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Trapping the tigers: Regulation of market entry and the rule of law in SE Asia

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ABSTRACT

Recent research identifies high barriers to registering a business as critical impediments to economic development around the world. Similarly, the lack of credible commitment to the rule of law – especially in the areas of property rights and contract enforcement – is also connected to economic underdevelopment. Scholarship treats these factors as rival explanations for underdevelopment. However, I argue the rule of law is the causal mechanism through which barriers to entry in the marketplace influence economic outcomes. Specifically, I present evidence perceptions of the rule of law in Southeast Asia decline as the legal restrictions on registering a business increase because public officials use their gatekeeping positions to extract rents and raise the costs of formalizing private enterprises. High disincentives to register a business drive entrepreneurs underground, which in turn leaves them vulnerable to extortion or confiscation by public officials and undermines perceptions of the rule of law. I employ pooled cross-sectional time-series data for all countries in SE Asia between 1996 and 2010 to test my theoretical argument. I use Two-Stage Least Squares Instrumental Variables, Time Series, Cross-Sectional and OLS regression models to isolate causal mechanisms and causal directions among my variables. My analyses demonstrate the deleterious effect of legal barriers to entry on the rule of law and provides a new direction for scholarship on the topic.

1. Introduction

Businesses in SE Asia often operate in the informal marketplace: transactions occur in a cash economy, taxes are rarely collected and enterprises are not represented in any formal, legal sense. Enterprises without legal standing face a challenge to expanding their businesses because their businesses do not officially exist. Entrepreneurs therefore cannot use their assets as collateral for small-business loans, license proprietary techniques, contract with other firms to sell products or safely reinvest their own profits – all because entrepreneurs have no guarantee of a legally binding contract. The informal market in SE Asian countries is vibrant and growing, but enterprises in these countries suffer from a regulatory glass ceiling on growth; state regulation hinders formal entry into the marketplace and undermines business expansion. For example, in SE Asia it takes an average of 88 days, requires 11 different steps and costs 920 dollars (in a region where per capita GDP is only $2800) to legally register a business. This translates into about a third of one's annual income and a quarter of a year's time compared to a US average of four days, three different steps and 151 dollars (Djankov, La Porta, López-de-Silanes, & Shleifer, 2002a, 2002b). On average, SE Asian governments have created relatively high barriers to formally register a business, thus raising the costs of official registration, decreasing the incentives to register and leaving businesses stuck in the informal sector.

Previous research shows high barriers to market entry in developing countries generally stem from public officials'

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desires to create rents, capture them and/or enrich themselves by soliciting bribes (Djankov et al., 2002a, 2002b). Relatively high SE Asian barriers likely serve two central purposes: first, high barriers enrich public officials as they exercise their gatekeeping authority. Second, high barriers to entry serve as a form of crony capitalism protecting political allies from market competition (Kang, 2002). In this case, SE Asian countries' relatively high state capacity compared to countries in other developing regions such as Latin America or Africa allows for a strong "grabbing hand" (Frye & Shleifer, 1996) as well as the protection of favored firms through barriers to market entry.

Missing legal protections for informal businesses in SE Asia render entrepreneurs vulnerable to public officials who can extort money from business owners or confiscate an entire firm. Such behavior is common and shows how high barriers to formal entry in the marketplace harm property rights and contract enforcement. Limited property rights and unenforceable contracts increase the risk of doing business and thus limit investment. Diminished investment in turn decreases economic growth for society as a whole. This problem impacts state revenues as well: countries have great difficulty to collect taxes from informal businesses, which represent a large share of employers in many SE Asian countries.[1] State services that might reduce poverty or stimulate growth through improvements in infrastructure or social spending are underfunded as a result. In short, economic development in SE Asia is much slower than it could be from both private and public perspectives because many of the region's countries are missing the rule of law.

Private investment thrives when countries commit to property rights, contract enforcement, and equitable protection for all citizens under the law (Barro & Gordon, 1983; Frye, 2002; Mauro, 1995; North & Weingast, 1989; Stasavage, 2002). Whether the rule of law exists in a country influences economic development because the costs and risks of doing business depend on whether property rights are protected and contracts are enforced.[2] Economic decisions are based on these costs and risks. The state cannot convince firms to invest unless it commits to rules protecting property and enforcing contracts. However, generating a *credible* commitment to these rules is difficult. Actors within the state (certain elected officials, bureaucrats, etc.) often have both motive and opportunity to violate property rights, fail to enforce contracts and provide preferential treatment to favored litigants in the judicial system. Officials in some political systems stand to gain financially from nationalizing profitable industries and enforcing contracts in their own favor to profit at the expense of private sector partners. Third, officials often have political motives to protect property rights and enforce contracts selectively to reward their allies and punish their opponents. The important and elusive nature of credibility raises the question: what generates credible commitment to the rule of law?

I present evidence that increasing the barriers to market entry results in decreasing perceptions of the rule of law in SE Asia. I argue the high costs of registering businesses undercut property rights and contract enforcement – two essential elements of the rule of law. I limit my analysis to SE Asian countries for both theoretical and practical reasons. First, SE Asian countries exhibit wide variation in their levels of political democracy as well as their levels of economic development. The limits political democracy places on politicians and bureaucrats are tied to both the rule of law and economic development in Political Science and Economics research (Maravall & Przeworski, 2003; North & Thomas, 1973; North & Weingast, 1989; North, 1981). Yet SE Asian countries such as Singapore and Vietnam score poorly on democracy measures while enjoying high economic growth rates (Polity, 2012; World Bank, 2012a, 2012b). SE Asian countries score an average of 3 on the −10 to 10 point Polity scale (10 is most democratic and −10 is least), but feature mean economic growth rates of 6% from 2003 to 2011 (compared to a global average of 4% for the same time frame, United Nations Conference on Trade and Statistics (2013)). This data suggests at least *some* political actors in SE Asia make credible commitments to *some* investors' rights in the absence of strong democratic political institutions that apply to society as a whole. SE Asia therefore provides leverage on the question of how states can begin to establish credibility – potentially before political institutions are strong or fair enough to generate that credibility on their own. This distinction is important for SE Asian countries, but also for shifting the global debate on the impact of political institutions away from arguments surrounding blunt dichotomies like democracy vs dictatorship and toward assessments of how states functions in practice, irrespective of regime type.

Second, SE Asia is useful as a practical environment for studying market entry and perceptions of governance. SE Asia features predominantly developing countries facing endemic poverty and poor governance. Geography, climate and other factors may weaken economic development in the region, but these factors are difficult to alter directly through policy and change slowly, if at all (Acemoglu, Johnson, & Robinson, 2000; Hausman, 2001). In contrast, lowering the costs of registering a business is a policy reform governments can implement over a matter of months. Determining whether the barriers to formally registering a business, which are high in SE Asia and other developing countries, influence the rule of law and in turn economic development may therefore be critical for designing policies to overcome growth challenges around the world. Of course, there are many other policies that might influence the rule of law aside from barriers to entry. My argument in this paper is only that differences in the hurdles entrepreneurs must overcome from one SE Asian country to the next are important for perceptions of governance – especially concerning property rights and contract enforcement.

The remainder of the paper proceeds as follows: first I provide a rationale for why high barriers to entry undermine the rule of law. Next, I describe the data I gather

[1] An average of 63% of the population in SE Asia is currently employed in the informal sector according to one estimate (Charmes, 2012). See North and Thomas (1973) for a general description of this argument.

[2] See De Soto (1989, 2000), Keefer and Stasavage (2003), North and Weingast (1989) among many others.