



# Harmonizing Regulatory Mechanisms

## Options for Deepening Investment Integration in South Asia

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### 1. INTRODUCTION

With the gradual reduction of cross-border trade barriers, domestic enterprise regulations—for example, 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, and 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 important, regionalization of regulatory policies—and supporting institutional strengthening—in principle could 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 significant impact on investment levels.

This chapter 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 the following:

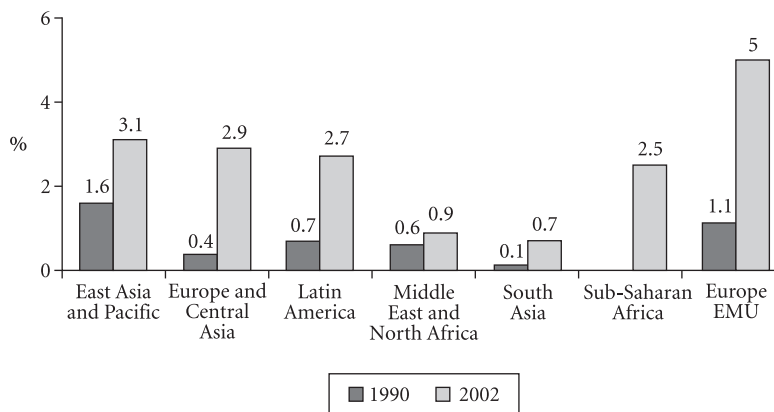
- Joint deregulation in selected areas, such as the more systematic removal of bureaucratic red tape obstacles to “doing business” and investment, the removal of key sectoral restrictions to allow 100 percent inward direct investment for all investors, the removal of double taxation, and the promotion of a regional open sky policy, starting with one such focused intervention and using 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 (MoUs) for securities markets within all South Asian Association for Regional Cooperation (SAARC) countries.
- Increased information exchange among regional infrastructure regulators, with the establishment of regional regulatory advisors to facilitate nonbinding advice on common issues.
- A regional hotline at the SAARC level (as a possible precursor to a SAARC Investment Authority) for harmonization initiatives that are focused on the areas of greatest concern to individual business people across the region, thereby fostering enhanced public–private interactions on these issues.

Although a coordinated program of regulatory reform and investment climate harmonization has advantages, such coordination takes time and effort. Because delays create the risk of providing a reason to defer individual country reforms, countries should be encouraged to proceed individually while working to agree on common reforms.

## 2. CONTEXT AND BENEFITS

Current low levels of extra- and intraregional investment flows could be increased through regulatory harmonization. Foreign direct investment (FDI) stock levels as a share of gross domestic product (GDP) historically have been exceedingly low in South Asia, and they remain at the lowest level for all developing country regions at 0.7 percent of GDP in 2002 (Figure 8.1). This low level of investment reflects low extraregional as well as intraregional investment flows. A more disaggregated look at the number of new (greenfield) and expansion FDI projects underlying these aggregate investment stock figures present a similar picture, and highlight the low level of intraregional investment relative to total projects.<sup>2</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 intraregional in origin—by far the largest foreign investors in the region over this period are the larger economies of the Organization for Economic Co-operation and Development (OECD), with the United States accounting for 561 projects, the United Kingdom 151 projects, Germany 64, Japan 52, and France 39. By contrast, the level of intraregional investment in Southeast Asia (including China) is more than three times higher, with 339 of the reported 4,458 projects being intraregional in origin (China alone accounts for 2,836 of these projects,

FIGURE 8.1 FDI as a Percent of GDP



Source World Bank 2004c.

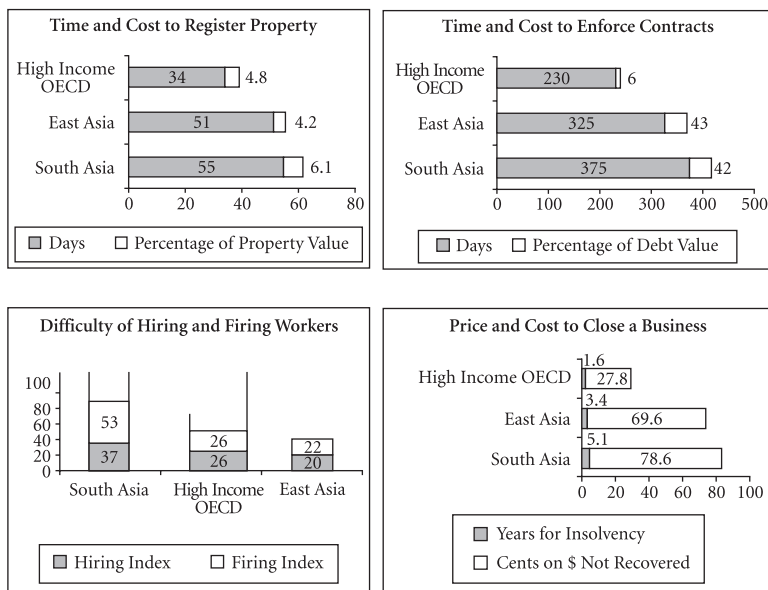
or more than twice the number of FDI projects received by all of South Asia).<sup>3</sup>

In spite of the existing low levels of extra- and intraregional 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 the North American Free Trade Agreement (NAFTA) and of recent new entrants to the European Union. 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 proportion 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 (Lederman et al. 2003). In the Czech Republic and Poland, regulatory harmonization and integration with the European Union contributed to increases in the proportion of FDI to GDP between 1993–94 and 2000–02 from 1.7 to 10.7 percent for the Czech Republic and from 1.9 to 3.6 percent for Poland. Net benefits of similar orders of magnitude are conceivable in South Asia following credible and sustainable political rapprochement between countries underpinned by regulatory harmonization, in particular given the low starting point of investment flows.

### 3. CONSTRAINTS

Key obstacles to investment and growth in South Asia include regulatory obstacles to “doing business”; inadequate access to reliable, reasonable-cost infrastructure services; controls on banking and movement of capital; and the absence of facilitating harmonized frameworks on competition and infrastructure. In spite of sporadic reforms across countries within the region, a large number of regulatory obstacles continue to pose obstacles to investment and the ability to conduct business. Although the larger class of firms that typically engage in cross-border investment activities generally do not face the same problems in starting 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 (Figure 8.2).

FIGURE 8.2 Cost of Doing Business



Source World Bank 2004a.

In addition to corruption, governance, and the poor state of business regulation in South Asia, the region’s most important barrier consistently highlighted in the various World Bank–sponsored Investment Climate Assessments (ICAs) is the poor quality of available infrastructure— inadequate access to power supply, followed by transportation, communication, finance, and land services (World Bank 2003a, 2003b, 2004b).<sup>4</sup> In India, for instance, the 2003 ICA found that, on average, manufacturers face almost 17 significant power outages per month, versus one outage in Malaysia and less than five in China. India’s blended real cost of power is 74 percent 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 percent in annual sales revenue because of power outages against a reported loss of 2 percent by its Chinese counterparts. Businesses in

Pakistan also would have to wait six to seven weeks to get a new fixed-line telephone connection, which is more than three times the wait in China. In Bangladesh, the most frequent complaint is the constraint imposed by the poor electricity system: 73 percent of large formal firms, 58 percent of urban informal firms, and 54 percent of rural enterprises assessed poor electricity as a major or very severe constraint. For rural Bangladeshi entrepreneurs, other top problems include 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 and 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 that could be achieved from increased investment in improved physical and business facilitation infrastructure services. This investment could create a virtuous circle with improved infrastructure services in turn creating an improved environment for further investment. The controls placed on banking and movement of capital into and out of South Asian countries are another key obstacle to investment and growth within the region.

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 extend to applying conditions to the sale of investments in India between nonresident 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—typically with the minimum capital entry requirements being significantly higher for a foreign branch or subsidiary than for a domestic bank. With 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 (Box 8.1).

## BOX 8.1 Controls on Direct Investments in South Asia: Illustrative Examples

<i>Inward Direct Investment:</i>	
India:	Restricted (less than 100 percent) in private sector banks; insurance; telecommunications; nonretail trading companies; mining for coal; diamonds and other precious stones; and airports. Restrictions also in Insurance sector and 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 US\$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 percent 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 approval by government in: air transport; coastal shipping; alcoholic beverages; large-scale mining of gems. Not permitted in retail trading with capital of less than US\$1 million; coastal fishing.
Nepal:	All investments require approval. Foreign securities firms permitted for form JVs with ownership restricted to 40 percent. Not permitted in cottage and small-scale industries.
Bhutan:	Controls on all direct investment transactions.
Afghanistan:	All investments require approval. Only through JVs.
<i>Outward Direct Investment:</i>	
India:	Overall limit of US\$100 million in one financial year through 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 capita, 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.

In infrastructure and the private provision of public services, there is a tremendous untapped potential for cross-country investment flows. India, for instance, has played a critical role in Bhutan's economic development by investing in hydroprojects and buying back the electricity. An ongoing proposal by the Tata Group, India's second largest conglomerate, to invest US\$2 billion in Bangladesh's substantial natural gas supplies to power a complex comprising a 1,000 megawatt 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 intercountry 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.

### 3.1 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 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 bureaucratic obstacles across the region, South Asia should set the goal of becoming the top reforming region over the next 5 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 because of the urgency of its own regulatory harmonization agenda: seven of the top 10 reformers that had a positive impact on “Doing Business” indicators were either new European Union members that had strong incentives to adopt best practice domestic regulations to join the club, or existing members that had to modernize to compete with the new entrants (World Bank 2004a, Table 1.1).

Regarding harmonizing 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 an MoU for securities markets, as recommended by the International Organization of Securities Commissions (IOSCO), although apparently discussions are under way with Nepal and Pakistan. In

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

Regarding product market regulations, a question arises whether national efforts to update and enhance 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 global level. India adopted a new competition law at end-2002, and a number of 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 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 would benefit from a degree of harmonization

in national laws and approaches, including ensuring that national competition authorities treat cross-border trade and investment in the same way they treat trade and investment activities within their own national borders.

Regarding harmonization of policy frameworks on infrastructure and public service provision, without doubt, a significant number of international business opportunities 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 hydropower potential, and 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, and communications and information technology infrastructure (for specific examples of cross-border infrastructure investment opportunities, see Sobhan 2004).

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

- 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.
- Efficient appeal and dispute resolution procedures.

One area in which immediate benefits may be realized from regional harmonization is the development and effective implementation of appeal and dispute resolution procedures for projects that require such assistance. Finally, significant gains could be achieved from cross-country sharing of information regarding potential PPP deals and ongoing experimentation with the required policy, legal, and regulatory frameworks to 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), particularly given that traditionally investors have suffered from too many obligations and arbitrary interventions and not enough enforceable rights. A number of approaches may be taken toward establishing regional investment agreements (FIAS 2000; von Moltke 2000; World Bank 2003c). The approach advocated in the SAARC regional investment code proposal (SAARC 1997) appears, in spirit, to be 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, although it may be desirable to restrict the law to direct investment, because 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; such an 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 appearing in accompanying regulations rather than in the law itself.

- Agreement among countries of the region 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 may be given to a regional SAARC Investment Authority to help at the regional level to carry out the activities aimed at attracting and facilitating intraregional and extraregional 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 Nonbinding Investment Principles (NBIPs) by the Asia-Pacific Economic Co-operation forum in 1994.

The 12 NBIPs are as follows:

- Transparency—all laws, regulations, and administrative guidelines pertaining to investment to be made publicly available in a prompt, readily accessible manner.
- Nondiscrimination 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 reduce the use of requirements that distort or limit trade and 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, and 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. This policy could be pursued toward 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 (Huang and Yeung 2004). 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 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 the vision to ensure that market expansion measures are accompanied by appropriate regulatory harmonization and supporting institutional strengthening—in product, infrastructure, and financial markets. It is important for leaders to have a balanced awareness of benefits and risks of cross-country harmonization, however. A coordinated program of regulatory reform has some advantages, but coordination takes time, negotiation, and effort, and thus could provide countries with a reason to defer individual reforms. Countries should be encouraged to proceed individually while working to agree on common reforms.

## NOTES

1. The author thanks Xavier Forneris and Andrew Stone for helpful feedback and suggestions, and Juan Costain for significant inputs on financial sector integration issues and priorities. The findings, interpretations, and conclusions expressed herein are those of the author and do not necessarily reflect the views of the Board of Executive Directors of the World Bank or the governments they represent.
2. The following data are based on the LOCO monitor global corporate FDI project database, an FDI tracking and analysis tool developed by OCO Consulting (a spinoff of Price water house Coopers), covering more than 21,000 announced and opened greenfield and expansion FDI projects worldwide with source-destination information (mergers and acquisitions, privatization, and alliances are not included; joint ventures are included when they lead to a new physical operation).

3. China in fact became the largest recipient of FDI inflows in 2003 (not counting “transhipped” investment through Luxembourg) with US\$54 billion, slightly more than 2002, while flows to the United States halved to US\$30 billion (UNCTAD 2003).
4. The ICAs did not especially highlight labor regulation as disproportionately constraining in the region, because they did not examine this issue empirically.

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