectors with high growth potential are another way to get reform started, as suggested by recent work outside of our case studies. In the Dominican Republic, for example, tourism and the *maquila* sector (the assembly of imported parts for re-export) were the main drivers of growth. Like the rest of the economy, they faced problems relating to infrastructure, security, and trade protectionism. But rather than tackle these difficult problems across the economy, the government insulated these two sectors and provided targeted solutions, improving security and infrastructure

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12. The term *strategic incrementalism* has been used to describe this approach. See World Bank (2005b), pp. 301–02.

around the main tourist areas and giving the *maquila* sector special trade policy treatment (Hausmann, Rodrik, and Velasco 2006, p. 15).

Pilots or sector-specific experiments can be important catalysts for nationwide reform rather than enclaves, provided they are properly designed. Reformers need to design these initiatives from the outset to be replicable elsewhere. They also need to tackle institutional and other constraints to the expansion of reforms beyond the pilot areas. And they need to keep their attention focused on the pilot throughout the process—from design through implementation and monitoring—to learn the lessons offered for broader reforms. Most importantly, while pilot and sector-specific approaches help elicit information about what works, they also require willingness and clear criteria or mechanisms for cutting off failures before they become too costly.

## **Building Coalitions to Support Reform**

Reform is most likely to succeed in a supportive political climate. Creating such a climate can be a central challenge of the reform process. It requires understanding the attitudes and influence of different stakeholder groups. It also requires the painstaking process of building coalitions for reform. And that requires strategies to leverage and mobilize supporters, both powerful and not so powerful, while diffusing resistance, especially from influential interest groups (figure 3).

## **Leveraging and empowering supporters**

Supporters or potential supporters of reform (A and B in figure 3) are often overlooked or taken for granted. But mobilizing them can help increase the strength or density of support for reform, which in turn helps weaken the opposition and influence of interest groups.

### ***Creating champions of reform***

Strong and influential proponents of reform can be easily identified and mobilized to become champions for reform. In Mexico the small, empowered group of technocrats leading the first deregulation unit

**BOX 2.****Special economic zones as the laboratories for China's land reforms**

In China special economic zones served as the laboratories for developing nationwide land reforms in the 1980s. The experiments with land started with the establishment of the Shenzhen special economic zone. When foreign firms started to invest in Shenzhen under China's "open door" policy, demand for land grew rapidly. Because the existing legal framework did not allow the transfer of land, the local government tested transfers of land use rights by allowing the allocation of state-owned land to serve as local firms' contributions to foreign joint ventures. Prompted by continued growth in demand and by learning from Hong Kong (China), the provincial government took the experiment further: in 1981 it issued regulations allowing the transfer of land use rights to investors and establishing fee standards for land use. By separating land use from land ownership rights, the new policy allowed foreign investors for the first time to lease land for a given period, with up-front fees for use rights. It also increased revenues for the provincial government and preserved its land ownership.

The experiment continued. In 1987 the provincial government declared the end of the old free land use policy, and the Shenzhen municipality conducted the first sale of land use rights to a local public company. And in 1988 provincial ordinances officially recognized that land use rights could be transferred, assigned, or mortgaged. The successful experiment in Shenzhen led to a national constitutional amendment allowing transfers of land use rights (leases) "in accordance with the law"—the critical step that permitted land market reforms to spread to the rest of the country.

*Source:* FIAS case study of reform in Shenzhen, China, forthcoming.

(UDE) became a major lobbying force for later transforming it into a commission backed by law (Cofemer). UDE and Cofemer in turn leveraged the support and influence of major industrial players and other private organizations by giving them a seat on the board of the Deregulation Council.

Other reformers created small, independent teams as the focal point for challenging the status quo and promoting reform—usually

**FIGURE 3.**  
**Strategies for managing different sets of stakeholders**



an interministerial commission, a special task force, or a working group reporting to top political leaders and comprising a mix of reform-minded technocrats and external experts. In Korea a group of presidential advisers chosen from outside the traditional bureaucracy championed the 1998 regulatory reforms (FIAS 2005f, p. 16). In Hungary a small, ad hoc task force in the Ministry of Finance closely linked to the prime minister's office led the 1994 regulatory reforms (FIAS 2005e, p. 24). And in the Slovak Republic a small team of advisers to the deputy prime minister for economic affairs—mostly trained overseas nationals lured back by the prospect of EU membership—worked to champion reform (Jurajda and Matheronova 2004, p. 19).

### *Informing and educating the public*

Mobilizing less influential groups and the public at large poses a bigger challenge. Many investment climate reforms are opaque or even an object of suspicion to voters. Negative public opinion can impede or even prevent reform. But policymakers fear that educating the public takes too much time and that publicizing bad economic situations can risk making the problems worse. Reformers also are reluctant to undertake public education programs because they lack information about the programs' benefits (Drazen and Isard 2004).

Yet public communication programs can help allay public fears, persuade citizens that change is in the national interest, and build broad public pressure for reform—making it harder for individual politicians and interest groups to resist change. Public education is especially important in new or controversial reforms that are not widely understood. To reduce opposition to land reform from municipalities, Peru's government mobilized support from informal urban settlers, the main beneficiaries, business associations and political parties by sharing information about the reform and its objectives and holding public hearings and debates in communities (Endo 2004, p. 20). Other reformers built support by linking new reforms to broader goals that already enjoyed wide support. Korea, for example, framed regulatory reforms as an anticorruption campaign. Vietnam linked enterprise reforms directly to employment growth. And in Cape Town, South Africa, reformers tied property tax reforms to “common equity objectives,” which secured support for a potentially divisive reform on the eve of local elections.

### *Encouraging public participation*

Going further, reformers can empower potential supporters by seeking their active participation in the reform process. In Hungary the commissioner for public administration, responsible for deregulation, organized conferences and technical workshops throughout the country and invited citizens and public employees to submit deregulation proposals, promising a monetary prize for the best one (FIAS 2005e, p. 30). In Korea reformers solicited inputs on a wide range of regulatory policy initiatives from NGOs and broad coalitions such as

the Citizens' Coalition for Better Government (FIAS 2005f, p. 12). And in Vietnam the government distributed drafts of the Enterprise Law to mass organizations and the public at large for comments and feedback (Mallon 2004, p. 36). These efforts helped foster national dialogue and generate public support—and provided a valuable citizen feedback loop in the reform process.

### **Diffusing opposition**

Diffusing resistance from opponents of reform (C and D in figure 3), particularly influential individuals or interest groups (D), is part of the process. Leveraging and empowering supporters and potential supporters are critical in this regard, but dialogue and compensation also have a part to play.

#### ***Establishing a process for dialogue and consultation***

In the early stages of reform, public education and persuasion can generate “buy-in” for reform. Some reforms may also require narrower and more structured dialogue with the private sector and other stakeholder groups on concrete policy alternatives. Consultation is particularly important for policies that will have wide distributional consequences and are likely to impact multiple stakeholder groups. In such reforms, failing to consult can lead to missed opportunities for “discovery” or the vital exchange of information that can inform policymaking.<sup>13</sup> It can also create suspicion and defer resistance to a later stage, as it did in Korea and Mexico, where the failure to build a sufficiently broad base of stakeholder support at an early stage hampered implementation of regulatory reforms (for more on this, see the section on creating oversight mechanisms). Moreover, dialogue and consultation can help make the outcome more credible, even at the expense of delays and compromise. And they can provide an incen-

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13. Rodrik (2004a) argues that industrial policy is like a “discovery process” (p. 3), where firms and the government through an institutional process of dialogue are able to exchange information about the underlying costs and opportunities and engage in strategic coordination.

tive for interest groups to participate in positive ways while weakening their ability to directly influence government.

Consultation proved to be important in both democratic and non-democratic settings, though the extent of it differed from case to case depending on the type of reform and initial circumstances. Several rounds of discussion among multiple players were needed to reach compromise and smooth the way for politically laden labor market reforms in Colombia (box 3) and Poland. Discussion also played an important part in countries commonly perceived as having top-down government with limited opportunities for public participation. In Vietnam reformers secured approval of the Enterprise Law through a formal process of public-private dialogue on various drafts with private sector groups and associations. The process also helped create a framework for discussions with members of the National Assembly, the legal establishment, and grassroots organizations (Mallon 2004). Similarly, in China the government of Hangzhou municipality set up a “hearing system” to elicit feedback from external experts, business groups, and the public on proposals to change the investment approval system. By doing so, the government refined its proposals and built broad support that helped weaken the resistance of line agencies (Yufei, Lei, and Yu 2004).

The process of consulting with multiple groups can be difficult and confrontational, requiring a delicate balance between achieving *political compromise* and *meaningful policies* that do not jeopardize the benefits of reform. Our cases showed that the process requires support and commitment from the top political leadership. But it also requires the support of technocrats, and sometimes external moderators, to focus on the policy issues, maintain continuity and political neutrality, and ensure accountability and legitimacy of the process. In Vietnam leaders from the Central Institute for Economic Management and the Viet Nam Chamber of Commerce and Industry—the central institutional players in the process—played key roles in engaging with policymakers, business, and the media. In Latvia technocratic staff at the Latvian Development Agency and Bureau of Public Administration Reform supported and sustained the process throughout. And in Peru the involvement of the Institute of Liberty and Democ-

**BOX 3.****How consultation helped pave the way for labor market reforms in Colombia**

Colombia's far-reaching labor reforms, passed in 2002, were, from the outset, deeply political and generated intense opposition from strong and powerful interest groups. Formal sector workers with the most to lose were vocal and active in their opposition through strikes and other means. Fierce opposition also emerged from other organized players who derived substantial benefits from the status quo: unions of the large public and private agencies that administered "parafiscal" taxes and services (a key non-wage labor cost imposed on employers to finance social welfare programs for the general population, amounting to 8 percent of payroll), which together managed about \$750 million per year and employed nearly 25,000 people throughout Colombia; unionized blue-collar workers who directly benefited from the social services; and members of congress, mayors, state governors, and other career politicians who used the agencies for patronage and other political purposes. These groups also mobilized other more powerful groups not directly affected by the reforms but with considerable disrupting power, including the teachers' union, university students, and pensioners. Meanwhile, the main beneficiaries of reform, the unemployed and informal workers, were too dispersed and too weak to lobby for reform.

Managing the opposition required efforts to slowly build consensus through stakeholder discussions. The government established a "discussion table" in 2000 with representatives from the most important groups—government, the main labor unions, key business federations, the main political parties, and academia. Their wide-ranging views made initial discussions of the reform contentious and confrontational. Agreeing on a diagnosis and

*continued*

racy was perceived as having made the process objective, fair, and transparent.

At the same time, consultation may have its limits in difficult reforms facing intense opposition from narrow interest groups. In such cases policymakers have often confronted opponents, fearing that consultation can be counterproductive because it gives too much

**Box 3—continued**

solution proved challenging. To make the case for reform, the reform team presented the underlying economic analysis and empirical evidence. But selling the story proved difficult: Interest groups rejected the evidence, questioned the underlying model, and successfully stigmatized the reforms as leading to unemployment and a reduction in income. Despite the difficulties, the continuity and conviction of a core group of technocrats proved crucial in keeping the discussions going.

The consultation process not only helped build awareness. It also exposed key players to reform ideas, and helped reach compromise on a set of proposals that were politically feasible and allowed for quick congressional approval. While many of the original proposals remained intact, bargains were reached on two of the most controversial elements of the reform package. First, the payment of parafiscal taxes was made more flexible rather than reduced, as originally proposed and defeated in an earlier attempt in 2001. With some restrictions, the law exempted payment of such taxes for new blue-collar workers for a maximum of four years, and for students under 25 years of age working part-time. And second, while the 2001 bill contained a provision for deepening the “salario integral,” an instrument that allows employers to hire workers under a contract that does not oblige them to pay certain non-wage costs, the 2002 package of reforms was passed without this provision. While the reform package did not include any direct provisions to compensate losers, it included a host of broader social protection measures, including the contemplation of an unemployment insurance scheme, the strengthening of public pension and health programs, and the creation of a microcredit program for small enterprises. The main lesson from Colombia’s experience: It can take years of slowly “selling” a reform until an initiative actually gains momentum and is passed.

Source: Echeverry and Santa Maria 2004.

influence to specific groups, takes too much time and delays reform, or leads to minimal reform proposals. For these reasons, port reform in Colombia and customs reform in Mexico were both largely top-down affairs: rampant corruption and inefficiency, broad public support for change, and a brief window of opportunity led reformers to proceed with little input from stakeholders.

### *Compensating losers*

A few investment climate reforms, such as infrastructure reform, can involve clear groups of losers—for example, state enterprise workers with high job security and generous pay and benefits. In these cases mitigating opposition may require directly compensating such groups. The port reform in Colombia for instance included generous severance packages to minimize opposition from workers, while telecommunications reform in Uganda was accompanied by a package of guarantees and new pension benefits for workers transferring to the privatized entity. Direct compensation programs may raise concern that payments are being captured by politically powerful groups, but such concerns can be minimized by demonstrating the net benefits from the reform for society as a whole. The programs also can entail high up-front costs and can backfire if not carefully managed. In Colombia, the severance program helped mitigate opposition but also became a problematic part of the reform program, creating favorable conditions for corruption and fraud in its administration, which eventually led to the imprisonment of corrupt officials (Navarrete 2004).

Most other investment climate reforms have little or no immediate and direct impact on a clearly identifiable group of losers who feel sufficiently threatened or are sufficiently organized to object. In some product market reforms (such as opening sectors to competition, reforming business registration, and reducing red tape), those who stand to lose are firms exposed to the normal risks of doing business, individuals or bureaucratic groups engaged in corruption, or local politicians wanting to retain local authority functions. While these groups may resist reform, they pose a smaller political challenge and so are usually not directly compensated. Moreover, uncertainties about who will lose, who will gain, and by how much together make direct compensation difficult.

Many investment climate reforms therefore involve indirect forms of compensation, often through political or economic concessions in the design of the reform or through policies to offset its effect. Unions in Poland became more inclined to support the 2002 labor reforms when they could make a “deal” protecting their position

against the rise of new unions: measures aimed at promoting labor market flexibility were accompanied by restrictions on dismissals for members of the three main trade unions. Also important: the costs of reform were not concentrated in any one group, and policymakers were able to convince the public that short-term benefits for employers would translate into better jobs for all. Similarly, in Colombia, combining the 2002 labor market reforms with a broad package of social protection measures (including pension and health programs) made it possible to reduce hiring and firing restrictions while meeting union concerns about the lack of social safety nets.



Once policymakers have identified the priorities for reform, gotten reform onto the policy agenda, developed credible and feasible proposals, and built coalitions to support the reform, they need to move on to the next stage: implementing the reform and sustaining it over time. That raises an entirely new set of challenges.



## IV. Implementing and Sustaining Reform

Implementing and sustaining investment climate reforms is a critical part of the reform cycle. Yet this stage is often neglected. And it is at this stage that reform most commonly fails, for three main reasons. First, reforms tend to become overly personalized. Policy initiatives that depend heavily on a few key individuals often collapse once these individuals move on or are replaced. Second, investment climate reforms typically cut across different agencies and levels of government and, as a result, lack oversight and coordination. Third, the lower-level organizations and officials responsible for implementing the reforms tend to have interests and objectives that differ from those of the policymakers who designed them. Local governments and civil servants often revert to old practices, once the political pressure for change has subsided. And they often have only weak capacity to carry out reform.

How can these institutional challenges be addressed? Key among the measures:

- Strengthening the incentives and capacity of the national and local officials and agencies responsible for implementing new regulations.

- Creating institutional mechanisms to provide oversight and sustain reform.
- Paying close attention to measuring and monitoring results, an important but neglected aspect of the reform process in all of our cases.

## **Strengthening Incentives and Capacity**

Reforms typically confront technical and administrative constraints at all levels of government, but especially at state and local levels, which carry the burden of implementation. This is also the stage where bureaucratic power typically exerts itself. These constraints are symptomatic of a need for broader public reform, even in relatively well-developed countries. Indeed, many of our cases highlight the interdependence of investment climate and public management reforms. Yet they also point to ways to overcome incentive and capacity constraints short of waiting for fundamental, long-term public sector reform—by using change management techniques from the private sector.

### **Bringing in new leadership and reform teams**

Implementing reform may require new leadership, as existing managers often find it difficult to reinvent themselves, are defensive about proposed changes, or suffer from a lack of credibility with stakeholders. Replacing obstructive officials in positions of influence with more reform-minded individuals helped smooth the way for regulatory reform in Hungary and the Slovak Republic. Bringing in new leadership and expertise from the private sector also proved to be a critical first step in reforming business registration and capital markets in Pakistan, and contributed to the success of customs reform in South Africa.

Developing small reform teams with staff recruited on a meritocratic basis is another way to bring in the expertise needed to implement reform. Including the core group of technocrats who helped

design the reforms in the first place helps ensure a sense of ownership and continuity, and can enable the process to persist despite changes in the political landscape. In Colombia the core team involved in formulating the 2002 labor market reforms later joined the ministry charged with implementing them. In Mozambique and Peru the small technical teams that designed land reforms continued to facilitate dialogue and implementation. And in Latvia the involvement of the core group of technocrats at the Latvian Development Agency and Bureau of Public Administration Reform allowed implementation to outlast several changes of government.

### **Revitalizing institutions**

Creating the right incentives and capacity in several cases required transforming the implementing agencies into new, more service-oriented ones. Pakistan converted the government body responsible for business registration into the Securities and Exchange Commission of Pakistan, a higher-powered, semiautonomous agency backed by a legislative act (box 4). South Africa combined the Customs and Excise and Inland Revenue Departments to form the South Africa Revenue Service. As a semiautonomous agency, the new entity has the authority to set its own human resource policies, establish competitive pay packages, acquire and dispose of property, and impose fees or charges for its services (FIAS 2005j, p. 9). In both cases fresh resources from outside helped bolster the commitment and quality of the existing staff.

In a few cases governments created new implementing agencies to bypass existing agencies that were considered difficult to change. In Peru, where corruption and resistance from bureaucrats and notaries prevented reform of the national land registry in the early 1990s, the government created a new, parallel agency (Cofopri) in 1996 to register informal property and develop the national formalization program. The goal was to shift responsibility for property registration from the municipalities, which had been resisting reform, to a central jurisdiction with decision-making power (Endo 2004, pp. 11–13). Cofopri became an executive branch semiautonomous agency chaired by a minister of state, reporting directly to the president.

**BOX 4.****Transforming organizational culture to support reform in Pakistan**

**C**reated by law in 1998 to implement the Companies Ordinance, the Securities and Exchange Commission of Pakistan (SECP) has been markedly successful—largely thanks to a radical overhaul of organizational culture. In a difficult and unprecedented step, it dismissed (with paid salaries) 80 of the 380 staff it inherited from the old Corporate Law Authority (CLA). That provoked fierce resistance and legal challenges, but most of the 80 have since found other civil service posts. The 300 remaining employees were given a choice: continue as civil servants with their job security assured regardless of performance, or become employees of the SECP. Becoming an employee would approximately double their pay and benefits, but it would also expose them to the risk of being made redundant if not deemed up to the job—and force them to compete for promotions purely on merit. All but one accepted the new terms of employment. The SECP supplemented these staff with 40 international and domestic experts, a group that brought along outside standards of service and integrity and became the driving force behind the cultural change. Unlike the CLA, where cases tended to be referred up a bureaucratic structure, the SECP encouraged employees to take responsibility for making decisions. It emphasized staff training, both in Pakistan and at regulatory bodies in other countries. And it set up a vigilance cell in the chairman's office to deal with complaints, within a year practically stamping out the staff corruption that had been entrenched in the CLA. Another critical step was the creation of a supervisory policy board to serve as a conduit between the government and the SECP. This proved crucial in overcoming the government's resistance to relinquishing the powers it had exercised through the CLA.

*Source: Khan 2004.*

**Creating performance targets and incentives**

Aligning managerial incentives with reform objectives is important. One way to achieve this is by translating these objectives into specific performance targets or indicators that can then be independently monitored (monitoring aspects are discussed in greater detail in the section below). Examples include output measures (e.g., the number

of land titles secured), input efficiency ratios (e.g., the number of companies registered per staff in the business registry), softer process measures (e.g., the incidence of employee and investor complaints), and outcome measures (e.g., a reduction in the incidence of workplace fires). In Korea, for example, President Kim Dae Jung's call for a 50 percent reduction in government red tape proved a useful goal for implementing regulatory reforms.<sup>14</sup> Similar targets were set in Australia, Hungary and the Netherlands, while EU accession requirements provided a clear set of targets for prospective member states in the Central and Eastern European cases.

Performance incentives help attract and retain skills and foster compliance. Peru's new land management agency introduced productivity-based promotions to provide incentives for staff, while South Africa's new Revenue Service established competitive pay scales and performance bonuses that helped attract qualified and motivated customs officers (FIAS 2005j, p. 9). But these examples are among the few exceptions. More often, established civil service procedures make it difficult to implement performance incentives. In Mexico sanctions for poor performers were developed but never used. In the Philippines civil service constraints made it impossible for the customs reform to address organizational and human resource issues, and as a result reforms were consistently undermined by customs personnel and other special interest groups (FIAS 2005a, p. 1). When modifying civil service rules is difficult, other mechanisms can be considered. Hangzhou municipality in China used public recognition of managers as a motivating tool. It also tried to attract younger and better-educated employees and create a service culture that placed a higher value on experts and technical staff (Yufei, Lei, and Yu 2004).

Training can help improve performance incentives by raising skills and increasing job satisfaction. In Latvia training for inspectorates was an integral part of the reform, with trained inspectors given a business advisory role in addition to their traditional roles. In South Africa, Cape Town's property tax reform program involved a major push to train data collectors and mass appraisal modelers, thus helping

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14. FIAS 2005f, p. 24

create a conducive work environment and team commitment to the project's success (FIAS 2005h, p. 5). Yet training is often not provided or not pursued seriously enough. In Hungary and Korea insufficient training at provincial and local levels led to slower implementation than planned (FIAS 2005f, p. 25).

### **Contracting out to the private sector**

When it comes to implementing certain reforms, the private sector often has greater expertise and capability than the public sector. The Jordanian and Mexican governments both took advantage of private sector strengths—the Jordanian government by contracting out port and airport management and the Mexican government by contracting out environmental auditing as part of its inspections reform. In both cases the initial results are promising. The challenge in these cases is to align the short-term incentives of private contractors with the longer-term objectives of the government institution responsible for implementation, and to build up the government's capacity to oversee and support private contractors.

### **Harnessing information technology**

Information technology is transforming the dynamics of the implementation process and can be a potent tool for sustaining change. Pakistan automated and electronically linked all its major business registries. Vietnam introduced business registration by Internet. And Mexico introduced electronic systems to help simplify environmental and customs inspections. All these information technology solutions helped simplify procedures, provide access to information (such as on laws, regulations, and procedures), and inform the public about its rights and about how to participate in the process. They also helped remove discretionary powers, improve transparency and accountability, and facilitate monitoring. Moreover, information technology solutions can be easy to replicate and scale up; in Jordan the customs system initially developed for Aqaba is now being used throughout the country. The effectiveness of these solutions depended in large

part on simplifying the underlying processes and integrating them into broader change management efforts.

## Creating Oversight Mechanisms to Sustain Reform

Many investment climate reforms are ongoing and cross-cutting, involving many different departments and levels of government. Sustaining reforms can therefore demand special efforts to make the reforms permanent, insulate the process from political and bureaucratic interference, and ensure transparency and accountability. That can entail a new set of functions, including providing continuous oversight and advocacy, fostering policy coordination and compliance, supplying technical support to local levels, and monitoring results.

The need for such new functions led to the creation of oversight mechanisms in 60 percent of our cases, largely in cross-cutting regulatory and inspections reforms and in infrastructure reforms (to regulate sectoral policies and tariffs). Among the oversight mechanisms put into place to guide and sustain reform, the most common were independent commissions, followed by interministerial coordinating committees and by new units created in an existing government department (table 3).

Oversight mechanisms varied by type of reform in their detailed structure and mandate, but they had common features aimed at ensuring independence from traditional insiders (such as political groups or business lobbies) and maintaining accountability. Key among these features:

- *Credible mandates and objectives backed by legislation* to signal government commitment, limit the scope for deviations or reversals by line agencies, and define the broad principles and guidelines surrounding the policy change. Reforming countries passed new “enabling” or umbrella laws that were difficult to argue against and not specific enough to provoke opposition from interest groups. In Korea the passage of a new Basic Administrative Law in 1996 gave special powers to the new Regulatory Reform Commission, making it more difficult for line ministries to resist

**TABLE 3. Oversight mechanisms for reform**

Area of reform and country	Oversight mechanism		Implementing agency		
	New unit in existing department	New commission	Inter-ministerial committee	New commission or unit	Existing agency
<b>Product market</b>					
Australia		✓		✓	
Hungary		✓			✓
Italy	✓				✓
Korea, Rep. of		✓			✓
Mexico		✓			✓
Pakistan		✓		✓	
United Kingdom	✓				✓
Vietnam			✓		✓
<b>Inspections</b>					
Latvia			✓		✓
Netherlands		✓			✓
<b>Land</b>					
Peru		✓		✓	
Russian Federation (Veliky Novgorod)			✓		✓
<b>Infrastructure</b>					
Colombia (ports)		✓		✓	
India (Mumbai ports)		✓			✓
Uganda (telecoms)		✓		✓	

reform. Most OECD countries have adopted similar laws to support specialized, independent units involved in reforming business regulations.

- *Participation of a wide range of stakeholders* to contribute knowledge, experience, and ideas, and to ensure transparency, minimize the risk of capture, and pressure reluctant line agencies to reform. The United Kingdom's Better Regulation Task Force drew its members from a range of backgrounds—including business, labor unions, and consumer groups—all appointed by the prime minister and charged with advising the government on the consistency of and compliance with new legislation (FIAS 2005d). Similarly, Mexico's Deregulation Council, created in 1995, brought together representatives from the government, the private sector, labor, academia, and other interest groups, such as agricultural organizations.
- *Development of transparency and accountability mechanisms* to ensure full public disclosure of the regulatory process through the Internet. In most cases reformers publicly disseminated draft proposals and regulatory impact assessments to allow feedback from consumers and expose reluctant agencies—often a sharp break from past practices of showing drafts only to selected interest groups. Such practices were designed to ensure that reform did not benefit favored groups over others. The oversight institutions themselves were held accountable by the participation of a wide range of stakeholders in their governing councils.
- *Greater integration with finance and planning authorities* to help provide incentives for compliance. In Korea a reform team was set up in the office of the prime minister to support the Regulatory Reform Commission, but without budgetary threats the group had little leverage over reluctant line ministries (FIAS 2005f, p. 21). Similarly, in Mexico, Cofemer's location in the secretariat of economy rather than finance made it harder for the commission to exert its powers because of the secretariat's narrow scope and its inability to provide consistent oversight and to assess the budgetary impact of proposed measures (Salas and Kikeri 2005, p. 4).

Obtaining political backing and building broader ownership proved to be just as critical in implementing reform as in initiating it.

Oversight agencies need political backing to do battle with the many vested interest groups opposing change, exercise leverage over line ministries and local governments, and ensure compliance. But sustaining political interest proved to be a challenge, especially under changing political circumstances. In Mexico presidential support was critical to the ability of the first deregulation agency (UDE) to remove price controls, repeal entry barriers, and simplify cumbersome commercial court procedures. But elections in 2000 fragmented Congress and weakened the president, making it harder for the new commission (Cofemer) to use its powers with line ministries, despite its new legal backing. In 2003, for example, Cofemer waived its right to issue an opinion on regulatory proposals for the underperforming telecommunications sector (Salas and Kikeri 2005, p. 4). A large part of the problem also stemmed from the fact that policymakers had worked only with the most senior public administration officials, leaving most of the bureaucracy feeling alienated from the reform effort. Korea's regulatory reforms similarly suffered as political support deteriorated, allowing different government departments to pull in different directions and resulting in piecemeal change (FIAS 2005f).

## Improving Monitoring

Measuring and monitoring results, though an essential part of the reform process, is often overlooked or not systematically followed up on. This function involves several tasks: evaluating the potential costs and benefits of the reform, translating reform objectives into specific performance targets or indicators (as discussed above) that can then be monitored, and reviewing compliance and outcomes once implementation begins.

In only a few cases was monitoring effective. Australia was the most positive example. The Australian program included monitoring agreements from the start, setting out quantitative targets, and requiring state governments to submit annual reports to the National Competition Commission detailing progress made and difficulties encountered. Latvia introduced “report card”-type surveys to moni-

tor inspections reform (box 5). Measuring initial conditions made it possible to later benchmark the progress of reform against target indicators.

#### BOX 5.

### Monitoring and evaluation helping to build trust in Latvia

In 1999, early in the process of EU accession, the new government of Latvia identified removing administrative barriers to investment as a priority for reform. It made inspections reform a critical part of this, prompted by complaints from business about burdensome, arbitrary, and harassing behavior by government inspectors. The government issued a new “instruction” aimed at improving transparency and accountability in all inspectorates, created an Inspections Coordination Council, and initiated training in a new “client orientation” for inspectors.

In 2001 the government was eager to evaluate its reform program. Earlier, progress had been assessed through focus groups and anecdotal evidence. Now the government wanted a stronger statistical basis to monitor progress and to determine which reforms were working as intended and which were off-track and in need of a new strategy. Supported by the Foreign Investment Advisory Service, it carried out a self-assessment of progress. The evaluation used templates to gather official information about administrative procedures, a business survey to collect information about experiences with such procedures, and public-private dialogue to discuss the implications of the data and to use the data to guide revisions to the program.

The 2001 survey confirmed that inspections were no longer a serious problem for businesses. It also made it possible to establish a baseline, using hard data about the frequency and duration of inspections, the incidence of bribery, and the perceived quality of each inspectorate. To take the gains further, the government used the data from the templates to fine-tune the reform strategy.

A second survey, in 2003, documented a solid reduction in the inspections burden. The frequency and duration of inspections had declined, and the perceived quality of most inspections had improved. Interestingly, the survey results showed a significant difference between national-level inspectorates (fire, worker safety, sanitary), which had participated in the reform

*continued*

**Box 5—continued**

program with clear signs of improvement, and municipal-level inspectorates (construction, municipal police), which had not participated and showed no improvement.

In 2005 the government requested FIAS support for a third survey, including assistance to make the effort fully local. Local survey firms had been used since the beginning, but there was concern that a government-sponsored survey would not be credible with the business community. A task force was organized to oversee the survey, with representatives from business, academia, civil society, and the government. FIAS provided basic training in sample design, quality control, and safeguards to protect the anonymity of respondents. While the data from the 2005 survey have not yet been fully analyzed, the participants, including key stakeholders from both the public and the private sector, are pleased to have a mechanism that both sides can trust to monitor the impact of ongoing reforms.

*Source:* FIAS 2006.

Elsewhere, systematic monitoring was absent, was poorly enforced, or ultimately bore little relation to the objectives of the reform. Even the United Kingdom had little systematic evaluation of outcomes. Instead, monitoring was largely left to outsiders such as the OECD and to academics (FIAS 2005d, p. 22). In Hungary the scope and breadth of reforms combined with a lack of administrative and analytical capacity undermined evaluation. And strong opposition from ministries made the process even more difficult (FIAS 2005e, p. 32). In Korea the problem was more a lack of coherence between targets and desired outcomes. When the regulatory agency was required to cut the number of regulations by 50 percent, it responded largely by focusing on less important and controversial ones.

## V. Conclusions

Our analysis of the literature and case studies on reforming the investment climate leads us to conclude with a summary of main lessons and some thoughts about issues that deserve greater analytical and practical attention.

### Main Lessons

There is no standard process for reform. There is and can be no “how to” manual. Different reforms involve different stakeholders and different mixes of technical, political, and institutional issues. Reform is also shaped by a country’s politics and capacity. The best we can do is to highlight common insights and lessons which emerge, and which may begin to add up to somewhat of a checklist for reformers:

1. Use the wide and growing array of new tools to benchmark and diagnose constraints and identify the reform priorities that will deliver.
2. Foster competition through trade and product market reforms to create pressure for other investment climate reforms.

3. Generate and leverage new information on specific policy reforms and proven good practices to expose the costs of the status quo, build support, and overcome opposition.
4. Seize crisis or political change to push through bold reforms.
5. Use pilots and sector-specific interventions as learning and demonstration tools when reforms face great uncertainty or strong opposition.
6. Leverage and empower supporters, using a mix of communication strategies and techniques, while maintaining dialogue with the private sector and other key stakeholder groups.
7. Do not wait for long-term public sector reform to create the right incentives and capacity for implementation. Bring in new leadership and skills from the outside, set performance targets and incentives, leverage new information technology solutions, and outsource implementation to the private sector.
8. Build on dedicated, empowered, and competent teams to lead and sustain the reform process while ensuring transparency and accountability.
9. Monitor progress closely against realistic and agreed targets and set up systems early in the process to measure results on the ground.
10. Pay as much attention to getting the reform process right as to the technical content of reform so as to achieve desirable and sustainable policies and outcomes.

## Future Work

The investment climate reform process remains understudied, and several areas could benefit from more in-depth analysis.

A first is to understand better how reform processes vary across different reforms and country conditions with the goal of generating context-specific lessons and insights. While a substantial academic

and practical literature is available on trade reforms, not much is known, with the partial exception of labor and land market reforms, about the politics and institutional aspects of specific reform areas such as business registration, licensing, investor protection, contract enforcement, and bankruptcy. More case studies of how reforms play out under different political and institutional country conditions could also be useful in answering questions such as: How do reform processes differ between democratic and authoritarian regimes—and between presidential and parliamentary systems? What is the tradeoff between speed of decision-making and the credibility and sustainability of reform? And how do countries with weak governance/low capacity go about reform compared to countries with more accountable governments and better institutional capacity?

Second, deeper analysis of complementarities across reform areas could be helpful in thinking about how to package and sequence reforms, particularly in countries with least capacity or in post-conflict. Which reforms can be bundled and which should not be—and which reforms are unlikely to produce results unless supported by action in other areas? More important, given limited capacity, what measures are needed to provide credible signals of commitment or policy certainty?

Third, much remains to be learned about building constituencies for change. More in-depth analyses of how persuasion and bargaining strategies work in practice to influence and change stakeholders' preferences over time could be useful, for instance through more analysis of: public information campaigns; side payments or outright buyouts; grandfather clauses and phase-ins and phase-outs of policy that spread the pain over time; and the involvement of private business associations, policy think tanks, academia, and watchdog and other civil society organizations in launching and sustaining reform. The role of the media and of a free press in making the public an active participant and pressure group for reform is another important area for analysis. Future work along these lines would help in moving from a static to a more dynamic understanding of building and supporting agents of change.

A fourth issue pertains to institutional arrangements for reform. Investment climate reforms often require an organizational overhaul

of the existing bureaucracy or the creation of new oversight or advocacy mechanisms to lead and sustain reform. But more detailed analyses, especially of experiences in low-income, low-capacity countries, are needed to ensure that proper arrangements are in place. In particular, more work is needed to shed light on such questions as these: How can incentives and capacity for implementation be strengthened in the absence of broader public sector reform? Are new institutional arrangements needed? If so, what types and under what circumstances? How do such institutions build ownership of reforms at the local level? What tools and approaches can and should they use to ensure transparency and accountability—and what are the main factors in ensuring their effectiveness?

Fifth, monitoring, often the most neglected part of the reform process, is an area that most invites in-depth work. Much of the problem stems from the lack of clearly defined performance indicators and monitoring and evaluation systems. Thus more work is needed to develop reform-specific indicators and assess what it takes to put into place effective monitoring and evaluation systems and capabilities. All this is central to evaluating impacts and outcomes, ensuring transparency and accountability, and providing a feedback loop to adjust course as needed.

The role of development partners, not explicitly addressed in this paper, is a final issue that deserves more analysis. In particular, how can reformers involve the private sector and civil society organizations (grassroots organizations, advocacy groups, service providers) in the delivery of investment climate services, building on the experiences and models from public service sectors such as health? Would regional or sectoral networks of practitioners help in information sharing and capacity building, and what lessons can be drawn from other reforms such as private participation in infrastructure where such networks have played a supportive role? In what ways can donors and international financial institutions support the reform process?

## VI. Selected Reform Case Studies

### Reforming Labor Regulations in Colombia

In 2002 the Government of Colombia reformed its labor legislation following two unsuccessful attempts in 1999 and 2001.<sup>15</sup> The politically laden reform was passed in the first year of the new Uribe government, when political and public support was high and there was little threat of defeat. The previous attempts, though unsuccessful, proved instrumental in preparing the ground and slowly building support among stakeholder groups deeply opposed to reform, allowing the new government to act quickly and take advantage of its popularity to pass reforms. The process benefited from the conviction of a core group of reform-minded individuals who continuously pushed the reform agenda even as the political landscape changed dramatically. Although it is too early to evaluate impacts fully, initial job creation figures are encouraging.

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15. This case study is drawn from Echeverry and Santa María (2004). The full case study can be accessed at: <http://econ.worldbank.org/wdr/>.

## Reform context

Prior to the 1990s, Colombia's labor regulations sought to provide employment security and stability. But restrictions on temporary contracts and high severance pay made it difficult for firms to hire and fire workers. In 1990, a first round of reforms was undertaken to reduce severance payments and make hiring decisions more flexible. These reforms proved initially successful. Between 1990 and 1994, unemployment fell from 12 to less than 8 percent, informality dropped more than two percentage points, and labor productivity increased.

But by the mid to late 1990s, labor market conditions began to deteriorate. The 1993 social security and health reform increased payroll contributions and led total non-wage labor costs to increase from 42.9 percent in the early 1990s to 53 percent in 1996. Another key non-wage cost was "parafiscal" taxes, which financed social welfare programs for the general population and amounted to 8 percent of the payroll. Total labor costs grew by 3.1 percent per year during the decade, and employers adjusted by reducing employment. The recession in the late 1990s further reduced the demand for labor.

In 1998, the new Pastrana government proposed further labor reforms to tackle unemployment. A team of lawyers at the Ministry of Labor initiated the efforts, drawing from their long practical experience in labor disputes and from a 1998 study that identified the impact of rigid labor regulations and benchmarked Colombia against its regional neighbors and a few OECD countries. A first attempt to reform the labor code was made in 1999, but in the midst of macroeconomic instability, the adoption of an IMF austerity program, and ongoing peace negotiations with a powerful and consolidated guerrilla group, labor reforms were put on hold and no reform bill was sent to Congress.

As unemployment reached 20.5 percent in 2000, a second reform attempt occurred in 2001. The same team from 1999 prepared a bill that deepened the 1990 hiring and firing reforms and addressed, for the first time, the problems of wage inflexibility and non-wage costs. There was broad technical support for the reform proposals within

different parts of the government, including the Ministry of Labor, Ministry of Finance, and the Department of National Planning (DNP). But the newly appointed Minister of Labor—a former union leader—had little appetite for an unpopular reform that would antagonize his constituency. The reform initiative was thus shifted from the Ministry of Labor to the DNP, but the bill was defeated in Congress because of strong political opposition to the proposed reduction in parafiscal taxes.

Though unsuccessful, these attempts helped the new Uribe administration to pass labor reforms less than nine months after assuming office in 2002. Many of the policy changes had already been discussed and debated, and the team in charge of the 2001 attempt had been able to build support for it in some segments of Congress and among the employers and other sectors of civil society. With a new Minister of Labor championing the reforms, the new government was able to act quickly and capitalize on its post-election popularity. The reforms aimed to increase business productivity and foster job creation.

The 2002 labor legislation was similar in most ways to the 2001 proposal but with a few important compromises made to ensure the political feasibility of reform. Among the key reforms that remained unchanged:

- Firms could hire apprentices at below minimum wage without obligations to pay parafiscal taxes.
- A “regular working shift” (RWS) was introduced that could cover any time or days of the week as long as it did not surpass 48 hours per week. Compensation for work outside the RWS or on Sundays was reduced to 10 percent over the regular wage.
- Employers were allowed to hire workers by the hour, as long as wages, contributions, and other non-wage costs were paid proportional to the time worked.
- Severance payments in the case of “unjust” dismissals were reduced, especially for workers with more than ten years of tenure.

## **Initiating reform**

Labor reforms were deeply political and generated intense opposition. Formal sector workers, especially those belonging to unions and large firms, had the most to lose and were vocal and active in their opposition through strikes and various political manifestations. They also mobilized other more powerful groups not directly affected by the reforms, such as the teachers' union, university students, and pensioners. Other groups that benefited from parafiscal taxes opposed the reforms: the workers' unions of the large public and private agencies that administer parafiscal contributions and provide the services funded by them, managing about \$750 million per year and providing stable and well-paid employment to nearly 25,000 people; blue-collar workers who directly benefit from parafiscal services; and politicians whose constituencies benefited from parafiscally funded institutions.

The main beneficiaries of reform were expected to be unemployed and informal workers who would have greater opportunities for formal employment, but they naturally were disorganized, and other interest groups mobilized them to oppose reforms. Overcoming opposition required political compromise, the creation of social safety nets, consensus-building efforts, and the commitment of a dedicated reform team.

### ***Engaging stakeholders***

Efforts were made to build awareness and consensus in the early stages of the reform process. A Discussion Table was established in 2000 with representatives from all key stakeholder groups, including government, the most important labor unions, business federations of key economic sectors, the main political parties, and academia. Initial discussions among these groups were contentious, and technocratic reformers struggled to counter those who rejected their models and argued that the reforms would lead to unemployment and reductions in income. Nevertheless, the very process of stakeholder engagement helped raise awareness, exposed key players to reform ideas, built constituencies, and ultimately produced a consensus text that enabled quick congressional approval.

Through this process, compromises were reached on two of the most controversial elements of the reform package. First, the payment of parafiscal taxes was made more flexible rather than reduced, as proposed and defeated in the 2001 bill. With some restrictions, the law exempted payment of such taxes for new blue-collar workers for a maximum of four years, and for students under 25 years of age working part-time. Despite a strong technical team, compelling economic evidence, and strong governmental will, interest groups succeeded in thwarting more profound reform of the parafiscal system. Second, the 2002 package dropped a proposed expansion of employers' ability to hire workers under a contract that does not oblige the payment of certain non-wage costs.

### ***Providing social safety net support***

The 2002 reform package did not include any direct provisions to compensate workers for potential losses, unlike the 1990 reform, which included a special severance provision. But it included a host of broader social protection measures aimed at protecting the most vulnerable segments of the population against income and employment shocks, and at gaining political and popular support for the reforms. For the first time in Colombian history, it contemplated the creation of unemployment insurance, the strengthening of public pension and health programs, and the creation of a special micro-credit program for small enterprises. In addition, the law introduced an employment subsidy, consisting of a monetary transfer from the government to small and medium enterprises that hire unemployed households heads for blue-collar jobs. The law also contained a provision to evaluate the impact of the reform at the end of 2004 by a commission composed of the government, representatives of workers and employers, and members of Congress. Provisions with negative results must be revised accordingly.

### ***Continuing involvement of dedicated reform team***

Throughout the process, and despite the differences within government, it was the continuity and conviction of a core group of technocrats—several of whom had been involved as far back as the 1990

reforms—that proved crucial in keeping labor reform on the agenda amidst growing opposition and changing political conditions, and in finally passing the 2002 legislation. The same team for the most part continues to be involved in implementation of the reforms.

## **Implementing and sustaining reform**

The newly created Ministry of Social Protection (MPS), a merger of the Ministry of Labor and Social Security and the Ministry of Health, was mandated to implement the new labor code and social protection program. It worked with the DNP, which housed most of the technical expertise and had traditionally been the leader for design and implementation of key economic reforms. All public agencies related to labor and social reforms were brought under the MPS, which is in the process of defining and assuming the roles formerly carried out by the Labor and Health ministries, enhancing the technical capacity of its staff, and implementing information systems to control, follow up, and evaluate the impact of its programs and actions.

Some aspects of the 2002 reforms have yet to be implemented. Slow progress with implementation of the apprenticeship contract is in large part due to continued opposition from labor unions and the teachers' union. The focus on other pressing but unpopular reforms—such as central government reform—also led the government to put on hold further regulatory efforts in this area. Progress on the training reforms has been slow, partly because the government was concentrating on other unpopular reforms, and partly because there has been a lack of agreement within the government on the best course of action. A recent decree requiring the state agency (SENA) to contract training with private firms, thus favoring competition and choice on the part of the beneficiaries, is expected to help move the process along.

## **Reform outcomes**

Although it is somewhat early to assess the reform's full impact on labor market outcomes, there are some initial positive signals.

Between June 2002 and June 2003 more than 750,000 new jobs were created, leading to 5 percent growth in the employment rate—compared to 3 percent growth in GDP—and a doubling of the rate compared to the previous year. While other factors could have affected these outcomes, partial disentangling of the pure reform effects attributes 40 percent of the new jobs mainly to the labor reform, with the rest due to economic growth. The informality rate declined from 61.5 percent to 60 percent during this period, and for the first time since 1997 the formal sector was more dynamic in job creation than the informal one. Unemployment duration declined from 53 to 49 weeks in the same period. Equally important, a recent survey of 75 mostly medium-size formal firms shows that 41 percent of firms increased employment, with 20 percent indicating they did so because of the labor reforms, in particular the reduction in the cost of work outside the regular working shift, and of the nocturnal shift, as well as flexibility in payment of parafiscal taxes.

## Conclusions

The 2002 reform and its outcomes were the culmination of efforts that started as early as 1990 with a first wave of labor reforms, followed by a second more recent wave with two attempts in 1999 and 2001—both of which were unsuccessful but proved crucial in reaching the wide consensus needed to facilitate the eventual passage of the politically laden labor reform in 2002. Tough but unique in its own way, Colombia's experience provides some important lessons for other countries undertaking similar reforms:

- It can take years of slowly “selling” a reform to various constituencies before an initiative actually gains momentum and reform is passed. For politically difficult reforms such as labor, the momentum of a new government in its first year should not be missed.
- Diagnostics are essential for the design of sensible reform proposals, while awareness building is needed to overcome opposition from a wide range of stakeholder groups. This should start by

building agreement within the government, which if neglected or taken for granted can lead to delays or blockage of the entire process.

- Implementation requires an institutional champion that has both the technical capacity and the willingness to battle with the many vested interest groups ready to thwart reform. Long and complicated reform processes require the endurance and conviction of a group of committed individuals who persist with policy changes, despite changes in the political landscape. The team's diagnosis and motivation are critical throughout the reform process.

## Inspections Reform in Latvia

As of 1998, it was clear that Latvia had a problem with its inspections program.<sup>16</sup> Businesspeople were complaining of burdensome, uncoordinated, and harassing behavior on the part of government inspectors. In 1999, the new government put inspections reform high on its list of priorities for reform. They initiated public-private dialogue on the issue, enacted a new “instruction” to improve transparency and accountability in all inspectorates, created an Inspections Coordination Council, and initiated training in a new “client orientation” for inspectors. By 2001, it was already clear that inspections were no longer such a serious problem for businesses, and by 2003 it was possible to document a significant reduction in the burden of inspections on businesses.

### Reform context

In 1999, a study of administrative barriers to investment found that in terms of the inspection system, business investors were subjected to inconsistent and discretionary implementation of laws and regulations, the imposition of unclear fines and sanctions, and ineffective appeal procedures. Inspectors with intimidating and aggressive behavior and excessive discretionary power were conducting frequent

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16. This case study is drawn from Coolidge et al. (2004). The full case study can be accessed at: <http://econ.worldbank.org/wdr/>.

and uncoordinated inspections, discovering infractions, and imposing harsh fines or other sanctions (e.g., freezing bank accounts, seizing equipment, or even forcing a business to suspend operation).

As the complaints from business on various administrative barriers, including inspection, appeared to fit a pattern, the Director of the Latvian Development Agency (LDA) Investment Department (responsible for investment promotion) took the initiative in requesting a comprehensive approach to assessing the investment climate. As a result, in 1998 the Ministry of Finance and LDA commissioned FIAS<sup>17</sup> to carry out a study on administrative barriers to investment in Latvia, which subsequently became a critical catalyst for reforms in inspections and other administrative barriers. The new government that was just entering office as the report neared completion was anxious to accelerate reforms and progress toward EU accession. Inspections reform was included as a high priority as part of the broader investment climate reform agenda, and was supported in part by a World Bank loan.

Key components of the inspection reform included:

- A new government “instruction” for the inspectorates to specify the rights and responsibilities of inspectors vis-à-vis inspectees (in particular, private sector businesses).
- Increased information available to businesses about the inspection process in general and about each specific inspection in particular.
- Formation of an Inspection Coordination Council.
- Annual (regional) meetings between inspectorates and client groups for selected inspectorates.
- A requirement for written inspection reports after all inspections.
- Compulsory annual performance reports that are publicly available.
- Training for inspectors on how to improve strategic focus and develop a “client orientation” in their work.

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17. FIAS is a multidonor facility managed by the World Bank Group.

## **Initiating reform**

Latvia developed an effective and sustainable mechanism to identify and reduce the burden of inspections and of other administrative barriers to investment through the process of structured dialogue among stakeholders that follows a “cycle of reform” consisting of:

- Systematic identification of problems;
- Structured dialogue between the government and businesses to agree on the priorities for reform and to draft an Action Plan.
- Adoption of the Action Plan and implementation of necessary reforms by policymakers.
- Ongoing monitoring of the business environment and evaluation of the impact of reforms.

### ***Designating responsibility***

The critical starting point of the inspection reform was to have an “instruction” on internal operating regulations and information material (on transparency of rights, appeals, legal requirements, etc.) in place for all the inspectorates in order to prevent inconsistent and arbitrary inspections and to address the problem of information asymmetry between businesses and inspectorates. The initial responsibility was given to the individual inspectorates, which were to prepare the relevant materials and then submit them by July 1, 1999 to the Bureau of Public Administration Reform (BPAR), which would place them in the public domain. However, as LDA began to gather information on the implementation of the Action Plan in August 1999, it became evident that the inspectorates needed more guidance to prepare these documents, as they either were not willing or did not have the in-house ability to fulfill this task.

LDA subsequently initiated the second wave of agenda-setting, with the new Minister of Economy as the political champion. The responsibility of preparing the “instruction” and reports on the appeals mechanisms was given to the BPAR—an agency that reported to the Chancellery at the center of government and served as a secretariat for most administrative reforms in Latvia. These new

responsibilities enabled the BPAR to assume an active role in guiding the inspectorates and to delve into the details of inspection regulations in a comprehensive and systematic manner. Altogether, these measures resulted in a process of institutional learning that helped to create much-needed analytical capacity at the center of government and turned out to be critical in further design of the reform.

### *Initiating public-private dialogue*

In December 1999 a seminar was organized to assess reform progress, focusing on the draft “instruction” on preparing operating regulations. The seminar brought together for the first time the heads of all 28 inspectorates, as well as representatives from the business community. At times there were tense discussions and strong voices opposing reforms, as the heads and inspectors were challenged *en masse*. Eventually, the participating inspectors gradually acknowledged that regardless of the technicalities, the on-site administrative procedures of inspection should be similar, and that they could all improve their effectiveness by helping their clients comply with requirements rather than focusing on discovering and punishing “infractions.”

The seminar also gave inspectors the opportunity to express their specific concerns about the draft “instruction,” which was a novelty in Latvia after independence—where the dominant mindset was that reforms had to be imposed from top down and that discussion would just be a waste of time. Quite contrary to this mindset, what actually happened through these discussions was that as the participants began to realize that their concerns were being taken seriously, they became more constructive, suggesting modifications to the reform program rather than dismissing it outright. In response to this, some of those who had been skeptical of the participatory approach to the design of reforms began to change their stance, and the concept gradually gained wider acceptance.

### **Implementing and sustaining reform**

As a successful outcome of this constructive dialogue, an “instruction” was adopted by the Cabinet of Ministers on January 18, 2000,

requiring each inspectorate to adopt internal operating regulations based on standardized requirements, including: (i) inspectorates' mandate; (ii) standardized operating procedures within the inspectorates and on-site inspection procedures; and (iii) well-defined scope of rights and obligations of both the inspectors and inspectees. The instruction was not an end of the reform itself, but just the beginning. Several features of the instruction were also incorporated in the broader (and more authoritative) Administrative Procedures Law, which also established an administrative court for appeals of administrative decisions. Another welcome by-product of the process was that different inspectorates were compelled to share their experiences in implementing the instruction.

The BPAR also organized training to encourage a “client orientation” on the part of inspectors. The training included input from international consultants, but was designed and carried out by the BPAR and local consultants. Swedish consultants also helped design more robust appeals mechanisms.

## **Reform outcomes**

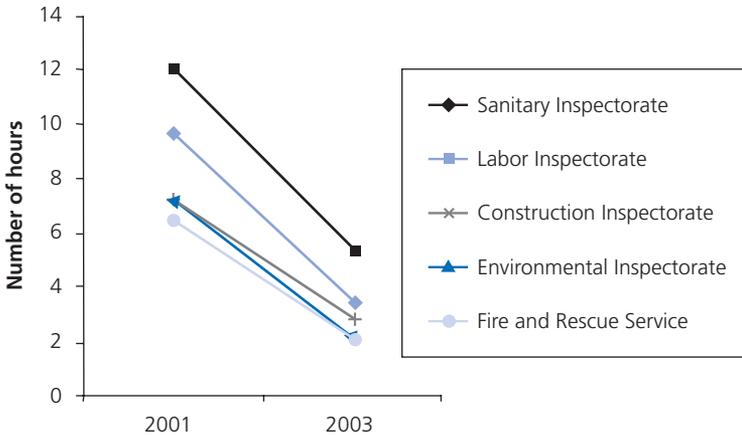
The reforms yielded tangible impacts on several fronts.<sup>18</sup> Inspection duration declined substantially between 2001 and 2003 (figure 4) due to the improvement in professionalism and competence of the inspectors achieved through training. As the business community noted in a focus group discussion in 2004, “The length of inspection depends on the qualifications of inspectors; if they know where to look and what to look for, the inspection is shorter. The inspectors have become more professional and they do not just look for anything but have developed their routines and standard procedure.”

The one inspectorate that did not show improvement—municipal police—was not part of the national-level inspection reform program (figure 5). In essence, this demonstrates the positive effects of the program for those inspectorates that were involved.

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18. In order to assess the reform progress, FIAS undertook two rounds of Administrative and Regulatory Cost Surveys in 2001 and 2003, followed by a Focus Group Discussion of Business organized by LDA in 2004.

**FIGURE 4.**  
**Inspection duration, Latvia**

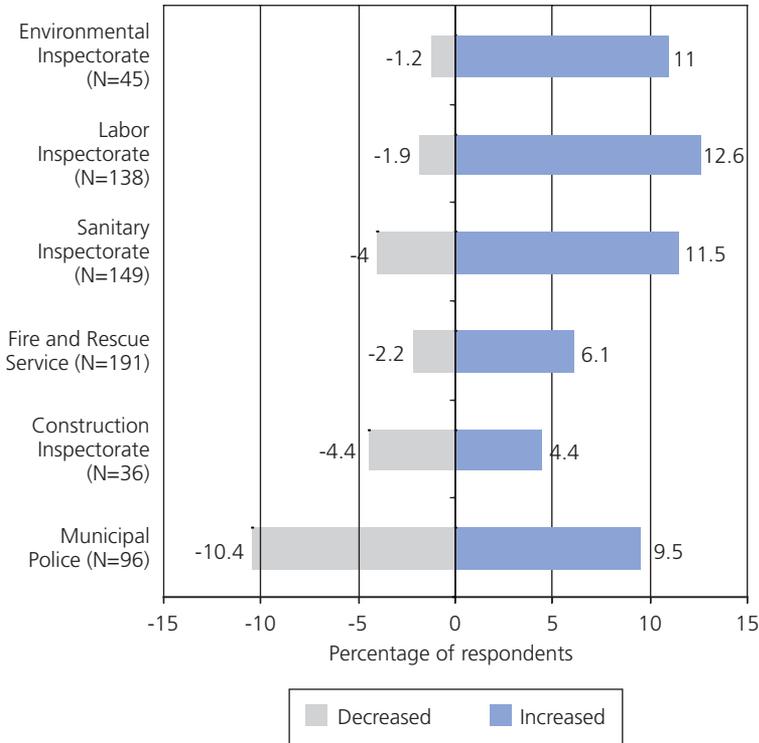


Inspections also became more targeted, resulting in a reduction in the relative number of inspected entities. More specifically:

- The incidence of inspections from labor, sanitary, construction, and municipal police was significantly reduced in 2003 compared to 2001 and before.
- There was a substantial reduction in hours spent in on-site inspections between 2001 and 2003.
- The probability of fines imposed by the labor, sanitary, fire and safety, and municipal police was reduced.
- The burden of inspections was reduced significantly for small firms and to some extent for medium firms as well.
- The burden of inspections is less now for firms located in the capital city (Riga) than elsewhere in the country, which may indicate that reforms have progressed more rapidly in the center and are spreading to the territorial offices of the inspectorates more gradually.<sup>19</sup>

19. Coolidge et al. (2004).

**FIGURE 5.**  
**Improvement in the quality of inspectorates, Latvia: 2001–03**



As a rule, inspectors are no longer penalizing firms for minor, technical mistakes but rather are offering advice to improve the situation. Finally, inspectorate reforms in Latvia have had a positive impact on internal management, persuading them to adopt a “compliance orientation,” and focusing on helping their clients understand and live up to government requirements, which in turn has driven the positive inspection outcomes for the business community. Reforms are continuing, with regular monitoring and evaluation and with regular revision of the Action Plan to keep it on track and effective in delivering improvements. Latvia earned the “CC-Best” award<sup>20</sup> from the

20. Candidate Country—Business Environment Simplification Task Force.

European Commission's Director General of Enterprises, making it a positive example for other EU candidate countries for improving their business environment.

## Conclusions

The following factors contributed to the success of Latvia's inspectorate reform program, providing lessons for other countries embarking on similar reform:

- EU accession and other external stimuli helped drive the reform process, as did a newly elected government starting with a fresh mandate, which in turn helped reinforce internal motivation for change in various ministries, departments, and agencies, including some of the inspectorates themselves.
- A core group of pro-reform “technocrats” at senior and middle levels of the civil service provided critical continuity as various governments came and went. This included the Latvian Development Agency (which had credibility with the business community) and the Bureau of Public Administration Reform (which had credibility with the national government).
- The business community played an active and constructive role as “dialogue partners” and participants in the development of various Action Plans for reform.
- Early emphasis on the “instruction” (i.e., requirements for transparency) and on learning and diffusion was crucial to ensure both acceptance by the inspectorates and quick acquisition of new technical skills and mindset. The technical solutions relied on standardized procedures across inspectorates (e.g., assurance of transparency, accountability, and access to appeals procedures).
- Synergies between the inspections reform and the broader administrative reform process (e.g., the Administrative Procedures Law and Administrative Court of Appeal) were exploited; the inspectorate “instruction,” for instance, provided input for the Adminis-

trative Procedures Law, and the law, once passed, strengthened the reforms initiated by the instruction.

- Efforts are underway to strengthen the use of objective performance measurement in each of the inspectorates, to more systematically measure and record outcomes (e.g., reduction in the incidence of workplace fires or accidents), and to monitor the impact of reforms over time.

## Regulatory Reform in Mexico

During the 1990s Mexico undertook some of the world's most far-reaching reforms of business regulations.<sup>21</sup> Many factors, including trade liberalization and firm political commitment, drove this process. But critical to its sustained success was the early development and then legal strengthening of a regulatory reform agency dedicated to pursuing consumer welfare and ensuring public scrutiny of regulations. The agency played a key role in creating an environment for improved business regulation and greater transparency.

### Reform context

Private business in Mexico had been heavily regulated since the 1930s, with serious effects on the economy. In the late 1980s and the following decade, however, Mexico pursued regulatory reforms of greater pace, scope, and depth than those of most OECD countries. A turning point came in 1986, when Mexico joined the General Agreement on Tariffs and Trade (GATT) and unilaterally started to open its economy. Many factors moved the regulatory reform process along. Top officials were strongly committed. For the first time, economists entered key policymaking positions, with the view that revamping the legal and regulatory framework was crucial to improving competitiveness and the rule of law. Entry into international trade agreements imposed policy discipline and made it harder to

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21. This case study is drawn from Salas and Kikeri (2005).

reverse reforms. Greater international competition demanded measures to lower the cost of doing business. And the atmosphere of financial crisis in the mid-1990s maintained fiscal discipline and rallied private sector support.

But another key factor in sustaining the reforms over a long period and multiple governments was the creation in 1989 of an agency dedicated to advocating regulatory efficiency and improvement. Based on international experience, policymakers saw a central unit as the most effective way to promote change. But in a culture of corruption and opacity they were bound to meet resistance. Political support proved crucial: the Economic Deregulation Unit (UDE) was created only with the backing of a newly elected president and the support of a disciplined incumbent party in control of Congress. It was established by presidential decree within the Secretariat of Trade (now Economy), but with broader powers than the secretariat itself.

The agency started out using a top-down approach. But as a more contested political system evolved and an economic crisis developed, the agency built consensus through wide stakeholder participation. As the political outlook for reform became more uncertain, the agency was transformed into a body backed by law, with greater autonomy and transparent, institutionalized regulatory reviews. The new institutional advocate focused on ensuring public scrutiny of the regulatory process and screening new regulations to secure the greatest consumer welfare—a big change within a culture of opacity and bureaucratic discretion.

The agency enjoyed some early successes. It helped to dismantle price controls, repealed legal barriers to the entry of new firms, and simplified cumbersome commercial court procedures. It also simplified federal procedures for starting a business, reducing the time required from 90 days to just one. Parallel fast-track schemes for business start-up have been created at the municipal level.

### **Initiating reform**

From the outset, UDE's effectiveness depended on the scope of its mandate. Charging it with simply reducing red tape would have

been less threatening to federal agencies and thus politically easier. But cutting red tape without tackling the underlying legal and regulatory framework would not have been enough: red tape was merely the consequence of poor regulation, not its cause. The challenge was to develop a mandate that would be politically acceptable yet give the agency sufficient authority and flexibility to exploit opportunities to improve regulation as they arose. The solution was to limit its mandatory authority (what it must do) to reviewing new regulations proposed by federal agencies while giving it broad optional authority (what it could do) to review and propose amendments of existing regulations.

### ***Mobilizing private sector support***

UDE capitalized on the 1994 “Tequila crisis” to muster broad stakeholder support. Faced with increasing competition, private firms lobbied for government protection, but fiscal stringency, the crisis, and the North American Free Trade Agreement ruled out direct support. To placate business, the government instead created the Deregulation Council in 1995 to bring the private sector and other stakeholders into the reform process. Chaired by the trade secretary, the council comprised key government officials and prominent representatives from labor, business, academia, and sector organizations. Its role was to advise UDE and monitor the performance of federal agencies in overhauling their regulations.

### ***Formalizing transparent reviews***

As a first step toward formal regulatory reviews, a 1995 presidential decree ordered federal agencies to compile an inventory of business regulations and procedures as well as proposals for reform, using a standard template. In 1996 UDE and the council introduced more systematic regulatory impact assessments, based on cost-benefit concepts, as a tool to evaluate regulatory proposals. Federal agencies were required to submit such an assessment with any proposed regulation. UDE could then publish, within 30 days, a nonbinding opinion of the proposal and its assessment—a big break from the past practice of showing proposals only to selected interest groups. The sponsoring

agency would then redraft or withdraw its proposal, and Congress or the president would issue final approval. In 1997 UDE opened the process to public feedback through a new Web site. The reform agency, in its new incarnation, continues this process today.

A small team of dedicated professionals carried out the agency's work, with regular input from the council and from peer agencies in Canada, the United Kingdom, and the United States. The council's support was pivotal, especially in pressuring laggard agencies, through the threat of public exposure, to improve their regulation. The council met quarterly, with secretaries required to present their cases personally.

UDE performed its review of federal agencies strategically, to build experience and credibility over time. It started with agencies expected to be cooperative, then moved on to the more reluctant ones. The agency exercised its optional authority with similar selectivity, proposing regulatory amendments only if believed to be economically and politically feasible.

Regulatory impact assessments proved especially challenging. Federal agencies often blamed UDE for creating a bureaucratic bottleneck when it issued critical reviews. A few secretaries openly opposed the agency's active role, as it threatened vested interests and the traditionally opaque way of creating and applying regulations. But the opposition was thwarted by strong presidential support and the trade secretary's ability to demonstrate that the complaints were a sign of the agency's effectiveness.

## **Implementing and sustaining reform**

In the late 1990s UDE and the council became concerned about the fragility of the process under a presidential decree. Success so far had depended heavily on a few individuals—a group of energetic technocrats with strong support from the president. There had been a few cases of noncompliance by government agencies. And agency heads often pressured UDE into refraining from criticism of impact assessments or issuing opinions too quickly and thus undermining the credibility of the review process. Moreover, the fast-track business

start-up program in Mexico City was abandoned in 1998 under a new administration, pointing to both the possibility of the same occurring at the federal level and the need for an effective process of coordination across different levels of government.

### *Transforming the reform agency*

UDE thus sought to put itself on a more permanent footing—to strengthen incentives for compliance, sustain reform through changes in administration, and improve coordination with subfederal entities. Key to success here were the president’s legal counsel, who supported the initiative out of a belief in the agency’s usefulness, and the council, which provided backing crucial in obtaining congressional support. The proposed changes also came at the end of an administration, when line secretaries felt little opposition to a law that would be applied after their tenure.

In 2000 UDE was transformed by law into the Commission for Regulatory Improvement (Cofemer), an autonomous body established within the Secretariat of Economy and headed by a presidential appointee. The agency acquired new optional authority to undertake cost-benefit analysis of how federal agencies operate and how they apply and enforce regulations. Cofemer also acquired a bigger staff and budget—and the legal backing and tools to become a powerful advocate for regulatory improvement.

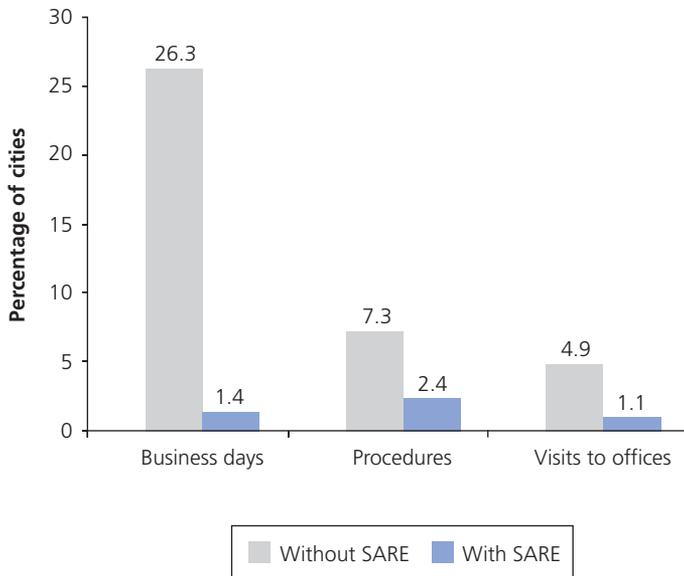
### **Reform outcomes**

Using its optional authority, Cofemer deepened transparency by drafting a 2002 law requiring federal agencies to open their files to the public. A one-year “regulatory moratorium” to discourage agencies from proposing new regulations unless clearly needed has cut submissions by a third. And a powerful new law designed to reduce bureaucratic discretion and abuse requires automatic cancellation of any new regulatory procedures not published in the federal register by their implementing agency.

In addition, Cofemer has promoted a fast-track business start-up program (SARE) at the subfederal level. With regional competition creating pressure for change, the program has spread to more than 20 cities, and initial results are promising (figure 6). Further progress will require tackling problems in the underlying legal and judicial framework.

Cofemer can exercise its full powers only if it enjoys broad support and acts decisively. One challenge is sustaining the support of the private sector. Earlier, rallied by the domestic crisis and strong political support, the private sector took an active role in pressuring agencies to improve regulation. Today many factors contribute to a more passive role: the loss of founding members of the council through turnover, a review process whose success has reduced it to routine, and the diminished role of the council, which now serves mainly as a

**FIGURE 6.**  
Initial results of fast-track business schemes at municipal level



Note: Data cover nine municipalities before and after SARE schemes were introduced.

forum for announcing successes. And new political circumstances and a fragmented Congress have shifted the private sector's lobbying efforts from the executive branch toward Congress.

Moreover, as recent events highlight, Cofemer's will to exert its optional authority in controversial areas has weakened. In 2003 it waived its right to issue an opinion on proposals defining the powers of the regulator for the underperforming telecommunications sector. It also has failed to publicize the fact that no federal department has published its procedures in the federal register. So the powerful new law that automatically repeals any unpublished procedures has not yet been enforced.

Another concern is Cofemer's location in the Secretariat of Economy. Because of the secretariat's narrower scope and the lack of strong political support, that situation has created institutional conflicts, making it hard for Cofemer to exert its broad optional powers. A better location would be in the Finance Secretariat, where Cofemer would enjoy a consistent oversight capacity and a better ability to assess the budgetary effect of proposed measures. Such reform would bring Cofemer closer to its Canadian and U.S. counterparts.

## Conclusions

Mexico's experience offers a key lesson: create institutions and procedures early in the process that can support reform over the long haul. As the political and administrative system slowly internalizes the improvements, adherence to principles of transparency, accountability, and consumer welfare becomes vital to signaling the credibility of the new regulatory culture. Empowering institutions such as Cofemer can promote compliance and sustainability, and using technologies like the Internet can reduce the time and costs of institutionalizing the principles.

Many of the circumstances are specific to Mexico. But any country carrying out regulatory reform will face similar challenges and can learn from its experience. Competitive pressures arising from trade liberalization and a domestic crisis provided a powerful impetus for reform. An institutional advocate was needed to achieve fundamen-

tal change in procedures and promote beneficial regulations. Decisive leadership and strong support from political and other stakeholders were critical to exploiting the reform agency's full potential. And a key factor was proper design:

- A broad legal mandate, based on advocacy of consumer welfare, to address both the root causes and the consequences of a flawed regulatory framework.
- An oversight body, with broad stakeholder participation, to review results and compliance by federal agencies while using public exposure to punish noncompliance.
- Active and sustained commitment of the private sector, especially the small and medium-size firms that had been on the losing side of the business lobby.
- A track record of well-publicized successes to build credibility.
- Promotion of regulatory improvement programs across all levels and branches of government.

## Reforming Business Registration in Pakistan

In the late 1990s, Pakistan undertook reforms to simplify business registration as part of a broader reform program aimed at developing capital markets and improving corporate governance.<sup>22</sup> Its Corporate Law Authority was transformed into the Securities and Exchange Commission of Pakistan. Where the CLA had been weak and ineffective, the SECP used its substantial financial, administrative, and operational autonomy to radically change its culture within a short period of time. The SECP leadership improved employee motivation and eradicated corruption by bringing in qualified professionals who could lead by example and doubling the salaries of its staff in return for giving up perquisites of civil service employment. Its reforms have dramatically reduced the time and cost of registering new businesses

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22. This case study is based on Khan (2004). The full case study can be accessed at: <http://econ.worldbank.org/wdr/>.

and led to a broader improvement in corporate governance and the functioning of financial markets.

### **Reform context**

In the early 1990s, Pakistan started to open and liberalize its economy, relaxing exchange controls, opening financial services to the private sector, and allowing foreign investment in the capital market. But although basic stock markets had developed, with automation and reasonable trading systems, the market was small and fragmented and there was little genuine investment activity. The corporate governance of firms was highly opaque: companies did not comply fully with company law or listing regulations, disclosure standards were inadequate, and auditing left a lot to be desired. Investors had little confidence that they were receiving their fair share of profits, and this lack of confidence held back development of the market.

The regulatory environment was also poor, and registration of companies was time-consuming and difficult; there were no formal guidelines on how long it should take. The body responsible for administering the 1984 Companies Ordinance, which stipulates the requirements and steps for registration, was the Corporate Law Authority, a government department established in 1981 and staffed by civil servants who had jobs for life and were promoted on seniority rather than merit—which created a working atmosphere that was not conducive to integrity, professionalism, and customer service. Bound by civil service pay scales, the CLA was unable to attract dynamic individuals from the private sector, and with its limited resources it could not afford professional training for its staff. Depending exclusively on budgetary grants from the federal government, it lacked authority even to buy computers and other equipment without the approval of the Finance Ministry. Lassitude and corruption were endemic.

There was a clear need to improve the investment climate for business by reforming the capital markets, improving corporate governance, and streamlining the company registration process. The impe-

tus for reform came from Pakistan's urgent need to raise foreign exchange, and to mobilize long-term resources while improving the efficiency of their allocation through a diversified and competitive capital market. The underlying goal was to reorient government policy away from the public sector toward greater reliance on the private sector as the engine of growth.

In 1997, with support from the Asian Development Bank, the government prepared a capital market development program that established the Securities and Exchange Commission of Pakistan as an autonomous body with quasi-judicial powers to replace the old Corporate Law Authority. Backed by a legislative act, the SECP, unlike the CLA, could finance itself from its fees and was given powers of expenditure. No longer bound by civil service pay and recruitment policies, it could offer sufficient remuneration to attract qualified professionals from the market. Its executive directors were given day-to-day responsibility to make operational regulatory decisions, which were kept separate from the SECP's policy-making powers so as to isolate technical operations from political pressure. The Act also established a Policy Board—consisting of the SECP chairman, four government officials, and four business representatives—to provide policy guidance, oversee its activities, and approve its budget. While the Board was set up primarily as a bridge between the SECP and the government, its operations were independent of it.

The SECP administers corporate laws and regulates securities markets and non-bank financial institutions. Independent, professional chief executives were appointed to head the stock exchanges, and brokers were compelled to register with the SECP and to adhere to a code of conduct. Margin requirements were strengthened and capital adequacy requirements imposed, blank sales were replaced by a regulated system of short selling, new market instruments were introduced, and an improved, rolling settlement system was put in place. The reforms made the market more balanced and stable, increasing the percentage of settled trades from 1 to almost 10 percent. Most importantly, systemic problems that used to arise two to three times a year have not occurred since 2001.

A new code of corporate governance barred brokers from being company directors, raised the quorum for general meetings of public listed companies, and required minutes of board meetings to be circulated to directors within fourteen days. Listed companies were mandated to make their audit papers available for quality control reviews, and auditors could not be engaged to perform any other services for the company and had to be replaced after five years. These reforms led to significant improvements in the quality of the annual financial statements of listed companies.

The SECP also made it quicker and cheaper to register a business. Standardized procedures and maximum time periods for processing each document received by the Registrar were issued, and an explanation from the Registrar is required where registration takes more than three days. The fees for registering a company were reduced, with the fee for the smallest companies halved. Three provincial governments agreed to reduce stamp duty.

## **Initiating reform**

### ***Securing leadership***

Leadership was key to getting the reform process going. An external candidate experienced in both capital markets and in Pakistan was selected to head the SECP and to lead the reform process with less vulnerability to political pressure from vested interests. Leadership was similarly important in overcoming initial resistance to the setting up of the SECP, which could have been blocked indefinitely by skeptics within the civil service had not the head of the CLA, whose position and credibility gave him the stature to influence opinion, been an enthusiastic advocate of reform. The idea of the supervisory Policy Board acting as a conduit between government and the SECP helped overcome government resistance to relinquishing the powers it exercised through the CLA.

### ***Engaging stakeholders***

In the initial stages, reform encountered heavy resistance from the regulated, from the bureaucracy, and from within the new SECP

itself. Through a long and difficult process, many of the stakeholders gradually came to recognize the determination of the SECP leadership and accept that reforms were in the best interest of all. Faced with an often hostile climate, the SECP consulted stakeholders and the public to explain the reforms it proposed. The SECP was legally required to seek feedback from the general public before finalizing its reforms, and it actively did so by inviting comments and suggestions on its directives before these were issued. The new code for corporate governance, for example, was initially proposed by the Institute of Chartered Accountants and discussed at length with various chambers of commerce and trade and professional bodies. Going beyond the legal requirements, SECP set up a Capital Markets Advisory Group comprising leading stock market professionals, asset managers, stock brokers, market participants, and regulators, which met monthly for wide-ranging discussions on capital market reforms; stock exchanges were consulted in regular joint meetings each quarter. Informal consultations with key individuals and opinion makers were held regularly. Regular communications from the SECP leadership through press conferences and television interviews helped explain the content and rationale for reform and build public support, which together with international support in turn helped offset resistance from entrenched interests.

## **Implementing and sustaining reform**

### ***Strengthening incentives and capacity***

At the root of the SECP's success was a radical overhaul in its organizational culture. In a difficult and unprecedented reform, 80 of the 380 staff it inherited from the CLA were paid their salaries but told to stay home. This provoked fierce resistance and legal challenges, but most of the 80 have since found other posts in the civil service. The 300 remaining employees were given the choice of continuing on civil service terms with their job security assured regardless of performance, or becoming employees of the SECP. This meant their pay and benefits would be approximately doubled, but they could be made redundant if they were not deemed up to the job—and it was

made clear that career progress in the SECP would be purely on the basis of merit, with no regard for seniority. All but one took the new employment terms. The SECP supplemented these staff with 40 international and domestic experts, a group which brought along outside standards of service and integrity and became the driving force behind the culture change through leading by example. It set up its guiding principles (box 6).

While in the CLA, cases had tended to be referred up a bureaucratic structure, the SECP encouraged employees to take responsibility for making decisions. Staff training was emphasized, both by providing classes within Pakistan and by sending people to learn from regulatory bodies in other countries. A vigilance cell was set up in the chairman's office to deal with complaints; corruption of staff members had been entrenched in the CLA, but within a year the SECP had practically stamped it out.

#### BOX 6.

### SECP's guiding principles

- **Be firm, helpful, and fair.** Staff were rewarded for giving prompt, clear, and comprehensive answers to letters/queries from the public, and admonished for replies that were delayed, vague, or meaningless.
- **Emphasize equity over technicalities.** While the CLA had been rigidly technical in its interpretation of the rules, the SECP engaged in a progressive interpretation of the law and regulations with a view to achieving an equitable dispensation.
- **Protect the small investor.** In the past, the widespread perception had been that stock exchanges benefited only brokers and majority owners; the SECP aimed to hold the small shareholder's interests supreme.
- **No compromise on integrity.** There was zero tolerance for corruption or malfeasance, not only from SECP employees but from any stakeholder, whether corporate managers, brokers, investors, or auditors.

### *Using information technology solutions*

Application forms were simplified in preparation for on-line filing through SECP's newly created Web site, while registration guidelines and model memoranda and articles of association were also made electronically available. All incoming documents are entered into a centralized electronic database, which covers all companies. All eight regional offices were provided electronic access to the new regulations and the company database, with monthly reporting to SECP headquarters. The Corporate Registration and Compliance System was set up to monitor regional performance on a regular basis.

### **Reform outcomes**

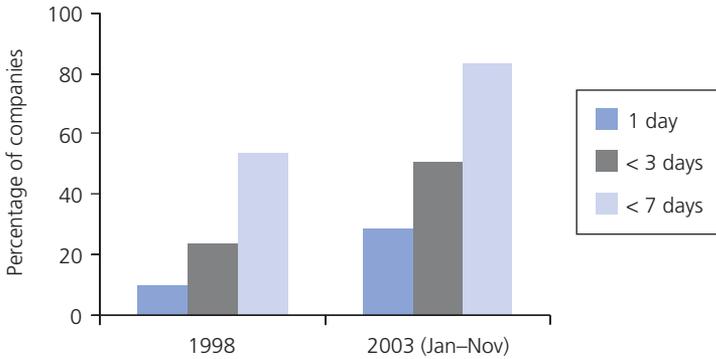
Initial results show a substantial decline in the time taken to incorporate new companies, as can be seen from data from the regional office in Karachi, the largest in the country (figure 7). Between 1998 and 2003 the percentage of companies registered in Karachi within a day tripled, and within three days doubled. The number of new companies registering in Karachi, meanwhile, increased by about 50 percent between 1998 and 2003, and the total number of incorporated companies in Pakistan increased by almost a fifth in the same period.

The cost of registering a new company also fell, partly because the SECP reduced the incorporation fee for private companies and partly because it successfully lobbied three regional governments to reduce stamp duty. The combined effect across five regions of the country is shown in figure 8, with the average overall cost of incorporating a new company reduced by 43 percent.

### **Conclusions**

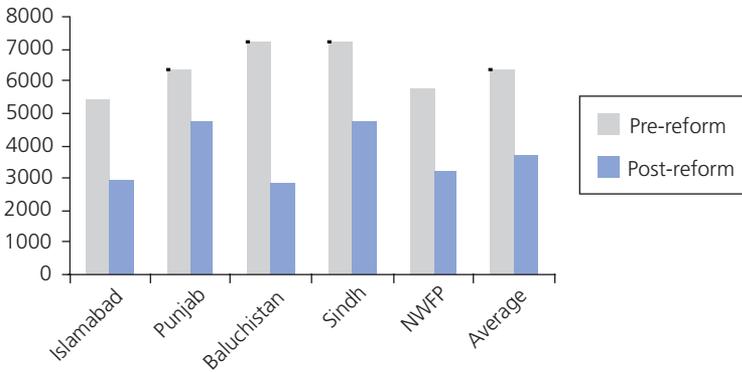
The SECP's reforms have been widely considered to be a successful step in the right direction and have gradually won the acceptance of interest groups who opposed their implementation. Pakistan's experience offers lessons to other countries dealing with similar issues:

**FIGURE 7.**  
**Time required to register business in Karachi**  
**(percentage of companies)**



Source: Additional Registrar of Companies, CRO, Karachi.

**FIGURE 8.**  
**Cost of incorporation (in rupees)**



- Leadership is vitally important. In the absence of a domestic political impetus, the support and initiative of the civil servant in charge of the body to be reformed (the CLA in this case) were crucial in pushing the process forward. The appointment of a dynamic chairman with experience and expertise helped establish credibility and acceptance of reform.

- Granting financial and administrative autonomy to the SECP was critical in changing its culture and giving it more control over recruiting and rewarding human resources. Attracting professional, well-qualified, and highly motivated staff is crucial to the success of regulatory bodies. A combination of carrot and stick proved important in changing the culture of the SECP: staff were rewarded with a performance-based salary for doing the job well and knew they could be fired for doing it badly.
- Resistance to reform is inevitable. Active consultation with key stakeholders is important to ensure that the aims and intentions of reform are understood, and to foster awareness that specific measures unpopular with particular interest groups are essential parts of a worthwhile overall goal. The media is a useful tool to build public support for reform.
- Regulatory reform is an ongoing task, requiring constant review to identify areas for improvements and lobby for necessary legal changes. Though much progress has been made in Pakistan, more remains to be done. Sustaining reform can also be a challenge. It is important to stop political interference from creeping in, as there is always a temptation for politicians to appoint political candidates to head regulatory bodies. The success of regulatory bodies depends on their operating, and being widely recognized to operate, with independence and integrity.

## Enterprise Reform in Vietnam

Since 1986, Vietnam has been moving from central planning toward a more market-oriented economic system.<sup>23</sup> Early reforms paved the way for private sector development, but a lingering bias against private firms remained. In 1999 the Enterprise Law was passed to simplify business entry, remove licensing requirements, and improve the corporate governance of firms. The results were impressive, with a dra-

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23. This case study is drawn from Mallon (2004). The full case study can be accessed at: <http://econ.worldbank.org/wdr/>.

matic increase in the number and total registered capital of new private enterprises. Political leadership and a clear strategic vision were vital in getting the enterprise reform process started. Achieving national ownership was a major part of the process: awareness-building and stakeholder consultation took time but proved crucial in securing broad-based support for the passage of the law. Consultation continues to be a key feature in implementing and sustaining the reform.

### **Reform context**

Starting with the launching of the Doi Moi (renovation) reforms at the Sixth Party Congress in late 1986, Vietnam began moving from central planning toward a more market-oriented economic system. Government decisions in a range of areas—land, exchange rate, trade, and administrative and financial sectors—paved the way for expansion of household businesses, while legislation passed in 1990 established the legal basis for private activity. These early reforms laid the foundation for private sector development and led to tangible results. By 1996, GDP growth accelerated to over 9 percent, exports more than trebled, and the number of household businesses increased from 0.84 million in 1990 to 2.2 million by 1996. The reforms contributed to sharp reductions in poverty, from more than 70 percent of the population in the mid-1980s to about 37 percent in 1998.

Despite these achievements, many private businesses preferred to remain as household entities. There were confusing, ad hoc laws governing different businesses, and a lingering bias against the private sector. Registration and licensing procedures for establishing new enterprises were onerous: registering a typical enterprise involved visiting ten different government agencies and submitting 20 different documents with official seals. The average time between submission of documents and approval was six to 12 months; fees paid to consulting firms to register a company varied across provinces but averaged about US\$700. Discretion in the approval process and inspections by government officials created opportunities for corruption.

With the onset of the Asian economic crisis in 1997, Vietnam faced a downturn from its previously strong export growth and FDI

inflows, while pressure began to emerge from the growing domestic private sector for the development of more formal market institutions and clearer rules. Rapid growth in the more successful provinces also began to put pressure on poorer performing provinces. The turning point for reform came with changes in the country's one-party government leadership in 1997, with the appointment of a new Prime Minister, President and Party Secretary-General, all committed to accelerating private sector development. An action plan to improve the business environment was announced in December 1997, and a Steering Committee, headed by the Minister of Planning and Investment, was set up to spearhead and coordinate the reform.

In June 1999, the National Assembly passed the Enterprise Law, which replaced the Company Law and the Law on Private Enterprises of 1990. The law provided an overall framework for the private sector. More specifically it served to:

- Reduce ambiguities and inconsistencies inherent in earlier legislation.
- Simplify enterprise registration and licensing procedures.
- Clarify the rights of investors and enterprises to be protected from undue state interference.
- Provide an umbrella framework for a range of business entities previously governed by different legislation, and allow for partnerships as a new form of business.
- Clarify procedures for changing the scope of business, for merging or liquidating business entities, and for shifting from one form of entity to another. Businesses no longer needed to seek additional approvals from state agencies to change their business activities, establish additional offices or plants, or change address, investment capital, and shareholders.
- Improve the corporate governance of enterprises by clarifying the rights of company members (especially minority shareholders), mechanisms for decision-making, the conditions for withdrawing capital, procedures for profit distribution to protect the interests of

shareholders, and procedures for transferring ownership of non-cash assets.

## **Initiating reform**

In many ways the process surrounding the formulation and passage of the Enterprise Law was more important than the changes in the law itself: it helped build national ownership and consensus for achieving fundamental economic change. Strong political support and official public endorsement of the private sector by the party and the National Assembly at various party plenums were crucial in overcoming resistance from mid-level officials and sending credible signals of government commitment to the private sector. Equally important were the specific measures undertaken by the government to build support: using diagnostics and public dissemination to make the case for reform; adopting a learning-by-doing approach; consulting intensively with key stakeholders; and establishing institutional mechanisms for policy coordination within government.

### ***Using diagnostics to make the case for reform***

The main institutional champions of reform—the Central Institute for Economic Management (CIEM) and the Vietnam Chamber of Commerce and Industry (VCCI)—put together early in the process a dedicated team to carry out the underlying diagnostic work needed to make the case for reform to a largely skeptical public. They carried out detailed studies that exposed the costs of doing business, benchmarked Vietnam’s performance against regional and international performance, and catalogued problems with the old Company Law, particularly the scope for corruption. They sought to mobilize grassroots support by using the print and television media to disseminate the studies and the evidence about the potential impacts of reform on employment and poverty. This helped foster public support for reform, which in turn proved critical in reducing resistance from vested interest group. As the public understood the negative effects of regulations that made it harder to do business, pressure increased on

line ministries, agencies, and local authorities to work within the spirit of the Enterprise Law rather than seek to obstruct it.

### ***Building on pilots and policy learning***

Unlike bankruptcy and state enterprise reforms, which were largely top-down and externally driven, the enterprise reforms were part of a longer term effort that was domestically driven through a process of “learning by doing.” There was little formal cost-benefit analysis of alternative policies; instead, the results of local policy experiments and pilot projects fed directly into policy formulation. Some provinces for instance experimented with pilot changes in business registration requirements before the formal regulatory changes were implemented. While regional experiences played a part—an initial draft of the Enterprise Law borrowed heavily from Thai corporate law—considerable internal debate and frequent consultation ensured that the final product was widely perceived as uniquely Vietnamese. Reformers also actively sought global experiences through workshops and study tours that were organized to bring in proven international practices that could help improve the quality of reforms.

### ***Engaging the private sector and other stakeholders***

Top political leaders recognized the importance of close dialogue and cooperation between government and business. VCCI, the largest and most prominent national business organization with a majority of private enterprise members, led this dialogue. Formal and informal meetings with business groups, senior managers of enterprises, and lawyers’ associations were organized throughout the country to identify and address business constraints, and written submissions of the discussions were sent to the policymakers. Drafts of the legislation were widely circulated for comments. These consultations signaled government commitment to the private sector and helped build investor confidence and change the public mindset in favor of reform. They were both time and resource intensive, often requiring donor support, but proved to be a major factor in the reform’s suc-

cess. Consultations are now expanding to cover emerging business associations representing the interests of the new private sector and of particular industry-specific groups, while the Vietnam Business Forum provides another venue for businesses to periodically discuss constraints with the government.

## **Implementing and sustaining reform**

### ***Achieving policy coordination***

Given that reforms cut across a large number of government departments and different levels of government, the Steering Group on Enterprise Law Implementation (SGELI) was established to resolve difficulties and secure ministerial consensus on regulations, and to monitor and evaluate implementation of the law. Consisting of 20 members drawn from government and the private sector, SGELI was led by the Minister of Planning and Investments and reported directly to the first Deputy Prime Minister. The Central Institute for Economic Management, a think tank leading the reform efforts, provided secretariat support to SGELI. Coordination proved more difficult than expected, and key regulations were passed several months after the Enterprise Law was enacted in January 2000. These regulations abolished about 150 business licenses and procedures that were inconsistent with the law and allowed private enterprises to use land use rights as collateral for borrowing. The regulatory changes were accompanied by gradual improvements in services provided by business registration offices, with a number of provincial offices maintaining Web sites to facilitate registration, and more systematic dissemination of information to businesses about their rights and obligations. Simplified procedures under the new law reduced opportunities and incentives for corruption, reduced uncertainty about the legality of business operations, and allowed investors to focus their efforts on business development.

### ***Strengthening the incentives and capacity for implementation***

Interagency coordination remains a challenge for implementation. Business registration offices in some provinces, falling under provin-

cial departments of planning and investment, still encounter delays in sending copies of the business registration certificate to the relevant state agencies. The capacity of provincial offices remains weak, while day-to-day government interference and perceptions about corruption continue. CIEM and VCCI train officials responsible for implementation, but they are increasingly giving priority to training business representatives to increase their awareness of their rights and responsibilities, particularly in poorer provinces, where to date only sporadic contacts have been made. Some provinces have established consultative mechanisms and “hotlines” to deal with corruption; others have taken steps toward ISO 9000 certification to ensure greater consistency and predictability in the services provided by provincial agencies to businesses.

### **Reform outcomes**

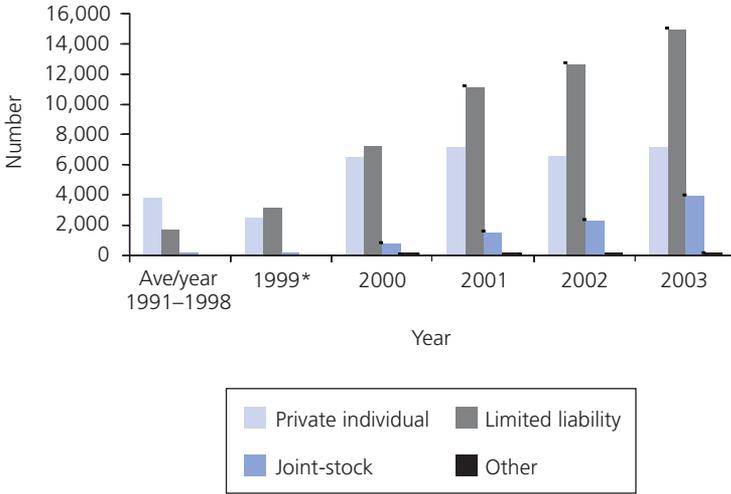
The results have been impressive, with a dramatic increase in the number and total registered capital of new private enterprises (figures 9 and figure 10), and an estimated 2 million new jobs. The time and cost for business registration decreased, from an average of six to 12 months prior to the law to about two months as of July 2003, with start-up costs declining from about US\$700–1,400 to about \$350. Simplification procedures especially helped businesses that were less well connected, such as those in rural areas or headed by women or ethnic minorities.

### **Conclusions**

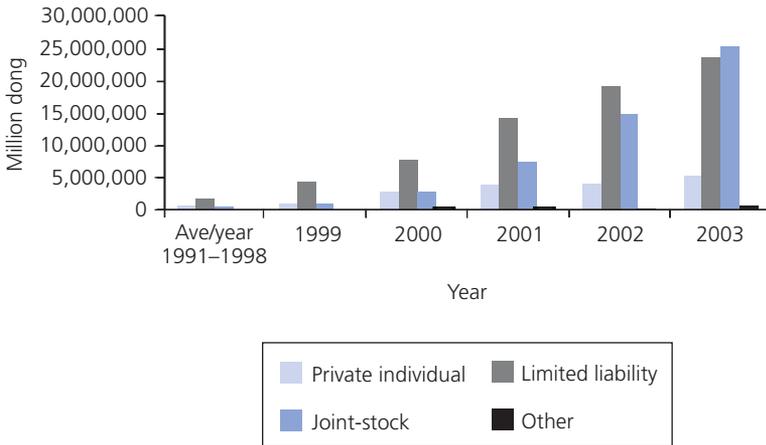
In an environment of fundamental economic and political transition, Vietnam’s efforts to promote private sector development through the Enterprise Law reforms have yielded impressive results. Its experience suggests lessons for other countries attempting to undertake a similar shift from a public sectors dominated economy and mind-set to a private sectors led one. These include the importance of:

- Strong national ownership of the reform process in undertaking economic change.

**FIGURE 9.**  
**Number of newly registered enterprises, Vietnam**



**FIGURE 10.**  
**Average registered capital of newly registered enterprises, Vietnam**



- Detailed diagnostics of reforms and their impacts to help foster momentum for change, with donors playing an important role in this regard, especially where there is national ownership and genuine local demand for reform.
- Deliberate consultative processes aimed at building coalitions for reform, even though the process can be time-consuming with unpredictable outcomes. The process requires a medium-term perspective even if individual reforms have a shorter time frame.
- Strengthening of policy coordination mechanisms and institutional capacities at various government levels, and education of businesses about their rights and responsibilities to ensure successful implementation.
- Recognition that enterprise reform is an ongoing process that requires sustained support to resist pressures for policy reversals.

## **Land Market Reform: Improving Access to Land and Buildings**

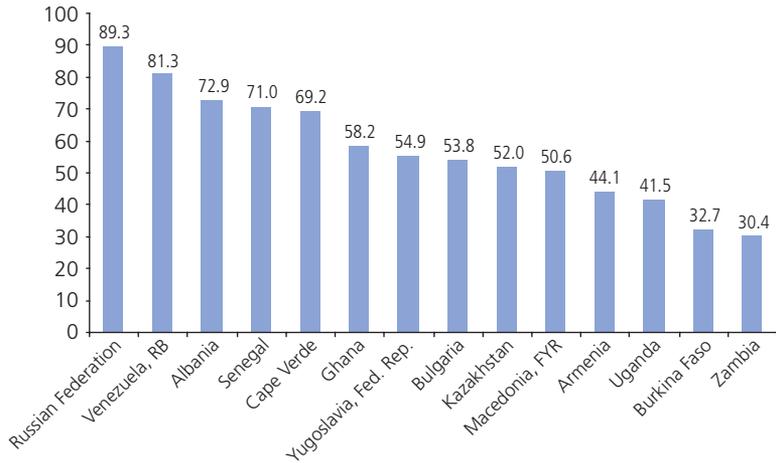
Land markets that allow access to land—and to buildings—through secure property rights, at transparent prices, and with efficient permitting processes and land tax systems are essential to a good business environment.<sup>24</sup> Creating such markets, however, can be a long, complex, politically charged process, especially where most land is untitled and where there are conflicting claims. But experience points to practical interim or step-by-step solutions that can have a positive impact and generate the political capital to reform the overall land market system.

### **Reform context**

Business surveys identify problems in gaining access to land as among the biggest complaints of investors in developing countries (figure 11). A detailed study in India shows that such problems, by constraining

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24. This case study is based on Muir and Shen (2005).

**FIGURE 11.****Survey respondents identifying procedures for accessing land as an obstacle to operating and expanding their business**

Source: FIAS, Administrative and Regulatory Cost Surveys, 2000–04.

investment and competition, can cost developing countries more than 1 percentage point of GDP growth annually (McKinsey Global Institute 2001). Studies of titling programs in Peru, Thailand, and Vietnam show big increases in investment and productivity on titled land compared with land without title (World Bank 2004b).

While investors seeking land have varying needs and priorities, they generally face four key related issues (table 4):

- *Access.* Is the land I need available? If so, from whom can I obtain it, at what price, and on what terms? How long will it take?
- *Security.* If I can get access to suitable land, what will be my rights over the land? Will my property rights be secure? Will I be able to use them as security for bank loans?
- *Use.* Once I have acquired land, how may I use and develop it? How long will it take to obtain all the permits for construction and related activities—and how much will it cost?

**TABLE 4. Land issues concerning investors, and factors determining the outcomes**

Issue	Factors determining outcomes
<b>Access:</b> Is land available, and at what price?	<ul style="list-style-type: none"> <li>• State-owned land</li> <li>• Tribal or communal land</li> <li>• Ownership or use restrictions</li> <li>• Zoning and planning requirements</li> <li>• Property tax</li> </ul>
<b>Security:</b> What are my rights? Are my property rights secure?	<ul style="list-style-type: none"> <li>• Titling system</li> <li>• Registration process</li> <li>• Collateral rules</li> <li>• Transfer of property rights</li> </ul>
<b>Use:</b> How can I use and develop land?	<ul style="list-style-type: none"> <li>• Location permits</li> <li>• Construction and building permits</li> <li>• Environmental impact assessment</li> <li>• Utility connections</li> </ul>
<b>Consistency of treatment:</b> Are my competitors treated like me?	<ul style="list-style-type: none"> <li>• Governance</li> <li>• Transparency</li> <li>• Accountability</li> </ul>

- *Consistency of treatment.* Are my competitors being treated in the same way?

## Key issues for investors

Of the many issues, the following are the most serious.

### *Access to state-owned land*

In many countries the state prohibits direct private ownership of land and often remains the largest—and sometimes the only—provider of land well served by essential infrastructure. Even where private ownership is traditionally recognized, such as in Botswana, Jordan, or Turkey, only a small fraction of the land suitable for new industrial and commercial development is privately owned. And many countries impose special restrictions on foreign ownership.

Where the state dominates land supplies, both foreign and domestic investors are concerned about how to obtain land at a fair price, in a reasonable time, and through a transparent and corruption-free process. Gaining access to government-owned land in the Russian oblast of Nizhny Novgorod, for example, takes 273 days and involves 11 key documents, 4 issuing authorities, and 7 approving authorities.

### *Access to tribal and communally owned land*

In many countries in Africa, the Pacific, and the Middle East, much of the land needed for developing mining, tourism, or agribusiness is tribally or communally owned and thus not easily available to investors. Where investors must negotiate for such land, it is often unclear which legal entity or group has ownership.

Where transparency is lacking, local politics tend to further complicate the transactions, making the negotiation process long, cumbersome, and frequently corrupt. But quick ad hoc fixes often fail. In Mozambique the government rushed to accommodate a large strategic foreign investor by setting an unrealistic 90-day deadline for completing all arrangements with the local communities. And in China the government has sometimes forced rural communities to relocate to free up land for foreign investment. Such strategies often backfire as relocated farmers move back to squat on the land and conflicts erupt between communities and investors.

### *Property rights*

Access to land without sufficient security is of little use to investors, who need secured long-term property rights as collateral for obtaining bank financing. Moreover, investors who have no assurance that they will benefit from the added value brought by long-term investments on land will have no incentive to make such investments.

Land property rights remain poorly defined in many developing and transition economies. This situation often stems from lack of developed land cadastres—the systems that record physical characteristics and identify boundaries—and of registration systems that record legal ownership of land. Another source is failure to unify

these systems, which results in conflicting records. These problems are sometimes exacerbated by the transfer of responsibility for registration systems from central to subnational authorities.

In a situation typical of much of Africa, less than 4 percent of the land in Mozambique has been surveyed, and even less registered. Even where property is registered, investors may still face big delays in recording land transactions. In Nigeria an entrepreneur seeking to buy property free of dispute and officially recorded must complete 21 procedures—a process that takes a staggering 274 days and requires official fees amounting to 27 percent of the property value. It need not be so. In Norway the same process takes only a day and requires payment only of a registration fee and 2.5 percent of the property value in stamp duty (World Bank 2005a, figure 5.3).

### ***Land development procedures***

Most investors are prepared to comply with host countries' laws and regulations governing what, how, and how fast they can build. Nevertheless, investors are frustrated by lack of regulatory clarity, overlapping institutions, and time-consuming and often discretionary approval procedures relating to such issues as zoning, construction standards, and environmental protection. In the Arab Republic of Egypt in the 1990s, for example, obtaining location and construction approvals could take 12–36 months in a process involving multiple authorities at central and local levels.

Dealing with the plethora of agencies and authorities responsible for approvals needed for site development often discourages serious investors while encouraging illegal construction and corruption. In Turkey, corrupt and illegal construction practices led to massive losses of life when earthquakes struck cities and villages.

## **Solutions**

The huge variation among countries in size, geography, and political and social systems rules out any universal approach to land reform that can be simply transplanted from one country to another. Moreover, comprehensive land reforms, requiring enormous resources,

political capital, and legislative effort, typically take 10–15 years. Countries seeking to encourage private investment cannot afford to wait that long, and many are looking for practical interim solutions. Some have carried out pilot experiments at the subnational level. This approach has often proved to be a useful way to kick-start private investment while providing learning and demonstration effects for national initiatives.

### ***Developing a market-oriented long-term lease system***

In some countries where privatizing land has not been politically acceptable, governments have turned to long-term leases to meet investors' basic needs. China's government offers renewable and transferable long-term leases of 40–70 years. Such arrangements appear to give foreign investors the assurance they need to make strategic investments on the land. Long-term leases have also provided a partial solution to problems in accessing communal land in Botswana and Mozambique.

### ***Streamlining access***

In countries where the state plays an important role in allocating land, whether through sales or long-term leases, many governments have recognized the need to streamline the process to encourage efficiency and prevent corruption. To facilitate tourism investment in Egypt, the government created the Red Sea Tourism Zone, where all government ministries concerned precleared the land for private investment. That greatly simplified the procedures for accessing land and immediately boosted investment.

China's government, recognizing the need for more transparent mechanisms to distribute public land to the private sector, conducted the country's first public land auction in 1987, in the Shenzhen Special Economic Zone. Developers responded with bids far exceeding the government's expectations. In 2002 the government amended the national land law to formally extend the Shenzhen experiment with public auctions throughout China.

Recent efforts in southern Africa, including Botswana, Mozambique, and South Africa, have also improved the process for accessing

customary land. These efforts have shown that positive results can be achieved if the three main parties—local communities, strategic investors, and the state—recognize that they have different interests but work toward sharing costs and benefits in a transparent, consultative process.

### *Securing property rights*

Many countries have recognized the importance of improving the cadastre and property registration systems to increase the security of property rights. Working since the 1980s, Thailand has developed a world-class land titling system with two procedures and a two-day turnaround. In Peru efforts persisting over more than 10 years produced a modern titling system providing secured property rights that the rural and urban poor have been able to use as collateral for business loans.

Other countries have resorted to relatively simple ways to improve land registration. Some have shown that it is possible to simplify or combine procedures. In Bolivia and Brazil the registry checks for payment of taxes rather than putting the onus on the entrepreneur, while in Cambodia and El Salvador the registry automatically forwards the notice of registration to the municipality rather than adding another step to the process. In Costa Rica and Lithuania the registry and cadastre systems have been linked to improve consistency between the two. And in China and Mongolia broader access to previously restricted information in the property registry has helped entrepreneurs identify owners and reduced the need for due diligence.

### *Streamlining use*

Some countries have tackled the problems in land development through comprehensive reform. In Slovenia the government overhauled the land use planning and construction legislation to make the national land development system simple, transparent, and efficient. Other governments, such as in China (Shenzhen), the Czech Republic, and India (Andhra Pradesh), have chosen pilot approaches to simplify procedures in demarcated areas by introducing clear guidance on land development for investors and executing agencies.

Many of these zones offer blanket approvals for zoning and environmental requirements along with readily available infrastructure. But the real solution to the problems lies in medium- to long-term reforms of the land use planning processes that can be applied nationwide—reforms that will require strong commitment from government to balance the imperative of economic growth with the need to safeguard environmental and other socioeconomic conditions.

## **Conclusions**

Land has long been a central issue in the policy debate over environmental protection, natural resource management, and rural and urban development. What has been missing is a systematic exploration of the land issues from the perspective of private sector development. This analysis suggests a taxonomy to capture the multilayered and inter-related obstacles facing private investors seeking access to land. And it gives examples of proven interim or pilot steps in land reform to reduce obstacles to investment. These approaches have been a useful way to kick-start private investment while providing learning and demonstration effects for national land reform initiatives.

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**M**ost people agree that a good investment climate is essential for growth and poverty reduction. Less clear is how to achieve it. Drawing from more than 25 case studies, this book shows that reform often requires paying as much attention to dealing with the politics and institutional dimensions as to designing policy substance. While there is no single recipe or “manual” for reform, the authors highlight three broad lessons. The first is to recognize and seize opportunities for reform. Crisis and new governments are important catalysts, but so is the competition generated by trade integration and new benchmarking information. The second is to invest early in the politics of reform. Public education can help gain wide acceptance for reform, while pilot programs can be valuable for demonstrating the benefits and feasibility of change. And the third is to treat implementation and monitoring as an integral part of the reform process and not merely as an afterthought. In the absence of public sector reform, reformers can draw on private sector change management techniques to revitalize institutions and put in place mechanisms to monitor and sustain reform. The book provides an emerging checklist for reformers and identifies areas for future work.



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