

Removing Impediments to the Mobilization of Local Resources

Charles R. Irish

1. Introduction

People are poor because they have no money. Countries are less developed because they have no capital. These truisms have a profound impact on the development assistance provided by rich countries to the poor countries, as evidenced by the tendency to measure development assistance by the amount of resources transferred from the rich to the poor and the emphasis on the creation of an environment friendly for foreign direct investment, with such investment widely viewed as an important addition to the capital starved economies of the less developed countries.

These common misconceptions, however, may obscure an important point and steer development assistance away from programs that would provide real stimulants to economic growth. The point is that in many cases the major impediments to growth may not be a lack of capital, but an inability to mobilize the capital that does exist. To be sure, it is rare that people sit in poverty surrounded by abundant resources; but oftentimes what makes the poor desperately poor are legal obstacles to the use of the few resources they do have. The legal obstacles generally are in the form of excessive business regulation and inadequate recognition of property rights and they result in *dead capital* – assets that are physically sound, but unusable.¹ The existence of dead capital is most apparent to people who have worked in the poorest parts of the world. In addition, recent studies by the World Bank have found that the inability to make use of local physical and human capital may be a more severe obstacle to economic growth than destructive macroeconomic and education policies. In **Doing Business in 2005**, the World Bank concluded that for countries in the bottom three quartiles in business regulation a hypothetical improvement in all of the business regulations sufficient to move into the top quartile would boost growth by an additional 1.4 to 2.2 percent per year, while improving to the top quartile in macroeconomic and education indicators would boost growth by only 0.4 percent to 1.0 percent.²

This paper briefly considers the legal impediments to the mobilization of local resources. The next section lists some examples of legal obstacles to local resource mobilization. The third section explains why the removal of obstacles to more productive use of local resources is likely to lead to such significant improvements in economic growth and human development indicators. The fourth section examines the major factors inhibiting the efforts to simplify and rationalize business regulations and improve property rights. The final section concludes with suggestions for legal assistance programs in less developed countries.

¹ World Bank, **DOING BUSINESS IN 2005**, at 3 (quoting from Hernando de Soto's *The Mystery of Capital*).

² *Id.* at 4.

2. Legal obstacles to local resource mobilization: A sampling

The legal obstacles to local resource mobilization fall into two broad categories. In one category are laws and institutions that provide inadequate protection of property rights. In this case, the deficiencies of the legal system result in weak or non-existent property rights. In the other category are burdensome regulations that limit the ability to start and carry on businesses. This category is somewhat the opposite of the first in that here the legal system is too aggressive and overbearing. The effect of both categories is largely the same, however: in both instances, the result is that potentially productive physical and human capital sits idle, or alternatively is driven into the informal economy beyond the reach of the government.

A. Deficiencies in the Legal System

The inadequate protection of property rights can result in significant under-utilization of capital. Consider three examples:

- *Example 1:* In 2003, Grace Roseau bought undeveloped land from John Hamilton. The land sits on a hill overlooking the harbor, is on the outskirts of a major city, and has easy access to a sandy beach. Because of very substantial stamp duties and corruption in the land registration office, the cost of formally registering the change in land ownership would equal about 25 percent of the total purchase price so Grace and John did what is common in the community – they informally transferred the land and did not register the transfer with the government. In 2004, when Grace tries to build a tourist hotel on the land, however, she discovers that she cannot use the land as collateral for a loan because she is not formally acknowledged as the owner.
- *Example 2:* Luke Mwanakatwe wants to expand his profitable equipment leasing business, but to do so, he needs additional financing. Luke’s only tangible assets are the business equipment and his accounts receivable, but because there is no reliable credit registry in the country and national law does not recognize accounts receivable as collateral, Luke cannot obtain the financing necessary to expand his business.
- *Example 3:* In 2003, Wang Microsystems sold stock to a small group of investors, including Mao Shih Ming. In assessing the risk of the investment, Mao considered the financial statements of Wang Microsystems and gave special weight to the certification by the outside auditors, Chen and Partners. In 2004, after Wang Microsystems declared bankruptcy, it appeared that the certified financial statements were very misleading and may have been fraudulent. When Mao filed a law suit against Chen and Partners for knowingly or negligently certifying the false financial statements, the case was dismissed because Mao had no formal relationship with Chen and Partners. Privity was lacking, the judge said. The judge also concluded (i) that only Wang Microsystems had standing to bring a suit against Chen and Partners for the improper certification and (ii) that Wang Microsystems’ recovery might be limited to the professional fee paid to Chen and Partners.

B. Burdensome Regulations

Excessive and overbearing government regulations result in under-utilization of physical resources, but they also stifle entrepreneurial talent. Two examples illustrate the effects of

such regulations:³

- *Example 4:* Suharnoko wants to start his own business services company. Suharnoko's education and his previous work experience make him a good candidate for success in this venture. He also has done marketing research that indicates his business will fill a gap in the business services industry. The problem is that the government imposes very significant costs and long time delays to start-up a new business. In order to satisfy the government regulators, Suharnoko must go through 19 different procedures which will take on average about 150 days and the total official cost of getting the business started is expected to be over US\$1,000, which is many times Suharnoko's annual earnings. In addition, it is widely understood that the time delays and large number of different procedures give rise to pressures to bribe government officials to speed up the process, so the actual cost often is much greater than the official costs. In frustration, Suharnoko gives up the plan to start the new business and continues in his job as a relatively low level employee.
- *Example 5:* Chartran, Inc. is a company engaged in manufacturing oil and natural gas pipeline equipment. The company's sales and profits are growing and Chartran want to expand its operations. Doing so, however, would require hiring new staff. The government mandates a minimum wage of US\$200 per month, night and weekend work are prohibited, women can only work a maximum of 8 hours per day, and firing workers requires the approval of the Minister of Labor and payment of 12 months salary as severance pay. To avoid the rigidity of the labor regulations, Chartran enters into informal employment contracts with five new workers. The informal contracts provide no health care, educational or pension benefits, they are not subject to any of the safeguards in the labor regulations, and in the case of employer abuses the contracts cannot be reviewed by the courts since the labor is not documented. Chartran also bribes key personnel in the Labor Ministry to look the other way with regard to the contracts.

Each of these examples illustrates how laws or the absence of law can limit the utility of otherwise productive property and stifle entrepreneurial talent. Of course, these examples are not limited to the poor countries – many of the failings illustrated in these examples also can be found in the richest countries. One of the most significant contributions of the World Bank's **Doing Business in 2005**, however, is to demonstrate the unfortunate relationship between economic under development, poor protection of property rights and excessive regulation of business activities. Based on an analysis of 7 areas of business regulation in 135 countries, **Doing Business in 2005** concluded that the 20 countries with the most burdensome business regulations and the least protection of property rights are all poor and many are among the poorest in the world. Among the 20 countries with the best records, only two could be characterized as less developed – Thailand and Botswana. The report lists the business regulations in the following countries as the least burdensome:

³ Examples 4 and 5 are inspired by the World Bank's, **DOING BUSINESS IN 2005**, at 17–32.

- | | |
|-------------------|---------------------------|
| 1. New Zealand | 11. Swizerland |
| 2. United States | 12. Denmark |
| 3. Singapore | 13. Netherlands |
| 4. Hong Kong | 14. Finland |
| 5. Australia | 15. Ireland |
| 6. Norway | 16. Belgium |
| 7. United Kingdom | 17. Lithuania |
| 8. Canada | 18. Slovakia |
| 9. Sweden | 19. Botswana |
| 10. Japan | 20. Thailand ⁴ |

The report also stresses that the lack of burdensome regulations should not be taken as evidence of zero regulation:

Being in the top 20 on the ease of doing business does not mean zero regulation. Few would argue it's every business for itself in New Zealand, that workers are abused in Norway or that creditors seize a debtor's assets without a fair process in the Netherlands. Indeed, for protecting property rights, more regulation is needed to make the top 20 list.

All of the top countries regulate, but they do so in less costly and burdensome ways. And they focus their efforts more on protecting property rights than governments in other countries.⁵

The conclusions of the report are:

- Businesses in poor countries face much greater regulatory burdens than those in rich countries. They face 3 times the administrative costs, and nearly twice as many bureaucratic procedures and delays associated with them. And they have fewer than half the protections of property rights of rich countries.
- Heavy regulation and weak property rights exclude the poor from doing business. In poor countries, 40% of the economy is informal. Women, young and low-skilled workers are hurt the most.
- The payoffs from reform appear large. A hypothetical improvement to the top quartile of countries on the ease of doing business is associated with up to 2 percentage points more annual economic growth.⁶

3. Why the Benefits of Reform Are So Great

Removing the obstacles to the mobilization of local resources is so promising because it produces several different consequences, all of which come together to support greater economic development and the more efficient use of human capital.

- Simpler and more rational business regulations require less time and expense on both sides of the regulatory process. The government bureaucracy overseeing the regulation

⁴ *Id.* at 2.

⁵ *Id.*

⁶ *Id.* at 3.

of business will require less of the government's resources, which will enable the government to divert personnel to the delivery of essential services, such as health, education, and infrastructure development.

- On the business side, more efficient regulations will require less time and resources for compliance, which will allow the businesses to spend more time on their productive activities. They will produce more goods and services and spend less time on government compliance matters.
- The simpler and more rational business regulations will stimulate new business development as people previously deterred by the high costs of business start-ups move to establish their businesses. In addition, businesses operating in the informal economy because of the excessive and unrealistic legal burdens in the formal economy will be encouraged to shift to the formal sector.
- The growth of the formal economy through the establishment of new businesses and shrinkage of the informal economy will expand the government's tax base. This will allow the government to further escalate the delivery of essential services. Note the important implication here – that rationalization of business regulation includes tax reform, with tax rates reduced to international norms and tax compliance penalties stepped up to increase the risks associated with operating in the informal economy.
- As the formal economic grows both in absolute terms and relative to the informal sector, the government's business regulations will become more relevant to business. Simplifying and rationalizing the regulatory process thus will actually lead to the regulations having a broader impact. This will have its greatest effect on those groups most at risk in the labor markets. Women and children now will be protected by the government regulatory process rather than being left unprotected in the informal economy.
- At the same time, the simpler and more rational business regulations aimed at mobilizing local resources will also be attractive to foreign investors. As local barriers to doing business fall and respect for property rights grows, not only will local capital be drawn into the economy, but also foreign direct and portfolio investment will be drawn to the market.
- Greater protections for property rights will bring dormant capital into productive use. The entire financial system will be on sounder footing as credit arrangements tend to follow economic opportunities rather than personal relationships.
- The emergence of local resources to finance economic activities will reduce the reliance on foreign assistance and build up national self-sufficiency. Economic growth beginning from within the economy is much more sustainable and is more likely to produce local linkages that further enhance the growth prospects.

4. The Barriers to Reform Are Substantial

It seems relatively easy to identify the regulatory obstacles to making more productive use of local resources. In addition, since examples of best or better practices are readily accessible, the critical question is “Why aren't reforms proceeding at a rapid pace? What is holding back the reform process?”

In fact, regulatory reforms aimed at improving the business climate and enhancing property rights are occurring, but according to **Doing Business in 2005** they are taking place more in the high and middle income countries and in recent years the reform process has been driven principally by the need to compete within the newly expanded European Union.⁷ Unfortunately, the lowest level of reform is occurring in the poorest countries, which are most in need of reform and have the most to gain from such reform. So, the question becomes Why aren't the poorest countries more active in reforming business regulations and investor protections? The answers lie in the reasons for government regulations.

There are three principal theories supporting government regulations. The first, and most sanguine, is the public interest theory of regulation. This theory assumes that unregulated markets experience frequent failures and that governments regulate to counter those failures and to make the markets safer and more efficient.⁸ The second is one variant of the public choice theory and suggests that the regulated industries capture the regulators and are able to turn the regulatory process to the advantage of the regulated.⁹ Under this theory, stricter regulations are in the interest of the existing operators because the regulations limit entry into the marketplace and enable the existing operators to earn monopoly rents. The third theory is a second variant of public choice theory and is referred to as the *tollbooth view*.¹⁰ Under this theory, government regulations exist to give politicians and bureaucrats the opportunity to create artificial scarcities and then extract the rents from such scarcities through bribes, campaign contributions, and employment opportunities for friends and family members.

In the case of less developed countries, there sometimes is a fourth reason for government regulations – legal inheritance or legal transplantation. The less developed countries may have inherited obsolete or counterproductive regulations from their former colonial masters and inertia or a lack of skilled personnel may have insulated the regulations from reform. In the alternative, naïve legal transplantation may have resulted in the introduction of unhelpful regulations and inertia, lack of skilled personnel, or the daunting influence of the imprimatur of a foreign assistance program may keep the regulations from the review process.

The public interest theory of government regulations suggests that regulations are designed to serve the broader public good. The two variations of public choice theory, however, proclaim the winners to be either the existing operators in the regulated industry or the politicians and bureaucrats who administer the regulations. Under either public choice theory, the general public is not well served. In the case of inherited or transplanted regulations, economic productivity may suffer, but the regulations themselves may not have a powerful constituency supporting them.

The regulations that are the most injurious to the public and have the greatest adverse impact on local resource mobilization are precisely the ones with the most powerful constituencies supporting them – either the regulated industries or the government implementing the regulations. Further, the World Bank's **Doing Business in 2005** has found extensive evidence

⁷ *Id.* at 1.

⁸ Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *The Regulation of Entry*, 117 *QUARTERLY JOURNAL OF ECONOMICS* 1–2, 2001.

⁹ *Id.* at 2.

¹⁰ *Id.* at 2–3.

that the most injurious regulations, especially regulations under the tollgate theory, are much more common in the more autocratic and less developed countries than in the more democratic and developed countries. This explains why reforms are so difficult to achieve in the less developed countries – they must be done in the face of formidable, local opposition.¹¹

Lest the rich countries get overly smug about the slow pace of reform in the poor countries, it should be recognized that their governments also stymie reforms that clearly are in the national interest in order to protect a few powerful vested interests. The clearest examples are the Japanese government's intransigent position on rice imports to protect local rice farmers or the U.S. government's cotton subsidies to guarantee the market for a few rich, but politically powerful cotton farmers. The governments in the poor countries are doing much the same thing as they oppose the reform process, it is just that they may be doing it to a greater degree and with more damage to the local economies than in the rich countries.

5. Conclusions: Implications for Legal Assistance Programs for Less Developed Countries

Apart from human rights and criminal law reform projects, it would appear that legal assistance programs for less developed countries should be concentrated in improving the regulatory environment affecting businesses and investors. The benefits from regulatory reform seem so great that there is a compelling case for directing all legal assistance for private sector development into the simplification and rationalization of business regulations. If the host countries are not willing to accept that emphasis, it may be that the technical assistance would be more effective if it were redirected to other host countries where the governments are more receptive to reforming business regulations.

Three concluding thoughts on the structure of legal assistance programs for private sector development:

- First, the initial phase of legal assistance program should be a catalogue of the business regulations. The World Bank's **Doing Business in 2005** and subsequent editions should help immensely with this process as they already have collected extensive information on 8 areas of business regulation in about 140 countries. As part of the cataloging process, however, business regulations should be defined according to the constituencies supporting them. In the case of unhelpful regulations lacking clear constituencies, the reform process may be expected to proceed quickly. On other hand, a regulatory program that enriches the prime minister's family may not be a good prospect for the first efforts at reform.
- Second, who are the most suitable technical advisors – local professionals or foreign experts? In developing its **Doing Business ...** series, The World Bank is depending on input from different local sources and the results seem impressive.¹² On the other hand, local professionals are more likely to be co-opted by powerful constituencies supporting particular regulatory programs, so the use of foreign experts may promote greater objectivity. A review of government regulations applicable to legal services

¹¹ World Bank, *DOING BUSINESS IN 2005*, at 3–4.

¹² *Id.* at 11–14.

may be skewed, for example, through reliance on highly regarded professionals within the regulated industry – especially since bar associations around the world are the best examples of regulatory capture under the public choice theory.

- Finally, the reforms must be implemented and then sustained to be effective. Just passing new and more enlightened regulations does not guarantee a change in the regulatory environment. As demonstrated by the U.S. experiences in pressuring East Asian countries to adopt greater protections for intellectual property rights, the passage of laws is only the first step towards actual change in the legal environment. Law reform programs thus should include multiple stages, including the formulation of reform proposals, passage of the proposals, implementation of the new proposals, and ongoing reviews of the proposals to insure that the reforms remain as positive forces for economic development and the mobilization of local resources.