BUSINESS INVESTMENT, THE RECOVERY, AND GOALS-BASED REGULATION

Jonathan Oppenheimer, June 2020

Key points

- The economies that will recover fastest will be those that are best able to re-establish and sustain strong demand and to unleash the dynamism of entrepreneurs, large and small.
- Business investment is the key to a recovery, both to boost demand and to enable businesses to adapt to the structural changes that are now inevitable, and governments must start thinking about how they can support business investment.
- Supporting business investment means reducing regulatory frictions, including by making permanent some of the temporary easing of regulations that we have seen during the early stages of the pandemic.
- Too much regulation is heavy on process, with the purpose of the regulation sometimes lost as a result, and rigid rules-based regulation too often stifles innovation or fails to keep up with industry changes, meaning it no longer serves its purpose.
- When whole sectors must adapt, regulation needs be flexible to encourage businesses to innovate and invest while also allowing regulatory objectives to be achieved, and that means shifting from rules-based to goals-based regulation.
- Goals-based regulation is inherently more responsive to market changes as it allows businesses to innovate and adapt their approach while still meeting regulatory objectives and without requiring regulators to overhaul their rules.
- The benefits from better regulation for productivity growth and in encouraging investment are likely to be particularly significant in relatively highly regulated economies.

1. Business investment and the post-pandemic recovery

The economy that re-emerges after the pandemic will be different. Some trends will be accelerated, such as the move online or towards a cashless economy. The way of working for many businesses will be transformed with, for example, less travel and less reliance on traditional offices. Many consumer behaviours will also change as people get used to new products, accessed through alternative channels, and as the experimentation in new ways of living, forced by the pandemic, leaves a permanent mark on preferences and lifestyles.

Inevitably, many businesses will fail, even where substantial government support is available, given the scale and likely duration of the economic shock. Some of the businesses that fail may have been operating at the margins of viability before the crisis. But it is likely that some good businesses will also fail, for example where they are unable to sustain adequate cash flow or to retain key staff or customers.

New businesses will emerge, either to fill gaps in demand as economies recover, or with innovative ideas to take advantage of the new opportunities that are presented by the structural changes to the economy. The churn in businesses will be reflected in the labour market. As the economy recovers, not everyone will go back to the same job.

The economies best able to recover and thrive in this environment will be those that are able both to re-establish and sustain strong demand and to unleash the dynamism of entrepreneurs, large and small. Strong demand is needed to pull the economy out of the downturn; dynamism is needed to enable the structural economic changes and innovations that are required in the transition to the post-pandemic economy.

The economies that rebound fastest and strongest will be those that let this change occur and which support it. Governments have played an important role in sustaining businesses during lockdowns. But businesses must play the leading role in the recovery phase. The nature of the challenge is such that business investment will need to be the main driver of recovery, both because of the boost this gives to demand and because business investment is the vehicle through which productivity-enhancing innovation and structural changes occur.

Governments need to be thinking now about how they can support business investment and economic dynamism. They should not underestimate how difficult the challenge of winning this race will be. Businesses are being weakened by the day and there is only so much that public balance sheets can do to offset the weaknesses of private balance sheets. But there are other ways in which governments can act to support business investment.

It is essential that governments do everything that they can to reduce regulatory frictions which may be holding back investment. Reducing regulatory frictions can make it easier for existing businesses to re-orientate how they operate and for new businesses to emerge. And reducing regulatory frictions can also tip the balance of commercial decisions in favour of new investments.

We have already seen examples of how many governments are easing regulatory burdens during the pandemic (see Annex 1 for details). In China, the government has simplified the approval procedures for foreign-invested projects. In France, the rules for the renewal of fixed-term labour contracts have been temporarily relaxed. And in Thailand, the Board of Investment has temporarily relaxed deadlines and waived filing requirements.

The US government has gone further than most, with an executive order imploring agencies to "address this economic emergency by rescinding, modifying, waiving, or providing exemptions from regulations and other requirements that may inhibit economic recovery".

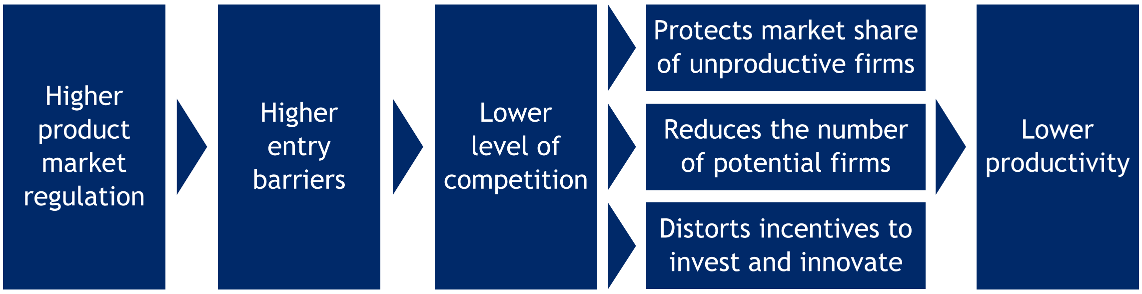
Some of these temporary changes could helpfully be made permanent. But it is also important to recognise that most regulations are intended to pursue sound public policy objectives. So instead of calling for regulations to be scrapped, a better approach is to seek a fundamental rethink of how we regulate.

2. The link between regulation, investment, and growth

Regulation can be good for growth, for example by preventing anti-competitive behaviour and so encouraging new entrants and investment into a sector. But regulation can also be bad for growth where it adds unnecessary costs, stifles innovation, or otherwise distorts the investment decisions of companies. Moreover, regulatory uncertainty can discourage investment, particularly in infrastructure or in other areas where there are high sunk costs and the commercial pay-off is over a long horizon.

The economic literature suggests that product market regulation is the area where the evidence is most conclusive about the impact of regulation on growth (Frontier Economics, 2012). Higher product market regulation can increase entry barriers, lower the level of competition and lower productivity by protecting unproductive incumbents, reducing the number of potential firms in a sector and distorting incentives to invest and innovate. The literature also shows that where regulatory burdens are higher, the reallocation of resources towards the highest productivity firms is weaker.

Fig. 1: mechanisms linking product market regulation and productivity (Frontier Economics, 2012)



If business investment is to help drive the post-pandemic recovery, then we must ensure that regulation does not hold it back. Moreover, if we are to ensure that the recovery is strong, which requires high productivity growth, then it is even more important that businesses have flexibility to innovate and to ensure that resources are allocated to the highest value activities.

The OECD assesses the restrictiveness of product market regulations in most of its member countries, and some non-members, every few years. Annex 2 shows the headline indicators and a selection of sub-indicators for the most recent assessment in 2018.

This shows both the wide dispersion of regulatory restrictiveness in member states and a substantial gap between the average for OECD members and three of the non-members evaluated (South Africa, Brazil and Turkey). This is particularly notable for the simplification and evaluation of regulations and the administrative burden on start-ups, but it is true for all sub-indicators.

These differences matter, because the empirical literature also suggests there is a non-linear or a threshold relationship between regulation and growth, which means the benefits from reducing the regulatory burden are larger for more highly regulated economies (Frontier Economics, 2012 and Busse and Groizard 2008). A study by Gørgens, Paldam and Würtz (2003) concludes that heavily regulated economies grow on average by 2-3 percentage points less than liberal economies, and that the effect on growth occurs when changing regulation from a high to a moderate level, with little gain when changing from moderate to laissez faire. The cumulative effect of this growth differential over time is substantial and could potentially explain large differences in country GDPs.

3. The choice of regulatory approach and the implications for the recovery

The mindset of regulators and the approach they take to regulation can significantly shape economic outcomes, sometimes in ways that may be unintended, making the choice of the regulatory approach an important one. Moreover, at a time when many sectors must innovate and adapt to a very different economic situation, the choice of the regulatory approach is even more important.

There are two main approaches to regulation, although in practice there are variants of each (Decker, 2018). At one extreme, there is rules-based regulation which specifies precise requirements for the regulated business, leaving little room for either ambiguity or discretion. At the other extreme is goals-based regulation, which sets objectives, principles or outcomes for regulated businesses, without specifying how these are to be achieved. Hybrid approaches may involve issuing non-binding guidelines as part of goals-based system, or by providing exceptions to a rules-based system.

The choice of approach has implications for the incentives of businesses, the allocation of risk, and the way in which the regulation is enforced (see Annex 3). Ultimately it also has implications for the likelihood of the regulatory objectives being achieved and the cost of achieving them.

Which system works best depends on the preferences and capacity of the regulator and the circumstances of the market that is being regulated. Importantly, where significant market change is occurring, requiring rapid innovation – such as the situation we face now as we deal with the economic consequences of the pandemic – a goals-based system is likely to be best.

A defining feature of goals-based regulation is a lack of prescription about process. Goals are usually cast at a high level. Compliance requires a focus on the substantive achievement of the goal. The flexibility this gives allows businesses to innovate and seek out better methods of achieving the regulatory goal. That flexibility also means that goals-based regulation is more adaptable when market conditions are changing rapidly, such as now.

Rules-based regulation tends to work best in relatively simple settings, where the regulated businesses are similar and regulated activities are well defined and frequently occurring. But in more dynamic markets, the rules themselves may require constant adaptation if they are not to become obsolete and fail to serve their purpose. The emphasis on process in rules-based regulation can lead to a mechanistic, box-ticking mindset among firms. It can also create incentives for some businesses to game the rules, by being strictly compliant while failing to respond to the spirit of the regulation.

Goal-based regulation is inherently more responsive to market changes. If the regulatory goal remains unchanged, then businesses must adapt their approach as circumstances change, without the need for intervention by regulators. Regulators can guard against the risk that regulatory goals are less likely to be achieved following extreme market changes by adjusting enforcement penalties. Adjustment to market changes is much more difficult under rules-based regulation. The regulator may not only need to intervene by changing the rules, but may even need to seek changes to legislation if the rules are to serve their regulatory purpose.

At a time when businesses and whole sectors are in need of change, regulation must be flexible if we are to encourage business investment while still allowing the objectives of regulation to be achieved. That means shifting – wherever it is practicable - from rules-based, process driven regulation, to goals-based regulation that puts more emphasis on actual outcomes from a regulatory perspective.

This will support investment and the post-pandemic recovery in two important ways. It will encourage adaptation of business models to the changed economic circumstances, backed by fresh business investment. And it will send a powerful signal of regulatory responsiveness to changing economic circumstances that, at a time when confidence is weak, may itself act as a catalyst for businesses to invest.

Annex 1: investment-friendly deregulation, Jan-May 2020

Categories:

Likely temporary | Potentially permanent

Directly encourages | May indirectly stimulate investment

Reduces regulatory process

Jurisdiction	Measure
Thailand	Board of Investment relaxed deadlines in cases such as the duty-free importation of machinery, as well as waivers for applications for temporary cessations of operations for a period of more than two months. Link
Thailand	Board of Investment measures to accelerate investments in medical sector, including reduction of 50 per cent of corporate income tax for an additional 3 years to qualified investments in the sector. Link
Myanmar	Announced it will accelerate approvals for investments in labour-intensive and infrastructure projects. Link
Myanmar	A 50% reduction of investment service fees announced for period of covid-19. Link
Indonesia	The government passed a new mining bill on May 12th which includes removing a limit on the size of mining operations, allowing automatic permit extensions up to 20 years, and reducing environmental obligations Link. The government is also considering a deregulation bill focused on job creation to target foreign investment, this is again highly controversial and has been suspended due to a backlash during the crisis.
China	FDI-specific measures including simplifying the approval procedures and convenience of filing for foreign-invested projects, and optimising the tax-free confirmation process for imported equipment of encouraged foreign-invested projects. Link
China	Promotion of paperless management of foreign investment records and free issuance of factual proofs of force majeure for foreign companies failing to fulfil contracts due to covid-19. Link
China	Allowed Chinese natural persons to establish new foreign-funded enterprises with foreign investors directly. Link

Jurisdiction	Measure
USA	Environmental Protection Agency suspends enforcement of environmental legal obligations, including compliance with routine monitoring (with intention to not pursue penalties for breaking these rules). Link
USA, Illinois	During the duration of the Gubernatorial Disaster Proclamation, the provision of the Coal Mining Act, 225 ILCS 705/8.06, requiring the Miners' Examining Board to hold an examination once in each calendar month, is suspended. Link
India	January 10th opened the coal-mining sector to non-coal companies (removing the previous restriction), which can now bid for coal mines. Link
Vietnam	Increased foreign ownership cap for domestic airlines (now 34 %, up from 30%). Decree came into effect January 1st. Link
International regulatory framework	Basel III implementation date deferred by one year to January 1st 2023. The accompanying transitional arrangements for the output floor (which limits the benefits banks can derive from using internal models to calculate minimum capital requirements) has also been extended by one year to January 1st 2028. The implementation date of the revised market risk framework deferred by one year to January 1st 2023. The implementation date of the revised Pillar 3 disclosure requirements been deferred by one year to January 1st 2023. Link
International regulatory framework	The Basel Committee on Banking Supervision and the International Organization of Securities Commissions extended deadline for completing the final two implementation phases of the margin requirements for non-centrally cleared derivatives, by one year. The deadline is now September 1st 2022 (with only a partial implementation on September 1st 2022). Link
UK	Financial Policy Committee reduced the countercyclical capital buffer rate to 0% of banks' exposures to UK borrowers. The rate had been 1% and had been due to reach 2% by December 2020. Measure expected to be maintained for at least 12 months, with any subsequent increase not to take effect until March 2022 at the earliest. Link
UK	A set of supervisory and prudential policy measures to help alleviate operational burdens on regulated firms and financial market infrastructures, to help them deliver the critical functions they provide to the economy. E.g. cancelling the Bank of England's 2020 annual stress test. Link
UK	The Competition and Markets Authority temporarily relaxes competition law to help supermarkets work together, stating it would not take competition law enforcement action against cooperation between businesses or rationing of products to the extent that this is necessary to protect consumers. Link

Jurisdiction	Measure
North Macedonia	New law to encourage strategic investments, January 20th. Preferential treatment awarded to investments of a certain size, and/or in certain sectors or regions. Link
Panama	Amended incentive regime for investment in tourism sector. Outside Panama district, a 100% tax credit for capital invested in bonds, shares and other financial instruments issued by tourism companies, under law signed January 2nd. Link
Uzbekistan	January 27th Law "On Investments and Investment Activities", including a so-called "one-stop-shop", enabling investors to reduce their communication with multiple state bodies. The Ministry of Investment and Foreign Trade will act as a "one-stop-shop" for investors. Link
Lesotho	Use of online registration system for e-licenses through the One-stop Business Facilitation Centre. Link
South Africa	Prudential Authority of South African Reserve Bank temporary regulatory relief measures: capital relief on restructured loans that were viable before the crisis; a lower liquidity coverage ratio; and lower capital requirements. Link
France	From May 15th, the government changed the rules for renewing fixed-term contracts and precarious contracts, enabling employers to derogate from the rules governing the renewal of fixed-term contracts until the end of 2020. Link
Kazakhstan (under consideration)	*KazakhInvest intend to introduce measures to increase the attractiveness of Kazakhstan to FDI, e.g. strengthening cooperation with international financial institutions and coming up with new approaches to develop SMEs. Link*
EU (under consideration)	*Week commencing May 11th the European Commission discussed the prospect of easing some financial-markets rules to help the economy recover. Suggestions include possible ways to relax requirements under the second Markets in Financial Instruments Directive (MiFID II) and the Market Abuse Regulation (MAR). Link*

Annex 2: the OECD's assessment of product market regulation

The OECD's economy-wide PMR indicators measure regulatory barriers to firm entry and competition in a broad range of policy areas. Aggregate indicators for 2018 are shown in Fig. 1 below, while the other figures show five (out of six) sub-indicators.

Fig 1: overall product market regulation

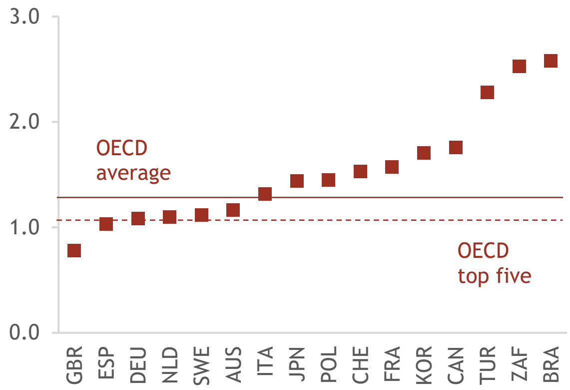


Fig 2: involvement in business operations

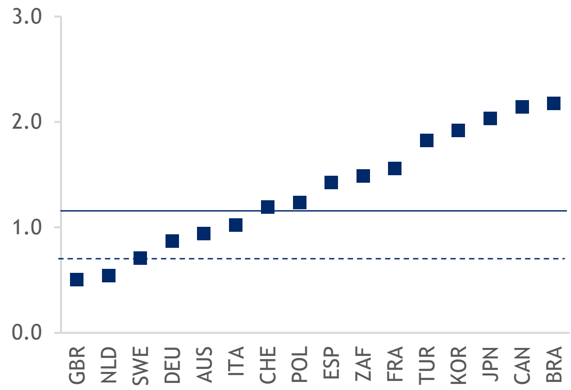


Fig 3: simplification and evaluation of regulations

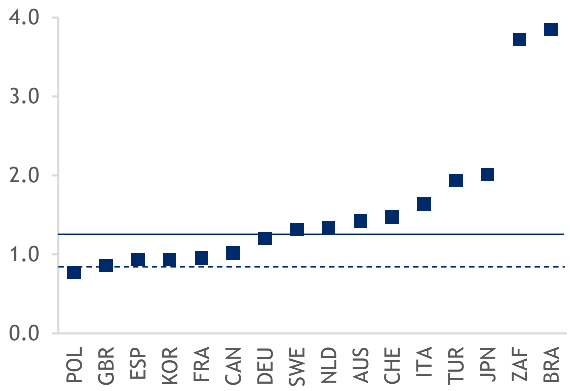


Fig 4: administrative burden on start-ups

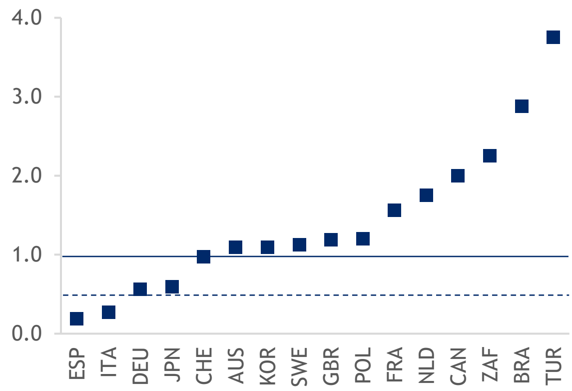


Fig 5: barriers in service and network sectors

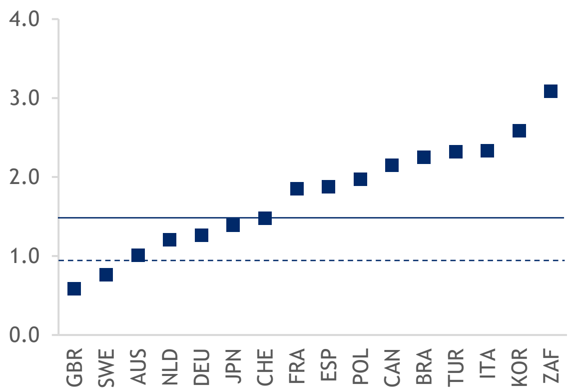
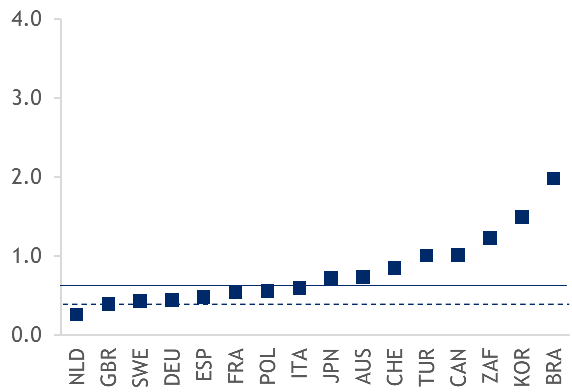


Fig 6: barriers to trade and investment



Source: OECD

Annex 3: relative advantages and disadvantage of regulatory models

	Goals-based regulation	Rules-based regulation
Flexibility	Seen as more flexible	Less flexible
Predictability and certainty	More imprecise, and potentially less certain	More precise and therefore potentially more certain
Promotion of innovation	Seen to encourage experimentation and alternative approaches to compliance	Limited incentives to innovate in compliance
Equality	Seen to promote substantive equality	Seen to promote formal equality
Impact on approach and mindset of regulatees	Requires regulatees to be forward-looking and think through consequences of actions	Can result in a tick-box mentality developing
Uniform or differential treatment of regulatees	Can allow for differential treatment of regulatees based on compliance history or other characteristics	Formally treats all regulatees the same
Ability to adapt to changes in environment/ market	More open-textured and therefore can be more adaptive to changes in the environment	Less adaptive to changes, rules can tend towards obsolescence, and require more rules to be introduced
Scope for exercise of regulatory discretion	Potentially significant scope for the exercise of regulatory discretion	Typically constrains the discretion of the regulator
Accountability	Devolves some responsibility to firms, and can create an accountability gap	Regulator is ultimately accountable for failures
Incentives for compliance	Can lead to over- or under-compliance depending on the precision of regulation, the size of enforcement penalties, and the risk profile of regulatees	Can create incentives to 'game the rules' and engage in creative compliance

Factors that are more important in a post-pandemic recovery

Adapted from Decker (2018)

Annex 4: selected past examples of reducing regulatory process

Reducing third-party involvement in company formation	Complex incorporation processes can lead company founders to spend significant resources on third-party services to navigate the process, providing a barrier to new businesses. One way governments can ease the opportunity cost for entrepreneurs is by making the use of third-party services optional. Burundi's 2011 removal of the need to have articles of association notarised, for instance, reduced the cost to register a firm by more than a fifth and the time by four days. Link
One-stop-shops for business registration	One-stop-shops for business registration can streamline the process and encourage new businesses. Rwanda, for instance, cut the number of interactions involved from nine to two. This helped cut the time needed to start a business from 18 days to three, and the cost from 235% of income per capita to 4%. Alongside other simplifications in 2006 and a wider reform agenda, this helped to increase by 77% the number of firms registering the following year. Link
Simplifying the process for starting businesses	In Colombia in 2005, Law 962 - the so-called "anti-paperwork" law - got rid of about 80 bureaucratic processes needed to start a business and brought in a provision preventing government agencies from adding new procedures. Between 2003 and 2011, reforms such as this helped shrink the time required to start a business from 60 days to 14, the cost from 28% of income per capita to 8%, and the number of procedures from 19 to nine. Link
Easing hiring processes	Almost 40% of low- and lower-middle-income economies forbid the use of fixed-term contracts for permanent tasks. Easing fixed-term contract rules can help firms and boost employment. Examples include Nepal allowing fixed-term contracts for permanent tasks in 2017 and Benin making fixed-term contract renewal unlimited. These reforms can be particularly impactful in countries that have significant youth populations and outdated legislation. Link
Easing redundancy processes	Easing redundancy processes can give employers more flexibility in adjusting to shocks. Research shows that overly strict employment protection can also impact firms' incentives to enter and exit markets and makes firms less likely to invest in new products. Burdensome redundancy processes can also divert management attention from more productive tasks. Mandatory approval obligations are one problem. In Ghana, for instance, an employer needs to notify the Chief Labor Officer and the trade union of the dismissal of any employee at least three months before termination. Link

Simplifying restructuring processes	Reorganisation procedures help reduce SME failure rates, prevent the liquidation of insolvent but viable firms, and encourage entrepreneurial risk-taking. Simplifying the process can boost this. One example is France's simplification of a 2005 safeguard procedure, which enabled debtors facing financial difficulties to apply for court protection while renegotiating terms with creditors but received low uptake. In 2008 France simplified the eligibility criteria, removing the obligation for firms to define or qualify the extent of their difficulties. Along with other reforms, this led cases filed to rise from 509 in 2006 to 1,386 in 2009 and 1,620 in 2014, with three out of four resulting in an agreement to allow the firm to continue operating. Link and Link
Electronic systems for filing and paying taxes	In 2006, just 43 economies had online systems for filing and paying taxes. 15 years later, 106 did. This has cut tax compliance times globally. Between 2004 and 2018, the average compliance time in Europe and Central Asia dropped from 473 to 225 hours per year, mainly because of the increased use of e-filing and e-payment (as well as streamlining of the individual tax systems). Link
Using technology to shorten customs clearance processes	Singapore's introduction of a single window for trade replaced 20 forms required for international trade with a single online form, significantly reducing processing times. Link. One example of the benefits of such improvements is the Port of Singapore. Customs clearance time is officially less than ten minutes and is in practice as quick as the click of a mouse for almost all imports. In contrast, the official minimum clearance time in Mombasa is 72 hours. Combined with Singapore's investment in automation, its improvement of process has contributed to the high efficiency and activity of the port, which enables more than 32 million containers to be offloaded yearly. Link and Link

Source: World Bank, Doing Business

Annex 5: goals-based regulation case studies

Zipline: drone-based medical deliveries in Rwanda	American drone company Zipline and the Rwandan government are at the forefront of contemporary goals-based regulation and its potential benefits for developing countries and emerging technologies. Zipline uses unmanned aerial vehicles (UAVs) to deliver emergency blood and medical supplies to rural hospitals in Rwanda, Tanzania and, most recently, rural parts of the United States. Most countries have taken a traditional rules-based approach to drone regulation, restricting drones to within line-of-sight use, limiting a person to operating a single UAV at a time, and specifying exactly which models are fit to fly – each model requiring its own certification. An example of rules-based regulation holding back technological development and commercial progress in this area was Amazon's decision to move its drone delivery testing sites to Canada after multiple delays in receiving regulatory approvals under the United States' rigid rules-based approach. Rwanda, on the other hand, has taken a flexible, goals-based approach to UAV regulation. Rwanda's civil aviation authority provides rapid access to its airspace by allowing any UAV to operate as long as it meets mission-specific safety standards. It is up to the operator to determine how best to meet those standards. This goals-based approach allows technology companies to rapidly test new drones, without having to await model certification, contributing to the growth of Rwanda's international stature as a tech-friendly incubator for emerging technology companies. In choosing Rwanda, Zipline was able to demonstrate the viability of its commercial concepts while reducing the time needed to deliver emergency blood supplies to district hospitals from hours to minutes. With over a million hours of flying time completed without incident, the Rwandan government and Zipline are now promoting Rwanda's goals-based regulatory approach through the World Economic Forum's Centre for the Fourth Industrial Revolution. Tanzania and several Asian nations have begun to adopt the Rwandan model as best practice.

New Zealand's goals-based building control regulation and leaky homes	New Zealand was an early mover in shifting from a rules-based to goals-based regulatory approach, pushing through significant changes to the regulation of the construction sector in the 1990s. Many have cited this example given it is a clear application of goals-based regulation, although not without its flaws. Before 1991, construction in New Zealand was regulated via prescriptive building codes. Following the passage of a new law that set out broad objectives and sub-objectives related to the environment, health and safety and the protection of workers and occupants, New Zealand shifted to a purely goals-based regulatory approach in. It was unique in that both local authorities and private certifiers can certify builders and developers, which many argue led to abuse of the system. Following the change, throughout the mid-1990s significant problems with weathertightness of new buildings became an issue, ultimately affecting 42,000 homes and costing $11.3bn in remedial works. While goals-based regulation did not create the crisis *per se*, the Kiwi government was forced to significantly tighten building regulations under the Building Act of 2003. Key reforms brought in to remedy the issue were more stringent specification of building standards and stronger monitoring of building inspectors—leading to a hybrid goals and rules-based system. The New Zealand case reaffirms the need for strong regulatory oversight and potentially heavy penalties for abusers of the flexibility provided in goals-based regulatory systems.