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Regulatory Competition in Globalising Markets for Improved Conditions for Private Investment

Herbert Oberhänsli

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E15 Task Force on
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Think Piece

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This paper draws on research done by the North-South Working Group of the European Round Table of Industrialists in the 1990s, a period when regulatory competition was particularly effective and widespread. It also uses elements published in Aussenwirtschaft (World Economics Quarterly), University of St. Gallen, Vol. 52, No. 3, pp. 449-71, and draws on analysis, reflections, and proposals made by the Investment Task Force of the 2010 B20 in Seoul, chaired by P. Brabeck-Letmathe.

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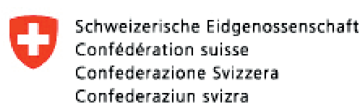

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ABSTRACT

The proposals in this paper are based on the results of three surveys conducted in 28 developing countries about changes in conditions for investment in the 1990s and early 2000s. The results show remarkable process in opening up of markets and deregulation, and modernization and globalization of local rules and institutions relevant to business, driven by regulatory competition. Considering the success of this process—an accelerated increase of economic growth and prosperity, and more than doubling the number of jobs in manufacturing and services created annually—and the ongoing changes in the character of multinational companies, these ideas are being presented for a global agreement on investment to strengthen the process of global policy change as observed in the 1990s. International public policy benchmarking to further foster an enabling environment for local and foreign invested businesses could be strengthened at the national level or introduced in such an agreement. Finally, a multilateral agreement could serve to lock in the progress made.

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LIST OF ABBREVIATIONS

CEOs	chief executive officers
ERT	European Round Table of Industrialists
FDI	foreign direct investment
GDP	gross domestic product
HR	human resources
IASC	International Accounting Standards Committee
IT	information technology
MFN	most-favoured nation
MNCs	multinational companies
MNEs	multinational enterprises
NGO	non-governmental organization
OECD	Organisation for Economic Co-operation and Development
R&D	research and development
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

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NEW POLICY PERSPECTIVE THAT EMERGED IN THE EARLY 1980S

The 1990s brought vast changes in public policies and institutions, affecting business globally, particularly in developing countries. These countries opened up markets and deregulated them, and modernized and globalized rules and institutions relevant to business—local and foreign invested—leading to significant acceleration in the growth of jobs and prosperity.

Over the past 40 years, these countries have changed their handling of, and attitudes towards, foreign direct investment (FDI) in spectacular ways. Looking back, one can discern four different phases.

1. Attitudes and policies of general distrust towards FDI in the 1970s.

2. Subsidy-type and interventionist policies to attract FDI selectively according to a country's development plans in the late 1970s and early 1980s, often coinciding with import substitution strategies.

3. Overall deregulation and liberalization since the mid-1980s in many countries to make themselves more attractive to foreign investment. Usually, measures to open access to markets were still meant as concessions to investors. The initial trigger was Deng Xiaoping's opening up of China in the late 1970s to speed up its economic development through foreign investment, ensure a more open market, and provide access to advanced technologies and management experience, a trigger that had effects far and beyond China, seen as a leader of the developing countries. At the same time, efforts to develop international rules for running business on a global scale were developed, but they remained fragmented and lacked coherence.

4. Starting in the 1990s, policy changes were undertaken with a clearer understanding of market and business mechanisms; their aim was to render markets more contestable, and foreign-invested businesses as well as the local private sector more efficient and competitive. Openings were now being conceived for the mutual benefit of host countries and investors. Under this new perspective, certain instruments also started to change, with some initial stages of public policy benchmarking driving regulatory competition.[1] Without using the term, countries started to benchmark their own policies against the content, speed, and focus of overall opening up of the most successful countries, and they started to benchmark specific policy areas and measures against best practices anywhere in the world.

RESEARCH ON POLICY CHANGES IN THE DEVELOPING WORLD SINCE THE END OF THE 1980S

Since the end of the 1980s, the changing conditions for FDI in the developing world have been an issue in the European Round Table of Industrialists (ERT). It is a grouping of 43 chairmen/chief executive officers (CEOs) of major European companies. Its objective is to improve Europe's competitiveness and strengthen the efficiency of the private sector in global markets. The group sees this as a way to create wealth and jobs. The ERT contributes ideas and proposals for long-term solutions.

Within this overall set of goals, the ERT undertook, in the 1990s and early 2000s, three surveys (ERT 1993, 1996, and 2000) to find out about conditions for investment in developing countries. They provided systematic analysis to describe the change—the new focus, the wider scope, the quality and high speed of the opening up of markets, and modernization—and to evaluate it from a business point of view. The questionnaire and the reports made no distinction between improvements for the foreign and the local private sector. Local private sector strength was a factor on the checklist of conditions for investment by foreign-owned firms. Any industrial investor from abroad needs open-minded, non-mercantilist local industrialists who accept competition as something positive. Multinational companies need them as competitors to ensure their own efficiency, as suppliers and distributors.

1 The ERT has done substantial work on benchmarking. Two reports should be mentioned here—"European Competitiveness — The Way to Growth and Jobs," Nov 1994, and "Benchmarking for Policy-Makers," Oct 1996.

QUESTIONS AND CHECKLIST

In the survey questionnaire sent to governments of the 28 developing countries, four questions were asked—what improvements were implemented in a given period of time; what impediments remained at the end of the period; what were plans for the future; and finally, where do you feel problems are caused by foreign investors? What should be done on the investor's part to improve cooperation between host country and investor? For the first three questions, the ERT had prepared a checklist, based on the practical experience of these companies (Box 1).

SOME OF THE SURVEY RESULTS

The survey results show significant progress of the countries in our sample against the benchmark of our checklist.

Figure 1 summarizes about 300 pages of country information. In an overall picture, the countries opening up and modernizing their business environment showed, in the 1990s, a resemblance to the pattern of flying geese. Countries that started somewhat later with the process followed those who had started earlier, who themselves continued to fly. There was considerable variety in the way this opening up took place. Some countries, such as China, gave local governments a free hand to test new policy ideas and initiatives locally before changing regulations. The difference in methods within and between countries contributed to make this opening and modernization a highly efficient process.

Diverse approaches were necessary to adapt policies to different situations in different countries, including cultural and political aspects. Changes of a complex existing system (for example, the one in India) would need more patience and circumvention than changes in countries where, for instance, the rule of law was only partly implemented before new policies started. The important thing was that steps were taken in the right direction, and the countries were also aware that speed mattered in competition.

BOX 1:

ERT Checklist on Items to Identify Impediments and Improvements

11. Problems specifically affecting foreign direct investment and international businesses (42 percent of impediments remaining at the end of 1996, according to weighted survey results)
- Restrictions on management control, ownership, access to specific sectors and acquisitions; performance requirements, minimum size of investment
- Restriction on currency transactions, intellectual property protection, remuneration
- Heavy approval procedures; inconsistent and/or erratically changing regulations
- Technology targeting, personnel policies; risk of nationalization or expropriation and exit restrictions

12. Macroeconomic factors, affecting all private sector investment (29 percent)
- General issues, e.g., inflation, convertibility, infrastructure, etc.
- Taxes, price and wage controls,
- Restrictions on foreign trade, marketing and distribution, shortcomings in local finance

13. Rules, institutions and their efficiency (10 percent)
- Overall shortcomings in a country's legal system: lack of consistency, transparency, certainty in the rule of law; administrative bottlenecks, qualification, motivation, overstaffing etc.; labour legislation
- Bribery and corruption; stability in the political system

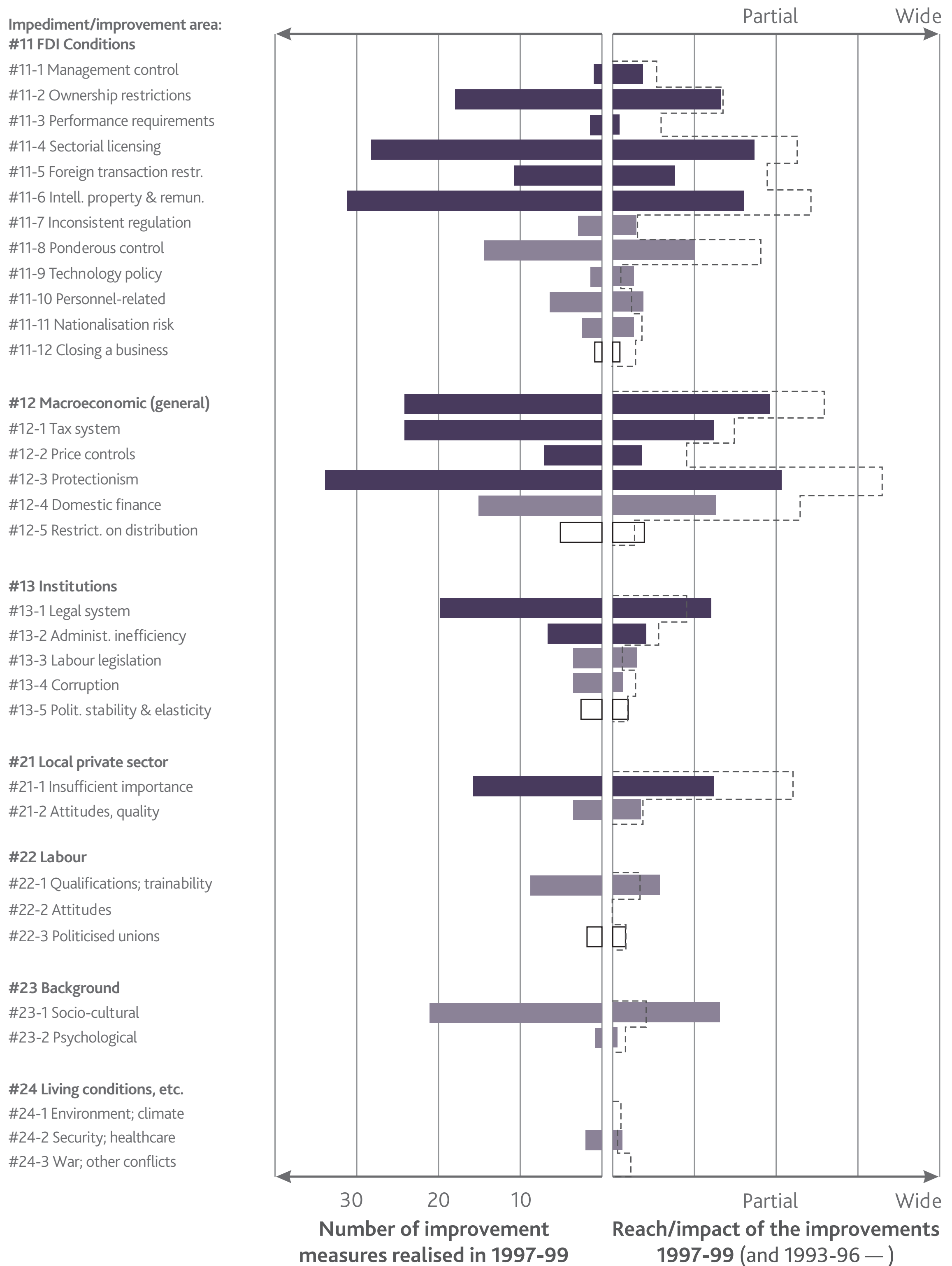
21. Local private sector and labour (11 percent)
- Inadequate local supplies in inputs for other industries; mercantilist attitudes and cartelist thinking of local business
- Lack of qualified people, attitudes

22. The overall social and psychological background relevant for business; living conditions and various (8 percent)
- Socio-cultural patterns and psychological factors (e.g., fighting attitudes, xenophobic reactions)
- Pollution; criminality, including thievery, squatting, Mafia protection, kidnapping; civil disturbances and societal imbalances.

FIGURE 1:

Improvements in Conditions for Investment, 1997–99 and 1993–96

Total of measures in 28 countries and average reach/impact of these measures



Importance of each impediment/improvement area to foreign investors:

LEGEND:

- High
- Intermediate
- Low

Number of improvement measures per impediment/improvement area: Total for 28 countries, added up disregarding the reach of each improvement measure. Reach/impact of these measures as evaluated by ERI; average for 28 countries. The wider the reach and the higher the importance of the area to investors, the more positively size and efficiency of private investment will be affected.

NATURE OF POLICY CHANGE, THE MAIN AREAS AND FOCUS

The process described by the survey is a broad change of conditions for investment taking place on four tracks:

1. Opening, which means more contestable markets, and lowering the barriers to entry for local and foreign private businesses.

2. Deregulation, which means making business activities less cumbersome and the overall environment more enabling to private business initiative.

But deregulation, particularly when taking place on a global scale and being driven by regulatory competition, does not mean reaching a situation where there is no regulation at all. A free market requires effective rules and a referee to enforce them. Therefore, the process also involved the following.

3. Modernization of rules and institutions relevant to business, for example, introducing a modern and clear set of rules for newly established or revived stock exchanges.

4. Globalization of rules, for example, in accounting (we will come back to this in more detail).

Figure 1 illustrates the areas where change was observed by the three ERT surveys. What is important is the policy focus on the facilitation of business in the private sector in general. There is less discrimination against foreign investors (but also less "retro" discrimination, that is, foreign investors being offered better conditions than the local private sector).

The following illustrates in more detail the changes that have taken place in a few selected areas:

In the area of impediments primarily affecting foreign investors and international businesses in general (11),[2] change was particularly significant in the access of foreign suppliers to national markets for infrastructure services; in many countries, it has become virtually unrestricted. In the period under survey, activities formerly considered strategic, such as water treatment and sewage, were, in many countries, opened to private investment. This was done to attract technical and managerial know-how for a more efficient service and, in some instances, also to finance these projects directly without running the risks of international debt. The same has been taking place to a larger extent with telecoms, where access provided to global companies is now being considered as a strategic move to link the country rapidly and efficiently with international networks and in anticipation of the emergence of a new global environment for telecoms.

In the 1990s, major changes also took place in the protection of intellectual property. Over the last 20 years, we have observed a learning process in host countries about the role of intellectual property and its protection for an efficient economy. This can be illustrated with the example of brands. Initially prohibited or restricted in many countries, they were later accepted because foreign investors insisted. Now, there is a better understanding of this powerful tool for market efficiency, and the necessary legal framework is being implemented. Countries are also becoming aware of the added value being created through efficient marketing and advertising. Here again, improvements introduced by governments are no longer made as concessions to foreign investors but for efficiency, wealth, and the global competitiveness of an economy.

Liberalizing finance locally (12) was another area where modernization of institutions and rules were following the global perspective. Financial markets were reorganized in a way that improved companies' access to local finance, and local companies' access to international finance. Last, but not least, local industrialists got permission to invest abroad (considered as illegal capital flight before).

Accounting standards (13) are an example to illustrate a new global focus in rule setting by developing countries (but starting from industrialized countries outside the United States [US]). To make financial markets and their users more transparent and efficient, corporate accounting needs to be improved. At first sight this may look like a technical issue, but it affects corporate structures, corporate behaviour, corporate governance, and, ultimately, competitiveness. Here we see developing countries moving directly towards international rules, without trying to come up with their own versions of standards. Several of them in our sample, in particular Indonesia, Turkey, Nigeria, Pakistan, and Zimbabwe, showed a clear preference for International Accounting Standards as developed by the International Accounting Standards Committee (IASC). A few others (Mexico for obvious reasons) seemed to lean towards the US system of Generally Accepted Accounting Principles (GAAP).

IMPACT OF POLICY CHANGES

Improvements in conditions for investment do affect investment decisions, but only when it is shown as a part of an already confirmed trend, when there is trust. If trust is lacking, investment may lag behind market-opening measures (while it instantly reacts to newly imposed restrictions and additional insecurity). Opening, first, has to gain credibility with investors, and they have to be convinced of the sustainability of new policy orientations.

Once established and accepted, the overall positive impact of improvements in conditions for investment goes beyond increasing total investment flows. Much more important is the improvement in the quality of FDI and overall private

1 The numbers refer to the checklist of impediments/improvements in Box 1.

sector efficiency. Improvements in conditions for investment in the sample of 28 countries of the ERT surveys might have led to an improvement of the incremental capital-output ratio of these countries by 0.3 (Oberhänsli 1992; Hall and Jones 1996). This means that policy changes increased the potential for average annual growth—with the same size of investment, expressed as a percentage of the gross domestic product (GDP)—by possibly more than two percentage points. Actually, the policy changes went along with a major acceleration in growth in prosperity, with annual GDP growth rates increasing from 3.4 percent (1980–90) to 3.9 percent (1990–2000) and 6.3 percent (2000–10).

In addition, it was the nature and speed of policy change and the room for manoeuvre that it created for the private sector across the world that significantly contributed to an acceleration in global job creation in manufacturing and services. According to a study by the University of St. Gallen and updated data from World Bank statistics, the number of net new jobs (that is, total jobs created minus those disappearing) increased from an annual average of 18.4 million during the period 1965–82 to 40.9 million during 1983–2010 (Brabeck-Letmathe 2013).

DEVELOPMENTS AFTER 2000

A review by the United Nations Conference on Trade and Development (UNCTAD) in recent years, similar to the one by the ERT in the 1990s, shows that the positive developments of competition on rules continued in 2000 and 2001 and then began to slow down (Figure 2). Since 2007, more than 25 percent of the changes in national investment policies have been restrictive in nature (UNCTAD 2014).[3] Many of the new impediments measured by UNCTAD are meant to enforce “good behaviour,” but there is the risk that the basic objective—generation of jobs and prosperity—has been at least partly lost sight of.

CHANGES IN THE CHARACTER AND STRUCTURE OF MULTINATIONAL COMPANIES

Along with changes in policies, the structure of companies, multinational companies (MNCs) in particular, has been changing, too.

Based on the significant ongoing transformations, and looking at the challenges and opportunities, MNCs may look quite different 10 to 20 years from now.

Therefore, any investment agreement should not only be able to build on the success of the dynamic policy changes during the period of regulatory competition, but also be flexible enough to respond to these structural changes, and not slow them down.

A few aspects of these transformations under way and/or ahead are listed below.

1. Lorraine Eden, in her E15 Investment Policy Task Force think piece, outlines the four benefits of multinationality—global integration for scale and scope; global arbitrage (labour costs, and so on); global

3 A note of caution: the UNCTAD chart also includes new restrictions in advanced economies, such as divestment prevention, where advanced economies clearly dominate.

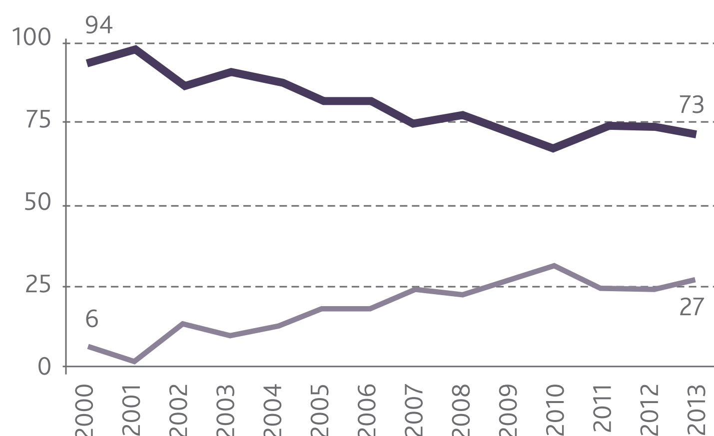


FIGURE 2:

Changes in National Investment Policies, 2000–13 (Percentage)

LEGEND:

Liberalization/promotion

Restriction/regulation

flexibility (ability to shift); and global learning (transfer of knowledge gained in individual markets and within its own knowledge-generating organizations such as research and development [R&D] centres across the world). With higher value added of the production share of multinational enterprises (MNEs), and with new technologies, the latter is clearly gaining in importance compared to the first three benefits.

2. As a result, manufacturing and service MNCs seem to be moving from a traditional centre-periphery approach with a "know-it-all" headquarters to networks, ultimately closed networks with close links within the "periphery," where the centre loses its importance/dominance. In such a network the main value contributed by the MNC is not physical investments, but knowledge, organization for an efficient flow of information, trust, and so on, within this network. In other words, MNCs are turning into drivers of globalization of knowledge, rather than further globalization of factories, trade in goods, and so on. This trend is further driven by the widening gap between companies concerning local versus global appearance, combining customization and standardization (rather than seeing it as conflicting), that is, the consumer face: for example, personalized food versus mass production of communication devices. The common denominator for the former: knowledge, organization, and so on.

3. Fragmentation of value/production chains within such network structures (not just linear/vertical) is accentuated and facilitated.

4. Restructuring is under way to set up regional/global shared services, also including parts of central headquarters functions (for example, human resources [HR]). A recent survey of Accenture (2011) among 100 companies/individuals shows that 75 percent of information technology (IT) services are delivered through shared services today, as are 51 percent of billing collections and other routine client-facing services, 50 percent of HR, 41 percent of procurement, and 39 percent of logistics/material management. Companies say that these services are competitive in an open market; partial outsourcing is used as a tool. One outcome is that the value chain will become even more fragmented and complex, and centre-periphery models even less viable.

5. We see the "old," increasingly regulated MNCs looking for alignment with a proliferation of global governmental and non-governmental organization (NGO) views and bureaucracy, exposed to all kinds of political pressure.

Simultaneously, new types of MNCs have been entering global markets, also as competitors.

6. With increasing importance MNCs from emerging economies, with a different culture and dynamics, are moving fast in markets and well rooted in their societies.

7. IT, social media, and so on, with new types of service companies—many, if not most of them, are not in the major business organizations; they seem to be a world apart.

Under these new circumstances, the actual allocation and cross-border flow of capital has become much more complex (for manufacturing companies, even more for the service sector, see 1–6) and often also more variable within short lapses of time. Their governance through static agreements, guidelines, and so on may become rather difficult. Also, cross-border investment flows as measured by the Organisation for Economic Co-operation and Development (OECD) and UNCTAD may turn out to be partly misleading.

SOME POLICY SUGGESTIONS

In a globalizing economy, industry needs a truly global framework for investment, be set up in a forward looking and strategic manner, and be able to cope with a diverse and constantly changing reality.

The ERT survey results could be taken as a starting point for new proposals. These results show that there is already a highly efficient process of opening and deregulating, modernizing and globalizing rules and institutions relevant for running businesses. Opening no longer needs to be invented and initiated by negotiators, but understood by them, accompanied and nurtured by a more adequate global framework. Instead, the goal should be to get as many countries as possible to open up their markets.

QUANTITATIVE AND QUALITATIVE PUBLIC POLICY BENCHMARKING

One of the more powerful instruments of market-led opening and modernization seems to be public policy benchmarking, which, in the 1990s and early 2000s, was done mainly at the national level. Benchmarking, in general terms, is a route to compare and improve performance, either with comparisons of statistics or of practical policy measures.

When using the already well-tested quantitative approach to benchmarking, policy makers look for the appropriate statistical yardsticks to compare themselves with the "best in class," take steps to improve, and then compare themselves again. The checklist for an enabling environment (Box 1) could be used for qualitative public policy benchmarking.

TOWARDS A FUTURE MULTILATERAL AGREEMENT FOR INVESTMENT

A new multilateral agreement for investment in the World Trade Organization (WTO) context could include the following features.

1. Provide rules and criteria to strengthen effective public policy benchmarking and institutionalize peer review as built-in devices for continuous opening, also at the sub-federal level. However, there should be no room for extraterritoriality or for imposing solutions in this mechanism (or in general).

2. Offer the flexibility to extend the coverage of the framework to additional areas that might be or become relevant to contestability and an enabling environment.

3. Introduce the most-favoured nation (MFN) principle in all policies opting for enabling environments and contestable markets. Extend on a non-discriminatory basis to all investors—from developed and developing countries—any new investment opening or protections offered autonomously, negotiated bilaterally or in regional agreements. Provide mechanisms to lock in the progress made, for example, notification procedures.

4. The new agreement should apply national treatment to foreign-owned firms and ensure non-discrimination of local investors. It should define common minimum standards for the protection of private business against state interference, at least in some areas.

5. Foresee a flexible range of dispute settlement mechanisms, including arbitration, which reflects the changing character of MNEs.

6. Develop a constructive modus vivendi with regional and bilateral agreements. They should become a source of synergy with global schemes, with subsidiarity, optimum regulation area, and variable geometry as constructive elements in a long-term perspective towards a global concept. Policymakers may also consider using sectoral opening as a pragmatic means to make progress, provided global opening remains the long-term goal.

CONCLUDING REMARKS

Private investors—local and foreign—today see a positive picture of well-focused opening and deregulation, and modernization and globalization of rules and institutions relevant for doing business. This process is progressing at a high pace, with developing countries often ahead of similar efforts in industrialized countries.

Opening and modernization are aimed at improving the efficiency and competitiveness of an economy, and creating new jobs—direct and indirect. Private companies are no longer those demanding, but one of the participants in an open policy dialogue.

Continuous change matters at least as much as where a country stands with regard to the usual criteria of a good investment climate. Any new global framework should therefore focus on this aspect, a “traditional” multilateral agreement of the “highest standards” may well be outdated once it is finally ratified. Governments should also look into the next-generation issues and mechanisms, as outlined (in part) in this paper.

Competition on rules and public policy benchmarking has become an efficient driver of the process of opening, deregulation, modernization, and globalization of rules. Opening no longer needs to be invented and initiated by negotiators, but understood by them, accompanied and nurtured by a more adequate global framework. There is a need to find efficient ways to focus and maintain momentum multilaterally, that is, a global agreement for private investment taking advantage of regulatory competition in globalizing markets.

Hoekman and Saggi (1999) argue that “the major potential gain from a multilateral agreement is avoidance of wasteful competition for FDI.” The proposed focus on regulatory competition would lead to a positive sum outcome, rather than a competition with tax incentives, for instance. And it will respond to the rapidly increasing complexity of markets and companies (only some aspects of which have been outlined in this paper).

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