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## The Economics of Doing Business in China, Indonesia, and Thailand

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## Introduction

Nobel laureate Ronald Coase, widely regarded as the father of modern law and economics, recently wrote:

...the rights which individuals possess, with their duties and privileges, will be to a large extent, what the law determines. As a result, the legal system will have a profound effect on the working of the economic system and may in certain respects be said to control it. [Coase, 1994, 11]

This remark captures the essence of an ongoing project by the World Bank to investigate how the scope and manner of national regulations enhance or constrain business activity in over 100 countries. The purpose of the Doing Business reports is to evaluate legal systems around the world with a view to measuring their impact on the private sector and, ultimately, on a country's overall economic performance. Since countries are reforming laws all the time, desirable legal reforms, everything else being equal, are those designed to enhance business activity in a country's private sector.

This paper provides an overview of the five reports on business law in Southeast Asia commissioned by the GIP. In particular, the main purpose of this paper is to furnish an overall critique of the methodology used in the Doing Business reports by analysing and contrasting the link between legal origin and the extent of business regulation in China and Indonesia. The papers by Bath (2006) and Ip (2006) investigate the impact of business regulation in China. Bath focuses on the practicalities of setting up a business and compares China's regulatory requirements to those of Australia. Ip focuses on the applicability of the Doing Business reports to Chinese bankruptcy law. Antons (2006) and McLeod (2006) discuss Indonesia. Antons focuses on the Indonesian system of business law since the end of the Soeharto regime in the late 1990s. McLeod critiques the Doing Business methodology and recounts the historical development of Indonesian business

law. This volume also contains a separate companion piece by Kuanpoth (2006) that analyses the different legal traditions that underlie business regulation in Thailand.

Table 1 below records the legal origin and income group of each country as well as their “ease of doing business rankings” in 2005, 2006 and the latest rankings for 2007. As can be seen from Table 1, the three countries analysed in the subsequent papers come from three different legal traditions. Moreover, all three are developing countries and are ranked very differently for the efficiency of their business regulatory environment.

Table 1: “Ease of Doing Business” Rankings for China, Indonesia, and Thailand.

Country	Legal Tradition	Income Group	2005 Ranking	2006 Ranking	2007 Ranking
China	German	Lower-middle	108	91	93
Indonesia	French	Lower-middle	131	115	135
Thailand	English	Lower-middle	19	20	18

Source: Doing Business reports 2004, 2005, 2006 and 2007. The World Bank.

In the next section, some of the theoretical economic underpinnings of the World Bank’s Doing Business methodology are discussed. As part of this discussion, the role of legal origin in explaining the degree to which business laws promote or hinder the functioning of the private sector is also analysed. In section 3, the methodology used in the Doing Business reports is critically analysed. In this section, we draw on some of the lessons learnt from the accompanying papers on Indonesia, and China to determine whether the World Bank methodology is suitable for developed and developing countries alike. Finally, in section 4 we discuss some of the main determinants of regulation identified in the South East Asian countries that are the subject of the following papers.

## Methodology of the Doing Business Reports

The World Bank Doing Business reports provide an annual cross-country comparison of the laws, regulations and bureaucratic practices that influence business activity. The reports have been carried out since 2004; the most recent report Doing Business in 2007 has just been released. The leading statement on the website devoted to the reports says:

The Doing Business database provides objective measures of business regulations and their enforcement. The Doing Business indicators are comparable across 175 economies. They indicate the regulatory costs of business and can be used to analyze specific regulations that enhance or constrain investment, productivity, and growth. [World Bank, 2006: <http://www.doingbusiness.org/>]

The database provides each country with a ranking that, essentially, is based on measures of the time and monetary costs of satisfying government requirements in matters such as business start-up, operation, trade, taxation, and closure. The ranking does not examine many other aspects of socio-economic performance, such as macroeconomic policy, quality of infrastructure, exchange rate volatility, investor perceptions, crime rates, or any other “quality of life” measures.

### The basic methodology

Beginning with Doing Business in 2004, legal systems were evaluated according to 5 common tasks that businesses commonly face: starting a business, hiring and firing workers, getting credit, enforcing contracts, and closing a business. The 2005 report added registering property and protecting

creditors to the list of tasks or criteria against which legal systems are judged. Dealing with licenses, paying taxes, and trading across borders were added to the list in the 2006 report. Thus, Doing Business in 2006 analyzes legal systems by how they perform according to the following 10 criteria:

1. Starting a business
2. Dealing with licences
3. Hiring and firing workers
4. Registering property
5. Getting credit
6. Protecting investors
7. Paying taxes
8. Trading across borders
9. Enforcing contracts
10. Closing a business

The output of the exercise is 10 indices that measure how each country performs in each of the 10 categories. From these 10 indices, an aggregate index is constructed that measures the overall ease of starting, managing, expanding, and closing a medium sized enterprise in each country. Countries are then ranked according to the overall index, which is prepared annually. In this way, countries can see how “business-friendly” their legislation is relative to others. Like many exercises that rank countries, the annual league tables detailing countries’ performance are reported widely in the business press

and the popular media. For example, the recently-released Doing Business 2007 rankings were reported in, e.g., *The Economist*, *Sydney Morning Herald*, and the BBC website, among many other newspapers and news agencies around the world.<sup>2</sup>

The methodology used to construct the overall doing business index for each country is relatively straightforward. Legal and business experts—such as incorporation lawyers, business consultants, litigation lawyers, and judges—are contacted in each country and asked to complete a questionnaire that covers the 10 criteria. The questionnaire is structured around a specific hypothetical business case in order to ensure consistency across countries. The hypothetical business is assumed to be a limited-liability company operating in the country’s largest city that is 100 percent domestically owned and with start-up capital 10 times domestic income per capita. In addition, the business is assumed to have up to 50 employees, to be engaged in industrial or commercial activities, to lease its plant and equipment, not to qualify for any special benefits, and have a turnover of at least 100 times income per capita. Based on this scenario, each of the 10 criteria is given a score according to a variety of indicators developed by the World Bank team. For example, the “starting a business” criterion is based on four indicators: the number of procedures, the time it takes to complete all the procedures, the total cost of the procedures, and the minimum capital required for start-up. The legal and business experts in each country furnish and validate the required information for the indicators, and an overall index reflecting the ease of “starting a business” is constructed. Indices for each of the other criteria are constructed in a similar fashion. The final step in the process aggregates the 10 indices to provide an overall index measuring the ease of doing business in each country.

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<sup>2</sup> “Doing business,” *The Economist*, September 7, 2006, “Australia eighth in easy business survey,” *Sydney Morning Herald*, September 6, 2006, and <http://news.bbc.co.uk/2/hi/business/5313146.stm>

The methodology has been expanded and refined every year over the 4 years the report has been produced. For example, the methodology for 4 of the topics was changed between the 2006 and 2007 Doing Business reports. The World Bank has responded to criticisms and suggestions from various constituencies (academics, jurists, government experts, etc) and, according to its website, is committed to further enhancing, refining, and development of the index in subsequent reports. Having said this, the basic structure of the procedure by which country indices are derived remains largely unchanged from the 2004 Doing Business report.

#### Economic rationale for the basic methodology

There is an extensive background literature justifying the choice of criteria and the methodology used to construct each of the indices including the aggregate index. The basic economic theory that lies behind the methodology is, however, quite straightforward. Suppose that an entrepreneur in a randomly chosen country in the world wishes to bring a business idea to market. That is, the entrepreneur (equivalently the “firm”) wishes to enter a market. The firm will only actually enter the market if it expects its post-entry profits to exceed the “sunk” (i.e. fixed and unrecoverable) costs of entry. Therefore, anything that causes the firm’s entry costs to rise will reduce the likelihood of entry.

If costs are sufficiently high, entry will not occur at all – the firm faces a prohibitively high “barrier to entry”. Entry barriers may be either structural, if they result from exogenous market forces, or strategic, if they result from the actions of existing firms in the market that the firm is planning to enter. Examples of strategic barriers are predatory pricing, capacity expansion, and limit pricing. Examples of structural entry barriers are low demand, high capital costs, limited access to scarce resources, and government regulation. It

is this last example, government regulation, which is addressed by the Doing Business reports.

In terms of the ten criteria investigated by the World Bank, government regulation may create entry barriers directly, e.g., in the case of starting a business, and indirectly, e.g., in the case of enforcing contracts. As an example, consider the case of Guatemala, which is ranked 118<sup>th</sup> overall out of the 175 countries in the 2006 report, and 130<sup>th</sup> in terms of starting a business. Starting a business in Guatemala in April 2005 <sup>3</sup> involved 13 procedures taking 30 days at a cost of 52% of per capita gross national income (GNI) and requiring a minimum capital at start up of 26% of per capita GNI. Contrast this with Australia, which is ranked 8<sup>th</sup> overall and 2<sup>nd</sup> in terms of starting a business, where starting a business involves 2 procedures taking 2 days at a cost of 1.8% of per capita GNI and requiring no minimum capital at start-up. Clearly, the government-regulation-imposed barriers to entry are much higher in Guatemala than in Australia.

What is the impact on business start-ups of high barriers to entry resulting from business regulation? One might be tempted to conclude that such entry barriers do indeed prevent entry, and that our entrepreneur's idea is stifled before it has an opportunity to appear in the market place. Alternatively the firm may seek to enter the market illegally, bypassing the required legal processes and operating in the informal economy. In fact, one might reasonably expect that low-ranked countries (i.e. those which impose onerous regulatory requirements on business) encourage start-ups to enter illegally in this way.

Note that this effect is independent of the amount of corruption or graft in any country: entry into the informal economy is a way of avoiding the costs associated with regulation, not a way of avoiding the cost of bribing of officials. Of course, if bribes are necessary to establish a business legally, this

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<sup>3</sup> The data for the 2006 report are taken from April 2005.

only adds implicitly to the barriers to entry that result from government regulation of start-ups. There is also, undoubtedly, a degree of endogeneity between the intensity of government regulation (i.e. the extent of the entry barriers faced by likely entrants) and graft. The greater the regulatory requirements, the greater the opportunity (other things being equal) for government officials to seek bribes and the more incentive firms have to pay bribes to avoid significant compliance costs.

If regulation in this manner pushes proportionately more start-ups into the informal economy, then the long-run effect on economies with high regulatory barriers to entry is to create a relatively larger informal economy, which has a host of negative implications for the affected countries. At the macro level a larger informal economy reduces a country's tax base and, possibly, its rate of economic growth, because firms in the informal economy have limited access to capital, limiting their ability to expand. In general, costly government regulation that affects any of the other 9 criteria besides starting a business can have the same impact. For example, by making it costly to hire and fire workers, regulation can either discourage employment directly or drive more firms into hiring and firing workers in the informal labour market. Again, this reduces a county's tax base, and, because larger firms find it harder to hide from regulation, limits the growth of firms participating in the informal labour market. Similarly, by raising the costs of trading across borders, regulation can harm tax revenues and economic growth.

In summary, by raising costs of doing business, regulation may push more firms into the informal economy, thereby reducing a country's growth rate and its tax base. The positive relationship between regulation and the size of a country's informal economy, and the resulting negative relationship between regulation and the rate of economic growth, is a major rationale for a methodology that focuses on the costs of doing business.

## The focus on legal origin

In the 2004 edition of the World Bank's Doing Business report, "legal origin" and country wealth are identified as leading determinants of the level of regulatory intervention in the business environment. In particular, it is argued that common law countries in the English legal tradition regulate the least. In contrast, countries whose legal heritage is based on French civil law tend to regulate more. Consequently, countries in this latter group tend to be ranked lower on the "ease of doing business" scale. In terms of wealth, poor countries tend to regulate more than rich countries.

Why is legal origin relevant? The thrust of the Doing Business research effort, it seems, is primarily to encourage developing countries to reform laws that hinder the efficient operation of their private sectors. The origin of the laws to be reformed is a side issue at best in this context. What matters is where a country's laws are heading, not where the laws have come from. Implicitly, more recent World Bank research seems to have adopted this view. The 2005 and 2006 Doing Business reports make no mention of legal origin.<sup>4</sup>

To some degree the partitions of countries into groups defined by legal origin is entirely artificial. In the bankruptcy law literature, for example, it is customary to classify bankruptcy systems according to whether they are "creditor oriented" or "debtor oriented" or somewhere in between. In this instance, bankruptcy laws in, e.g., the United States and Canada, are classified as being debtor oriented. That is to say, bankruptcy laws in North America favour a bankrupt firm's incumbent management and shareholders over the firm's secured and unsecured creditors.

Using the same classification system, bankruptcy laws in the United Kingdom and Australia are typically classified as being debtor oriented. The same system can be used to evaluate bankruptcy law reform over time. For instance, the 1992 changes to Canadian bankruptcy law were viewed as

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<sup>4</sup> McLeod [2006, 30] makes the same point.

moving the system further in favour of debtors. Of course, the legal tradition of these four countries is English common law. Thus, while their legal origin is the same, the orientation of the bankruptcy system towards debtors is perceived to be different.

The orientation of bankruptcy systems matters because legal experts tend to speak of bankruptcy law reform in terms of whether a system is becoming more or less creditor oriented. To lump the US, UK, Australia, and Canada into one group seems to miss an important distinction among the laws of the countries. In this case, it is more useful to speak of the orientation of the laws towards creditors rather than the legal origin of the laws. Moreover, given that encouraging reform is an avowed objective of the Doing Business reports, it seems counterproductive to have classified countries by legal origin rather than by orientation towards debtors, which is the way jurists tend to view the bankruptcy law reform process.

Another methodological issue surrounds the classification of countries according to legal origin. The appendix to Doing Business in 2004 explains that legal origin is determined according to the origin of commercial and business law in each country. But some business legal systems are a hybrid of more than one legal tradition, and the classification into one or other origin seems quite arbitrary. For example, business law in Saudi Arabia, which according to Doing Business in 2004 is classified as having its origins in English law, is actually a hybrid of Islamic or Sharia law and English common law. Canada is classified as being an English origin country in terms of its legal system, but laws in the Canadian province of Quebec are derived from French civil code.

As pointed out in Kuanpoth's (2006) companion piece to this volume, Thailand's legal system is most accurately described as a hybrid of both English common law and Roman civil law. In contrast to common law systems, the decisions of Thai courts in general cannot set legal precedent. Only decisions made by the Supreme Court may "develop a body of law". It

is also interesting to note that, according to Kuanpoth, Thailand adopted western legal principles in the early 20<sup>th</sup> century in a bid to maintain its sovereignty from Western colonial powers. In light of Kuanpoth's paper, therefore, it would appear that the classification of Thailand's legal tradition as "English" in the Doing Business reports is a little simplistic.

Even within a legal system of singular origin, there may be important differences across jurisdictions that can impact on business. An obvious example is the US state of Delaware, which is well known as a corporate haven. Over 50% of US publicly-traded corporations and 60% of the Fortune 500 companies are incorporated in Delaware (<http://www.state.de.us/corp/>). Thus, to speak of a US system of corporate law may be misleading. Moreover, given that legal systems continually evolve, origins become increasingly irrelevant over time. Indeed, if the Doing Business reports are successful in their aim of encouraging countries to reform business law, the very idea of classifying countries by legal origin will become anachronistic.

## Critical Analysis of the Methodology

In this section, we discuss the suitability and robustness of various elements of the Doing Business ranking methodology.

### Choosing suitable ranking criteria

The basic normative argument of the Doing Business reports is that laws that enhance business activity are preferred, *ceteris paribus*, to laws that do not. An obvious concern with this premise is that its focus is too narrow. For example, consider the quality of the natural environment in a country. How is one to judge laws that promote business activity at the cost of damage to the

environment? Or how should one evaluate a law that enhances the rights of creditors at the expense of worker safety? Were the laws in the Doing Business reports assessed in broader terms, it is not obvious that encouraging law reform that enhances business activity is necessarily beneficial to society. Put simply: society might care about a wider set of objectives than merely facilitating private sector activity. But even if we set aside this concern, there are a number of specific criticisms that apply to the construction of the indices in the World Bank reports.

In the first place, the various criteria used to measure the efficacy of one legal system over another are presented without much discussion of their merits.<sup>5</sup> To illustrate the problems this can cause, consider the example of the “getting credit” index. One factor that affects the availability of credit to firms is the rights of creditors in bankruptcy. Basically, the more extensive are creditor rights, the more secure creditors are in making loans or advancing credit to firms, and the greater access firms will have to credit. The creditor-rights indicator in Doing Business in 2004 measures four powers of secured creditors in bankruptcy: (1) whether there are restrictions, such as creditors’ consent, on entering into reorganization proceedings; (2) whether there is no automatic stay (or “asset freeze”) on realizing collateral upon bankruptcy; (3) whether secured creditors are satisfied first on liquidation; and (4) whether management is replaced by a court- or creditor-appointed receiver in reorganization. Based on these four mutually exclusive criteria, the legal systems of the countries are given a score from 0 to 4. Countries that score a 4 are considered to give a high value to creditors’ rights and those with a score of 0 give a low value to creditor rights. The scoring system thus reflects the notion that a higher level of protection for creditors encourages the supply of credit. However, conditional on insolvency, the argument can be made to overrule the interests of creditors in order to facilitate the continuation of

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<sup>5</sup> To be fair, the Doing Business reports cite a wide range of literature in support of the criteria adopted. Nonetheless, since it is not feasible to assess this voluminous literature here, we address our criticisms directly at the criteria in the reports.

viable enterprises. In such a case, it may be optimal to subjugate the interests of secured creditors in order to enhance the likelihood that the insolvent firm continues.

Formally, we can use the concept of “filtering failures” [White (1994)] to characterize the resolution to a firm’s insolvency. Essentially, we can think of insolvent firms as being either “viable” or “non-viable”. A viable firm is fundamentally a sound, profit-making business that has run into financial difficulty, such as a cash-flow problem. A non-viable firm, on the other hand, is not solvent in any ongoing sense. In an ideal or first-best world, the viable firm would be given time to restructure its affairs and work its way out of financial difficulty whereas the assets of a non-viable firm would be quickly liquidated. According to White’s (1989) classification, a Type I error occurs when a viable firm is liquidated and a Type II error occurs when a non-viable firm is allowed to restructure its financial affairs. Owing to asymmetries in the negotiating and controlling abilities of shareholders, secured creditors, and unsecured creditors, a bankrupt firm may be directed towards liquidation when restructuring is optimal, resulting in a Type I error, or it may be routed towards a restructure when liquidation is optimal, resulting in a Type II error. Bankruptcy laws that give a high value to secured creditors’ rights may be expected to favour liquidation over reorganization, thereby increasing the likelihood of Type I errors. In other words, the Doing Business methodology, which gives countries a high ranking for creditor protection, ignores the possibility that such protection may increase the number of viable bankrupt firms that are liquidated. The methodology is thus incomplete.

In Doing Business in 2006, there are three measures of investor protection: an index of director liability, a shareholder suits index, and a disclosure index. An important aspect of investor protection is the degree of shareholder control, which essentially boils down to how closely managers exercise the interests of shareholders. A simple and direct measure of shareholder control is executive compensation. Everything else being equal,

senior management that is able to increase its compensation does so at the expense of shareholder returns. This suggests that executive compensation could be used as a proxy for investor protection. The Doing Business reports do not discuss executive compensation. However, it is well known that executive compensation in the US and the UK is much higher than in the rest of Europe, Japan, Canada, Australia and so forth. By not including executive compensation as a measure of shareholder control, one could argue that shareholder control has not been correctly measured, or at the least that there is a bias in the Doing Business reports that overstate the degree of shareholder control in North America and the United Kingdom.

The point here is not so much that there is a problem with the particular variable pertaining to “getting credit” or to “protecting investors”, although the aforementioned arguments suggest that there are indeed problems with these measures. Rather, the main point is that most of the criteria used in the Doing Business reports are open to criticism and debate. In the complex issues surrounding the operation of a business, economic theory does not always present a clear-cut answer. One economic model may suggest a particular measure of the performance of a legal system, but another model may suggest a different measure. As most economists would say in the context of the Doing Business reports, ultimately the performance of a legal system is an empirical question: what is the effect of a given legal structure on the performance of the economy? But the World Bank’s reports do not attempt to do this: the reports quantify legal systems; they do not evaluate the performance of the systems in terms of economic outcomes in their countries of origin.

#### Differentiating between “administrative” and “behavioural” regulation

One of the fundamental underlying trends in regulation is that as societies develop and grow they become more regulated. Shleifer (2005)

points out that “the American and European societies are much richer today than they were 100 years ago, yet they are vastly more regulated.” To confirm this, one need look no further than the increased complexity of taxation law and environmental regulation in developed economies such as the United States and Europe. On the other hand, the Doing Business reports argue that poor, developing countries tend to regulate business more. These two statements are not as inconsistent with one another as may first appear to be the case. The key to understanding these two stylised facts of regulation is in distinguishing between different forms of regulation.

In particular, a distinction can be drawn between what may be termed “administrative” or procedural regulations and “behavioural” regulations. Administrative regulations simply define which tasks need to be completed in order to legally close a particular business transaction. In the Doing Business reports, these types of regulations are measured by the “starting a business”, “trading across borders” and “closing a business” indices. Here, regulatory costs to business arise, not so much because of the complexity of regulation, but rather because of the number of tasks that need to be completed in order for a business transaction to be considered legally closed. The cost to firms of such regulation is basically the opportunity cost of time. In general, the economic benefit to the economy of such regulation is likely to be marginal.

Behavioural regulations, on the other hand, govern the behaviour of economic agents and, therefore, the quality of the relationship between firms and their stakeholders—shareholders, creditors, customers, other firms or the neighbours with whom they share the surrounding environment. In the Doing Business reports, this type of regulation is captured, for example, by measures for “protecting investors”, “enforcing contracts” and “dealing with licences”. With behavioural regulation, the volume of regulation is often very large. The aim after all, is to regulate a relationship between economic agents—an inherently complex problem. Unlike with procedural regulations, here the regulatory cost to business arises primarily from the cost of business

opportunities forgone due, for example, to the inability to operate a monopoly, or hire and fire workers easily.<sup>6</sup> Moreover, in a second-best world, benefits may actually accrue to business from more, as opposed to less, complex behavioural regulation. To the extent that complexity resolves uncertainty as to the legality or otherwise of certain behaviour, the cost of doing business may, in fact, be reduced. In the presence of less exhaustive legislation in contract law, or bankruptcy law, for example, businesses and their stakeholders may be forced to resort to the courts more often in order to adjudicate the acceptability or otherwise of certain behaviour. Unlike the case of procedural regulation, the potential benefits to other agents in the economy from behavioural regulation is also likely to be potentially very large – in the form of, for example, improved environmental outcomes, lower prices and higher quality goods and services due to competition between suppliers and higher company taxation revenues.

In public debate, the various motivations behind different types of regulation and their different impact on the cost of doing business are rarely acknowledged. Hence, despite the potential benefits of behavioural regulation, the compliance costs of regulation typically dominate debate about business regulation. The reason, of course, is that compliance costs of all types of regulation are highly visible. After all, they are real costs which directly impact a business's bottom line. On the other hand, any benefits accruing to business from (behavioural) regulation are not so easily quantified. More often than not, the value of these benefits is based on the following counterfactual: what costs would business have incurred if the regulations had not been enacted. In other words, what is the opportunity benefit of the regulation? That is, relative to the costs of regulation, the most significant benefits (in terms of costs forgone) are highly invisible.

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<sup>6</sup> Of course, compliance with behavioural regulation often involves a significant time cost as well. However, unlike with administrative regulation, the opportunity cost of time is not the only (and certainly not the most significant) cost a firm faces in this case.

In the papers below, Bath focuses her discussion primarily on administrative regulations in China and Australia. Ip provides an in-depth discussion of both the administrative and behavioural aspects of bankruptcy law in China. Kuanpoth, in his accompanying study of Thailand, analyses both procedural and behavioural elements of Thailand's business regulatory framework.

The Doing Business reports lump both administrative and behavioural regulations into a single "ease of doing business" index and weights them equally. As a result this index does not capture the different costs and benefits to business and the economy as a whole that are inherent in each type of regulation. As such, it is quite difficult to maintain with confidence that "heavier regulation brings bad outcomes" (Doing Business 2004) or that a systematic relationship exists between the degree of regulation and economic performance.

As a final comment on measuring regulation, it should be remembered that the World Bank's "ease of doing business" ranking compares only those countries in the survey. It is not an absolute measure of the fundamental quality of a country's regulatory environment. That is, countries that rank highly do not necessarily have a low absolute level of regulation. Moreover, there is no guarantee that highly ranked countries have an "optimal" level of regulation. This can be seen in the papers by Ip and Bath, both of whom note that notwithstanding its high ranking, the Australian Productivity Commission (and certainly Australian business leaders) do not believe that the "ease of doing business" in Australia is ideal.

Does “one size fit all”? Regulation in developing countries may require special treatment

The 2004 Doing Business report claims that “one size can fit all” (p. xvi) in the matter of business regulation. The studies presented in this volume suggest that this is not quite the case, at least not for China (and, according to Kuanpoth’s companion study, not for Thailand either). As described by Shleifer (2005), the standard public interest theory of regulation assumes that unregulated markets fail either because of monopoly or externalities, and that governments are benign and capable of correcting these market failures through regulation. This theory has been criticised on three grounds, namely: (i) markets can and often do correct market failures without government intervention of any kind, (ii) where markets do not work, private litigation or self-regulation can efficiently resolve conflicts between market participants and (iii) even if markets and courts cannot solve problems perfectly, governments are often corrupt or can be captured by interest groups subject to regulation. Underlying all these arguments is an implicit minimum requirement that effective legal institutions exist. This, however, is usually not the case in developing countries.

For the developing economies that are the subject of this volume, it is certainly true that the assumptions underpinning public interest theory do not hold. First, market failure is widespread and endemic. The reasons for this include not just the reasons of monopoly and externalities suggested above but also incomplete or missing markets, poorly defined property rights, and, in general, underdeveloped institutions. Second, the assumption that governments are benign and capable of correcting these market failures is also unrealistic. For example, not only has Indonesia been ruled by despots and the military at various times, but widespread corruption suggests that government would be unlikely to regulate in a responsible and economically efficient manner. Indeed, as McLeod points out, the Soeharto regime that ruled Indonesia evolved into a “franchise system” of state-organized

corruption, the very essence of which was to facilitate illegal payments to government officials.<sup>7</sup> It is hard to reconcile the Indonesian government of the Soeharto period with the broader public interest.<sup>8</sup> Of course, in the case of China, until recently at least, markets were simply controlled by the central government – the market mechanism was not given an opportunity to work freely.

While, on this basis, the environment for regulation in these countries appears less than ideal, the argument for minimal regulation seems even more problematic. A lack of well-developed legal institutions, including the ability to effectively enforce legal outcomes, suggests that it is a forlorn hope to expect private litigation to resolve conflicts among economic agents in developing economies. Moreover as Ip explains in her paper, even in China, with its well developed legal system, judges are invariably subject to political interference which could bias court outcomes. In the case of bankruptcy law, courts may, under pressure from government officials, err on the side of permitting inefficient state owned enterprises to continue operation. Hence, even Coase's (1960) famous logic in favour of allowing courts to resolve situations of market failure is potentially problematic in this environment.

#### Determinants of the degree and nature of regulation

As mentioned above, the 2004 edition of the World Bank's Doing Business report identified "legal origin" and country wealth as leading determinants of the level of regulatory intervention in the business environment. Nevertheless, the studies undertaken for this volume suggest that the nature and degree of regulation may be determined by economic

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<sup>7</sup> We refer to the Indonesian leader by the name "Soeharto" and not by the Anglicized spelling "Suharto".

<sup>8</sup> The Soeharto family fortune has been estimated at US\$15 billion [Time Asia, May 24, 1999].

events outside an individual nation's control. This can hold equally true for both developed and developing countries.

Often, the nature of regulation, particularly in developing countries such as those discussed below, is determined not so much by legal tradition as by economic necessity. Countries such as China and Indonesia, for example, depend upon a consistent and large flow of foreign direct investment (FDI) in order to maintain their growth and economic development. This growth is essential not just to increase the living standards of large, poor populations, but also to avoid civil unrest resulting from the extreme poverty and inequality, which characterises many countries in the early stage of their development.

Consequently, any sudden external shock which threatens this flow of foreign capital may act as a catalyst for regulatory reform. The nature of this reform may even be determined externally by international aid donors, large trade and investment partners or international organisations like the International Monetary Fund (IMF) or World Trade Organisation. In Kuanpoth's companion study of Thailand, for example, he points out that IMF support for Thailand during the early 1990s was conditional on Thailand removing foreign exchange and capital controls – regulatory reform which, he claims, may well have exacerbated the severity of Thailand's suffering during the Asian crisis of 1997-1998.

The design and reform of regulation is dynamic. Moreover, the relationship between the nature of government regulation and foreign direct investment is endogenous. It is no doubt true that, other things being equal, economies characterised by favourable business regulatory regimes should generate greater levels of investment sourced both domestically and from abroad. On the other hand, it is equally true that regulatory reform is itself driven, in part, by the prevailing level of incoming FDI. After all, foreign

investors can “vote with their feet” if they identify a more compelling investment environment elsewhere.

The pressure on China to reform its bankruptcy laws, described by Ip in her paper, is in no small part due to the growing presence of international investors in that country and the desire of others to enter. As pointed out by Bath, China’s admission to the WTO has also necessitated major reform of its international trade regulations and ongoing reform of its intellectual property laws. Kuanpoth notes that trade reforms and reform of intellectual property laws have also been undertaken by Thailand as part of its commitment to WTO membership as well as in response to “bilateral pressure” from large trading partners like the United States. Moreover, recent moves to standardise accounting regulations worldwide based on a set of international standards, are yet another illustration of the fact that, in an increasingly integrated world, the nature of national regulation will become progressively less reflective of tradition and, instead, will increasingly be used as a strategic instrument with which to attract scarce international capital.

Indonesia provides the most extreme example of how a nation’s legal structure can be influenced by legal origin. However, the Indonesian experience has very little to do with the mechanism, ascribed to by the Doing Business reports, that links present-day laws to colonial heritage. The paper by McLeod describes how the Soeharto regime, which ruled Indonesia from 1966 until 1998, evolved a legal and bureaucratic system designed to maximize the flow of income to the power elite in the country. Thirty years of government that fosters legislation designed to further the economic and political interests of a small elite group can render the origin of the legal system of little more than historical interest. In other words, the experience of Indonesia shows how colonial legal heritage is, to some extent, irrelevant. For example, McLeod [2006, 12] points out that the Indonesian system during the Soeharto regime was deliberately designed to make starting a business difficult as a way of maximizing the bribes that the regime could extract from the private

sector. It is hard to see how the French legal origin of Indonesia can be blamed for this. Surely, the apparently dysfunctional legal structure that exists in present-day Indonesia is a result of years of distorted legislation and not of the French civil code.

Lastly, it is helpful to think of the legal system of a country as a form of infrastructure – it forms part of the services and facilities that support day-to-day economic activity. In this context, “good” infrastructure promotes private sector business activity; “poor” infrastructure hinders it. A theme that emerges from the reports on China and Indonesia is the pernicious influence of corruption throughout the economies. Corruption may take the form of small bribes to lower-level government or law enforcement officials, which is common in many countries (not just those of Southeast Asia), to full-scale perversion of a country’s legal system, as in the case of Indonesia from the mid-1960s to the late 1990s. In all cases, corruption raises the costs of doing business and, therefore, discourages business activity at the margin. It is an open question as to whether corruption hinders economic performance more or less than laws that affect businesses. However, the extent of corruption is not investigated by the World Bank reports through to the 2007 version.

## Conclusion

A number of conclusions emerge from the foregoing analysis. First, the methodology in the Doing Business reports is far from perfect. There are questions about the choice of criteria used to evaluate business law, the methods by which the indices are calculated, disagreement about what the extant indices actually reflect, as well as a host of concerns about the characterization of the business law in China, Indonesia, and Thailand.

The discussion in Doing Business 2004 that attributed shortcomings in the performance of the business sectors of various countries to the legal

origins of the law in those countries seems to have disappeared from the more recent reports. This may reflect the fact that the link between legal origin and business performance is tenuous at best. In the preceding analysis, this relationship has been disputed on a number of grounds, including the difficulty of accurately classifying the legal origins of countries' laws, the fact the legal systems are in a state of constant change, and the role played by other factors such as a country's political system and its state of economic development.

Notwithstanding the drawbacks with the World Bank's approach and methodology in the Doing Business series, the basic idea of comparing business laws across countries is potentially very useful. It serves to provide a benchmark for countries that are genuine about legal reform. It provides a single, concise reference of business laws around the world that can be used by countries to gauge their own laws against those of trading partners, countries with a similar culture or in the same geographic region, and perhaps against laws of countries with which they are competing for FDI. Moreover, judging by the changes to the approach and methodology used by the Doing Business series over the last four years, it seems that the World Bank is responsive to criticism and is willing to change its approach. For example, the methodology that derives a single index for a legal procedure in a country was criticized on the grounds that there may be substantial regional differences in how the law is applied. The 2006 report recognizes the problem and suggests a way to mitigate its impact. In sum, given the media coverage that the reports generate, it seems unlikely that the World Bank will consider discontinuing them in the near future. Thus, one can expect the series to continue and to evolve into the foreseeable future.

Several general themes emerge from the five papers on doing business in China, Indonesia, and Thailand that accompany this paper. In the first instance, authors find numerous errors and omissions in the World Bank reports. Typically these errors and omission are inconsequential, but they are

reminders of the fact that the Doing Business project is an ambitious, large-scale undertaking that, by its very nature, is subject to mistakes at the level of individual countries. A second theme that emerges is the essential futility of an exercise that classifies countries according to their colonial legal heritage. This is either because the classification used by the World Bank is open to debate (consider the case of Indonesia in Antons [2006, 19]) or because it is irrelevant due to ongoing reform. Moreover, many authors note that legal systems evolve as a consequence of the particular circumstances a country faces (Indonesia under Soeharto being an obvious example), suggesting that legal reform may be disconnected from legal origin.

A third major theme is the extent to which economic outcomes measured by the World Bank flow from legal structure or economic policy. The most obvious example of this distinction is the so-called Asian financial crisis of 1997. Thailand and Indonesia suffered greatly, in terms of unemployment and lost output, from the regional crisis (although it did hasten the end of the Soeharto regime in Indonesia), whereas China emerged relatively unscathed. As McLeod (2006) suggests, the explanation seems to lie, not so much in the countries' legal structure, but rather in the response of policymakers to the crisis. McLeod (2006) focuses on missteps made by Indonesia's Central Bank with respect to the conduct of monetary policy. More generally, however, Chinese and Indonesian policymakers responded in very different ways on a range of policy fronts, all of which to some extent contributed to the different experience of each country both during and after the crisis period.

Exchange rate policy represents one of the most crucial differences in policy response between Indonesia and China. Indonesia floated its exchange rate early in the crisis period. This left it exposed to the vagaries of foreign exchange markets, not least to the whims of currency speculators. Not surprisingly, the value of the rupiah plunged catastrophically and a short but

very acute period of soaring inflation duly followed – with all the accompanying economic hardship and social costs.

In contrast, China effectively fixed the renminbi, pegging its value to that of the US dollar – an economy only indirectly exposed to the crisis. Consequently, China's exchange rate was spared much of the turbulence to which the rupiah was subjected. As Roberts and Tyers (2003) argue, China's staunch (and successful) defense of its currency peg, in no small part due to the substantial foreign exchange reserves at its disposal and the imposition of strict capital controls, ensured that China was impacted to a lesser extent than other countries in the region.

The enduring lesson from this analysis is that implementation of legal structure is often as problematic as the nature of the laws themselves. Moreover, a well designed legal framework may be undone by careless government management and policymaking. To the extent that a country's economic performance is determined by myriad factors, one of which may be legal architecture, it is difficult to argue for a definitive link between legal heritage and economic performance. By focusing on legal structure, the World Bank reports are destined to capture only part of the overall story.

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