EAST ASIAN BUREAU OF ECONOMIC RESEARCH

EABER WORKING PAPER SERIES

PAPER NO.27

THE ROLE OF MICROECONOMIC POLICY REFORM IN REGIONAL INTEGRATION – ANALYTICAL AND EMPIRICAL ISSUES

PHILIPPA DEE
CRAWFORD SCHOOL OF ECONOMICS AND GOVERNMENT
AUSTRALIAN NATIONAL UNIVERSITY
PHILIPPA.DEE@ANU.EDU.AU

PAPER PREPARED FOR DISCUSSION AT THE
NCAER/EABER CONFERENCE ON THE MICROECONOMIC FOUNDATIONS OF ECONOMIC POLICY PERFORMANCE IN ASIA
NEW DELHI 3 – 4 APRIL 2008

EABER SECRETARIAT
CRAWFORD SCHOOL OF ECONOMICS AND GOVERNMENT
ANU COLLEGE OF ASIA AND THE PACIFIC
THE AUSTRALIAN NATIONAL UNIVERSITY
CANBERRA ACT 0200 AUSTRALIA

The role of microeconomic policy reform in regional integration — analytical and empirical issues

Dr Philippa Dee
Crawford School of Economics and Government
Crawford Building (13)
Australian National University
Canberra ACT 0200
Australia
philippa.dee@anu.edu.au; ph 61 2 6126 8598; fax 61 2 6125 0767

March 2008

Abstract :
Economic integration should not be an end in itself, but the outcome of domestic reforms that increase the general contestability of markets. The paper finds that for India, comprehensive domestic regulatory reform dominates as an integration strategy, while an ASEAN+6 PTA would fail to deliver gains. Multilateral action is an intermediate strategy, important for delivering trade liberalisation in sensitive sectors and in highly protected economies. The paper then considers what institutional approaches might facilitate further domestic structural reforms. Key to this are mechanisms to review the desirability and performance of all regulations and institutions on an ongoing basis, and in a way that involves all relevant stakeholders. Such policy review institutions can provide technical solutions, helping to identify particular reform options. They can also be part of a strategy to manage the domestic political economy of reform, by providing a forum in which countervailing interests could marshal against vested interests, thus helping to build a coalition in favour of reform. Finally, they can facilitate policy coordination within and across levels of government. The paper considers desirable characteristics of such institutions, and provides examples from around the Asian region.

JEL Classification: F13, F15
Keywords : economic integration, preferential trade agreements, regulatory barriers to competition, domestic regulatory reform, Asia, institutions

Paper prepared for NCAER/EABER conference on the Microeconomic Foundations of Economic Policy Performance in Asia, New Delhi, 3-4 April 2008.

1 Nature and objectives of economic integration

Economic integration goes beyond simple trade liberalisation. 'Deep' integration is aimed at reducing the market segmenting effects of behind-the-border, domestic regulatory policies through coordination and cooperation (Lawrence 1996). The aim is to ensure that domestic prices are no higher than they need to be, relative to foreign prices, thus promoting economic efficiency and maximising income levels.

It is often assumed (eg Commission of the European Communities 1985) that at the core of deep integration is the removal of all border and behind-the-border discrimination against foreign suppliers of goods and services (and sometimes labour and capital). *If* there are no significant non-discriminatory barriers affecting both domestic and foreign suppliers, then removing all discrimination against foreign suppliers will mean that domestic prices will be no higher than they need to be, relative to foreign prices. But this definition of deep integration may be too weak. If there are significant non-discriminatory regulatory barriers affecting both domestic and foreign suppliers, then domestic prices may still be higher than they need to be, relative to foreign prices, even if all discrimination against foreign suppliers is removed.

By contrast, some writers (eg Cooper 1976, Lloyd and Smith 2004) define deep integration in terms of the law of one price holding in all markets. *If* all goods and services are relatively homogeneous, and *if* all are potentially tradable, then an absence of market segmenting barriers will ensure that a single good or service is priced the same in all markets. But this definition of deep integration may be too strong. If goods and services are not the same in all markets, then market segmenting barriers may mean that the prices in one market are higher than they need to be, relative to those elsewhere, but that removal of those market-segmenting barriers may not bring prices fully into equality.

To restate, the aim of deep integration is to remove the market segmenting effects of barriers, both at the border and behind it, so that domestic prices are no higher than they need to be, relative to foreign prices. The relevant barriers need not be explicitly discriminatory against foreign suppliers, but could affect domestic and foreign suppliers equally. Removing these market segmenting barriers should bring domestic and foreign prices closer together, although it may not bring them into full equality.

This definition raises broad questions about the appropriate policies to achieve economic integration. What relative priorities should be given to removing explicit discrimination against foreign suppliers, or removing the non-discriminatory regulatory restrictions that affect domestic and foreign suppliers equally? And what domestic institutional arrangements can best support the reforms that are needed for deep economic integration? These are the questions to be addressed in this paper.

2 Assessing different paths to economic integration

According to the above definition, economic integration should not be an end in itself, but the outcome of domestic reforms that increase the general contestability of markets. By contrast, preferential trading agreements (PTAs) pursue economic integration as an end in itself. Dee (2007a) evaluates some of the possible paths to Asian economic integration by comparing three key integration strategies — preferential trade agreements, multilateral action through the WTO, and comprehensive domestic regulatory reform. The paper characterises the types of policy measures that could be expected to be achieved under each strategy, and compares the economic effects of each set of policy measures.

The paper notes that while those PTAs that have addressed behind-the-border issues in their chapters on services and investment have generally gone further than the GATS (see also Roy, Marchetti and Lim 2006), they have tended to be selective in two important ways:

- they have tended to be preferential, even in the provisions that go beyond goods trade;
- they have tended to target only those provisions that explicitly discriminate against foreigners.

The paper gives various reasons for these outcomes. One is that the logic of trade negotiations dictates that countries should never 'give something for nothing'. So PTA negotiators have tended to avoid extending the preferences they grant trade partners to third parties, even when economic arguments suggest there would be strong domestic gains from doing so.

Partly as a result, recent PTAs have tended to target only those provisions that explicitly discriminate against foreigners. This is because, in many cases, the only provisions that can feasibly be liberalised on a preferential basis are those that discriminate against foreigners.

But even without this feasibility constraint, there are various economic and political economy forces that tend to limit concessions within PTAs to those that explicitly discriminate against foreigners. One of the key reasons is that when trade negotiations take place via request-and-offer, demandeurs typically only make requests for the removal of discrimination against foreigners — in this way, their market share is maximised. Foreign producers would generally have little interest in unleashing competition from promising domestic new entrants. They would rather join a cartel on a far more selective basis! And in these circumstances, the liberalising countries risk simply handing monopoly rents to foreigners. Indeed, this is the basis of the East Asian desire to have safeguard provisions in services negotiations.

Another consideration is the requirements for WTO consistency. WTO disciplines only require PTAs to remove explicit discrimination against foreigners. They do not require them to address regulatory restrictions that affect domestic and foreign suppliers equally.

Dee (2007a) shows that if a PTA involving ASEAN+3[1] managed to eliminate all discrimination against foreigners in those sectors where empirical evidence is available (as well as eliminating tariffs among PTA partners), the gains would be small compared to a successful completion of the Doha Round.[2] And they would be trivial compared to a comprehensive program of unilateral regulatory reform, one that instead targeted non-discriminatory behind-the-border restrictions that affected domestic and foreign suppliers equally.

A key reason for the findings is that there appears to be a reasonably strong correlation in practice between measures that discriminate against foreigners and measures that create rents, rather than raising real resource costs. In a broad sense, this is understandable. One of the easiest ways to discriminate against foreign suppliers is to create explicit artificial barriers to their entry, either cross-border or via direct investment, and these barriers tend to create rents rather than raise costs. However, the gains from liberalising cost-escalating barriers is likely to exceed the gains from liberalising rent-creating barriers by a significant margin (compare figures 1a and 1b).

Dee (2007b) extends the analysis to the consideration of an ASEAN+6 grouping, one that includes India, Australia and New Zealand. For the initial ASEAN+3 group of countries, the relative benefits of the alternative paths to economic integration are shown to be about the same as before.

India, Australia and New Zealand as a group are shown to be worse off than they otherwise would be if ASEAN+3 were to form a PTA without them. But interestingly, they would not gain much as a group from being included in the PTA either. A key driver of this latter finding is that India is projected to be slightly worse off than otherwise from its inclusion in an ASEAN+6 PTA. According to the levels of tariff protection embodied

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[1] ASEAN+3 = ASEAN plus China, Japan and Korea.

[2] The indicative Doha Round settlement involved a 25 per cent cut in agricultural protection (tariffs, export subsidies and domestic support), a 25 per cent cut in tariffs on manufactures, and the granting of national treatment to all other WTO members. It was thus judged that significant progress on agricultural trade reform would not occur in an ASEAN+3 PTA, but would require multilateral action in the Doha Round.

in the FTAP model,[3] India's tariffs on manufacturing are higher on average than elsewhere in the ASEAN+6 grouping, despite its recent trade reforms. India is thus susceptible to terms of trade losses from joining a PTA with more open trading partners. This has been highlighted as a theoretical possibility by Panagariya (1999, 2000), and is a feature of the model results in Dee (2007b).

India is projected to be much better off when tariff liberalisation takes place multilaterally, with many more trading partners, than it is when it joins a PTA with a few, more open trading partners. The terms of trade effects are much more benign in these circumstances. In fact, for India, Australia and New Zealand as a group, a successful Doha Round settlement is projected to be almost as worthwhile as comprehensive domestic regulatory reform to which they were a party. Elsewhere in the Asian region, comprehensive domestic regulatory reform clearly dominates both the multilateral and PTA strategies as a way of raising real incomes.

The results for India alone from that exercise are shown in Table 1. The table confirms that India is projected to lose slightly from joining an ASEAN+6 PTA. By contrast, it is projected to gain almost $4 billion a year from a successful completion of the Doha Round, but almost $6 billion a year from joining a region-wide program of comprehensive unilateral regulatory reform. Significantly, almost all of this $6 billion would accrue from India's own reforms — it would gain a mere $0.13 billion from unilateral regulatory reforms elsewhere in the ASEAN+3 countries.

The analysis therefore suggests that for most of the Asian region, comprehensive domestic regulatory reform dominates as an integration strategy,[4] while PTAs deliver relatively trivial gains. Multilateral action is an intermediate strategy, and is important for delivering trade liberalisation in sensitive sectors or in highly protected economies. These results are shown to be relatively robust to the size of the Asian PTA grouping.

3 Furthering domestic structural reform

Comprehensive domestic regulatory reform of non-discriminatory restrictions can deliver large gains to much of the Asian region, including India. But to date this agenda has not been greatly fostered by PTAs or by the WTO, both of which tend to concentrate on national treatment and discrimination against foreigners. India has been undertaking its

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[3] The tariff data are taken from version 6 of the GTAP database (Hertel 1997). The FTAP model itself differs from GTAP by including a treatment of foreign direct investment, thus allowing consideration of policies to liberalise services and investment. The model is described briefly in Box 1.

[4] The modelling results did not presuppose that all countries removed their non-discriminatory restrictions at the same time, or at the same rate.

own structural and trade reforms on a unilateral basis. The reminder of this paper considers institutional approaches that might facilitate further reforms along these lines. What are the important domestic barriers to structural reform? And what domestic institutional structures could best support this policy agenda?

Since the economic focus of domestic structural reform is on behind-the-border measures, the political economy of deep economic integration is primarily domestic. And there is a wide diversity of economic interests involved. These include incumbent producers, potential new entrants (both domestic and foreign), ‘upstream’ industries that supply inputs to the reforming sector, ‘downstream’ industries that buy inputs from the reforming sector, final consumers, and governments. The ways in which these actors are affected by a particular structural reform can vary, and can depend on some quite complicated economy-wide interactions.

If institutions are to support the structural reform process, they need to support both the economics and the political economy of structural reform. Structural reforms may deliver a better set of rules governing the operations of markets, and these new rules will require institutions to implement and enforce them. These institutions, which support the economics of reform, include competition policy regulators, national audit offices, and so on. But if structural reforms are to happen at all, it can also be helpful to have institutions that can mediate among the diverse range of economic interests involved, and build a coalition for reform.

Impediments to structural reform

There are at least three possible reasons why good domestic regulatory reforms are not adopted.[5] Each has different implications for the types of institutional approaches that could help support the domestic reform process.

- Governments do not know what is policy ‘best’ or ‘better’ practice, or lack the capacity to implement it. This argues for governments to allocate the resources to undertake systematic reviews of existing policy arrangements, and to identify policy alternatives. It also argues for an international exchange of policy experience to raise awareness of what constitutes better practice, and how to implement it. The APEC regional processes have been highly effective in providing a forum for such exchanges of policy experience to date. Finally, some governments may find it useful to tap into external sources of expertise to undertake policy reviews and to build implementation capacity.

[5] The following taxonomy is due to Ross Garnaut.

- Governments know what is ‘better’ practice, but face political resistance from vested interests. This argues for government-sponsored policy reviews to analyse the gains and losses to all players, not just the vested interests, so as to help marshal countervailing interests in favour of reform. It also argues for an international exchange of experience about how to handle vested interests, and how to strengthen domestic institutions in favour of the public interest.
- Governments do not want ‘better’ policy, because they rely on the rents from current policies for political funding purposes. In these circumstances, government itself is a vested interest, and will be resistant to initiating its own policy reviews that would expose the costs to others of current policies. However, there is a potential role for private (or otherwise independent) policy review institutions to carry out the necessary work of scrutiny, and to marshal countervailing interests in favour of reform.

In all three cases, there is a useful role for institutions that can undertake policy reviews. But the purpose of the reviews varies, depending on the nature of the problem. If the problem is one of identifying better policies, then the policy reviews provide a *technical* solution — they review current policy settings and identify better options. But if the problem is managing vested interests (which may include those within government), then the policy reviews are a *strategy* rather than a technical solution. The policy review institution can provide them as ammunition with which to manage vested interests and build a coalition in favour of reform, but there is no guarantee that the reviews will be decisive in any particular instance. Over time, however, they can help influence the terms of the debate. Finally, policy reviews can facilitate policy coordination within and across levels of government. Each of these roles of policy review institutions is now discussed in turn.

Identifying better policy options

For a policy review process to make a useful contribution to identifying better policy options, there needs to be an orderly policy development process,[6] and the policy review needs to be done early enough to articulate viable options before positions become locked in. Quite often, policy making does not fit this model. Rather, policymaking often results from political imperatives calling for quick action, from deals with particular interest groups and from bargaining between political interests or parties. Sometimes these approaches result in good policy outcomes, but the risk of failing to do so is undoubtedly higher than in cases where a more open and orderly policy development process is adopted.

[6] Parts of this section are taken from Coghlan (2000), PC (1998) and Banks (2003).

Figure 2 shows such an open and orderly policy development process. The figure presupposes having certain institutions, or at least institutional divisions. However, an orderly policy development process does not depend on having those exact institutions — other institutions could perform the same functions, depending on the system of government. What is important is the functions themselves.

When the system works in an ideal fashion, a great deal of policy development work takes place before a proposal is put to government. This includes the policy review — a sequential process of articulating the problem and the desired objectives, assessing a range of options, evaluating the effects of each option on all stakeholders, recommending the best option, or else explaining why some other option is preferred, and outlining a strategy to implement the preferred option and then review its operation, thus providing an ex post check on policy performance.

The ideal policy development process also involves a great deal of consultation. Ideally, there would be two rounds of consultation with all relevant stakeholders, one at the inception of the policy review as the review panel or agency is starting to develop its ideas, and again after the preparation of a draft report that outlines the full analysis and possible policy solutions (sometimes, but not always, including a preferred solution at the draft stage). This consultation process helps the review agency to identify all the costs and benefits to each stakeholder, and provides an opportunity for the review panel to explain its preferred solution to stakeholders.

At the very end of the ideal process, a policy proposal is put to government by the responsible officials and Minister, and a decision is made as to the appropriate form of regulation or other policy action. In a parliamentary system, this decision is often made by Cabinet, a grouping of all government Ministers. When a Minister makes a submission to Cabinet, other Ministers can scrutinise the proposal, although this Cabinet scrutiny is typically not made public. In a presidential system, the decision may be made by the executive branch, with scrutiny only from within the presidential office.

If the decision is to implement ‘black letter law’, then legislation will be drafted and tabled in the legislature. This allows for public debate and scrutiny by members of both the ruling government and opposition parties. If the decision is to institute lower level regulations of any sort, these will typically not be tabled in the legislature.

As noted, sometimes the policy development process does not work in an orderly fashion, and a proposal is put to government without any prior policy review or consultation. In this case, there is very little scope for those other than the responsible Minister to have input into the decision-making process. And there is no public scrutiny, if at all, until after the decision is made.

No political system in the Asia-Pacific region measures up to the ideal in every respect. But many have at least some of the institutional elements that allow for prior policy review and consultation, as will be seen later. And the opportunity provided by policy reviews for transparent consultation is the key to their strategic role in managing vested interests.

Managing vested interests

An independent policy review process can help deal with vested interests in a number of ways.

First, policy reviews can help set the agenda — policy change will not happen if nobody talks about it. At this early stage, policy reviews do not need to provide policy recommendations. Indeed, to do so may be seen as pre-emptive of the subsequent policy development process. But they can carefully analyse the costs and benefits of current policy settings, and perhaps canvas some of the policy alternatives without taking a strong or preemptive stance on any particular one. The aim is to highlight who is losing from current policy settings, perhaps to quantify the size of those costs, and to show how the losers might be better off under policy alternatives. This can help alert the losers, who may be aware of the direct costs they face, but may be less aware of the indirect costs. Policy reviews can galvanise them to start pressuring for policy change, and provide ammunition for such a campaign.

Second, reviews can also set the parameters of the debate. Vested interests typically highlight the effects of policy changes on themselves alone. Policy reviews can establish analytical frameworks within which to examine the costs and benefits of current policy settings to all stakeholders — incumbents, new entrants, upstream and downstream industries, consumers and governments. Such frameworks may attract criticism, and lead to sometimes frustrating debates about the assumptions underlying them, and the relative sizes of the costs and benefits. But such frameworks make it much harder to ignore the interests of particular stakeholders altogether, particularly those, such as consumers, who may not be well-organised or are less able to represent themselves.

Third, a policy review process can help to depoliticise a debate. A highly politicised environment is not conducive to rational policy analysis. Nor is sound policy development helped by populist public sentiment that emphasises slogans over analysis. Most governments will therefore find it in their own interests on occasion to take the heat off an issue by referring it for independent, objective study. The results of such study can then be brought back to the public at a later stage, to educate public opinion about the range of stakeholder interests involved.

Fourth, policy reviews can 'name and shame' the recipients of special deals. This needs to be done carefully, and as neutrally as possible, so as not to inflame the political debate or unduly threaten the credibility of the review institution. But vested interests often rely on a lack of transparency in their dealings with government. So reviews that expose the outcomes of those dealings can help to clarify the gainers from current policy settings, as well as the losers. This in turn can also start to put pressure on the political processes themselves.

Fifth, a policy review process can marshal countervailing interests against vested interests, and help to build a coalition in favour of reform. It may not always be obvious to governments in advance who the champions of structural reform might be. A carefully laid out policy review process that invites the participation of all interested parties can help the champions to self-select. It also provides a forum for groups of champions to identify their common interests, and to agree to cooperate in pro-reform strategies.

Sixth, policy reviews with a sufficiently broad purview can help to identify policy *combinations* that lead to so-called Pareto improvements, where at least some stakeholders are better off and none is worse off. It is sometimes possible to identify such 'virtuous cycles' of structural reforms. For example, manufacturing firms that are put under competitive pressure when their tariff protection is reduced may benefit in turn from transport reforms that reduce their input costs. Importantly, policy reviews can also identify options such as phased implementation or adjustment assistance, which can ease the burden on those that would otherwise lose from structural reform. Both the policy reviews and the review institutions can then achieve acceptance from particular vested interests, and the reviews can thus help to build a *grand* coalition in favour of reform.

Assisting policy coordination across government ministries

A policy review process can help to build a pro-reform consensus outside of government. But Ministers with an economic reform agenda also have to build consensus within various government ministries.

Although the structures of government vary widely across the Asian region, there are some broad elements in common. Most bureaucracies have at least some government departments with economy-wide responsibilities. These typically include the ministry in charge of tax policy. Sometimes they include a central agency in charge of government spending, or a single agency charged with overall responsibility for structural reform. These ministries tend to take a broad, horizontal view of economic issues.

There are also government departments in charge of overseeing sectional policies. These might include ministries in charge of telecommunications policy, industry policy, health policy, and so on. These ministries are responsible for administering and enforcing current policies, and are staffed with highly skilled and qualified specialists capable of performing these tasks. The interests of such ministries are often closely aligned with the interests of the producers in their respective sectors. It is not necessarily that the ministries are 'captured', just that they have a sectional rather than an economy-wide focus.

Thus Ministers with an economic reform agenda need to be able to harness the economy-wide views of the central agencies in the policy development process, while using the specialist skills and expertise of the sectoral agencies for both policy development and implementation. Coordination problems can arise when the narrower perspective of the sectoral line agencies means that they are against structural reform.

Policy reviews can help with such coordination problems. An independent policy review agency can consult with various central and line government departments, just as it consults with all other potential stakeholders. This can alert the sectoral departments to broader economic considerations, just as it does to other stakeholders.

Some economies assign an active coordinating role to one of the central agencies with broad, horizontal portfolio responsibilities. If such agencies are armed with high-quality, independent policy reviews, this too can strengthen the public interest during the policy coordination process.

A final coordination problem is to ensure that sectoral departments abide by coordinated decisions, and implement the structural reforms as intended. Where a central agency has been assigned a coordinating role, it may be in position to exercise budgetary sanctions over line departments. But *ex post* policy reviews can also be used as way of exposing any non-performance by sectoral line agencies.

Assisting policy coordination across levels of government

Ministers with an economic reform agenda may also have to build consensus across different levels of government, particularly when the reform agenda requires the cooperation of sub-national (eg State, local) levels of government.

A well-designed Federal system may itself be a tool for improving economic performance. By clearly defining what level of government is responsible for providing and financing various services and delegating appropriate authority, responsibility and resources, local services may be provided more effectively and local accountability may be enhanced. When populations can move, then variations in the bundles of services provided by different sub-national jurisdictions can also improve community well-being by providing greater choice, allowing citizens to self-select towards the jurisdictions that suit them best.

Policy reviews of the quality of service provision at the sub-national level can be a powerful tool to provide transparency and thus improve accountability of those lower levels of government. Such reviews can help establish benchmarks for sound policy making at the local government level. *Comparative* policy reviews of service provision across sub-national jurisdictions can also provide a form of 'benchmark competition' to those service providers. For example, annual reviews that published information about the prices, costs and productivity of service providers across jurisdictions could provide strong incentives for lagging suppliers to improve their performance.[7]

Whether because of jurisdictional overlaps, or simply because of the economic linkages between different service areas, central governments may sometimes need specific forms of cooperation from sub-national governments in order to implement a particular reform agenda.

Different countries have different mechanisms to facilitate such cooperation. Some have established intergovernmental forums to initiate, develop and monitor the implementation of policy reforms that are of national significance and which require cooperative action. The Council of Australian Governments is one such forum. Some central governments actively 'incentivise' lower levels of government, by linking inter-governmental funding transfers to the achievement of specific reforms. India's Thirteenth Finance Commission is currently tasked with producing recommendations on the distribution of certain tax proceeds between the Union and the States over a five year period, having regard to (among other things) 'the need to improve the quality of public expenditure to obtain better outputs and outcomes'.[8] This could provide a vehicle for such incentive payments.

When formal cooperation is required, *ex ante* policy reviews can play a role in defining the reform agenda, and highlighting the potential impacts on various jurisdictions, including highlighting which jurisdictions might suffer from the reforms (eg if productivity improvements need to be achieved via major labour-shedding) and thus warrant adjustment assistance. *Ex post* policy reviews can help monitor progress in achieving the reforms, perhaps providing a trigger for incentive payments.

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[7] An example of such an annual review publication is SCRGSP (2008), which compares the performance of government service providers across the Australian States in six broad services areas. The report always receives very broad media coverage, with each State jurisdiction showing a strong interest in how its services providers compare with those in other jurisdictions.

[8] Thirteenth Finance Commission Public Notice, accessed from www.fincomindia.nic.in/fincom13/pubnot.htm.

The characteristics of effective institutions to support the policy process

Keeping in mind the various uses of policy reviews, it is now possible to canvas the characteristics of effective policy review institutions.[9] There are three key attributes.

- *Statutory independence.* The review agency should not be bound by current government policy, as line government departments often are. In conducting its reviews, it needs to be able to provide a full critique of current government policy settings, as a necessary first step in developing and promoting structural reforms. The review agency need not be independent of government funding. Secure tenure arrangements for the individuals responsible for the reviews may be as important as the funding arrangements. The critical point is that the review agency should be able to be fearless in its criticisms.

  Further, the review agency should not have an implicit stake in the status quo, as regulatory agencies in charge of implementing current economic policy often do. At worst, such agencies may be captured by current vested interests. But even statutorily independent regulatory institutions can have a strong implicit stake in the regulatory status quo, as this is often required to implement current policy effectively. Ideally, therefore, a policy review agency should be independent of current regulatory agencies.

- *An economy-wide view* — the review agency needs to look beyond narrow sectional interests, and to consider net gains to the economy as a whole. Tracing through all the economic effects of a particular reform on all the various stakeholders can require considerable analytical capacity. Ensuring that the review agency has access to analytical resources, including skills in partial and general equilibrium modelling and cost benefit analysis, can help to provide such analysis and ensure its credibility.

- *Transparent processes* — the review agency needs to ensure the transparency of the arguments and analysis put to it. It could do this, for example, by holding its consultations in the form of public hearings, or by publishing summaries of its consultations shortly afterwards. The agency's reports to government should also be made public, ensuring the transparency of its own advice to government. Transparent processes bolster the ability of at least some countervailing interests to marshal against particular vested interests, so helping to ensure that an economy-wide view will be taken by policy makers. This can also relieve the government from having to marshal those countervailing interests itself.

A requirement to take an economy-wide view is critical, and a requirement to maintain transparent processes and to consult widely is not enough, for two reasons. Without a

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[9] Parts of this section are taken from PC (1998) and Dee (2006).

requirement to take all views into account, a review agency may simply ignore some views. More importantly, one key group of stakeholders — consumers — rarely participate in public consultation processes. In many economies, consumer interest groups are active on consumer safety issues, but rarely participate on matters of economic efficiency. Having a review agency required to take an economy-wide view ensures that consumer interests are taken into account, as well as the interests of producers and upstream and downstream industries.

Such an agency cannot possibly undertake the policy development for every single policy proposal. But it is particularly useful in those policy areas where there are major potential efficiency or other payoffs to the community from change, but where existing entitlements create resistance to reform. As noted, referring such issues to a statutorily independent body can help to de-politicise them, and allow breathing space for more careful analysis.

The government need not be bound by the recommendations of such a review agency. Indeed, the independence of the agency may be assisted by removing it from any responsibility for downstream policy implementation. Nevertheless, a review agency can still have influence, even if it can sometimes be ignored, for several reasons:

- transparent processes have influence, and such an agency can identify the winners and losers from current policy setting; and
- ideas have influence, and such an agency can formulate reform proposals with high-quality intellectual backing.

A policy review institution will be subject to inevitable attack from vested interests, and so needs to protect its credibility in the face of such attacks. Credibility is enhanced if the organisation has the resources to ensure that its analysis is of the highest quality. Credibility may also be enhanced if it can maintain the status of an ‘honest broker’, mediating among the special interests and making recommendations, but not becoming involved in the politics of the subsequent decision-making. If it is to remain ‘above the fray’, but if its ideas are to have influence, its ideas need to be championed, or at least debated, by others. Thus an educated and literate commentariat has an important role in adding credibility to an independent review institution. Alternatively, a review agency could credibly remain involved in the subsequent decision-making, so long as it had no clear conflict of interest. However, this involvement would divert resources from its review tasks. Finally, credibility can be built over time as each vested interest becomes the beneficiary of some reforms, even though it loses from others. Thus, even vested interests can come to recognise that they have a stake in the long-term survival of a policy review institution.

A statutorily independent review body is not the only type of organisation that could carry out the review and consultation phases of policy development. Government departments can develop their own consultation mechanisms, such as holding round-tables of relevant stakeholders or asking for written submissions from interested parties, as input to their own policy development processes. Such consultations are facilitated by e-government initiatives, and may be effective in eliciting countervailing producer interests.

Inter-departmental committee processes convened by a central agency (such as a Finance Ministry or Presidential office) can also bring a number of stakeholder interests to bear by proxy, through the representative line departments. Inter-departmental processes can be important in themselves for ensuring policy coherence among the different departments. The process is assisted if a central coordinating agency has the authority to ensure that final committee decisions are honoured. Coordinating agencies that have control over the purse strings are generally in a strong position in this regard. So too are agencies that control access to leaders.

However, neither departmental consultations or inter-departmental committees necessarily ensure that consumer interests are taken into account. Further, public consultation is often limited to the first round of consultation shown in Figure 2. Not often do government departments or inter-departmental committees circulate their own reform proposals for public comment once they have been tentatively formulated.

Another type of review mechanism is to convene a review panel of eminent persons on a once-off basis to consider a particular issue. Such panels often rely on the integrity of individual appointees for their independence and impartiality. For example, appointees who come from an independent judicial background may maintain that independence in a review context, while more overtly 'political' appointees may be neither independent nor impartial. Such panels also depend for their effectiveness on their terms of reference, which may direct them to take a broad or narrow focus on a particular issue. And terms of reference that are tailor-made to a particular issue are more likely to be manipulated than policy guidelines that need to be applied across a whole range of issues. Resourcing such panels with a well-trained secretariat from the bureaucracy can provide the skills to carry out economy-wide analysis, but is not sufficient to ensure that it is actually carried out. The commitment of panel members may suffer since their participation is on a one-off basis, especially if it is also part-time.

Finally, a bicameral system of government can sometimes provide one other important mechanism of policy review. Upper houses of government can sometimes instigate their own reviews of legislation before it is voted on in the upper house. The reviews may included public consultation, and may be a useful final screening mechanism. But they are typically highly charged politically, and occur too late in the policy development process to have a major influence on policy design.

Regional examples of institutions to support structural reform

To summarise, policy review institutions can support the political economy of structural reform in two distinct ways. They can provide a technical solution by helping to identify better policy options, and they can be part of a strategy to deal with vested interests, including those inside government. These dual roles suggest that there could be three key attributes of effective institutions — statutory independence, an economy-wide view, and transparent processes.

Regional examples of such institutions vary widely. However, they all bear at least some of the hallmarks of effective policy review institutions.

One clear example is the Council on Economic and Fiscal Policy in Japan. According to Hosen (2007), this was an institutional innovation of the Koizumi government in Japan designed primarily to deal with the predominance of vested interests in the previous policy making process, and the lack of transparency in that process. It has been instrumental in achieving structural reforms of pensions and medical care, among others.

One key attribute of the Council is its transparency — summary minutes of Council meetings are published within three days of Council meetings. This has helped to expose, and therefore neutralise, the special pleading of business vested interests. Another key attribute is the representation on the Council of government departments with broad portfolio responsibility, as well as two representatives each from academia and the business community. This has ensured an integrated approach to economic policy-making and helps to neutralise vested interests within the bureaucracy.

The Council was not designed to provide technical solutions by identifying policy options. So to date, the Council has not commissioned or undertaken extensive policy reviews on its own initiative. However, Japan faces the challenge of ensuring that the Council's role and influence survive beyond the Koizumi era. According to Hosen (2007), one strategy has been to involve the Council in medium-term economic planning, particularly in the area of fiscal policy.

Another example is the Australian Productivity Commission. Rattigan (1986) describes how it began life in the 1920s as the Australian Tariff Board, and was expected to implement the then government's policy of tailor-making assistance to industry. Instead, considerations of how to design a rational assistance policy led the organisation to consider the negative effects of tariffs on inputs, as well as the positive effects of tariffs on outputs. This in turn highlighted how assistance to manufacturing could act as a tax on efficient agricultural exporters — there was no such thing as ‘assistance all round’, contrary to government intentions. Thus, adopting an economy-wide approach led the organisation to a quiet revolution in its own thinking, which was in turn reflected in its policy recommendations to government.

The institution’s role has evolved since. Wonder (2007) describes how, as the deadening effects of high protection became clear, the organisation was instrumental in arguing for reductions in industry assistance. In the 1990s, it turned its attention to the inadequate performance of Australia’s government-owned enterprises in the infrastructure sector, arguing for reforms that would subject them to greater competition — either ‘benchmark’ competition with each other, or real competition through the entry of private suppliers into at least some segments of the market. After several name changes, the organisation now advises on most areas of structural policy. It remains a purely advisory body. But the three key characteristics of an effective policy review organisation are enshrined in its legislation. It was recently commended by the Australian Treasurer as a vital source of public information and advice to government on policy reforms needed to underpin Australia’s long-term prosperity.

Llanto (2007) describes how the National Economic and Development Authority (NEDA) in the Philippines serves as the national and regional development plan and program coordinator among the various branches of government. It issues planning guidelines and conducts multisectoral and regional consultations for inputs to the Philippines Medium Term Development Plan. The NEDA Board is a cabinet level board composed of the major government departments and is chaired by the President of the Philippines. The NEDA Secretariat provides technical and secretariat services to the various NEDA committees. It has comprehensive information on the implementation of government policies and has the capacity to comment on policies issued by government. According to Llanto (2007), NEDA has latent powers to lead the policy development process, but has not exercised these to date.

Another Philippine institution with a powerful coordinating and ex post review role is the Department of Budget and Management. Its public sector management framework has been developed with technical assistance from donors, who drew from the earlier experience of Australia in public expenditure management reform. The department requires various line agencies and corporations to adhere to performance-based or outcome-oriented budgeting, helping to ensure adherence to and implementation of government policies.

A third institution is the Philippines Institute of Development Studies, which has acted as an independent and impartial policy review institution and analyst for more than 25 years. It produces independent policy reviews, research and analysis, which are turned over to the public domain by way of publications, seminars, workshops, and testimony on hearings arranged by various Congressional committees. The organisation is not resourced for conducting significant public consultations.

The Philippine examples described by Llanto (2007) illustrate how further useful work to support structural reform could take place within a medium-term economic planning framework. Old-fashioned economic planning is often seen as outmoded in an era of open markets and outward-oriented growth strategies, but a medium-term planning process could also provide a useful forum for detailed ex ante reviews of policy options, providing a lead in the policy development process. Such a medium-term focus can then bind successive governments and guard against excessive ‘short-termism’ in policy development.

Mid-term reviews carried out during the planning cycle could also provide an opportunity for ex post policy reviews. Thus a traditional planning process could potentially be transformed into a system of continuous rolling ex ante and ex post policy reviews. Indonesia’s BAPPENAS is a traditional planning agency with the technical expertise to undertake detailed policy reviews. However, according to Soesastro, Aswicahyono and Narjoko (2007), it has not yet taken on a more pro-active policy review role. Malaysia is another economy in which the planning process could potentially be transformed into a process of critical ex ante and ex post policy reviews. According to Nambiar (2007), however, its planning process has been more concerned with ensuring the smooth implementation of given policies, and its policy development sometimes lacks transparency. According to Nitsmer (2007), Thailand could also benefit from a more transparent medium-term perspective in policy development to counter pressures of public opinion that is sometimes overly simplistic.

Other economies besides the Philippines have think-tanks that conduct impartial policy reviews and analysis. Other regional examples are the Centre for Strategic and Independent Studies in Indonesia, the Thai Development Research Institute, the Fiscal Policy Research Institute in Thailand, the Malaysian Institute of Economic Research, the Central Institute for Economic Management in Vietnam and the Chinese Academy of Social Sciences. These organisations vary in the extent to which they sit inside or outside formal government structures, the extent to which their contributions are used in the policy development process. But all have at least some of the characteristics of independent policy review institutions, and perform at least some of those functions.

The problem of developing a mandate for structural reform is not confined to democratically elected governments. China and Vietnam also face the problem of managing vested interests. Early in Vietnam’s transition to a market economy, many reforms were seen as clear Pareto improvements — with at least some clear winners, and with no clear losers. According to Vo and Nguyen (2007), the reform process is now more difficult, with some of the government's priority reforms potentially creating losers as well as winners. One strategy that Vietnam has tried is a taskforce approach — putting together groups of experts from within and outside government to consider one particular area of reform. The approach has had mixed success. It has injected a much-needed economy-wide view, but has suffered problems of commitment from the taskforce participants. According to Fan (2007), China too is at the stage where reforms can potentially create losers as well as winners, and so it requires new strategies to deal with vested interests. China, along with Indonesia, also has problems of coordinating reforms among different parts of government, not just at the national level, but also regionally. For example, a lack of interdepartmental coordination has been identified as a major cause of policy incoherence in Indonesia's sugar trade policy (Stapleton 2006).

4 Conclusion

Economic integration should not be an end in itself, but the outcome of domestic reforms that increase the general contestability of markets. The goal is to promote competition, wherever appropriate. This certainly includes removing barriers to foreign competition, not just from cross-border trade, but also from foreign direct investment. But it also includes removing behind-the-border barriers to the entry of domestic new entrants, and allowing existing firms to exit the marketplace in an orderly fashion if the market dictates that they cannot survive. The core of structural reform is often to remove the artificial barriers that protect incumbent firms from *any* competition, be it from domestic or foreign new entrants. And the real art is to ensure that policy settings promote competition, not just particular competitors.

Domestic structural reform is an ongoing process. Economic growth and technological change mean that there needs to be constant reassessments of whether and how markets can deliver efficient outcomes, whether the regulatory solutions to market failures are adequate, and whether the relative priorities given to economic and non-economic objectives are appropriate. In the best-managed economies, structural reform is never done.

Governments in all political systems require a mandate of some sort to undertake structural reforms, but a key question is how that mandate is cultivated. At one extreme, a government could choose to implement an economic reform agenda in a 'crash through or crash' style — simply implementing reforms until the cumulative opposition from vested interests and/or public opinion erodes their legitimacy. Alternatively, they could attempt to influence the terms of the debate.

A reform program that makes provision for an independent policy review process may be slower than a ‘crash through or crash’ program. But it is likely to be more sustainable in the longer term. This is because the reviews do not just identify reform options, they help ‘sell’ them in the face of opposition from vested interests, overly simplistic public opinion and/or bureaucratic or Ministerial resistance.

In the same way that no economy starts out with the best set of economic policies, no economy starts out with the best institutions to support the policy-making process. Instead, they inherit institutions that reflect their own unique culture and history. But as the above examples illustrate, these institutions have sometimes evolved over time in response to perceived needs, just as the economic policies themselves have evolved through a process of structural reform. Sometimes the institutional evolution has been the result of political leadership. Sometimes the institutions have been responsible for their own evolution, inspired by the power of ideas to exploit an existing mandate for new purposes.

These national institutions can be further strengthened, with assistance from regional processes. But regional assistance would need to be tailored to the particular needs of each economy, which would depend in turn on their particular impediments to structural reform. Regional assistance to support the political economy of structural reform would also need to put responsible Ministers in the driving seat, ensuring their ownership and accountability from the outset. This would be critical, since the prime purpose of such assistance would be not just the identification of ‘better’ practice, but selling it domestically.

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Figure 1a **Welfare cost of rent-creating barriers to services trade**

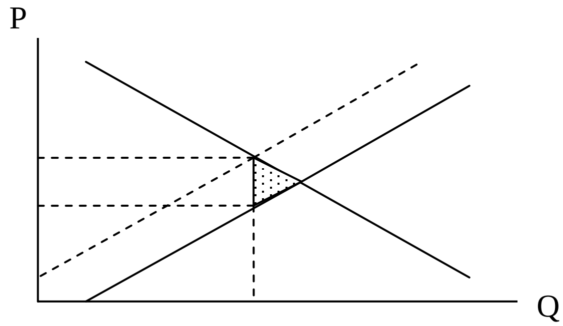
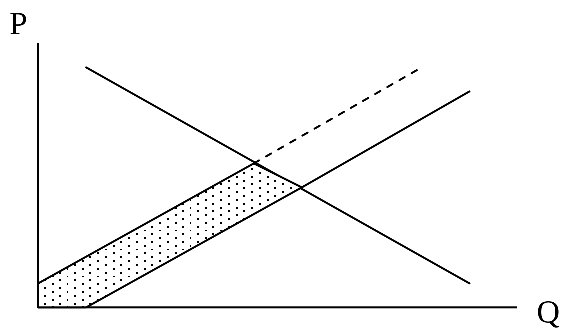


Figure 1b **Welfare cost of cost-escalating barriers to services trade**



Box 1 **The FTAP model — GTAP with foreign direct investment**

The FTAP model is a computable general equilibrium model incorporating services delivered via FDI. It was developed by Dee and Hanslow (2001). It differs in turn from GTAP (Hertel 1997), the 'plain vanilla' model from which it was derived, in three important respects.

First, because many services are delivered primarily via commercial presence, the modelling framework includes foreign direct investment as a mode of services trade delivery, and covers separately the production and trading activity of foreign multinationals. In other words, GTAP, the conventional multi-country model, is split out by ownership as well as location. Foreign ownership shares are generally imputed from UNCTAD data on bilateral FDI stocks, together with data from the US International Trade Commission on the ratio of FDI stocks to sales in various US multinational firms around the world. Alternatively, foreign ownership shares may be obtained directly from sources such as WTO Trade Policy Reviews for particular services sectors.

Second, by virtue of foreign ownership, at least some of the profits of foreign multinationals will be repatriated back to the home countries. Thus the profit streams in the conventional multi-country model have to be reallocated from the host to the home country, after provision is made for them to be taxed in either the home or host country. This reallocation leads to a distinction between GDP — the income *generated* in a region — and GNP — the income *received by residents* of a region. The latter forms the basis of (although is not identical to) the welfare measure in FTAP. The information on profit repatriation comes from the Balance of Payments Statistics of the IMF.

Finally, not all profits of foreign multinationals need be repatriated to the home country. Some may be reinvested in the host country. To account for this phenomenon, and to allow for the effect that regulatory reform may have on both domestic and foreign direct investment more generally, the model makes provision for savings and capital accumulation. This is particularly important, since some regulatory barriers are aimed directly at limiting foreign equity participation. It is therefore important to capture how regulatory reform will affect not just foreign ownership *shares*, but also the *total amount* of productivity capacity available to an economy. National savings rates are derived from the macroeconomic data in the International Financial Statistics and Balance of Payments Statistics of the IMF. Government savings rates are derived from the Government Finance Statistics of the IMF. Household savings rates are calculated as a residual.

The FTAP model also differs from GTAP in other respects. In particular, it allows for firm-level product differentiation. This is also important, since services tend to be highly specialised, being tailored to the needs of individual customers.

Source: Based on Dee and Hanslow (2001).

Table 1 **Asian integration scenarios and their effects on welfare in India**

(Deviation from control in real income, measured in 2001 US$ billion per year)

Sector	*Asian PTA involving*		*Possible Doha round outcome*	*Comprehensive unilateral regulatory reform in*	
	ASEAN+3	*ASEAN+6*		ASEAN+3	ASEAN+6
Regulatory reform (services and investment)	National treatment in Asia		National treatment in the world	Reform of all non-discriminatory regulation in Asia	
	-0.03	0.19	0.81	0.13	5.67
Manufacturing tariffs	Elimination of tariffs against Asian partners		25% reduction in tariffs globally		
	-0.09	-0.34	2.08		
Agricultural protection	No action		25% reduction in agricultural protection globally		
	0.00	0.0	1.09		
Total	-0.12	-0.15	3.98	0.13	5.67

Source: FTAP model projections.

Figure 2 **An orderly policy development process**