

**Policy Reforms and Economic Growth**

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## POLICY REFORMS AND ECONOMIC GROWTH

Until the middle of the twentieth century, and with the exception of Japan, economic growth at a rate sufficient to transform peoples' lives took place only in Europe and the countries of recent settlement in North America and in the South Pacific. After the Second World War, policy makers in a large number of other countries sought to achieve the same sorts of transformation for their people. In most countries, there were at least a few years of growth rates significantly above what had earlier been achieved, but these rates usually diminished over time. There were only a few that attained sufficiently high and sustained rates of growth to enable the transformation of the economy and society. Korea was certainly an outstanding success story in that dimension.

As leaders in other countries sought to understand why they had not been able to sustain the rapid growth rates of the successful countries, attention began focusing on the policy stances that had been adopted in those countries. It came to be recognized that, to a considerable degree, some of the policies that had been adopted had, contrary to intentions, been inimical to growth. This led to discussions of the ways in which policies supported or retarded growth, to analyses of "reform" of economic policies, and to increased understanding of the role of policy in supporting or hindering economic growth.

In this paper, I seek to set out what I think is our current understanding of the role of policy in fostering rapid economic growth, and of the nature and need for reforms. I

will start by trying to provide a definition of “reform”, a word that is now used to cover a variety of policy changes, that is appropriate for present purposes. I shall then briefly provide an overview of economic growth and the role of policies. Thereafter, I will discuss the ongoing relationship between economic growth and reform, and its several dimensions. I will use examples from the Korean experience, and from the longer economic history of Europe and the United States, to draw out the implications.

One of the key propositions of this paper is that economic growth brings with it changes that invariably alter the appropriate policy framework. When those adaptations are not made, they may simply retard growth (if the needed changes are not too far-reaching) or they may halt it until adjustment is undertaken. In the last section of the paper, I will illustrate with regard to two key arenas for reform: the trade regime and labor markets.

### 1. What is Reform?

The word “reform” has become fashionable and now takes a large number of meanings. In democratic societies, the opposition seems always to be promising to “reform” the incumbents’ policies with which it disagrees. “Reform” can sometimes be almost synonymous with change: and changes can be very small – putting out a first-class stamp that will last in perpetuity in the U.S., as contrasted with a 41 cent stamp which will no longer suffice for first class mail if the price rises again – or fundamental, as for example, when a country moves from a regime of fixed exchange rates to a freely floating exchange rate.

Minor tinkering with the system, often referred to as “reform”, can have beneficial (if the changes are in the right direction) or harmful consequences. But it is

hard to call changing to a permanent first class stamp a significant reform of the system. Moreover, there are a large number of dimensions to reform. These include the motivations and degree of consensus about the need for reform; the speed of reforms; the policy framework existing at the time of reforms; the degree to which the reforms are appropriately conceived; the economic circumstances under which reform takes place (crisis, recession, normal growth); and much more.

Since this paper is about reforms and economic growth, I shall focus on reforms undertaken where the apparent motive is to improve the functioning (including the growth rate) of the economy. While this definition may include changes such as were made in China after the Long March and other decisions to have centrally planned economies, I shall not consider those here, partly because they were so very different politically and economically from the reforms considered appropriate in economies today and partly because the motives for the change to much more central ownership and control were in significant part political.

It is useful to consider these various dimensions first. To start with, there is the scope of reform. There are reforms which attempt to alter the fundamental relationships between governments and markets (and hence incentives) in influencing economic activity throughout the economy. Second, there are reforms that provide basic alterations in the relationship between government and markets in a particular sector. Thirdly, there are reforms that improve the overall functioning of the economy in the relationship between governments and markets without challenging the overall framework of government-market relationships. And, finally, there are reforms that improve the

functioning of a particular sector again without changing the overall framework of economic policy toward the sector.

Turning first to types of reform, the first type – basic alterations in the relationship between government and markets – has been attempted to varying degrees, and with different rates of success, in a number of countries. Chile comes is a country in which the government exercised control or ownership over much economic activity in 1973; in that year, a new government took power and began shifting incentives and government policies toward a much more market-oriented economy. The reforms were fundamental and far-reaching; they did not all take place instantaneously, but the intention of the authorities to shift was clearly enunciated. Thereafter, macroeconomic policy changed abruptly (and inflation was brought down from triple digit to single digit within a few years); the exchange rate regime was altered, quantitative restrictions on imports were abandoned, and tariff levels were reduced. Ownership of copper mines and much else was shifted back to the private sector. Of course, it should be noted that the previous Chilean government, which came into office in 1968, also believed it was reforming as it shifted control over economic decisions to the public sector. The policies introduced with that reform, however, were by 1973 seen to be incompatible with sustained economic growth, while the reforms of 1973 were, in the longer run, sustained and economic growth accelerated.

The second type of reform happens in almost all economies, including the very successful. Sectoral reforms can be attempted (and sometimes succeed) in many arenas. In recent years, many governments have undertaken reforms of pension systems. Some reforms have been much more far-reaching than others; a few have been sufficiently

ambitious that looming demographic changes do not appear likely to present a major fiscal challenge, while others have either reduced the magnitude of the anticipated financing needs or postponed the onset of fiscal difficulties without fundamentally solving the problem. Canada and the United Kingdom seem to be in the first category, with existing levels of support for pensions seemingly sustainable without major fiscal efforts, while the United States appears to be in the second category: reforms have been made with gradual increases in the age at which people become eligible for public pensions and increased incentives to continue working, but experts still state that the current system is not sustainable without a fiscal drain or further adjustments. Yet other countries have yet to address the demographic issue seriously, and may not do so until fiscal unsustainability and its consequences forces them to do so.

Reforms which improve the functioning of the system, or of a particular sector, but which are not fundamental, can be of many types. At the overall, or macroeconomic level, examples of such a reform might be a major change in the bankruptcy law, a reworking of the commercial code, or a tax reform to remove distortions. Examples of sectoral reforms which are not fundamental but which are intended to improve the functioning of the system are many. In Sweden, for example, cars used to drive on the left side of the road; there were enough difficulties with drivers from other countries (and, one might guess, Swedish drivers going to the rest of Europe) so that the system was reformed and drivers all went to the right. The perpetual first-class U.S. stamp is another example of a reform improving the system. Splitting an economy ministry from a finance ministry, reorganizing an agricultural research and extension service from a central to a decentralized system, instituting a large taxpayer unit, giving a central bank

independence, and a myriad of other changes are all examples of sectoral reforms which are intended to improve the functioning of the system within the existing framework. It may seem that each of these alone, while improving the functioning of the system, need not be considered in relation to the overall growth rate. But, in fact, as will be discussed further below, combinations of these smaller reforms can have a huge impact on the overall system, and failure to make changes in them, if they are sufficiently inimical to growth, can greatly reduce growth potential.

Motives for reform also can differ (and need not be the same for all those supporting reform). In some instances, it is evident that existing policies are not working. In others, experience from other countries provides convincing evidence that alternative policies will work better. These motives often underlie policy reform in circumstances in which a new government has come to power.<sup>1</sup> And, in some circumstances, the situation is so dire – and on present policies expected to deteriorate further – that action is clearly called for (even if there may be disagreement as to what that action should be). Some changes become desirable because of changed technology: a good example is the regulation of telecommunications. Phone services were deemed to be a natural monopoly until technology changed; by the 1970s, however, it became evident that there could be competition among phone carriers, and the need for regulation diminished.

Other changes become economically warranted because of economic growth itself: economic policies that are not too costly in poor rural societies may become very costly as economic development progresses. Financial development is an important

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<sup>1</sup> The World Bank (2006, P. 5) reports that about 85 percent of all reforms it monitored for three years up to early 2006 were undertaken by new governments in their first fifteen months in office. These reforms would appear mostly to be instances where the motive was to improve future economic prospects, rather than to resolve crises.

example: credit rationing and connected lending in Korea in the 1960s and 1970s was not too costly, as it was clear that expansion of export oriented activities was highly profitable and exporters received most of the rationed credit. With economic growth, however, the absence of a financial system that could appropriately evaluate the prospective risk-adjusted rates of return for alternative activities became increasingly costly. The same set of economic policies had increasingly negative effects over time. Sometimes, too, public opinion increasingly moves in support of a policy change: a good example is the mounting concern with the large corporations in the United States at the end of the 19<sup>th</sup> century and the development of anti-trust law.

Reform may come about because of decisions made in “normal” times by the decision making bodies. If it does not, and problems are sufficiently serious, a “crisis” may induce reform. Deciding what is a crisis and what is a “normal” decision is sometimes difficult.<sup>2</sup> But clearly the Korean financial reforms of 1997-98 were in response to crisis, while earlier financial changes (such as insuring that real interest rates were positive) were undertaken in more normal times.

In some instances, successful reforms seem to induce further reforms. In Chile, for example, initial reforms were far-reaching and covered both macroeconomic issues and microeconomic sectoral issues. Once the reforms were underway, other reforms, both macro and sectoral, followed. Not only were most of the initial reforms sustained, many were furthered in later moves. Tariffs, for example, had initially been significantly lowered, but subsequent steps lowered them still further until, at the present time, the

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<sup>2</sup>To take just one example: in India, when the rate of inflation threatens to rise to double digits, political sensitivity is such that measures are immediately undertaken; by contrast, Turkey experienced inflation rates above 50 percent for the entire period from the mid 1980s to 1999, and the average rate of inflation from 1971 to 1999 was over 60 percent.

uniform Chilean external tariff is 5 percent, except for countries with which Chile has free trade agreements.

There are also differing speeds of reform. In India, for example, reforms began seriously in 1991, but continued throughout the 1990s. Policy makers emphasized that reform would be “gradual”. In other instances, major changes have been effected rapidly: such was the case in Turkey in 1980 (in the context of a perceived crisis) when (among other reforms) the exchange rate regime was altered, tariffs and quantitative restrictions on trade were greatly reduced, the interest rate was freed, and fiscal deficits were greatly reduced.<sup>3</sup>

One aspect of the speed of reforms is seldom noted: in the 19<sup>th</sup> and early 20<sup>th</sup> century, the now-industrial countries were adapting to changing conditions and altering policies over time. But their growth rates were normally 5 per cent or less. Thus, reforms could proceed rather slowly. For developing countries today, the situation is different: they hope to attain growth rates closer to ten per cent than to five. But to do so means that the economy will change more rapidly, which in turn means that the speed with which reform has to be undertaken increases.

While the speed of reforms initially can vary, it is important to recognize that no economy has ever been “reformed” into a new status, only to remain there unchanged. Some reforms can be undertaken relatively quickly by administrative decree (such as removal of quantitative restrictions on imports in some cases); some take acts by parliament, some only after legislative passage and the establishment of the rules by which the new processes will be implemented. And some reforms, once undertaken, lead

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<sup>3</sup> See Krueger and Turan (1993) for a full analysis.

to changes in the functioning of the economy that induce decision-makers to seek still further reforms.

The policy framework existing at the time of reform also matters. In some instances, reformers are focusing on one or a few sectoral reforms in the context of other policies deemed satisfactory. In other cases, existing policies untouched by reforms have seriously reduced the degree to which reforms could achieve their intended results. In countries with agricultural marketing boards, for example, devaluation (which should have stimulated increased production and exports of some agricultural commodities) often left farm gate prices unaffected, thereby rendering nugatory the exchange rate change for producers of those commodities.

It needs also to be recognized that the payoff to any particular reform will depend in significant part on other economic policies. If, for example, the labor market is fairly rigid and import-substitution policies are in place in a labor abundant country, there will be a bigger payoff to labor market reforms if the trade regime is liberalized than otherwise, and vice versa. And both of these reforms will have higher returns if the judicial system and commercial code are market friendly. Hence, once reform is underway, there are cumulative benefits from early reforms as later changes are undertaken.

Policy reforms can be well conceived or otherwise. In some instances, failure to diagnose the key problems correctly can be crucial. In others, failure to understand interactions between policies affecting decision makers can thwart the intended outcomes of reform. In the Turkish reforms of 1980, for example, it was correctly recognized that the inward-oriented, state-directed, set of economic policies was inconsistent with

sustained growth but decision-makers underestimated the negative impact of large fiscal deficits.<sup>4</sup> In India, the devaluation of 1966 failed to result in expansion of exports, which had been a central purpose of the reforms. In fact, the government of India had earlier extended subsidies to exporters of a variety of commodities and removed those subsidies at the time of devaluation. As Bhagwati and Srinivasan (1975) show, the rupee prices received by exporters were largely unchanged and sometimes even reduced. At the same time, there had been false invoicing of exports in order to collect the subsidies, so that recorded exports had been overstated prior to devaluation.

In the early postwar years, it was widely believed that governments could undertake economic activity through state owned enterprises and controls over the private sector at least as efficiently as markets. When ideas changed, and it was recognized that policies designed to achieve desirable goals in market-friendly ways would yield superior outcomes, the design of policy reforms also changed.

Economic circumstances at the time of policy reform also matter. In the context of favorable terms of trade and reasonable growth, reform is probably politically more palatable than in times of recession or deteriorating terms of trade but, of course, the impetus for reform is less. A good harvest year in an agrarian economy can improve the performance of the economy post-reform, while poor weather and a weak harvest can lead to poor performance.

Both types of fundamental reform – economy wide and sectoral – may succeed or fail. Failures may come about because the initial reforms were badly conceived and/or implemented, because of bad luck, or because political opposition forced their reversal

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<sup>4</sup> This happened only after several efforts to ameliorate the situation through exchange rate changes without adjustments to the trade regime or control of the economy had failed to result in accelerated growth.

before sufficient time had elapsed to show their success. When there is sufficient political consensus that a better-functioning sector is essential, a failed reform may be followed by a successful one. In India, for example, a first pass at reform of the telecoms sector (which, at the time, was publicly owned) failed in significant part because the regulator was simultaneously the operator of the system; thereafter, a second reform was undertaken which basically shifted operation to the private sector, and it succeeded.

Indeed, one might say that “crisis” is what happens when decision-makers fail to find a way to ameliorate or resolve a problem and its costs keep mounting. A clear-cut case in point is when financial regulators overlook (or fail at all to recognize) growing non-performing loans in a banking system: if those loans are permitted to be “evergreened” and rolled over indefinitely, they will grow as a proportion of banks’ portfolios until a financial crisis is reached. The same may happen in countries where actions are not soon taken to address the fiscal problems that will mount with aging populations and no changes in pension systems in some countries.

### Reforms and Growth

The above discussion was necessarily somewhat vague, in part because reforms can encompass such a variety of policy actions and implementations. But once focus is upon economic growth and reform, it is possible to make the discussion somewhat more concrete.

By definition, economic growth brings about change in the structure and operation of the economy. In most developing countries, conscious efforts to accelerate growth began after the Second World War when almost three quarters of the population was rural and when subsistence agriculture was the mainstay of the majority of the

population. Often, initial development efforts were undertaken in the public sector, with public sector enterprises started or expanded in a variety of manufacturing activities. Exchange control was imposed, with import licensing intended to prevent the importation of goods that would compete with newly established (public and private) manufacturing enterprises.

The characteristics I just mentioned were all widely known at the time, but there were some others that, while recognized, were deemed relatively unimportant. These included phenomena such as weak bankruptcy laws, property rights and commercial codes, and an absence of diversified financial institutions.

Superimposing governmental ownership and control on these economies enabled a certain success with economic growth for a few years in the postwar period. But those same controls quickly became a factor significantly retarding growth. Only those countries whose governments recognized their mistakes and changed course were enabled to accelerate growth; those countries where the entrenched import-substitution, government-led, growth model remained in place experienced significant slowdowns in growth.

What had happened was that, in the initial phases, establishment of new manufacturing activities in the public or private sector, while high-cost, nonetheless started in areas with some degree of comparative advantage and where productivity was, or was measured to be, not significantly different or perhaps even a little higher than in subsistence agriculture. But, as more of these activities were started, they were further and further away from comparative advantage and often confronted very small domestic markets that did not permit reaching minimum economic size. Simultaneously, already-

existing establishments could expand only to the extent there was domestic demand, as their costs were above levels that could have made exporting profitable. As this process continued, other things also took place, too numerous to mention here. But the upshot was that growth rates tended to slow over time, while simultaneously the demand for imports rose rapidly and export growth was slow even if positive.

Stated another way, and in more general terms, a policy that had delivered some economic growth ran out of steam and could not be sustained if growth was to continue. Usually, the signal that something needed to change was “balance of payments” crisis. When foreign exchange debts and arrears mounted and reserves were largely depleted, the authorities often took measures intended to ameliorate the situation. These measures included devaluations (to new, fixed, nominal exchange rates when domestic inflation rates were above world levels) which made exporting at least somewhat more attractive and raised the cost of imports, sometimes rationalization of import licensing regimes, and other measures (often intended to slow the rate of inflation).

But these measures, while “reforms”, often did not address the fundamental problem, which was the inner oriented nature of the trade regime and the control system for regulating the economy. The trade regime failed to provide sufficient incentive for exporting while the control regime stifled incentives for producers in many lines of activity. It was not until fundamental reforms took place in Korea, Taiwan, and elsewhere that analysts began fully recognizing the extent to which more than a simple once-and-for-all patch-up of the existing regime was needed. Thus, as already mentioned, in 1980 the Turkish authorities recognized that the old model would no longer deliver the desired

growth, and the Chilean authorities reversed course with fundamental reforms in the 1970s.

But all of these reforms were necessary essentially because policies that earlier had been adopted and had delivered some growth had ceased to do so. Those policies were fundamentally ill-advised; and growth could have been more rapid in those economies in the early stages with alternative policies. But as growth proceeded, the retarding effects of the policies intensified. In some instances, policies were simply unsustainable as when foreign debt mounted or fiscal deficits led to higher and higher interest rates and domestic debt-servicing obligations of the government.

However, as already pointed out, even when growth is proceeding rapidly, policies (or an absence of policies) that earlier were not highly detrimental to growth become so. Here, the important link with growth is that policy adjustments are necessary because past growth has led to changes in the structure and functioning of the economy;

The economic history of the now-industrial countries is full of reforms.<sup>5</sup> Some took place because of needs felt and expressed by various economic interests. Rosenberg and Birdzell (p. 116) report that

“...it was not until the latter part of the eighteenth century that the royal courts in London had accumulated enough experience in deciding disputes over agreements, patents, arbitrations, and other commercial transactions to make English courts and law seem a factor contributing positively to the development of English commerce.”

Indeed, as they stress, changes from the economic institutions and arrangements were a necessary condition for the beginning of the industrial revolution. The joint-stock company, and then the corporate form of governance were developed; banks became

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<sup>5</sup> See Rosenberg and Birdzell (1986) for an overview stressing the necessary changes.

bigger, more specialized, and more active, and other forms of finance (including equity in corporations) were developed.

Without these, and many other, reforms along the way, the economic growth of the west would inevitably have been much slower, if it could have proceeded at all. And that continues to be true. As growth proceeds, financial instruments must become much more diversified and sophisticated, commercial codes need to be finely developed, regulatory mechanisms need to be adjusted (or discarded, as appropriate), and the relationship between governments and markets continues to evolve. At present, the network characteristics of the telecoms revolution and the externalities associated with concerns about the environment are both presenting challenges to government-market relationships in all economies. Both the telecommunications innovations themselves and the environmental challenges are themselves outcomes of successful growth. But they present new challenges which, if not met, will diminish growth potential going forward.

Many reforms simply enhance growth potential. But some are essential and, if not undertaken, their absence can result in a crisis or in a deceleration, if not cessation, of growth. In the nineteenth century in the United States, there were periodic banking crises which led to severe recessions or depressions. It was only in the early twentieth century, with the establishment of the Federal Reserve System, that the American banking system became much sounder. Even then, it was not until the Great Depression that it came to be recognized that the Federal Reserve and other central banks had a major responsibility for preventing a downward spiral in the money supply. Some of the reforms undertaken in response to the Great Depression have lasted until the present time. Others were seen to have represented too big a shift in structure (as, for example, with the Taft-Hartley Act,

which removed some of the provisions that policy analysts felt had shifted power too much toward labor unions, and which was amended in 1948), or to have become counterproductive (as for example the Glass-Steagall act which separated investment and commercial banking).

As economic growth proceeds, new issues arise. Currently, many observers are focusing on the development of derivatives in financial markets as a new innovation (in response to growth) which may or may not warrant some degree of government supervision or regulation. And, as already mentioned, the foreseeable requirements for funding of pension systems will either be met smoothly or will lead to unacceptable outcomes mandating change.

#### Growth-Promoting Reforms

From the preceding discussion, the reasons why it is difficult to generalize about economic reforms should be evident. There are so many policies that can be altered or supplanted, the range of possible change is so great, and there are so many possible combinations of reforms and speed at which they occur that general lessons are hard to come by. But, to make the preceding discussion somewhat more concrete, I shall focus here on the variety of areas in which reform efforts are being made.<sup>6</sup> A useful source of data and analysis is the World Bank's Doing Business, which provides estimates of some measurable aspects of economic policies that affect growth.<sup>7</sup>

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<sup>6</sup> Space considerations prevent coverage of other types of reform. For a good survey of reforms pertaining to infrastructure, see World Bank, 2004.

<sup>7</sup> Any effort to measure the number and extent of reforms is imperfect because of the many dimensions to reform discussed above. That is recognized in the Bank's introduction. But, as the authors point out, having some concrete measures is preferable to having none, and the Bank's work seems to have spurred further reforms.

The ten categories of “doing business” that the World Bank evaluates include starting a business, dealing with licenses, employing workers (including firing costs), registering property, getting credit, protecting investors, paying taxes, international trading, contract enforcement, and closing a business. All of these are important for economic growth, and the reasons are well known. Most large businesses start as small ones, and the successful ones grow larger; if entry is difficult, there will be fewer small firms and there is no guarantee that those discouraged may not be the ones that might have been successful. In countries where there are barriers to starting a business (formally), one often finds an informal sector into which most economic activity has been forced, and those activities undertaken in the formal sector are normally the domain of very large businesses. Licensing requirements can also serve as a deterrent to entry but, in addition, can substantially raise costs because of delays and extra paperwork. Issues surrounding employment are discussed below, as are those covering international trade. But registering property, getting credit, and protecting investors are all part of what enabled the west to move from the feudal structure of economic activity to modern large-scale organizations as discussed by Rosenberg and Birdzell.

In its 2007 edition, the Bank’s staff presents an analysis of “How to Reform”, starting with a ranking of “top reformers” in the preceding year. By count, there had been 213 reforms in 112 economies (out of 175) introduced between January 2005 and April 2006. In the Bank’s analysis, the top reformer was Georgia, where reforms had been carried out in 6 of the 10 categories of policies covered by the Bank. Georgia had reduced the minimum capital required to start a new business by 90 percent; customs procedures at the border had been simplified so that it took 13 days instead of 54 days to meet the

administrative requirements for exporting, and the court procedures for commercial disputes had been simplified so that the time required to resolve cases was reduced from 375 days to 285. Georgia had also altered labor regulations, cutting business social security contributions from 31 to 20 percent of wages and simplifying procedures for hiring new workers.<sup>8</sup>

Since many countries are reforming, those that do not reform fall behind those that do. Standing still can mean losing competitive advantages. However, it is important to recognize that not all reforms make things better. The World Bank cites a number of countries that changed their laws and regulations in counterproductive ways: in one country where licenses are required to begin construction, the government simply stopped giving licenses in January 2006 (P. 15).

Before turning to trade and labor market reforms, it should be noted that the cumulative negative impact of poor rankings for the items included in "Doing Business" can be very large. The lowest ranking country for 2007 is the Democratic Republic of the Congo. In that country, there are 13 procedures, taking 155 days and costing 481 percent of per capita income, required to start a business. Obtaining licenses takes 15 procedures, by the Bank's estimates, taking 175 days and costing 1243 percent of per capita income. Registering property takes 137 days and costs more than a quarter of the cost of the property, while there are 47 procedures needed for efforts to enforce a contract, which take 560 days and cost 45 per cent of the value of the contract. (p.106).<sup>9</sup> In circumstances

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<sup>8</sup> World Bank (2006), p. 1.

<sup>9</sup> By contrast, Australia (which is ranked eighth, contrasted with the Democratic Republic of the Congo's 175 ranking) has only 2 procedures, taking two days and costing 1.8 percent of per capita income to start a business; Although 17 procedures are necessary to obtain licenses, these take 140 days and cost 14 percent of per capita income. Property registration takes 5 procedures taking 5 days, and costs 4.8 percent of the value of the property. Contract enforcement requires 19 procedures, taking 181 days and costing 12.8 percent of the value of the claim.

such as these, it is understandable that there are few start-ups, and that most economic activity takes place outside the “formal” sector”. Reforming any one or two of these obstacles by reducing the number of procedures, or the costs, would clearly be a step in the right direction. But, until there is a fairly extensive streamlining of judicial and regulatory treatment of business, it cannot be expected that growth in the formal sector will accelerate significantly.

The World Bank’s publication itself seems to have spurred competition among countries to improve the ease of doing business. The Bank reports that, in some countries, national authorities are ranking local governments on a variety of performance measures, and that these, too, seem to have spurred reform.

#### Trade Regime Reforms

Although there is disagreement among analysts on a variety of aspects and dimension of reform, virtually all recognize that a relatively open trade regime is essential for sustainable economic growth. Countries that had high barriers to trade in the 1950s and 1960s sometimes experienced satisfactory growth rates for a few years, but the recurrent “foreign exchange crises” previously referred to, were a major source of difficulty. In fact, these crises were often referred to as part of a “stop-go” cycle, in which growth was reasonably rapid until the current account deficit became unfinanceable, whereupon the measures taken to reduce the deficit also resulted in a sharp slowdown, if not a temporary halt, in economic growth. It gradually came to be recognized that, in most countries, growth in each successive “go” part of the cycle was slower than in the preceding one, while the recession phase generally became deeper and lasted longer.

No developing country has managed rapid and sustained growth with high barriers to trade. The reasons for this are well known: 1) with small domestic markets, producers have in effect monopoly positions and, without competition, have little incentive to increase productivity; 2) again, because of the small market, many activities are undertaken at a scale sufficiently small to be uneconomic; 3) import licensing and high tariff barriers (not to mention import prohibitions) induce costly substitution to high-cost low-quality domestic production and/or evasion or smuggling; 4) the profitability of obtaining import licenses is sufficiently great that enterprises are often led by those with connections rather than those whose focus would be on greater economic efficiency; 5) countries cannot take advantage of their comparative advantage when most profitability is located in the domestic market; and 6) producers who are insulated from the international market are often uninformed about the latest technology, alternative techniques, and other developments in the industry.

For present purposes, the question is how reform of the regime can take place. Reform is especially difficult in trade regimes precisely because reform, if successful, will reduce the profitability and monopoly positions of domestic producers who were earlier encouraged to enter into their lines of activity and will thus encounter their opposition. Moreover, there are ample grounds for believing that, in attempting to undertake fundamental macroeconomic reforms of the type discussed above, trade liberalization should take place early in the process. In part, this is because investments will not be channeled into the most (socially) profitable activities as long as import-substitution policies are in place; in part, it is because the "foreign exchange shortages"

previously discussed will probably prevent very rapid growth and therefore the payoff to other reforms.

First steps in reforming a trade regime almost always entail a move to a realistic exchange rate (because there is little incentive to export with an overvalued exchange rate and export earnings are unlikely to grow sufficiently rapidly), which could be fixed if the authorities were willing to adapt their monetary and fiscal policies to the dictates of the trade regime, but more likely would be to a floating exchange rate. It is always crucial as well that quantitative restrictions to imports and virtually all export licensing be removed. These two measures taken together in effect result in convertibility on current account. Thereafter, or simultaneously with these measures, tariffs can be brought down. This can be done with a reduction in the highest tariff rates first, with moves to uniformity coming later. If export growth accelerates, relaxation of restrictions on foreign exchange transactions must follow if growth is to be sustained.

But, usually, there are many other things that need to be done if trade liberalization is to result in more rapid growth of exports and of real GDP. Customs and licensing procedures need to be examined and simplified, if not eliminated – long delays in granting licenses or clearing imports through customs can be as deadly as a highly overvalued exchange rate. Hong Kong requires two documents for either importing or exporting; export procedures take 6 days while import procedures take five. By contrast, Indonesia (whose trade regime has been substantially liberalized) requires 7 documents for exporting, 10 for importing, and it takes 7 days for exporting and 30 for importing (World Bank, P. 119). Some countries fare much worse: it takes 66 days for export procedures and 74 days for imports in Mongolia, for example.

Beyond these factors are the costs (and delays) of getting goods to and from port and delays and costs of shipping. For some goods (such as fresh fruits and vegetables) delays, either in getting to port or on the seas, can of course preclude exporting altogether. Some African producers are severely disadvantaged, as well, because the costs of sending their goods to the nearest port exceed the total shipments costs of goods sent from some European and other origins. A container shipped from Hong Kong costs on average \$425 to ship, while one from Swaziland costs \$1,857.

Ironically, reducing delays and costs of licensing, transport, customs, and the like can often be more difficult than removing quantitative restrictions. When a number of licenses are required, delays can take place at each licensing agency; moving to a one-stop shop has recently become a popular reform in an effort to remove these bottlenecks. But when different ministries are involved, as they usually are, there can be considerable resistance from each to giving up any authority it may have. Likewise, while quantitative restrictions can, in principle, be removed with the stroke of a pen, lowering transport costs and reducing port delays are not once-and-for-all events.

Thus, even in countries that have undertaken major reforms, as in the trade regime, there can remain much that could be done to increase competitiveness still further. Chile, which has greatly liberalized her trade regime and has a uniform 5 percent tariff, nonetheless, ranks only 44<sup>th</sup> among countries in the ease of trading across borders: 7 documents are required for export and 9 for importing; and it takes 20 days to get the export procedures done and 27 for imports. Further reform could be beneficial.

#### Labor Market Reforms

Whereas trade reforms appear to be a prerequisite to sustainable rapid growth, labor market rigidities in general seem to slow the attainable rate of growth. Only in extreme cases do they appear to choke off growth possibilities. And, whereas the main outlines of trade liberalization seem clear, as described above, there are many dimensions of labor market regulation that may require adjustment. On top of those discussed here, policy toward education and improving educational opportunities and attainment are of prime importance.

Labor market regulation can encompass a variety of factors: conditions of hiring and of firing, conditions of employment, taxes on the employment of labor, regulations governing unemployment compensation, and more. Moreover, in different countries it is probably different aspects of labor market regulation that are most important for restraining employment and growth in the formal sector.

Paradoxically, regulations that make it difficult or impossible to lay off or fire workers normally induce employers to give existing employees overtime or to substitute more machines for workers. In Chile, removal of provisions that prevented firing workers with more than a few months' seniority appears to have been a major factor in increasing employment

Minimum wage regulations can also be harmful, especially if they are set at a relatively high level. Some years ago, the author was consulting in Papua New Guinea, and the authorities were concerned that little foreign direct investment leading to manufacturing employment had developed in the country. It turned out that the minimum wage had been set at a level more than three times the average unskilled wage in the Philippines! But minimum wages need not be set that high to have adverse effects:

foreign investors are normally reluctant to ignore domestic laws, whereas domestic producers sometimes simply avoid the formal sector of the economy. But when they do so, they usually lose prospects for exporting (because the paperwork required entails the licenses described above), and even for large-scale production, which is often economic for goods produced using relatively large amounts of unskilled labor.

Taxes on labor can also serve to discourage employment. In some countries, nonwage labor costs can be 25 percent or more of the wage labor costs. This discourages employment in the formal sector, and can lead to a large informal economy. In Bolivia, the World Bank reports that only 400,000 workers have jobs in the formal sector, out of a population of 8.8 million. Other countries with restrictive labor laws and high nonwage costs of employment also have large informal sectors.<sup>10</sup>

The greater the restrictiveness of the labor market, the less the flexibility of the economy. This is true for all economies. The World Bank formed an index of labor market restrictiveness: even for European countries, the unemployment rate was found to increase with the rigidity of employment index.<sup>11</sup> As economic growth proceeds, the need for flexibility in the economy increases, and employment rigidity can seriously reduce potential rates of growth. Countries that have reformed their unemployment compensation (providing generous compensation but for shorter periods of time and requiring workers to undergo retraining if necessary) have experienced improved economic performance, including lower unemployment rates and higher growth rates.

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<sup>10</sup> See Hechman and Pages (2004) for an analysis.

<sup>11</sup> World Bank (2006), P. 21.

Addressing rigidity can have a large number of dimensions. It can include easing of hiring and firing restrictions as well as regulations governing conditions of work. But it can also address issues such as the portability of pension rights (which enable workers to move from one job to another without losing their rights), reducing taxes on labor through social insurance reforms (increasing the age of eligibility for example), and other measures.

For many of the industrial countries today, there is considerable evidence that existing labor market regulations reduce their potential rates of growth. The correlation between unemployment rates and labor market rigidity was already mentioned. But for some countries, including many in continental Europe, regulations such as the 35 hour work week, high minimum wages and taxes on labor, are judged to be a significant drag on the rate of potential output growth.

Unlike trade liberalization where controls are shifted from the government to the market, labor market liberalization is a matter of degree and can be done at varying speeds. But, for many countries, reducing rigidity in labor markets is now among the high priorities for permitting sustained growth.

### Conclusions

Once developing countries had shifted from their earlier inner-oriented, government controls strategy to a more market-friendly outer-oriented strategy for achieving economic growth, growth potential was significantly enhanced. Some countries have greatly reformed, while others have undertaken reforms more slowly and less wholeheartedly. But for those countries that have undertaken thoroughgoing reforms, the payoffs in terms of economic growth have been sizeable.

But, as economic history tells us, reforms are never completed. Economic growth and the accompanying technical change present new challenges. Those countries whose policy makers can appropriately identify the key arenas for reform, and carry out reforms before existing policies serve as strong deterrents to growth will experience more rapid growth (other things being equal) than those countries whose policy makers postpone or fail to recognize the major issues. Addressing issues such as labor market rigidity, pension reforms, and financial market stability, before they become crises is obviously desirable. But, even before that, taking actions earlier can provide a longer time horizon in which to achieve the necessary changes in the framework for economic activity.

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