



Asia-Pacific  
Economic Cooperation

August  
**2007**

# Enhancing Investment Liberalisation and Facilitation in the Asia-Pacific Region (Stage 2): Reducing Behind-the-Border Barriers to Investment

Investment  
Experts Group



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## Foreword

Investment is crucial to delivering the economic growth needed to reduce poverty and improve welfare across APEC economies. The companion report, *'Enhancing Investment Liberalisation and Facilitation in the Asia-Pacific Region (Stage 1): Reducing Barriers to Investment across APEC to Lift Growth and Lower Poverty'*, focused on the barriers to foreign direct investment (FDI). But since most investment is sourced domestically, reducing barriers that impede domestic investment offers the greatest potential gain for economic growth. Where Stage 1 focused on barriers to investment at the border, this Stage 2 report focuses on behind-the-border barriers to investment that impact upon both foreign and domestic investment.

Behind-the-border barriers to investment are diverse, and impede investment through different channels, and to different extents. This report develops a conceptual framework to assess behind-the-border barriers to investment and identifies the mechanism through which these barriers impact upon investment. To illustrate the importance of these behind-the-border barriers to investment, and the benefits of their removal, case studies of positive reform in APEC economies have been included. These case studies help inform policymakers about the process of reforming behind-the-border barriers to investment and their impact. They provide useful lessons on how to remove barriers to investment to promote economic growth.

This study was undertaken on behalf of the Australian Department of the Treasury by the Centre for International Economics, based in Canberra.



Dr Andrew Stoeckel  
Executive Director  
Centre for International Economics



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## *Acknowledgements*

This study was prepared by a small team from the CIE with contributions and valuable comments from many sources. Most notable was the contribution from our collaborators to the case studies. Specifically:

- Dr Filologo Pante Jr, consultant and former economist with the Asian Development Bank, in the *Improved infrastructure in the Greater Mekong Subregion* case study;
- Mr Nuttanan Wichitaksorn, PhD Candidate at Rutgers University, USA and Mr Wisit Wisitsora-at, Judge and Director-General of the Office of Justice Affairs, Thailand, in the *Insolvency law reform in Thailand* case study;
- Mr Yi Zhang, of the Institute for International Economic Research, National Development and Reform Commission, China, in the *Improving policy predictability, China joins the WTO* case study; and
- Dr Le Dang Doanh, consultant and retired President of the Central Institute for Economic Management (CIEM), Viet Nam, in the *Barriers to entry – Viet Nam enterprise law reform* case study.

In addition to the contribution from collaborators, input and feedback was provided through consultation with researchers, government officials, and non-governmental and private-sector organisations. We also thank the Australian Embassy officials in China, Thailand and the Philippines for their assistance during the in-country consultation process.

Mr Roy Nixon, Convenor of APEC's Investment Experts Group, and Dr Paul Kennelly of the Australian Treasury have played a significant role in the design and production of this report. Helpful comments have also been received from IEG delegates and members of other APEC groups and committees.



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## Summary

Reducing poverty among low-income APEC economies remains a pressing issue. The best way to alleviate poverty has been shown to be higher economic growth. More and better investment is a necessary precursor for this higher economic growth.

But there are significant barriers to investment around the APEC region. These barriers are restricting the amount and type of investment that would be made and hence unnecessarily restrict economic growth.

The restrictions to investment are found to be greater in lower-income APEC economies<sup>1</sup> than in more prosperous ones. The restrictions to investment are both external and internal. The internal or behind-the-border barriers to investment are far more important because typically around 90 per cent of investment for a low-income economy is sourced domestically.

The behind-the-border barriers to investment are not just formal restrictions on investing in certain business activities – although these do exist. The barriers cover a raft of domestic policies, rules, procedures and laws (or lack thereof) that unnecessarily impede investment in domestic businesses. The barriers come in many forms from excessive regulation, unclear property rights and poor legal systems to a lack of appropriate laws that foster competition. All of these barriers have a deleterious effect on investment and impede growth through one or more of three channels:

- They can unnecessarily increase *costs* making businesses less profitable and therefore less attractive to invest in. Examples would be excessive regulation, complex licensing procedures and poor infrastructure such as inadequate roads that increase transport costs.
- Second, barriers can increase *risk* that chills the incentive to invest. Examples would be unclear property rights, poor legal enforcement of

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<sup>1</sup> APEC lower-income economies are those classified as low income or lower-middle income by the World Bank (China, Indonesia, Papua New Guinea, Peru, Philippines, Thailand and Viet Nam).

contracts and the uncertainty and unpredictability of government policy and its enforcement.

- Third, barriers can limit business *competition* that, while perhaps helping a favoured few firms obtain monopoly status, increases costs for other firms, impeding their competitiveness and stifling innovation.

The cost of these barriers is lower productivity and growth. Each of the above channels – particularly the third – can reduce productivity in the economy. Productivity growth – and hence economic growth – is lower because investment in new technology is held back.

One key contribution of this study is the framework that links each barrier and its economic effect. Assessing the economic effects of barriers to investment is a critical step in helping policymakers remove them.

Where behind-the-border barriers to investment have been reduced, significant benefits have flowed:

- In Thailand, farmers with title over their land were able to borrow between 50 and 500 per cent more from banks than those without titled land and output was 14 to 25 per cent greater. Also, Thailand's bankruptcy law reform has significantly improved the efficiency of settling insolvency cases.
- New road infrastructure linking Thailand, Viet Nam and Southern China through the Greater Mekong Subregion project has lowered transport costs, improved travel times, and encouraged greater investment in the region. Economic integration between countries in the subregion is now higher.
- In Mexico, in those states that operated the legal system more efficiently than the average, firms were 10 to 15 per cent larger.
- China's entry into the WTO made the policy environment for investors more predictable. The World Bank finds that, globally, more predictable and credible policy can increase the probability of investment occurring by more than 30 per cent.
- In Viet Nam, enterprise law reform – making it easier for firms to enter new businesses – increased the share of investment in GDP by up to 20 percentage points from two decades earlier and created 2 million new jobs.
- In Australia, the removal of unnecessary legislation restricting competition under National Competition Policy increased the annual level of GDP by 5 per cent.

The current global macroeconomic imbalances provide further evidence of the importance of impediments to business investment. The flipside to the

‘global savings glut’ described by US Federal Reserve Chairman, Ben Bernanke, is an investment ‘dearth’.

Many of the lower-income APEC economies, where investment in infrastructure, schools, and so on is sorely needed, are running current account surpluses. That means domestic savings in these economies is greater than domestic investment with the excess being invested offshore – mostly in richer economies. Funds from lower-income economies are invested offshore because the expected returns are greater. Returns are lower in low-income APEC economies because there are more impediments to doing business which act as barriers to investment. That is, the limitation to growth in lower-income APEC economies is not low savings, but barriers to investment.

Despite the gains from their removal, many behind-the-border barriers to investment in APEC economies remain. They do so generally for one or more of three reasons:

- Policymakers may not be aware of the *net benefits* that removing an investment barrier could make;
- A policy change may not be *administratively feasible*, mostly due to a lack of capacity to implement the change; or
- Removing the barrier to investment may not be *politically feasible* or narrow vested interests are able to block the common good.

So how can countries surmount these barriers? A lesson from the case studies of successful removal of barriers to investment and other reforms across APEC economies is that assessing the economic benefits and costs of barriers and appreciation of the net benefits by a wide enough constituency was important in making the change. Policies changed because enough people thought they would be better off.

Having a set of institutional arrangements to enhance this wider public appreciation of benefits from change can be most helpful. But each APEC economy is different and what has worked well in some economies may not work well elsewhere. Each economy needs to address the question: *what institutional arrangements – either public or private – could help facilitate the removal of barriers to investment?* While the answer will differ across APEC economies, the lessons from successful removal of barriers by APEC members suggest some desirable core elements of any institutional arrangements.

Assessments are best if they are independent, appraise economy-wide costs and benefits, take public input from stakeholders, are ongoing, produce transparent reports, and their findings are formally considered by

governments. If investors in APEC economies face fewer barriers, investment would be higher and of a better quality, economic growth would rise and the incidence of poverty across APEC would fall.

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# 1

## *Introduction*

Reducing poverty and improving welfare in developing economies is one of the most pressing economic and moral issues for Asia-Pacific Economic Cooperation (APEC) members to address. The most effective way to reduce poverty and improve welfare is to increase economic growth. And for economic growth to occur there must be the right quantity and quality of investment.<sup>2</sup>

Investment drives economic growth in two ways. Investing in additional capital (such as machinery and equipment) increases the productivity of labour – it allows each worker to produce more output. Investment in new technology and ways of doing business, however, can increase the productivity of *all* resources used in production. Investment expands production and improves productivity, driving economic growth.

East Asia's rapid growth over the early 1990s is mostly attributable to investment that expanded the capital base, adding more capital per worker and thereby increasing incomes (see Krugman 1994). But the productivity gains from investment are often more important than the gains from increasing the capital stock, and depend heavily upon the type of investment. Good quality investment, which means investment of the right kind in the right areas at the right time, and at least cost, leads to productivity gains. These productivity gains are the biggest driver of economic growth.

Developing economies, including those that are members of APEC, stand to reap substantial benefits from getting the amount and type of investment right. Despite the importance of investment to economic growth, particularly in lower-income APEC economies, there continues to be many barriers restricting investment in APEC economies. This study focuses on those barriers, what they are, how important they are and what can be done about them.

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<sup>2</sup> In recognition of the vital role that investment plays in driving economic growth, and the importance of improving the investment climate to encourage investment, the World Bank devoted its World Development Report of 2005 (World Bank 2004) to looking at issues affecting the amount and type of investment. This report borrows heavily from that World Development Report.

Investment must be funded from either domestic or foreign savings. Foreign-funded investment can be either foreign direct investment (FDI) or portfolio investment. If a foreign firm has some control over business activities it is considered FDI. FDI is particularly important for developing economies because it can bring technology and management best practice and can generate productivity spillovers for the local economy. Despite these benefits, many APEC economies maintain barriers to FDI. The prevalence of border barriers to FDI flows was the subject of a preceding report for APEC's member economies: *Enhancing Investment Liberalisation and Facilitation in the Asia-Pacific Region (Stage 1): Reducing Barriers to Investment across APEC to Lift Growth and Lower Poverty*. That report was the first stage of a project looking at ways to enhance investment in APEC economies.

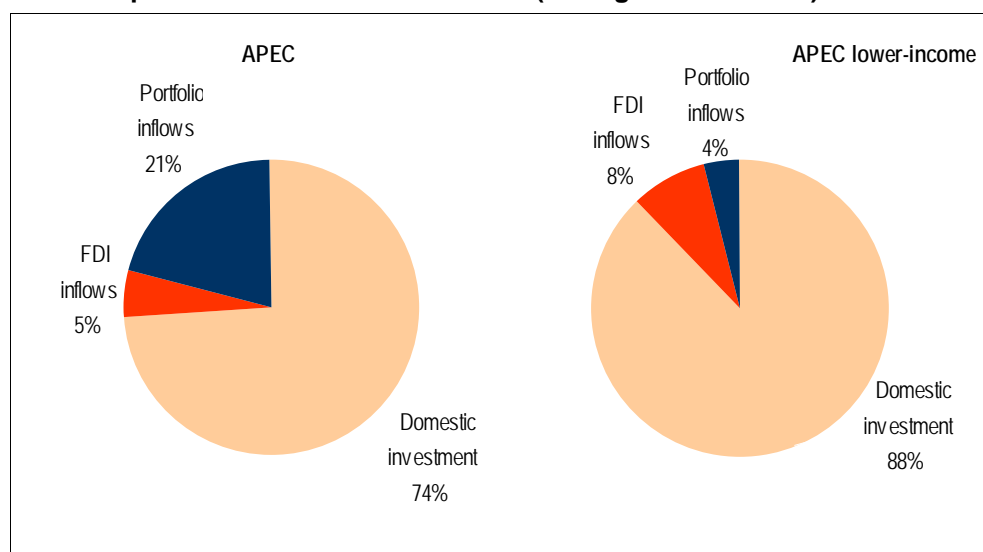
The Stage 1 report found that border barriers to FDI are a major impediment to investment and economic growth in APEC economies. If the barriers to FDI were removed, analysis by the OECD and World Bank showed FDI could be 20–30 per cent higher in APEC economies. But that calculation assumes average responses from cross-sectional data. In reality there are large differences between economies in their response to liberalising FDI. These differences are due in part to other behind-the-border barriers to investment. These barriers include impediments such as unclear property rights, the inadequate enforcement of contracts, inadequate or onerous regulations and many more. They all chill the incentive to invest.

If these behind-the-border barriers are onerous, removing border barriers to FDI may yield no new investment flows to a member economy. Unfortunately, in many economies this is the case. The result is that investment, both domestic and foreign, is too low, which reduces the potential growth rate. Behind-the-border barriers are important because they affect all investment – both domestic and foreign. Typically for a lower-income economy, domestic investment amounts for up to 90 per cent of an economy's total investment (chart 1.1).

Removing these behind-the-border barriers to investment is crucial to increasing investment and economic growth and is thus a priority issue for APEC economies. This report aims to assist in addressing these barriers by providing a framework for analysing these barriers, and drawing lessons from how APEC economies have gone about removing these barriers. As figure 1.2 shows, it extends the work of the first stage of the overall study of ways of enhancing investment in APEC economies.



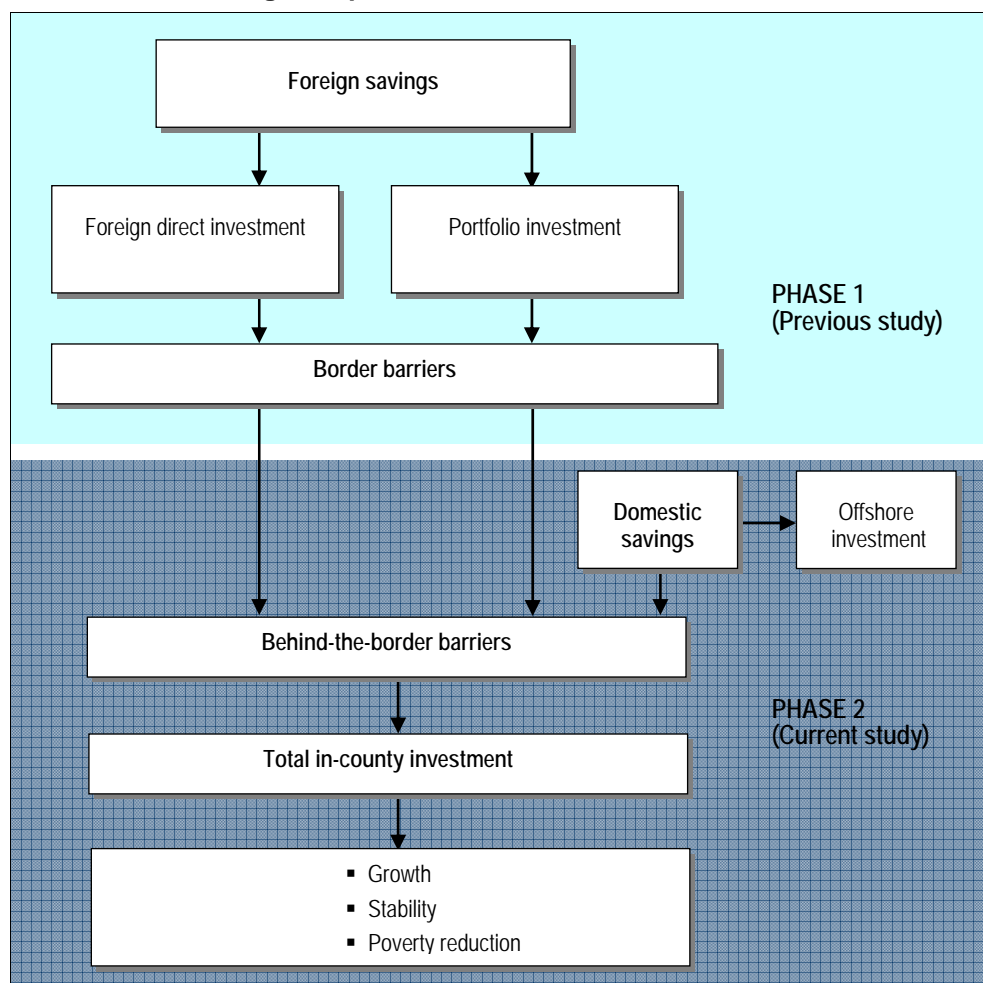
### 1.1 Composition of investment in APEC (average 2002 to 2004)



*Note:* APEC lower-income economies are those classified as low income or lower-middle income by the World Bank (China, Indonesia, Papua New Guinea, Peru, Philippines, Thailand and Viet Nam).

*Data source:* UNCTAD (2005), IMF (2005) and CIE calculations.

### 1.2 Context for Stage 2 report



The framework used to analyse behind-the-border barriers to investment outlines how each barrier discourages investment and impedes economic growth. Analysing how each barrier increases costs, increases risks for investors, reduces competition or lowers productivity helps in identifying actions to eliminate or mitigate the effects of the barrier.

And because circumstances in each APEC economy are so different there is no 'one-size-fits-all' prescription for addressing barriers. But as the case studies explored in this report show, there seem to be some common elements in how best to approach reform of these barriers. The case studies cover a range of different barriers to investment across a range of APEC members, with a particular focus on the Asian economies. They have been chosen for their breadth across the range of behind-the-border barriers as well as across different APEC economies. The case studies illustrate the importance of transparent assessments of the costs and benefits of barriers. Some barriers may result from efforts to achieve sound regulatory objectives; others may persist because some groups in the community benefit from them. Either way, it is important to assess these barriers' effects on the economy, and to help the public understand the consequences for overall national welfare of retaining or removing them.

## **Structure of the report**

Chapter 2 develops the framework used to analyse behind-the-border barriers to investment. Chapters 3, 4 and 5 discuss the most important barriers to investment in the APEC region and outline how each barrier affects investment and therefore retards economic growth. The case studies sit within these chapters. Chapter 6 discusses how to reduce behind-the-border barriers to investment, drawing on lessons from the case studies.

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# 2

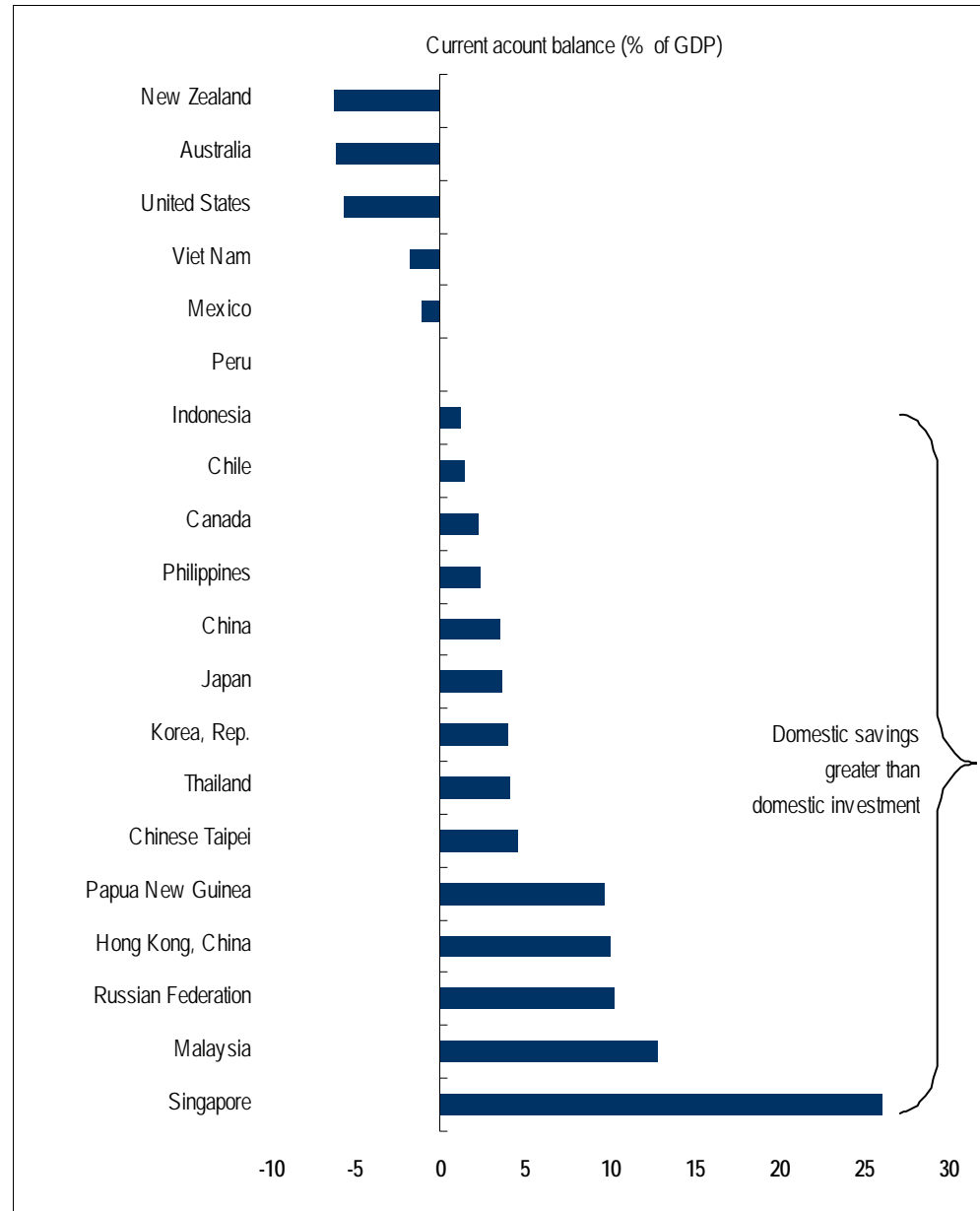
## *Analysing behind-the-border barriers to investment*

Behind-the-border barriers to investment matter because they needlessly restrict the amount of investment in an economy, thereby limiting economic growth. If an economy restricts the investment opportunities available to households and businesses, the savings of that economy will be depressed or deployed elsewhere in the world.

As chart 2.1 shows, a substantial portion of the savings of many developing APEC economies are already being channelled elsewhere: many lower-income APEC economies that badly need capital investment in infrastructure, hospitals, schools and more, actually have a net capital outflow. That means they are net lenders to other economies. A current account surplus means that savings in these economies are larger than domestic investment, and are being channelled to other economies. This implies domestic investment in these economies is not being limited by low levels of saving: the problem is that the domestic returns on savings are too low. Returns are higher in other economies so that is where the capital flows to. One of the reasons why the return on invested capital in lower-income economies is too low is the existence of unnecessary barriers to domestic investment.

The importance of behind-the-border barriers in inhibiting investment is acknowledged by large international organisations like the World Bank and the OECD. The World Bank addressed the investment climate in the *World Development Report 2005: A Better Investment Climate for Everyone*. The OECD, too, recognises the importance of domestic policies upon investment. In the *Policy Framework for Investment* it provides a comprehensive taxonomy that can be used as a self-assessment diagnostic tool to test investment climate reform strategies to ensure greater policy coherence.

### 2.1 Current account balance for APEC economies as a percentage of GDP, 2004



*Note:* Papua New Guinea data is for 2001, Viet Nam for 2002 and Malaysia for 2003. Data for Chinese Taipei is for 2005 from the CIA Fact Book.

*Data source:* WDI Online database (accessed 6 July 2006).

Both documents provide valuable perspectives on the challenge of improving the policy and institutional environment for investment. This report is concerned with helping economies to identify the economic effects of impediments to investment, as a step to understanding the need for change and prioritising efforts for reform.

Behind-the-border barriers to investment are so broad and inter-related that it is necessary to go beyond standard investor surveying techniques

and develop some means of classifying them by their economic effect. This can help in identifying the high payoff areas for reform. Analysing and publicising the effects of barriers can also play a key role in motivating a sufficiently large constituency for change. Because the World Bank's methodology emphasises this 'mapping' between investment barriers and economic effect, and because there are useful data sets behind the World Bank's work, the approach adopted here draws heavily on, and extends the World Bank's approach.

## What are behind-the-border barriers?

Behind-the-border barriers to investment are aspects of the domestic investment climate that deter both domestic and foreign investment. The World Bank defines the investment climate as 'the location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs and expand' (2004, p. 1). This definition includes policy as well as some non-policy factors such as proximity to major markets and susceptibility to natural disasters. But the primary focus of this study is on what can be directly controlled by government – namely, policy. That said, it should be noted that good policy can help minimise physical constraints. For example, although proximity to major markets cannot be changed, policy that facilitates the development of good transport and communication networks will help provide access to markets in different geographical locations.

Behind-the-border barriers come in many forms, covering aspects of the institutional and regulatory framework. Among the most important behind-the-border barriers to investment are:

- poor infrastructure;
- excessive regulation;
- corruption;
- policy uncertainty;
- weak legal systems, poor protection of property rights and ineffective arrangements for enforcement of contracts;
- regulatory barriers to market entry;
- policies that suppress competition and allow anti-competitive behaviour; and
- poorly functioning financial markets.

The relative importance of these behind-the-border barriers will differ from economy to economy, supporting the need for individual analysis of the importance of behind-the-border barriers for each economy.

## How do behind-the-border barriers affect investment?

Firms and households invest to make a profit, and investment decisions are based on expected returns. Policies that create behind-the-border barriers can discourage investment by reducing expected returns through one or more of the following channels:

- *Increasing costs.* Policies that increase the cost of producing and selling goods and services reduce expected profits and lower the incentive to invest. An example would be policies that lead to inadequate provision of roads, either through under-investment or inadequate maintenance. If roads are inadequate or poorly maintained, wear and tear on trucks will be high and transport times long. Getting goods to market will be costly, profits low and therefore investment too low.
- *Increasing risk.* Investment decisions are about future profits so investors are forward-looking. The future is always uncertain and bearing some risk is a normal part of doing business.<sup>3</sup> However, government actions can unnecessarily increase the risk associated with investing. For example, uncertainty about how future policies and regulations may be shaped, let alone interpreted, makes the investment climate unpredictable. Firms will then require a higher expected rate of return on their investment to compensate them for higher risk. Alternatively they adopt shorter time horizons for the investment, or they may choose not to invest in the local economy at all, preferring to put their money into another economy where the investment climate is more predictable. The World Bank reports that improving policy predictability can increase the probability of new investment by more than 30 per cent (World Bank 2004).
- *Creating barriers to competition.* Government policies that create barriers to competition are beneficial to incumbent firms, because they offer the opportunity for firms to make monopoly profits. However, in doing so they deny other firms the opportunity to invest while increasing the cost to consumers. For example, a monopoly granted to a telecommunications company will see higher phone charges to users

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<sup>3</sup> Although risk and uncertainty are technically different concepts in economics, they are used interchangeably in this report.

and lower profits for other firms that rely on telecommunications for business.

### *The cost of these barriers is lower productivity and growth*

Behind-the-border barriers to investment matter because, by deterring investment, they slow increases in productivity and hence growth in incomes.

Investment affects economic growth in two ways. The first is capital accumulation, which is an increase in the amount of capital per worker. An increase in the capital to labour ratio expands output. Take for example a seamstress who sews by hand. Providing the seamstress with a sewing machine (capital) increases the amount of sewing she can complete in a day. Labour productivity rises and the firm's owner can afford to pay higher wages as well as increase their own profits after paying the cost of the capital. The limitation of relying upon capital accumulation for economic growth is that the benefits to economic growth from increasing capital will eventually decline. In the example of the seamstress, providing another sewing machine would not increase her output because she can use only one sewing machine at a time. The amount of sewing the seamstress completes in one day can only be increased by providing a faster sewing machine; that is, by increasing total factor productivity.

The second channel through which investment underpins economic growth is through increasing the productivity of all factors of production by investing in new technology and ways of doing business. Gains in total factor productivity (which measure the part of output growth not accounted for by capital accumulation and growth in the labour force) offer one of the best explanations of aggregate growth performance across countries. What this means for investment is that it is not just the *amount* of investment that matters, but the *type* of investment. In fact, the relationship between the investment rate and growth is weak, particularly when public investment is taken into consideration.

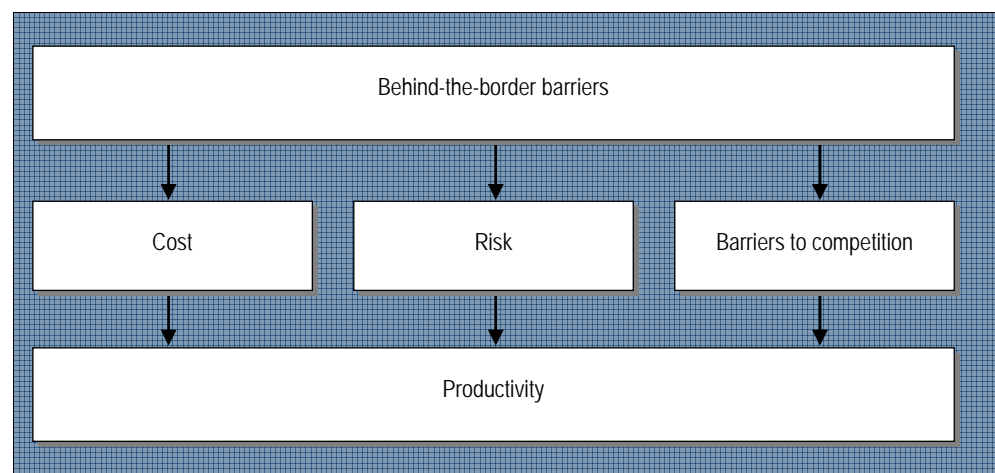
To achieve productivity gains from investment it is important that the right amount of investment is directed to the right areas, at least cost. In a dynamic world, it is impossible to predict *ex ante* which are the 'right' areas and 'right' amounts, and market economies rely on private investors risking their own money in the search for good opportunities to efficiently allocate savings. It is important that the policy environment does not distort or suppress this search: if it does, economies will forgo investments that generate sustained productivity gains.

This is one reason why policies that inhibit competition can be among the more costly behind-the-border barriers to investment. One of the most powerful stimuli to productivity is competition. Firms in industries not exposed to strong competition have less incentive to keep improving technology and processes. Competition provides this incentive. If a rival firm sees an opportunity to innovate, cut costs or improve the product and win market share, they will do so. Other firms will be forced to do likewise if they want to remain in business. Research has shown that firms are 50 per cent more likely to innovate if they are subject to rigorous competitive pressures (World Bank 2004).

## Fitting behind-the-border barriers into the framework

To make the assessment of behind-the-border barriers to investment more tractable, the barriers can be categorised according to the channels through which they affect investment and hence productivity and growth: increasing cost, increasing risk or acting as a barrier to competition (chart 2.2). Many barriers will impede investment through more than one channel – regulation, for example, may increase costs and risk. These channels may also interact: increased costs of entry may act as a barrier to competition. Understanding the principal ways in which specific policies impact on investment is an important starting point in working out whether and how to change them.

### 2.2 Framework for behind-the-border barriers



Some behind-the-border barriers have a larger effect upon productivity than others. A qualitative assessment of the relative strength of the relationship between different types of behind-the-border barriers and productivity is shown in table 2.3. Bastos and Nasir (2004) confirm that competitive pressure is the most important factor driving productivity



levels. Therefore, removing barriers to competition is likely to result in the largest productivity gains. Similarly, granting clear and enforceable property rights, particularly over intellectual property, is a powerful incentive to innovate, so productivity effects are also likely to be large.

### 2.3 Behind-the-border barriers, productivity and examples of reform

	<i>Behind-the-border barrier</i>	<i>Productivity effect</i>	<i>Reform example</i>
<b>Cost</b>	Finance costs	Small	
	Distorting taxes	Small	
	Regulatory burden	Small	Mexican agency for reducing red tape
	Corruption	Small	
	Inadequate infrastructure	Medium	Road network in Greater Mekong Subregion
<b>Risks</b>	Poorly performing financial markets and poor investor and creditor protection	Medium	Thailand bankruptcy law reform
	Weak legal systems, property rights and enforcement of contracts	Large	Land titling in Thailand
	Lack of policy predictability and credibility	Small	China's accession to WTO
<b>Barriers to competition</b>	Poorly functioning finance market	Large	Philippines' General Banking Law (2000) and Securities Regulation Code
	Poorly structured Infrastructure access arrangements	Large	
	Regulatory barriers to entry and exit	Large	Viet Nam's Enterprise Law Reform
	Lack of strong competition law and policy	Large	Australia's National Competition Policy

Source: Compiled by the CIE

By contrast, Bastos and Nasir found that the costs imposed by bribery, bureaucracy and inspections, while significant, have a relatively small effect on productivity. Higher finance costs and taxes also have small effects on productivity.

The productivity effect of poor supporting infrastructure was found to be somewhat higher than for bribery, bureaucracy and inspections, but less than the effect of competition. This barrier has therefore been given a medium rating. The other barriers to be given a medium rating are financial markets, insolvency law and creditor protection and labour market regulation. Georgakopoulos (2002) argues that bankruptcy law is important for productivity because it revives productive capacity destroyed as a consequence of financial failure. Similarly, deregulating the

labour market is likely to increase the incentive for workers to increase their productivity. However, it seems unlikely that the productivity effects of these barriers will be as great as those achieved by removing barriers to competition.

Links between the barriers to investment are not shown in table 2.3. For example, excessive regulation, while principally imposing extra costs on business, can also have the effect of increasing risk. When there are too many regulations there is always the possibility that officials will place different interpretations on them. Lack of consistency in applying regulations increases risk.

## **Institutional framework for addressing behind-the-border barriers**

Understanding how barriers impede investment and growth is an important step towards addressing these barriers. But so is developing an appropriate institutional mechanism to evaluate barriers and to pursue reform. The case studies presented in this paper show how constituencies developed an understanding of the costs of investment barriers. The case studies also discuss the institutional arrangements underpinning each economy's reforms to improve the investment climate. The lessons of these experiences can be used to expand collective knowledge about the institutional mechanisms for successful reform.

As the history and institutions of each member vary markedly across the APEC region, there is no universally appropriate template for reform. What works in one economy may not necessarily work in another. Nevertheless, there are common challenges that all economies face when reducing barriers to investment. The case studies outlined in subsequent chapters provide valuable lessons that APEC economies can share as they wrestle with the issue of how best to address their own barriers to investment to boost growth.

# 3

## *Cost-increasing barriers to investment*

The cost of producing and distributing goods and services is an important aspect of the investment climate. Higher costs result in lower profits. Since private investment decisions are based on expected profits, high operating costs act as a barrier to investment. Operating costs vary significantly across economies within APEC. This is heavily influenced by government policies and behaviours. Government actions that unnecessarily increase the cost of doing business mean that fewer investment opportunities will be profitable and investment will be lower.

Governments can impose costs on business both directly and indirectly. Business taxes are an example of a direct cost. Governments can also indirectly increase the cost of doing business by neglecting to provide public goods and services that firms cannot easily or efficiently provide for themselves. For example, by failing to provide good quality infrastructure or create appropriate incentives for private infrastructure provision, governments increase the cost of doing business.

Unjustified costs imposed by government policy and behaviour discourage both foreign and domestic investors. Foreign investors look to invest in locations that allow them to produce and distribute their products at the lowest possible cost. Government actions that unnecessarily increase the costs of doing business are likely to result in FDI being directed elsewhere. Similarly, domestic savings are likely to be diverted offshore if few profitable investment opportunities are available at home.

### **Cost-increasing barriers to investment**

Important cost-increasing barriers to investment are:

- inefficient or excessive taxes;
- excessive regulation;
- corruption;

- finance costs; and
- poor quality infrastructure.

Improving the investment climate does not necessarily mean reducing government-imposed costs to zero. However, it does require the benefits brought about by the intervention are greater than their associated costs.

### *Inefficient or excessive taxes*

It is hard to develop detailed prescriptions for the optimal way for government functions to be financed, and nearly all (if not all) approaches impose costs that alter the incentives facing business. Considerations of tapping into as broad a revenue base as possible, while keeping compliance and administrative costs in check enter into the calculus, as do concerns of an equitable distribution of the ultimate burden of taxation.

#### *Tax structure and tax rates*

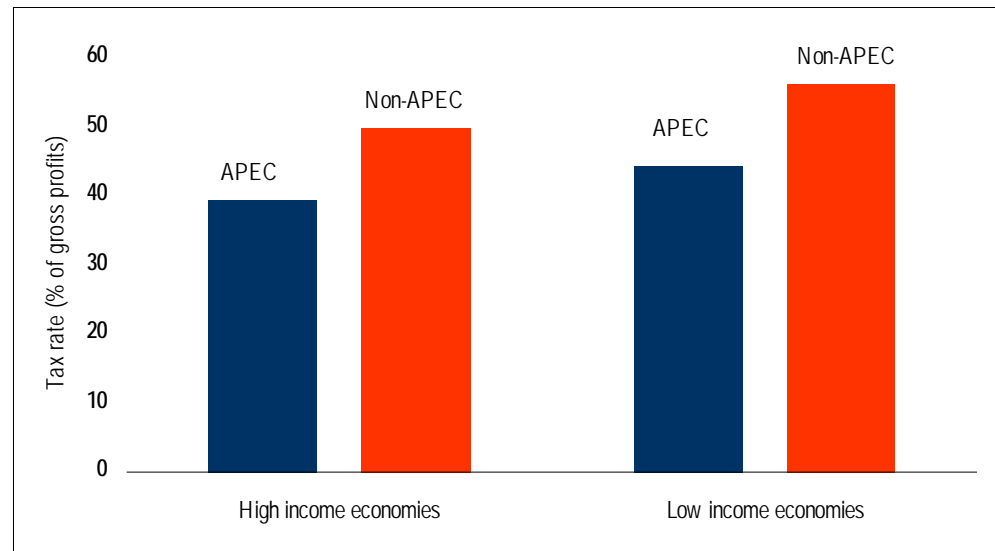
Business tax rates depend on the size of government and how the tax burden is allocated among alternative sources. Government spending must ultimately be funded from tax revenue. A larger government sector therefore requires higher taxes. The optimal size of government is when the marginal social benefit from extra government equals the marginal social cost. In practice, that is a difficult calculus to make but the following observation can be made. Developing countries tend to have a larger government sector than most developed countries did at a comparable stage of their development (World Bank 2004). The implication is that government may be too large in many developing economies. Also relevant is the allocation of expenditure, which is frequently suboptimal, with too little allocated to infrastructure – a point taken up later.

Business income is almost always part of the revenue base in modern economies. The share of the tax burden carried by firms will be influenced by efficiency and equity considerations. Excessively high business tax rates dampen investment or push firms into the informal sector, thereby reducing the tax base and revenue collected. Indeed, there is evidence to suggest that tax systems that rely heavily on business taxation do not have the best revenue yields. In poor countries, higher business tax rates (tax paid as a percentage of gross profits) are not positively related to tax revenue collected (World Bank 2006a, p. 50). Furthermore, it may be possible for firms to pass taxes on to consumers and workers. The ultimate burden of business taxes is therefore shared around an economy according

to supply and demand conditions in product and factor markets (World Bank 2004, p. 108).

Business tax rates are relatively low among APEC members compared with the rest of the world (chart 3.1). Among high-income economies, business tax rates average around 40 per cent of gross profits in APEC members, compared with around 50 per cent in non-APEC economies. Similarly, for low-income economies, business tax rates average around 12 percentage points less in APEC economies than in the rest of the world. There is, however, considerable variation among APEC economies; business taxes are equal to around 77 per cent of gross profit in China, compared with around 26 per cent in Chile.

### 3.1 Business tax rates (percentage of gross profit)



Data source: World Bank (2006b).

This chart also shows that low-income economies tend to have higher business tax rates than high-income economies, both within and outside of APEC. Most likely, this is because less developed economies tend to use business as a collection point, charging higher business taxes (World Bank 2006a, p. 47).

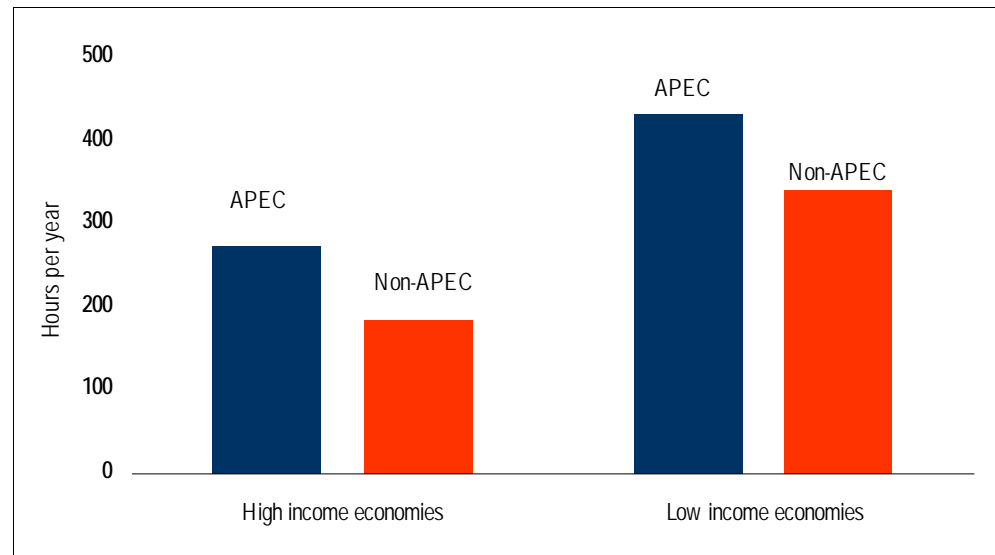
#### *Tax administration and compliance*

The structure of taxation and the rates that are levied on different parts of the base are measures of the costs that can be imposed on business and investment. In many economies, costs associated with the administration of taxes, and the costs that firms face in complying with tax laws, can be high. Firms in 90 per cent of countries surveyed in a World Bank review of tax ranked tax administration among the top five obstacles to doing business

(PriceWaterhouseCoopers and World Bank 2006, p. 8). More complex tax arrangements increase the cost of compliance for firms. This chokes investment and increases the incentive for tax evasion.

One indicator of the cost of tax administration is the average number of hours firms spend on tax compliance every year. On average, tax compliance is more costly in APEC economies, compared with the rest of the world (chart 3.2). This is particularly the case in low-income APEC economies. This suggests that administration of tax systems is one area of tax policy where APEC economies can do better.

### 3.2 Time spent on complying with tax regime (hours per year)



Data source: World Bank (2006b).

### *Excessive regulation*

Government regulation can affect the investment climate, through all three channels identified in chapter 2. This section specifically focuses on regulation that increases the cost of doing business. Aspects of the regulatory environment that increase risk or act as a barrier to competition will be considered in chapters 4 and 5 respectively.

The cost of complying with government regulation can discourage firms from investing. Regulations are often introduced with the purpose of achieving economic and social goals but because of poor design place such a large burden upon business that many firms migrate into (or never leave) the informal sector. These costs may be monetary, but it is often the time taken to comply with procedures that delay and reduce the profitability of an investment. A common example is found in the procedures required to

start a business. Time-consuming and complex procedures increase the costs, in terms of both time and money, of starting a business legitimately.

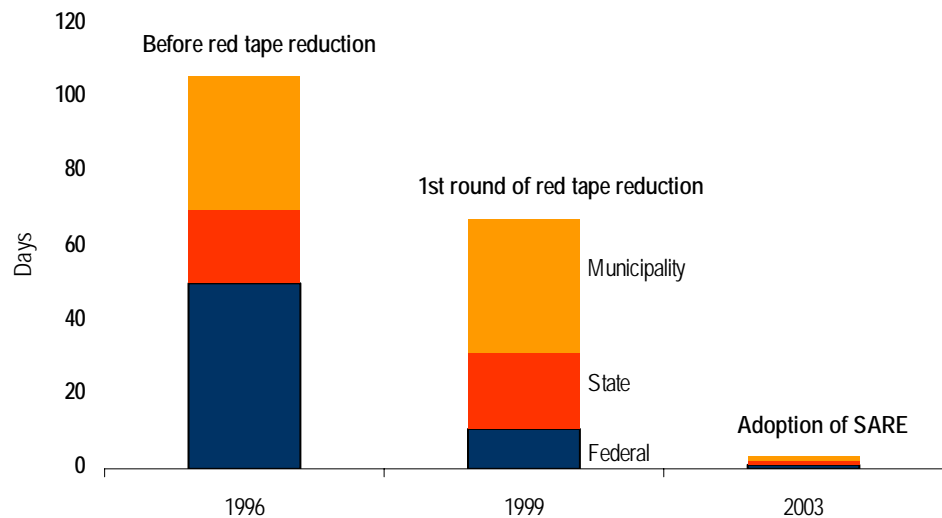
Heavy regulation of product markets has also been found to have a large negative effect on investment (Alesina et al 2003). Yet some regulation is necessary to address market failures and achieve efficient social outcomes. Indeed some regulations, such as those that promote competition, actually improve the investment climate. Governments must balance the benefits of a favourable investment climate for firms against the interests of society more broadly.

Too often regulation imposes costs on firms, without a clear public benefit. Even if there is market failure, the costs imposed by poorly designed regulations may ultimately outweigh the benefits. It is therefore important to subject all regulation to rigorous cost-benefit analyses. An excellent example of this is Mexico's deregulation unit. Their experience is summarised in box 3.3.

### 3.3 Reducing red tape in Mexico

In 1989 the Mexican government set up a deregulation unit to reduce the amount of red tape. The deregulation unit focused on improving existing regulations as well as removing unnecessary ones. The deregulation unit introduced a process which ensured that regulatory decisions are based on sound analysis, transparency and public consultation. This has helped the deregulation unit reduce red tape and improve the domestic investment climate. The reduction in the time taken for business to comply with federal, municipal and state regulation since 1996 is shown in below.

#### Days taken by formalities



Note: SARE (Sistema de Apertura Rápida de Empresas) or Prompt Business Start-up System, which reduces formalities for businesses.  
Data source: Salas (2004)

Building codes are an example of the trade-off between the investment climate and wellbeing of society more generally. Building codes are generally designed to protect the safety of tenants, construction workers and passers-by. A stricter building code imposes greater costs on firms but would be expected to result in fewer deaths and injuries (unless construction moved into the informal sector). However, there is no evidence to suggest that lower compliance costs mean lower building safety standards.

As part of the *Doing Business* project, the World Bank (2006b) conducted a cross-country survey comparing the procedures, time and cost involved in complying with building regulations required for a medium-sized company to construct a two-storey warehouse. Among APEC economies, the cost of complying with building regulations is lowest in Thailand, at only 11 per cent of per capita income. Costs are also relatively low in many of the more developed APEC economies, namely Australia, the United States, Japan, Singapore, Hong Kong and New Zealand (chart 3.4). At the other end of the spectrum, the cost of complying with building regulations is more than triple an average income in Peru and Indonesia and more than double an average income in Russia and Chinese Taipei. It is therefore likely that the cost of complying with building regulations could be reduced in some APEC economies without sacrificing safety or other standards.

### *Corruption*

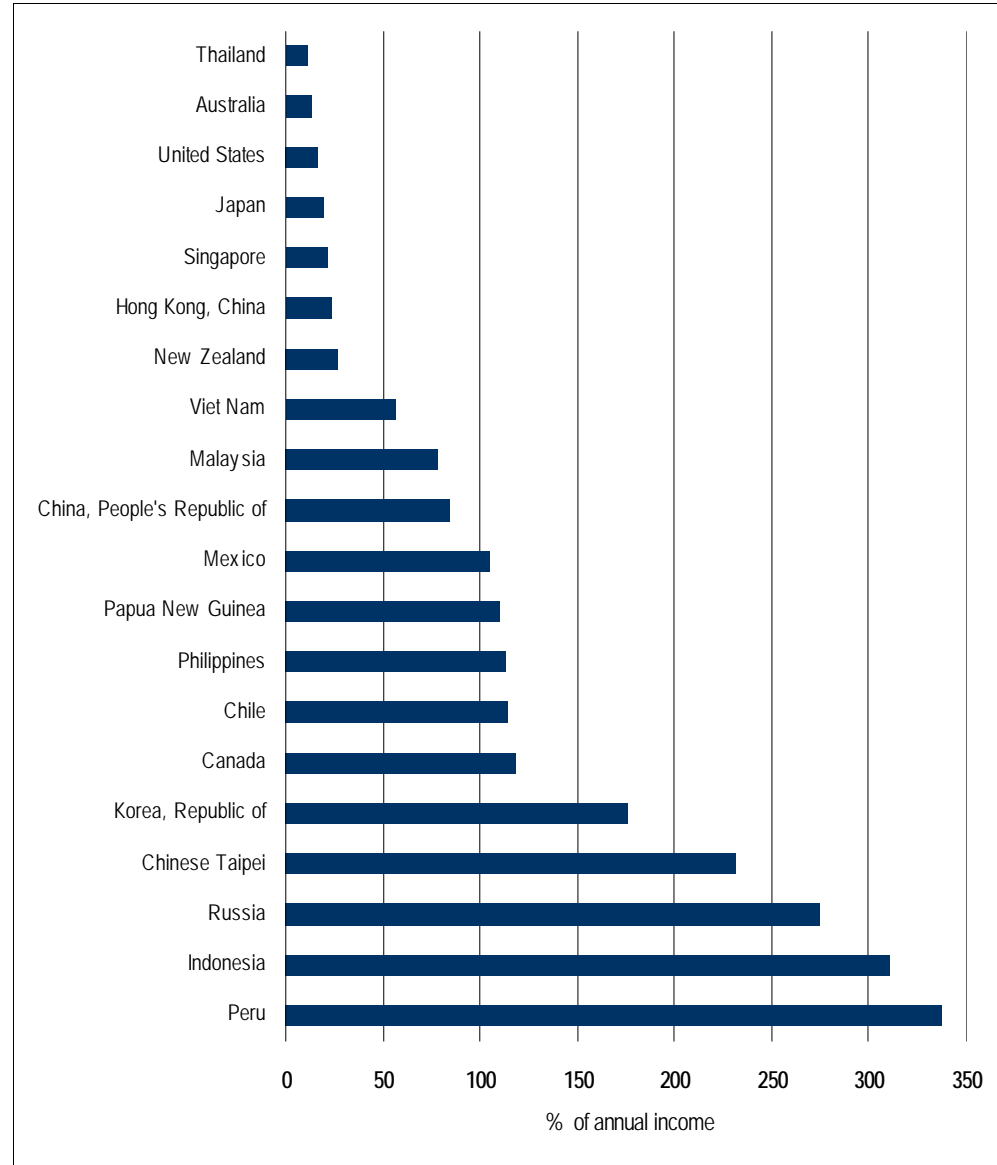
Corruption is the abuse of public office for private gain. Public office is abused when an official accepts, solicits or extorts a bribe, or when private agents give or offer bribes to circumvent public policies and processes for competitive advantage (World Bank 2006c, p. 2).

The payment of bribes imposes a cost on business. The risk associated with doing business also increases, as the amount of a bribe is often unknown and corrupt officials may not always honour their side of the deal. This increase in the cost and risk of doing business is a deterrent for investors.

Transparency International publishes an indicator measuring the degree to which business people and country analysts perceive corruption to exist among public officials and politicians. On average, APEC economies are perceived to be less corrupt than non-APEC economies (chart 3.5). This is the case in both high-income economies and low-income economies. Nevertheless, the high average score for the low-income APEC economies shows there is plenty of room for improvement.



### 3.4 Cost of complying with building regulations (percentage of average income)

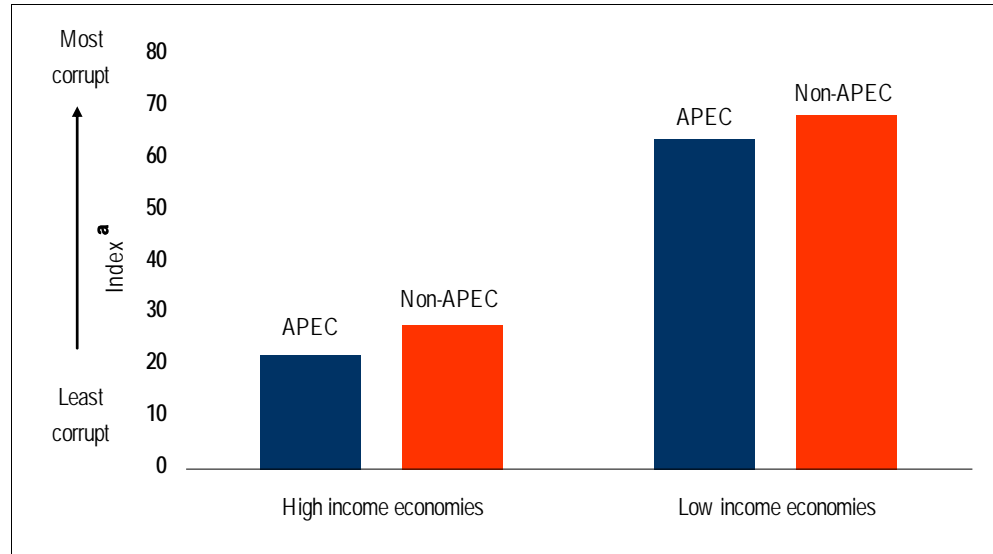


Note: Data not available for Brunei Darussalam.

Data source: World Bank (2006b).

While corruption is clearly a cost of doing business, there is a question of what causes it. One source of corruption is from failings in the institutional environment elsewhere. A firm will generally pay a bribe for one of two reasons. First, a firm may pay a bribe if it believes officials will prevent it from receiving an entitlement without the bribe. In this case, corruption can be viewed as a symptom of weak or unclear property rights. Second, a firm may pay a bribe to circumvent onerous regulation. In this case, while corruption is a cost to the investor, it may be a smaller impediment than the bad regulation that is being circumvented. In this second case the solution

### 3.5 Corruption perceptions by business



<sup>a</sup> The Corruption Perceptions Index has been inverted such that a high index value reflects a high level of corruption and a low index value reflects a low level of corruption.

Data source: Transparency International (2006).

to corruption is regulatory reform. Indeed the World Bank has found that regulatory red tape and unwieldy public sector enterprises are associated with poor governance and corruption.

So, if corruption is viewed as a symptom of other institutional failings, it may be better to focus on fixing the root causes of the problem. All too often, these root causes are excessive and unclear regulations, unclear property rights, weak enforcement of contracts or ineffective legal systems. That is, it may make sense to tackle the other behind-the-border barriers first and then address the issue of corruption.

### *Finance costs and financial markets*

The financial system gives firms access to funds outside of the business, making it possible for them to pursue potentially profitable investment opportunities without relying on internal funds. Many studies have shown a positive relationship between the functioning of financial systems and long-run economic growth, and hence poverty reduction (see Levine 1996). However, financial systems do not always function as effectively as they could. This is particularly the case in developing economies, where small firms are often unable to access credit, even for investments that are likely to achieve a reasonable rate of return. Consequently, the level of investment in these economies is often far too low. The lack of a well-functioning financial system is therefore a barrier to investment. And often, government policies inhibit the development of the financial system.

The financial system is one area in which there is significant overlap between the three channels of costs, risk and barriers to competition. In a well-functioning financial system, firms' borrowing costs correspond to the risk associated with the investment. Consequently, any government policies that increase economy-wide risks will also increase borrowing costs for firms. One example is when poor policy decisions contribute to an unstable macroeconomic environment. This increases the risk faced by lenders, resulting in higher borrowing costs for firms. So firms' borrowing costs are intrinsically linked to the risks faced by lenders. Furthermore, poorly functioning financial systems can be a symptom of a lack of competition caused by government policy. In the framework used in this study, it is important to separate out what aspects of a poorly functioning financial system increase firms' costs, what aspects increase firms' risks and what aspects are caused by barriers to competition.<sup>4</sup>

In every loan transaction, lenders risk losing their money if the borrower defaults on his repayment obligations. One way government policy can reduce the risk of default for lenders (and, therefore, reduce borrowing costs for many firms) is by removing barriers that restrict lenders' access to credit information. Information on a potential borrower's credit history allows lenders to be selective and charge a rate of interest that corresponds to the risk of default. However, collecting and processing this information on a wide range of firms, managers and economic conditions is likely to be quite costly for an individual saver. Without credit information on individual borrowers, lenders charge an interest rate that corresponds to the average risk of default across all borrowers. This interest rate will be higher than the risk of default for many low-risk, low-return investments. Consequently, many of these investment proposals will not proceed because borrowing costs are too high. Recent research has shown that the availability of credit information on borrowers is the most important factor determining the amount of credit extended to firms in developing economies (Djankov, McLiesh and Shliefer 2006)

Private credit bureaus or public registries reduce the cost of obtaining information on potential borrowers. The introduction of both public

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<sup>4</sup> This section focuses on some aspects of the regulatory environment that increase firms' borrowing costs. Aspects of the regulatory environment that increase the risk to creditors and investors are covered in chapter 4. Barriers to competition reduce investment in the finance industry, but also affect investment in the economy more broadly, by increasing borrowing costs. Nevertheless, these barriers to competition in the finance industry are dealt with in chapter 5.

registries and private bureaus increases the credit to GDP ratio by 7 to 8 percentage points (Djankov et al 2006). Access to credit information also reduces loan default rates (World Bank 2004, p.122). In many economies, legal obstacles prevent the sharing of credit information (World Bank 2006b). Removing these legal barriers would improve the flow of credit information, facilitating investment and growth. Alternatively, governments in developing economies could facilitate the flow of credit information by establishing a public registry.

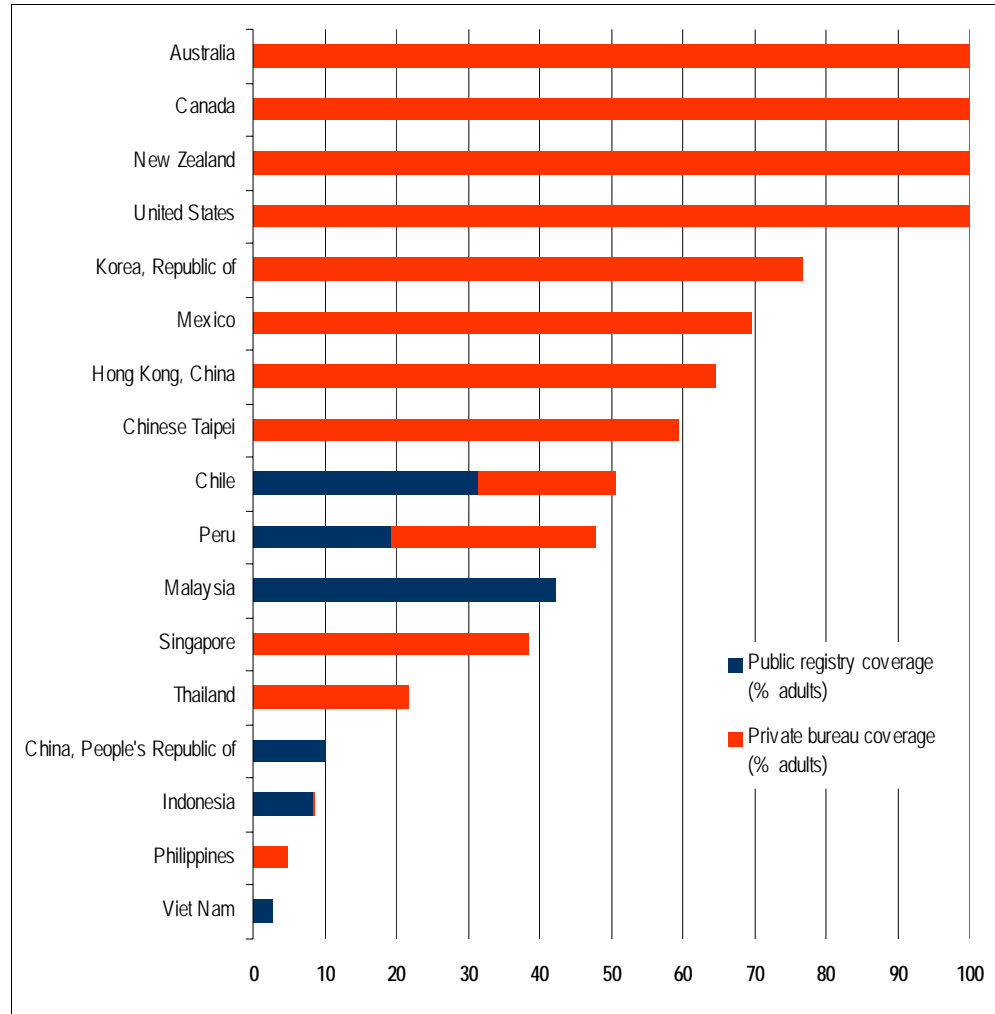
In the more developed APEC economies, credit information on the whole adult population is available through private credit bureaus (see chart 3.6). In some countries, such as Malaysia and Chile, public registries supplement or take the place of private agencies. However, in some of the least developed APEC economies such as Indonesia, the Philippines and Viet Nam, little credit information is publicly available. This results in high information costs for creditors and reduces the amount of credit they are willing to extend in the domestic market.

Improving the flow of credit information is also likely to have important productivity effects. Greater access to information helps ensure that funds are allocated to those firms that can use capital most productively.

### *Poor quality infrastructure*

Access to good quality infrastructure, including transportation, power and communications is a critical part of the investment climate. Infrastructure connects firms to customers and suppliers. Poor quality infrastructure unnecessarily increases the cost of doing business. Poor transportation infrastructure increases the cost of inputs into production processes, and of getting outputs to markets and final consumers. Poor power infrastructure increases the costs of converting inputs into outputs, and poor telecommunications infrastructure increases the costs of acquiring information and interacting with markets. Poor infrastructure reduces incentives to specialise and pursue economies of scale, and discourages investments where scale or timely and cost-effective access to markets is important. This section presents a case study of successful efforts to improve transport infrastructure, but first discusses issues with respect to telecommunications and electricity.

## 3.6 Credit information coverage for APEC economies (per cent of adults)



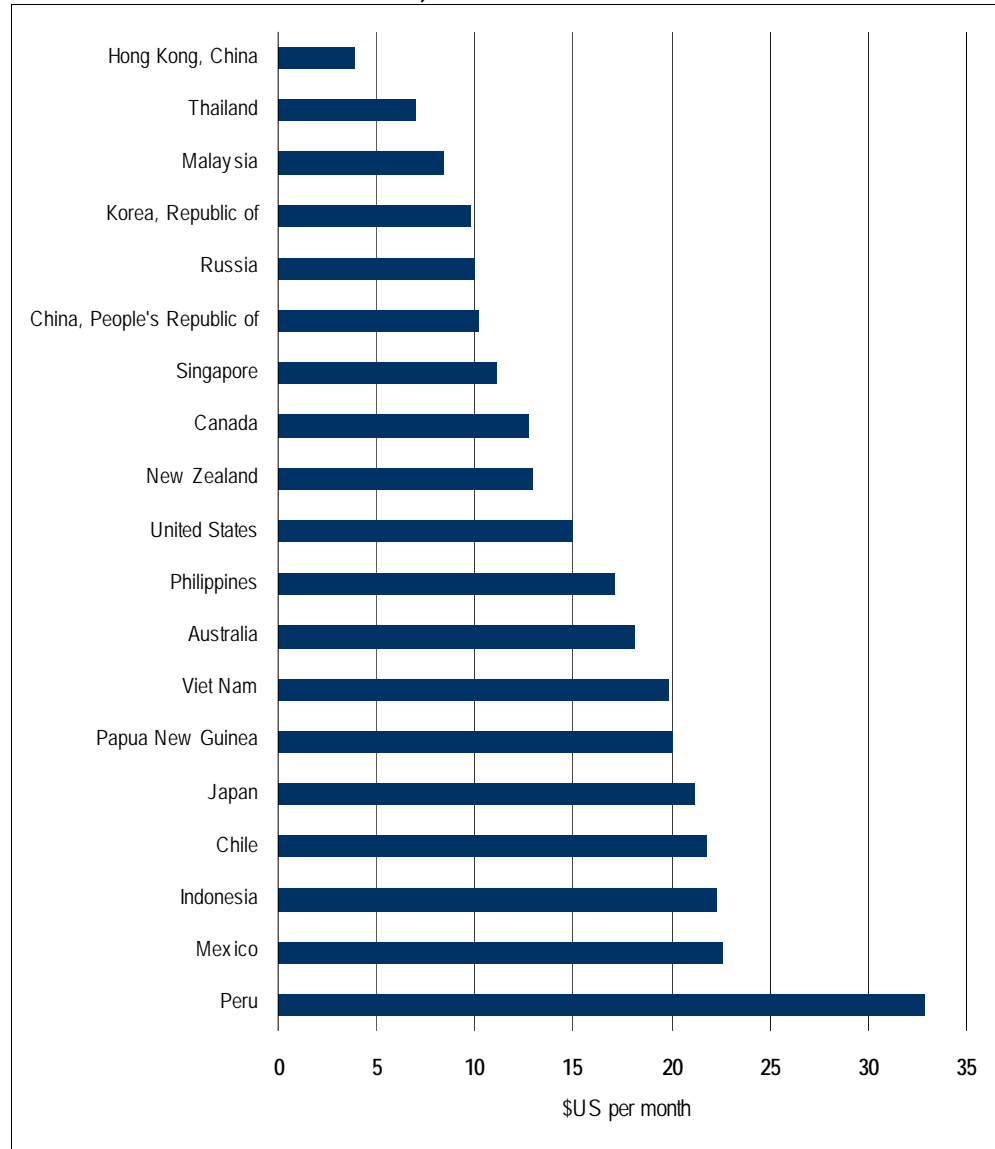
Note: Data is not available for Brunei Darussalam. There is no coverage of credit information in Japan, Papua New Guinea or Russia.

Data source: World Bank (2006b).

### Telecommunications

Modern telecommunications services have become increasingly important to business. Good quality telecommunications enable firms to quickly communicate and transact with suppliers and customers at a relatively low cost and to search for information at high speed. However, the cost and reliability of telecommunications services varies markedly across economies. For example, the cost of an internet connection ranges from US\$ 3.85 per month in Hong Kong, up to an exorbitant US\$ 32.84 per month in Peru; this is US\$ 10 per month more than in the next most expensive APEC economy (see chart 3.7). Nearly all of this variation can be explained in terms of differences in government policy: costs are higher

## 3.7 Cost of internet connection, 2003



*Note:* Data not available for Brunei Darussalam or Chinese Taipei.

*Data source:* WDI Online database (accessed 23 January 2007).

where governments have restricted entry and been unable to develop regulatory regimes that encourage competitive supply of telecommunications services.

According to the World Bank, increased competition in the telecommunications market in many economies in recent decades has resulted in lower prices, shorter waiting times for connections, and faster expansion of services. However, as the World Bank shows, a number of APEC economies still do not allow full competition in provision of international telephone calls (2004, p. 131).

### *Electricity*

Electricity is a vital input into the production process for most firms. Access to a reliable electricity supply at a reasonable price will therefore be a key consideration for firms when choosing a location to invest. Temporary loss of electricity supply is costly for firms in terms of lost production. The World Bank reports that firms estimate electricity outages cost them, on average, 5 per cent of their annual sales (World Bank 2004, p. 131). Unreliable supply also leads to firms, frustrated by power fluctuations, to invest in self-generation. But electricity generated this way is far more expensive, making it difficult for small firms that do not have the capacity to absorb the fixed costs associated with self-generated electricity (Adenikinju 2003). Fluctuations in voltage can also damage machinery which can lead to long-term higher business costs because equipment needs to be replaced more frequently. And in some countries governments require electricity utilities to cross-subsidise supply to households by charging higher prices to industrial users.

## **Case study: improved road infrastructure in the Greater Mekong Subregion (GMS)**

During the 1980s and 1990s many formerly centrally planned economies started a transition towards market-based systems. Among these were several economies (China, Viet Nam, Lao PDR and Cambodia) that share the waters of the Mekong River, and which form (with Thailand and Myanmar) the Greater Mekong Subregion (from here on the GMS).

The transition programs have underpinned strong growth performances in most of these economies. However, governments have been concerned that poverty remains high in landlocked regions and in areas with limited transport access to markets. Indeed, empirical evidence suggests that the high transport costs for landlocked areas are negatively related to economic growth.<sup>5</sup> The GMS economies have thus chosen to embark on a major regional initiative to improve connectivity with each other and with the rest of the world by improving transport infrastructure and reducing policy and procedural barriers to the movement of goods and services within the region.

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<sup>5</sup> When controlling for other factors that affect economic growth.

### ***GMS road infrastructure improvement program***

In 1992, with the Asian Development Bank playing the role of facilitator, six GMS economies<sup>6</sup> came together to develop a program to enhance economic connectivity in the region. The program aims were to link the GMS economies through improvements in infrastructure, thus overcoming domestic constraints and promoting trade and investment to boost economic growth. The GMS Program prioritises and implements subregional projects in transport, energy, telecommunications, tourism, trade and investment, agriculture<sup>7</sup>, human resource development and the environment. This case study focuses on the Program's efforts to improve road infrastructure.

Road infrastructure has been developed along three main economic corridors: North-South, East-West, and Southern, linking the GMS economies and providing access for land-locked areas to ports. The corridors are illustrated in chart 3.8. With just three economic corridors, the road network covers six economies, allows passage east-west from the Andaman Sea off Myanmar across to the South China Sea off Viet Nam, and north-south from China all the way to the Gulf of Thailand. The road networks have been designed to include capital cities and ports, and to pass through some of the poorest, landlocked areas. Full implementation of the road transport infrastructure is expected to be complete by 2015. It is important to note that the exact design and path of new road infrastructure is a continually evolving process, responding to the changing needs of the GMS.

Priority infrastructure projects worth over US\$6.8 billion have been completed, or are in the process of being completed since the GMS Program began. The Asian Development Bank has been a major financial supporter of the GMS Program, extending loans of US\$1.9 billion and grants of US\$73.2 million. Other financing has been provided by country governments (US\$2.2 billion) and other sources, both official and private, on a co-financing basis (US\$2.7 billion) (Pante, F. personal communication, 5 March 2007).

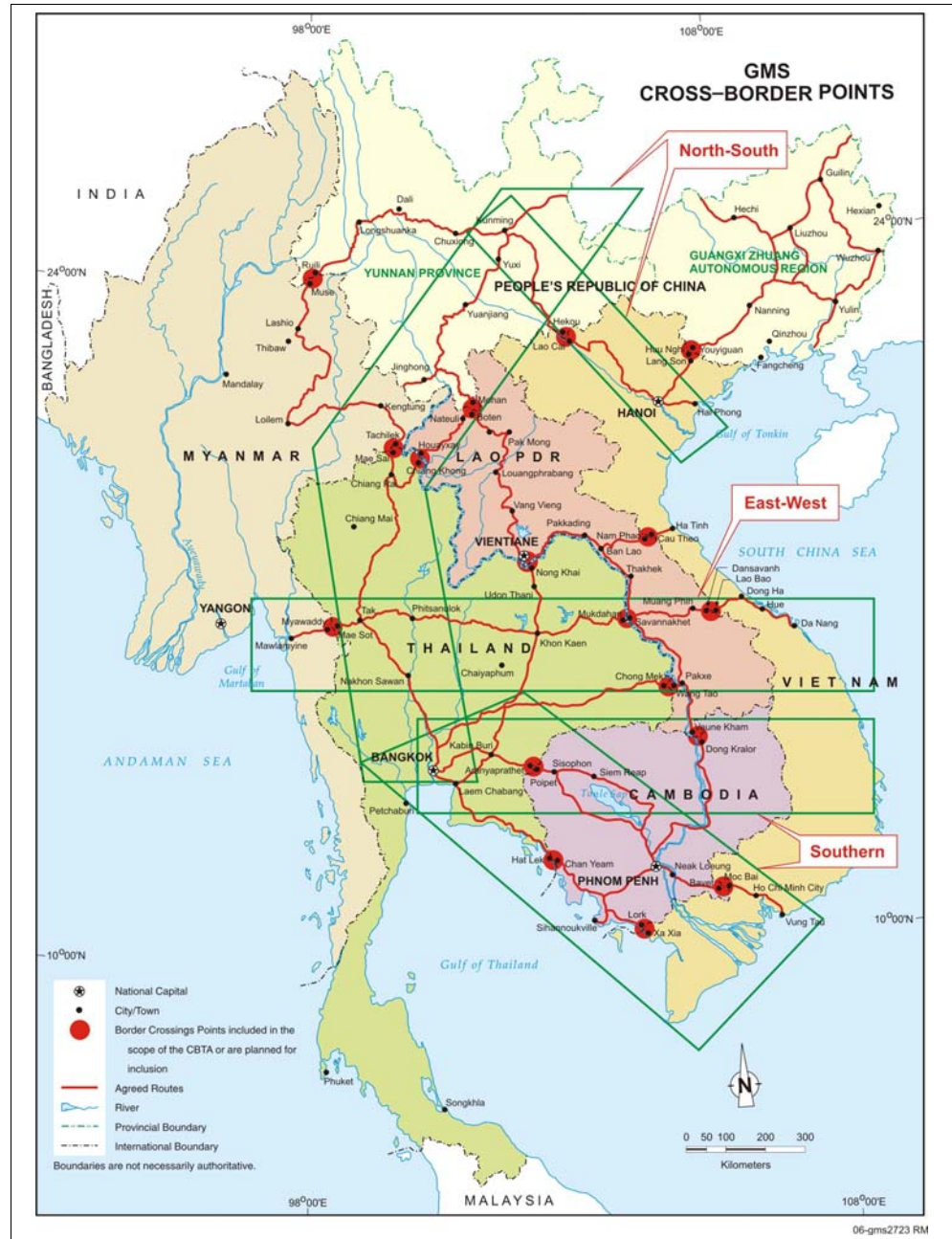
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<sup>6</sup> Thailand, Viet Nam, the People's Republic of China (the latter joining in December 2004), plus non-APEC member economies Cambodia, Myanmar and Lao PDR.

<sup>7</sup> Agriculture was added to the Program in 2003.



3.8 Economic corridors for GMS



Source: Turner, P. ADB, personal communication (2 April 2007).

**Motivation for the GMS Program and the road infrastructure component**

The principal motivation for the GMS Program at the time of its establishment was to help promote economic growth among the GMS economies through subregional economic cooperation. The Asian Development Bank judged that it was the perfect time to initiate such a program of cooperation, considering the onset of peace in the subregion and the ongoing transformation of centrally planned economies to market-

based economies. The Asian Development Bank also reasoned that subregional economic cooperation would contribute to regional peace and stability (the ‘peace dividend’) after long periods of conflict.

The underlying strategy was to eliminate the barriers to economic cooperation. The lack of physical connectivity was considered to be one of the major obstacles. The high cost of moving goods and people, in terms of both time and money, was discouraging cross-border transport, which in turn reduced the economic interaction between the subregional economies.

### ***Process of GMS Program and road infrastructure***

The initial impetus for reform came from the Asian Development Bank, which facilitated the GMS Program. An initial report by independent consultants on the transport sector provided much of the framework for the current road infrastructure. This report was developed in consultation with the GMS member economies, and was endorsed by all members. In that report, projects for improving road infrastructure (along with other transport infrastructure) were identified and prioritised according to five principles. These principles are summarised in box 3.9.

#### **3.9 Principles for project selection and prioritisation — GMS Program**

1. Priority given to improvement and rehabilitation of existing infrastructure rather than the construction of new infrastructure.
2. Priority given to subregional projects on which there is already agreement among economies directly concerned.
3. Trade generation impacts need to be taken into account in the formulation of projects.
4. Projects should provide immediate benefits, and should be implemented in sections or stretches.
5. Financial considerations and criteria for project selection including the subregional (rather than national) character of the project.

Source: Asian Development Bank (1993).

Underlying the rationale of these five guiding principles is a pragmatic approach to improving roads – do what you can, where you can, when you can. Improving existing road infrastructure was given a higher priority than the construction of new roads because this provided a greater benefit relative to the cost. Similarly, the project focused on road infrastructure rather than other transport infrastructure like rail, because roads are much less expensive to construct or improve, and standards don’t differ as significantly.

The success of these investments has helped to garner support for the overall framework of road networks by building trust between the GMS economies and the Asian Development Bank. It has facilitated greater cooperation amongst the economies, enabling positive outcomes from negotiations on sensitive issues like harmonizing of customs, institutional, legal and other related elements of the transport system.

The Cross-Border Transport Agreement provides the GMS with a comprehensive common approach to all cross-border issues, which are generally recognised as more sensitive than hard infrastructure. The agreement was ratified in December 2003, with full implementation expected by 2007–2008. This agreement helps the GMS economies deal with potentially sensitive issues such as customs, road infrastructure standards, movement of persons across the border (for example visas for people in the transport industry) and road vehicle standards.

### ***Benefits of reform***

To date, there has been no comprehensive assessment of the benefits and costs of improved infrastructure along economic corridors in the GMS. However, significant benefits are apparent. The benefits and costs of individual projects have been assessed, often several years after the completion of the project. The costs and benefits of the road infrastructure frequently differ across projects and economies, and tend to be related to the level of economic development of the economy and other geographical considerations.

The direct benefits of the road infrastructure are measured through reduced vehicle operation costs and savings in reduced maintenance costs. While these costs are estimated when the project is proposed, only a handful of projects have been evaluated. A recent report on the Phnom Penh (Cambodia) to Ho Chi Minh City (Viet Nam) highway noted that the project road improvement has

realised considerable time savings and reduction in vehicle operating costs; eased traffic jams at the An Suong Intersection; induced more competition among transport service providers, leading to lower passenger fares and freight shipping charges; raised land values in the area; and led to an increase in economic activities, creating off-farm employment opportunities for the local population ... (Viet Nam Ministry of Transport 2006).

As a consequence of lower cross-border transport costs, trade within the GMS is expected to increase. Econometric modelling by Fujimura and Edmonds (2006) shows that improving road infrastructure has played an important role in increasing trade within the GMS economies. This

illustrates that better physical infrastructure is helping the GMS Program achieve its goal of greater integration and connectivity.

Trade flows have increased because of the lower costs associated with transport, in terms of both time and money. Early figures show dramatic improvements in travel times for completed sections of the economic corridors (Asian Development Bank 2007). These travel times will again dramatically improve as the necessary customs procedures are streamlined at border crossings through the Cross-Border Transport Agreement.

The flow-on effect of shorter travel times highlights the importance of improved road infrastructure for economic development. Shorter travel times mean more goods will be transported at lower cost across borders to reach new markets and provide greater competition and other gains from increased trade. The new road infrastructure is also increasing economic activity in the regions around the economic corridors, creating employment opportunities for the local population (Viet Nam Ministry of Transport 2006). This increase in economic activity should have important benefits for the poorest people, since the economic corridors pass through some of the poorest parts of the GMS economies.

The benefits of these and future improvements in road infrastructure are expected to increase as the institutional, legal and other related elements of the transport system to support the physical infrastructure are implemented. These related institutional aspects of the transport system will increase the efficiency of the use of the roads, lower costs, increase the return from the investment in infrastructure, and encourage economic growth.

## Key messages

Private investment decisions are based on expected profitability. Therefore government actions that increase business costs discourage firms from pursuing investment opportunities that would otherwise be profitable.

Some of the main cost-increasing behind-the-border barriers to investment are inefficient taxes, high costs of financial intermediation, excessive regulation, corruption, and inadequate provision of infrastructure.

Some of these costs arise because governments are not yet using the most efficient ways of financing their activities or of intervening in markets to achieve regulatory objectives. Others arise because governments may not be giving sufficient priority to the delivery of public goods and services

that are essential to economic development. And some costs, such as corruption, may be symptomatic of excessive or inefficient regulation or the need for broad-reaching public administration reform.

# 4

## *Risk-increasing barriers*

Investment involves an upfront cost in exchange for a future stream of benefits. Investment decisions are therefore always forward-looking. But investors do not have perfect foresight, so all investment involves accepting some risk. Indeed accepting risk is a normal part of doing business. However, government actions can unnecessarily increase the risk associated with investing and thus create a barrier to investment.

Investors generally require a higher expected return on an investment to compensate them for bearing more risk. Increasing risk therefore reduces the range of investment opportunities on which firms would expect to earn a rate of return they consider satisfactory. According to the World Bank (2004, p. 23), firms operating in some high-risk economies require more than twice the rate of return they would in lower-risk economies. Alternatively, firms may adopt shorter time horizons or choose not to invest in that location at all. Consequently, the level of investment in those higher risk economies is lower, and domestic and foreign savings flow to locations with lower risk even though expected returns may also be lower.

Some of the most important risk-increasing barriers to investment are:

- an inefficient legal system and poorly defined property rights;
- lack of developed financial markets, insolvency laws and creditor protection; and
- lack of policy predictability and credibility.

### **Legal system and property rights**

Clearly defined property rights are fundamental to a market-based economic system. They must also be enforceable, which requires the backing of the legal system.

A cross-economy comparison of property rights protection is attempted by the Heritage Foundation as part of its *Economic Freedom Index*. For each economy, the strength of laws protecting property rights and the degree to

which they are enforced is graded against a set of criteria. Most of the more developed APEC economies received a grading of 90 per cent on this measure (chart 4.1). This means that:

- private property is guaranteed by the government;
- the court system enforces contracts efficiently;
- corruption is nearly non-existent; and
- expropriation is highly unlikely.

By contrast, Viet Nam received a grading of only 10 per cent. This suggests that:

- private property is poorly protected and property rights are difficult to enforce;
- the court system is so inefficient and corrupt that outside settlement and arbitration is the norm;
- judicial corruption is extensive; and
- expropriation is common.

### *Property rights*

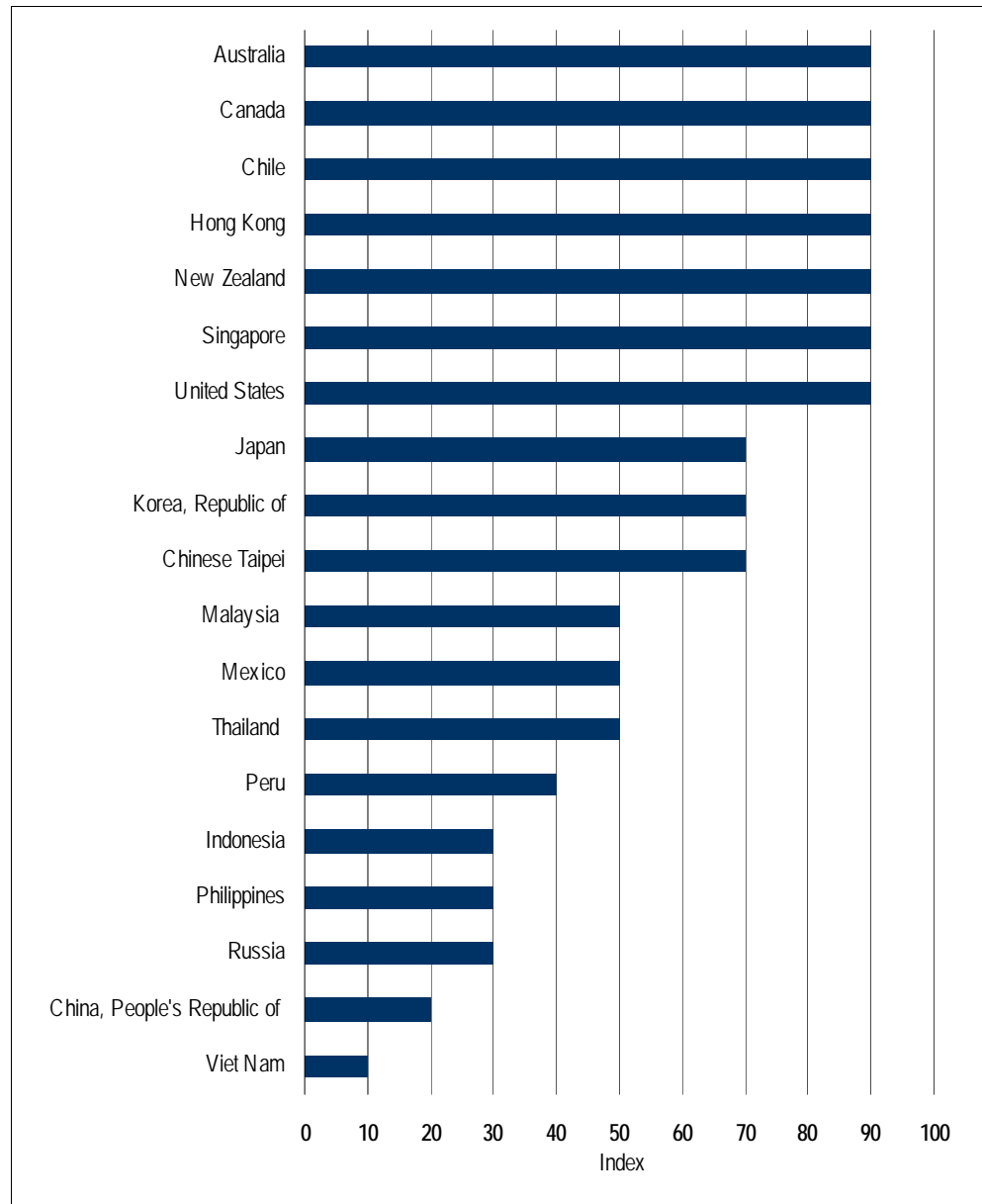
Property rights give the owner control over something of value, that is, an asset. These assets can be physical (such as title over a piece of land), financial (such as a share in a company) or they can be some exclusive right (such as intellectual property rights or the right to fish a piece of water).

Control of the asset is defined as:

- the right to use it;
- the right to income derived from it; and
- the ability to transfer those rights.

Property rights are a fundamental necessity of a market-based economic system. They are the link between effort and reward and underpin market exchange. Without secure property rights, there is little incentive to invest, since there is no enforceable link between the investor and the rewards generated by that investment. A farmer without secure property rights over land and its produce is less likely to plant a crop if someone else can reap the reward from it. Lack of clear property rights in Peru prompted eminent economist Hernando de Soto to write his seminal work, *The Mystery of*

## 4.1 Property rights index, 2007



Note: Data not available for Brunei Darussalam and Papua New Guinea.

Data source: Heritage Foundation and The Wall Street Journal (2007).

*Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else.* This work has helped to establish property rights as the 'foundation stone' of a market economy.<sup>8</sup>

<sup>8</sup> While Hernando De Soto and the Institute for Liberty and Democracy, of which he is founder and President, initially focused on property rights in Peru, their work has been extended to developing economies in general and former Soviet nations making the transition to a market-based economy. For more information on the work carried out by Hernando De Soto and the Institute, see [www.ild.org.pe](http://www.ild.org.pe).



Many studies show a strong relationship between growth and property rights security. In Thailand, farmers who were granted title over their land invested to such an extent that their output was 14 to 25 per cent greater than those farmers working untitled land (Feder et al 1988). Land and other property rights can also be used as collateral on a loan, since ownership is much easier to verify for registered titled property. Verifiable property rights are always useful as collateral, since they provide the lender with some assets to seize, should the borrower default. So, property rights increase small businesses' access to finance. In the case of Thailand, farmers with titled land were able to borrow between 50 and 500 per cent more from banks than those without land titles (Feder et al 1988).<sup>9</sup> Using these borrowed funds, farmers were then able to invest and expand production.

Property rights are so insecure in some economies that guarding occupied property is necessary to prevent someone else taking it. In Peru those people who had titled land were able to work an additional 20 hours per week than those in the same neighbourhood but without land titles (Field 2002).

One way governments can directly compromise the security of property rights is through expropriation (see box 4.2).

#### 4.2 Expropriation of private assets

Expropriation is when the government takes possession of a private asset, often without adequate compensation. In some circumstances expropriation may be justified in the public interest. Governments must be able to order the destruction of livestock to fight a health crisis, or take land to build important infrastructure that benefits many citizens. However, governments in some economies have also seized private property without a clear public benefit and without adequate compensation. The threat of expropriation is a risk to firms and a barrier to investment. All governments have the power to expropriate private assets; however, firms perceive the risk to be much greater in economies where the government has a record of expropriating private assets and where there is no legal requirement to provide adequate compensation.

In Peru in the 1980s there was a spate of expropriations under a law providing for minimal compensation. The risk of expropriation discouraged firms from investing and fixed capital investment fell to 16 per cent of GDP. The 1993 constitution now requires governments to reimburse firms for the actual value of any property taken, as well as any possible loss (World Bank 2004, p. 94). This measure restored confidence and the investment share of GDP recovered to 24 per cent by 1997.

An efficient land titling system therefore encourages investment. According to the World Bank's *Doing Business* survey (2006b), it takes 144

<sup>9</sup> The titled and untitled properties were of identical quality.

days to register a land title in Malaysia (table 4.3). This is significantly longer than in any other APEC economy and is clearly a barrier to investment. By contrast, it takes just two days in New Zealand and Thailand to register property, and five days in Australia and Chinese Taipei.

#### 4.3 Time taken to register property

<i>Economy</i>	<i>Days taken</i>	<i>Economy</i>	<i>Days taken</i>
New Zealand	2	China, People's Republic of	32
Thailand	2	Peru	33
Australia	5	Philippines	33
Chinese Taipei	5	Indonesia	42
Singapore	9	Russia	52
Canada	10	Hong Kong, China	54
Korea, Republic of	11	Viet Nam	67
United States	12	Papua New Guinea	72
Japan	14	Mexico	74
Chile	31	Malaysia	144

*Note:* Data not available for Brunei Darussalam.

*Source:* World Bank (2006b).

Property rights are not just about physical assets. Government-enforced intellectual property rights confer on creators of inventions or artistic material a right to the exclusive use of that material for a period of time. They therefore encourage investment in research and development, innovation and creativity. Intellectual property rights give the holder control over an idea through patents, copyright and trademarks.

Without intellectual property rights, it is not possible to profit from an idea. This discourages investment in new ideas and knowledge because there is no link between effort and reward. However, intellectual property rights are also a barrier to competition because the holder has exclusive control over the idea. Governments must find a balance between encouraging innovation and minimising barriers to competition.

There is a close link between innovation and productivity growth. In a competitive environment, firms are constantly innovating to find the best technology and management practises in order to gain a competitive advantage. Intellectual property rights encourage innovation and therefore are an important contributor to productivity growth.

### *Contract enforcement*

To be of value, property rights must be enforceable. This requires the backing of the legal system. Property rights also underpin market exchange. When property rights are exchanged both parties face the risk

that the other does not honour their obligations. In these circumstances, it is important that the contract can be enforced through the legal system. According to the World Bank, 'delays or uncertainties in the enforcement of exchange erode the value of property rights and diminish the opportunities and incentives to invest' (2004, p. 84). To emphasise the point, de Soto (2001) points out that the majority of the world's poor live outside the protection of property law.

When the cost of resorting to the legal system to enforce a contract is high, or the probability the court will make a correct decision is low, firms are much less likely to pursue matters through the legal system. In these circumstances there is less incentive for firms and individuals to honour their obligations. This increases the risk associated with doing business and discourages investment. In many economies, inefficient court systems raise the cost of enforcing contracts.

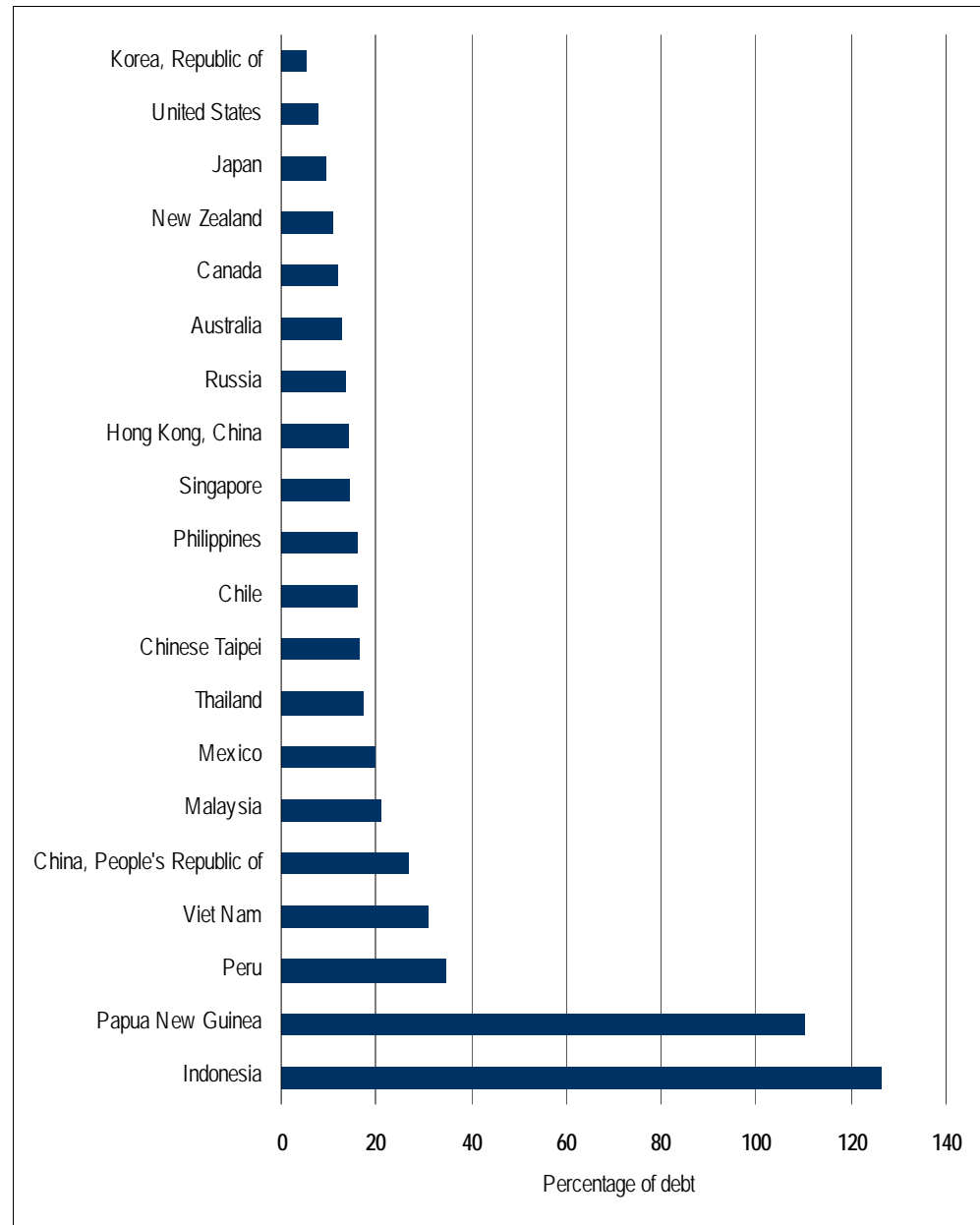
The importance of an efficient court system is highlighted by the findings of Laevan and Woodruff (2003). They found that in Mexico, larger firms are found in states with better court systems. A one-standard deviation improvement in the quality of the legal system increases the average firm size by about 10 to 15 per cent. So even though all states in Mexico have the same legal origin and firms are governed by the same nationwide laws, those firms in states with more efficient court systems faced lower risk, which encourages greater investment. Furthermore, the technical efficiency of firms tends to increase with firm size. Better court systems will therefore also encourage greater productivity.

As part of the *Doing Business* project, the World Bank (2006b) uses a number of indicators measuring the efficiency of the judicial (or administrative) system in collecting overdue debt. The indicators compare the number of administrative procedures, the time taken to resolve the case, and the cost as a share of the debt being collected for a comparable case across economies. Each indicator is a measure of the cost of enforcing a contract through the legal system. The comparable case is based on a legal transaction, where the debt is worth 200 per cent of the economy's per capita income. Initially the debtor defaults on the payment. The plaintiff is assumed to have fully complied with the contract and attempts to recover the debt by filing a lawsuit or commencing an administrative process, if available. Essentially the debtor opposes the complaint where possible and the judgement is eventually in favour of the plaintiff.

Indicators of judicial efficiency vary widely across APEC economies. In Korea, collecting an overdue debt through the legal system costs only 5.5 per cent of the debt, compared with 126.5 per cent in Indonesia (chart

4.4). The cost of collecting the debt through the legal system also exceeds 100 per cent in Papua New Guinea. When the cost of collecting the debt exceeds the amount of the debt, there is clearly no incentive to enforce contracts through the legal system in those economies. There is also considerable variation among APEC economies in terms of time taken to collect the debt. The time taken ranges from 109 days in New Zealand to 600 days in the Philippines.

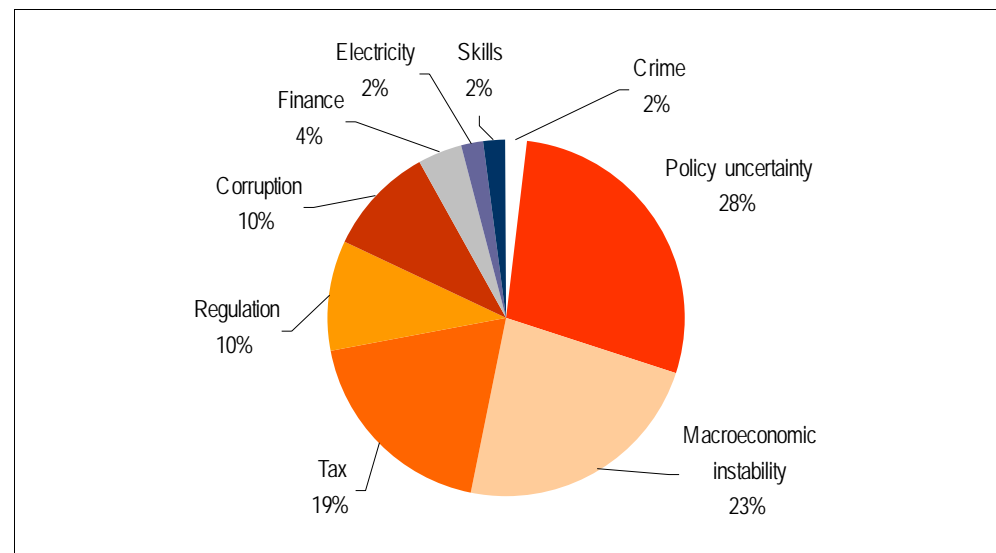
#### 4.4 Cost of collecting an overdue debt



## Policy predictability and credibility

The government is a key source of risk for firms in many developing economies in APEC. Risk stems from government policy and behaviour include the future direction of policy and how existing policies are interpreted. The World Bank's investment climate surveys show that firms in developing economies rank policy uncertainty and macroeconomic instability as their dominant concerns (chart 4.5). More predictable and credible policy can increase the probability of investment by 30 per cent (World Bank 2004, p. 23).

### 4.5 Policy uncertainty dominates the investment climate concerns of firms



<sup>a</sup> Share of economies where firms report issue as top constraint in surveys of 48 economies.

Data source: World Bank (2004).

One example of where improved policy predictability and credibility has decreased the risk for firms is in the area of monetary policy. While not always achieved, the importance of a stable macroeconomic environment is widely accepted as an important policy goal. Large fluctuations in demand and unstable prices directly affect firms' profits. Macroeconomic instability therefore increases risk and reduces investment.

Inflation targeting has become a popular monetary policy over the past 15 years. Within the APEC region, New Zealand, Canada, Australia, Korea, Chile, Thailand, Mexico, Peru, the Philippines and Indonesia have all adopted an inflation targeting framework. Inflation targeting regimes are characterised by a clear commitment to an explicit inflation target, which is the primary goal of monetary policy. It is important for the central bank to have independence from the government so that monetary policy decisions are not compromised by political pressure. These characteristics help to

build credibility and anchor inflation expectations. Greater transparency also increases the predictability of policy. Furthermore, a number of studies have suggested that inflation targeting has been associated with improved macroeconomic performance in both developed and developing economies (International Monetary Fund 2005).

Another source of risk for firms comes from changes to the regulatory environment. Even an exclusive property right is not necessarily unrestricted. The owner of a car has the exclusive right to drive the car, but must still abide by traffic rules; they must drive the car on the designated side of the road, not exceed the speed limit, stop at red traffic lights and so on. These restrictions may be necessary to ensure public safety, but nevertheless impinge on the way the car owner can use the car. By changing the traffic laws, the government effectively changes the property rights of all car owners. So there is a link between property rights and regulation.

In a business context, changing regulations can change the way firms are able to use their assets. Often this will affect profits. Frequent policy backflips and inconsistent application of regulation therefore increases risk for firms and discourages investment. One way governments can enhance their credibility is by entering international agreements that commit to sound policies, as the following case study shows.

## **Case study: improving policy predictability, China joins the WTO**

### ***Background***

In 1978 China embarked on a path of modernisation that included widespread reform to open the economy to the world and orientate itself towards a market-based economy. While China was an original member of the General Agreement on Tariffs and Trade (GATT), predecessor of the World Trade Organisation (WTO), it left shortly after GATT's inception in 1949. Almost forty years later China applied for renewed membership in the GATT, and so began the 15 year accession to the GATT/WTO. China officially joined the WTO on 11 November 2001. In order to join the WTO China has undertaken what is considered one of the most extensive accession processes.

The WTO is a global organisation that deals with rules of engagement for trade between member countries. Through multilateral trade agreements

that operate in 'Rounds', the WTO also facilitates reductions in trade barriers. Trade liberalisation is a particularly important step for an economy such as China (which was then in transition to market status) because opening up to the global economy injects competition into the domestic economy and encourages innovation, productivity growth and, ultimately, economic growth. Just as important is that membership of the WTO means that tariff rates cannot go above agreed 'bound' rates and the government has to commit to WTO rules and dispute settlement procedures. These features restrict domestic governments from arbitrary changes in policy and provide traders with comfort concerning dispute settlement procedures. This gives those countries trading with China greater certainty about the policy behaviour of the government, and more confidence to invest. The latter is the focus of this case study, as it improves the policy predictability and credibility of the investment climate, reducing risk and thereby encouraging investment.

### ***What does accession to the WTO require?***

Joining the WTO has meant China's laws, trade policies and domestic regulation have had to change dramatically. As part of its entry commitments, China has had to reform these policies in order to make domestic laws and regulations compatible with WTO arrangements. This has required more than 20 laws relevant to trade to be enacted, revised or abolished by the National People's Congress. Some 756 WTO-compliant regulations have also been implemented. The application and administration of these laws and regulations, as agreed by China, must be in a uniform, impartial and reasonable manner.

The accession process requires greater dissemination of laws, regulations, and any changes to these, providing greater transparency in policies pertaining to or affecting trade in goods, services, trade-related aspects of intellectual property rights and the control of foreign exchange. All the relevant laws, regulations and measures governing international trade are available from open sources such as the websites of Chinese government agencies, and published documents. They are also translated into one or more WTO official languages. Moreover, enacting new laws and rules about international trade must be made public, with consideration of relevant stakeholders' opinions.

### ***The motivation for joining***

During China's years of accession to the WTO, support for joining the WTO fluctuated. Early on when China first applied, the focus was to renew the

membership in GATT. This was only nine years after the initial opening up of the economy. The application to join was more symbolic of China returning to the international community – hardly anyone knew what it meant for China to be a member of GATT at that time.

Since the mid-1990s, however, the focus changed and China's motivation for joining the WTO can be explained by several reasons:

- Joining the WTO would provide the necessary impetus to keep domestic reforms moving. For example, after 1985, the reform of state-owned enterprises achieved little because of protection from international competition.
- China realised that, to participate in the hi-tech revolution of the 1990s, it would have to be accepted as a credible player in the international economic system, which included protection of intellectual property rights. This is supported by China joining the Information Technology Agreement to phase out all tariffs on IT products by 2005 (Prime 2002, p. 6).
- WTO membership would encourage more FDI in the economy, which is particularly important for developing China's technological capabilities.
- The 1997-98 Asian financial crisis signalled the urgent need to secure access to world markets via acceptance of the rules of the WTO. The growth rate of China's exports dropped to almost zero in 1998 due to extensive currency devaluations by South-East Asian countries. This was particularly important given sluggish domestic consumption due to the state-owned enterprises' growing debt crisis.
- It was apparent that joining the WTO would create a more certain policy environment for economic activities. Joining the WTO would give traders access to dispute settlement mechanisms. It would also avoid the requirement for China to be subject to annual US Congressional reviews of their Most Favoured Nation (MFN) status.
- Finally, as an emerging economic power, it was no longer in China's interests to act passively according to the international trade rules set by others. Once in the WTO, China could 'weigh in' and influence international rules of trade and governance.

Ultimately, the Chinese leaders recognised the motivation for joining the WTO was to carry forward the policy of opening the domestic economy in a more certain policy environment.<sup>10</sup>

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<sup>10</sup> Summarised by Long Yongtu, China's chief negotiator during the WTO accession talks.



### ***Benefits of accession to the WTO***

Benefits from the accession to the WTO come from both the reforms undertaken to comply with conditions of accession to the WTO and from the benefits of being a member of the WTO.

Accession to the WTO, as already mentioned, has required that domestic laws and regulations be compatible with the WTO. Fulfilling this obligation has meant that governmental functions have had to be transformed, and a less interventionist approach adopted. Market mechanisms have replaced control economy regulations, allocating resources more efficiently, and there has been greater corporatisation of state-owned enterprises, creating a more efficient and competitive operating environment. Many of these reforms of legislation and regulation have meant more equitable treatment of foreign firms. As these laws have allowed for greater inflows of foreign capital, investment in the Chinese economy has boomed. China is now among the world's largest recipients of FDI, attracting US\$72.4 billion in 2005 (UNCTAD 2006). This large capital inflow has also been partly encouraged through the establishment of a more stable and predictable policy environment, which has lowered the risks for domestic and foreign investors.

WTO membership gives its members access to a rules-based system with a dispute settlement body available should members break the rules. The rules-based system of the WTO provides a fair, transparent, stable and predictable legal system and environment for doing business. The rules-based system is particularly important for improving the predictability of the behaviour of governments and business. The dispute settlement mechanism is important for giving credibility to the policies of member countries. It does this through creating a disincentive to break the rules of the system because there will be consequences to such actions.

Joining the WTO means members are bound by their agreements, which provides market access for Chinese exporters into foreign economies on an MFN basis and, likewise, access for foreign firms into China. China's share of international trade has grown at a staggering rate – more than 20 per cent per year. Agricultural exports alone have averaged around 15 per cent growth over the past five years and China has become the fifth-largest agricultural commodity exporter in the world.<sup>11</sup> Many factors explain this increase in trade but opening to the world economy is a large part of the explanation.

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<sup>11</sup> China continues to be a net importer of agriculture commodities, but only because demand for industrial raw goods is so large.

The greater predictability and credibility of the policy environment facilitated through WTO membership has encouraged greater investment. WTO accession reforms and membership has contributed to staggering growth in FDI and international trade and China's amazing record of economic growth. GDP growth has averaged more than 10 per cent from 2001 to 2006 and now China is the world's fourth-largest economy. National income per capita reached \$1,700 in 2006, and those in poverty in rural areas have been reduced by 500 million people. Again, while many factors account for this boom in investment, joining the WTO has facilitated a large part of the extra investment.

As the five-year transition period ends, the protection of sensitive industries will cease. Acting within WTO rules, China will promote development by competition. That is an irrevocable trend. Joining the WTO has cemented China's globalisation and encouraged a more secure and predictable policy environment at home and abroad, and so encouraged investment and growth.

## **Financial markets, investor protection and insolvency laws**

A key function of the financial system is to price and trade risk (Levine 1996). This enables risk to be shared and held by those more willing to bear it (World Bank 2001). This reduces the risk faced by individual firms and therefore encourages investment.

As noted in chapter 3, greater access to external financing increases investment. A key element of financial system development is the legal environment. Failure to provide adequate legal protection for minority investors is therefore a barrier to investment. Weak investor protection increases the risk faced by minority investors. Consequently, they will be less willing to fund investment opportunities. A strong legal environment is therefore critical to the development of financial markets.

Adequate legal protection for minority shareholders increases the depth of equity markets. This reduces liquidity risk, which arises due to uncertainties associated with converting an asset into a medium of exchange. Some high-return investment projects require a long-term commitment of capital. However, savers often do not like to relinquish control of their savings for long periods of time. Consequently, in the absence of liquid capital markets, many high-risk, high-return projects would not go ahead. Liquid capital markets make it easy for equity holders to sell their shares and gain access to their savings, while giving firms

permanent access to the capital initially invested. So, by reducing liquidity risk, financial markets facilitate investment.

Inadequate legal protection of shareholders increases the incentive for company directors to use corporate assets for personal gain. This is referred to as self-dealing (World Bank 2005). The World Bank's investor protection index is an indicator of the strength of minority shareholder protections against directors' misuse of corporate assets for personal gain. The index is constructed from a survey of corporate lawyers, based on a fictitious self-dealing transaction. Three elements of investor protection are covered by the index:

- transparency of the transaction, which is the extent to which the transaction must be disclosed;
- the extent to which a director engaging in self-dealing is able to be held liable; and
- shareholders' ability to sue officers and directors for misconduct.

The investor protection index ranges between zero and ten, with ten indicating stronger shareholder protection (chart 4.6). Minority shareholders in New Zealand are the most protected from self-dealing in the APEC region, with a score of 9.7. By contrast, Viet Nam received a score of just 2, indicating weak shareholder protection.

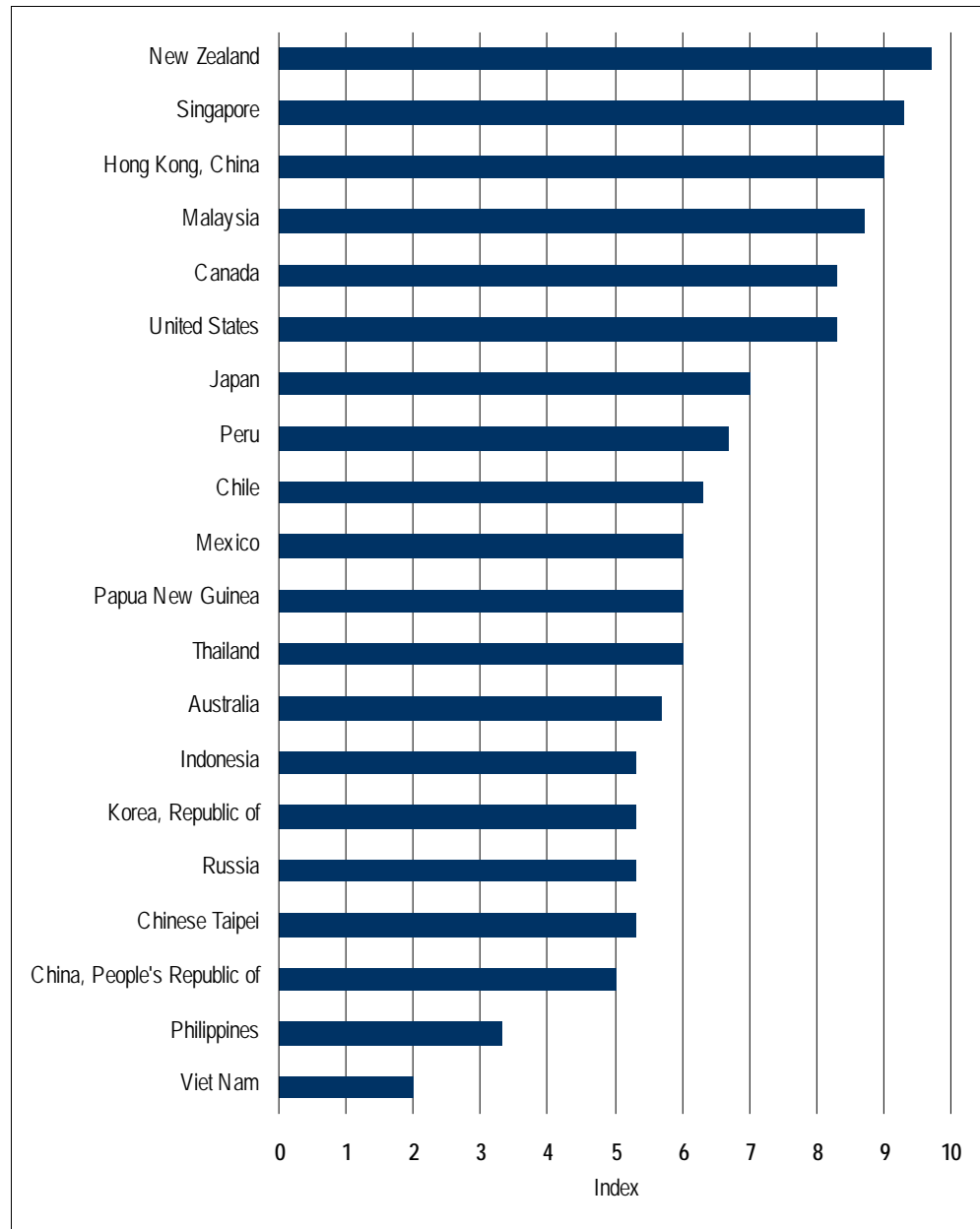
The legal protection given to creditors is another aspect of the regulatory environment that affects the default risk faced by lenders. Inadequate legal protection of creditors increases the risk associated with lending to firms. If the creditor has greater power to force repayment, grab collateral or gain control of the firm, the loss from default is lower for the creditor and so they will be more willing to extend credit.

The World Bank publishes a legal rights index, which measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending (chart 4.7). The index includes seven aspects related to legal rights in collateral law and three aspects in bankruptcy law. The index ranges from 0 to 10, with higher scores indicating that collateral and bankruptcy laws are better designed to expand access to credit.<sup>12</sup>

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<sup>12</sup> See Appendix A for more detail on the construction of the World Bank's *Doing Business* indexes.

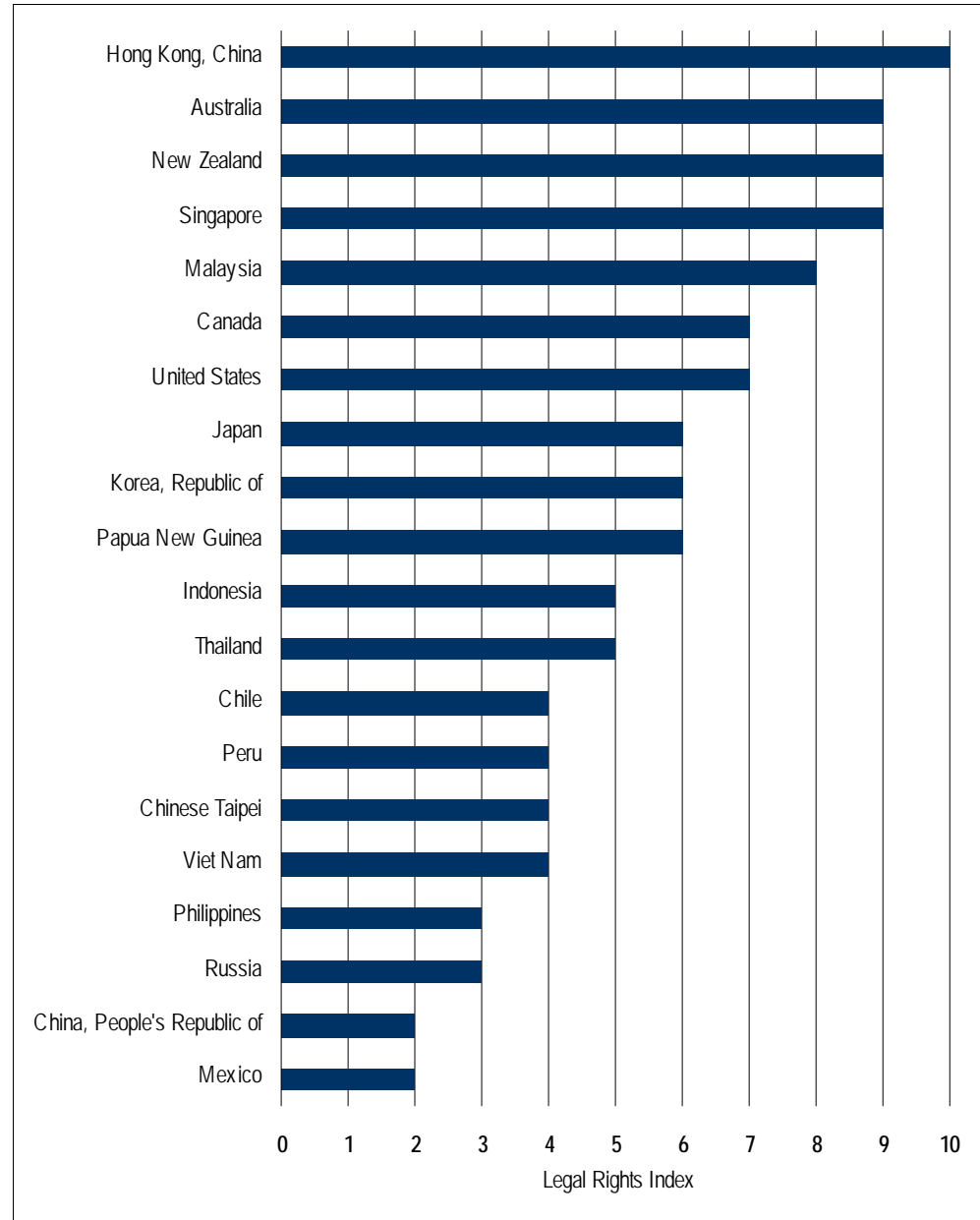
## 4.6 Investor protection index



Note: Data not available for Brunei Darussalam.

Data source: World Bank (2006b).

## 4.7 Legal rights index



Note: Data not available for Brunei Darussalam.

Data source: World Bank (2006b).

The ten aspects of bankruptcy and collateral laws are as follows (World Bank 2006b).

- Secured creditors are able to seize their collateral when a debtor enters reorganisation.
- Secured creditors, rather than other parties such as government or workers, are paid first out of the proceeds from liquidating bankrupt firms.

- Management does not stay during reorganisation. An administrator is responsible for managing the business during reorganisation.
- General, rather than specific, description of assets is permitted in collateral agreements.
- General, rather than specific, description of debt is permitted in collateral agreements.
- Any legal or natural person may grant or take security in the property.
- A unified registry that includes charges over moveable property operates.
- Secured creditors have priority outside of bankruptcy.
- Parties may agree on enforcement procedures by contract.
- Creditors may both seize and sell collateral out of court.

In general, the more developed countries have higher scores on the legal rights index. The Hong Kong economy has all ten desirable features protecting creditors and borrowers, while Mexico and China have only two each.

Protecting creditors is a major element of encouraging a better investment climate and therefore investment and growth. A good example of the benefits from better protection of creditors is Thailand's bankruptcy law reform following the Asian financial crisis of 1997-98 that started in Thailand.

## Case study: insolvency law reform in Thailand

During the 1990s Thailand was one of the world's fastest growing economies. But from 1993, the Thai economy became increasingly vulnerable, due to a build-up of foreign debt, strong credit expansion and asset price booms (EAAU 1999). Furthermore, inflows of foreign capital led to strong growth in real wages. With a pegged currency, this induced a rise in the real exchange rate and a loss of export competitiveness.<sup>13</sup> The fundamental weaknesses in the Thai economy became all too apparent with the onset of the Asian financial crisis in 1997-98.

As a result of the strong inflow of foreign capital, the current account deficit widened, reaching 8 per cent of GDP, with much of it financed by

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<sup>13</sup> Thailand's export slowdown was also caused by demand-side factors such as the decrease in demand from the US (World Bank 1998).

short-term debt. The build-up of short-term foreign debt soon outstripped Thai debtors' ability to repay it,<sup>14</sup> leading to speculative attacks on the pegged Thai baht. On 2 July 1997, the government was forced to abandon the peg and introduce a managed float, while the baht was allowed to depreciate.

The depreciation of the baht had two main effects. Firstly, foreign financial institutions lost confidence in the Thai economy and currency. This led foreign creditors to reclaim the debt from Thai financial institutions and the private sector, causing a large capital outflow. Secondly, since a large portion of Thailand's private sector debt was held in foreign currency, especially US dollars, the burden of debt increased as the baht depreciated. The increased debt burden coincided with a rise in interest rates, leading many businesses to become technically bankrupt.<sup>15</sup> Fifty-six finance companies closed down, which reduced the liquidity of debtors and led to a dramatic increase in non-performing loans (Wisitsora-at nd (a)).

### **Motivation for reform**

As the number of bankruptcies began to increase, the need for some form of liquidation process became apparent. Thailand's bankruptcy law had remained predominantly unchanged since 1940. While it provided protection for the creditor, the process of liquidating the firm was lengthy and the cost of resolving bankruptcies was high.<sup>16</sup> This encouraged creditors to use alternative laws and procedures.

Resolving bankruptcies out of court can be complex when multiple creditors are involved. This had become increasingly common with the financial liberalisation and booming real estate market of the 1990s. Because bankruptcy in Thailand was viewed as a stigma, the traditional practice was for debtors and creditors to have ties that enabled them to reach an agreement that was not too harsh on the debtor (Wisitsora-at nd (a)). When firms started bankrupting en masse, however, there was an increased need for a more efficient process.

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<sup>14</sup> In mid-1995 the short-term foreign debt plus current account deficit was four times higher than Thailand's international reserves (Siamwalla and Wichitaksorn 2004)

<sup>15</sup> Technical bankruptcy occurs because the debt is higher than equity.

<sup>16</sup> Implicit in the previous bankruptcy law was an option for creditor and debtor to negotiate or compromise their debt obligation. Since the bankruptcy law was not the first avenue the creditor used, this option was also infrequently used. Collective action was another disincentive for creditors to use the bankruptcy procedure.

Thailand had a substantial incentive to undertake the necessary reform as the financial crisis spread across the economy, reducing real consumption per capita from Bt7500 to Bt6000-6500 in the period from early 1997 to 1999 (ADB 1999).

### ***Bankruptcy law reform***

Thailand's 1940 bankruptcy law was first amended in 1998 in response to the Asian financial crisis – to speed up the process of liquidation as well as to introduce a process for the restructuring of insolvent organisations (Wisitsora-at nd (a)). The new law allowed companies to be reorganised under court supervision. This process could be initiated either voluntarily by debtors or involuntarily by creditors. A plan of restructuring was devised through court proceedings, binding all parties to the restructuring process, and allowing the organisation to continue operation (Wisitsora-at nd (b)).

The Central Bankruptcy Court was established in 1999 through an amendment to the bankruptcy law. This is a specialised court that has jurisdiction over all bankruptcy filings and its establishment increased the efficiency and implementation of the bankruptcy law (Wisitsora-at 2001).

In addition to the formal mechanism provided by the Bankruptcy Court, the out-of-court Corporate Debt Restructuring Advisory Committee (CDRAC) provided an informal mechanism for debt restructuring.<sup>17</sup> The CDRAC mechanism was a pre-packaged negotiation for the creditor and debtor before entering the bankruptcy procedure to legalise their obligation. With the benefit of low costs, the CDRAC handled a large portion of non-performing loan restructuring. As of May 2003, CDRAC had successfully assisted debtors to restructure debts amounting to US\$37.5 billion or around 70 per cent of non-performing loans at the end of 1999.

### ***Reform process***

The need to improve these laws was recognised long before the Asian financial crisis. Several years before the crisis, drafting had begun on an amendment to the bankruptcy law, but impetus was lacking to move beyond the draft phase. Amendments to the bankruptcy law were passed in 1998 after pressure was placed upon the legislative body by the International Monetary Fund (IMF), and was again amended in 1999.

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<sup>17</sup> Established in June 1998, the CRDAC was decommissioned in 2006.



The IMF provided financial assistance to Thailand, as well as other countries in the region, on the condition that reforms were implemented. While the final push to implement the reforms came from the IMF, the earlier drafting process ensured that the reforms were regarded as internally based and with the understanding of the country (Wisitsora-at nd (b)).

### ***Benefits of the reform***

Bankruptcy law provides a procedure for determining how the assets of the firm are allocated in the reorganisation. From a conceptual standpoint, bankruptcy law is important in reducing the risk associated with lending and borrowing, and consequently the supply of credit (from creditors) and the level of investment (by debtors). Good bankruptcy law provides a framework for resolution of assets belonging to bankrupt firms, with rules governing what and how assets are divided amongst creditors (White nd). This gives creditors confidence that there is an established process for recouping debt in the event of insolvency. It also assists debtors to know the extent of their liability to repay debt.

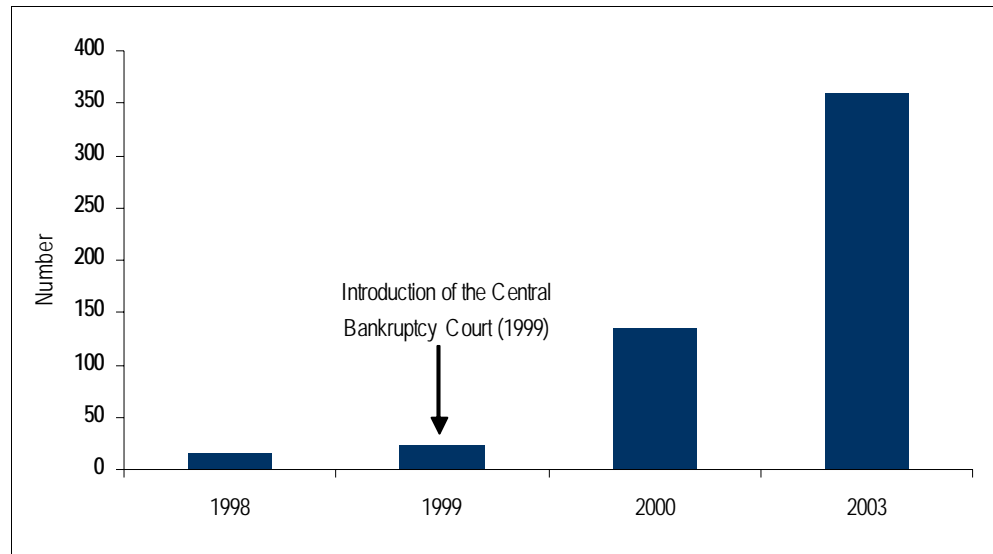
There are many elements that impact upon the risk of investment, making it difficult to isolate or estimate the impact of Thailand's new bankruptcy law upon the supply and demand for credit. What is more apparent is the efficiency gains from the new law. The new law provides a more sophisticated framework for resolving bankruptcy cases, increasing the use of the court system as well as its efficiency. A speedier resolution of bankruptcy means that assets and capital tied up in the firm can be returned to productive use faster. The new bankruptcy law, through providing a more transparent process in the event of bankruptcy, gives creditors and debtors more certainty in their interaction, reducing the risk associated with investment.

The Central Bankruptcy Court has been the main contributor to the more efficient process. A central court that holds the stock of expertise means those decisions will be more consistent, enhancing the predictability of the court and the law (Wisitsora-at 2001). These benefits can be expected to increase as the judges gain more experience in bankruptcy cases.<sup>18</sup> Since the introduction of the Central Bankruptcy Court in 1999, the number of reorganisation cases has increased dramatically (chart 4.8). At the end of 2003, restructuring plan-approval debt was valued at US\$23.2 billion.

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<sup>18</sup> The judicial staff came from the Civil Court, where they usually specialised in liquidation rather than reorganisation.

## 4.8 Reorganisation cases, Thailand



*Note:* Data is stock data and is accumulative since the first case came to court.

*Data source:* Wisitorsa-at (2001) and Wichitaksorn, N., personal communication (24 March 2007).

Another benefit from the new law is the gains from restructuring insolvent firms, rather than simply liquidating them. This allows a temporarily distressed firm that is fundamentally an efficient enterprise to restructure and continue operation. After the Stock Exchange of Thailand introduced new floor and ceiling price limits for trading in December 1997, financially distressed companies were found to have improved their performance after their debt had been restructured (Vongvipanond and Wichitaksorn 2006). The majority of these companies had been restructured under the court-based system, illustrating that restructuring provides a positive avenue for breathing life into distressed firms.

## Key messages

Investment decisions are forward looking. Accepting risk is a normal part of doing business. But government actions can unnecessarily increase the risks associated with investing.

Well-functioning legal systems and clear and consistently enforced property rights are basic requirements for good economic performance.

- Property rights are the bedrock of any modern economy and no economy has managed to progress without addressing this aspect – China being the latest example.
- Enforcing contracts under well-functioning legal systems is needed to underpin property rights to allow a market-based economy to function

effectively. For example, the legal system is common across Mexico but those states running their legal systems more efficiently had larger, more efficient firms.

Modern economies have progressed because they have been able to aggregate the savings from millions of lenders into large sums of capital for business to borrow and invest. This activity is performed by the financial system. It follows that protecting creditors and shareholders can help mobilise an economy's capital through the financial system and encourage investment.

Some of the most frequently reported unnecessary risks faced by firms in developing economies are policy uncertainty and macroeconomic instability. The importance of macroeconomic stability is well understood. Less appreciated are the real costs from policy uncertainty. The case study of China joining the WTO is a good example of government action to lower policy uncertainty and the risk of doing business. Joining the WTO 'cemented' a legal commitment to an open market-based economy with exchange through a transparent set of rules and known procedures to resolve international trade disputes. Joining the WTO prevented the Chinese government from making arbitrary and unpredictable changes to policies affecting traders. In providing a more predictable policy environment, this policy decision facilitated enormous investment in the Chinese economy.

# 5

## *Barriers to competition*

Competition is a cornerstone of an efficient, innovative market-based economy. Competition encourages firms to explore better ways of meeting consumers' needs, and to do so at the lowest possible cost. Competition also encourages innovation. Innovation either leads to new products and services or the same things being produced more cheaply. When government policies restrict competition it often means that firms are able to charge higher prices, resulting in unusually large profits at a cost to consumers. These unusually large profits are known as 'rents'. While the restrictions on competition benefit existing firms, they also prevent other firms from pursuing potentially profitable investment opportunities. A barrier to competition is therefore a barrier to investment. Removing barriers to competition is likely to have a large impact on investment as new firms enter previously protected markets.

Barriers to competition are also barriers to investment in innovation. In a competitive environment, firms are constantly looking for opportunities to cut costs through new technology and management practises and to improve products to win market share from rivals. According to the World Bank, firms are at least 50 per cent more likely to innovate if they are subject to rigorous competitive pressures (2004, p. 3). Furthermore, Bastos and Nasir (2004) found that competitive pressure is the most important factor driving productivity levels. Reducing barriers to investment in innovation can play an important role in fostering productivity growth.

Removing barriers to competition can be more difficult than removing other types of barriers to investment. Even though they are bad for consumers and bad for firms wishing to enter the market, barriers to competition do benefit those firms that are permitted to operate in the market. Firms that are protected from competition are therefore unlikely to support the removal of these restrictions. By contrast, incumbent firms are likely to support reforms that reduce costs and risks discussed in previous chapters, because these reforms result in larger and more predictable profits. It can therefore be harder to achieve political support for removing barriers to competition.

Policies that reduce competition are usually embedded in regulation. The cost- and risk- increasing aspects of the regulatory environment have been dealt with in previous chapters. While all barriers to investment reduce competition to some extent, this chapter deals with regulations that specifically limit competition by creating barriers to market entry and exit and failing to prevent anti-competitive behaviour by firms.

## Barriers to competition

The most restrictive barriers to competition explicitly ban new firms from entering the market. Public enterprises are often protected from competition in industries that are critical to the investment climate, such as:

- the finance industry; and
- infrastructure industries.

Other aspects of the regulatory environment that result in less competition and therefore less investment and productivity growth are:

- regulatory barriers to market entry and exit; and
- inadequate competition law and policy.

## The finance industry

Well-functioning financial markets are critical to the investment climate. However, financial markets often do not function as efficiently as they could because of a lack of competition in the industry. A key role of financial markets is to provide firms in all industries with access to credit. Access to credit allows firms to pursue potentially profitable investment opportunities, without relying on internal funds. In many countries, government policies restrict competition in the finance industry, particularly in the banking sector. A significant proportion of investment is financed by bank lending, particularly in developing countries. Borrowing costs depend on the operational efficiency and the competitiveness of the banking sector (World Bank 2001).

Barriers to competition in the finance industry include entry restrictions (particularly for foreign banks) and state ownership of banks. Removing these restrictions increases investment by improving bank stability, reducing interest margins and expanding access to credit.

Entry into the banking sector is often highly restricted. Indeed foreign banks are frequently banned. Research across 80 countries shows that the entry of foreign banks reduces both the profitability and the overall expenses of domestically owned banks (Claessens, Demirgüç-Kunt and Huizinga 1998). The latter implies that entry of foreign banks forces domestically owned banks to operate more efficiently. In the Philippines, relaxing restrictions on foreign banks in 1994 resulted in a narrowing of interest rate spreads and a decline in operating expenses (Unite and Sullivan 2001). Competition from foreign banks reduces interest margins, reduces the cost of borrowing and therefore encourages investment.

Extensive state ownership in the banking sector has also been found to reduce competition, reduce access to financing and constrain the allocation of credit (World Bank 2004, p. 117). La Porta, Lopez-De Silanes and Shliefer (2002) found that state ownership of banks is associated with slower financial development and lower productivity growth, leading to lower growth of per capita incomes. Their analysis suggests that a 10 percentage point increase in government ownership of banks is associated with an annual growth rate reduction 0.24 per cent. Political interference in credit allocation is also likely to be more pervasive in state-owned banks. This results in the misallocation of credit and therefore reduces productivity growth.

## Infrastructure

Good quality infrastructure is a critical part of the investment climate. According to the World Bank (2004, p. 125), firms with access to modern telecommunications services, reliable electricity supplies and efficient transport links invest more, and their investments are more productive.

Infrastructure has traditionally been an area of the economy with low levels of competition. This is largely because infrastructure provision is characterised by high fixed costs, leading to a judgement that they are natural monopolies. Huge investment is needed to construct the networks required to supply electricity, transportation and telecommunications services. But once the network is in place, an extra customer can be supplied at very little additional cost. As a result, it was thought that customers could be supplied at least cost by a single supplier, as it is usually costly and impractical for a competitor to replicate the electricity grid or build a rival road.

Consequently, infrastructure services have traditionally been provided by state-owned enterprises, operating with a legislated monopoly. The lack of

competition reduced the incentive to innovate and contain costs, resulting in poorer quality service and unnecessarily high costs. When services are provided by a single supplier, prices are generally tightly regulated, sometimes to achieve policy objectives rather than to reflect the cost of providing the service. Prices are often held artificially low, resulting in losses and under-investment, which can also put pressure on the budget. This has particularly been the case in the electricity markets in developing countries. In the early 1990s, underpriced electricity imposed an annual fiscal burden of US\$90 billion on developing countries, equivalent to around 7 per cent of government revenue (Kessides 2004). Alternatively, high costs have been passed onto consumers of these services. This has generally been the case in the telecommunications industry. As discussed in Chapter 3, higher prices for key services increases the cost of doing business and reduces investment.

Over the past couple of decades, significant reforms to infrastructure industries have improved performance. Removing barriers to competition through industry restructuring has been a key element of these reforms, along with privatisation and improved regulatory arrangements. These reforms have shown that the introduction of competition has led to improvements in the quality and costs of the service.

In recent years, there has been growing recognition that providing infrastructure services involves several distinct activities with entirely different characteristics (Kessides 2004). Furthermore, competition is feasible in some activities, particularly where technological developments have changed the cost structure. Consequently, the industry supply chain has been unbundled in many economies and competition introduced in activities compatible with a competitive market. Table 5.1 summarises the breakdown of several industries' supply chains into activities that are compatible with competition, and those that still require extensive regulation.

The introduction of competition in infrastructure industries can increase investment in those industries and reduce costs, which has flow-on effects on investment through the economy more broadly. However, where the market is small, as is the case in some countries, for some utilities like electricity, separating supply into different activities is unlikely to reap significant benefits (Kessides 2004).

### 5.1 Non-competitive and competitive components of network industries

<i>Industry</i>	<i>Activities that are usually not competitive (require regulation)</i>	<i>Activities that are compatible with competition</i>
Electricity	High-voltage transmission and local distribution	Generation and supply to final customers
Gas	High-pressure transmission and local distribution	Production, supply to final customers, and storage
Telecommunications	Local residential telephony or local loop	Long-distance, mobile and value-added services
Railways	Short-haul track and signalling infrastructure	Train operations and maintenance facilities
Water	Local distribution and local wastewater collection	Production, long-distance transportation, purification and sewage treatment
Air services	Airport facilities	Aircraft operations, maintenance facilities, and commercial activities

Source: Kessides (2004).

Barriers to competition in the telecommunications industry have been successfully dismantled in many countries. Boylaud and Nicoletti (2001) found that in OECD countries, greater product market competition within the telecommunications industry results in productivity and quality improvements and lower prices. Indeed, the prospect of competition is enough to encourage incumbent firms to improve productivity and quality of service and reduce prices.

Introducing competition into electricity supply has proved more difficult, due largely to physical and economic characteristics of electricity. Electricity cannot be stored economically. Consequently, production and consumption must occur at almost the same time; that is, supply and demand must be balanced continuously. The quantity of electricity demanded is insensitive to changes in price in the short-run, so electricity supply must respond to fluctuations in demand. This requires significant co-ordination, making competition difficult to achieve.

Nevertheless, some barriers to competition have been removed and competitive wholesale and retail markets for electricity have been successfully established in a number of countries (Kessides 2004). The model has varied across countries, depending on the characteristics of the market, but there are several common characteristics. Transmission, distribution and system operations are separated from the competitive activities of electricity generation and retail. A regulatory agency sets tariffs for transmission and distribution, while a competitive wholesale and retail market is established. This requires new market entrants to have non-discriminatory access to the grid and customers (World Bank 2004).



Well-designed and implemented reforms to the electricity supply industry have improved performance. Removing barriers to competition has been a key element of successful reform, along with privatisation and better regulatory arrangements. Joskow (2003) highlights some benefits from reform in the electricity supply industry:

- Labour productivity and service quality in the electricity industry has improved in a number of countries, including APEC member Chile, Peru and New Zealand.
- The performance of existing generation plants has improved.
- There has been significant investment in new efficient generating capacity.
- Wholesale electricity prices have fallen in some countries.
- Retail prices have become better aligned with supply costs.

Reforming infrastructure industries can be difficult. No single model is appropriate in all situations so reform requires careful consideration of the characteristics of the industry. The sequencing of reform can also be important. Nevertheless, when the structure is right, there are significant benefits from removing barriers to competition in these industries. Among the most important are greater investment in infrastructure, improved quality of service and lower prices. These benefits have flow-on effects on investment and growth throughout the economy.

## **Regulatory barriers to entry and exit**

In a competitive environment, firms can freely enter and exit markets. This encourages investment and productivity growth. New and innovative firms are able to pursue profitable investment opportunities in new markets by competing with existing firms with cheaper or better quality products. On the other hand, less productive firms that cannot compete can easily exit the market, freeing up capital to be used elsewhere. Easy market entry and exit is therefore critical to the investment climate. However, regulatory barriers often make it difficult for new firms to enter and exit a market. This reduces investment, competition and the incentive to innovate and improve productivity. Recent research suggests that the entry and exit of firms generally accounts for between 20 per cent and 50 per cent of total productivity growth (Bartelsman, Haltiwanger and Scarpetta 2004, p. 35). Exit of firms always has a positive effect upon productivity growth since the least efficient firms exit, raising the average productivity of those firms remaining. In most countries, the entry of new firms has a positive effect

upon productivity growth. This is the case when new entrants harness new technology that contributes to greater efficiency.

### *Barriers to market entry*

There are many barriers preventing firms from entering new markets. These barriers can be structural in nature, such as in industries with high start-up costs, or where customers are loyal to incumbent firms. Strategic barriers, such as exclusive dealing arrangements, are intentionally created by incumbent firms to deter entry. These barriers can be dealt with through competition law. This section deals with regulatory barriers to market entry.

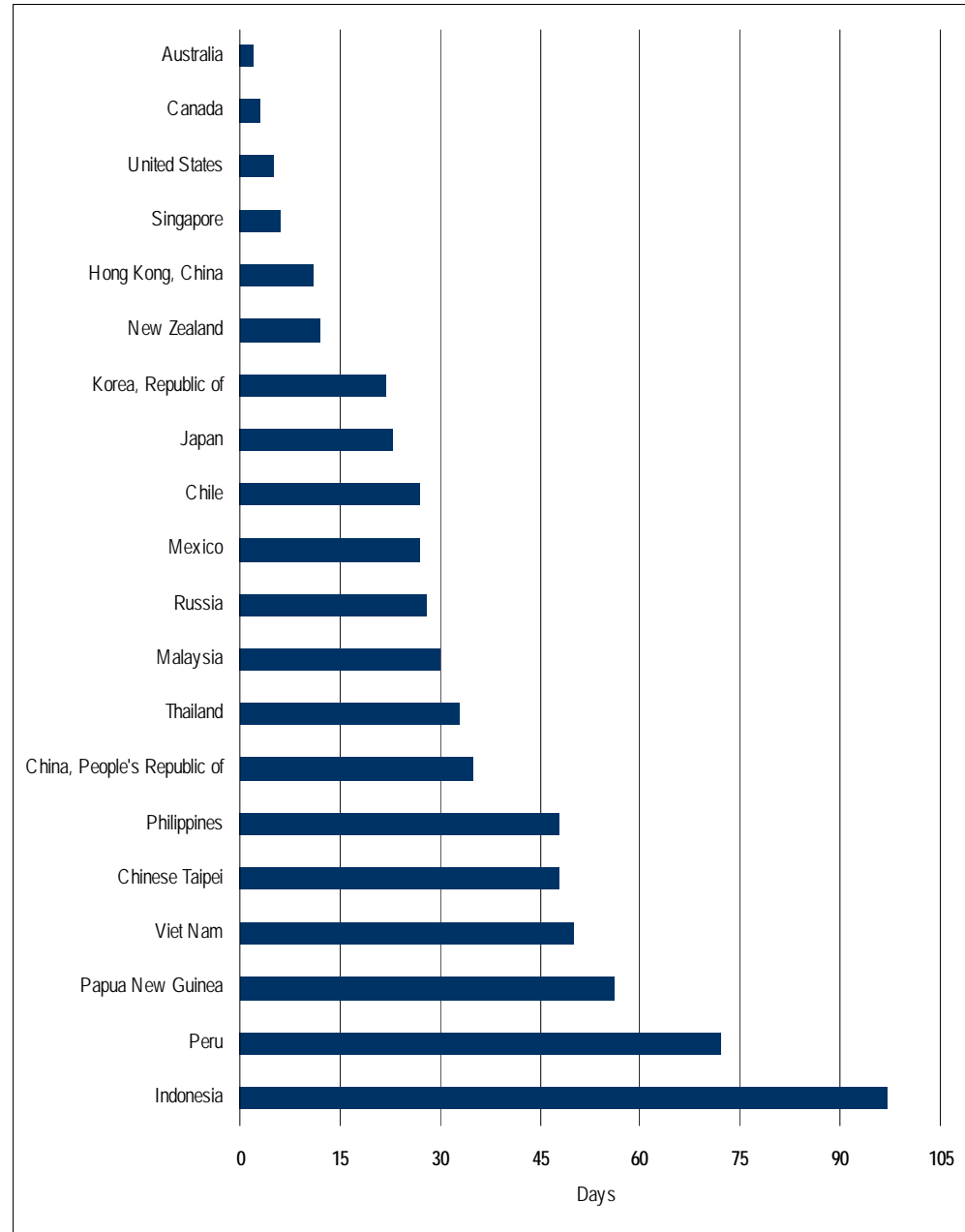
One such barrier is the cost of registering a new business. High business registration costs deter new firms from market entry, thereby reducing investment. The World Bank's *Doing Business* project has several indicators measuring the costs of registering a new business, including the direct cost, the number of procedures required and the number of days it takes. Business registration tends to be much less costly in the developed APEC economies. In Canada, it involves two procedures, which take three days and cost 0.9 per cent of an average annual income. The same undertaking in Indonesia involves twelve procedures, takes 97 days and costs nearly 87 per cent of an average annual income (see chart 5.2).

In addition, some countries require a minimum amount of capital before a business can be registered. The minimum capital requirement is three times an average income in Korea and more than double an average income in China and Chinese Taipei. The minimum capital requirement can therefore be a significant barrier to market entry in some economies.

### *Barriers to market exit*

Regulatory barriers that prevent firms from leaving the market are also detrimental to the investment climate. A barrier to exit is a barrier to entry – firms are less likely to enter a new market if it is difficult to exit. Furthermore, long and costly bankruptcy procedures discourage troubled firms and their creditors from pursuing this option. As a result, many unproductive firms remain in the market, limiting the investment opportunities for new, more productive entrants.

## 5.2 Days taken to open a new business



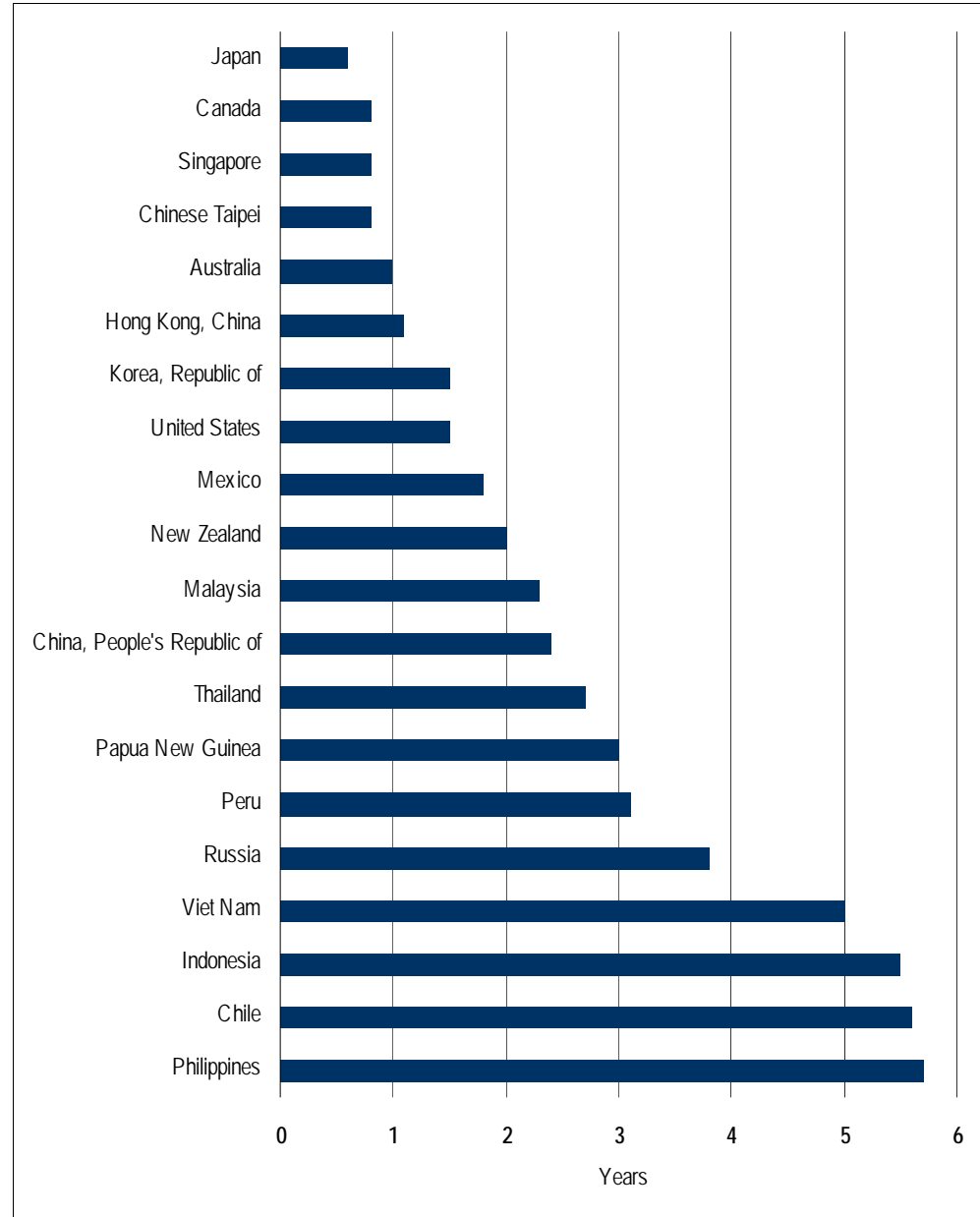
Note: Data not available for Brunei Darussalam.

Data source: World Bank (2006b).

Cumbersome bankruptcy laws are the most pervasive barrier to exit (World Bank 2004, p. 104) and, as with many barriers to investment, bankruptcy procedures tend to be more costly in developing economies. As part of the *Doing Business* project the costs associated with bankruptcy proceedings against a company that operates a hotel as its major activity are compared across countries. In Japan, bankruptcy proceedings cost 3.5 per cent of the debt, take just over half a year, with 92.7 cents in the dollar recovered by creditors, tax authorities and employees (chart 5.3). The

same proceedings in the Philippines cost 38 per cent of the debt, take over five-and-a-half years, with only four cents in the dollar recovered by claimants.

### 5.3 Years taken to close a business



*Note:* Years taken to complete bankruptcy procedures against a limited liability company that operates a hotel as its major activity. Data not available for Brunei Darussalam.

*Data source:* World Bank (2006b).

## Case study: barriers to entry — Viet Nam enterprise law reform

While Viet Nam had previously experimented with reform and liberalisation, the main point of departure in its transition from central planning to a market economy occurred with a key decision in 1986 to embark on a process of renovation known as 'doi moi'. This decision, made in the context of economic crisis and the legacy of many years of conflict, began processes of relaxing controls on private sector activity, particularly in agriculture. The reform process gained momentum, culminating in a comprehensive break with the central planning system in 1989, as the economy faced shocks such as the collapse of the trade and assistance links with the Soviet bloc.

Initial reforms in the agricultural sector were an overwhelming success, confirming the potential of the private sector as an engine for economic growth. In December 1989, the Law on Company and Law on Private Enterprise provided the first legal guarantee for the private sector. The re-opening of private business in urban regions helped to stabilise the economy.

By the mid-1990s, the macroeconomic environment had stabilised. GDP growth exceeded 9 per cent, while inflation had dropped below 10 per cent, having exceeded 400 per cent at the start of the reform period. However, growth was narrowly based and highly dependent upon foreign savings. This left the economy vulnerable to external shocks, which became apparent when the 1997-98 Asian financial crisis hit many of Viet Nam's neighbours (Mallon 2004, p. 5).

### ***Motivation for reform***

Viet Nam's 1992 Constitution explicitly recognised a role for the private sector, and laws introduced in the preceding years provided for the establishment of sole proprietorships and joint stock companies. But the general thrust of policies, and the ways in which they were administered, created limited space for the development of private enterprises other than household enterprises. Private sector development also had to wait for the legal framework to be established that would cover the basic elements required for the operation of a market economy. As the economy was opened up to private foreign investment, the constraints on the domestic private sector became more apparent. Concerns about the impact of the Asian financial crisis and the fall in FDI reinforced domestic pressures to reduce barriers to development of the domestic private sector (Mallon 2004, p. 161). In 1998, a critical survey undertaken by the CIEM revealed onerous

barriers to market entry for new enterprises and many unnecessary bureaucratic procedures. Existing laws were confusing and applied inconsistently. Furthermore, the large number of licences and permits created fertile soil for bribery, corruption and harassment. Consequently, the cost of starting a business was high in terms of time and money. The inequitable application of laws also increased risk. This was discouraging investment and therefore constraining development. Work on addressing these problems was initiated in the context of drafting the new Enterprise Law.

### ***Enterprise law reform***

The introduction of the Enterprise Law meant that enterprises were no longer required to obtain authorisation from the Chairman of the Provincial Peoples Committee to register a business. Consequently, there was greater freedom for entrepreneurs to start a business. Other business registration processes were also simplified by:

- reducing licensing requirements; and
- reducing ambiguities and inconsistencies inherent in earlier legislation.

A total of 186 requirements for obtaining licences and permits were cancelled, tangibly reducing the costs in terms of time and money to create a business.

The Enterprise Law also improved the corporate governance of enterprises by clarifying:

- the rights of company members (minority shareholders in particular);
- the conditions for withdrawing capital, better protecting the interests of lenders; and
- procedures for the distribution of profits so as to protect the interests of shareholders.

### ***Reform process***

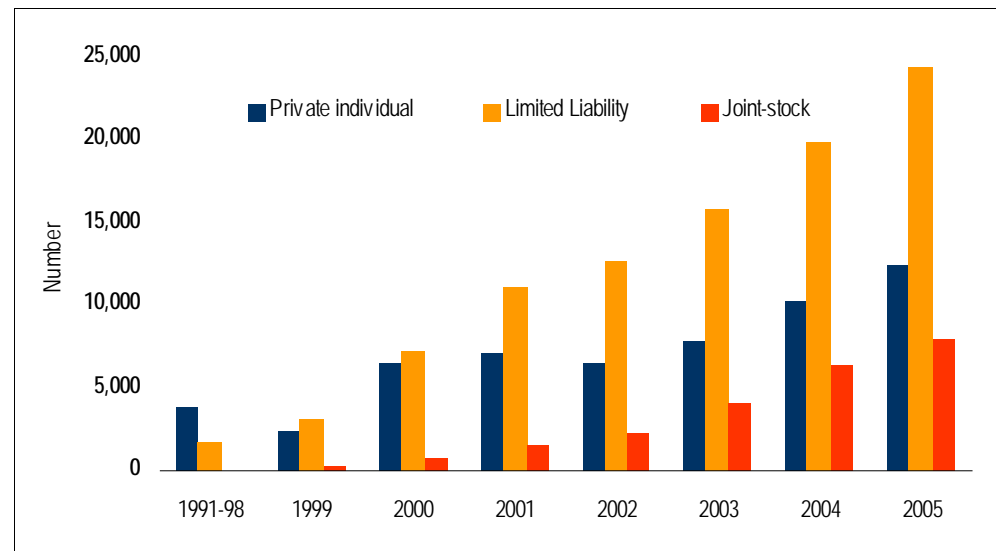
Ultimately, a high-level commitment to reform associated with new leadership and articulated in resolutions of Viet Nam's single party in 1997 proved to be a turning point for Enterprise Law reform. The then new Prime Minister established a Taskforce which in 2001 uncovered the operation of at least 303 unnecessary licences and permits.

Support from key institutions such as the CIEM was also important. The CIEM helped to build the case for reform through clear and logical analysis. The mass media was also used to increase awareness and build public support. Pressure from the domestic private sector for market institutions and clear regulatory rules had been growing since the legalisation of private activity in 1990 under the Company Law and Law on Private Enterprise. The Steering Group on Enterprise Law Implementation was particularly important in overcoming resistance to the reform, as well as helping to keep the momentum for reform on track.

## Reform outcomes

The Enterprise Law reforms successfully reduced barriers to business start-ups. The cost of business registration declined from US\$700-1,400 prior to the reforms to roughly US\$350 in 2004 (Mallon 2004). The average time taken for the process of starting a business also dropped dramatically from an average of 6-12 months to about 2 months (as of July 2003). This resulted in an increase in the number of new enterprises, as illustrated by chart 5.4. Furthermore, the majority of new enterprises are limited liability. The reform is estimated to have contributed to the creation of 2 million new jobs (Kikeri, Kenyon and Palmade 2006, p. 95).

### 5.4 New business registrations, Viet Nam



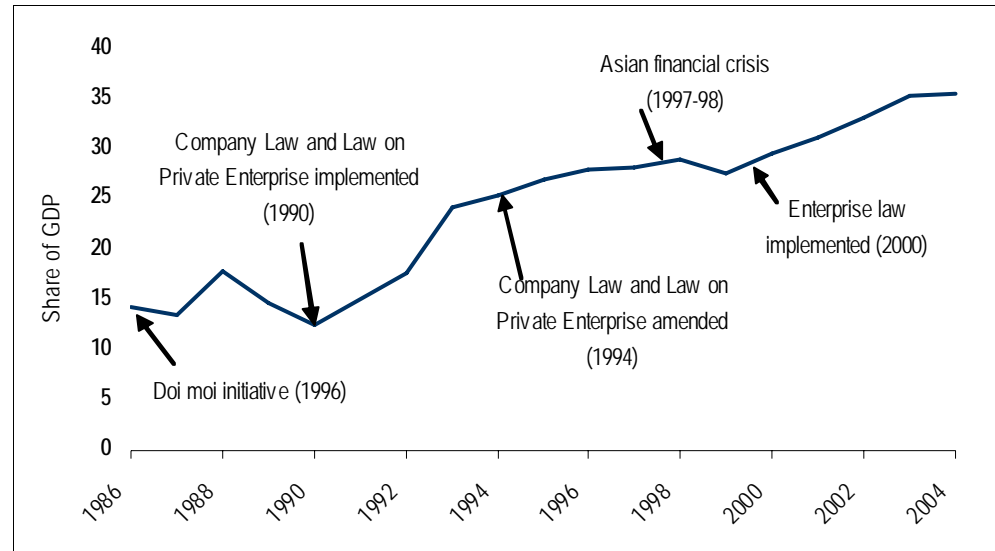
Note: Years 1991-1998 have been averaged.

Data source: Mallon (2004).

Most importantly, these reforms have contributed to an improved investment climate. There is now greater protection of investors through improved corporate governance. Following various reforms, the share of investment in GDP had increased from around 15 per cent in the late 1980s

to almost 30 per cent by the mid-1990s (chart 5.5). However, the investment share of GDP had levelled out in the late 1990s. Following the implementation of the Enterprise Law in 2000, the investment share of GDP increased to more than 35 per cent.

### 5.5 Investment as a share of GDP and milestones in reform process



Data source: WDI Online database (accessed 30 January 2007)

Importantly, an increasing share of investment has been from the domestic private sector. The domestic private sector is important in terms of both the quantity and quality of investment. In the centrally planned economy prior to 1986, the private sector legally did not exist. But the Tenth National Congress of the Communist Party of Viet Nam (April 2006) emphasised that the private sector is the driving force for the country's economic growth.

Domestic private investment in Viet Nam is growing steadily now and was twice as large as FDI in 2004 and 2005. The domestic private sector has contributed more than 90 per cent of new employment and its share in total non-oil exports is now more than 50 per cent. The domestic private sector also contributes increasingly to budget revenue and reached 23 per cent in 2006.

Strong investment has helped to drive rapid growth and reduce poverty. Over the whole reform period, poverty has fallen from roughly 70 per cent in the mid-80s to about 37 per cent in 1998 (Kikeri et al p. 90).

A key success of the Enterprise Law reforms in 2000 was the significant reduction in the number of business licences and permits. However, in the subsequent period, the number of business licences and permits has once



again increased. Indeed, there are now more business licences and permits than there were prior to the reform. Furthermore, the Taskforce working on further reforms to Enterprise Law in 2005, was until now (April 2007) unable to have any of these new licences cancelled. This highlights the importance of not only reducing barriers to investment, but creating a process whereby new barriers are subject to a rigorous public benefit test.

Nevertheless, Enterprise Law reform has been an important step in Viet Nam's ongoing reform process. Viet Nam began a new phase of reform in connection with WTO accession and international integration. As part of these commitments, the National Assembly approved the Unified Enterprise Law in November 2005. This law provides a roadmap for domestic and foreign enterprises to be governed by the same corporate legislation, irrespective of ownership. Furthermore, enterprises are able to choose the form of corporate entity; previously, foreign enterprises were allowed to operate only as limited liability companies.

## Competition law

Not all barriers to competition are directly created by governments. Since incumbent firms benefit from a lack of competition, they may attempt to limit competition in the market. They can try to do this by colluding with rivals, entering restrictive agreements with suppliers or customers, misusing market power or merging with competitors. Sometimes they hide behind onerous regulations, ostensibly to 'protect' the consumer. Consequently, most developed – and an increasing number of developing – economies have introduced laws preventing firms from engaging in anti-competitive practices, on the presumption that regulation preventing anti-competitive behaviour by firms can encourage competition and therefore investment and productivity growth.

The United Nations Conference on Trade and Development (UNCTAD 2004) recommends that competition laws include:

- provisions that prevent firms from reducing competition by colluding with rivals or forming cartels. Collusion includes:
  - agreements fixing prices or other terms of sale;
  - collusive tendering;
  - market or customer allocation;
  - restraints on product sales;

- refusals to purchase or supply; and
- collective denial of access to an arrangement, or association, which is crucial to competition.
- provisions that prevent firms from abusing their market power through:
  - predatory or discriminatory pricing; and
  - imposing unreasonable restrictions on supply; and
- a requirement that proposed mergers be reviewed by a specialist agency, to ensure that the benefits of the merger outweigh the cost of reduced competition.

However, there are a number of difficulties associated with implementing competition laws in developing economies, where institutional foundations such as enforceable contracts and property rights are not so well-developed (Cuthbertson et al 1999). The World Bank (2004, p.106) notes that the introduction of competition laws in developing countries has had mixed results, one reason being that these laws often do not address the more pervasive barriers to competition arising from government policy, and enforcement is often complicated and politically challenging.

Besides, a competitive domestic environment for business can be fostered by means other than competition law. An open trade environment can do more to encourage competitive domestic markets than any competition policy. Removing trade barriers is straightforward and simple to do, requiring little expertise.

The World Bank suggests that a comprehensive competition policy incorporates laws dealing with anti-competitive conduct in a broader strategy that aims to reduce regulatory barriers to competition and to promote a more pro-competitive culture. Australia's experience with competition reforms, summarised in the following case study, bears out the logic of this approach.

## **Case study: the importance of competition — Australia's National Competition Policy**

Up until the 1960s, Australia was one of the richest economies in the world. However, during the 1970s and 1980s, economic performance deteriorated relative to other OECD economies. Output growth slowed, inflation and unemployment rose and productivity growth was consistently low

(Productivity Commission 2005). By 1990, Australia's GDP per capita had fallen into the bottom third of OECD countries (OECD 1992, p. 57).

From the early 1980s, the Australian government implemented a series of significant economic reforms that freed up markets and promoted competition (Banks 2005). The Australian dollar was floated, the financial sector was deregulated, import quotas were abolished, tariff protection was reduced and more flexible labour market arrangements were introduced. Yet by the early 1990s it had become clear that aspects of the broader competition policy framework were inhibiting growth and that more reform was needed to improve Australia's international competitiveness (Hawke 1991).

## **Process**

Australia's federal system of government increases the difficulty of achieving a nationally consistent approach to reform. Many of the reforms implemented through the 1980s fell under the responsibility of the Australian Government. However, many of the structural issues that were inhibiting growth in the early 1990s were the responsibility of the state governments. With a national approach to reform required, achieving consensus among all government leaders that reform was necessary and would yield benefits was a key factor in the success of National Competition Policy (Banks 2005).

While there was broad agreement across governments on some key reform principles, these were crystallised by an Independent Committee of Inquiry into a National Competition Policy, which was commissioned in 1992 and became known as the Hilmer Review. The Committee consulted widely with key stakeholders in the reform process, including government and industry representatives as well as trade unions and professional and consumer organisations. The independence of the review and the extensive consultation gave the review credibility and improved transparency. This credibility was important in building political support for the reform process.

The recommendations of the Hilmer Review were reviewed by the Council of Australian Governments<sup>19</sup> which had become the key forum facilitating reform. Importantly, the Industry Commission was asked to model the impact of the Hilmer recommendations, finding that Australia's level of real GDP would be 5.5 per cent higher once the productivity gains, price

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<sup>19</sup> This Council is represented by all eight Australian State and Territory Governments and the Federal Government.

rebalancing and other changes associated with the reforms had fully worked their way through the economy (Industry Commission 1995). This independent modelling provided credible evidence that reform would indeed yield large benefits to the community.

Finally, the recommendations of the Hilmer Review were brought together to form the National Competition Policy. The National Competition Policy was formally adopted by the Council of Australian Governments in 1995.

### ***National Competition Policy***

A key element of the National Competition Policy was the systematic review of all national and state government legislation. The main guiding principle of National Competition Policy reviews was that legislation should not restrict competition unless it can be demonstrated that:

- the benefits of the restriction to the community as a whole outweigh the costs; and
- the objectives of the legislation can only be achieved by restricting competition.

Reviews were normally undertaken by an independent review team that consulted widely with key stakeholders and the public more generally. Importantly, all new legislation is also subjected to the ‘public interest test’.<sup>20</sup> National Competition Policy therefore established an open and transparent review process, where the onus was to prove that the barrier to competition was in the public benefit.

The other main elements of the National Competition Policy are outlined below.

- The anti-competitive provisions in the Trade Practices Act (Australia’s competition law) were extended to include unincorporated and government-owned enterprises (Productivity Commission 2005). The Trade Practices Act encourages competition by preventing enterprises from engaging in anti-competitive behaviour.
- Public monopolies and other government businesses were reformed.
  - Regulatory and commercial functions were separated.

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<sup>20</sup> The ‘public interest test’ requires that legislation that restricts competition must have benefits that exceed the costs to the community as a whole, and that the objectives of the legislation can only be delivered by restricting competition.

- Competitive neutrality, which required government-owned businesses to compete on an equal footing with private enterprise, was introduced.
- Independent authorities were created to set, administer or oversee prices for monopoly service providers.
- A national access regime was implemented, which provided access to essential infrastructure.

### ***How was the National Competition Policy implemented?***

The National Competition Policy was underpinned by a series of intergovernmental agreements between the Australian and all State Governments. Under these agreements, National Competition Policy payments were made from the Australian Government to the States, subject to their progress in implementing National Competition Policy and related reform obligations. Progress on implementing the reforms was assessed by the newly-established independent body, the National Competition Council, which then made a recommendation to the Australian Treasurer on the National Competition Policy payments. These recommendations were publicly available, which improved transparency and held governments accountable for their reform failures.

National Competition Policy payments were made on the basis that the States were implementing a large amount of the reforms, but in fiscal terms, the Australian Government received most of the benefits through greater tax collection associated with a higher level of economic activity. The competition payments ensured that the fiscal benefits were shared with the States, but also provided an important incentive for State governments to progress the reform agenda.

Since 1997-98, more than \$5 billion in National Competition Policy Payments have been made to state and territory governments. This represents around 96 per cent of the total pool available. Based on recommendations from the National Competition Council, the Australian Government has permanently withheld payments from various states for failing to meet their reform commitments. A further \$80 million in competition payments have been suspended subject to further progress on reform.

By June 2005, governments had reviewed and, where appropriate, reformed around 85 per cent of identified legislation. This included the stock of legislation identified by each jurisdiction in their original legislation review schedules as well amended and new legislation

containing restrictions on competition identified by the National Competition Council. However, it excludes most water, electricity, gas and road transport-related legislation (Productivity Commission 2005).

### ***What have been the benefits of National Competition Policy?***

As with all reforms, it is extremely difficult to separate the effects of the National Competition Policy reforms from other factors that affect economic performance. Nevertheless, the Australian economy has performed strongly in the period since the reforms. Having recorded 16 years of uninterrupted growth, the Australian economy has proved remarkably resilient, despite a number of external shocks such as the doubling of oil prices and the Asian financial crisis.

Australia's rank amongst OECD countries, which had slumped to 16th by 1990, has now climbed back up to 8th. Of course, the prosperity of the economy cannot be directly linked to reforms implemented under National Competition Policy, but they have been an important contributor (see OECD 2003).

Underpinning these economic outcomes has been an improvement in Australia's productivity growth. Chart 5.6 shows that in the productivity growth cycle<sup>21</sup> from 1993-94 to 1998-99, multifactor productivity<sup>22</sup> grew at the fastest pace on record, increasing at an average annual rate of 2.3 per cent over this cycle. However, average annual productivity growth slowed to 1.1 per cent in the latest complete cycle (from 1998-99 to 2003-04).

Quantitative modelling suggested that the reforms recommended by the Hilmer Review and other related reforms (which formed the basis for the National Competition Policy) would increase the level of GDP by 5.5 per cent annually. More recent modelling shows that reforms in six key infrastructure sectors<sup>23</sup> alone have generated a permanent increase of 2.5 per cent in GDP (Productivity Commission 2005). Not captured in these models are the 'dynamic efficiency' effects that can be expected from a

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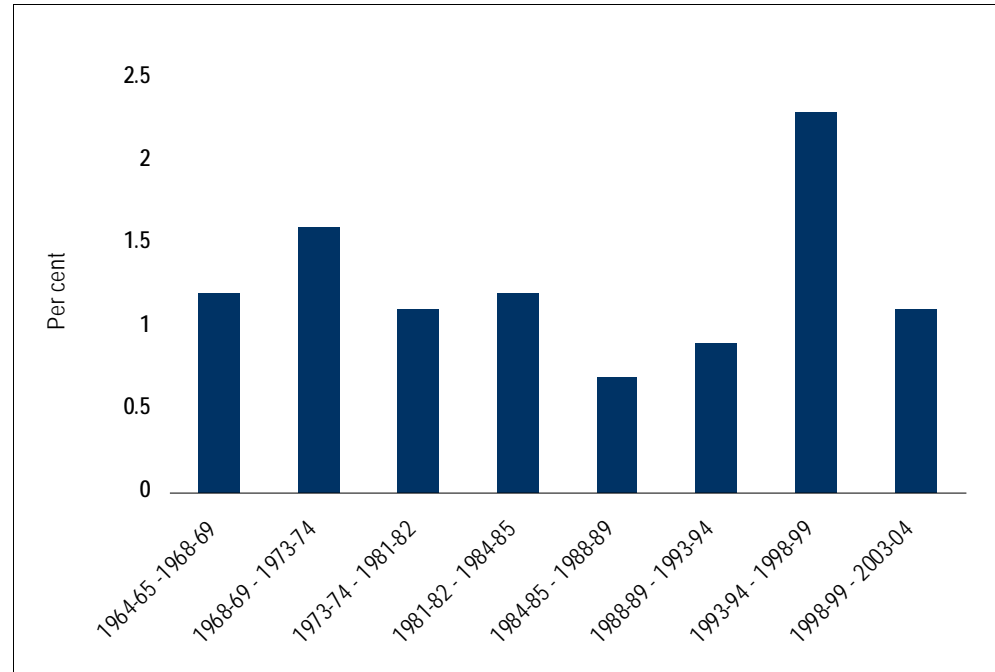
<sup>21</sup> The productivity growth cycle is the best indicator of the true change in productivity as it takes into account the business cycle. By using the productivity growth cycle the influence of the business cycle can be minimised, making it easier to identify the drivers of growth in different periods.

<sup>22</sup> Multifactor productivity is used as the measure for productivity growth as it is a more comprehensive measure of productivity than either labour or capital productivity measures alone.

<sup>23</sup> The key sectors are electricity, gas, urban water, telecommunications, urban transport, and ports and rail freight sectors.

more flexible and innovative economy, the lagged impact of some reforms, or all reforms under National Competition Policy.

### 5.6 Compound annual percentage change between multifactor productivity growth cycle peaks



Note: Productivity growth cycle peaks are determined by comparing the original multifactor productivity estimates with their corresponding long-term trend estimates.

Data source: ABS Cat. No. 5204.0, National Accounts.

However, the benefits of National Competition Policy run much deeper than the one-off economic impacts of the reform agenda. The processes established under National Competition Policy have helped to establish a culture among policymakers of subjecting most economic policy to rigorous analysis. This has raised the awareness of the various benefits and costs associated with regulation. Finally, the National Competition Policy has improved the transparency of government decision-making and highlighted the importance of community consultation and helping affected groups accept change.

## Key messages

Government protection of a small numbers of firms behind barriers to competition increases 'rents' flowing to those firms. However, those barriers deny opportunities to other firms and are therefore a barrier to investment. Removing barriers to competition is likely to have a large impact on investment as new firms enter previously protected markets and as it reduces costs to firms investing in industries that use the outputs of

protected industries. Furthermore, competition encourages firms to innovate and adopt new technology and ways of doing things and is therefore an important driver of productivity growth. Consequently, removing barriers to competition is likely to provide a significant boost to productivity.

Some of the main barriers to competition lie in the regulatory framework for the finance and infrastructure industries, which provide critical inputs into production throughout the economy. Barriers for firms to enter (and exit) industries are also a problem, and regulations targeted at a range of economic and social objectives often have an unintended effect of reducing competition.

Viet Nam's Enterprise Law reform was successful in removing regulatory barriers to market entry, which increased investment, particularly by the private sector.

Australia's National Competition Policy was a comprehensive package of reforms that improved the competitive environment and contributed to improved economic performance. It has encouraged greater economic efficiency, improved productivity, and consequently may have permanently increased the level of GDP by 5.5 per cent.



## 6

*How to remove behind-the-border barriers*

In general, those APEC economies with fewer impediments to doing business and a more favourable investment climate are more prosperous. Many economies have removed barriers to business behind their borders and have therefore encouraged greater investment and economic growth than otherwise. Across APEC between 2006 and 2007, the reforms in nine economies have been significant enough for them to lift their rankings on the index of ease of doing business, as tracked by the World Bank's *Doing Business* project.<sup>24</sup> These include many developing APEC economies with China and Mexico being among the top reformers.

Why are some economies able to create a much more favourable investment environment than others? If it only takes two procedures and three days to register a business in Canada, why are not all APEC economies following that best practice? And how are some economies, like China, able to reform a lot faster than others? As the World Bank succinctly puts it:

Watch out, rest of the world: China is a top-10 reformer. The government sped business entry, increased investor protections and reduced red tape in trading across borders. China also established a credit information registry for consumer loans. Now 340 million citizens have credit histories. (World Bank 2006b, p. 3)

The removal of those barriers to investment in China came on top of a host of other reforms associated with the country's transition to a market economy and accession to the WTO. Besides opening to trade and investment, China has also privatised many state-owned enterprises, strengthened its legal system, spent heavily on infrastructure and moved to strengthen property rights over time. The results are there for the entire world to see. It is the *improvement* in the investment climate in China compared to other economies that has mattered most for the global pattern

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<sup>24</sup> The nine APEC economies were Australia, China, Hong Kong (China), Japan, Mexico, Peru, Russia, Singapore and Thailand.

of investment. The more barriers to investment are removed, the better the prospects are for growth. But if it is so obvious that removing barriers to investment has beneficial effects, what stops APEC governments from removing those barriers and how can they speed up the reform process? These questions are addressed in this chapter, starting with the lessons from the case studies.

## **Insights from the case studies on how to reform**

The five case studies were included in the study to support the other evidence that removing behind-the-border barriers to investment leads to better economic performance. They also contain valuable lessons about the reform process. These lessons are important for the motivations behind the reforms and how they were done.

The Greater Mekong Subregion (GMS) Program's infrastructure building project was initiated by the Asian Development Bank, taking advantage of the desire to cement peaceful relationships in the region through greater economic and social integration. Better roads and transport links were an integral part of fostering stronger economic linkages. The initial focus on building roads delivered early visible benefits, which made it easier to move into the later elements of the program. From that perspective, the program had sustainability built in. One lesson is that success breeds success.

As economic integration in the GMS has progressed, so the emphasis of the project has moved onto deeper, less visible, but equally important issues such as harmonisation of customs procedures and setting regulatory arrangements for the ongoing physical and financial maintenance of the infrastructure. This evolution highlights how one change leads to other beneficial changes and that the reform process is an evolving and ongoing one. Individual member governments have progressively assumed greater responsibility for the program and the Asian Development Bank now plays more of a facilitating role. The motivation for this change has been the greater recognition of the benefits to the GMS members themselves – another lesson from this case study.

Thailand's bankruptcy law reform had a different genesis. There the Government had for some time realised that the country's bankruptcy laws needed changing, but it took the onset of the Asian financial crisis of 1997-98 to provide the necessary impetus to accelerate reform. The crisis made a large number of companies insolvent and threatened the integrity of the whole banking system. Lender of last resort facilities from the IMF

were utilised to stabilise the system, and a comprehensive program of economic reform was instigated to win back business confidence and address the problem of large non-performing loans. Part of that comprehensive program was bankruptcy law reform, which became an imperative as a result of the crisis. Although the changes were controversial at the time, they were finally adopted. Since the recovery of the economy, there is no suggestion that the reforms should be unwound, so the inference must be that the changes have not only *been* beneficial, but are also *seen* to be beneficial.

It would be easy to infer that the policy reform in Thailand only occurred because of crisis. But the necessary changes to bankruptcy law were identified before the crisis and the changes that were made were done in the belief that they would make Thailand better off. So even though outside agencies – in this case the IMF – played a role in motivating the change and the crisis altered the political feasibility of the change, the reason this reform was chosen as part of an overall comprehensive program of reform of the Thai economy was the expectation that Thailand would be better off over time. Again, the lesson is that the motivating force for change is the expectation that, overall, citizens will be better off.

China's membership of the WTO has other lessons about the process of reform. While it may appear as though a small group of policy reformers decided to cement China on the path of globalisation and rejoin the multilateral trading system, the accession process took 15 years – a long time, even by the WTO's standards. The length of time reflects intense internal debate *within* China about joining the WTO as much as the time taken on negotiations with member countries. In the end, it became apparent to a wide group that rejoining the WTO would send a powerful signal to the world community that China was an integrated member of the world economy and a secure place to do business. Joining the WTO had strong implications for domestic rules and regulations – they had to conform to the economy's new international commitments. China's laws and regulations would have to be more closely aligned with those of the rest of the world.

A key lesson from China's accession to the WTO is, again, that to achieve the necessary consensus among key players, a domestic consensus around the question of whether the people would be better off, had to evolve. And the message was that doing business in and with China was going to be more secure than before.

Viet Nam's enterprise law reform illustrates the above lessons as well as introducing one other – the need for ongoing processes to evaluate the

efficacy (or otherwise) of maintaining existing regulations or introducing new ones. As with the reforms highlighted in the other case studies, key Vietnamese leaders and researchers were aware excessive regulation was stifling the development of a vibrant private sector, which was impeding investment and growth. An extensive program of analysis and consultation helped show that Viet Nam would be better off if unnecessary regulation of business could be eliminated. The vehicle for addressing this was a new Enterprise Law. The Enterprise Law was successful. Scores of superfluous regulations were removed; others were streamlined. Large numbers of new businesses started up to benefit from a more competitive, flexible and dynamic economy.

Viet Nam's law reform process also highlighted the need to address the underlying reasons for unnecessary regulation. Why, if the regulations were superfluous and not beneficial, did they persist for so long? And why, when the new law was introduced, were new constraints on business put in place? One reason is that there was not a clear understanding throughout government of the costs of holding back private investment. To help resolve this, the Government is exploring ways of embedding stronger and ongoing processes of regulatory review into the policy process. The original enterprise law reform process was successful because it subjected existing practices to robust assessment of costs and benefits, and alerted the public to this assessment. The challenge now is to institutionalise the initial review process on an ongoing basis, to ensure that all new regulation is routinely assessed for its economy-wide benefits and costs, and to subject old regulation to similar tests. Therein lies another powerful lesson.

If regular ongoing review of regulation is so important, is there an example in an APEC economy where this does occur? Fortunately there is at least one and that leads to the final case study – the reform of Australia's competition law and policy under National Competition Policy.

Australia's program of competition reform grew out of a formal, public and independent inquiry into competition policy. This inquiry itself was the culmination of a period of trade liberalisation and extensive reform of product and factor markets in the economy. The inquiry process involved all stakeholders and the national benefits and costs were formally assessed. The central recommendation adopted was to encourage a more competitive business environment within Australia. This would be achieved by legislative change regarding monopolies, public businesses, independent regulators and, importantly, a systematic review of all federal and state government legislation to ensure there were no anti-competitive aspects in the legislation that did not demonstrate net benefits to the public.

The review process established under Australia's National Competition Policy involved clear transparency elements, namely, independent public review of the economy-wide benefits and costs of policy and the formal consideration of findings by governments. Many policies were changed as a result of these reviews. It has been estimated that these reforms have lifted the annual level of GDP by over 5 per cent. Again, the lesson is that the main motivator of change was the expected benefits to the economy. The independent, transparent review process assisted the wide appreciation of the reform's benefits.

The benefits of National Competition Policy run much deeper than the one-off economic impacts of the reform agenda. The processes established under National Competition Policy have helped to establish a culture among policymakers of subjecting most economic policy to rigorous analysis.

### Three elements of policy reform

Transparent assessment of the costs and benefits of policy do not automatically lead to the removal of behind-the-border barriers to investment. In Australia, for example, not all recommendations made under the National Competition Policy review process have been adopted by government. Other considerations came into play, such as the political feasibility of a policy change.

The World Bank's study on improving the investment climate (World Bank 2004) graphically demonstrates the three areas or criteria that must be met to see policy reform that will lift investment prospects. These three elements are represented by the three circles in chart 6.1.

First, a proposed reform should be desirable in that it will make people better off. That means the economy-wide benefits are greater than the costs, taking into account all external and social effects. There must be a gain to public welfare. If this is not already well understood, it can be ascertained from reviews by international agencies such as the World Bank or IMF or by considering the experience of other economies.

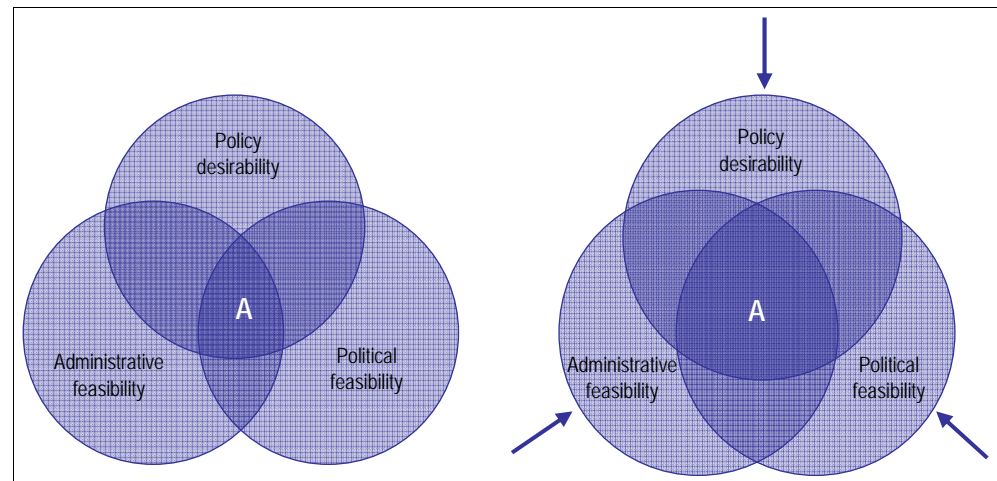
Second, the proposed removal of the barrier to investment must be administratively feasible. This area can be a stumbling block for governments in some APEC economies that do not have the requisite capacity to implement potential changes. Some reforms are technically challenging to formulate, and often even more institutionally challenging to implement – tax reform is a good example. Expanding administrative

capacity is one area where technical cooperation among APEC economies can help.

The third and harder element is the political feasibility test. The desirable change must appeal to a sufficiently broad constituency so that the resistance from beneficiaries of the existing policy who may stand to lose can be overcome. All too often, narrow vested interests can block moves that may be in the public interest. And all too often it takes a crisis to focus attention on the need to address problems or to accelerate existing reform processes – the example of Thailand’s bankruptcy law reform being a case in point.

Unfortunately, all too often the policy reforms that meet all three criteria are small, as represented by area A in chart 6.1 – the ‘sweet spot’ as the World Bank calls it – where the three circles overlap. The outcome is little change and many behind-the-border barriers to investment remain. The obvious goals, of course, are to improve the desirability of policies, enhance the administrative feasibility and improve the political feasibility of change. Doing so increases the degree of overlap, the ‘sweet spot’ increases as depicted in the right hand panel of chart 6.1 and more barriers to investment are removed.

### 6.1 Expanding the zone of feasible and desirable policy improvements



Source: World Bank (2004), p. 68.

Governments in all APEC economies place strong emphasis on building human and institutional capacity to support and implement economic reform, and international cooperation is playing a role in these efforts. International organisations such as the World Bank, the Asian Development Bank, the OECD and the IMF can assist with identifying and assessing the desirability of policy change. But reform is ultimately a domestic prerogative. Political feasibility of policy change can be enhanced

through careful design, such as by using appropriate adjustment programs that alleviate the concerns of those most adversely affected by change. But the lessons from the case studies of successful change show clearly that fostering a clear understanding that change is in the national interest and makes people better off overall is a powerful motivating force for beneficial change. So good processes of domestic transparency that independently and publicly assess what is in the national interest can be a major factor in enhancing the political feasibility of removing barriers to investment.

Australia's competition policy review process offers one model of institutional arrangements that have worked well. But that is within an Australian context and models that work well in one setting do not necessarily translate well into other settings where the history, culture, laws and social norms are different. Nevertheless, the experience of other APEC members is still instructive and a useful exercise for each APEC member is to assess the following question: what domestic institutional arrangements would improve the public awareness of the benefits and costs of removing unnecessary barriers to investment? While that is a hard question, some common principles of value emerge from this review:

- The assessment must be *within* each economy. Change imposed from outside is not likely to succeed. It must be domestically owned.
- The assessment should be *independent* in that it must be seen to be credible by the public at large.
- The assessment should be *public*, taking input from all stakeholders.
- The assessment should appraise the *national benefits and costs*, including social and environmental aspects.
- The findings should be public and fully *transparent*, able to be scrutinised by stakeholders.
- The recommendations must be *considered by government* and, if not adopted, clear reasons given for this decision.
- The reviews need to be *ongoing*.

Sometimes existing organisations and institutions may be able to meet the above criteria. In other instances new arrangements may have to be put in place. The key is that each APEC member draws upon the lessons of others as input in building institutional arrangements that consider their own particular circumstances and results in the systematic, regular, independent economy-wide review of the benefits and costs of removing behind-the-border barriers to investment.

In summary, four steps are required for APEC economies to address behind-the-border barriers to investment.

The first step is to compile a comprehensive description of all barriers that exist, organised or grouped in a useful way – a taxonomy of barriers. Existing approaches that can help with this task include surveys by the World Bank and the OECD. The domestic barriers to investment are so pervasive that this comprehensive taxonomy will often turn out to be quite large.

The second step is to determine a set of priorities. Effort needs to go to those areas where the expected payoff is highest. The expected payoff from change is the combination of the size of the payoff and the probability of success in removing the barrier to investment. One way to assess the payoff from removing a barrier to investment is by using the framework outlined in this study. Each barrier needs to be appraised for its effect on costs, risk, competition or productivity. And a barrier to investment can have multiple impacts in those four areas. But mapping each barrier according to its economic effect will indicate where the high payoff from removing the barrier may lie.

The third step is to develop a better way to address each of the priority areas. Barriers to investment remain either because people are not aware they exist (addressed by the first two steps), the capacity or expertise to make change does not exist (also addressed by the first two steps since the donor community will respond to need), or change is not politically possible because a sufficient domestic constituency for change does not exist. It is this third area which needs bolstering to see beneficial change. Economies should assess how the public awareness of the benefits and costs of removing unnecessary barriers to investment can be improved. That will involve a stocktake of how policies are appraised and change implemented. The key principles behind this stocktake assessment are also outlined above.

The fourth step is for APEC economies to share the lessons from step three. There is no 'one size fits all' prescription to how to systematically appraise barriers to investment and remove those where the benefits exceed the costs. Through each economy conducting their own domestic stocktake of policy processes and sharing the lessons, each APEC member will be able to adopt those aspects which may suit its own particular circumstances. More investment, growth and poverty reduction will be the result.



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## *Appendix*





# A

## *'Doing Business' indicators and their methodology*

### *Construction of the indexes*

The *Doing Business* database referred to in this study is a rich resource for measuring various impediments to business, the regulations behind those impediments and their enforcement. The database covers 175 countries. Data is collected on ten topics, related to the regulatory environment in which firms operate.<sup>25</sup> Standard assumptions are applied in the collection of data to ensure it is transparent, easily replicable, and enables comparison across countries. For example, in ease of starting a business, the assumptions about the business are that it:

- is a limited liability company;
- operates in the country's most populous city;
- is 100 per cent domestically owned, and has five owners, none of whom is a legal entity;
- has start-up capital 10 times income per capita, paid in cash;
- performs general industrial or commercial activities;
- is not a proprietor of real estate (rents the commercial plant);
- does not qualify for special benefits or investment incentives;
- has up to 50 nationals employees;
- has turnover of at least 100 times income per capita; and
- has a company deed at least 10 pages long.

Within the 'Ease of starting a business' topic, there are also assumptions about the procedures, time, cost and the paid-in minimal capital requirements.

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<sup>25</sup> The World Bank has plans to extend the number of topics further.

For each topic, data are collected on 'indicator components'. These components are quantifiable variables, such as the number of days to start a business, the number of procedures to go through to start the business, and the cost, expressed as a percentage of per capita income. Table A.1 gives the full list of all ten topics and their indicator components.

### A.1 Indicators used to construct 'Ease of doing business' rank

<i>Topic</i>	<i>Starting a business</i>	<i>Dealing with licences</i>	<i>Hiring and firing workers</i>	<i>Registering property</i>	<i>Getting credit</i>	<i>Protecting investors</i>	<i>Paying taxes</i>	<i>Trading across borders</i>	<i>Enforcing contracts</i>	<i>Closing a business</i>
<i>Indicator component</i>	Procedures (number) Time (days)	Procedures (number) Time (days)	Difficulty of hiring index Rigidity of hours index Difficulty of firing index	Procedures (number) Time (days) Cost (% of property value)	Strength of legal rights index Depth of credit information index Public registry coverage (% of adults) Private bureau coverage (% of adults)	Extent of disclosure index Extent of director liability Ease of share-holder suits index Strength of investor protection index	Payments (number) Time (hours per year) Total tax payable (% of gross profits)	Documents of export (number) Signatures for exports (number) Time for export (days) Documents for import (number) Signatures for import (number) Time for import (days)	Procedures (number) Time (days) Cost (% of debt)	Time (years) Cost (% of estate) Recovery rate (cents on the dollar)

Source: *Doing Business* database, World Bank (2006b).

The indicator components are measured in different units such as days or dollars. These different components and their units make it difficult to construct an overall measure of performance for each topic. For example, it takes 13 procedures and 35 days to start a business in China. In Indonesia it takes fewer procedures (12) but more days (97). Indonesia is better on one component of starting a business but worse on another. Are procedures more or less important than days to start a business, or are they measuring the same thing? How should days be combined with number of procedures to get an overall indicator of whether it is easier to start a business in China or Indonesia? To overcome this problem each indicator component is ranked across all 175 countries. The rank of each indicator component is averaged, creating an average percentile rank for the topic. To clarify this process an example is provided (see table A.2).

### A.2 Ease of starting a business in China

	<i>Procedures</i>	<i>Time</i>	<i>Cost</i>	<i>Minimum capital</i>
	Number	Days	% of income per capita	% of income per capita
	13	35	9.3	213.1
<b>Rank</b>	<b>142</b>	<b>84</b>	<b>49</b>	<b>146</b>

Note: Ranks refer to 2006 data.

Source: *Doing Business* database, World Bank (2006b).

The average rank of China's indicator components is 105.25, placing China in the 105<sup>th</sup> average percentile for ease of starting a business. This process is replicated across all ten topics, creating a rank for China's performance in each topic. This enables policymakers to identify an APEC economy's strengths and weaknesses across different areas of business regulation and enforcement, as well as within areas of business activity. Correlation between the different areas of business activity is relatively low (0.39), indicating that each topic covers a distinctly different aspect of the business environment.

To create an overall index for ease of doing business, the average rank for each topic is aggregated as before, but is then ranked against all other countries.

### A.3 China's rank for ease of doing business by area of business activity

<i>Starting a business</i>	<i>Dealing with licences</i>	<i>Employing workers</i>	<i>Registering property</i>	<i>Getting credit</i>	<i>Protecting investors</i>	<i>Paying taxes</i>	<i>Trading across borders</i>	<i>Enforcing contracts</i>	<i>Closing a business</i>	<i>Overall rank</i>
128	153	78	21	101	83	168	38	63	75	93

Note: Ranks refer to 2006 data.

Source: *Doing Business* database, World Bank (2006b).

The average rank for China across the 10 topics is the 90<sup>th</sup> percentile. Against all other countries, these indicators rank China 93<sup>rd</sup> for ease of doing business in 2006.

### *Alternative approaches*

Implicit in the simple-average rank methodology is equal weighting of each indicator component within each topic, and an equal weighting for each topic in the overall ranking of ease of doing business. Giving each component equal weighting implies that they are equally important to the business climate.

However, not all topics are likely to be of equal importance in their impact on business activity. What would happen if different degrees of importance (or weights) were attached to each topic? Statistical techniques such as

principle component analysis and unobserved components can be used to shed light on this question. Principle component analysis is used to avoid double counting of the same attribute captured by different variables. For example, low levels of regulation may be captured by several variables counting the number of steps in a process. Unobserved components are used to remove outliers that don't fit the pattern.

In calculating the ease of doing business index, the unobserved components and principle component analysis give ranks almost identical to those constructed using simple-averaging (World Bank 2005). The correlation coefficient between simple-average rank and principle component analysis and unobserved components was 99.7 and 98.2 per cent respectively.

Given the high degree of correlation between the techniques, the more complicated techniques do not improve upon the simple-average rank method. Consequently the simple-average rank is used, as it has greater transparency in its calculation.

### ***Summary of limitations of ease of doing business rank***

The rank score of a country's ease of doing business has some limitations. Not all impediments for business activity are captured in the *Doing Business* index, although the World Bank plans on adding more. Other impediments to businesses such as the quality of infrastructure and macroeconomic conditions are outside the scope of the *Doing Business* project.

The scoring methodology and aggregation implicitly weights all components of indicators and topics equally through a simple averaging methodology. This does not seem to be a serious drawback.

Another issue is how representative the case studies are of the domestic economy at large. To refer back to the earlier example of business registration requirements, when constructing a rank for ease of starting a business, how representative are these assumptions of all businesses within a country? Evidence from a recent World Bank report (2006d) would indicate that in the case of China the answer is no. This report found that despite business law and regulation being roughly consistent across the country, the city-level investment climate varied widely.

It is important to note that the rank does not say anything about the appropriate level of regulation. Generally, higher-income countries have less onerous regulations, but this association is not linear. For example,

lower levels of labour market regulation provide greater flexibility for businesses, but may not provide sufficient job security for employees.

Perhaps the main issue is what use should be made of the index of ease of doing business and the ranking of each country?

Ultimately the purpose of such quantification of impediments is to encourage policy reform, changing regulation and behaviour to encourage more private business activity and hence more economic growth. What is needed is some idea of the importance of making changes to each impediment to business activity for economic growth. That is why in this study various impediments to investment by business have been classified into costs, risks, competition and productivity since once that step is made, each impediment can be measured for its impact on overall business activity and hence growth. The economy-wide costs and benefits can therefore be measured and effort concentrated on the highest payoff areas for reform in each economy. Knowing what is in a country's self interest is a key driver affecting the political economy for beneficial reform. Faster progress towards prosperity can therefore be made.

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