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ASSESSING THE IMPACT OF REGULATORY REFORM IN DEVELOPING COUNTRIES[1]

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SUMMARY

Effective economic governance is a key condition for economic growth and development, and donor support to developing countries has increasingly been focused on regulatory reforms that are intended to enable markets to function more efficiently thereby providing a stable and supportive environment for investment, private sector development, and market-led economic growth. This article reviews the empirical evidence on the impact of regulatory reform in developing countries. The evidence is broadly consistent with *a priori* expectations, showing a positive relationship between regulatory reform and improved economic performance. However, various methodological and data problems weaken the robustness of these findings and point to the need to broaden the range of designs and methods for evaluating the results of donor-supported regulatory reforms in developing countries. © 2014 The Authors. *Public Administration and Development* published by John Wiley & Sons, Ltd.

KEY WORDS—regulatory reform; private sector development; developing countries

INTRODUCTION

Effective economic governance is a key condition for economic growth and development. By enabling markets to function efficiently and by providing a stable environment for investment, "good" economic governance sustains the process of private sector development (PSD) and market-led growth. In recent years, donor support to developing countries has focused increasingly on projects and policies that are intended to strengthen the state's capacity to provide better economic governance that will strengthen private sector activity and deliver improved economic performance.

Regulation is the key instrument for economic governance. The case for economic regulation is grounded in the need to deal with the market failures that arise in all economies and are most prevalent in low income economies. Regulation is intended to correct these market failures and thereby support market efficiency and economic growth. In this article, the term "regulatory reform" is used to refer to a set of measures that have the common objective of strengthening the regulatory environment. These measures include regulation policy, regulatory institutions and regulatory processes (OECD, 2011). Regulatory reform is intended to affect the economic behavior of agents in ways that will increase economic welfare. According to Douglass North's widely cited definition, the term "institution framework" refers to the set of informal and formal "rules of the game" that constrain political, economic, and social interactions (North, 1990, 1991). From this perspective, a "good" regulatory institutional environment is one that establishes an incentive structure that reduces uncertainty and promotes efficiency, thereby contributing to stronger economic performance. The Organization for Economic Co-operation and Development (OECD) has been

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at the forefront of developing 'best practice' guidelines for regulatory reform (OECD, 2002). However, problems of inappropriate policy transfer are likely to arise when the OECD model of regulatory governance is applied in the very different economic and institutional realities in low income countries, where human resource constraints and institutional capacity weaknesses mean that a "one size fits all" approach to regulatory governance is unlikely to produce the expected economic outcomes (IFC, 2008; Zhang, 2010).

Donors and their developing country partners increasingly demand credible evidence on the impact of aid programs in terms of development outcomes and value for money (ICAI, 2011; Sinha *et al*., 2013). This article responds to this demand by providing a review of the empirical evidence on the impact of regulatory reform on PSD and economic growth in developing countries. In doing so, it builds and expands on previous findings from an extensive review by the OECD of the quantitative evidence on the impact of regulatory policy (Parker and Kirkpatrick, 2012).

Private sector development has long been a significant part of the international development community's toolkit, with PSD being seen as a key driver of economic growth (DCED, 2013a, 2013b). The most common area for donor support within PSD is in creating business enabling environments, "including a focus on infrastructure, improving the education and health of workers, and enhancing economic reform and governance. In the governance sector the priority is on reducing administrative and regulatory barriers to business, building capacities in relevant ministries, reviewing existing legislation and policies, strengthening public financial management, improving tax collection and spending and improving legal/regulatory frameworks" (Donor Committee for Enterprise Development (DCED), 2013a, 2013b:2). Box 1 provides examples of donor interventions on regulatory reform.

Box 1. **Examples of donor interventions on regulatory reform**

1. Enterprise law in Vietnam (United Nations Development Programme)

United Nations Development Programme, with support from Australia, provided technical and other support to the Vietnamese Parliament in drafting and implementing a new Enterprise Law. Enacted in 2000, the new law helped to ease some of the key difficulties related to starting and operating a business.

2. Reforming business inspections in Uzbekistan (International Finance Corporation)

Since 2003, the International Finance Corporation's small and medium enterprise policy project has championed reforms to reduce the number of inspections incurred by firms and to educate firms about how to manage inspections.

3. Business registration and licensing—Minas Gerais, Brazil (World Bank)

This project sought to simplify the procedures for starting, maintaining, and closing a business, with an emphasis on small and medium enterprises. It included support to all the municipalities in Minas Gerais in the creation of a synchronized business database.

4. Regulatory impact assessment in Albania (World Bank)

This project supported the establishment and implementation of a system of RIA for all new legislative proposals, as part of a broader business environment reform and institutional strengthening project.

5. Business regulation simplification in Moldova (United States Agency for International Development)

The "Guillotine Law" of 2005 laid out a guillotine approach to review and streamline, over a 6-month period, what was originally anticipated to be a total of 300–500 regulations affecting business activity. This reform was intended to assist the government in rapidly and substantially simplifying the regulatory environment for businesses, and so support investment, start-ups, and job creation, particularly for small and medium enterprises.
Sources: DCED (2013a); Jacobs and Associates (2006).

Ideally, we would like to have direct evidence on the impact of donor-supported regulatory reform measures. However, there is a paucity of statistical data on development assistance for regulatory reform, and as a result, it has not been possible to test the impact of donor support for regulatory reform directly. This adds a further difficulty in interpreting the evidence on the impact of regulatory reform in terms of the effectiveness of aid,

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particularly when "ownership" of reforms can act as an intermediary factor in the causal chain linking donor supported regulatory reform to economic outcomes.

EMPIRICAL EVIDENCE ON THE IMPACT OF REGULATORY REFORM IN DEVELOPING COUNTRIES

Much of the quantitative evidence relating to the impact of regulatory reform is concerned with the effect on economic growth. The World Bank's Doing Business and Worldwide Governance Indicators (WGI) databases have been used to provide indicators of the quality of regulatory governance in developing countries. The Doing Business database provides annual cross-country rankings on 10 different components of regulatory burden on business: starting a business, construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business. The WGI database provides panel data on six separate indicators of governance: voice and accountability, political instability, governance effectiveness, regulatory quality, rule of law, and control of corruption.

The aggregate level evidence on regulatory reform and economic growth is consistent with *a priori* expectations, showing a statistically significant and positive relationship between the quality of the regulatory environment and economic growth. Djankov *et al*. (2006) find a statistically significant negative relationship between the regulatory business burden (measured using Doing Business database) and economic growth. Haider (2012) also uses the Doing Business database but replaces the annual regulatory status variable with a regulatory change variable, which measures the total number of regulatory reforms happening in a country over a 4-year period. Jalilian *et al*. (2007) use the WGI data to derive a measure of the quality of regulation in developing countries. The regression results are consistent with the hypothesis that regulatory quality has a positive and causal impact on economic growth.

The evidence relating to regulation and investment in developing countries is also consistent with the hypothesis that the quality of the regulatory environment matters. Eifert (2009) finds a positive relationship between the overall measure of regulatory governance and aggregate investment (and economic growth), suggesting that "relatively well-managed poor countries stand to gain from a broad push for streamlining regulations and procedures affecting business." Kirkpatrick *et al*. (2006) test the hypothesis that an effective regulatory environment provides regulatory credibility to the private sector and thereby encourages private investment. The results show the indicators of regulatory quality to be statistically significant and positively related to the private investment in infrastructure in developing countries. The empirical evidence of a positive relationship between the quality of the regulatory environment and macro-level investment and economic growth provides reassurance to donors and policymakers that improving the quality of regulatory governance can be expected to impact positively on economic performance. However, this body of literature provides no guidance on the particular types of regulatory reform that are likely to be most effective. Indeed, where researchers have disaggregated the measure of governance into separate policy areas, the results have often failed to produce statistically robust evidence on the impact of individual reform measures. For example, when Eifert (2009) examines the impact of reform in five separate areas (business registration, contract enforcement, labor laws, property registration, and import–export) on investment and economic growth, the regression results are insignificant and in many cases have the wrong sign.

More recent research has adopted a more disaggregated approach to assessing the impact of regulatory reform. Enterprise development is the key driver of PSD with the entry of new businesses enhancing competition, employment, and economic growth (Djankov *et al*., 2002; Klapper *et al*., 2006). The reform of enterprise registration and licensing procedures has been a significant part of regulatory reform in developing countries, on the basis of the belief that complex and time-consuming procedures for registering a new business act as a barrier to the growth of new firms and formal sector development. Specific interventions have included the establishment of one stop shops, the use of a fixed registration fee regardless of company size, the separation of registration from licensing regulations, and reviewing procedures to ensure they still fulfill their intended purpose. The Doing Business rankings, for example, provide detailed information on the number of procedures that have to been complied with and the length of time spent on registering a new firm. Over the period 2003–2011, Doing Business recorded 349 business registration reforms in 146 countries.

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The evidence on the impact of enterprise registration and licensing reform is mixed. The majority of studies have applied regression analysis to cross-country or panel data. In general, the results show a positive relationship between registration and licensing reform and various indicators of economic performance, including the number of new registrations, size of the formal sector, employment growth, and tax revenues. Audretsch *et al*. (2006) show how cumbersome regulations and administrative procedures for starting a business are associated with a smaller number of legally registered firms, greater informality, and more opportunities for corruption. Klapper and Love (2010) combine panel data on the number of newly registered companies and Doing Business data to investigate the impact of enterprise set up costs on the growth of new enterprises and find that barriers to starting a business are significantly and negatively correlated with business registrations. Ciccone and Papaioannuou (2007) combine industry level data on employment growth and the growth in the number of establishments with data on the time taken to obtain legal status to operate a business. Their main empirical finding is that in countries where the legal status to establish firms can be obtained more quickly, there is significantly higher growth of new firms. Bruhn (2011) and Kaplan *et al*. (2011) both study a business registration reform in Mexico which reduced the time required to register a business from 30 to 2 days and find an increase in the number of registrations. De Mel *et al*. (2012) conducted a field experiment in Sri Lanka that provided incentives for informal firms to formalize by registration and find that simply reducing the costs of registration did not result in any increase in registration.

Economic regulation is intended to correct market failure and improve market competition. An important determinant of the success of regulatory reform therefore is the effectiveness of the regulatory institutional framework for promoting competition and controlling the anti-competitive behavior of dominant firms (Parker and Kirkpatrick, 2004). The empirical evidence on the effectiveness of regulatory institutions in developing countries is broadly consistent with *a priori* expectations. Zhang *et al.* (2005) model the impact of electricity generation privatization in developing countries and find that the establishment of a regulatory body before privatization was introduced had a positive impact on post-privatization performance. Gutierrez and Berg (2000) also identify the importance of effective regulatory governance in achieving performance improvements in Latin American telecommunications. Wallsten (2001) provides an empirical study of telecommunications in 30 African and Latin American countries and finds that post-privatization performance is related to effective regulatory institutional capacity. Gutierrez (2003), studying economic performance in telecommunications Latin American countries between 1980 and 1997, finds that sound regulatory governance has a positive effect on network expansion and economic efficiency.

Many developing countries lack strong regulatory capability in terms of trained personnel and sound laws to sustain regulatory commitment and credibility. Regulatory offices tend to be small, under-manned for the job they face, and possibly more expensive to run in relation to gross domestic product than in developed economies (Domah *et al*., 2003). These general findings are confirmed by country-level case study evidence that confirms that national regulatory bodies have functioned poorly due to inadequate skills, internal governance problems, and the prevalence of political capture (e.g., Cariño, 2004 (the Philippines); Knight-John, 2004 (Sri Lanka); Arun, 2004 (India)). In part, these problems can be attributed to the uncritical adoption of models of sector regulation that were developed in the advanced OECD countries in institutionally less well endowed developing countries (Minogue, 2004).

Regulatory impact assessment (RIA) has been a feature of regulatory reform initiatives in a growing number of developing economies (Kirkpatrick *et al*., 2004; Kirkpatrick and Parker, 2008). RIA helps to improve the quality of new regulatory proposals by providing a methodological framework for analyzing the problem that the regulation is intended to solve, identifying alternative ways of dealing with the problem, and assessing the likely positive and negative impacts of adopting the proposed regulation. *Ex post*, RIA can be used to review the net benefits of existing regulations and to ensure that regulations remain consistent with their intended policy objectives. RIA also contributes to the attributes of good regulation in terms of transparency, accountability, consistency, targeting, and proportionality.

There is no single "best practice" model for RIA, and the institutional set up varies according to the legal, political, economic, and social conditions in the country concerned (Parker and Kirkpatrick, 2004; IFC, 2010). Kirkpatrick *et al*. (2004) survey RIA procedures and practice in 40 developing and transition economies. The results suggest that a growing number of low and middle-income countries are applying some form of regulatory assessment but that the methods adopted are partial in their application and are not systematically applied across government. Although there is a general recognition of the desirability of including benefits as well as costs in an

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RIA, the main focus is on costs. Methods of quantification were generally underdeveloped. Finally, in almost half of the countries from which completed questionnaires were received, RIA appeared to have been adopted on a standalone basis rather than as part of a broader program of regulatory governance reform. Zhang (2010) examines the extent to which RIA as a tool for better regulation design has been integrated into a broader program of regulatory reform. The analysis is based on data collected through questionnaire surveys in a sample of developing countries in Asia and Africa in 2003 and 2007. The results show that while the majority of countries in the sample have adopted some form of RIA, few have shifted to taking a systematic view of regulatory reform.

SUMMARY AND CONCLUSIONS

The objective of this article has been to review the empirical evidence on the impact of regulatory reform on economic performance and PSD in developing countries. There is a paucity of data on donor interventions in the area of regulatory governance, which would allow direct testing of the impact of donor funding in the area of regulatory governance. As a consequence, the scope of this article has been limited to the evidence relating to regulatory reform *per se*, rather than to donor-supported interventions in this area.

The empirical testing of the effects of regulatory reform on economic performance in developing countries has relied heavily on the use of econometric analysis. Used appropriately, regression analysis provides statistically validated evidence on the tested hypothesis. Nevertheless, there are important caveats about its use. Correlation is not the same as causality. Evidence of a statistically significant correlation between, for example, regulatory quality and gross domestic product growth does not prove that the causality chain runs from regulation to economic outcomes. It is equally possible to argue that higher economic growth encourages lower regulation or that poorly performing economies are more prone to regulation. A second caveat relates to interpretation of results derived from panel data, which combine time series data (data over time) with cross-country data (comparing across countries in a particular year). Cross-country heterogeneity can be expected to be a serious limitation if the quality of regulatory governance is affected by within country factors, such as law and order, regulatory capture, or corruption. These problems are exacerbated when cross-country differences occur over time. A third limitation relates to data adequacy. It is common practice in econometrics to use proxy variables in the absence of other, more appropriate, data; but particular care needs to be taken with proxy variables for regulatory reform, which combines regulation policies and institutional factors. Typically, the regulation reform variable is treated as a "stock" variable, whereas the target outcome variable may be dependent on the change in regulatory environment. In other words, understanding the dynamics of regulatory reform requires a more refined approach to regulation than can be extracted from regression analysis.

Subject to these qualifications, the empirical evidence is consistent with the hypothesis that better regulatory reform can stimulate PSD and economic growth. The evidence also suggests that an improvement in the quality of regulatory governance is likely to be more effective in terms of economic outcomes when the quality of the existing regulatory environment is low. The literature on the economic effects of particular areas of regulatory reform is more limited. The availability of cross-country enterprise level data has allowed investigation of the effects of regulation on the entry of new firms into industries and enterprise sector diversification and growth. In general, the findings are consistent with the notion that excessive regulation can reduce the entry of new firms into markets and discourage new investment by existing enterprises. However, there are again problems in interpreting the empirical results, particularly in identifying the underlying causal relationship between regulatory reform and the growth of new and existing enterprises. The impact of enterprise registration reform, for example, appears to be more affected by broader regulatory environment conditions, rather than registration cost reduction *per se.* The importance of regulatory institutions in determining economic outcomes is confirmed in the empirical literature, which shows that the independence of regulatory institutions is a significant determinant of economic outcomes, by protecting them from the threat of continuing political interference in regulatory decisions and regulatory capture. In the same way, institutional capacity is a key determinant of the effectiveness and sustainability of RIA procedures in developing countries.

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These findings have a number of practical implications for donors and policy makers engaged in regulatory reform in developing countries. While the empirical literature shows that regulatory policy interventions can facilitate PSD and ultimately encourage improved economic growth performance, it also shows that the institutional framework in a country and adherence to the principles of open regulatory governance have a significant effect on the economic outcomes. In other words, the results of regulatory reform are likely to be heavily influenced by context-specific factors, and donors should be alert to the dangers of adopting a "one size fits all" approach to regulatory reform. Regulatory reform initiatives need to be designed in a way that allows for the country's institutional and regulatory endowment. For example, the reform of enterprise registration procedures, without at the same time reforming licensing regulations is unlikely to succeed. Similarly, it is unrealistic and ultimately counterproductive to introduce a comprehensive RIA procedure across all departments and applied to all new legislation, where human resource capacity within the public sector is limited. Independent regulatory institutions will be less likely to affect an improvement in economic outcomes where there is the risk of "capture" by the regulated industries or where there are inadequate safeguards against arbitrary political interference.

Greater public accessibility to donors' data on funding for regulatory governance initiatives and to internal monitoring and evaluation data would allow for more robust external evaluation and would demonstrate donors' commitment to the principles of greater accountability and value-for-money. At the same time, there is a need to broaden the range of designs and methods for impact evaluation to include quantitative, qualitative, and mixed methods of impact evaluation in an effort to address the limitations of econometric evaluation methods (Ravallion, 2009; DFID, 2012). There is much more work to be carried out in broadening the range of designs and methods for impact evaluation and in supplementing the available data on aid for regulation before donors' support for regulatory reform can be judged to be firmly evidence-based.

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