Institutions for Enhancing Economic Policy Performance

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1 Introduction

Behind-the-border reforms are critical to growth. Regulatory impediments to competition do not need to be *explicitly* discriminatory against foreigners in order to have the effect of raising the prices of goods or services above those in neighbouring countries. Such market segmentation violates the conditions for allocative efficiency and possibly also productive efficiency, and so reduces income levels.

Accordingly, a process of ‘deep’ economic integration should target not just the inappropriate restrictions that explicitly discriminate against foreign suppliers, but also those that are not explicitly discriminatory, but nevertheless raise prices above those in neighbouring countries. Such a wide-ranging reform process, if pursued on a non-preferential basis, would target all the inappropriate impediments to competition, and therefore likely have a significant impact on real incomes.

Hence 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 pursue economic integration as an end in itself. Recent PTAs have tended to target regulatory restrictions on a preferential basis, and partly as a result, they have tended to concentrate only on those regulatory restrictions that discriminate explicitly against foreigners. Dee (2005) shows that the gains from such PTAs are small compared to a moderately successful completion of the Doha Round. And they are trivial compared to a comprehensive program of unilateral regulatory reform, one that targets non-discriminatory behind-the-border restrictions on competition.

However, such domestic regulatory reform is not easy, because of the diversity of economic interests involved. These include the interests of incumbent producers, potential foreign entrants, potential new domestic entrants, upstream supplying industries, downstream using industries, final consumers, and governments. The players are primarily domestic, so a necessary forum for managing the political debate is a domestic forum, not an international one (such as in trade negotiation).

In order to improve growth outcomes to the maximum possible extent, it is therefore necessary to understand two things — what constitutes better domestic economic policies (and the institutions required to implement them), and what stops better policies being adopted domestically. The first can be called the static problem, and the second the dynamic problem, of domestic economic policy.

Recognising that there are two types of policy problems means that there are two possible roles for institutions — institutions to implement better economic policies, and institutions to support the policy-making process. The first role supports solutions to the static problem, and the second role supports solutions to the dynamic problem.

2 The static policy problem

Economists often take a static view of economic policy and institutions. They identify the strengths and weaknesses of current policy, and the institutions that implement it. They use economic theory to identify optimal policy, and institutions to implement it. And when the optimal is not attainable for various reasons, they identify better policy and institutions.

An example can be drawn from the area of telecommunications. Many East Asian economies with a colonial background inherited a system where telecommunications services were provided by a government department (for example, the Department of Post and Telegraph), which was charged with meeting many competing objectives, but faced few economic disciplines. As a result, pricing structures were often the antithesis of those required for allocative efficiency, while cost structures were often far from productive efficiency. The policy was one of provision by a government monopoly. The institution to implement it was the Department of Post and Telegraph.

Economic analysis has contributed greatly to understanding the regulatory issues associated with regulating infrastructure networks where some network elements (for example, the copper wire connection between subscribers and their nearest switching station — the so-called 'last mile') have the characteristics of a natural monopoly. The best policy settings in this context could involve encouraging full competition in all but the last mile, but regulating to ensure that the incumbent does not use its monopoly control over the last mile to thwart competition in other segments. This might require allowing competitors access to the last mile on a regulated basis. So the 'best' economic policy might be competition in all but the last mile. And the institutions required to implement this might include an independent regulator to oversee the access regime for the last mile.

In some East Asian economies, such a regulatory outcome may be infeasible. Technical regulatory capacity may be lacking, or governance problems may make it difficult to ensure the true independence of a regulator. In either case, a policy that may promise a 'better' outcome than the current policy may be to licence one or two new entrants, who may have to tolerate inflated costs of access to the incumbent's network, but may still provide useful competition in retail telecommunications markets. If governance is weak, it may be wise to limit the discretionary power of the licensing agency to set licence conditions, so as to minimise the scope for corruption or political interference. A 'better' economic policy may be to license a fixed number of competitors. The institutions required to implement it may include a licensing agency administering licence conditions that are fixed in advance.

What constitutes 'best' or 'better' economic policy may therefore depend on the level of a country's economic development — there is unlikely to be a one-size-fits-all solution. So if countries need regional help in solving the static policy problem (that is, identifying better economic policy), that assistance will also need to be tailored to their particular circumstance. There may be some domestic policy problems that create international spillovers (for example, where energy networks extend across national boundaries), where policy solutions may require a single, coordinated regional approach. Otherwise, solutions will tend to vary from one country to the next.

Arguably, however, there are not many instances where countries have few ideas about their own economic reform priorities, or their own reform options. This is because organisations such as the World Bank and the OECD have been highly effective in establishing regulatory benchmarks, such as through the OECD's indicators of product market regulation and the World Bank's questionnaires to assess services trade policy and performance. And regional organisations such as APEC have been highly effective forums for countries to compare experience about domestic reform options. Those at lower levels of development have been able to observe the experiences of the countries higher up the ladder, and so to develop a hierarchy of reform options for themselves as their economies grow.

3 The dynamic policy problem

The key dynamic problem is how to get from current policies (and institutions) to 'better' or 'best' policies (and institutions). This raises three subsidiary questions.

- What stops better policies being adopted?
- How does (or should) the policy-making process work?
- What institutions could help lead to better policy-making *processes*?

There are three possible reasons why good microeconomic policy reforms are not adopted.[1] Each has different implications for the type of institutional changes that could better support the reform process.

- Governments do not know what is regulatory 'best (or better) practice'. This argues for external assistance to governments to provide the expertise to undertake systematic reviews of existing regulatory arrangements, and to evaluate regulatory alternatives. It also argues for an international exchange of regulatory experience to

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

raise awareness of what constitutes better practice, as has occurred to date through APEC.

- Governments know what is 'better practice', but face political resistance from vested interests. This argues for government-sponsored policy review institutions to help marshal countervailing interests. 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 good policy, because they rely on the rents from bad policies for political funding purposes. In these circumstances, government-sponsored transparency institutions will tend to be sidelined, as appears to have happened with the National Economic and Development Authority in the Philippines. However, there is a role for private (or otherwise independent) policy review institutions to carry out the necessary work of scrutiny, and to marshal countervailing interests.

Thus in all cases there is a useful role for 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 policy reviews provide a technical solution — they can review current policy settings and identify better options. But if the problem is managing vested interests (which may include those within government), then policy reviews are a strategy rather than a technical solution — they can provide ammunition with which to manage vested interests and build a coalition in favour of reform, although there is no guarantee that they will be decisive in any particular instance. Over time, however, they can help influence the terms of the debate. Each of these roles for policy reviews is now discussed in turn.

Policy reviews to identify better policy options

The elements of a policy review are shown in Box 1.[2] This assessment forces policymakers to work through a sequential process of articulating the problem, assessing a range of options and recommending the best option or explaining why some other option is recommended. The third element, setting out some viable options as to how the desired objectives might be achieved, prompts officials to work through all the possibilities on the regulatory spectrum. The fourth element, setting out the costs and benefits of each option for each stakeholder, and the overall effect on the community as a whole, can help to identify a preferred option. A full consultation process with all stakeholders can assist in identifying all the costs and benefits to each stakeholder. A strategy to implement the preferred option and then review its operation provides an ex post performance check.

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

Box 1	**Elements of a policy review**

A policy review may set out

- The problem or circumstances which give rise to the need for action
- The desired objective(s)
- The options (regulatory and non-regulatory) that may constitute viable means for achieving the desired objective(s)
- An assessment of the impact (costs and benefits) on consumers, business, government and the community of each option
- A consultation statement (the process and results of consultation with all stakeholders)
- A recommended option
- A strategy to implement (including consideration of appropriate enforcement mechanisms) and review the preferred option

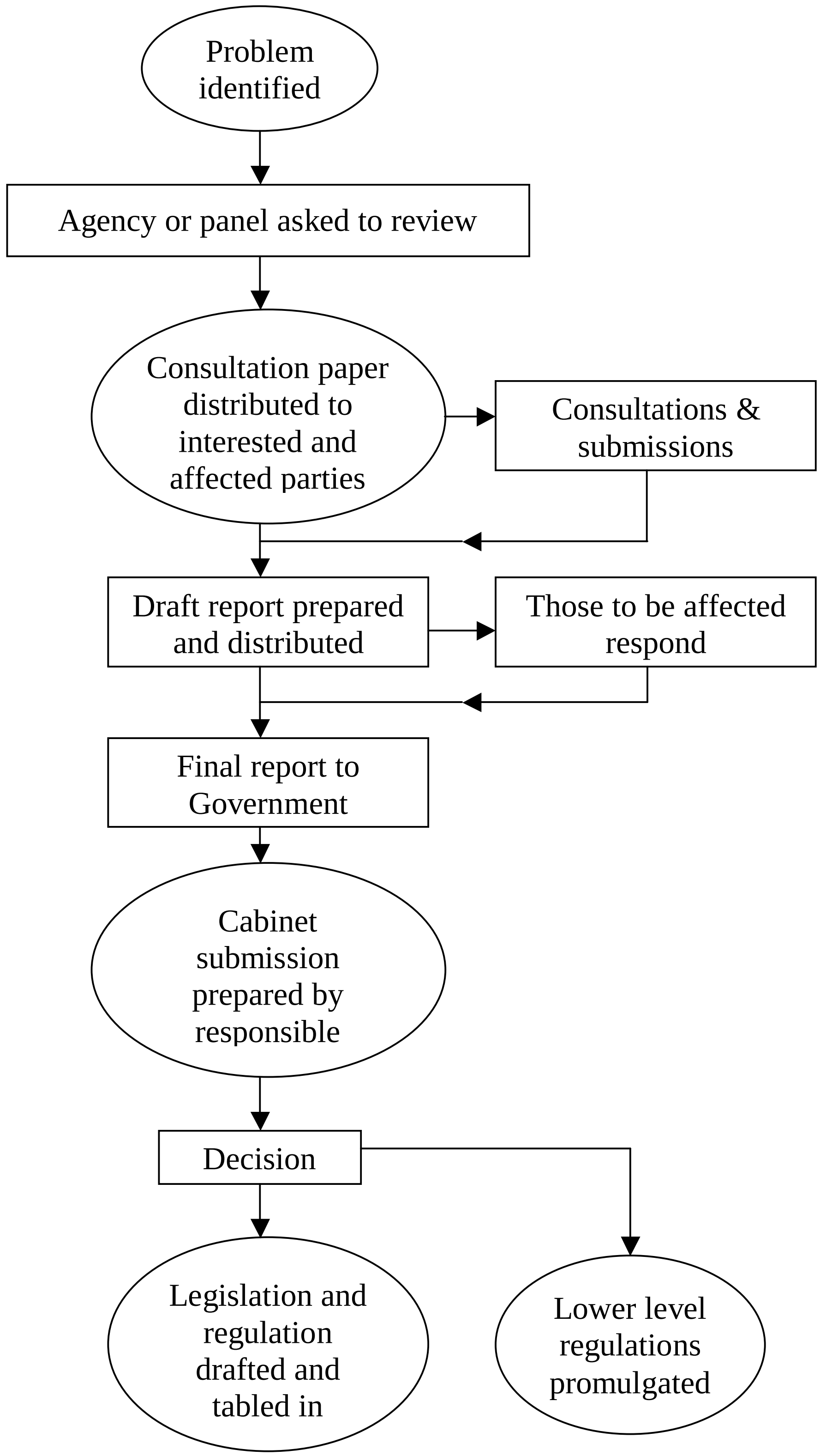
For a policy review process to make a useful contribution, there needs to be an orderly policy development process, and the review needs to be done early enough to articulate viable options before positions become locked in. Quite often, policy making does not fit this model. Rather, policymaking often 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 on 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.

Figure 1 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.

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.

Figure 1 **An orderly policy development process**



As noted, sometimes the policy development process does not work in an orderly fashion, and the above process is *all* that takes place, once a problem has been identified. 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.

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 policy development process involves policy review, as outlined above. It 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 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 regulatory solutions (sometimes, but not always, including a preferred solution at the draft stage).

The opportunity provided by policy reviews for transparent consultation is the key to their strategic role in managing vested interests.

Policy reviews to manage vested interests

Independent policy reviews can help deal with vested interests in a number of ways. First, they can help set the agenda — policy change will not happen if nobody talks about it. Reviews can also set the parameters of the debate. The analysis in such reviews may be contested and thus controversial, but if it establishes a framework that takes into account consumer and other countervailing interests, it makes it much harder for these interests to be ignored. Reviews can also help to depoliticise a debate. And most governments will find it useful on occasion to take the heat off an issue by referring it for independent, objective study. Reviews can 'name and shame' the recipients of special deals. They can marshal countervailing interests, helping to build a coalition in favour of reform. They can identify policy combinations that lead to a so-called Pareto improvement, where at least some are better off and nobody is worse off. This helps to build a *grand* coalition for reform.

Independent, transparent, economy-wide policy reviews have a role in helping to build a pro-reform consensus outside of government. But governments with an economic reform agenda also have to build consensus within government. Good processes of policy coordination are required to ensure that all relevant ministries are consulted. Mechanisms are also required to ensure that final decisions reflect the public interest, not just narrow sectional interests. One such mechanism is to provide the coordinating role to an agency that has broad, horizontal portfolio responsibilities, as has happened through the Council on Economic and Fiscal Policy in Japan. Arming such agencies with high-quality, independent policy reviews can also strengthen the public interest during the coordination process. Finally, mechanisms are required to ensure that coordinated decisions are abided by. A threat of budgetary sanction is one mechanism. Threat of exposure through ex post reviews is another.

The characteristics of policy review institutions

Keeping in mind the two possible roles of policy reviews, it is now possible to canvas the desirable characteristics of policy review institutions.[3] There are three key attributes.

- S*tatutory 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 openly criticise current government regulatory initiatives, and government policy more broadly. The ability to provide a full critique of current regulation is a necessary first step in proposing regulatory reforms. The review agency may still be dependent on government funding — the critical point is that it not be constrained in criticising government policy.

  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.

- *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 consult widely is not enough, for two reasons. Without a requirement to take all views into

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

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 countries, 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 downstream using industries. This is better accomplished if the agency has the analytical resources, including skills in partial and general equilibrium modelling and cost benefit analysis, to estimate the gains or losses in consumer surplus as well as producer surplus from any reform initiative.

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 an agency. For example, in Australia the government quite frequently modifies aspects of the recommendations made by its policy review agency, the Productivity Commission, when implementing them, and occasionally rejects its recommendations in whole or in part. Indeed, this is the 'other side of the coin' to its statutory independence. Nevertheless, an agency can still have influence, even if it can be ignored, for several reasons:

- transparent processes have influence, and such an agency can 'name and shame' the beneficiaries of special-interest policy deals; and
- ideas have influence, and such an agency can present 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' department (such as a Finance Ministry or Presidential office) can also bring a number of stakeholder interests to bear by proxy, through the representative departments. Inter-departmental processes can be important in themselves for ensuring policy coherence among the different departments, so long as the 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. The lack of interdepartmental coordination has been identified as a major cause of policy incoherence in Indonesia's sugar trade policy (Stapleton 2006).

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 1. 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.

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.

4 Ensuring better policy making processes

To summarise, policy reviews can play two critical roles — 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 a policy review institution — statutory independence, an economy-wide view, and transparent processes.

But which actual institutions in each economy do, or could, carry out such policy reviews? The answer is not straightforward. In the same way that no economy starts out with the best economic policies or supporting institutions, no economy starts out with the best policy-making institutions. Instead they inherit a set of policy-making processes that reflect their own unique history. So the answer may vary from economy to economy. In particular, the nature of the dynamic solution may depend on the nature of the dynamic problem.

If the key problem is identifying better policy options, then policy reviews are a technical solution. A key consideration for any agency undertaking policy reviews is therefore its analytical capacity and an economy-wide view.

If the key problem is managing vested interests, then policy reviews are a strategy rather than a technical solution. A key consideration for any agency undertaking policy reviews is therefore its independence, transparency, and credibility in the face of attack from vested interests. Credibility can in turn be cultivated and maintained by having a strong analytical capacity, although this is not the only strategy. A further consideration is whether the ruling government is itself a vested interest, and whether an appropriate review agency can be government-sponsored, or needs to be a private think-tank.

The nature of the dynamic policy problem has varied around the East Asian region. So too has the institutional innovations in policy-making processes to correct it.

One clear example is the Council on Economic and Fiscal Policy in Japan. 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. Key attributes of the Council are its transparency — summary minutes of Council meetings are published within three days of Council meetings. This helps to expose, and therefore neutralise, the special pleading of business vested interests. As noted, another key attribute is the representation on the Council of government departments with broad portfolio responsibility. This helps to neutralise vested interests within the bureaucracy.

The Council was not designed to provide a technical solution 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. One strategy has been to involve the Council in medium-term economic planning, particularly in the area of fiscal policy. It is conceivable that initiating ex post reviews of recent policy reforms may also provide the Council with another longer-term role, also ensuring its ongoing relevance and usefulness.

Although old-fashioned economic planning is now seen as outmoded in an era of open markets and outward-oriented growth strategies, a medium-term planning process can nevertheless provide a useful forum for detailed ex ante reviews of policy options. 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 can also provide an opportunity for ex post policy reviews. Thus a traditional planning process could potentially be transformed into a system of continuous rolling policy reviews, as occurs now in Australia. Indonesia's BAPPENAS is a traditional planning agency with the technical expertise to undertake detailed policy reviews. However, 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. Currently, however, its planning process seems more concerned with ensuring the smooth implementation of given policies, rather than with critical evaluation of those policies.

China and Vietnam do not have democratic forms of government, but still 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. Now the government's priority reforms are creating losers as well as winners, and policy implementation is more difficult, accordingly. 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. China, too, is at the stage where reforms are creating losers as well as winners, and so China requires new strategies to deal with vested interests. China, along with the Philippines and Indonesia, also has the problem of coordinating reforms among different levels of government.

Governments in all political systems require a mandate of some sort, 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 independent policy reviews 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 sabotage.

5 How can regional processes help?

Regional processes such as APEC could provide a range of assistance in conducting independent, transparent, economy-wide policy reviews — from marshalling external expertise for such reviews, to providing a forum for the exchange of experience about the conduct of such reviews. But if regional assistance is to be useful, it needs to help with the policy 'selling' function as much as with the policy identification function. Accordingly, regional assistance needs to be tapped into actual policy making processes, with mechanisms to ensure real contact with stakeholders (to manage diversity of opinion outside government), and real follow-up from Ministers and the bureaucracy (to manage diversity of opinion inside government).

Giving regional assistance mechanisms a point of contact with responsible Ministers, and holding the responsible Ministers accountable for stakeholder contact and bureaucratic follow-up and Ministerial coordination, would be one way to ensure this. The particular Minister responsible would vary from one instance to the next, depending on the scope and subject matter of the review. But each Minister would be likely to welcome the opportunity, since they would benefit most from the chance to de-politicise sensitive or divisive issues by referring them for independent policy review.

The APEC Economic Committee is one possible forum though which Ministers could identify the reform priorities for individual countries or groups of countries, and through which relevant Ministers could self-select for regional assistance in undertaking independent policy reviews. Regional assistance could be in the form of drawing up terms of reference for such reviews through an office associated with the Economic Committee, and marshalling the collective expertise available in independent think tanks and elsewhere around the region for undertaking such reviews. Ministers could usefully also agree in advance that such reviews should follow standard policy guidelines of independence, transparency and an economy-wide view.

The relevant Ministers would need to organise forums for contact with relevant stakeholders (including government departments) during the course of such reviews, to help marshal all points of view. It is an open question how many rounds of stakeholder meetings would be appropriate, but it is important that they be open to the public. It is also critical that the resulting review document be made public. This could be ensured by a policy guideline that required the responsible Minister to release the final document within a specified time of its completion. Finally, the responsible Minister should be required to have the review document given due consideration by all relevant Ministers with a country, also within a specified time frame. The lead Ministers could not be held accountable for the outcomes of that consideration, since that would be a matter for all Ministers. Nevertheless, a requirement to have the matter considered could provide the lead Ministers with a mandate for Ministerial coordination, where such mechanisms might be lacking at the moment.

This method of organising regional assistance for independent policy reviews differs from one based on an OECD-style secretariat, essentially by putting lead Ministers in the driving seat, ensuring their ownership and accountability from the outset. This is critical, since the prime purpose of such reviews is not just the identification of ‘better practice’, but also the selling of it domestically. An office of some sort would still be required to service the process, through writing terms of reference, commissioning the services of independent researchers to undertake reviews, providing intellectual leadership and guidance for such reviews, and perhaps assisting the lead Minister to organise stakeholder consultation and Ministerial follow-up (where their own bureaucratic resources for such efforts were scarce). But the process would be under the guidance of the APEC Economic Committee and the lead Ministers themselves.

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