

## **South Asia Regional Integration**

# **Harmonizing Regulatory Mechanisms: Options for Deepening Investment Integration in South Asia**



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# **Harmonizing Regulatory Mechanisms: Options for Deepening Investment Integration in South Asia**

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**Summary: Harmonization of domestic regulatory mechanisms and supporting institutional strengthening could promote increased investments in infrastructure, in industrial goods and services, and in banking and capital markets. In addition, harmonization of national investment laws through an international best practice regional code could further enhance investor confidence in the region while avoiding the costly “race to the bottom” that countries engage in when awarding investment incentives (provided incentives are also harmonized).** With the gradual reduction of cross-border trade barriers, domestic enterprise regulations –entry/investment, exit/disinvestment and operational regulations including licensing, taxation, “behind-the-border” trade and logistics-related rules, banking and capital market rules, legal dispute settlement mechanisms, competition law, as well as the heavier regulation of infrastructure sectors and frameworks for Public Private Partnerships (PPPs)—have become an increasingly significant factor affecting the relative prices of exports, imports and domestic production. The effects of inefficient domestic regulations transcend national borders, distorting and reducing not only trade but also investment levels. The issue has therefore become an important matter of regional economic policy. One driver of regionalization of regulatory policies is the high fixed cost of regulation and prevailing technical capacity constraints, especially in the more specialized regulatory areas and for the smaller countries. Even more importantly, regionalization of regulatory policies –and supporting institutional strengthening— could in principle help improve the capacity of individual countries to credibly commit to more open and stable regulatory policies, and thereby facilitate increased flows of finance within and across countries. This could have a very significant impact on investment levels.

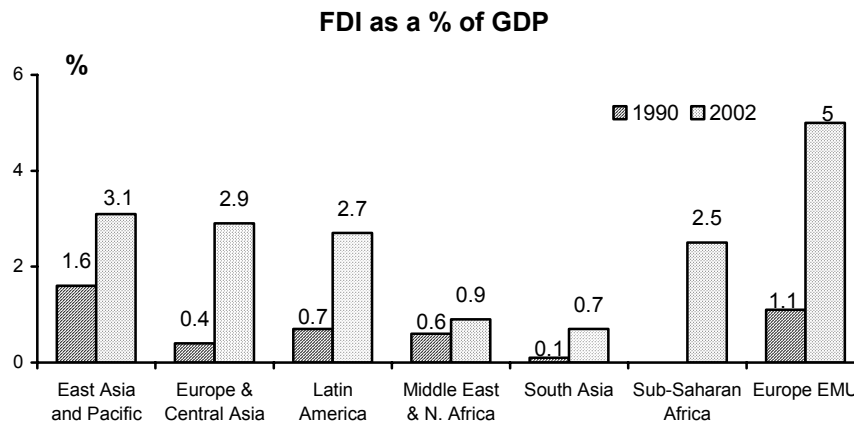
This note presents some options for deepening investment integration in South Asia as a foundation for more substantive follow-on work in this area. As elaborated below, initial concrete steps for enhanced cooperation could include:

- **joint deregulation** in selected areas, such as the more systematic removal of bureaucratic red tape obstacles to “doing business” and investment, the removal of key sectoral restrictions to allow 100% inward direct investment for all investors, the removal of double-taxation and the promotion of a regional open sky policy -- and then start with one such focused intervention and use it as a "quick win" demonstration pilot to create momentum for more such regional pro-competition policies;
- **financial sector integration**, with relaxation of capital controls, starting with the Securities and Exchange Board of India (SEBI) entering into Memorandums of Understanding for securities markets with all SAARC countries;
- increased **information exchange** among regional infrastructure regulators, with the establishment of regional regulatory advisors to facilitate non-binding advice on common issues;
- establishment of a **regional hot-line** at SAARC level (as a possible precursor to a SAARC Investment Authority) for harmonization initiatives to be focused on areas of greatest concern to individual business people across the region, thereby fostering enhanced public-private interactions on these issues.

While a coordinated program of regulatory reform and investment climate harmonization has advantages, coordination takes time and effort, so could risk providing a reason for deferring individual country reforms. Countries should be encouraged to proceed to reform individually while working to agree on common reforms.

**Context and benefits: Current low levels of extra- and intra-regional investment flows could be increased through regulatory harmonization.** FDI stock levels as a share of GDP have historically been exceedingly low in South Asia, and remain the lowest of all developing country regions at 0.7 percent of GDP in 2002 (see chart, below). This reflects both low extra-regional as

well intra-regional investment flows. A more disaggregated look at the number of new (greenfield) and expansion FDI projects underlying these aggregate investment stock figures



Source: World Development Indicators 2004, The World Bank

presents a similar picture, and highlights the low level of intra-regional relative to total projects.<sup>1</sup> Of the 1,232 FDI projects in South Asia over the last 30 months (January 2002 to June 2004), only 31 or 2.5 percent are intra-regional in origin – by far the largest foreign investors in the region over this period are the larger OECD economies, with the USA accounting for 561 projects, UK 151, Germany 64, Japan 52 and France 39. By contrast, the level of intra-regional investment in South-East Asia (including China) is more than three times higher, with 339 out of the reported 4,458 projects being intra-regional in origin (note that China alone accounts for 2,836 of these projects, or more than two times the number of FDI projects received by all of South Asia).<sup>2</sup>

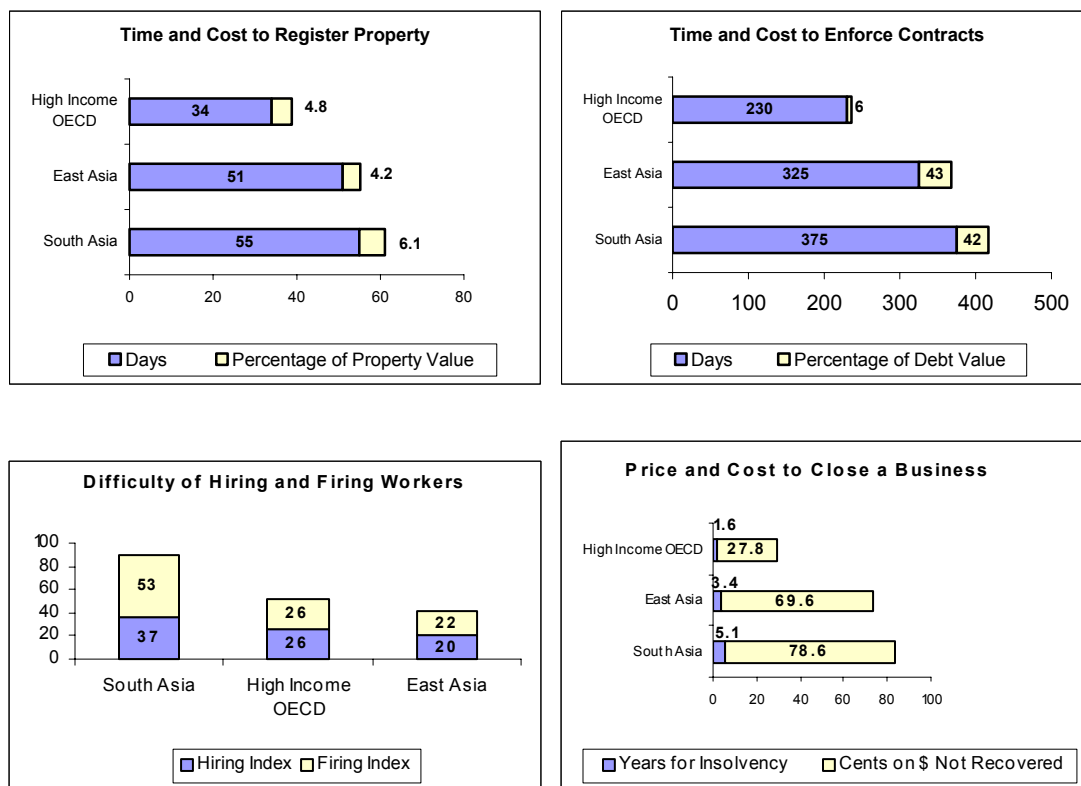
In spite of the existing low levels of extra- and intra-regional FDI flows, recent history suggests that these flows have the potential to increase significantly following credible regional regulatory harmonization, as evidenced by the experience of NAFTA and of recent new entrants to the EU. NAFTA entered into force in January 1994, and contained 900 pages of required regulatory harmonization to which each nation was required to conform its domestic laws. In Mexico, the share of FDI to GDP increased from 1.1 percent in 1980-85 and 1.2 percent in 1985-93 to 3.0 percent in 1994-2001.<sup>3</sup> In the Czech Republic and Poland, regulatory harmonization and integration with the EU contributed to increases in the share of FDI to GDP between 1993-94 and 2000-02 from 1.7 to 10.7 percent for Czech Republic and from 1.9 to 3.6 percent for Poland. Net benefits of similar orders of magnitude are not inconceivable in South Asia following credible and sustainable political rapprochement between countries underpinned by regulatory harmonization, in particular given the prevailing low starting point of investment flows.

<sup>1</sup> The following data are based on the LOCOMonitor global corporate FDI project database, an FDI tracking and analysis tool developed by OCO Consulting (a spin-off of PricewaterhouseCoopers), covering over 21,000 announced and opened greenfield and expansion FDI projects worldwide with source-destination information (M&A, privatization and alliances are not included; JVs are included when they lead to a new physical operation).

<sup>2</sup> China in fact became the largest recipient of FDI inflows in 2003 (not counting “trans-shipped” investment through Luxembourg) with \$54 billion, slightly more than 2002, while flows to the US halved to \$30 bn. See UNCTAD, *World Investment Report 2004*, September 2003.

<sup>3</sup> See D.Lederman, W.Maloney and L.Serven, “Lessons from NAFTA for LAC Countries: A Summary of Research Findings”, The World Bank, December 2003.

**Constraints: Red tape regulatory obstacles to “doing business” and inadequate access to reliable, reasonable-cost infrastructure services, controls on banking and movement of capital, and absence of facilitating harmonized frameworks on competition and infrastructure are key obstacles to investment and growth in South Asia.** In spite of sporadic reforms across countries within the region, a large number of red-tape type regulatory obstacles continue to pose obstacles to investment and “doing business”. While the larger class of firms that typically engage in cross-border investment activities generally do not face the same problems in starting up a business as smaller enterprises, regulatory obstacles across South Asian countries in registering property, enforcing contracts, hiring and firing workers, and closing a business – combined with uneven enforcement of all such rules—create a significantly more unfriendly investment climate than East Asia, and especially than higher income OECD countries, impeding entry and expansion (see accompanying charts).<sup>4</sup>



Source: *Doing Business in 2005: Removing Obstacles to Growth*, The World Bank, 2004

In addition to corruption, governance and the poor state of business regulation, the most important barrier consistently highlighted in the various World Bank-sponsored Investment Climate Assessments (ICAs) in South Asia region is the poor quality of available infrastructure – inadequate access to power supply, followed by transportation, communication, finance and land services.<sup>5</sup> In India, for instance, the 2003 investment climate survey found that, on average, manufacturers face almost 17 significant power outages per month, versus 1 in Malaysia and less

<sup>4</sup> Underlying data is from *Doing Business in 2005: Removing Obstacles to Growth*, The World Bank, 2004.

<sup>5</sup> See The World Bank, “The investment climate in India: Why is industry doing so much better in some cities and states than in others?”, 2004; “Improving the investment climate in Pakistan: an investment climate assessment”, 2003; and “Bangladesh investment climate assessment”, 2003. One reason that the ICAs did not especially highlight labor regulation as disproportionately constraining in the region is that they did not much examine it empirically.

than 5 in China. India's blended real cost of power is 74 per cent higher than Malaysia's and 39 percent higher than China's. In terms of regional variance within India, the "better climate" states are much better off in the provisioning of infrastructure, including power supply, transport and telecommunication, highlighting the importance of these indicators of the business environment in channeling investments within India. In Pakistan, the typical business estimates that it loses 5.6% in annual sales revenue due to power outages against a reported loss of 2% by its Chinese counterparts. It also would have to wait 6-7 weeks to get a new fixed line telephone connection, which is more than three times the wait in China. In Bangladesh, the most frequent common complaint is the constraint imposed by the poor electricity system: 73 percent of large formal firms, 58 percent of urban informal and 54 percent of rural enterprises assessed it as a major or very severe constraint. For rural Bangladeshi entrepreneurs, other top problems are road conditions (63 percent of respondents), access to finance (56 percent) and transportation to markets (42 percent). In all countries, "behind-the-border" trade and logistics-related rules, including inefficient and differing cross-border facilities and customs procedures, and standards & certification processes written to match difficult-to-replicate features of local products rather than used as performance criteria to stimulate upgrading, further impede investment flows across the region. These results highlight the tremendous potential gains from increased investment in improved physical and business-facilitation infrastructure services, and the virtuous circle that could be thereby created, with improved infrastructure services in turn creating an improved environment for further investment.

Controls on banking and movement of capital into and out of South Asian countries are another key obstacle to investment and growth within the region.

#### **Controls on direct investment in South Asia: Illustrative examples**

*Inward direct investment –*

India: Restricted (less than 100%) in private sector banks; insurance; telecommunications; non-retail trading companies; mining for coal; diamonds and other precious stones; and airports. Restrictions also in insurance sector; print media. Not permitted inter alia in retail trade; housing and real estate; agriculture (with exceptions); and plantations (excluding tea).

Pakistan: Permitted in services, infrastructure, social and agriculture conditions subject to the condition that the foreign equity investment be at least \$300,000 or equivalent. Not permitted in production of alcoholic beverages.

Bangladesh: All investments, except in the industrial sector, require approval.

Sri Lanka: Restricted (40% or less) in growing and primary processing of cocoa, coconuts, rice, rubber, spices and tea; mining and primary processing of non-renewables; timber processing using local timber; deep-sea fishing; mass communications; freight; travel; shipping agencies; education. Permitted only up to limit approved by government in: air transport; coastal shipping; alcoholic beverages; large-scale mining of gems. Not permitted in retail trading with capital of less than \$1 million; coastal fishing.

Nepal: All investments require approval. Foreign securities firms permitted to form JVs with ownership restricted to 40%. Not permitted in cottage & small-scale industries.

Bhutan: Controls on all direct investment transactions

Afghanistan: All investment require approval. Only through JVs.

*Outward direct investment –*

India: Overall limit of \$100 million in one financial year thru automatic route. Approval in India and abroad required in financial sector activities.

Pakistan: Prior approval under foreign exchange laws. Equity-based investments including portfolio investments also require prior permission.

Bangladesh: All outward transfers of capital require approval (for resident-owned capital, approval only in exceptional cases).

Sri Lanka: Prior approval of MOF; priority to investments promoting domestic exports.

Nepal: No permission for Nepalese residents except by government notice.

Bhutan: Controls on all direct investment transactions.

Source: IMF, Annual Report on Exchange Arrangements and Exchange Restrictions.

Across the region, there are exhaustive controls on the movement of capital between countries. These restrictions, which extend to the repatriation and surrender of trade receipts, are a material impediment to direct and portfolio investment. Although direct investment restrictions have been extensively liberalized in India in recent years, companies seeking to invest in financial sector activities abroad must obtain approval from the regulatory authorities in India. The Indian restrictions even extend to applying conditions to the sale of investments in India between non resident investors and to the ability to open bank accounts in Rupees. More generally across the region, greater licensing flexibility would be required for financial institutions; there are limits on foreign banks owning domestic banks, and limits on foreign banks entering the domestic system – with typically the minimum capital entry requirements being significantly higher for a foreign branch or subsidiary than for a domestic bank. With very few exceptions, banks in one country cannot hold accounts in the currency of another (Nepali banks can hold Rupee accounts but they are not allowed to earn interest). Inward and outward direct investment is heavily restricted in a wide range of sectors (see box).

In infrastructure and the private provision of public services, there is a tremendous untapped potential of cross-country investment flows. India, for instance, has played a critical role in Bhutan’s economic development by investing in hydro projects and buying back the electricity. An ongoing proposal by the Tata Group, India’s second largest conglomerate, to invest \$2 billion in Bangladesh’s substantial natural gas supplies to power a complex comprising a 1,000 MW power station, a fertilizer plant and a gas-fired steel finishing factory, would combine Indian capital with Bangladeshi natural resources to create local production and jobs. While inter-country political tensions clearly affect the prospects of success for such deals, these types of projects would no doubt be facilitated by increased harmonization in regulatory frameworks for infrastructure and public service provision.

**Policy options: Cross-country investment flows would benefit from the increased credibility of commitments to openness and stability from regulatory harmonization – including joint deregulation of bureaucratic red tape obstacles, financial sector integration, frameworks on competition and infrastructure, and an international best practice regional investment code.**

To achieve the benefits of greater cooperation in investment, progress is needed on a number of fronts. Regarding the reform or repeal of existing bureaucratic red tape obstacles across the region, South Asia should set itself the goal of becoming the top reforming region over the next years – aided by an explicit harmonization agenda. It is instructive in this regard to note that over the past year, Europe improved the most in large part due to the urgency of its own regulatory harmonization agenda: seven of the top ten reformers that affected “Doing Business” indicators were either new EU members, who had strong incentives to adopt best practice domestic regulations to join the club, or existing members who had to modernize to compete with the new entrants.<sup>6</sup>

Regarding harmonizing of financial market regulations, there are significant benefits to be reaped from transferring expertise and technology from India’s relatively developed capital markets to other countries in the region. To date, Sri Lanka is the only country with which India has executed a Memorandum of Understanding for securities markets, as recommended by the International Organization of Securities Commissions (IOSCO) – though there are apparently discussions underway with Nepal and Pakistan. In addition, the Securities and Exchange Board of India (SEBI) has executed the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, but India is the only country in the region to have done so. As a low-cost but helpful step towards market integration,

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<sup>6</sup> See *Doing Business in 2005: Removing Obstacles to Growth*, The World Bank, 2004, Table 1.1.

SEBI should enter systematically into these MoUs with all SAARC countries. Complementary to increased cooperation between stock exchanges through joint training and eventual cross listings and joint issues, enhanced cooperation between all central banks in the region also would help improve financial system linkages.

Regarding product market regulations, a question arises whether national efforts at updating and enhancing competition policy, together with possible regional harmonization efforts, should be encouraged as a priority issue. Indeed, as a direct response to the increasing role of markets in national economies, there has been a burgeoning of competition laws on a world level – in South Asia, India has adopted a new competition law at end-2002, and a number of the other SAARC countries are contemplating new policy initiatives in this area.

- At the domestic level, competition authorities –given sufficient status and ability— are well placed through their competition advocacy mandate to promote investments by helping address missing or poorly-functioning rules and institutions and by removing rules and procedures that suppress entry and rivalry. In principle, competition authorities could be the natural advocates throughout the rest of government at central and local levels to improve the investment climate and remove bureaucratic red tape obstacles to “doing business” – helping spur the entrepreneurial dynamism of national and international firms for the benefit of national consumers.
- At the international level, in response to an increasing level of cross-border trade and investment, there also has been an increasing level of competition policy activity. While the practice of competition policy at the level of international markets to-date has been principally concerned with cross-border mergers and the operation of international cartels, arguably larger competition issues arise from the range of government-imposed regulations as well as private conduct that limits foreign access to national markets. As part of the enforcement of any new or updated regulation, it will of course be important to ensure that national competition law enforcement does not undermine cross-border trade and investment. This in would benefit from a degree of harmonization in national laws and approaches – including to ensure that national competition authorities treat cross-border trade and investment in the same way that they treat trade and investment activities within their own national borders.

Regarding harmonization of policy frameworks on infrastructure and public service provision, there are without doubt a significant number of international business opportunities that are being inhibited by the existing state of regulatory policies in the infrastructure sectors across countries. In addition, the market areas for electricity, transportation and communications infrastructure – which operate more efficiently when their networks are organized according to the patterns of their transactions— often transcend national borders. In the energy sector, cross-border cooperation would allow India and Bangladesh to use their coal and gas reserves more efficiently while allowing Bhutan and Nepal to further develop their large untapped hydro-power potential; while electricity and gas grids should efficiently link supply and demand irrespective of national borders. Similar cross-border opportunities exist in transport, logistics and customs facilitation, communications and information technology infrastructure.<sup>7</sup>

Typical areas of the legal and regulatory framework for infrastructure and public service provision that should be aligned with the expectations of international and local sponsors, lenders and investors include:

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<sup>7</sup> See F.Sobhan, “Promoting and facilitating investment in South Asia”, 2004, for specific examples of cross-border infrastructure investment opportunities.

- clarity and commitment regarding the scope of central and local government levels to award projects, including sectors, types of infrastructure and financing mechanisms for which PPPs may be granted;
- a one-stop permitting arrangement to facilitate administrative coordination and rapid issuance of required approvals, permits, licenses and consents;
- clarity regarding project site, assets and easements;
- adequate finance, security and insolvency provisions;
- clear regulatory authority with separation between economic regulator and providers, and transparent regulatory decisions;
- rights for the provider where necessary to collect cost-recovery or sufficient subsidy-augmented tariffs or user fees; and
- efficient appeal and dispute resolution procedures.

One area where there may be immediate benefits from regional harmonization concerns the development and effective implementation of appeal and dispute resolution procedures for those projects where benefits could be achieved from raising the issues to this level. Finally, there would be significant gains from cross-country sharing of information regarding potential PPP deals, and regarding ongoing experimentation with the required policy, legal and regulatory frameworks to help ensure that these deals are both affordable and bankable.

Regarding harmonization of national investment laws through a regional best practice investment code, it may be desirable to strike a better balance between private interests (investor rights) and public goods (investor obligations), given that traditionally investors have suffered from too many obligations and arbitrary interventions and not enough enforceable rights. There are a number of approaches toward establishing regional investment agreements.<sup>8</sup> The approach advocated in the SAARC regional investment code proposal<sup>9</sup> appears in spirit close to the NAFTA approach of developing a set of specific rules for investment inspired by national investment laws. The proposed draft agreement appears largely in line with best practice recommendations on FDI legislation, containing an article on most of the following six core topics:

- definitions of FDI and foreign investors, though here it may be desirable to restrict the law to direct investment, since portfolio investment is normally regulated under another legislation ;
- guarantees of national treatment and Most-Favored-Nation treatment, ensuring that every foreign investment and investor will be treated at least as well as investors from any other foreign country or from the host country;
- guarantees against expropriation except for clear public purpose and with due process of law, with “prompt, adequate and effective” compensation;
- repatriation and the right to convert and transfer funds;
- freedom to invest in all sectors of the economy, with as few sectoral restrictions as possible: here the agreement would provide a context for agreement between countries of the region on a list of sectors to be included on a common negative list (and would apply only to sectors, not size of project, technology used or foreign ownership limitation – with any list in accompanying regulations rather than in the law itself);

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<sup>8</sup> See, for example, “International agreements to improve investment and competition for development”, Chapter 4 in: The World Bank, *Global Economic Prospects and the Developing Countries*, 2003; K.von Moltke, “An international investment regime? Issues of sustainability”, IISD, 2000; and FIAS, “A review of investment policy harmonization initiatives: Implications for the East African Community”, 2000.

<sup>9</sup> SAARC, “Draft agreement between the Governments of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka for the promotion and protection of investment”, prepared by delegation of India during the First SAARC Meeting on promotion and protection of investment, New Delhi, 1997.

- countries of the region could agree on the fact that investor entry will be through a minimal registration system, which should be simple, short, inexpensive, accessible and not through any screening or ex-ante approval process;
- dispute settlement, including the right to international arbitration and guarantees that foreign arbitral awards will be recognized by the host country's courts and executed by the host country's government.

Consideration also may be given to a regional SAARC Investment Authority to help at the regional level to carry out the activities aimed at the attraction and facilitation of intra-regional and extra-regional FDI – including investment generation, investor servicing and image-building activities, with an emphasis on information sharing and capacity building in all these areas across participating governments.

Depending on the level of political consensus surrounding the adoption of a SAARC-level investment code, the countries of the region may wish to consider a more gradual approach as typified by the adoption of the 12 Non-binding Investment Principles (NBIPs) by the Asia-Pacific Economic Co-operation (APEC) forum in 1994.

The 12 NBIPs are:

- transparency – all laws, regulations and administrative guidelines pertaining to investment to be made publicly available in a prompt, readily accessible manner;
- non-discrimination between source economies
- national treatment
- investment incentives – members will not relax health, safety and environmental regulations as incentives to encourage investment
- performance requirements -- members will minimize use of requirements that distort or limit trade & investment
- expropriation and compensation
- repatriation and convertibility
- settlement of disputes
- entry and sojourn of personnel
- avoidance of double taxation
- investor behavior – foreign and domestic investors must abide by host laws, regulations, administrative guidelines
- removal of barriers to capital exports.

Transparency, for instance, could be adopted as the initial focus since its implementation does not require changes in policies other than their clarification and public articulation, beginning with an agreement to provide a regional Investment Authority with comprehensive, liberal and transparent national investment policy statements – towards the eventual goal of fully harmonized national investment codes.

It has been argued that the main underlying cause of the 1997 Asian financial crisis was the poor quality of the afflicted countries' economic institutions.<sup>10</sup> The crisis did not happen because the region lacked trade and FDI opportunities, but rather because poor governance and corruption led to inefficient allocation of capital. Strong market-supporting institutions can help as buffers to absorb the shocks that come from increased integration into the global economy. As South Asian leaders consider the promotion of increased trade and FDI liberalization, they also should have

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<sup>10</sup> The following is inspired by Y.Huang and B.Yeung, "ASEAN's institutions are still in poor shape", *Financial Times*, September 5, 2004.

the vision to ensure that market expansion measures are accompanied by appropriate regulatory harmonization and supporting institutional strengthening – in product, infrastructure and financial markets. However, it is important for leaders to have a balanced awareness of benefits and risks of cross-country harmonization: while a coordinated program of regulatory reform has some advantages, coordination takes time, negotiation and effort, so could risk providing a reason for deferring individual country reforms. Countries should be encouraged to proceed to reform individually while working to agree on common reforms.



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